Economic Outlook
May, 2012

Written by William H. Bergner, CFA
Chief Investment Strategist

"Derivatives can be weapons of mass financial destruction and are not infrequently an excellent hedge against capital gains."

- *Barron's*

"As we have seen in a number of countries recently, interest rates can soar quickly if investors lose confidence in the ability of a government to manage its fiscal policy"

- *Ben Bernanke, Fed Chairman*

"I am worried, so I am going to stay liquid, so I can rip my money out whenever I need to."

- *Hedge fund manager*

Brookfield Investment Partners LLC

The U.S. economy continued to pick up steam in the first quarter of 2012, steadily if not speedily. GDP grew at an annual rate of 2.2%, a far cry from the 0.4% rate of a year earlier. Corporate profits have improved and hiring has increased, with the unemployment rate falling to a new cyclical low of 8.1%, down from 9.0% 12 months earlier. Residential housing seems to have found a bottom albeit at a very low level and with little near-term chance of significant upside. The manufacturing sector continues to lead the way out of the Great Recession, led by rising exports and improved hiring (even including a tentative reversal of the offshoring of jobs over the past 10 – 15 years). Bank lending has begun to expand both to consumers and to businesses.

Along with the stock markets having their best first quarter in 15 years, first appearances would suggest that economic activity was slowly returning to some sort of normalcy. And, on the surface, it has. The Fed and Congress have provided stimulus and liquidity to keep the economy successfully moving forward in the near term; so far they have done little to resolve the core issues underlying the imbalances caused by excessive debt creation at the government, corporate and individual levels. The challenge for policymakers will be to maintain these trends over the coming years. If this were a normal recovery from a normal recession, this task would not be difficult, as economic expansions have tended to feed on themselves. But the current recovery period is far different from its predecessors.

The U.S. and global economies find themselves at or near the end of a generational credit expansion during which has allowed economies, governments, businesses and individuals to borrow freely while spending same. As our updates have reiterated, that game is over, replaced by a "new normal" regime where deleveraging, lower consumption and saving are the watchwords. These new circumstances have totally altered the landscape for economic and financial policies and outlook. The old tools no longer work and new, untested tools will have to be developed "on the fly", so to speak, all while attempting to extricate the world financial system from its existing fragile condition. This, then, is the overarching challenge for policymakers.

Meanwhile, back in the real world, a number of immediate hurdles are facing governments and central banks……..

The financial banking and sovereign crisis has returned to front-burner status with the renewed focus on Greece. Its recent elections have raised the question of whether that country will go along with agreed upon fiscal tightening measures agreed upon by prior Greek officials, and rioting and doleful economic results have beset the country. Greece is only one of several southern European nations in difficult financial straits due to large fiscal deficits, loss of bond market access to roll over debt and the economic hangover from the prior recession. These nations' sovereign and bank credits are now totally intertwined so that problems in one directly affect the other. The 1 trillion euro liquidity injection by the European Central Bank last December and February took immediate funding pressure off of Europe's banks. That said, it could only buy limited time for their government's follow up with prompt and decisive actions to fundamentally confront Europe's financial woes. When this did not happen, and the Greece political and financial situations started to self-destruct (Greece's next election is June 17th with confrontation and threats against the EU rising), markets again closed not only to Greece but to the other "Club Med" countries as well. Eventually Italy and Spain were also brought under suspicion and their bond yields soared back to the highs of 2011.

Confidence in the Greek banks and government has fallen drastically in recent weeks. Without agreement on new loans to Greece, it will run out of funds by mid-July. An ensuing development has been the exit of bank deposits from the weaker Euro economies, mainly Greece so far, to those of the stronger Euro countries since there is no impediment to an individual or business in Greece, say, transferring its euro deposits in Greece to a bank in Germany electronically. The danger is that this deposit outflow may spread to other weaker Euro countries, and that this run on the banks would lead to banking and sovereign collapses, one or more countries defecting from the European Union with further negative implications for the euro currency and its Union. This financial "domino theory" is seen as then having the potential of continuing to spread to the remaining developed countries' banks. No one knows whether this will or could happen but that is precisely the point: given the lack of prior government and central bank experience in dealing with these problems, the glacial pace of remedial action to date, the total failure of the EU charter to address these issues, the heavy sociopolitical context of any changes needed, and the potential severity of a policy error, there is an inordinate degree of risk and uncertainty present. The cost of policy complacency has been extremely high for Europe; let us hope that those watching in Washington, D.C. will learn from this in dealing with the challenges we face here.

And the timing and resolution of the challenges that we face in the U.S. are critical to future growth and prosperity. The facts and details of the sorry U.S. fiscal position are well known. In brief, they are:

- We are in the fourth straight year of $1 trillion deficits.

- The U.S. borrows over 50% of the money it spends annually.

- In its first 200 years, federal debt had reached a total of $1 trillion in 1980, six years later it reached $2 trillion and the CBO's own estimate is that it will total $14.7 trillion at the end of this fiscal year.

- Total public debt this year will total about 74% of GDP versus about 40% in 2008, not too different than Portugal. A ratio of 90% has been shown to be the area where a country begins to lose control of its fiscal destiny. These numbers do not include off balance sheet liabilities or future Social Security, Medicare costs.

- Rising interest rates will materially worsen the budget deficit irrespective of any other budget cuts. The CBO estimates that every 100 basis point rise in Treasury interest rates over the next decade will add almost $1 trillion of new federal debt.

- The U.S. faces a so-called "fiscal cliff" at the end of this year. This is when a number of federal tax increases and spending cuts take effect and, barring any government action by December 31, 2012, will result in a combined hit of 3.5 – 5% of GDP. Such a blow would easily short circuit the economic recovery and few expect that all these changes will take effect. But with the elections set for November, little meaningful decision-making is expected other than to kick the can down the road again.

- The U.S. will once again reach the federal debt limit in late 2012, triggering another round of agonizing debate between the two political parties. The Treasury has the means to keep the government running until February of next year, i.e., post-election, meaning that any serious discussion will be put off until then.

- It was just last summer that the U.S. bond rating was downgraded from AAA to AA+ due to congressional bickering over federal tax and spending policies as well as raising the debt ceiling. Another downgrade is likely early next year absent meaningful progress from Washington on these matters.

From a U.S. consumer finance standpoint, progress has been made in deleveraging from the extreme debt levels of the mid-2000s. Consumer spending as a percent of income has moderated and the savings rate went from 0% (or possibly negative) to over 6% during the financial crisis. Unfortunately, with incomes rising slowly and consumption rising faster, consumer spending is more and more financed from savings (savings rate has fallen to 3.7%) and additional debt (now rising at a near 6% rate). In a similar vein, household debt as a percent of income has fallen from a high of 138% at the beginning of the recession to 112% currently. While this is a positive trend, the level would need to decline to the 80's to reach a typical level in the 1990's and to the mid 60's to reach the level of the 1970's and 1980's. This suggests that the more recent strength in consumer spending is likely unsustainable and that progress in healing the balance sheets of individuals will be halting at best and has only begun.

Another trend bolstering the U.S. (and other) economies has been the strength of U.S. exports of goods and services. This force has been facilitated by the weaker value of the dollar and the strength in emerging markets. With the recent resurrection of the Euro crisis, a stronger dollar and the ensuing slowing in the emerging markets and broader world economy, it seems unlikely that strong U.S. exports will continue in the near or intermediate term.

The Fed continues to hold to its strategy of extreme accommodation. The possibility of QE3 is debated daily as prospects for its commencement rise and fall. Also, the Operation Twist program is scheduled to expire on June 30th and its continuance is also an open question. With the economic expansion still somewhat tenuous and the fiscal cliff issue just ahead, pressure will remain on the Fed to keep rates low for the foreseeable future. The more basic and starker issue however is when and how the Fed will reverse the QE strategies – that is, how will it dispose of the trillions of dollars of Treasury and various mortgage-backed securities that it owns.

Amid today's environment of low yields and slow growth, there still remains the latent but dangerous risk of rising inflation. With the CPI at an annual rate of 2.3% as well as a core rate of 2.3% (excluding food and end energy), recent inflation figures are not yet troubling to the Fed but bear watching as they are in a mildly rising trend over the past two years. The personal consumption expenditures core inflation rate, the most closely followed by the Fed, remains under 2%, a non-threatening level. However, with U.S. and major global economies' monetary and fiscal policies currently set at the most stimulative in history, there is ample reason to watch for signs of incipient inflation. The threat to bondholders especially is highly significant. With interest rates at historic lows any meaningful upward shift in inflation rates or, as importantly, inflation expectations, will likely lead to painful declines in bond prices.

Wage rates in Asia, especially China, are rising rapidly – over 10% - meaning that these countries will no longer be exporting deflation as in recent years but rather inflation. In the U.S., capacity utilization rates have quietly risen back to the 80% area where bottlenecks begin to cause price pressures. This may be even more of a consequence in the current cycle as much excess capacity has been shut in or rendered uneconomical during the recession. Thus, current estimated levels of capacity are highly uncertain. A similar situation is true for the labor force. While the overall unemployment rate remains relatively high at 8.1%, the availability of the skilled labor actually in demand in today's economy is quite a bit more limited, suggesting that there may be more than a de minimus risk of wage pressures in coming months. Markets will be following these elements closely.

All of these factors create an extraordinary amount of uncertainty in the eyes of global investors, not to mention the general citizenry. Not only are these factors numerous but their possible outcomes could have extreme consequences. Thus, with little to base their decisions on, investors avoid making firm decisions and huddle in what are perceived to be ultra-safe harbors until some level of certainty returns. As a result markets lack conviction and endlessly fluctuate in response to the latest news headline. It seems probable that these circumstances will remain facing investors for some time given the severity of current problems and the polarized political environments