

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

JULY 1, 2011

Investors were alarmed during the 2nd quarter by signs of slumping U.S. and international economies and deteriorating equity and commodity prices. The key question for investors at this time is: will the current global economic “soft patch” be painfully rough and/or prolonged? In particular, are there serious threats of a double-dip recession and a further retreat of global equity markets into bear territory? The most probable scenario, in our view, is that the global and U.S. economies will recover modestly in coming months. We continue to project over 4% world GDP growth for 2011 followed by a slight acceleration in 2012. Renewed investor confidence in the sustainability of the global expansion should lead to a further advance in the 2-year bull market for equities. Our major concern is that governments and central banks in the U.S., Euro Area, and the leading emerging economies (especially China, Brazil, and India) will adopt ill-advised policies that abort a recovery.

Highly respected professional forecasters have recently lowered their global and U.S. growth estimates, yet support our outlook that the “soft- patch” most likely will be short in duration and mild in severity:

- On June 17, the International Monetary Fund (IMF) predicted a U.S. and international economic recovery in the 2nd half of the year that will result in global GDP growth of 4.3% for all of 2011 and 4.5% in 2012 (see our June 20 blog “IMF Forecasts Rebound From Economic Soft Patch”). Predicting U.S. growth of 2.5% in 2011 and 2.7% in 2012, the Fund’s Economic Counsellor, Olivier Blanchard, labeled the soft patch “a bump in the road rather than something more worrisome.”
- The latest polling of economists by *The Economist* (6/25/11) reveals that the consensus anticipates positive growth in almost all major economies this year and next. Only 2 (Greece and Japan) of the 42 countries in their polling are expected to have negative growth in 2011 and only 1 (Greece) in 2012. Our tracking of major investment firms reveals similar optimism. Bank of America Merrill Lynch (*Global Economic Weekly*, 6/24/11), Deutsche Bank (*Global Economic Perspectives*, 6/23/11) and Citigroup (*Global Economic Outlook and Strategy*, 6/22/11) are representative. The lowest estimates of the three are from Citigroup, yet they confidently assert “We continue to expect strong global growth this year, and the next.”

	Global GDP Growth Forecasts	
	<u>2011</u>	<u>2012</u>
Bank of America Merrill Lynch	4.2%	4.9%
Deutsche Bank	3.9	4.4
Citigroup	3.4	3.8

- The *Economist's* consensus forecast for U.S. GDP growth is an increase of 2.6% in 2011 and 3.0% in 2012. Bank of America Merrill Lynch, Deutsche Bank, and Citigroup predict 2.4, 2.6, and 2.5% respectively in 2011 and 3.0, 3.7, and 2.8% respectively in 2012. The U.S. Federal Reserve raised concern on June 23 by cutting its estimates for U.S. growth, yet the official Fed forecast of 2.7-2.9% in 2011 and 3.3-3.7% in 2012 is rosier than the general view. We think these forecasts are reasonable.

The immediate causes of the soft patch suggest it should be temporary. The earthquake/tsunami catastrophe in Japan severely weakened its economy, disrupted supply chains, and curtailed global industrial production. The Japanese economy, however, is recovering quickly and the disaster's impact on global growth will be temporary. A second cause was the "Arab Spring" upheavals, which drove up the price of oil from \$84.32/barrel on February 15 to a high of \$113.52/barrel on May 2. The recent retreat of oil to \$90/barrel, coupled with plunges in the prices of many other commodities, should alleviate inflation pressures and fears.

These immediate causes of the soft patch should cease to be a growth deterrent, but more consequential political/economic problems have been building for 2 years that are now serious obstacles to economic and equity market progress. The sovereign debt dilemma in Europe, the deficit/debt and job creation impasse in the U.S., and the inflation fires in the emerging economies will require key decisions to be made by governments and central banks in the next month. We acknowledge that economic forecasting is difficult enough, but predicting the behavior of policy makers is even more problematic. However, if the policy makers take constructive steps to confront and deal effectively with their crises, and we think they will, the consequence could well be major stock market advances around the world.


- The European Central Bank (ECB), the IMF, and the governments of Greece, Germany, and France have been debating acrimoniously for months over a bailout of Greece, but now the clock is ticking on Greece's urgent July need for funds. The negative possible consequences of a default, highly publicized by the Euro Area media, include a fiscal contagion spreading to other countries, a crisis among European banks, the demise of the euro currency, and a slide into a nasty recession. We do not think that any of the participants are willing to take the risk of being held responsible for a possible "Lehman Brothers" apocalypse.
- U.S. consumers and small-business owners urgently need a renewed confidence in the willingness and ability of Washington to put aside partisan politics, reach

agreement on the deficit/debt ceiling crisis, and adopt policies that will create jobs and grow the economy. Political observers agree that the economy, and in particular the deficit and jobs, will be the key issues in next year's election. Voters want action and may punish incumbents viewed as obstructive. We expect Congress and the White House will feel intensifying pressure to compromise as the August deadline approaches, and we see an opportunity for landmark agreements.

- Rising inflation has plagued the leading emerging economies for over a year, and their governments and central banks have taken increasingly restrictive steps to slow their overheated economies and quell inflation expectations. This has raised fears that China, Brazil, and India would plunge into economic hard landings, and their stock markets have reflected these worries. We think this summer will mark a turning point. We agree with many leading economists and market strategists that in coming months inflation will subside, the policy makers will be credited with piloting soft landings, and emerging market stocks will advance (see our June 30 blog "China Watch Update").

Global stock markets, especially in the U.S. and the leading emerging economies, have considerable strengths. In the U.S., corporate profits and balance sheets are very strong and market valuations are attractive. Inflation and interest rates remain low, Fed policy is accommodative, and politicians at the national and local levels are energetically promoting economic growth initiatives. In addition, alternative investment options of money market funds, bonds and real estate are not appealing. We think these positive conditions will serve as a platform to launch stock prices if the summer's developments are propitious and provide a cushion against downside market risk if they are unfavorable. Our view is that it would take a severe economic downturn, which is very unlikely, to trigger a serious further decline in stock prices.

In recent *Outlooks* we have mistakenly been negative on prospects for the U.S. bond market. We underestimated the extent to which investors would flee to the perceived safety of U.S. Treasury securities as the soft patch intensified and political crises in Europe and the U.S. threatened further economic upheaval. We think bond yields will rise again if (when?) the global economy recovers and focus shifts to the threat of inflation and monster government deficits. As we suggested in our June 9 blog "Bond Market Considerations," investors should evaluate the appropriateness and diversification merits of international bonds.


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