

Economic Outlook

April, 2011

“We believe there is a material risk that U.S. policy makers might not reach an agreement on how to address medium- and long-term budgetary challenges by 2013. If an agreement is not reached and meaningful implementation does not begin by then, this would in our view render the U.S. fiscal profile meaningfully weaker than that of peer AAA sovereigns. ”

- Standard & Poor’s

“ Look! The Emperor has no clothes! ”

- child in Hans Christian Andersen tale

The prior statement from Standard & Poor's Corporation on April 18, 2011 stunned financial markets. S&P lowered the outlook on the AAA U.S. credit rating to "negative" from "stable", while affirming the actual AAA rating itself. S&P went on to say that there is a one in three chance that it will lower the rating in the next two years. The cost of credit default protection on U.S. debt rose.

While the timing of this decision may have been a surprise, the reasons for it have been all too clear for a long time. As readers of these letters know, the fiscal position of the U.S. has been drifting towards crisis for years with severe conditions having been reached within the last decade. While Washington and others will likely criticize S&P in a shoot-the-messenger mentality – the Administration pooh-poohed the ideas a "political judgment" – S&P has done the country a favor by bringing its pathetic financial condition to the fore and, hopefully, may even accelerate needed change. As S&P dryly noted, the U.S. is the only developed nation (ex-Japan) without a plan to reverse its stimulative programs. Europe and the UK, along with China, India and other developing countries not only have developed plans but have already begun to execute them.

The sudden but inevitable recognition of fiscal improbity comes at a delicate time for the U.S. Like any overextended borrower, the U.S.'s financing options continue to narrow. Over one half of its \$14 trillion in debt is held by foreign investors, both public and private. China alone holds over \$1.2 trillion of that along with almost \$900 billion held by Japan. The last thing those creditors want to see is the largest part of their portfolios threatened by declining credit quality along with a declining dollar. With the end of quantitative easing arriving in two months, those foreign purchasers will become more important than ever.

It is likely that the value of the dollar will decline in coming years. With its huge trade and budget deficits, the U.S. has flooded the world with dollars for many years. The two large quantitative easing programs of the last two years have added significantly to the global dollar "inventory". The laws of supply and demand apply to the dollar as well and more supply equals lower prices. The only advantage the dollar has had is that by virtue of its market size and past reputation for stability, it has been accepted as a reserve currency by every other government and international agency. That status is being seriously called into question in the minds of governments, businesses and investors around the world as the supply of dollars and Treasury debt has ballooned.

Already institutions and individuals have shifted substantial assets out of the dollar and into gold and other precious metals as well as other currencies. Simultaneously, China has taken and continues to take important steps to establish its currency as an international reserve currency. The BRIC nations and many South American and Middle Eastern countries have been calling for a new reserve currency for political and economic reasons for years. Thus, the advent of reserve status for the Chinese yuan will be heartily welcomed by these countries which will shift out of the dollar as fast as they reasonably can. The timing of this shift is the only question – it could be as soon as three to five years. This trend will accelerate unless meaningful change is instituted soon in U.S. fiscal and monetary policies. In the absence of these changes, the U.S. will experience accelerating inflation, a falling dollar and slow economic growth.

* * * *

The U.S. economy has continued to expand in a moderate fashion coming out of the Great Recession. GDP grew 3.1% in the fourth quarter of 2010, with an expected rate of 2+% in the first quarter and 3% for the year 2011. Total GDP has recovered all of the ground it lost during the recession and is moving to new record levels. Manufacturing, mining and capital spending have been quite strong. Retail sales have been stronger than expected and accompanied by declining credit card balances. Total consumer debt has fallen over the last two years but still remains at quite high levels historically.

Atypical for a recovery in the U.S. have been the lagging recovery in employment and in housing. It would appear that the housing market will continue in the doldrums for yet a while more due to slow wage growth, job insecurity, tight credit, prior overbuilding and generalized fear of homeownership stemming from the gruesome experiences of the last housing cycle. Foreclosures, while having declined some, are likely to rise in the months ahead, further depressing prices. Housing starts are close to a fifty year low. Annual existing home sales at around 5 million are above the low of 4 million but far from the exuberant levels of over 7 million in 2005. It is not likely, or even desirable, that home sales will regain their prior peaks but rather the hope is for stabilization followed by modest growth.

While the current expansion has the feel of a normal recovery, investors and business people should be asking the question - Why? Looking at the mostly positive monthly economic statistics as they come out overlooks the questionable foundation supporting them. What's different about the recovery is the reality that it is in large part due to the enormous fiscal and monetary stimulus programs entered into by governments and central banks around the world. As this stimulus is withdrawn, a headwind is created for economic growth, already not all that strong. Unfortunately for most of the developed nations, including the U.S., they were already highly leveraged before the recession and the ensuing spending/borrowing binge which followed. Now these countries must try to grow, increase employment and pay down these vast debts simultaneously while at the same time their consumer and business sectors are highly leveraged. And this attempt assumes no increase in interest rates, a doubtful outcome. Accomplishing this would set a new precedent in economic history.

The massive stimulus surging through the global economy has caused imbalances. A portion of the increased liquidity has not gone to finance economic growth but rather has ended up in risky assets, such as stocks, commodities, junk bonds, commercial real estate and developing market economies. This has raised the specter of inflation, a concern not much discussed in recent years when deflation was the fear. While commodity prices have risen substantially, higher material prices alone generally do not lead to high levels of inflation. Normally they have to be accompanied by rising wage rates, certainly not a factor at the moment in most developed countries. But the inflationary danger lies in the price and wage pressures which are developing overseas in countries like China, India and some South American countries.

These countries were expanding rapidly before the global recession hit and recovered from it fairly quickly. Then, when the record amount of worldwide monetary and fiscal stimulus materialized, they began to grow even faster. In short, their economies are expanding rapidly, infrastructure demands are intense, commodity consumption has soared, labor shortages have developed and wages and prices are rising. In that, in our interconnected world, countries' economies are more closely related than ever, price and wage trends are transmitted rapidly. Thus, in fact, wage pressures are building - just not in the

U.S. at the moment. Because these foreign countries are now a larger and growing part of the global economy and they are significant exporters to the developed world, these inflationary pressures are highly likely to arrive on our shores.

The combination of excessive debt creation, loose monetary and fiscal policies and rapid economic growth overseas is a dangerous one for inflation globally. The European central bank just raised its rates in response to the fastest monthly increase in inflation on record. Year over year, inflation was 2.4%, the highest since 2008. In China annual inflation has hit 5.4% along with GDP growth of 9.7%, causing the central bank of China to raise its rates 10 times since last October while raising bank reserve requirement to 20.5%. India is experiencing 9.9% annual inflation and many Southeast Asian nations are at similar levels. In the U.S., inflation has been low but rising at 2.7% driven primarily by rapidly rising food and energy prices (the core rate is at 1%). There is increasing debate and some skepticism in the U.S. about the value of the core inflation measure. The Federal Reserve has claimed that the recent rises in food and energy will be “transitory”. These two elements will need to slow soon to reassure market participants and consumers of their temporary nature.

The U.S. is likely to experience a rise in interest rates ahead as well. The factors enumerated above will put upward pressure on rates. With inflation pressures and interest rates rising abroad, the U.S. will not likely remain unaffected. In addition, the withdrawal of the U.S. quantitative easing programs is still ahead of us, not to mention the (hopefully) subsequent reversal of the super-low interest rate levels administered by the Fed. The increase shouldn't be too extensive due to the fragile nature of the world economy which could not sustain high levels of rates for too long. The pace and timing will likely be determined by the degree of continued foreign investor interest in U.S. Treasury debt. It would seem safe to say though that the era of historically low debt yields experienced over the prior decade are drawing to a close.

There are still many reasons, then, to maintain a defensive posture toward current financial markets and the economy. Many of these reasons derive from the unpredictability of coming events as they are impacted by political decisions in many locales. Under these circumstances, one safe assumption seems to be an increase in volatility going forward as we sail through uncharted waters.