Economic Review & Investment Strategy: 2011/II

A JOURNEY AROUND A DYSFUNCTIONAL WORLD

The tsunami/nuclear meltdown in Japan and the unfolding events in the Middle East highlight the physical and emotional devastation that frequently appear on the global stage uninvited and unwelcomed. While the first was triggered by an accident of nature, the uprisings in the Arab world are the outgrowth of human failures. Remedial measures can address the former over a relatively short time span, but unrest in the Arab world likely will continue to unfold with unknown consequences over a much longer period.

Although the tragic developments in Japan will become a notable part of history, their psychological impact may well accelerate the country's decline. For nearly two centuries, until its defeat in World War II, Japan maintained a high profile in Asia as it intimidated or invaded many of its neighbors in an effort to expand its sphere of influence and obtain the natural resources it lacks. Its military defeat in 1945 may have temporarily derailed its prominence, but did not end it. General Douglas McArthur's decision to absolve Emperor Hirohito of war crimes and return him to the country's throne achieved its primary objective of preserving a functioning institutional structure. Aside from not repeating the tragic mistakes of the World War I victors—who imposed punitive reparations on Germany and set the stage for World War II—Japan was further freed of the burden and expense of a military defense system during the most critical period of post-war superpower confrontations. As a result, it was able to focus on rebuilding its economy, aided by deeply protective industrial and trade policies. Because this strategy was designed mainly to counter the threat of a communist incursion, it went largely unchallenged for more than three decades. The outcome manifested itself in a vigorous, disciplined and competitive Japan which quickly transformed its economy into the world's second largest. Nonetheless, these notable achievements did not last long. As excesses developed—including rapid wage increases, an overvalued currency, and unsound, barely rational investments—the underlying fundamentals began to crumble, inviting deflation, sluggish growth and fiscal rot. Initially in denial, then further corroded by two decades of policy failures, the country seems to have run out of remedies to revive growth.

As the point of impact of the recent disaster begins to fade, it is quite likely that the Japanese public will find itself discouraged and frustrated as it contends with an economy relegated to anemic growth and burdened by the escalating cost of supporting a rapidly aging population, fiscal distress, shrinking personal savings, and frequent changes in government. These shortcomings may take on an ominous hue psychologically as the economy continues to slide in global rankings, giving way to other countries that are blessed by more vigorous attributes.

Moving to the Middle East, the applause in support of the widespread uprisings is almost deafening. As demonstrators succeed in dismantling the existing institutional structure of one country after another, they appear to offer no viable alternatives other than lofty words and quixotic aspirations. While the search for "democracy" is admirable, it is not likely to forge quickly the basic changes that would eliminate centuries of backsliding, sociopolitical upheaval, and corrupt governance.

Perhaps the central cause for such failure is the rigid definition of "democracy" that the West seeks to sell. Democracy comes in many flavors and colors. It is not a customized, prepackaged sociopolitical order that can be conveniently acquired, installed and practiced in a manner we associate with Western governance. The most stable and lasting variety has deep historical roots, and evolves within a nation's culture and social institutions. It can rarely be copied efficiently or imposed successfully, and it tends to be viewed with suspicion and hostility if imported from an alien culture. As a form of government, it requires suitable institutions to make it work and succeed, and it must gain the trust and acceptance of citizens to evolve in an enlightened direction. Both Singapore and Sweden are democracies in their governance even though the former favors the authoritarian variety that demands discipline and self-reliance, while the latter is more permissive in its approach and supports a generous social welfare structure.

To a member of a tribe in central Africa, the concept of Western democracy would appear as a social exercise meant to damage an eternity of family ties and to compromise tribal discipline and devotion. Even some of the most advanced of the developing nations view Western-style democracy as a form of government too ambiguous to provide the needed discipline that fosters social progress. This lack of differentiation has frequently impeded the efforts of the United States and other countries to export their brands of democratic ideals to areas not yet prepared to adopt the necessary changes.

In addition to extensive political and institutional restructuring, the Arab countries of the Middle East must also deal with a lack of public trust in their political systems. Unemployment is arguably the most urgent problem, particularly since the real jobless rate perhaps exceeds 30%, on average. With each country's wealth narrowly controlled by few influential families imbued with political connections, fear of social upheaval nearly always drives the affluent to shun domestic investments and instead shelter assets elsewhere, thus depriving their country of related economic benefits. In the absence of a long prelude of political stability, it would be difficult to imagine any meaningful repatriation of wealth that would rapidly create an industrial base and generate substantial employment. As a result, current euphoria will soon fade and frustration and disappointment will likely return quickly to undermine whatever new social order emerges as it becomes evident that hope may have far exceeded reality.

A further impediment to social progress in the Arab world is a pervasive unwillingness to keep church and state separate in public affairs. Because Islam is a religion deemed by its adherents to be all-encompassing, it will continue to play a pivotal role even in countries that shun strict religious orthodoxy. While tyranny in pursuit of political ends has long been discredited in modern governance, it is often overlooked or granted absolution if it claims to be committed to the defense of the faith. This convenient distinction makes it difficult for secular governments to mount organized campaigns to counter religious extremism. Hence, despite claims to the contrary, many political movements with strong religious overtones, such as the Muslim Brotherhood in Egypt, will continue to cultivate their influence and gain political traction.

Meanwhile, Europe is almost overwhelmed by a set of problems that defy easy solutions. Several members of the Eurozone are battling fiscal distress that can only be alleviated by drastic measures that would adversely impact both the givers and receivers. Most of the sinners in this drama appear beyond redemption unless they either renege on some of their obligations or exit the system. In either case, Europe's economy will face timid growth for an extended period. With the fiscally-strapped countries uncompetitive, particularly in a race against low-wage developing economies, the only possible remedy is a severe scaling down of the standard of living of those unwilling to accept extreme sacrifices. Therefore, it is doubtful that the givers (including many financial institutions) will tolerate repeated punishments with each succeeding crisis. At a minimum, either the European Union (with 27 members) or the Eurozone (with 17 members) will succumb to extensive restructuring that may require greater integration and flexibility. Until then, instability in the financial system will persist as most of the countries in distress (such as Greece, Portugal and Ireland) find themselves losing ground to other players, notably those that do not suffer from the rigid and expansive social welfare systems that plague the European continent.

Surveying the economic and political landscape of the world at large, one is almost compelled to conclude that, despite its myriad problems, the United States emerges as an island of relative tranquility that justifies a bit of a premium in the investment arena.

THE U.S. ECONOMY: WHERE ROSES BLOOM

Until the tragic events in Japan caused a very brief detour, the U.S. economy and stock market were scaling heights largely justified by unfolding fundamentals. Growth was accelerating at an unthreatening pace, business profits were rising at a solid clip supported by continued gains in productivity, personal consumption was in a revival mode as confidence improved, and exports were benefitting from firm global demand. In all, a smooth transition from recovery to expansion was on course despite a few remaining impediments, such as the absence of a sustained rebound in housing and a slow upturn in employment. Fortunately, the momentum noted above has not sustained any lasting damage as the market's rapid rally from a brief correction is confirming.

The magnitude of human tragedy in Japan aside, our calculations lead us to estimate a modest but temporary negative impact on global growth, perhaps in a range of 0.2% - 0.4%, with a timeline confined to the short-term. This will be mostly the consequence of disruptions in supply chains, as well as currency volatility triggered by Japan's efforts to raise its domestic liquidity through the sale of sovereign holdings and the repatriation of the related proceeds. This last exercise has already lifted the value of the Yen to record levels which is likely to restrain the country's exports and further penalize its economic growth.

For the United States, Japan's distress should not derail the ongoing expansion due to the latter's rapidly shrinking share of the global economy, recently calculated by the International Monetary Fund at 8.7%, down sharply from 17.8% in 1994. Nonetheless, pressure to rebuild the devastated region should generate a wide range of activities, including the importation of equipment and building materials. Looking beyond reconstruction, it would be logical to anticipate that Japan may opt to further diversify its industrial investments by establishing manufacturing facilities in countries with relative political tranquility and limited exposure to the whims of nature. Hence, the recent appreciation in the Yen, particularly relative to the dollar, may intensify Japan's industrial footprint in the U.S.

On the domestic front, the economy appears to be on course to generate moderate but respectable growth. While consumption has revived, it still lacks the notable dynamism of prior expansions as the gains in personal income remain timid while individuals continue to rebuild their finances. The most notable source of incremental demand is to be found in spending on plant and equipment which is being driven by an intense focus on productivity, the effective use of abundant corporate liquidity, rising exports, and the impact of rapid technological obsolescence.

Even without comparing the lifespan of the current recovery cycle to those of the 1980s and 1990s (each lasting about 9 years), the ongoing upturn remains youthful. A potential revival in housing and further gains in employment, when they unfold, will no doubt give added impetus to the current expansion. As it is, the employment train appears to be gaining speed, with jobless claims having already declined to its 10-year average of less than 400,000. In addition, the number of temporary workers and overtime hours worked are signaling a sustainable uptrend.

In small, cautious acknowledgements, the Fed is providing confirmation of the economic revival, possibly hinting that its controversial QE2 intervention may not be extended beyond its scheduled expiration next June. However, given the central bank's seeming complacency on inflation, even in the face of sharp increases in the prices of industrial and agricultural commodities, there are reasons to be concerned that monetary policy may be allowed to lag behind the curve. The Fed's seeming reluctance to reverse course may reflect unease that tampering with a fragile expansion still burdened by a number of imbalances, including elevated unemployment, an unresponsive housing market and unbridled deficits, would compromise its sustainability.

The Fed's relatively relaxed monetary policy may be only one reason for the recent decline in the dollar. As other central banks, such as China's and India's, move decisively in the direction of restraint, and the European Central Bank hints at some tightening perhaps as early as April 7, the greenback is positioned at a disadvantage. Reduced dollar purchases by China and a hint of some liquidation by Japan to finance the recovery from the recent disaster may also keep the dollar in the penalty box a while longer.

In summary, we are of the opinion that in 2011: (1) the U.S. economy will continue to expand at least in line with its long-term trendline; (2) events in Japan will have a limited adverse impact on both domestic and global growth; (3) inflationary pressures will intensify but not enough to derail the ongoing expansion; (4) the Fed is likely to be the last of the major central banks to move toward restraint; (5) business profits will continue to increase at least in line with revenue gains in the short-term, although we expect margins to peak by early 2012; (6) having recently come under pressure as many central banks tightened and Japan began to liquidate some of its holdings of U.S. Treasury obligations, the dollar may recoup some of its recent losses when such interventions abate; (7) supported by strong corporate fundamentals, U.S. stock indices should be in a position to make a run at the highs attained in 2007 for another double-digit gain from current levels; and (8) given the apparent revival in inflation, the fixed income sector will likely trail equities in performance.

INVESTMENT STRATEGY: UNCERTAINTY AT A DISCOUNT

In the past few weeks stock markets around the world have had to contend with intense fiscal and monetary pressures in the Eurozone, natural disaster and its aftermath in Japan, and pervasive political instability in many Middle Eastern and North African countries. While the implications of these events are still unfolding, investors' response has been essentially muted, with declines in the indices consistent with normal corrections during a secular advance. The key reason for such equanimity rests with a global economy that appears to be cranking out solid growth, still estimated to exceed 4%. We view this pace as sustainable for an extended period, aided by a robust capital spending cycle and the determined entry into middle class of many consumers in developing countries.

While many of the global markets provide profitable opportunities, we believe U.S. stocks represent the cheapest major asset class, risk considered. Our optimism flows from a number of fundamental considerations, notably strong corporate balance sheets with abundant liquidity, managements' continued focus on productivity, superior profit margins, revived exports, widespread benefits that flow from new technologies and the reinvention of old ones, and valuations that remain unthreatening even without discounting future growth. To these tangible attributes must be added some that may be hard to measure, including relative sociopolitical stability, and resiliency in dealing with urgent issues, as was the case during the financial crisis of recent years.

The optimism expressed above is not intended to ignore many delicate problems, although their risk and urgency may ease if economic growth persists or accelerates and Washington is brave enough to take advantage of such respite to address urgent fiscal problems.

A number of considerations are likely to influence the intermediate-term prospects of the economy and the stock market. At the top of the list is monetary policy which appears to be headed toward restraint despite the Fed's desire to keep interest rates and liquidity quite friendly. Given recent price trends in many commodities, with oil the most advertised, the monetary monks would be remiss if they continued to insist that inflation is not rapidly becoming a source of concern. At this juncture, a hint at forthcoming discipline is likely to be greeted with favor by investors, particularly since the yield on U.S. Treasury debt has already delivered a similar message.

Second, Washington has apparently pushed any effort to tackle the country's fiscal stress to some undefined future. Deficits are best addressed during periods of economic expansion when the pain of remediation can be more easily tolerated. With projections indicating no fiscal relief even in the outer years, current policy of benign neglect would cast a dark shadow on the current expansion and heighten the risks when growth begins to wane.

Third, there are early signs that some domestic companies that had long shunned establishing new manufacturing facilities in the U.S. may now be reconsidering their position due to an improved relative cost structure. A better-defined strategy to encourage such repatriation appears to be both desirable and timely. If such approach gains traction, it would provide benefits on many fronts, including additional employment, tax revenues and a reduction in trade deficits.

As the expansion phase of the current cycle continues to unfold, we expect the manufacturing sector to show the greatest improvement, giving durable goods further momentum and keeping producers of industrial commodities in a favorable position. While the energy sector will remain in the spotlight due to geopolitical uncertainty, we note that profit gains generated substantially or entirely from price increases are greatly discounted in the group's valuation mechanism. Hence, forecasts of sharply higher oil quotes do not guarantee a commensurate performance by the sector's shares.

Financials have remained laggard so far this year, in part because the housing market continues to be mired in its own depression; this is in addition to concern over residual charges from the restructuring of the past three years. While it is difficult to time the sector's revival, we deem the potential rewards to far exceed risks for investors with the requisite patience.

We believe caution is justified in the consumer staples arena as many of the companies must contend with rising commodity prices and higher distribution costs. Although retailers may not be as negatively impacted, the exporting countries that manufacture and supply goods to such outlets must deal with increased costs which they need to pass through to consumers.

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Vice Chairman

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ECONOMIC FORECAST
(AS OF APRIL 1, 2011)

	2009	Preliminary 2010	Estimated 2011	Projected 2012
Real GDP (Y-O-Y)	(2.6%)	2.8%	3.2%	3.7%
Real Consumption Expenditures	(1.2%)	1.8%	3.0%	3.2%
Business Fixed Investment	(17.1%)	5.6%	8.0%	7.8%
Inventory Investment (Billions)	($113.1)	$60.4	$50.0	$35.0
Residential Investment (Billions)	$342.7	$332.4	$332.0	$381.0
Government Spending* (Billions) (a)	$2,546.4	$2,575.0	$2,610.0	$2,650.0
Trade Balance-Goods & Services (Mil.)	($363.0)	($421.9)	($455.0)	($460.0)
Federal Budget*: Unified (Billions)	($1,413.8)	($1,294.2)	($1,450.0)	($1,335.0)
Gross Federal Debt* (Billions)	$11,910	$13,167	$14,620	$15,950
Consumption Price Deflator	(0.3%)	1.7%	2.4%	2.6%
Producer Price Index (Finished Goods)	(2.60%)	4.30%	5.80%	4.20%
Consumer Price Index	(0.3%)	1.6%	3.2%	3.1%
Industrial Production	(9.3%)	5.7%	4.8%	4.6%
Real Disposable Income	0.6%	1.3%	2.5%	3.1%
Hourly Compensation	2.0%	2.3%	2.6%	3.0%
Unit Labor Costs (Non-Farm)	(1.6%)	(1.5%)	0.6%	1.2%
Productivity Growth (% Change)	3.00%	3.20%	2.00%	1.00%
Personal Savings Rate (% DPI)	5.9%	5.8%	5.6%	5.3%
Capacity Utilization – Total Industry	70.0%	74.2%	77.5%	79.0%
Trade Weighted $ Exchange Rate (b)	4.7%	(3.0%)	(6.0%)	(2.1%)
Vehicle Sales (Million Units)	10.3	11.5	12.5	13.0
Housing Starts (Million Units)	0.554	0.585	0.592	0.750
Civilian Employment (Millions)	139.9	139.1	141.5	143.7
Civilian Unemployment Rate	9.3%	9.6%	8.7%	8.2%
Corporate Profits – After Tax – NIPA	3.60%	31.9%	16.5%	11.0%
S&P-500 Earnings-Operating	$65.50	$86.02	$95.00	$101.00
S&P-500 Dividends	$24.20	$24.50	$26.25	$28.00
90 Day U.S. Treasuries-Yield (%)	0.01-0.32	0.03-0.18	0.25-1.00	1.00-2.50
10-Year U.S. Treasuries-Yield (%)	2.20-3.95	2.39-3.99	3.15-5.00	3.75-5.50

**Fiscal Year-end 9/30. (a) Federal, State, and Local; in 2005 dollars; (b) Fed Major Currency Exchange Rate.*