



Economic and Market Update – December 5, 2011

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Summary: There is good news and bad news. The good news, in my opinion, is the German French proposal to coordinate fiscal policies among Eurozone members coupled with the coordinated central bank agreement to provide liquidity and lower lending rates to the world banking system. The bad news is the shape that the European banks are in, and the possibility that key Eurozone members will not accept the mechanisms to enforce fiscal discipline.

The U.S. economy continues to grow at a likely 2.5-3% rate in the fourth quarter. I remain concerned about growth in the first half of 2012 due to a probable recession in Europe and the failure of Congress to inspire confidence in U.S. fiscal policy. Nevertheless, recent confidence data suggests this is not preventing growth. Payrolls continue to expand but at a rate that will only bring the employment rate down very slowly.

Fixed income markets will likely react sharply to the success or failure of the December 9 European Union Summit to get a commitment for the largest and most vulnerable Eurozone countries to agree to allow their fiscal policies be dictated and enforced by the European council or the IMF. I am optimistic that a deal will be reached and have, as a consequence, raised my S&P forecast. Failure will have very negative consequences.

If an agreement is reached that includes key Eurozone countries, U.S. Treasury rates are likely to rise while risk premiums decline. If, as a consequence of an agreement, the ECB becomes a more aggressive buyer of European sovereign debt and IMF-led buying results in private capital sovereign debt buying, the Euro will have a limited rally. Both stock and the euro are already rallying in the expectation of a successful summit.

Economy: I am narrowing my forecast for fourth quarter growth to 2.5-3%, the high end of my previous 2-3% range. Consumer spending appears to be holding in the 2-3% range. Inventories are well contained and will likely not subtract as they did in the third quarter. Investment and capital spending should add a bit to growth. Net exports will likely be a neutral although the net export sector will likely weigh on GDP in the first half of 2012 as Europe is in recession. Government spending should be a slight negative.

For the second month in a row substantial upward revisions to payrolls in the two previous months added to the otherwise lackluster gains bringing the two month total to a somewhat

healthy increase close to 400,000. The 0.4% fall in the unemployment rate to 8.6% should be qualified, however, since half of the fall is due to individuals dropping out of the labor force. Still, the gains support continued growth through the quarter and probably into the first quarter of 2012.

Although still at a low level, confidence has improved in the past month and, despite the failure of Congress to reach a budget deal, current momentum should carry through yearend. However, I remain concerned that growth will slow in the first half of 2012. Even if there is a successful conclusion of fiscal and monetary coordination of the European debt crisis, the result will be more austerity and, at a minimum, a mild recession in Europe. A failure of the December 9th European Union economic summit will likely lead to a financial crisis that is very negative for Europe and will have a negative spillover impact on the U.S. economy as well.

The Fed meets on December 13 and will probably change the wording of the communiqué to reflect the vulnerability of the U.S. economy to the European debt crisis. However, if the results of the December 9 European summit are positive, I do not think the Fed will change policy or announce a further increase in the balance sheet. For now, U.S. growth is solid enough to stay the Fed's hand.

Regarding inflation, the recent liquefying of the world banking system, for the most part, is countering a deleveraging in the system (deflationary). Moreover a European recession would also mitigate inflation. Nevertheless, gold bugs will continue to warn of the dire consequences of printing money. Moreover a further rise in gold and other commodity prices will further excite the inflationists. But in my opinion, gold is acting as a safe haven for risk and as a surrogate currency since none of the three major currencies offers an alternative safe haven.

Although I am not concerned about runaway inflation, I think that the inflation rate will be a bit higher over time. Last month I forecast some "stagflation", a level of inflation that exceeds what one might expect given the high level unemployment. But for the most part, I think the additional liquidity added by aggressive central bank policies will be accumulated by banks to shore up reserves and to boost asset prices, so the inflationary impact is small.

A note on tax avoidance: Part of the fall in the unemployment rate has been a drop in those participating in the labor force. One of my mentors was an expert on the "underground" economy and suggested that, in economically difficult times, individuals without jobs often work off the books for cash. I have no way of telling how much this is occurring in the present situation, but I assume that many of the seemingly unemployed may have some earned income that does not get recorded. To the extent that this occurs, one important source of tax revenues does not get collected. Moreover, tax avoidance schemes, legal for the most part, are rampant among wealthy households. So although I have often written that revenue increases will have to be a part of any deficit reduction policy, increase revenues from a more enlightened growth policy and from tax law changes and enforcement can offset much if not all of the need to raise tax rates.

Europe: The previous framework for dealing with the Eurozone debt crisis and leverage, the ESFS was a bust. Without strong enforceable guarantees that ensure countries will live within

their means, neither the ECB nor outside investors were willing to support the European banks or sovereign debt of Eurozone countries. The November 3-4 G20 meeting was, in effect, a failure.

It took a further rise in sovereign interest rates, first in Italy, then spreading to other Eurozone countries to convince Germany, France and Italy that they had to come up with a policy that would assure investors that the countries with unsustainable deficits would put themselves on a sustainable fiscal path before being overwhelmed, like Greece, and be forced to default (although Greece is not calling it a default, the 50% or greater “haircut” that Greek bondholders are being forced to accept is a default!). The appointment of Mario Monti, an experienced “technocrat”, to head the Italian government was a huge positive in this regard. Still, the level of debt that Italy already has incurred makes it very difficult and painful for Italians to achieve a sustainable path. And they almost certainly cannot bring their debt load down to a manageable level if interest rates on the sovereign debt stay at current levels.

Since Spain, Portugal and Ireland face similar problems to those of Italy, and Belgium and France have difficult debt situations (in France because of the shaky nature of their banks), it is unlikely that outside investors would be willing to invest in much of the sovereign debt. The ECB could potentially bridge the sovereign debt and hold down rates, thus lowering the borrowing costs of debt-strapped nations. But it will not do so if it does not see a path to making these securities attractive to investors.

The only solution, then, is if the European nations involved agree to a credible monitoring, with sanctions, of their budgets. This is what is being proposed at the December 9th summit of Economic Union members. To summarize:

- The hope is that a credible agreement of debt-strapped countries to submit to fiscal discipline with an enforcement mechanism will be reached on December 9.
- Such an agreement would allow the ECB to buy sovereign debt more aggressively, bring down interest rate levels and reducing the debt service and refinancing costs.
- A fiscal agreement and more active ECB purchases would allow the IMF to supplement ECB purchases with their own purchases.
- The success of the above measures would likely get outside nations with huge sovereign funds such as China, Japan and Brazil to invest in European sovereign debts.
- Private investors such as pension and hedge funds would be attracted to purchase European sovereign debt if they feel the guarantees of the debt were sufficient.

Recent news reports have focused on the potential for a downward spiral that would result in another financial crisis. But it is also possible that the above bulleted outcome would result in a virtuous cycle that would quickly lead to lower rates and, in time, rating upgrades. Still, because of the austerity needs, the “workout” period will take years and European growth is likely to be subdued for at least a couple years.

U.S. Fiscal Policy: The failure of the super committee to achieve an agreement continues the negative fiscal situation resulting from the August 2nd failure to agree on a long-term solution to budget deficit problems. So, for now, U.S. budget policy remains adrift. Nevertheless, Congress is likely to pass an extension of last year’s payroll tax relief and may even expand it, providing a small new net job stimulus.

Markets: Following is a summary discussion of my market interest rate, currency and U.S. equity forecasts.

- Interest rates: The outcome of the December 9 European Union economic summit has a significant implication for U.S. treasury rates and spreads. A successful conclusion to the summit will, in my opinion, result in a rise in Treasury rates and a reduction in risk premiums for other fixed income instruments. Thus, Treasury rates could rise into yearend while high yield instruments in both the U.S. and Europe would come down.

Conversely, a failure of the December 9th summit will likely result in the 10-year treasury rate again moving below 2% and sharply higher yields for high yield securities. European bank stocks might be especially hit (and, of course, have already lost much of their value) since this would make it virtually impossible for them to raise capital and, in some instances, nationalization is a distinct possibility.

- Currencies: Near term, the dollar is likely to retain a bid as the G7 nations and the IMF attempt to keep currencies reasonably stable. Longer term, I remain negative on the U.S. dollar. Despite Japanese yen intervention, I have raised my range on the yen and expect it to fall to near the 70 yen per dollar level by mid-2012. The fate of the Euro will be determined by the whether the framework for resolving the debt crisis can be implemented and contagion can be stemmed. If so, capital will flow into Europe and the euro will hold its value (my forecast). Alternatively, if contagion spreads, the Euro will fall as capital flows out.
- Stocks: If my outlook is correct, the equity rally should continue. The European Union economic summit will dominate the news this week although Thursday's ECB policy outcome will also be important. I suspect the stock market rally will make further limited gains into the summit as investors buy expecting a positive result. My pre-meeting target for the S&P is, say, 1280. If the outcome is positive (I think it will be), the initial reaction will likely be limited because of the run-up in advance of the summit. Still, I think the market would enjoy further gains into year end. My yearend S&P target if the outcome is positive is the 1300-1320 area.

Given the dependence of European bank integrity and sovereign debt rates on the summit outcome, **a failure to convince the key Eurozone countries to sign on to fiscally enforced discipline would likely cause the S&P to fall quickly to the 1070-1120 area.**

Table 1: Economic Forecast second half 2011 – First Half 2012

	3 nd qtr.	4 rd qtr.	1 st qtr.	2 nd qtr.
Growth (%)	2.0%	2.5-3%	1-2%*	1-2%*
Unemployment (%)	9.1%	8.6-9.0%	8.5-8.9%	8.4-8.8%
Inflation (qtrly %)	3.6%	3.2%	2.9%	2.7%
Core Inflation (%)	2.5%	2.4%	2.4%	2.4%
Fed Funds	0-0.25%	0-0.25%	0-0.25%	0-0.25%

*Growth in the first half of 2012 depends on a successful outcome of the December 9 European Union economic summit.

Table 2: Market Forecast Ranges 2011- First Half 2012*

	4 th qtr.	1 st qtr.	2 nd qtr.
10 yr. Treasury Rate (%)	1.90-2.25%	2.20-2.50%	2.25-2.60%
Dollar Index (futures)	75-79	72 -76	68-74
Euro (in U.S\$)	1.32-1.44	1.30-1.42	1.28-1.40
Dollar/Yen	74-78	72-76	68-74
Canadian (in U.S.\$)	0.96-1.00	98.00 -1.02	1..00-1.04
S&P	1150-1320	1250-1380	1250-1400

* My forecasts are based on a successful European Union economic summit outcome (see text).

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