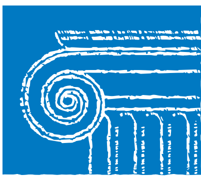

Economic Commentary and Capital Market Update

December 2011

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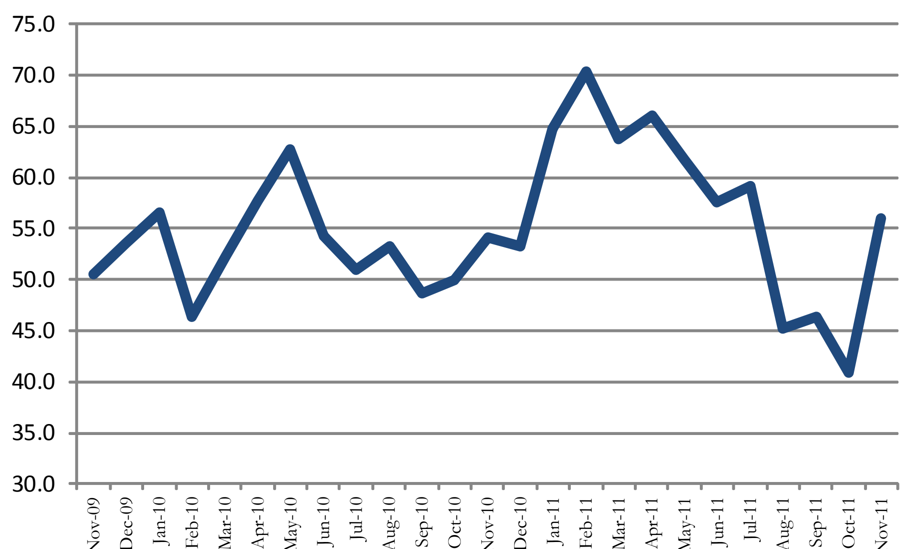
Political change has been a major theme in Europe in November with three governments changing hands in as many weeks. Markets will be watching the new leaders of Greece, Italy and Spain closely to see if they are up to the Herculean task of reducing fiscal uncertainty. There is no question that Europe is the number one risk to the global economic and financial outlook. The most worrying development in recent weeks has been an increase in the yields of Italian and Spanish government bonds to levels that had triggered bailouts elsewhere. In the face of rising yields, the European Central Bank has been buying Spanish and Italian bonds in the secondary market, helping to keep a lid on yields.

On this side of the Atlantic, the economic news has been largely positive over the past couple of weeks. The U.S. economy grew at a 2% pace in Q3, and early indications are pointing towards a 2.5% showing in Q4. October retail sales were healthy, and initial jobless claims are signaling improved hiring ahead. At least for now, there is little sign of a double dip recession.

But these positive indicators could come to naught if policymakers in the U.S. and Europe cannot act decisively to restore confidence to financial markets. Unfortunately in the U.S., exactly the opposite is the case. The bi-partisan super committee has failed to meet its deadline for a plan to save $1.2 trillion over the next 10 years, in theory triggering automatic expenditure cuts. If the full force of the fiscal restraint from those "automatic" cuts is felt, it could derail the economic recovery. However, with the deadline set last summer being self-created, an alternate path will hopefully be worked out by legislators. In the meantime, the uncertainty has contributed to souring sentiment in markets, undermining the U.S. recovery at a time when it just looks to be picking up steam.

GDP: U.S. third quarter real GDP was revised down to 2.0% (annualized) from an initial estimate of 2.5%. There were slight downward revisions to most components of GDP, with the largest single source of revisions being inventory investment. The revised estimates, while showing less growth in Q3, bode well for growth in the fourth quarter. Retail sales in October point to an acceleration in consumer spending and with a cut in inventory investment, production in the fourth quarter is also likely to accelerate.

Consumer Confidence: Consumer confidence rose 15.1 points to 56.0 in November (see Chart 1 below), with solid gains in both the present situation index and future expectations series. With November's increase, the Consumer Confidence index is at its highest level since July, which was just before the debt ceiling/credit rating downgrade debacle. Early indicators have pointed to a strong kickoff to the holiday shopping season, which should help to maintain economic momentum through the final quarter of 2011.



A significant near-term risk to economic growth over the next year is that financial contagion from Europe slows the flow of credit to U.S. consumers. While credit indicators in the U.S. have shown steady improvement over the last few months, measures of financial stress have also begun to rise. Which one of these forces wins out will be a key factor to maintaining the recent improvement in consumer sentiment and spending over the next year.

Industrial Production: Industrial Production (IP) increased 0.7% in October, following two consecutive weak months. The manufacturing sub-index accelerated 0.5% in October from 0.3% growth in the month prior. Capacity utilization, an indicator of whether industrial production is operating at potential, increased to 77.8%. It is now 2.1% above its rate from a year earlier, but still 2.6% below its long-run average from 1972 to 2010.

Auto production surged in October, despite reports that auto makers are facing further supply chain disruptions, this time from flooding in Thailand. So far there is little evidence that these disruptions have materially impacted production. The auto sector continues to be the main driver of growth in IP. However, it only accounts for less than 5% of total industrial activity. So despite its recent strength there is a limit to how much it can drive overall IP in re-capturing its prerecession peak. At that point, the onus will be on other sectors to keep pushing IP growth forward.

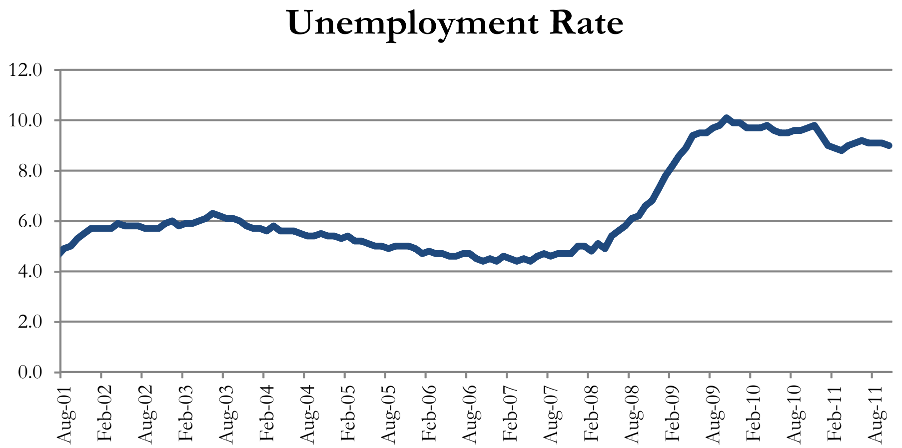
Housing: Residential construction continues to struggle across much of the country amid a glut of excess single-family homes and condominiums. With so much supply on the market, home prices have continued to drift lower. Moreover, price declines have accelerated in recent months, as distressed transactions account for a larger proportion of overall sales. Housing starts fell 0.3% to 628,000 a unit pace in October, with the volatile multi-family component accounting for the decline. Multi-family starts fell 8.3%. Single-family starts, on the other hand, rose 3.9%, the first increase in four months. The increase is encouraging and may be a sign of improvement in the coming months, but the level remains very depressed and any recovery will be slow. With foreclosures and short sales still accounting for a large share of total transactions, home prices will remain under pressure, which gives builders little incentive to compete with deeply discounted existing homes.

On a seasonally adjusted basis, the S&P Case-Shiller (C-S) 20 city home price index declined 0.6% in September. This has pushed the 20-city composite home price index to a new post-recession low. Although more recently reports show that national home prices are falling, there is no indication that the housing sector is taking a turn for the worse. Instead, ongoing price declines are the result of the foreclosure crisis. So long as this supply glut remains, home prices will struggle to move higher.

Inflation: The U.S. Consumer Price Index (CPI) fell 0.08% in October. Annual headline inflation now stands at 3.5%. On the other hand, core inflation – a measure that excludes energy and food prices – gained 0.2% in October. As a result, annual core inflation is now 2.1%. The decline in headline inflation resulted from a decline in the transport and recreation sub-component. Barring any major shock to commodity prices – crude oil in particular – inflation should trend lower in the coming months. We expect core inflation to end 2011 around 2.2%.

In the short term, a moderation in headline inflation, in combination with core inflation hovering around 2% and stable inflation expectations means the Federal Reserve's FOMC will likely put more emphasis on the full employment portion of its dual mandate. However, this does not mean further monetary easing is imminent.

Labor: As the economic recovery begins to show signs of life, there is growing evidence that the labor market recovery, which up until this point has been uneven at best, is itself beginning to regain some positive momentum. This is reflected in the November employment report, which shows a modest acceleration in the pace of private sector employment growth. Employers added 120,000 jobs last month. And the previous two months were revised to show that 72,000 more jobs were added. The unemployment rate dropped to 8.6%, its lowest level in more than two and a half years, as employers stepped up hiring in response to the slowly improving economy.



Taken all together, this is an encouraging report. Moderate job gains have been the story for some time and this suggests the economy has settled into expansion mode. Faster job growth will depend on a speedier economy. While corporations are lean with lots of cash on hand, growth is struggling against three rather strong headwinds: the European crisis, fiscal tightening, and a depressed housing market. Until these are lifted, job creation is unlikely to reach the level of at least 150,000 per month necessary to materially bring down the stubbornly high unemployment rate.

Europe: With the debt crisis in Greece grabbing the headlines for months, Italy is now taking center stage in the euro-emergency zone. Both Greece and Italy have installed new administrations as part of the political fallout from these crises. Why is Italy so important?

The main reason is size: behind Germany and France, Italy is Europe's third largest economy. It would be a really important domino if it fell. European bank exposure to Italian debt is a multiple of what they hold in Greek debt. If Italian debt eventually has to take a "haircut" it would continue to erode the capital of banks in Europe and surely curtail lending there, economic growth and employment. Making matters worse, the Italian GDP growth rate has slowed making its debt burden relatively heavier. Recently, the yield on 2-year and 10-year Italian bonds exceeded 7% suggesting illiquidity in the market. Over the next 12 months, 300 billion euro in debt will be maturing. The EFSF fund put in place by the European Central Bank may not be enough to bail out Italy.

So what does this mean for the U.S.? Firstly, U.S. bank exposure to Italian debt is significantly higher than the Greek debt. Any worsening of the Italian debt situation is likely to have some effect on U.S. financial (banking) stocks as a result. This could be another obstacle the already troubled money center banks have to climb over. Secondly, in terms of trade, the direct effect of a drop in Italian imports from the U.S. will be small though a few states have roughly 5% of their state GDP related to exports to Italy. Thirdly, if the U.S. dollar continues to appreciate due to investors' flight to safety this could negatively impact U.S. net exports which have been one of the driving forces behind our fragile economic recovery.

Central Bank Coordination: The Federal Reserve, the European Central Bank (ECB), the Bank of Canada, the Bank of England, the Bank of Japan and the Swiss National Bank just announced a coordinated action that is designed to improve liquidity in interbank funding markets. The aim of this action is to reduce borrowing costs for households and businesses. Specifically, the central banks have agreed to reduce the interest rate that they charge each other for U.S. dollar borrowing by 50 basis points .

This is an important step in addressing some of the fallout from the ongoing European sovereign debt crisis. That is, LIBOR rates have been pushed up by concerns about the financial health of European banks that hold significant amounts of European sovereign debt. The Banks' actions may help to reduce LIBOR rates in coming weeks. However, the underlying sovereign debt crisis will not be entirely solved until European governments make some more painful decisions regarding ECB intervention in sovereign debt markets, budgetary authority among individual governments and labor market reforms.

Outlook: Barring a banking crisis in Europe, recent U.S. data are pointing to continued slow to moderate growth. The question is - where are financial markets headed? At the risk of sounding like a broken record, there is a particularly high degree of uncertainty at the moment. We see two major headwinds: European sovereign debt and U.S. fiscal brinksmanship. If there is a European fiscal crisis that causes a European banking crisis, the financial environment could be like late 2008. There would be a big drop in equities and commodities, a rally in U.S. Treasury bonds, a shift to cash and strength in the U.S. dollar. If the U.S. government cannot make progress on fiscal challenges, the impact will be more muted, but there is a risk of increased market fears of the economy faltering and the possibility of another downgrade of U.S. sovereign credit rating.

However, if Europe and the U.S. can show decisive leadership there is a huge upside potential for the economy and financial markets. Reduced consumer and business confidence is currently constraining economic growth. Non-financial corporations are currently sitting on record levels of cash. If these idle funds were put to work they could create investment and jobs. They would also fuel a strong rally in equities and lead to higher bond yields.

Index Performance as of November 30, 2011	1 Month	QTD	YTD	1 Year	5 Year
Russell					
3000 Growth Index	-0.05	11.29	2.50	8.32	2.59
3000 Index	-0.27	11.21	0.20	7.00	0.06
3000 Value Index	-0.49	11.13	-2.04	5.72	-2.55
1000 Growth Index	-0.01	10.96	2.97	8.65	2.64
1000 Index	-0.26	10.92	0.66	7.38	0.07
1000 Value Index	-0.52	10.87	-1.59	6.17	-2.59
Mid-Cap Growth Index	-0.49	12.93	-0.16	6.07	2.56
Mid-Cap Index	-0.50	12.45	-1.43	5.39	1.44
Mid-Cap Value Index	-0.52	11.97	-2.60	4.75	-0.01
2000 Growth Index	-0.53	15.25	-2.69	4.70	2.08
2000 Index	-0.36	14.72	-4.80	2.75	0.09
2000 Value Index	-0.20	14.18	-6.96	0.77	-2.01
S&P 500	**-0.22**	**10.68**	**1.08**	**7.83**	**-0.18**
Consumer Discretionary	-0.65	11.16	4.79	9.16	2.22
Consumer Staples	2.67	7.30	10.93	15.62	7.55
Energy	2.02	19.41	5.80	15.31	4.50
Financials	-4.75	8.90	-18.50	-9.75	-16.56
Health Care	1.03	6.85	9.54	14.45	2.46
Industrials	1.02	15.17	-1.74	5.86	0.49
Information Technology	-1.66	9.68	3.31	8.75	3.74
Materials	0.13	17.87	-7.81	1.75	2.34
Telecommunication Services	0.79	3.78	2.21	10.18	1.52
Utilities	1.11	4.75	16.00	19.58	3.26
Other U.S. Equity					
Dow Jones Industrial Avg	1.18	11.02	6.70	12.39	2.47
MSCI USA	-0.27	10.68	1.03	7.79	0.01
Wilshire 5000 (Full Cap)	-0.03	11.49	0.18	6.87	0.48
International Equity - Broad Market					
MSCI EAFE	-4.83	4.36	-10.90	-3.68	-3.49
MSCI Emerging Markets	-6.66	5.71	-17.18	-11.26	3.86
MSCI Frontier Markets	-2.95	-0.81	-17.46	-13.57	NA
MSCI AC World	-2.94	7.48	-6.71	0.15	-0.94
MSCI AC World ex USA	-5.08	4.93	-12.36	-5.49	-1.67
MSCI AC Asia ex Japan	-8.32	2.69	-17.56	-13.00	3.61
International Equity - Country Region					
MSCI Brazil	-6.96	11.10	-20.03	-14.30	10.82
MSCI BRIC	-7.96	6.75	-20.95	-17.21	3.18
MSCI China	-8.40	5.49	-20.22	-20.79	4.96
MSCI Europe	-4.48	7.09	-9.11	-1.48	-3.72
MSCI India	-15.97	-8.77	-33.15	-28.07	0.69
MSCI Japan	-4.41	-4.65	-14.90	-8.41	-6.13
MSCI EM Latin America	-5.95	10.53	-17.87	-12.64	8.64
MSCI Russia	-0.29	18.80	-9.72	0.30	-5.78
Fixed Income					
BC Aggregate Bond	-0.09	0.02	6.67	5.52	6.14
Merrill Lynch 3-month T-Bill	0.00	0.00	0.10	0.12	1.57
BC Government	0.67	-0.04	8.06	6.31	6.22
BC Credit Bond	-1.68	-0.24	6.29	5.21	6.20
BC High Yield Corporate Bond	-2.16	3.71	2.26	4.12	7.21
BC Muni Bond	0.59	0.22	8.63	6.53	4.75
BC TIPS	0.77	2.65	13.52	11.76	7.44
BofA ML Global Broad Market Ex USD	-2.70	-0.74	4.13	7.25	6.03
BofA ML Global Broad Market	-1.54	-0.39	5.23	6.44	6.08
BofA ML Emerging Market Credit	-1.31	5.20	4.26	6.51	8.46
Alternative Investments					
NAREIT Equity REIT Index	-3.76	9.98	3.32	8.13	-2.65
DJ-UBS US Commodity Index	-2.22	4.25	-9.95	-0.32	-2.24
	-1.60		-4.88	-1.59	
	-0.21				