

**OBSERVATIONS REGARDING THE ECONOMIC
AND FINANCIAL MARKET OUTLOOK**

OCTOBER 4, 2011

The world's economies continue to slow and the risk of a further deterioration has increased, yet the consensus view of economists is that the global, developed, and emerging economies will avoid recession this and next year. From this perspective, global stock markets are very oversold, especially in the emerging economies, and offer attractive bargains to investors with a tolerance for volatility and a longer term horizon. In the near term, however, markets are likely to remain bumpy, and thus it is prudent for risk-sensitive investors to maintain above-norm reserves and reduce overexposure to cyclical, economy-sensitive companies until the fog lifts. On the other hand, higher quality U.S. bonds are, in our view, overbought and their prices are vulnerable to an improvement in economic optimism.

In its semi-annual report released in late September, the International Monetary Fund (IMF) forecasted global GDP growth of 4% in 2011 with an additional 4% in 2012 (see our September 26 blog "Global Growth Revisions"). The U.S. is expected to avoid recession with 1.5% growth in 2011 followed by a modest pickup to 1.8% in 2012. The Euro Area is predicted to slip from 1.6% this year to 1.1% in 2012. The emerging economies will continue to drive the global economic expansion and China (9.0% growth in 2012) and India (7.5%) will be in the vanguard.

The monthly polling of economists by *The Economist* supports the IMF's outlook. They expect the U.S. to grow 1.6% in 2011 followed by a rise to 2.0% in 2012. They also anticipate the Euro Area will remain positive but slump from 1.7% this year to 1.0% next year. In further agreement with the IMF, the economists predict China's growth to moderate slightly from 9.0% to 8.6% and India to rise from 7.9% to 8.2%. We think these forecasts are realistic, but we would adjust downward the IMF's 2012 global growth forecast to 3.0-3.5% from 4.0%.

Although the sharp downturn in the U.S. and international stock markets reflects a very gloomy investor economic outlook, we concur with the Federal Reserve's September 21 assessment that it "continues to expect some pickup in the pace of recovery over coming quarters." We acknowledge that there is a rising risk of a mild dip into recession, but we think it is highly improbable that the U.S. economy will retreat to the severe recession levels of 2008. The major considerations buttressing our view are:

- Recent U.S. economic data (employment, retail sales, manufacturing, construction spending, et.al.) indicates a slowdown but does not point to an imminent collapse.
- Households have shed debt and their balance sheets are in better shape.
- Corporations continue to enjoy strong profits and are sitting on a mountain of cash estimated at over \$1 trillion.
- The paralyzing credit crunch and bankruptcy crisis of Wall Street investment banks in 2008 is history. Financial institutions are now better capitalized, high risk loans are considerably reduced, and loan losses are under control.
- The housing market crisis of 2008 has eased. Home prices are now more affordable, mortgage rates are at near-record lows, and the foreclosure crisis is slowly improving.
- Commodity prices dropped precipitously in recent months, creating the equivalent of a tax break for both consumers and corporations. The CRB Index of commodity prices fell 20.0% and crude oil prices plunged 37.3% from April 29 through October 3.

The inconsistency between the outlook of investors and economists is dramatic. *Bloomberg* has summarized its September 26 poll of international investors with the observation that they “expect the world economy to relapse into recession, with more than one in three forecasting a global economic meltdown within the next year.” This gloomy and arguably unwarranted prediction is reflected in stock prices. The U.S. market plunge during the 3rd quarter has pushed the valuation of the Standard & Poor’s 500 Index 25% below the average level of the last 9 recessions and only marginally above the nadir P/E ratio of early 2009. Companies in the Index now trade at 10.2x 2012 forecast earnings, which is well below the past recession average of 13.7x. For the current P/E ratio to be appropriate, there will need to be a severe recession and a sharp decline in corporate earnings in 2012, yet Wall Street research analysts estimate S&P 500 profits will rise 12% next year on top of this year’s increase of 17% (*Bloomberg*). In other words, the dismal outlook of investors reflected in current stock prices clashes with Wall Street research analyst estimates as well as the consensus forecast of economists.

Conditions in Europe are more ominous than in the U.S. The sovereign debt crisis threatens to spread from Greece to Portugal, Italy, and Spain. European financial institutions are endangered if these countries default. Also, the austerity budgets of Euro Area governments have pushed their economies to the brink of recession. Still, the IMF and most other economists are projecting positive 1.0% growth in 2012. In contrast, the *Bloomberg* survey reveals that 74% of international investors expect the Euro Area economy to sink into recession in the next 12 months and see Euro Area stock markets to be among the least attractive in the world. We think Euro Area economies will remain

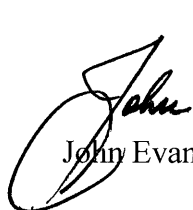
troubled and may dip into recession, yet their markets are oversold and the stocks of some multinational and recession-resistant companies remain attractive.

Why are investors so pessimistic regarding the U.S. and Euro Area economies and markets? We think it is a result of the inability of policy makers to take decisive and effective action to confront their economic problems. Investors around the world are frustrated and have developed an almost complete lack of confidence in their policy makers. Uncertainty breeds anxiety, which permits worst case scenarios to gain plausibility and popularity. This in turn encourages panic selling, which then feeds upon itself. A U.S. breakthrough on an effective job creation policy and/or an agreement in Europe on a long-term solution to the sovereign debt crisis would work wonders to restore investor confidence and lift equity markets. We think one of the two is probable and both are possible.

The lack of agreement between consensus economic prospects and stock market valuation is especially pronounced in the emerging economies and particularly China. As the iShares MSCI Emerging Markets ETF sank 26.3% in the 3rd quarter, P/E ratios descended to March 2009 levels. This development is inconsistent with the IMF's projection that emerging economy growth will be 4 times as great as developed economy growth in 2011 (6.4% vs. 1.6%) and more than 3 times as high in 2012 (6.1% vs. 1.9%). Further, the decline in commodity prices has given emerging country central banks room to reverse anti-inflation interest-rate increases that had led to laggard stock performance the previous 3 quarters. We predict that a future global stock market rally will be led by emerging economy markets, as was the case in 2009 when recession fears ebbed.


We favor the forecast of economists and research analysts over the doom and gloom predictions of the pessimists. 2011 has been a year of negative surprises, however, and disappointing economic data may lead us to reevaluate our *Outlook*. We will keep a vigilant watch, remain flexible, and provide updates on our blog.

The plunge in global stock markets triggered a flight to safety and a large drop in the yield of benchmark 10-year U.S. Treasury bonds from 3.16% on June 30 to 1.92% on September 30. The yields on investment grade corporate and tax-exempt bonds similarly declined. If the economic forecast of the IMF and most economists proves to be correct, it is likely that the flight to safety will be reversed and bond prices will drop. We recommend that investors consider international sovereign bonds as an alternative or simply maintain elevated cash positions.


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