



## Economic and Market Update – January 8, 2012

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**Summary:** I have outlined three strategies that could materialize in 2012, with my base case being between a more optimistic and a very pessimistic case. I have given each a probability and will monitor these alternatives, modifying them and revising my ex-ante probabilities as needed each month. The economic and market forecasts in the tables reflect my base case that I start with a 65% probability.

There are no changes in my growth outlook this month although first quarter growth is likely to be at the top of my current range. Employment has been stronger than I, and the consensus, expected, but I had already “shaded” my fourth quarter, 2012 growth forecast, 2.5-3% (to be released at 8:30am EDT on Friday, January 27) to the positive side.

Europe remains the most important factor for the markets although concern over the slowdown in Asian growth (India close to recession and China slowing to the 6-8% level from the 10-11% level) is also a big concern. I posit a relatively optimistic scenario although Greece has already effectively defaulted and, if investors do not accept an incredibly high “haircut” on their Greek sovereign debt, Greece will likely exit the euro. This could happen as soon as the current quarter. My economic base-case depends completely on the European Union being able to “ring-fence” the Greece situation, so as to give private investors confidence that Italy, Spain, Portugal and other Eurozone nations do not go down the “haircut” route.

The Fed will provide more transparency on their deliberations and there will be some limited further fiscal progress in 2012. But, to date, the election is a “side-show” that I do not consider relevant to the economy and markets, yet. I will begin commenting on the election in the third quarter. For now there is more “chat” than effect regarding the election. Europe and the U.S. budget remain the two macro policy forces that are most important. Other than that the biggest “surprise” factor that I have not considered in my analysis comes, as it often does, from the Middle-East.

I think short term interest rates will remain at near-zero in the first half and longer-term Treasury rates to rise only moderately. I raised my forecast for the dollar index and lowered my forecast for the euro in the first quarter. Longer-term I remain negative on the dollar, and look for the yen and Chinese currencies to continue to rise over the longer-term. Despite the inevitable corrections, I think the S&P will rise as high as the 1335-1350 range in the first quarter before

continuing the upper portion of the 2011 range in the second quarter. My forecast range for the first quarter is 1200 to 1350.

***The Year Ahead:*** I see one of the following three themes unfolding in 2012.

My base case is that the European and ECB plans work reasonably better than the consensus. However, Greece will be forced to leave the Euro, Europe has a mild recession, and the Merkel prophecy that the workout period, and hence slow growth, will be long and arduous is correct. For the base case to succeed, an official default and/or euro exit by Greece must not increase the perceived threat of an Italian, Spain or other Eurozone country to default.

The base case also assumes U.S. lawmakers will make some further, but very limited progress in controlling the deficit and will pass some stimulating “goodies” for the election year, including extending the UI insurance period and the cut in SS payroll taxes for the full year. I give the base case a 65% probability.

A more optimistic scenario is as follows. The Merkel/Sarkozy proposal to enforce fiscal discipline longer term and the ECB master stroke to allow banks to borrow unlimited funds at 1% will, coupled with Italian and Spanish austerity, convince private investors that neither country will default. Sovereign debt interest rates will fall significantly. And banks will be able to recapitalize more quickly than currently thought, in part, by buying Sovereign debt at interest rates that meaningfully exceed their 1% borrowing cost.

At the same time, U.S. lawmakers, seeing how unpopular they are come to their senses and adopt a credible longer-term deficit reduction program that reduces future deficit by \$3 trillion or more over \$10 years while providing a stimulus such as a \$50-\$100 billion infrastructure or other investment package to augment growth and, thus tax revenue. I tentatively give this a 10% probability.

My pessimistic case is that market forces overcome the European plan and the debt crisis continues leaving Italian and Spanish Sovereign interest rates at too high to allow the debtor nations to avoid a potential default in the future. I give this a 25% chance of occurring. If it does my market forecast would become significantly more negative, with a “mini” version of the 2008 crisis repeated (see stock market section below).

***Economy:*** My base case assumes that the GDP forecast I have maintained for several months remains intact. Growth in fourth quarter, to be announced on Friday, January 27 is likely to be in my 2.5-3.0% range. First quarter growth looks a bit stronger than I previously expected although I am, until I see the composition of first quarter data, holding my range at the 1-2% level. I expect growth to be at the top of my range.

The 200,000 payroll increase and the 0.1 rise in weekly hours worked support the notion that growth in the 4<sup>th</sup> quarter was near 3 percent. Many forecasters will be raising their range for both the quarter just completed and for the first quarter as well. Even subtracting the 8,000 job revision from the previous two months, the net increase of 192,000 and the fact that there was no

giveback in the unemployment rate suggest that the momentum in the economy of the past few months continued in December.

I expect corporate profits in 2012 to grow slowly, say, about 5%. Productivity gains are harder to come by once the “low-hanging” fruit resulting from layoffs and cost-cutting is achieved. Given the increased need to hire to achieve further gains, profits will depend more on demand growth. While real U.S. household incomes should continue to grow at approximately 3%, the recession in Europe and slowdown in Asia will keep export growth fairly weak. Government demand will also continue to fall at the state and local level and slow at the Federal level if an infrastructure stimulus is not passed. Corporate investment will likely remain a positive source of demand given the intense pressure on U.S. businesses to remain competitive. The rise in the dollar’s value should not be a negative in the first half and could be supportive if it causes purchasers of U.S. exports to “buy ahead”. However, if the dollar rise extends beyond my current forecast, it could eventually become a drag on exports.

**Europe:** In the early 1900’s a Russian economist, Nikolai Kondratiev, formulated a theory that financial crises would develop periodically. His “long-wave” business cycle, supported by data from the Western world, suggested such crises would take place, say, every 50-60 years. The rationale for these crises is pretty much the same today as it was then. Over time, households and businesses lose the discipline imposed by such crises and once again become over-extended. This results in another round of default and deleveraging that takes a decade or more to recover from. In the process, stock prices generally “crash” and the economy goes into a deep recession/depression.

I consider the recent research by, among others, Rogoff and Reinhart to be a modern update of this cyclical behavior and one, supported by much more data. I have long advocated, as do many others including PIMCO officials and, more recently, German Chancellor Merkel, that the work-out period from the mortgage and housing crisis and, currently, the European debt crisis will take many years.

The “cutting edge”, in my opinion, is whether we now have the economic policy tools and, just as important, the political will to lessen the damage of the dual financial crisis and avoid a similar fate that resulted on the world depression of the 1930’s. In my opinion, the tools are there and the more likely Achilles heel is the political will. In the European case, the longer-run question is whether sovereign countries will give up enough of their power avoid exacerbating or creating future sovereign debt crisis. Near term, the question is whether the ECB’s recent “back-door” attempt to spark the private purchase of huge amounts of sovereign debt will work to bring down financing rates to levels that sufficiently reduce the pace of austerity that, itself could undermine country deficits by lower tax revenues. That question will be answered as 2012 unfolds.

The U.S clearly has more “breathing room” than Europe, or else the U.S. Treasury market would not be such a ‘safe haven’. However, if elected members of Congress fail to compromise by implementing a credible deficit reduction policy without unduly damaging the current situation, a crisis could develop in the U.S. as well. The combined private and public debt level remains far too high for comfort and the one thing that policymakers on both sides of the aisle agree on is

that the least painful solution for relieving the onus of the debt is by growing the economic base while trying to slow the percentage of further debt increase to below the growth rate. And in doing this, a meaningful rise in inflation must be avoided in order to minimize the misallocation of resources and pain on those most hurt by inflation.

***U.S. Fiscal Policy:*** The Federal Reserve will move in January to further make their deliberations transparent by issuing interest rate expectations of the staff and FOMC members. Policy is on hold for the moment but will respond with more expansion of its balance sheet if developments in Europe lead to my pessimistic scenario. As long as this does not happen, their main concern will be keeping mortgage rates low and trying to facilitate the refinancing and recapitalization of the housing-related lending sector.

### ***Markets:***

- Interest rates: Short term Treasury rates will remain near zero in the first half and will only rise in the second half of 2012 if my most optimistic scenario unfolds. Policy rates are likely to stay anchored near zero for the entire year as the Fed will be reluctant to hike rates prematurely, given the negative consequence if they err in tightening too fast. Given that the Federal deficit is high but trending a bit lower, it would be better to accept a bit more inflation rather than risk deflation (the Fed will not formally admit this, given the potential to drive Treasury financing rates higher if inflation expectations rise).

I expect longer-term rates to begin to rise in the first half, although slowly. Fed policy will be geared to holding mortgage rates as low as possible and will use their options if they have to. This includes their present policy of extending maturities, and more dramatic measures of introducing QE3 and direct purchases of mortgage debt if needed. But if, and as, the safe-haven effect from avoiding European debt fades, U.S. Treasuries will lose what is perhaps the most powerful stimulus investors have to buy them at such very low interest rates.

- Currencies: I have raised my quarterly range for the dollar index to 79-84 based on my notion that, near term, the dichotomy between European and U.S. financial and economic forecasts is supporting the dollar. However, I continue to be negative on the dollar longer term, especially against Asian and emerging market currencies. My biggest debt concern is about the U.S. external debt. And although, as pointed out in a recent NYT editorial by Paul Krugman, the U.S. is earning more on its foreign investments than foreigners earn on their U.S investments, the net debt differential is huge and increasing rapidly.

Complementing my hike in the dollar index, I lowered my range on the euro based on the reluctance of foreign sovereign funds and other foreign entities to buy Eurozone debt. The Eurozone recession, excepting in Germany, is also an ongoing negative. However, as foreigners gain confidence that the European plans to deal with the debt will avoid an Italian and Spanish default, the higher rates on these countries will attract foreign investment. Thus, I think that the euro will be a buy if, as I forecast, it moves to a low near the 1.20 area on the first quarter. A Greek default and exit from the euro would, in my opinion, be a positive for the euro if, and only if, it does not lead to further concern

that other Eurozone currencies will default. Thus, as mentioned above, I think the Europeans are doing their best to “ring-fence” the rest of the Eurozone countries before a default occurs.

Although I have reigned in my forecast for the yen in the first half, I continue to think that, over time, the yen will appreciate. Japan authorities will do what they can to smooth and slow the appreciation and the U.S. will probably back this policy as long as the Japanese do not try to appreciate the yen. I also think the Chinese currency to continue to appreciate slowly.

The rather rapid rise in the Canadian dollar the past few years is well justified by both the superior fiscal policy (relative to the U.S. and other G7 countries) and Canada’s excellent strategic position in resources. However, Canadian manufacturing is suffering as a result and I expect Canadian policy will do what they can to stop or slow a further rise in the Canadian dollar until the manufacturing sector has more time to adapt. Thus, I forecast the Canadian dollar holding its gains of the past few years, but continuing to consolidate near present levels.

- Stocks: Although the S&P did not move quite as high as I anticipated in the year-end rally, I continue to think the index will move cautiously higher in the first quarter, but not without occasional news-related setbacks. The primary positive factors driving the market will be (1) the success, though limited, of Eurozone countries to make progress on deficit reduction and the ECB-bank-related support of sovereign-debt purchases, and (2) improved confidence that the European recession and Asian growth slowdown will only slow, but not reverse the growth in corporate profits.

I am less optimistic about stocks in the second quarter and have the same range as in the first quarter. I think the prospects for more gridlock in Congress on budget negotiations and increasing caution that the election will not provide the mandate that allows us to resolve policy and budget issues is likely to result in a trading range. Although I am cautiously optimistic that some very limited further progress will be made on the budget I do not think this will be factored into the market until the third quarter.

Consistent with trading in 2011, I think stocks will undergo a number of 4-8% corrections as news from Europe blows hot and cold. And despite my optimism that the ECB is masterminding a positive outcome for both lowering sovereign debt interest rates and, simultaneously, helping to recapitalize European banks, anticipation of the Greek default is likely to lead to the most significant correction in 2012. Timing is uncertain, but will be sooner rather than later if the current bailout negotiation cannot be finalized.

If my base case is wrong, the following could easily happen:

1. Under the more optimistic scenario, if investors gained more clarity on the European situation, the recession turned out to be mild, there would be no default beyond Greece and U.S. lawmakers finally compromise to achieve the positive goals stated previously, the S&P could test the previous all-time high in the 1560-1580 area by the end of the year.

2. Under the pessimistic scenario the S&P would likely survive the mid-600 level of March 2009, but almost certainly fall below 1000, probably to the 850-900 level.

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

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

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

	1 <sup>st</sup> qtr.	2 <sup>nd</sup> qtr.
10 yr. Treasury Rate (%)	1.90-2.40%	2.25-2.60%
Dollar Index (futures)	79-84	78-82
Euro (in U.S\$)	1.20-1.34	1.20-1.30
Dollar/Yen	74-78	72-76
Canadian (in U.S.\$)	98.00 -1.02	1.00-1.04
S&P	1200-1350	1200-1350

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