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ECONOMIC OUTLOOK & MARKET FORECAST

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The end is near as reflation kicks in

By Richard Croft

Looking at the long-term chart for the S&P 500 Composite Index (Chart 1), we're tempted to reassert our contention that this particular bear market is finished. The market has plunged as much as it did when the dot-com bubble burst, but it has done so a lot faster. The credit crunch quickly morphed into a consumer-led, balance sheet recession – that's the nastiest kind – with the predictable nasty effect on business earnings, and of course, on earnings projections, which continued to be revised down with boring regularity through the first quarter.

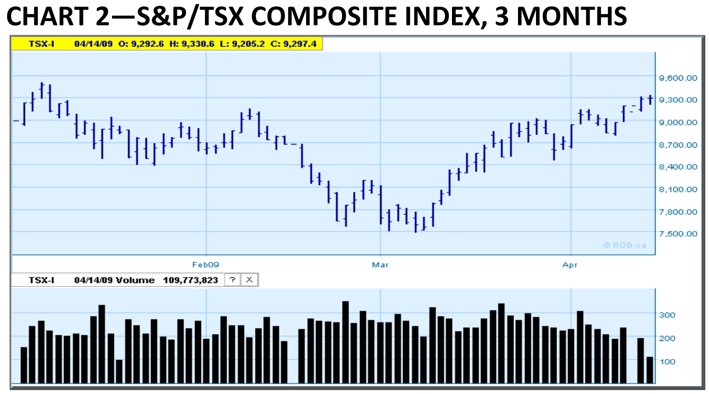
But with markets plumbing new lows in early March (Chart 2), can we say for certain that the worst is now behind us? Truth is, nothing in this business is "for certain." As investors, we work with a balance of probabilities. We read the tea leaves, consult the stars, pore over arcane financial statements and economic data, frame our theses, make our decisions, and then hope for the best. Mostly it works as planned. Sometimes we see the freight train coming, and for a variety of reasons, are unable to do much about it.

Back in early 2007, for example, an inverted US Treasury yield curve was signalling that there would be a recession within a year – a phenomenon that had occurred pretty much without fail since 1970. But which advisor, portfolio manager, or planner would, in March 2007, try to per-

CHART 1—S&P 500 COMPOSITE INDEX, 10 YEARS

Courtesy BigCharts.com

CHART 2—S&P/TSX COMPOSITE INDEX, 3 MONTHS



Courtesy Globeinvestor.com.

suade clients in the midst of one of the great bull markets of history, to put all their money into T-bills? Some tried and failed. Some lost clients as a result of even suggesting such a move, because, of course, it was “different this time.” The “paradigm had shifted,” said the experts. Economic momentum had migrated to the “BRIC” nations (Brazil, Russian, India, and China). The days of American influence on the global economy were at an end.

Trouble is that the BRIC, and most other, nations still relied on the mighty US economy as a market for exports. And through the decade, that market had been voracious, a black hole for mountains of consumer goods. Fuelled by a seductive combination of low interest rates, easy credit, and innovative financial engineering that seemed the spread the inevitable risk far and wide through global markets, the good times seemed permanent.

But things aren’t really ever “different.” The iron laws of economics cannot be ignored for long. Debtors must always settle up with creditors. Always. That settlement, if put off for too long, can be protracted and painful, as we have seen. Trillions of dollars worth of so-called toxic debts are being settled now, through the auspices of governments and central banks everywhere, as the burden of payment shifts inexorably to taxpayers everywhere around the world.

“Things aren’t really ever different. The iron laws of economics cannot be ignored for long.”

And the effects of that retrenchment are being felt most painfully in economies that are least able to cushion its effects. Economies like the BRIC nations, whose domestic growth, as strong as it was, still could not offset their reliance on export – largely to the US – as a major GDP driver.

In Eastern Europe, the situation is particularly grim, with as many as 16 emerging nations teetering on the edge of bankruptcy. That spells big trouble for the entire European financial system, because many of Western Europe’s largest banks are heavily exposed to the East. The International Monetary Fund, the World Bank, as well as two European institutions have already provided billions in loans in an effort to ward off a regional currency crisis. Western European governments have already implemented bailout and relief programs for their banks, similar to US efforts. But still the troubles come.

In Britain, Royal Bank of Scotland Plc reported the biggest financial loss in British history (US$43 billion in 2008), and has been nationalized in all but name by the UK government. In the US, Citigroup Inc. got three new directors on its board, as the US government increased its ownership in the beleaguered bank to 36%. While the so-called stress tests of US banks with more than US$100 billion in assets show that capital is adequate to support losses under a sustained economic downturn this year, but a massive bad debt load will continue to be an obstacle recovery.

The economy

It looks very much as if the recession will grind on through the second and third quarters of this year in both Canada and the US — and, of course in Europe — although output will not shrink at quite the hair-raising rates we saw in the fourth quarter of 2008 and the first quarter of 2009. We should begin to see some early signs of growth in the fourth quarter of this year.

The Canadian economy shrank an annualized 3.4% in the fourth quarter last year, about half the steep 6.3% annualized rate of contraction posted by the US economy. Gross domestic product in the 15-country eurozone shrank at 1.3% annual rate in the fourth quarter.

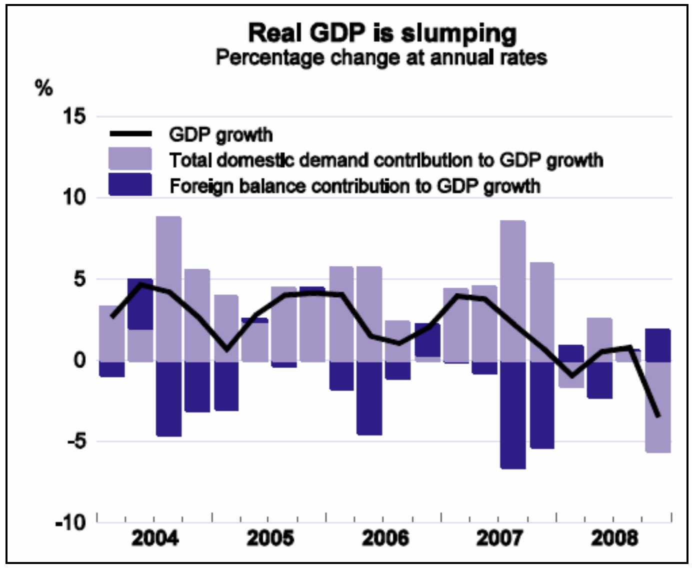
Mounting job losses in both Canada (see Chart 3) and the US continue to darken the economic outlook. In March Canada’s annual unemployment rate reached 8%, a seven-year high and a much higher rate than in past recessions. Canada's job losses are in proportionately in line with the carnage seen in the US, where the unemployment rate rose to 8.5% in March, the highest in 25 years. The speed at which employers are shedding jobs during the recession indicates a much faster response to deteriorating business conditions than in the past, and would suggest that unemployment has become a coincident rather than a lagging economic indicator.

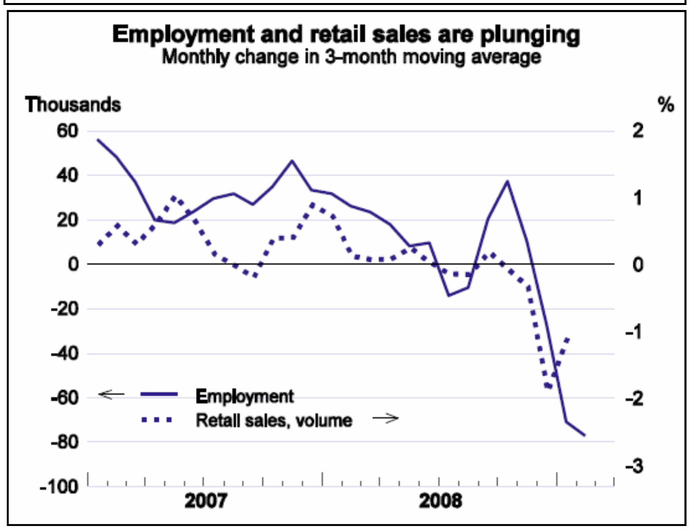
Job losses have been heavily concentrated in construction and manufacturing in both the US and Canada, although unemployment is also beginning to rise in the services sector. High unemployment rates, of course, weigh heavily on consumer spending, taking a heavy toll in retail sales as well as on financial institutions, where mortgage and loan delinquencies continue to rise. And this clouds the picture for GDP growth over the next two quarters.

However, there are some rays of hope in all the gloom, suggesting that the economy may be stabilizing and that we may see a rebound in the fourth quarter. Most significantly, the decline in US manufacturing seemed to moderate in March as the Institute for Supply Management's key manufacturing index rose half a point in March, to 36.3. Any reading below 50 still indicates contraction, but the small increase in March was seen as a slower pace of contraction.

In another hopeful sign, manufacturing production is running well behind final sales, meaning that the mountain of inventory is rapidly being purged to a level barely adequate to meet existing demand. That has factored heavily in falling GDP numbers over the past two quarters. But as inventory drawdown eases and begins to build again through the third and fourth quarter in order to meet growing new orders, we expect to see that feed through to a concomitant stabilization of GDP.

CHART 3—CANADIAN ECONOMIC TRENDS





Courtesy OECD.

Other hopeful signs of, at the very least, a beginning of the end to the recession were the implementation of massive fiscal and monetary stimulus policies in both Canada and the US, rising US exports and a narrowing trade deficit, and surging demand for US commercial paper. This last signal is perhaps most significant of all, because it indicates that the Fed's efforts to lure investors back into this market are meeting with some degree of success.

Our forecast: Given the steep declines in GDP in the first quarter, the road to recovery has gotten just that much steeper, removing the possibility of a strong comeback in the second quarter altogether, and pushing the likelihood of a return to positive growth back to the fourth quarter of this year and into the first three months of 2010. We are therefore revising our annual GDP estimates for 2009 to a range of –2.0% to –2.5% for the US and to –1.5% to –2.0% for Canada.

We believe that the recession has already reached a bottom. However, the path ahead will not be smooth, and rising levels of unemployment will continue to pose great risks to our recovery scenario. The continuing weakness in the bank sector in the US and abroad, and the very real possibility of an unfolding currency crisis in Europe, also contribute considerably to the level of risk in our scenario.

Interest rates and inflation

As if to add weight to these fears, measures of consumer price inflation in both Canada and the US remains almost invisible. In fact the US consumer price index marked a 0.4% annual decline in the March, the first such drop since 1955. Canadian consumer prices rose 1.2% year over year in the month, well below the Bank of Canada's 2% mid-point target.

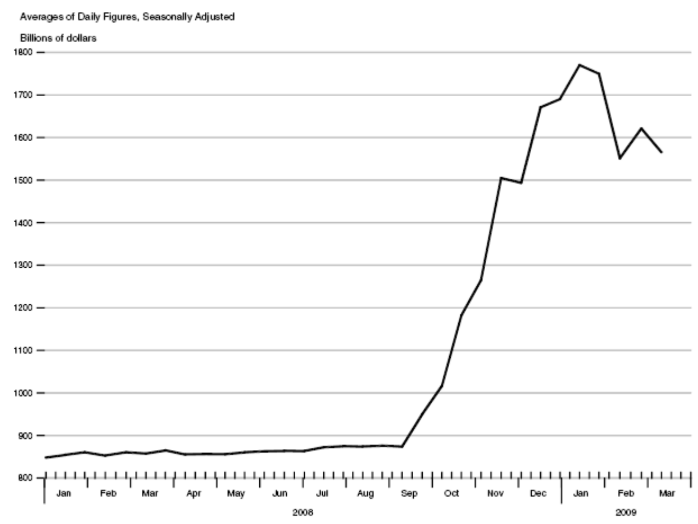
Still, the fear of a resurgence in inflation over the longer term hangs over the market. It's not hard to see where such fears originate. Check out Chart 4, which plots of the growth in the US monetary base – the total money in circulation. The increase since last September has been nothing short of astounding, as the Fed has nearly doubled the size of its balance sheet. The price of gold has followed a coincident uptrend in the same period, climbing 35% from its low around US$740 per ounce back to nearly US$1,000 in February, pulling back to US$922 at the end of March.

Reflationists argue that the only remedy against a deflationary spiral of the kind that plagued Japan through the 1990s is precisely this kind of massive quantitative easing. This argument goes that the economy is likely to perform well below potential for the next couple of years. With growing slack in the economy, as seen in Chart 5, which illustrates the plunge in capacity utilization, the risk of a deflationary spiral rises proportionately.

In normal times, the Fed would cut short-term interest rates to stimulate spending and tighten excess capacity. But the Fed has already cut rates effectively to zero, to no avail. The rate of manufacturing utilization languished at 67.4% in February (Chart 5), the lowest rate since 1948, when the Fed first began keeping records. The US unemployment rate now sits at 8.1% and is rising. And the housing market, where all the trouble began, continues to search for a bottom.

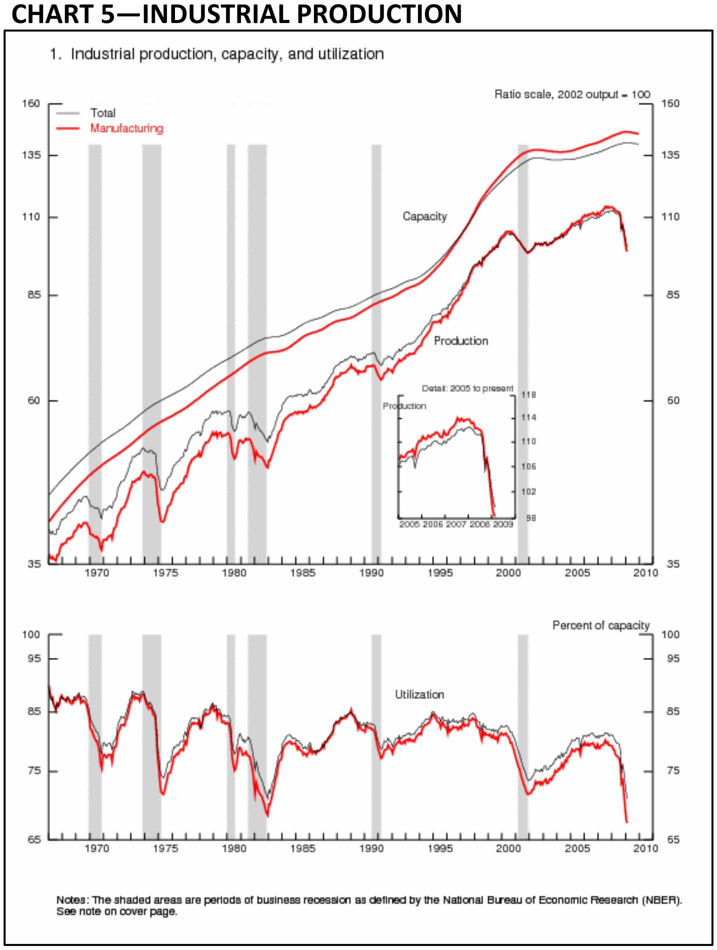
A near-term surge in inflation is therefore highly unlikely, according to this thesis. The key to the riddle lies in credit markets, which while not at the extreme crisis stage of last October, still remain considerably tighter than normal. An indication can be seen in the so-called TED spread, the difference between the 3-month dollar-denominated Libor rate and the 3-month US Treasury bill rate. This rate is often used an indicator of risk – the greater the risk, the higher the premium. As illustrated in the accompanying chart, the TED spread is still around 1%, about twice its average over the past five years or so.

CHART 4—US ADJUSTED MONETARY BASE



Courtesy Federal Reserve Bank of St. Louis

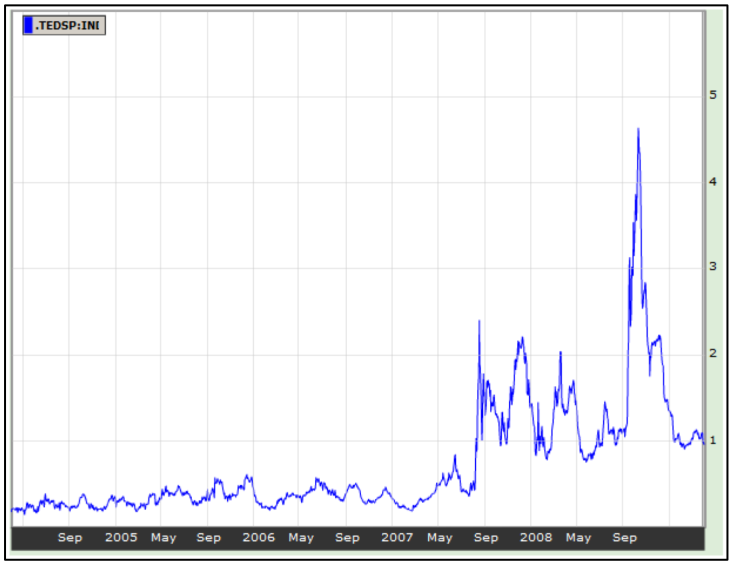
CHART 5—INDUSTRIAL PRODUCTION



Source: US Federal Reserve, Statistical Release March 16, 2009-03-2009

Until the TED spread "normalizes" back to around 0.5% (Chart 6), credit conditions are likely to remain stressed. In Canada, the spread between BBB corporate bonds and the 10-year Canada bond was still about 400 basis points in March. This adds more pressure on the Bank of Canada to implement a program of quantitative easing or credit easing over the next two quarters, involving the purchase of government bonds or liquid corporate bonds respectively. The BoE's stated aim is to keep overnight rates at a maximum 0.5%, implying just such further interventions in the market over the coming months.

CHART 6—TED SPREAD, 5 YEAR



Courtesy Bloomberg LLP

On the fiscal side, governments are madly trying to get credit markets thawed out using the equivalent of a blast furnace. You know it's a blast furnace rather than a space heater when you hear, almost daily, about the "trillions" in this or that guarantee, loan facility, or budget deficit.

US$1 trillion is a lot of money. The number is routinely bandied about everywhere these days and has become a commonplace unit of financial measure (usually on the liability side of the ledger). For most of us, it's an abstraction, and an unfathomable one at that. In the American system of counting, it's the numeral "one" followed by 12 zeros (a thousand billion). In the British system, it's the numeral "one" followed by 18 zeros (a million billion). It's almost impossible to visualize – football stadiums, supertankers, and so on filled with dollar bills, stretching to the moon or wherever. But think of it in terms of another abstraction – time – and you get a really clear picture: one trillion seconds equals 31,546 years!

US$1 trillion is just about equal to the total of the illiquid real-estate and other bad debt assets on US banks' balance sheets that the Obama administration wants to refinance through the Public-Private Investment Program (PPIP).

The PPIP (which was instantly dubbed "Pee-Pip," of course) was announced with much solemnity and brow-furrowing in March by the foot-in-mouth-prone US Treasury Secretary Timothy Geithner, and it sparked a tremendous rally in equity markets around the world, making the great bull-and-bear debate just that much noisier.

The trouble is that the war against rising yields, which is at the heart of the matter, isn't won yet. With government spending ramping up into long-term fiscal deficits and newly created money flooding through the system in an effort to avoid a deflationary collapse, the hazards of excessive inflation have become very real. Past inflationary episodes have provided a convenient way to shrink government and consumer debt loads. Indeed, this sort of monetary mischief has been a tried and true way of shirking real debt by governments through the ages.

Though such an outcome may not be the intention this time around, even Fed Chairman Ben Bernanke admitted that the current bout of monetary easing is unfamiliar and "may raise practical problems of implementation and calibration of their likely economic effects." In other words, "priming the pump" with the equivalent of Niagara Falls may have unintended nasty consequences down the road.

For better or worse, however, that's the road governments in the industrial world have taken. And again, given the deterioration of economic conditions since our last update, and additional pressure on central banks to stabilize monetary conditions and prevent a deflationary spiral, we're adjusting our forecast for inflation and interest rates slightly.

Our forecast: We now believe the Bank of Canada target overnight rate will remain in a range of 0.5% to 0.75%, with a 75% probability of rates staying at the lower end of the range for the year. Canadian consumer price inflation will remain muted in 2009, with an annual rate in a range of between 0.7% and 1.2%, with the balance of probabilities weighing on the side of CPI at the lower end of the range. We also expect the Canadian dollar to trade around US$0.90 by the end of the year.

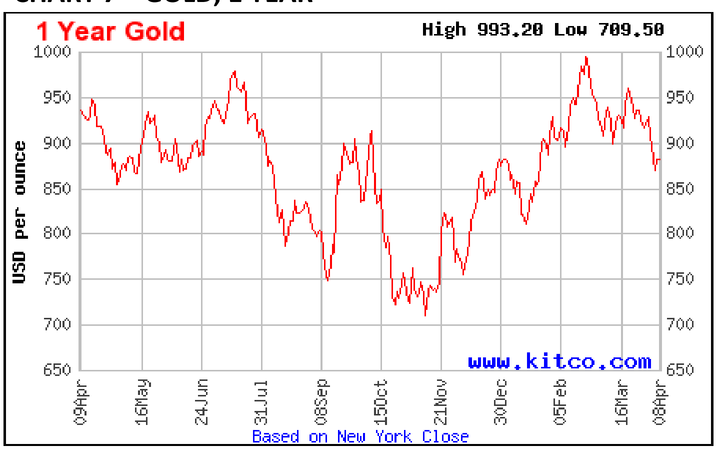
In the US, the inflation story is more critical, with a very real danger of persistent deflation for a few months. However, this will change as the flood of new money enters the system later this year. We believe that US CPI will range between 0% and 0.5% in 2009, unchanged from our previous forecast. But in a slight change from our January projection, we've narrowed our forecast range for the US federal funds rate by 25 basis points and now it to remain between 0% and 0.25% for the remainder of the year.

Gold, oil and other commodities

The price of gold rose to a peak near US$1,000 an ounce in the first quarter (see Chart 7), coinciding with the strength of the US dollar (Chart 8), the slide in equities to new lows, and a general "flight to safety" during the period.

Gold especially has been the subject of surging demand, as skittish investors return to the precious metal's chief characteristic as a reliable store of value. The argument goes that the current round of quantitative easing by the world's central banks, led by the US Fed, will tip the scales from the threat of a debt-deflation spiral to an equally pernicious threat of rapidly rising inflation combined with widespread currency instability as the greenback slides from its long-held reserve-currency status.

CHART 7—GOLD, 1 YEAR



Courtesy Kitco.com

CHART 8—US DOLLAR INDEX, 1 YEAR

Courtesy Bloomberg LLP

However, we believe that any threat of large inflationary price increases is still off more than a year into the future. The recent coincident firming in commodity prices is therefore simply a transitory event, a temporary hot-money flow, driven largely by sentiment, and unlikely to produce a sustained rally. In fact, demand for all commodities remains weak, keeping downward pressure on prices until there are more persuasive signs that central banks' efforts to stimulate economic growth are actually working.

Our forecast: As the threat of a financial crisis eases, the price of gold is likely to soften. We expect that for the rest of the year, gold will be driven more by commodity fundamentals than by its value as a crisis hedge. For the year, then, we'll hold to our original forecast for a price range of US$700 to US$900 per ounce.

The demand for crude oil in the US has plummeted as the recession curbs appetite for gasoline. Not only have automobile sales crashed, but automobile usage has also declined as cost-conscious consumers cut back on extended road trips and switch to commuting for daily travel needs. This is a significant change, and one that affects the entire crude oil supply chain, because one-tenth of all crude oil production goes into US gasoline alone — more than China uses in total. The US

Energy Information Administration says that demand for all petroleum products fell 7.1% in 2008, and that demand will continue to shrink in coming years as higher fuel efficiency standards are implemented and alternatives are sought out.

Our forecast: US crude oil stockpiles are, meanwhile, near their highest point since 1990, with no pick up in demand in sight. As a consequence, we believe crude oil will continue to trade not far from the US$50 per barrel mark for the rest of the year.

Equity markets

As we pointed out at the outset, stock markets rallied strongly in March. Is it truly the beginning of a sustained rally based on a positive turn in fundamental estimates? We saw a similar rally after last November's bottom (see Chart 9), only to fizzle going into the New Year. Or is it a classic bear-market rally – a sentiment-driven head-fake that will burn out as markets resume their final leg down?

We'll stick to our view that it's neither…yet. Markets are displaying the kind of volatility that's characteristic of a major bottom. Remember, this bear trend is now 18 months old in US stocks and about nine months old in Canada. Significant spikes in volume around key support levels now signal an intensive weighing process. Negative economic data seem to have only limited impact to the downside, while even a glimmer of positive news pushes investors into the kind of sentiment-driven bullish behavior we saw last week. And sentiment can turn rapidly.

We say this because bond markets have yet to confirm equity investors' enthusiasms. US corporate bond spreads are about four percentage points above US Treasury issues, and most of the demand for corporate debt is for non-financial issues. Borrowers are still simply bypassing the banking system altogether, which tends to keep spreads from narrowing. US corporate debt is basically pricing in a high risk premium, in keeping with the surging level of global corporate defaults so far this year (47, according to rating agency Standard & Poor's, about three times as many as at the same time last year). This is hardly a rousing confirmation for any sustainability of the March equity advance. Quite the opposite in fact.

CHART 9—S&P/TSX COMPOSITE INDEX, 1-YEAR

Courtesy Yahoo Inc.

That's because the credit markets are still in dire straits. Until the banking mess is cleared up, equity markets aren't going anywhere fast.

The US Federal Reserve believes that disinflation and even deflation continue to be greater risks than inflation at this point. The Fed continues to buy long-term Treasuries and mortgage debt, and announced in March that it would buy up to US$300 billion in government debt in the next six months. The Fed's balance sheet ballooned to US $2.06 trillion in March and is expected to climb to more than US$4 trillion by the end of the year as it continues to basically print money through various lending and purchasing "facilities."

Most companies that trade on stock exchanges are, unfortunately, not printing money, or making it any other big way either. Hence the volatile rallies and retreats we're seeing in the market indexes. And we're likely to see that process grinding along for some time yet, keeping valuations under pressure, even if earnings begin to show signs of life later this year. But that could change very quickly if governments' efforts to reflate the economies of the world show any signs of success later this year.

Canadian investors are sitting on about $1 trillion in cash. Any sign of recovery in

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global demand for commodities, especially energy and metals, is likely to bring a substantial portion of that cash back into Canadian equities. Even a portion of that is a sizable chunk of money and could propel stocks out of this market bottom and into a true bull market.

More short, sharp rallies are not out of the question at this stage, with investors looking for any excuse to exit dicey bond positions and buy back into stocks at bargain prices. The big question is whether stocks are, in fact, bargain-priced. By some estimates, S&P 500 earnings for 2009 are down to around US$64, from about US$113 a year ago. At a recent close of around 757, that gives the S&P 500 a price-earnings multiple of around 12, almost spot on its historical average. So, apparently no bargain there yet.

At a "bargain" multiple of, say, 10, with recent forward estimates, the S&P 500 would have to drop to 640, a further 15% decline from current levels. A recently revised bearish estimate from Goldman Sachs, however, puts forward S&P earnings at US$40, for a p/e multiple of about 19 at current levels – obviously way too high. Adjusting for a "bargain" p/e multiple of 10, Goldman's estimate implies an S&P level of 400, down 47% from recent levels!

We'll never say "never," because that would be tempting fate. But it does seem highly unlikely that we'd see the S&P collapse to 400. It would be a 74% drop from its high in July 2007. And it would probably be the end of the world as we know it.

While we are not prepared to declare the birth of a bull just yet, we are prepared to suggest that a bottom has been set. Which at least establishes a floor with a worst-case scenario.

Our forecast: Historically, stock markets lead the economy by anywhere from six to eight months. Given that we expect the recession to end in the second half of this year and growth to resume in the first quarter of 2010, we still expect the S&P/TSX Composite Index to range between 8,500 and 10,000 this year. Likewise, we believe that the S&P 500 Composite Index will continue to fluctuate between 900 and 1,000. The Dow Jones Industrial Average should also remain range bound, between 8,500 and 10,000 this year.

Our lingering concerns are twofold: 1) Are we likely to retest the March bottom before moving higher? and 2) Barring that, how long are we likely to bounce along the bottom before making serious noise to the upside? Those concerns will haunt us as long as those appalling systemic trillion-dollar risks hang over credit markets.■

ECONOMIC OUTLOOK & FORECAST FOR 2009

Measure	Range	Change since last update
Canadian GDP	–1.5% to –2.0%	Revised down
BoC rate:	0.5% to 0.75%	Revised down
Canadian CPI	0.7% to 1.2%	Revised down
C$	US$0.90	Unchanged
US GDP	–2.0% to –2.5%	Revised down
US fed funds rate	0% to 0.5%	Unchanged
US CPI	0% to 0.5%	Unchanged
Gold	US$700 to $900/oz.	Unchanged
Oil	US$50/bbl.	Revised up
S&P 500 Composite	900 to 1,000	Unchanged
S&P/TSX Composite	8,500 to 10,000	Revised down