

***Economic Outlook  
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***William H. Bergner, CFA  
Chief Investment Strategist***

*[The U.S. debt ceiling debate got so bad that] “Observers have begun comparing U.S. political dysfunction with that of Italy. Judging by recent days, the comparison is unfair to Italy.”*

- *Financial Times*

*Most of the economic policies that support robust economic growth in the long run are outside the province of the central bank.*

- *Ben Bernanke, Jackson Hole*

Over the past few months, investors have had to digest some of the most volatile, (and for equities, mostly declining) markets as have been seen since the calamitous post-Lehman Brothers period of late 2008. With headlines reporting slowing economic growth worldwide, imminent default by the U.S. Treasury, tightening monetary policies in China and most of Asia and fiscal collapse in Europe, while the world watched the horrifying events and their aftermath in Japan, the disruptions in global markets should not be surprising. Stock markets lost over 18% from the year's earlier highs while the 10 year Treasury bond yield fell 125 basis points. As if these changes weren't jarring enough, *within this period*, the daily and weekly volatility was near record highs.

While the economic reports since June have been disappointing, the short term outlook may not be as bad as is feared. It is quite understandable that recent data have been disconcerting.

- Housing, the key sector in past recoveries is still in the doldrums and the near term outlook is poor.
- The government sector – at federal, state and local levels – has been shedding jobs for months.
- The manufacturing industries, along with exports, have been the saving grace for the economy post-recession are now slowing.
- GDP and employment have grown at the weakest rates for a recovery since 1970.

As discouraging as these data are, there are some more positive offsetting factors in the short run. Corporations' profit margins are at record peaks and their liquidity positions are as high as they've been since the 1960's. They've paid down borrowings, pre-refunded future debt maturities and refinanced bonds and loans at lower interest rates, giving them flexibility for capital spending, hiring, dividend increases or stock buybacks. Households have delevered to some extent and have reduced spending and borrowing, giving them some maneuvering room for modest continued future outlays. International growth, though slowing, continues at a solid pace which supports U.S. exports and foreign sales of U.S. subsidiaries. Even the slowdown in manufacturing is a normal occurrence after the dramatic post-recession bounce, as in previous cycles. The Treasury yield curve, while flattening due to Fed policy, is still positive, indicating that the economy growth can continue to expand. As remote as it may seem, the rebuilding in Japan will consume an enormous amount of resources and create robust demand for goods and services worldwide. And, again in the short run, both global fiscal and monetary policies will lean firmly in the direction of ease to support economic growth.

Barring a financial meltdown in Europe, all in all, growth over the remainder of the year is likely to proceed at a 1 ½ to 2% rate. Interest rates, especially at the short end, will remain low. Inflation should continue to expand at a low but upward-trending rate. Consumer spending and capital expenditures should continue at a modest pace.

The intermediate to longer term backdrop is not as positive. The reality is that the global economy is lacking in final demand for goods and services. This stems from the fact that economic entities at all levels are trying to deleverage themselves from the extreme borrowing binge of the past twenty years. To do so requires that all entities cut back on spending in order to pay down debt. While this can work for one, if all attempt it at the same time, a worldwide recession occurs due to the sudden drop in spending/demand, and this is what we are experiencing now.

Central banks can, and are, attempting to stimulate demand by various means including zero interest rates and purchases of government debt. This can be effective if the stimulus refires the economy's engines leading to a resumption of normal demand. The stimulative policies can then be reversed and a normal monetary regime can be reestablished. If the stimulus fails to resuscitate demand and economic growth, the liquidity pumped into the financial system simply sloshes around and gets used for other, usually noneconomic, purposes. Recent examples of these include speculative bubbles in real estate, dot.com stocks, diabolical mortgage-backed securities and commodities, and eventually inflation. This latter outcome is what exists now. Because existing debt levels are so high, even free money is unattractive. Therefore, until existing debt is far more extensively worked down, economic players will not use the available liquidity – they won't until they reach a diminished level of debt that is comfortable for them. While households and businesses have decreased their borrowings somewhat from peak recent outstandings, it is estimated that another decline of nearly four to five times this amount is needed to attain a sustainable level. This will require time – perhaps years - and effective fiscal policy to bridge the deleveraging period. The unanswered question is whether governments have the ability and willingness to accommodate those needs.

The Federal Reserve is in a difficult position. It has gone “all in” on monetary ease with little to show for it. Demand in the real economy is slack, unemployment is stubbornly high and inflation is beginning to stir. Excess bank reserves in the system have risen by almost exactly the amount of the most recent Fed program, QE2. In other words, the Fed has provided \$600 billion of liquidity and because banks have been unable or unwilling to lend it, it has all ended up back at the Fed. Private borrowing in the economy has been essentially flat-to-declining for 2 years; government borrowing has been the offset. It is likely that there will be further “easing” steps by the Fed in coming months; it is also likely that, excepting an immediate psychological boost, it will not matter.

The position that Ben Bernanke took at the recent Jackson Hole conclave was probably the right one at this point. He said that, despite recent lackluster data, there was no indication that the economy couldn't recover and that there was not a need for further Fed steps at that time. The Fed needs to stand by and let the economy and markets find their own level. It is likely that they will recover stronger and sooner by taking this route.

He knows that 1) the underlying problem is not liquidity or the cost of money; it is too much debt. This issue is not resolvable by monetary policy alone. He also realizes 2) that U. S. CPI inflation is slowly rising – at the core level now at 1.8% Y/Y and 3.1% at an annual rate over the past three months. It is 3.6% Y/Y for the total CPI. Inflation in China has reached 6.5% and even higher in other emerging markets. These inflation rates are working their way to the rest of the world through rising commodity prices and rapidly increasing local labor costs as workers there demand a “piece of the pie”. He can see 3) that interest rates are already close to zero and not attracting any takers. He can't push on the proverbial string.

The situation in Europe is not improving. After all that the European Central Bank has done to support Euro area economies, conditions continue to worsen. The southern countries are attempting austerity measures to reign in their deficits and high debt levels with only small progress. Indications are that the Greek budget deficit is not only *not* declining to lower targeted levels but in fact may be expanding meaningfully. Greece and its neighbors are caught in a kind of liquidity trap – the more they cut spending, the more the economy slows and the less tax revenue is taken in, thereby requiring more cuts, etc. Once again the issue is not liquidity – it is solvency. Significant amounts of sovereign debt must be wiped out in order to restore financial sustainability. And, as in the U.S., government fiscal actions have been delayed by haggling and ineptitude. Two of the core Euro nations, France and Italy, have now been drawn into the pool of “suspect” debtors, leaving only Germany to carry the load. It is quite unlikely that Germany will be willing to attempt this. As a result, the Euro interbank markets are beginning to seize up as they did in 2007-08.

With global business and consumer confidence at low ebb, the BRIC countries economies slowing with rising inflation, consumer spending and housing limping and government hiring and spending plunging, the glaring need is for coordinated worldwide government policies to temporarily mitigate these problems while the fundamentals can work themselves out. Regrettably, global cooperation has rarely been lower and most countries are taking the every-man-for-himself route. It is likely that conditions must worsen for an integrated global program to be put place.

In the current circumstance, China and India are the main drivers of global growth and the assumption is that they will continue to be. This is a risky situation, just as it was when the U.S. played this role in prior decades. It represents an unbalanced condition where all of the world's economic eggs are in one regional basket. Certainly those governments are working feverishly,

with some success, to sustain their countries' growth. The unasked question seems to be what happens if they stumble. Growing bad loans and wobbling real estate markets in China are troubling. It is quite possible that they will maintain their high rates of expansion going forward but the risks are not negligible and not priced into markets.

The two passages cited above at the outset pointedly reveal the challenge currently facing the U.S., and, indeed, all of the western economies. The Federal Reserve has done all it can to support U.S. (and global) economic growth through its stimulative monetary policies over the past three years. All a central bank can do following a financial recession is buy time for governments to install pro-growth fiscal policies to lead the way to healthy long term growth. These central bank policies are only effective in the short run, and sometimes not even then. Government fiscal authorities, then, must use that limited time period effectively. This is the crux of the current dilemma and the genesis of pervasive doubts about the future internationally: existing economic and financial problems can only be resolved by prompt, potent, competent government long run policies at the same time that those governments are regarded as almost totally paralyzed and ineffectual. The U.S. budget, debt-ceiling and bond rating downgrade fiascos and the dithering European response to its internal solvency issues are all the proof needed, if any further were thought necessary.

The next closely-watched challenges in the U.S. will be the newly created Subcommittee on the Budget tasked, oddly, with cutting the deficit *and* stimulating economic growth, the President's new economic program to be announced on September 8 and the FOMC meeting on September 20-21. If indications are that little or no real progress will be forthcoming, markets will react negatively. Investors can only hope that the seriousness of the moment comes through to elected officials worldwide, and that they work in a cohesive manner to implement rigorous, growth-oriented policies.

Given the tenor of current politics, economies and markets, Brookfield Investment Partners is secure in its present investment strategies for client accounts. This is a period of time where capital preservation comes to the fore. With the outlook for elevated risk and volatility, and little value in longer maturity fixed income securities due to elevated current and anticipated inflation, our client portfolios are maintaining a high level of quality in investment holdings and higher than normal cash and cash equivalent positions. In these circumstances, for nonbank clients, selected well-run large cap, high dividend-paying stocks may be a good store of value and provide some protection against rising inflationary pressures. Adding in some high quality dividend paying emerging market stocks as a hedge against a depreciating U.S. dollar would seem appropriate for those investors that can withstand the volatility associated with what is likely to be a bumpy ride.