

## The Long, Hard Slog Continues

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### 2011 Outlook

**GDP GROWTH:**  
2.5%

**UNEMPLOYMENT:**  
9.0%

**INFLATION:**  
1.75%

**FED FUNDS RATE:**  
0.35%

Last week was a big week. We have been projecting concern over the last couple of months regarding our economic and financial markets outlook. The tone and momentum of many announcements during the last couple of months have not, on balance, been particularly robust. The data, which was released last week, confirms, in our view, that at the least the economy has hit a soft patch, and at worst, a return to the “Long, Hard Slog” theme, which we believe has been operative since the fourth quarter of 2007.

### Weekly Data

Last month, we highlighted seven rather positive items that we need to keep in mind when thinking of shorter-term economic momentum. We also highlighted 12 items which give us pause regarding Gross Domestic Product (GDP) growth. We stated that at the end of the day, the summer months may be a little “hotter” for the world’s investors than has been the case during the last couple of years. The data released last week further bolsters our view that economic momentum and domestic corporate profit growth rates are currently under question.

There was meaningful domestic economic data released last week and comments, including:

#### Housing

- The Case-Schiller Index was released, which showed that housing values, on average, declined by 1.9 percent during the first quarter of 2011. Additionally, the report stated the year-to-year change was -4.9 percent. This information fueled concern that the U.S. has entered a “double-dip” decline in housing values, which if true, could have a negative effect on consumption final demand. When home values decline, they feel less wealthy, and tend to consume less, leading towards economic weakness.

#### The Institute for Supply Management (ISM) Index

- ISM is a survey of new orders, production and employment drawn from purchasing managers who work at our nation’s industrial concerns. For the month of May, the index lost 6.9 points – which represented the worst one-month decline since 1984. The manufacturing side of our economy has been one area of reasonable strength. This report threw the maintenance of this strength into question.

### Consumer Confidence

- The release was weak, at 60.8, down 5.2 points for the month of May. The recent data from the University of Michigan survey backs this report's conclusions – the U.S. consumer is going through a period of nervousness.

### Chain Store Sales

- Retail chain store sales index was up 0.4 percent, on the heels of data released by Target Corp. that same-store sales have recently been at the low-end of expectations.

### Employment

- Finally, the employment report from the Bureau of Labor Statistics (BLS) showed lack of strength. The data from the ADP report showed the employment report may be weaker than expected. Most analysts lowered their expectations for the BLS report – but most did not lower their expectations enough. The economy created 54,000 jobs during the month of May. The average outlook was for 130,000 jobs, down from earlier expectations of more than 200,000 jobs. In addition, the last two months job reports were revised downward by a total of 66,000 jobs. Taking the actual number in relation to expectations this time two weeks ago, and then factoring in the downward revisions, indicates the economy “created” 212,000 fewer jobs than were originally thought just two weeks ago. This represents a huge miss.

## Our Response

In response to these disappointments, the stock market declined by 2.1 percent in value last week (as of this writing) – as measured by the Standard and Poor's 500 Index. GDP growth rate estimates have been under assault. On May 13, we lowered our outlook for GDP expansion from 3.0 percent to 2.75 percent for the entire year of 2011. **Due to the factors mentioned above, and other issues, we are now lowering our outlook for the entire year from 2.75 percent GDP growth to 2.5 percent. Currently, the “average” expectation for GDP growth by our nations’ economists is 2.9 percent. We believe that expectation will be contracting during the next few weeks.**

Let's count the numbers. The nation's economy grew by 1.8 percent during the first quarter. According to MacroAdvisers, the economy is tracking a growth profile of 2.6 percent during the second quarter. For the economy to grow by 3.0 percent for the entire year, the last two quarters will need to show growth of 3.8 percent. Given the current momentum and lack of stimulus on the horizon, we see little chance that type of uptick in economic activity will occur. For the economy to grow by 2.75 percent, the economy will need to grow by 3.3 percent, on average, during the last half of 2011. We see the likelihood of that occurring to be somewhat slim, at this stage.

Since the end of WWII, the U.S. economy has averaged 3.2 percent real GDP growth per year (on average, including good and bad years). The economy grew by 2.8 percent last year. If our analysis is reasonable, the economy has been, and continues to grow at a sub-standard pace. **This gives us further confidence that our long-held “Long, Hard Slog” theme is still intact. We expect that slower-than-normal growth, combined with higher-than-normal unemployment will continue to plague the economy. This trend may continue, on balance, for a number of years going forward.**

## Capital Markets Reaction

Late January, we wrote that it appeared short-term risks were rising within the nation's financial markets. Again in mid-March, we reiterated our view that a correction in stock prices may be due. Additionally, in late April, we wrote on the “Sell in May and Go Away” concept. If nothing else, we have been consistent. By the way, since mid-March, stock prices are now down slightly (as measured by the S&P 500 Index).

We suspect the stock market has been, one by one, losing its props supporting higher values.

- QE2 – going away
- GDP acceleration – waning
- Employment gains – questionable

- China industrial demand – seems to be slowing (witness weakness in the ISM survey)

A number of short-term props which have been standing behind higher equity valuations appear to be weakening. At the same time, rising concerns over the world's "balance sheet" worries have not yet been solved. Greece and other areas of Europe are in question as to how that mess will ultimately be handled. How will Japan fund the rebuilding of its nation's needs? And lastly, how will we in the U.S. take care of our own fiscal mess?

### Final Word

We believe it makes fundamental sense, at least over a short horizon, to lower portfolio economic sensitivity and risks.



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