

Scout Investments

Economic and Market Outlook

Changes

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2011 Outlook

GDP GROWTH:
2.6% - 2.9%

UNEMPLOYMENT:
9.0%

INFLATION:
1.75%

FED FUNDS RATE:
0.35%

Gross Domestic Product (GDP) rates of change have slowed. Economic growth has been anemic since 2007. During the last four years, GDP growth has averaged 0.5 percent per year! This compares unfavorably to the long-term secular average growth of the U.S. economy since the end of WWII of 3.3 percent. This growth rate is net of inflation. Due to many factors, GDP growth has been decelerating worldwide.

We are lowering our growth forecast for the U.S. economy. At the beginning of the year, we were forecasting a wide range of growth of 2.9-to-3.5 percent and entitled our outlook for 2011 "Return to Trend." Last month, we narrowed that range to 2.9-to-3.2 percent, following the release of significant sentiment data during the last 60 days and a disappointing Q1 GDP growth rate of 1.8 percent. We are now lowering the range once again. For the year, we expect GDP growth to register in the range of 2.6-to-2.9 percent. We are effectively lowering our expected GDP growth range by 0.3 percent.

In addition, we are reducing our assumption of housing starts for all of 2011. We are also lowering our outlook for consumption expenditure by 0.3 percent, and shaving our outlook for long-term interest rates. It is important to understand that the lowering of expected growth is not necessarily, and solely, a U.S. issue. Rather, we are witnessing lowering of growth expectations on a global scale, from the U.S. to Europe and to the developing areas of Asia.

The Changed Outlook

Many factors have been released during the last few months which have led us to the outlook that the U.S. economy may not grow in excess of 3.0 percent (as measured by real GDP growth) during 2011. The factors that have led us to this outlook include:

- First quarter GDP (unrevised) was reported at a growth rate of 1.8 percent (prior to adjustments). For the U.S. economy to grow by 3.1 percent for all of 2011, the economy will need to grow by an average of 3.49 percent per quarter for the remaining three quarters of the year. We find this highly improbable, given momentum and historical precedent.
- Housing prices and housing starts are not gaining traction as per our earlier forecast. Recent Case-Shiller data, along with fresh housing start information, support this changed view.
- While we are encouraged by the recent employment report, business and consumer sentiment continue to indicate a lackluster growth profile, particularly in the area of discretionary consumer expenditure. Consumers continue to be able to “transact” but appear to be unwilling to do so.
- We expect strong gains in productivity to soften, which is typically the case two years into an economic cycle.
- If we are correct that the economy continues to grow at a “sub-three percent” range, gains in the employment picture may be forthcoming, but will be hard-fought.
- The reduction in economic growth momentum which has occurred in the U.S. is not a country-specific issue. We are noticing similar trends on a worldwide scale, where economic momentum is slowing in many areas of Europe and Asia. From a domestic standpoint, if maintained, this slowing in foreign economic momentum will eventually negatively impact export growth rates.

Details of the Changed Outlook – GDP Macro Factors

The U.S. economy just passed the seventh quarter of economic growth since the end of the Great Recession of 2008 – 2009. From a GDP production standpoint, the economy formally left the “recovery” phase and entered the “expansion” phase last year – where the actual production of the economy is higher than the old high – which was registered during the second quarter of 2008.

From a historical standpoint, a number of developments tend to occur when the economy has entered the “expansion” phase and left the “recovery” phase. First, productivity gains tend to weaken. Secondly, employment gains tend to accelerate. On average, productivity gains explode upward during the first quarter that a recession is ending. NOTE: the average for recoveries since the end of WWII has been gains in excess of eight percent! Normally, GDP tends to increase between 7.0-to-8.0 percent during the first quarter of recovery following the end of recessions (this recovery has not been normal). Employment gains are not normally witnessed until the second quarter of an economic recovery, and continue well into the expansion phase of the economic cycle.

At the same time, productivity gains tend to weaken as the economic cycle becomes more mature. This makes intuitive sense for a number of reasons. Additionally, GDP growth tends to be explosive at the start of a recovery – and eventually winds down as the economy enters expansion. Indeed, if we look at all of the postwar business cycles, the eighth to the 10th quarter of the average business cycle shows GDP gains have averaged in the 3.0 percent range. For U.S. GDP growth to register 3.1 percent for the entire year, the economy will need to grow by at least 3.4 percent quarterly for the next three quarters. Given the lackluster nature of the business cycle to date, we find the probability of the economy accelerating to the 3.5 percent growth rate to be unusual.

Housing

During the month of March, housing starts reported an annual rate of 549,000, up 7.0 percent from February but 13.0 percent below the housing starts of March 2010. We have been forecasting that housing starts for the entire year would be in the 660,000 range. We are lowering that estimate to the 600,000 range. Home prices, inventories of unsold new and existing homes, and stickiness in the unemployment rate have led us to the conclusion that housing starts will probably not gain real traction for the majority of this year. The reduction in expected housing starts lowers our GDP forecast by roughly 0.2 percent.

Home prices are starting to fall again. According to the FHFA Index, home prices fell by 1.0 percent in both December 2010 and January 2011. Since then, the declines in the FHFA index have accelerated to a decline of 1.6 percent month-to-month. Due to historical lags, this suggests data from the Case-Shiller Index will start to indicate accelerating declines as we head into the summer months. Affordability is good. However, many Americans are now asking themselves why own a home? Jim Moffett, chief international strategist at Scout Investments, has said in the past “when a bubble busts, it tends to stay burst.” For those who have been looking for a quick turnaround in housing values, the wait may be longer than some had anticipated

Sentiment – Consumers and Small Businesses Unwilling to Transact

At the beginning of this year, we stated that our outlook focused on consumers’ (and businesses’) *ability and willingness to transact*. One without the other does not create an increase in final demand. Since the end of the year, we have seen personal income levels increasing at a 4.0 percent rate – which is reasonably good. So consumers are gaining the *ability* to increase consumption. At the same time, we have been monitoring the monthly Thomson Reuters/University of Michigan Consumer Sentiment Index. This index is the result of survey data which basically asks how consumers feel about the economic environment. Normally, this index registers in the 80-to-95 range during times when consumers are comfortable with the economy. As of the end of April, the index is at 69.8. The index has not been above 78 since before the onset of the Great Recession of 2008-2009. Consequently, it appears that while consumers have the *ability* to transact and create an upward move in final demand, they do not currently have the *willingness* to do so.

It appears the same sentiment exists in the nation’s small business community. The National Federation of Independent Business: Small-Business Optimism Index is released monthly. The latest report was released May 11 and indicated a decline of 0.7 points from the previous month. The index is currently registering at 91.2. Historically, a reading of 100.0 indicates small businesses are “neutral” towards the overall economic environment. Of course, small businesses represent a major supplier of job opportunities within the economy. One has to wonder about sustainable gains in the employment picture with small-business sentiment at low levels.

Looking Abroad

The recent slowdown in growth is not limited to the U.S. The slowdown in growth, which can be tied to rising oil and gasoline prices and other factors, is having an impact on the world’s overall economic environment. The following is information regarding six major economic areas, representing 74.0 percent of the world’s economic power.

	Latest Quarter GDP	Last 12 Months GDP	% of Worldwide GDP
Japan	-1.3%	+2.2%	9%
United States	+1.8%	+2.3%	23%
China	+8.7%	+9.7%	9%
Britain	+0.5%	+1.8%	4%
Euro Area	+1.2%	+2.0%	26%
Brazil	+3.0%	+5.0%	3%
Weighted Average:	+1.99%	+3.17%	74%

As can be seen, the world's major economic geographic areas have witnessed a growth slowdown – on average by 1.2 percent. The U.S. has experienced a slowdown of 0.5 percent, while Britain, Brazil and Japan have all experienced a slowdown of more than 1.0 percent. So, the impact of higher commodity prices, and the concern regarding governmental deficit spending, etc., is not being solely reflected within the U.S.

In addition to the above, rising commodity prices translating to higher consumer prices are on many minds. This is not simply a U.S. issue. Indeed, inflation has been rising, not only in our economy, but also on a worldwide basis. So far, the increases have been rather slight, but they are broad-based in geographic dispersion.

	Prices – Latest	Prices – Year Ago
Japan	0.0%	-1.1%
United States	+2.7%	+2.3%
China	+5.4%	+2.4%
Britain	+4.0%	+3.4%
Euro Area	+2.8%	+1.6%
Brazil	+6.3%	+5.2%
Weighted Average	+2.95%	+1.83%

On a broad-based level, inflation has been rising. The area most negatively impacted by rising prices appears to be China, with inflation currently running at 5.4 percent on an annualized basis – up from 2.4 percent during the previous 12 months. Inflation has more than doubled in China – no wonder the Chinese authorities are attempting to cool the growth rate in their economy. Inflation is becoming a real issue.

If one gets a “whiff” of stagflation – it is no wonder – given this information.

Final Word

In addition to the above, we are questioning our view that 10-year Treasury yields will rise to the “above 4.0 percent” camp by the end of 2011. We believe that while inflation is pressing – slowly – to the upside, there is a tremendous amount of slack in economic capacity such that not only will inflation remain reasonably subdued – but also demand for capital will be reasonably low (at least from the private sector). Consequently, we believe interest rate gains won't be as dramatic as we originally thought.

Now – about the end of QE2 and the Federal budget deficit...



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