Economic Outlook
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" Most voters in these places [the developed counties] have yet to come to grips with the notion that they have promised themselves benefits that, at current tax rates, they cannot afford. Their economies have been growing too slowly, for too long, to pay for the coming bulge of retirees".

- New York Times

"The Fed is worried about the US becoming Japan while the Treasury is worried about the US becoming Greece".

- Wrightson Plc

As we enter 2012, the U.S. and global economies face conflicting prospects. With the exception of the Eurozone, most countries are demonstrating slow to modest growth. U.S. economic indicators show an economy that is slowly but steadily healing from the recession of 2007. Growth in China and India, while decelerating noticeably, is still expanding at a healthy rate. Canada, Australia and Africa all have healthy economies and financial markets. Other emerging markets (Brazil, Russia and Eastern Europe) are slowing more quickly. But all in all, not a bad picture relative to immediate prior years. Under that placid surface, however, the view is not as sanguine.

In the U.S., the exports and manufacturing sectors have been the leaders of economic growth. With the declining dollar as a tailwind, exports of nearly all products and services have boomed. With the pace of imports having decreased somewhat, net exports have grown, adding to domestic GDP. Unemployment has slowly diminished, wage rates are rising modestly and consumer spending is steady. Even residential housing construction has appeared to have found a bottom, although home prices are expected to continue to decline for another year. While this sector will not likely be leading us out of the recession, its mere stability means it will not be *subtracting* from GDP growth going forward.

U.S. GDP in 2012 will likely average around the 2% mark. Inflation looks to come in within a range of 2 -2 1/2%. Federal Reserve policy is unlikely to change – the federal funds rate will remain at 0-0.25%, the two current Quantitative Easing programs will remain in place, possibly to be joined by a third toward the middle of the year targeting mortgage-backed securities. Thus, most interest rates out to a five year maturity are also unlikely to change notably this year.

Looking at the current economy and noting an improved (and welcome) economic backdrop, an investor or businessperson still must ask the question, "*Why* are things seeming to get better?." Here is where the trouble lies for the future. It is likely that the recent strength shown here in the U.S., and to a lesser extent overseas, stems not from improving economic fundamentals but rather shorter-term factors whose positive effects are likely to subside in coming months. This will reveal the unresolved underlying imbalances which have impeded economic growth for so long.

There are a number of short-term factors which have aided economic expansion for the past few months, the major ones being:

1. As sentiment has turned more positive/less negative, businesses and consumers have stepped up their purchasing of goods and services. Businesses have increased hiring and raised some wages while boosting capital spending to replace older equipment and acquire more productive new machinery and software.
2. As sentiment and final sales depleted inventories, private firms restocked inventories back to normal levels. Although inventories nationally are not at high levels, this restocking is a one-time event.
3. The European Central Bank embarked on a looser monetary policy for European banks. Over the summer of 2011, European banks and governments were having increasing difficulty raising funds, even overnight, in money markets or as longer-term debt caused by

fears that weakened sovereign and bank credits and an impending Euro area recession would lead to defaults. Simultaneously, the ECB was reluctant to lend in size directly to its constituent banks other than overnight or for very short terms due to Euro treaty restrictions. With the advent of a new head of the ECB, Mario Draghi, the ECB has cut its interest rate twice and embarked on a 489 billion euro collateralized loan operation with a three year maturity. This has enabled the banks there to access the funds that they need away from the closed public markets. And in the same breath, this allowed the struggling European countries to attract funding they needed and were having difficulty acquiring. This is because the banks turned around and invested the ECB funds they received at low interest rates into European sovereign bonds at a much higher yield, resulting in a massive "carry trade".

Thus, the ECB funded the flailing euro governments indirectly through the euro banks. This was something the ECB and its prior leader, Jean Claude Trichet, were adamant in opposing. Another auction of three year loans is scheduled for February 29th and will likely exceed the first in size. This strategy has worked in the short run. Interest rates on Euro government and bank debt have fallen significantly though not to pre-crisis levels. In the process, the ECB has bought time, not solved the region's problems. The risk ratings that Euro banks apply to their loans are generally considered to be far too lenient given current stressful conditions and their loan to deposit ratios are far higher than U.S. banks. New regulatory demands for capital are expected to lead Euro banks to shrink their balance sheets, negatively impacting loan capacity.

4. More recent data coming from the housing market has given rise to hope that we are past the worst. Indeed, foreclosures have fallen, the number of houses on the market has declined and prices in some areas have risen. However, foreclosures were significantly impacted by mortgage processor moratoriums late last year stemming from legal liability concerns. These moratoriums have passed and a material amount of homes is due to hit the market in coming months. This, plus weak appraisals, new regulations and tighter credit standards stand in the way of an early recovery in residential housing. A warm winter so far has also benefitted construction.

5. Recent strengthening in consumer spending has been materially aided by a decline in the savings rate and an increase in consumer credit extensions which are unlikely to continue in the face of the broad desire to pay down debt and considerable doubts about the job market.

6. The payroll tax reduction and other tax reductions were finally approved, reducing D.C.-generated stress, but only for three months. Thus, this painful scene will begin anew shortly.

7. Despite budget constraints, Congress is not prevented from adding to short-term stimulative programs, especially in an election year. The housing sector is a likely target for such initiatives

given its prominence in the current debate. Any action to accelerate mortgage refinancing, lower interest rates or reduce mortgage balances would add to consumer spending and consumer confidence in the short run.

These positive elements are shorter term in nature and do not address the underlying impediments facing the global economy. Most basically, the problem of two decades of overborrowing and overspending worldwide has not been reversed. The historic amount of debt amassed by countries, individuals and businesses in that period remains. While the deleveraging process has begun it is thought to be only 20 –25% completed. For any entity having reached the upper limits of its borrowing capacity, part of current income must go to debt repayment, thereby leaving less to current consumption. Thus, the debt overhang will be with us for many years, acting as a brake on economic growth that could otherwise occur. History tells us that the fact that the most recent recession was financial in nature (as opposed to commodity shocks, central bank tightening, etc.) indicates that the recovery will be longer than a typical "cyclical" one. Normal recoveries can happen in two to four years; financial recessions can take up to ten years. This stems from the long term nature of the prior debt-fueled build-up. Debt must be paid off, defaulted or inflated away – which course will be taken is yet unknown which adds its own element of uncertainty.

What **is** known is that the current level of debt owed by the governments of the developed western countries is wholly untenable in relation to their ability to repay. The only way possible for this situation to be remedied by normal processes is for economic growth to occur at a high rate which would allow debt to be paid off over time from a higher income stream. Unfortunately, this exit door is blocked by the stifling amount of existing debt. At the same time that the growth option is precluded, the solvency problem has metamorphosed from one that is "long term" which can be dealt with "someday" to one that is immediate. The long term is here; everyone now knows what the fiscal realities are. Thus, the European governments are forced to face these problems now since they can't go back to business as usual where budget deficits are covered by more borrowing. Government and central bank programs like quantitative easing, superlow interest rates or bailouts can deal with short term **liquidity** problems but these programs do not address longer term, or structural, **solvency** problems. The Euro-area experience has also shown the limited powers of a central bank – it can keep short rates low and control the short end of the yield curve but it does not control the long end when credit quality and/or overwhelming supply appear.

As a result, Euro governments have raised taxes and cut spending, which has led to lower growth and rising unemployment (now at a post-euro peak), which has led to falling tax revenues, and, in turn, more budget cuts. It is highly unlikely that a heavily-indebted government can cut its way to a balanced budget. It now seems apparent that Greece will default and probably be followed by Portugal soon after. Germany and its fiscal allies will resist reversing austerity measures and further bail-outs of the weaker members which will lead to conflict within the Eurozone. Italy and Spain are under pressure as well – Italy being the third-largest issuer of debt globally.

The remaining shoe to fall is acknowledgement of the U.S. fiscal predicament. While the European and other governments have been forced to face music, the U.S. Congress and Administration still have the ability to spend more than they take in while also ignoring the debt build-up of the past as well as enormous unfunded liabilities of the future. A cursory glance at a few U.S. budget data gives one a feel for the scope of the challenges:

1. Total federal revenue for fiscal 2011 was $2.3 trillion, expenditures were $3.6 trillion for a deficit of $1.3 trillion. In one year, the deficit was 57% of receipts (8.6% of GDP) and $1.3 trillion was added to total government debt of $14.4 trillion, an increase of 10%. Total U.S. debt as a per cent of GDP has already returned for the first time to post WW II levels.

2. The present value of future unfunded liabilities – just Medicare and Social Security alone – is estimated variously at between $60 to $78 trillion.

So, just to simply maintain the current level of outstanding debt (which everyone agrees is far too high and should be reduced), i.e. balance the budget going forward, and begin to fund future liabilities with the meager amount of a trillion per year would require an immediate swing from a deficit of $1.3 trillion to a surplus of $1 trillion, or $2.3 trillion in total. Against total receipts of $2.3 trillion last year, one begins to appreciate the scale of the problem.

The expiration of accelerated depreciation and other "temporary" tax breaks will add to revenues starting in 2013 but also serve as a drag on growth with negative revenue implications. The Congressional Budget Office has just released projections for future years indicating that federal budget deficits will total over $1 trillion annually over the next few years. And with the poisonous atmosphere in Washington, any sort of meaningful fiscal compromise seems far distant. Europe has proved that at some point in time market participants do in fact care about debt levels. The question then becomes not if but how soon the U.S. will be called to account.

The point is not that the budget problem can't be solved (it surely will be by either our politicians or, in their absence, by the markets), but rather that the uncertainties surrounding financial markets are many and severe – what mathematicians and credit risk people would refer to as tail risk. Other important risks to the U.S. economy also exist apart from the budget/debt issues including a weakened and shrinking banking system, spillover from Europe and parts of Asia and South America, still-elevated amounts of low quality debt in the financial system, exposure of U.S. banks to vast amounts of credit default swaps on European banks and sovereigns and the threat of what rising interest rates might do to the U.S. budget deficit. Under these circumstances, it is still quite appropriate to retain the defensive investment posture taken by Brookfield Investment Partners for its managed accounts.