

Review and Forecast

Issue No. 73

January 2011

A BETTER YEAR THAN EXPECTED

Looking back, 2010 turned out to be a better year than expected for both investors and the U.S. economy. The S&P 500 Index recorded a total return of 15.1% and the S&P/TSX Composite Index recorded a 17.6% return. Real consumer spending in the U.S. accelerated in the final quarter of 2010 and business investment in new equipment and software has shown strong gains for several quarters. By year-end a self-sustaining recovery in the U.S. in consumer and business spending appeared to be taking hold.

A CHANGED U.S. OUTLOOK

There has been a big change in the economic outlook. In testimony to the Senate Budget Committee in early January, Fed Chairman Bernanke said that he expects a moderately stronger pace of economic activity in 2011. Earlier there had been fears of prolonged weakness beginning in the summer of 2010 after the initial economic stimulus and the inventory cycle had worn off. Growth did in fact slow last spring and European debt problems triggered another round of financial market volatility. Fortunately another large U.S. stimulus package has been put in place and it will have a major economic impact.

NEW FISCAL STIMULUS

President Obama used the Bush tax cut exemption to provide a wide range of tax cuts and benefit extensions. The U.S. Tax Relief Act signed by the President on December 17, 2010 goes far beyond a mere extension of the tax regime already in place. It is estimated to add a full percentage point to 2011 U.S. GDP growth. In addition, the U.S. economy was already accelerating well before this new fiscal stimulus will kick-in. It is estimated to have advanced at an above potential rate in the final quarter of 2010. The December fiscal stimulus package will keep the U.S. growing at an above-potential rate in 2011.

MORE FEDERAL RESERVE STIMULOUS

In early November, the Federal Open Market Committee (FOMC) formally announced its intention to purchase an additional \$600 billion in Treasury securities by the end of the second quarter of 2011. It also left the door open to even more asset purchases if necessary.

The Federal Reserve's target for the federal funds rate has been close to zero since December 2008. As a result, there has been no scope for further reductions in order to deal with high unemployment and an inflation rate so low that deflation is still a danger. The Fed has therefore been using quantitative easing for the last two years as another way to provide monetary support to the economy.

THE EFFECTS OF QUANTITATIVE EASING

Quantitative easing (also known as large-scale asset purchases) puts direct downward pressure on longer-term interest rates. The main effects are through higher stock prices and a lower USD. As bond yields fall, investors are pushed into assets such as stocks. There is also a positive valuation impact on equities prices and the prices of other assets. Lower risk-adjusted discount rates increase present values of future cash flows from dividends, earnings and rents.

The Fed had signaled the likelihood of another asset purchase program well before its early November FOMC meeting. In response equities prices began to rise and they set fresh 2-year highs through November and December. Stock prices are important determinants of overall confidence and discretionary spending by higher-income households. A lower longer-term interest rate environment will also keep the USD competitively priced for American exporters.

JOB CREATION IS CRITICALLY IMPORTANT

There has been a modest improvement in the U.S. job market. Through the final six months of 2010, private payroll employment increased on average by 126,000 per month - an improvement from 96,000 per month through the first half of the year. This is not strong enough to bring the unemployment rate down to tolerable levels but indicators of job openings and hiring plans have recently strengthened. Initial claims for unemployment insurance declined in both November and December. Monthly employment gains are likely to pick-up in 2011 and the unemployment rate is expected to move significantly lower by year-end.

AMERICA'S UNEMPLOYMENT PROBLEM

Unemployment will remain higher than what could be considered normal for a number of years. Roughly 40% of unemployed Americans have been out of work for six months or more. Long-term unemployment is imposing exceptional hardships and has created a new era of austerity. Persistently high unemployment is likely to produce a Fed bias towards easing for an extended period. It will prefer to err on the side of providing too much ease rather than not enough. More quantitative easing may still lie ahead.

AMERICA'S BALANCE SHEETS

The financial causes of the Great Recession of 2008-09 are being addressed in the United States. Corporate balance sheet repair is generally completed and household balance sheet repair is well underway. More improvement is expected in 2011 and 2012. An important threshold will be the coming stabilization in U.S. house prices. We expect to see this before the end of 2011. It will be triggered by declines in the U.S. unemployment rate in the 2nd Half of 2011.

REPLACEMENT DEMAND

Looking ahead replacement demand will become an increasingly important economic recovery driver. For example, the average age of the U.S. automobile fleet is over 10 years which is an unprecedented high. Motor vehicle sales in the U.S. have shown a stronger than expected recovery in the final months of 2010, indicating a strong replacement demand effect.

CANADA'S EXPORT LINKAGE

With Canada's best customer shifting into an above potential growth path, its export performance will improve. This has been the weak link in Canada's economy. There has been plenty of domestic demand in Canada - real consumption has been growing at almost a 4% rate and plant & equipment has been showing double digit growth. However, there was a big import drain in 2010 and exports slumped. Looking ahead, Canadian exports will be helped by accelerating U.S. economic activity.

CANADA'S ECONOMIC OUTLOOK

Above potential growth in the U.S. also increases the likelihood that the global economy will continue to drive the commodity cycle. Energy, base metals and lumber prices will continue to rise. Canada should at least match the U.S. and perhaps show a growth premium in 2011 as a new global commodity cycle takes hold. Canada did not suffer as much financial damage as the U.S. during the crisis. The CAD is overvalued at parity with the USD but this will not prevent a turnaround in net export volumes. Cross-border trade is mainly priced in USD. As a result, the currency effect will be on profit margins rather than on export and on import volumes.

CANADA'S DEBT PROBLEM IN PERSPECTIVE

Canada's household debt levels are making headlines and undoubtedly could put its economy and Canada's housing sector in a vulnerable position in the future. However this is not in the short-term planning horizon over the coming three years. For now it is the cost of servicing debt that matters, not the actual level of debt.

The reality is that Canadian households can afford to carry their debt. The share of disposable income taken up by debt payments is close to a historic low and is on a downtrend. In addition, asset values have been increasing as fast as debt. The ratio of debt to household net worth has been moving sideways. The debt story will not be a problem until the debt service ratio is much higher than it is today.

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