

Economic Income Statement and Balance Sheet Issues

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2011 Outlook

GDP GROWTH:
2.5%

UNEMPLOYMENT:
9.0%

INFLATION:
1.75%

FED FUNDS RATE:
0.35%

Executive Summary

The world's banking and currency system is currently under a high level of scrutiny. This retrospection is at its highest in Europe. The sustainability of the European Currency Unit (ECU) in its current form is under question. This is a serious question – and one that needs to be answered. Greece, Portugal and Ireland have struggled and will continue to experience issues. We currently fail to see serious viable systemic risks present in Italy and Spain. However, in certain circumstances, governments are “running out of other people's money to spend.” The world's investors are showing concern about the sustainability of today's governmental social contracts in certain cases.

The developed world's citizens are attempting to answer the question – what do we expect from our governments? This question is serious and the debate, elections and actions surrounding this question are at times violent and unpleasant. But this process is necessary. We have long stated that the way democracies answer serious systemic questions involves three episodes. These three episodes are shock, discovery and solution. We believe the world has entered the third stage of this episodic series.

Prior to discussing the world's “balance sheet” problems, a quick update on our second half economic/capital market outlook is appropriate.

National Income Statement Items

- We are forecasting second quarter GDP to register in the 1.6-to-1.9 percent range. The latest piece on trade balance was another hit on second quarter business activity.
- We believe third and fourth quarter GDP growth will reaccelerate to the 2.5-to-3.0 percent range. This slight increase in economic activity will be spurred by a reduction in oil prices (average price of \$99 per barrel during the first half) and improvement in economic activity in Japan, which should lead to continued improvement in export activity. Additionally, we believe auto sales will accelerate during the second half. We are again reviewing our 2011 full-year outlook, due primarily to lower-than-expected growth in Fixed Investment spending.
- Problems within the economy – on the Income Statement side – are many and various, but primarily center on confidence. This view is firmly backed by survey data from both the small business and the consumer sides of the equation.
- It appears Personal Consumption Expenditures will grow in the 1.6 percent range for the first half of 2011. This is a serious retracement from an annualized growth rate of 4.0 percent during the fourth quarter of 2010 and 2.6 percent for the year 2010. For the time being, we maintain our view that Consumption Expenditures should grow by 2.2-to-2.6 percent for the year.
- During the first half of the year, Fixed Investment appears to have grown by 2.0 percent on an annualized basis. We expect this series to improve to an annualized 7.5-to-8.0 percent growth for the year.
- Housing starts, as expected, have been “multi-family” oriented so far this year. We continue to expect total housing starts to run in the 570-to-580k range for the year.
- The unemployment rate recently moved upward to 9.2 percent. We believe our previous expectation of unemployment being 8.5-to-9.0 percent by the end of the year is valid.
- Our outlook for S&P 500 profit growth – at 8.0 percent – is decidedly below market expectation (as our expected GDP growth rate has consistently been all year). From a top-down standpoint, median expectation is currently at 11.0 percent. First quarter earnings growth came in at a whopping 34.0 percent growth rate (\$26.60 vs. \$19.76). We expect to see \$23.25 for the second quarter (up 7.4 percent from last year) and \$47.00 for the last two quarters (up from \$45.30).
- We have firmly entered the “economic expansion” phase of this business cycle. Historically, growth in most forms slows during this phase of the economic cycle.
- Our price forecast of 1125 to 1400 for the entire year of 2011 stands for the S&P 500.

National and Worldwide Balance Sheet Items

- Will U.S. policymakers raise the debt ceiling? We believe the answer to this question is yes. What will happen if there is a delay of some type? It appears government spending may be reduced by up to 44.0 percent (according to studies recently completed). From a numerical standpoint, if this delay lasted for one month, this would reduce third quarter GDP by roughly \$106 billion, or about 3.0 percent. It is assumed this amount would not necessarily be “lost” economic activity – rather it would be transferred from the third quarter to later in the year.
- Europe – the Euro-experiment is under attack. Debt structure matters. Countries (and organizations) who live by “spending other people’s money” are struggling. We in the U.S. suffer from the same disease. Raw data:

	<u>Greece</u>	<u>Italy</u>	<u>Spain</u>	<u>U.S.</u>
Govt Budget Deficit as % of GDP	7.4%	4.6%	9.2%	8.8%
Govt Debt as % of GDP	142.8%	119.0%	60.1%	80.1%

Where are the bond-market vigilantes going to hit next? Is the focus going to be maintained on Italy? We believe, while that is the operative question of the day, it is not the operative question that needs to be answered for the long-term.

- The question that needs to be asked is: what is the future of the Euro – will it remain a viable big-market currency over the intermediate to long term? While the jury is out, we believe the current functioning and status of the Euro may not have long-term staying power. This is due to a mismatch between central bank control and a lack of centralized political control. This mismatch has led to a lack of ability to control fiscal budgets while controlling monetary policy on a centralized basis. As an example, Germany (and others) is being asked to finance Greece’s and potentially other countries’ spending patterns without any input into the decision to spend – receiving assurances of spending discipline (which has not materialized in some cases). In other words, Europe is currently faced with a “responsibility” and “authority” mismatch. The savers on the continent have the responsibility to make the system whole without the authority to impose fiscal balance. We view this mismatch as unacceptable by a few - those with money.
- As stated on previous occasions, the western world is going through a period of asking what government’s role is going forward. This question is being answered worldwide.
- In the meantime, Europe’s GDP growth appears to be threatened. Indeed, we don’t expect Europe to show much more than 2.0 percent GDP growth during the second half of 2011.

Getting Back to Business – Asia and Other Thoughts

- Japan should be on the mend. Rebuilding and capital spending levels should accelerate during the second half of 2011 due to their earthquake and nuclear problems. This is in a country where GDP growth has actually contracted by 0.25 percent per year for the last 16 years!
- China is the wild card. It appears to us that China's GDP growth is going to be a function of getting inflation under control (as is the case for many foreign countries). We expect Chinese growth to exceed 7.0 percent for the entire year.
- Better than 40.0 percent of the world's economy is currently under the influence of central banks who are tightening money supply through raising interest rates – led by Europe and China. This will eventually lead to more hurdles for continued economic growth for major segments of the world's economic base.
- It is highly possible that the motivation behind a number of the recent European Central Bank interest rate rises is to defend their currency, rather than a fear of rising inflationary pressures. They need the money to continue flowing into the banking system on the continent.
- Within our Global Equity Strategy, Scout currently favors the U.S. over other major economic segments of the world.

Final Word

We believe the world's economies have entered into a period where, from a short-term standpoint, growth should accelerate in Japan and the U.S. Europe is struggling not with "income statement" issues – per se – rather Europe is struggling with "balance sheet" problems which have the capability of impacting "income statement" items by negatively impacting confidence. We expect to see slower-than-normal growth in most of the world's developed economies as the last half of 2011 continues and we head into 2012. With this view, we expect interest rates to remain subdued, inflation to remain tame and corporate profit growth rates to start receding.

On cue, the world's investors started shifting focus on the world's "balance sheet" problems. Most major western societies are attempting to answer the question – what do we expect and demand from our governments? This process is not new and has been ongoing in the United States since 1776. However, this episode of the debate is serious and mature. Serious and thinking people have come to the conclusion that, as Milton Friedman stated – "there is no such thing as a free lunch." People in Europe and the U.S. are actively debating the social and economic role of government. As was stated above, we believe this process is the third - and potentially the final - episode of this serious series.

This is not to say that "all is well." Indeed, the western world is facing an income statement/balance sheet dislocation which is highly serious. This dislocation has led, and in our opinion will continue to lead, to a high level of volatility – in both the financial markets and in political circles. That being said, we sense the world's investors and people will address the questions which need to be answered. As this economic drama continues to unfold, we believe significant opportunities will present themselves. We urge investors to remain vigilant during this volatile period, seeking opportunities which occur on a worldwide scale.



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