

Scout Investments

Global Economic and Market Outlook

2nd Half – 2011

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%

Overview

Historically, as many of our readers are aware, the focus of these pieces from Scout Investments has resided in the U.S. We have long written on our outlook for the U.S. economy and markets, and will continue to do so. We launched our formal Global Equity product in the fourth quarter of 2008 (good timing!). Since then, we have focused not only on the U.S. outlook but also on leveraging our considerable expertise in the foreign markets to the advantage of our Global product. With this in mind, this piece represents our first Global Economic and Market Outlook.

As has historically been the case from a domestic standpoint, our Global Economic and Market Outlook discipline will consider:

- Projected GDP growth on a regional basis
- Projected inflationary pressures
- Central banking activities and potential ramifications of those activities
- Expected corporate profit momentum and sustainability
- Relative equity market valuation
- Regional political stability

It is in this spirit this piece is offered. Please find below bullet points, summarizing our view of the economic and market drivers we expect to unfold as we wind through the second half of 2011, and head into 2012.

Executive Summary

- We expect macro-economic growth rates (worldwide Gross Domestic Product (GDP)) to remain in a repressed state – as they have been for the better part of the last three years. Elements of increased final demand are lacking, as the major western economies continue their attempt to adjust to a slower economic growth profile. This profile is representative of the “Long, Hard Slog” which we have been writing about since the fourth quarter of 2007, as the western over-levered world struggles in the post-financial crisis era.

- We expect worldwide GDP growth to average in the 2.8-to-3.1 percent range for the second half of 2011, an uptick from growth witnessed during the first of the year. The “soft-patch” which the world’s economy has been experiencing is, on the margin, transitory. However, as stated above, we firmly hold the view that the world’s economy has been going through a period of significant adjustment, driven by demographics and productivity gains which definitely favor the developing world as compared to the developed world.
- Inflation should be lacking, but persistent. Due to weak levels of increased final demand, we see little on the horizon, from a cost-push or demand-pull basis that will fuel sustainable increases in pricing levels. Base monetary inflation is another issue that may start to “bite” major economies in the future.
- Capital resource allocation should continue to favor areas of the world where sustainable growth and lower inflation are the rule of the day, and not a passing fancy. We see growth in the U.S. as being key to the worldwide growth profile, as the U.S. represents 23.0 percent of worldwide GDP. Following a very weak first half, we believe U.S. GDP growth will accelerate as the second half of 2011 unfolds. That being said, we fully expect second half growth to remain “sub-par” as high levels of unemployment will continue to contribute to slow growth in consumption and final demand increases. Inflation should remain subdued in the U.S. The picture for additional worldwide resource allocation to the U.S. appears bright.
- Within Europe, the Greek credit problems along with attendant banking system strains will affect market valuation and investor attitude. The Greek solvency issue will continue to haunt the markets until at least a temporary liquidity injection takes place. Understand that a liquidity injection is not going to solve the Greek insolvency issue. Liquidity injections (more loans) are never a solution for insolvency. They only delay the fix which is needed. To date, we believe the sustainability of the Euro monetary system to be highly questionable. This uncertainty will continue to negatively affect economic resource allocation away from the Euro space.
- Japanese economic activity has obviously been a major drag on worldwide economic growth this year. During the first quarter, GDP declined by 3.7 percent in Japan. In addition, we suspect the economy contracted in Q2. As the Japanese economy returns to some degree of normalcy, we expect a leveling and then resurgence in economic activity will start by the end of 2011. At the least, we expect Japan will cease to act as a negative on overall economic activity as the second half of 2011 unfolds. Our core expectation is Japan will act as a reasonably significant economic catalyst towards the end of 2011 and into 2012.
- Developing markets, led by China, will continue to grow more rapidly over the long term than the world, on average. Central banking activities within these countries on balance have been restrictive for various periods of time, and are starting to affect business activities. We expect inflation to be moderate in many areas of the developing world, which should eventually lead to higher sustainable growth rates. That being said, we currently harbor concerns about the growth trajectory of China. Pressures appear to be building regarding the sustainability of close-in economic growth patterns. Indeed, if there is a “surprise” which may be released on the markets during the second half of 2011 that “surprise” may occur in China.
- The capital markets have surged, doubling in value in many cases, since the bear-market lows witnessed in 2009. On balance, in many markets, valuation does not appear stretched, but it’s also not ragingly cheap. Earnings growth has been strong, far eclipsing economic growth rates in many cases. The growth engine for the world has been the developing economies. We believe adding Japan to the drivers behind economic momentum makes sense at this stage. The markets look forward, and correspondingly, will be focused not only on second half economic developments but expectations for 2012. We believe long-duration assets (stocks) should outperform fixed income alternatives during the second half of 2011, driven by higher earnings, fairly stable pricing and an improvement in fundamentals surrounding the world’s third largest economy (Japan).

- The wild card to this rather constructive market environment will continue to be the world's economic "balance sheet" items. Uncertainty will affect markets and economies rapidly as the world works its way through the adjustments which surround the "Long, Hard Slog" scenario. Additionally, we are sensing building stresses in China. Short-end growth and other stresses are appearing. Expect volatility to remain high, providing both risk and opportunities to market participants. Flexibility in structure leading to the ability to take advantage of periods of uncertainty and market volatility will be key to the investment process as we head into 2012.

The Final Word

From a macro-economic viewpoint, we believe the world's economic environment will not only stay out of an overall contraction, we believe growth should accelerate as the second half unfolds, as compared to the first half. With this in mind, corporate revenues and profits should remain positive. Due to slack in the productive capacity side of the economy, inflationary pressures should remain subdued. Central banks activity has been mixed, and will probably continue to be so. We expect the U.S., Japan and many areas of the developing world will lead the growth parade for the remainder of 2011. Europe will probably lag.

At the end of the day, growth should be positive, but the question dogging the major developed economies (U.S., Japan and Europe) will continue. This area of the world represents 58.0 percent of worldwide economic power. The "meat of the coconut" in these areas, is the definition of the role of government. What do the peoples of these areas expect and demand from their governments? This question is being answered. As this question is being answered, the focus of the world's investors at times shifts towards the "balance sheet" side of the economic question. When this occurs, the markets swoon. This will not go away until this question – what is the proper role of governments – is answered.



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