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Economic and Capital Markets Outlook

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US Economy – a Longer View

In the last three months, significant changes have occurred in the economic landscape and the financial world. As we advocated previously, now is not the time to be overly pessimistic. A scenario proclaiming that the rough economic times we are experiencing presaged depression seems increasingly unlikely. Strong policy responses, both monetary and fiscal, may have averted such an ugly outcome and on the contrary we are witnessing good signs of stabilization. In the following we highlight events that we have been seeing in the financial markets, the US economy and the world economy that point toward stability. In the second part, we present scenarios of how the US economy, in particular, may cope with the current challenges and what path it may take towards normalization over the next few years.

The first and most obvious sign of an improvement in financial markets is the significant recovery in stock prices from the lows reached in early March 2009. The MSCI World Index is up by 33.1% and the S&P 500 index has rallied 36.9%.

Improvements are also visible in the fixed income markets. The bellwether 3-month LIBOR rate in US dollars is now down to 0.60%, the lowest level in history. In addition, the spread between the LIBOR rate and the 3-month T-bill rate at 43 basis points compares to a high of more than 300 basis points following the failure of Lehman Brothers and an average of 107 basis points during the first quarter of 2009.

The issuance of corporate bonds in the US has become very active again. During the first five months of the year, such issuance totaled $753 billion, a 54% increase compared to the same period in 2008 and equivalent to a full year's average in the years 2000 to 2005. Primary equity issuance has also been very active particularly for banks. This significantly reduces the refinancing risk that has loomed for many corporations and thereby reduces the risk of bankruptcies. Despite these encouraging signs, activity in asset backed securities, including non agency mortgage backed securities and commercial paper remains depressed and the outstanding balances of these securities continues to shrink.

PERSONAL AND CONFIDENTIAL
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In the US notwithstanding further job losses and an increase in the rate of unemployment to 9.5%, many important indicators are showing signs of stabilizing. Since December retail sales have remained stable in a range of $335-$340 billion per month. Consumer confidence surveys are also back up to the levels seen in the first quarter of 2008. The widely followed business surveys from the Institute of Supply Management indicate improving trends for receipts of new orders for both manufacturing and non-manufacturing firms.

Around the world, similar evidence is manifest. European retail sales volumes have been stable since November 2008 while industrial production has been steady from January through to April 2009 albeit at levels that are 20.7% below a year ago. In Asia, data has been more encouraging. Exports from China and Japan have been stable in the past three months. Japanese industrial production has steadied over this period, while similar improvement has been evident in China for the past six months.

Assuming these trends persist for the balance of 2009 we have tried to develop scenarios for the US economy over the medium term, i.e. the 2-3 years.

A key element in developing a credible forecast is the outlook for personal incomes and spending as the latter accounts for more than 65% of the US GDP and about 20% of global personal consumption. Looking at employment trends, we conclude that the decreases in employment are in line with the economic contraction seen thus far. As economic output stabilizes, we expect the same of the job market with its customary lag. Given this backdrop of high unemployment, wage inflation should remain modest, between 1 to 3% in 2010 and up to 2012.

As mentioned in our past notes, we have forecasted US households would progressively increase their savings rate from close to 0% in the period from 2006 to 2008 toward levels of 5% and possibly higher in the years ahead. In May, the savings rate jumped to 6.9% as tax cuts and refunds benefitted taxpayers. Under our base case, the savings rate moves from 5% in 2009 to 8% in 2012. Under this scenario, personal consumption is expected to grow about 1% on average from 2010 until 2012.

Alternative scenarios we considered assumed weaker labour markets which would limit wage gains, providing less disposable income and less overall GDP growth. Another scenario calls for the savings rate to remain in the 5% area as opposed to 8% and thus boost household spending, economic activity and create a positive feedback loop of higher employment and stronger wage growth.

Residential investment is also a sector that depends on the consumer, although its dynamics are different. As of now, new housing construction is operating significantly under what is necessary to replenish the housing base and satisfy the needs of newly formed households. As of May, 500,000 new houses were under construction while we estimate that around 1,500,000 new houses are needed annually in the US. The low level of building is the result of a significant overhang of unoccupied finished houses, the consequence of a decade of overbuilding. We expect that residential investment will stay at today's low levels until the end of 2010 as it will take another year for today's excess supply to be absorbed. Then, a significant ramp up should occur in 2011 and 2012. By 2012, we expect the industry to be building close to 1,500,000 homes again.

Non-Residential investment is a difficult sector to forecast as there are a multitude of drivers that influence the many sub sectors. Investment in structures will see a low level of activity. First, there is limited demand for additional retail, office and lodging space. Financing for this type of investment will remain difficult. Second, investments in oil & gas wells, mining and materials generally will be lower given the sharp correction in commodity prices. As for investments in equipment and software, there is room to be more optimistic. At 9.5% of GDP this sector operated at its lowest level since the 1960's. We are convinced that US firms will continue to find reason for investment to remain competitive and increase productivity.

Government spending will expand in 2009 and 2010 following the adoption of a significant fiscal stimulus package. The majority of spending increases will occur late in 2009 and in 2010 while lower taxes and larger government transfer payments are already in effect. This increased spending, coupled with lower revenues, is forecast to lead to an overall government deficit of approximately 10% of GDP both in 2009 and 2010. Under our base case scenario, the deficit will drop back to a more normal level of 3% of GDP by 2012, through higher taxes and cutbacks in spending. The significantly higher deficit will drive federal debt outstanding to 67% of GDP by 2012, up from 45% in 2008. This will be the highest level of debt to GDP since the US came out of the Second World War.

One peculiar aspect of the US government sector is that states are legally forced to balance their budget. States and local governments spend significantly more than the Federal government, $1.8 trillion compared to $1.1 trillion. In addition, state and local governments are large employers, employing about 15% of all US workers, many through education and health care services. Today, many states and municipalities are in a state of fiscal crisis as their costs are stable or rising while revenues are declining. The majority of state revenues come from sales taxes, personal income taxes and corporate taxes. All three sources have dropped 6.1% to date in 2009. We estimate Washington will fund a part of the shortfall, in order to maintain aggregate state and local government spending flat over the next few years. In more severely impacted states, spending will have to be cut or taxes raised.

Trade has been a significant contributor to economic growth over the past two years, as exports have outgrown imports, reducing the trade deficit. In Q1 2009, the nominal trade deficit was $333 billion or 2.4% of GDP, compared to $757 billion or 5.7% of GDP in 2006. Going forward, the main question is whether the trade deficit will continue to contract, boosting economic growth. This might occur if the rest of the world grows faster than the US and requires more US goods and services while Americans reduce their appetite for foreign goods and services. This is not an unreasonable expectation which could receive additional help from a lower valued US dollar. A thorny part of this equation is imported oil which accounts for $250-$300 billion of the country's international trade deficit and is unlikely to improve significantly in the medium term. Furthermore, significant export capacity is ready in Asian countries to feed any increase in US demand for consumer and capital goods. Third, given the US dollar status as a reserve currency, the US has run a trade deficit almost every year since the end of the Bretton Woods agreements in 1971 and foreigners have been willing to accept and accumulate US dollars. Recent speeches by Chinese leaders proposing substituting IMF drawing rights for US dollars may herald a change of sentiment but real change is not likely for now. Given the large role imported oil has in the US, we believe the trade deficit is unlikely to disappear over the next few years.

When we aggregate the forecasts for the US economy as a whole, we envision a pace of nominal GDP growth of 1.25% to 2.0% from 2010 until 2012. Under a more positive scenario, where the savings rate stabilizes close to 5% of disposable income, the trade deficit falls to 2% of GDP and non-residential investments goes to long term averages in terms of GDP; we could experience nominal GDP growth slightly above 3% from 2010 until 2012. This pace would still remain significantly lower than what was enjoyed during the period from 2002 to 2007, when growth averaged 5.3%. Consequently, we assume the US economy may go through a prolonged period of subpar growth as it corrects its past imbalances.

Recent Conditions in Bond and Stock Markets

Federal government bond rates have increased from the lows touched in December 2008 but remain relatively low particularly in the face of a very heavy calendar of government issuance. Five year rates in the US have increased from 1.1% to 2.0%, 10 year bonds have moved from 2.0% to 3.3% while 30 year issues have risen from 2.5% to 4.2% after briefly running up to 4.7%. Canadian interest rates have followed a similar path with the exception of long Canada's which currently trade at yields of 3.9% or .3% below US yields. Over the next year, we think interest rates should remain steady at these low levels given modest inflation, weak employment and still low capacity utilization. In addition, central banks will be very careful as they move toward reducing the amount of monetary stimulus given the depth and breadth of the current recession. In Canada provincial and corporate bond spreads have narrowed materially in recent months with provincials having improved from 160 basis points above federal issues to a still healthy 85 basis points. Our focus has been on provincial bonds with target portfolio duration of 5 years. While corporate issues offer somewhat more yield we believe that still difficult economic conditions argue for low risk in bond selection since one is not well compensated for risk.

Over the last 2 weeks equity markets have fallen slightly in the wake of some disappointing data. The level of unemployment inched up further to 9.5% and the number of unemployed grew to 14.7 million. The pace of job loss has moderated but initial claims remain close to twice normal levels while the growth in hourly wages slowed in June to 2.7%. The latter development undoubtedly reflects the actions of many companies to freeze salaries. We believe it is the combination of mixed economic data along with the fact that share prices recovered over 30% in a short period that has given many investors market vertigo and so some pause is sensible.

Over time however share prices will be a function of success of the businesses they represent and clearly profits will be the most important driver. In this regard S&P 500 profits are widely forecast to suffer an aggregate decline in the area of 30% this year which would follow a drop of 17% in 2008. Profits in 2009 will of course be worse than in 2008 simply because the recession will last through much of this year compared to one particularly bad quarter last year. Forecasts however suggest the worst level of profits will have been experienced during the first 2 quarters with improvement likely in the 3rd and 4th quarters. Should this prove correct the low point for profits is behind us but yet to be confirmed. At current prices the S&P 500 is trading at 14.3x 2009 forecasts and 12.4x 2010. These valuations based on somewhat depressed profits are below those experienced over the last 15 years.

The point we wish to emphasize is that while none of these circumstances will make anyone cheer, after all we are in a serious recession; economic conditions are showing signs of stabilization. Stock markets have discounted this fairly quickly and the next stage will require further evidence that the recovery does have legs. This may take some months and will require patience by stock market investors. Equities however remain our preferred investment vehicle and should provide returns that are significantly better than cash or bonds.

All dollar references in the text are U.S. dollar unless otherwise indicated.

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