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ECONOMIC TALKING POINTS

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Economic Growth Will Accelerate in 2010 --- But Geopolitical Events Could Be The Big Spoiler

The U.S. economy in 2010 will be defined by two broad dynamics. The first centers on the durability of the current economic recovery. Many forecasters warn the economy will run out of steam in the second half of the year, once the Obama stimulus program winds down and businesses complete restocking their inventories. The risk of a double-dip recession is thus real, according to this group, unless Congress acts quickly to pass a second stimulus plan to keep the economy afloat.

We fundamentally disagree with that outlook. Our forecast has the private economy gaining enough momentum during the year to finally stand on its own by year end (though some government aid may still be necessary to backstop the banking sector). The combination of greater consumer and business spending, along with rising exports should keep growth firmly in positive territory throughout this year and next.

Our forecast calls for the economy to grow by 3.5% in 2010, with the unemployment rate dropping to 8.8% in the final quarter. Both short and long-term rates will drift higher to reflect the economy's improved vigor and heightened concerns over future inflation. However, we see no actual eruption in inflation the next two years because of the slack in labor and industrial resources worldwide, and our belief the Federal Reserve will move adroitly to remove much of the liquidity it has injected since 2008.

GEOPOLITICAL WORRIES

The second dynamic deals with the possible eruption of non-economic shocks and the risks they pose to spoil the recovery. For obvious reasons, economic forecasting typically does not include hypothetical geopolitical events, since such situations are inherently unpredictable and therefore extremely difficult to quantify in a forecasting model. Nevertheless we have an obligation to say up front when our risk-assessment concludes that there is a fairly high probability 2010 will be marked by one or more consequential geopolitical eruptions. We have identified below three prominent hot spots that could explode the next 12 months and potentially derail the global economic recovery.

Iran

The most menacing involves Iran. Rampant fraud in the presidential election last June, which returned Mahmoud Ahmadinejad as president, has ignited several bloody clashes between protestors and security forces. At this juncture, we view four possible outcomes from these confrontations.

(1) The Khamenei -Ahmadinejad regime collapses. (There have been rumors that the supreme ruler Ayatollah Ali Khamenei, has a jet on standby ready to take him and his family to Russia.) The old government is replaced with a different theocratic leadership, one that is more moderate and willing to work with the West, particularly on the sensitive issue of nuclear enrichment.

(2) Khamenei forces Ahmadinejad out and schedules new elections, but remains secretly committed to the pursuit of nuclear weapons.

(3) Both Khamenei and Ahmadinejad are swept aside in a historic revolution that introduces a more open, secular government.

(4) The current regime digs in, perhaps declares martial law, and threatens to block oil flows if foreign governments continue to intervene and foment more clashes. Iran charges ahead with building a nuclear device.

Of the four possible outcomes, the 3rd scenario is least likely in our view, with the 1st only slightly less improbable. The remaining two have a higher probability, with the 4th scenario topping our list as the most likely to occur. Both, however, still have Iran continuing to press forward in constructing one or more nuclear weapon. If one of these two scenarios materializes, Iran could cross the nuclear military threshold by the end of the year.

Given the abject failure of diplomatic efforts to get Iran to suspend or sharply curb its uranium enrichment program, time is now running out. The long -simmering confrontation with Iran is expected to culminate in 2010, most likely in the form of a military strike against its key nuclear facilities. Such a showdown would quickly kick oil prices above $150.

Pakistan

Aside from Iran, there are other hi-probability non-economic risks that could endanger the recovery this year. Pakistan already possesses 60 to 100 nuclear weapons but has a notoriously unstable government. The country has waged a mediocre battle against Taliban and Al Qaeda forces. The next 12 months will determine whether U.S. and Pakistani forces have the resolve to neutralize both groups, stabilize the government in Islamabad, and fortify control of the country's nuclear trigger.

Saudi Arabia

A third red flag is the growing threat against Saudi Arabia. Iranian-supported terrorists based in Yemen and elsewhere are being equipped with more sophisticated weaponry for missions that seek to eradicate or pressure the Saudi Royal family to end the country's ties with U.S. Any success along those lines or a damaging attack on Saudi oil fields will also boost the price of crude to levels that may damage the global economy.

What is the prospect of a geopolitical shock in 2010?

Viewed in the aggregate, there is a "significant" 40% probability of a major geopolitical eruption in 2010 that will have repercussions serious enough to threaten the economic recovery process. The presence of such a highly volatile geopolitical environment means investors and business leaders have to better anticipate non-economic disruptions this year and be nimble enough to act quickly to protect the value of their financial and other assets.

THE GLOBAL ECONOMIC OUTLOOK

Let's start with a broad view. The world's economic recovery is real and gaining traction. The U.S., Germany and France emerged from the recession last spring and summer. China and India, of course, technically avoided an economic decline, while Brazil bounced back nicely after contracting late in 2008 and early 2009.

There is increasing confidence that the economic and financial crises that began in 2008 and brought the world to the brink of another depression, has now run its course.

This is not to say we won't confront a few more aftershocks in 2010. Banks will certainly have to book more losses from failed commercial real estate loans and some countries will have difficulties servicing their sovereign debt. But these setbacks, while unnerving, won't reach a level that poses a systemic risk to the global banking system. We therefore believe the global economic turnaround is real and durable.

This is especially the case for the U.S. economy.

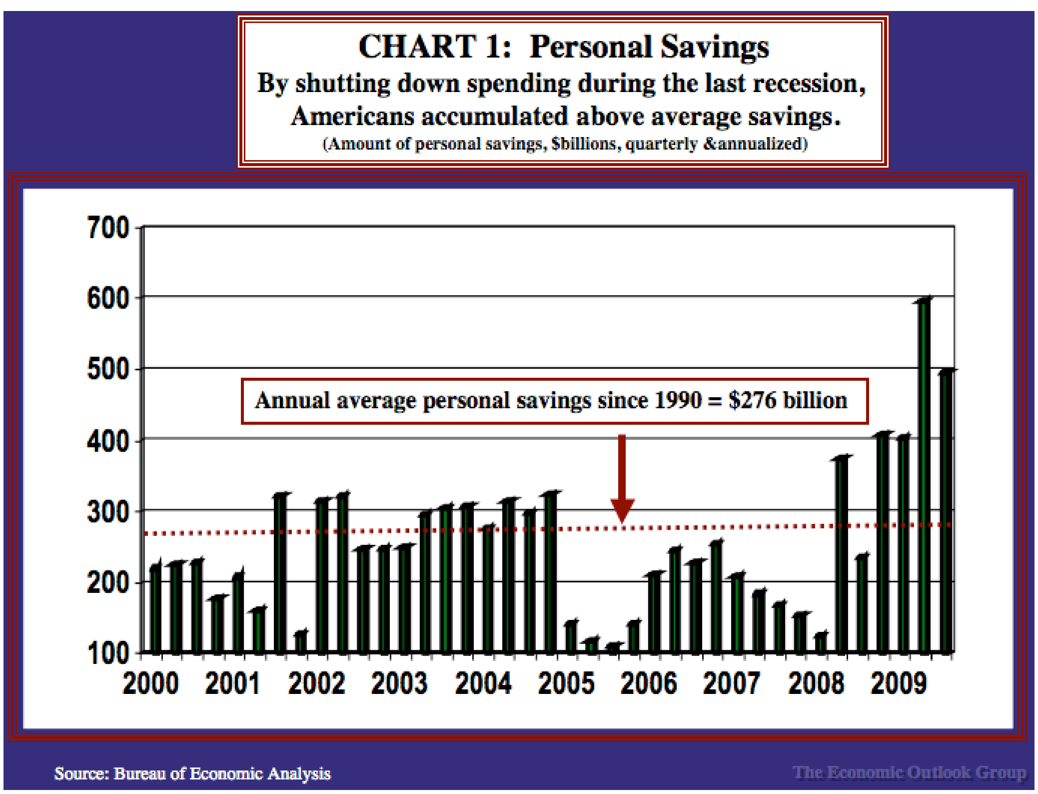
WHY SO OPTIMISTIC ABOUT THE U.S. IN 2010?

Consumers:

While the days of excessive spending and reckless borrowing are over (at least for the next few years), it would be a mistake to underestimate the consumer's role in contributing to GDP growth in 2010. The fundamental difference between the non-stop shopping and overleveraging by households seen the last decade --- and the spending we expect from consumers in 2010 is that this time expenditures will be kept more in line with income growth. In other words, Americans are going to rely less on debt to finance consumption. Yet even with this change in consumer behavior, household expenditures will bounce back and be an important driver of economic activity. Our forecast calls for real personal spending to climb more than 3% this year.

How so? Here are six reasons.

(1) For one, there is a greater willingness to spend. Households are growing more confident this recovery is real. Virtually every major consumer confidence poll (the University of Michigan, Conference Board, ABC News Consumer Comfort index) ended 2009 on a high note of optimism about the future. This improvement in consumer psychology has to be viewed in its proper context, which is this: Even during the most difficult months of the last recession, nine out of ten Americans in the labor force had jobs and earned income. But given the deep anxiety over how secure their jobs are, most workers chose to shut down spending and save more of their income as a precaution (See Chart 1.) That behavior is now expected to change again in light of the economic recovery and encouraging job numbers lately. And so after a two-year build-up in pent up demand and in personal savings, many are ready to increase spending this year.



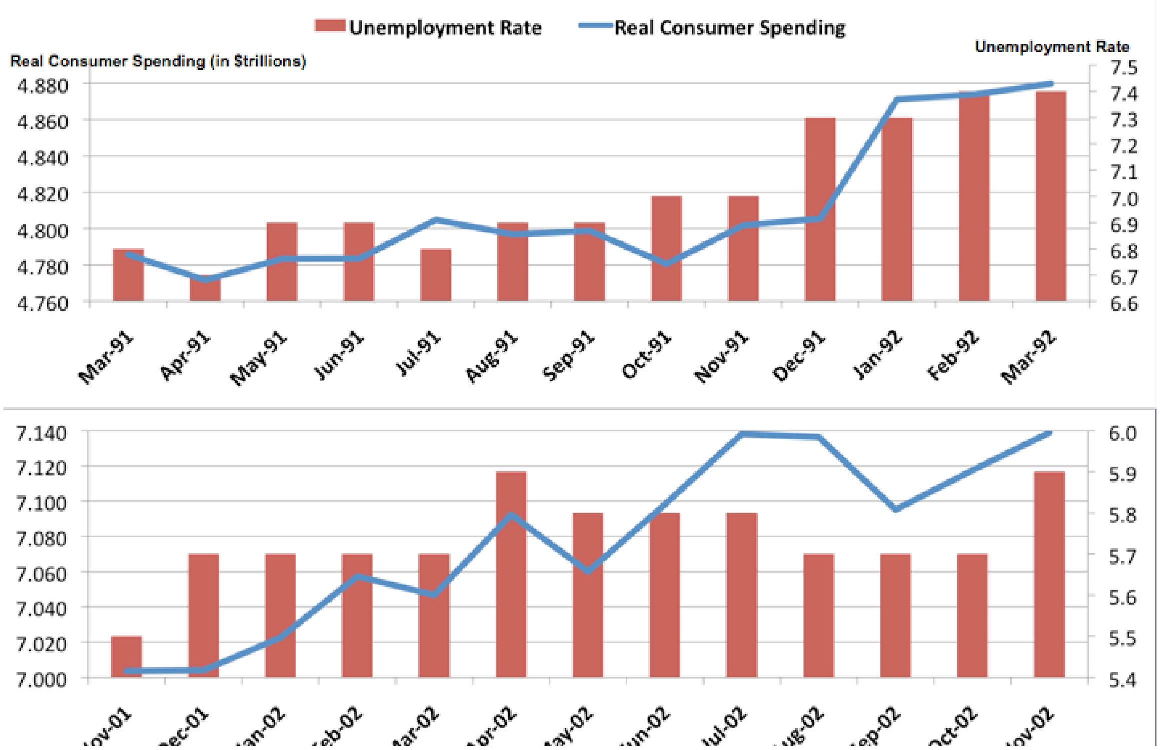
(2) As we noted above, labor market conditions are improving. Not only are companies laying off fewer workers, employers appear ready to accelerate the pace of new hiring. The monthly jobs report will report positive payroll growth in the first quarter--- which means companies are for the first time since 2007 are creating more jobs than are being eliminated. This will add to household income, lift consumer spirits and increase their propensity to spend.

Why will business ramp up hiring in the coming months? Simple, they have to! Firms rushed to slash a record 7.3 million jobs the last 23 months, a brutal and unprecedented pace that reflected deep fears the U.S. economy was headed for a prolonged, if not catastrophic, downturn. While the recession did turn out to be the longest since the Great Depression, emergency actions by the Bush and Obama administrations helped terminate the economic decline last summer. Since then, the rebound in production has come on the backs of a smaller and increasingly stressed out work force, and it is taking a toll. Employees become fatigued and that tends to erode quality control. So employers are starting to recognize the need to supplement their current workforce.

Companies are also in a much better financial position to hire again. Their internal cash holdings are at a 40-year high and corporate profits just jumped 10.8% in the third quarter, the biggest gain in more than five years. All this suggests we should resume seeing positive payroll growth on a monthly basis in the quarter.

This does not mean we've seen the peak in joblessness. Our forecast calls for unemployment rate to peak at 10.4% early in the first quarter as more Americans who gave up looking for work re-enter the labor force and earnestly search for jobs again. The key point to make here is that the rise in the unemployment rate at this stage of the business cycle will not endanger the recovery in consumers spending. (See Chart 2.)

CHART 2: **In the first year of a recovery, consumers will increase spending EVEN while unemployment continues to climb.**



As you can see from the graph, in the first year of a recovery we tend to see increases in both consumer spending and the unemployment rate. Thus, the main factor propelling the jobless rate higher at this juncture is that more of the unemployed are actively hitting the pavement as employment conditions improve, and that's a good thing.

(3) Another key contributor to spending will be recovery in household balance sheets. Between the end of 2006 and the first quarter of 2009, Americans looked on in horror as some $16 trillion, or nearly 25% of their personal wealth, went up in smoke. While it will take years to recoup this loss, they have already recovered about a third due to the rise in the value of their stock investments and the stabilization of home prices. If the bull market continues and the housing market improves in 2010 --- both of which we expect will happen--- then household wealth will keep climbing and that too will encourage more shopping.

(4) It has been repeatedly argued that a high savings rate by definition leads to less consumer spending. But that's a simplistic statement. If one is committed to a fixed savings rate of, say 5% or 7%, it is possible to have households increase both savings and spending. For example, during the 1990s, the personal savings rate averaged 5.5% a year (even more than what Americans now save) yet real personal consumption expenditures that decade still climbed 3.4% on average. Some will argue all that extra spending in 1990s occurred because consumers financed it by taking on massive amounts of new debt, a practice they will not likely repeat this year. The problem with that statement is it's untrue. According to the Federal Reserve, household debt during the 1990s actually rose at the slowest pace of any decade in the post-world War II period! So we return to our main point: If household income rises and the savings rate holds steady, both savings and consumption can increase.

(5) Looking ahead, we also expect to see a pick-up in real (inflation-adjusted) household income, and that will increase consumer purchasing power. The growth in employment in 2010 and the hiring of skilled workers should lift wages. That, in combination with subdued inflation, means consumers can buy more with each dollar earned.

(6) Finally, home buying should accelerate in the first six months of the year, and then ease back a little in the second half. Prospective homebuyers who have been holding off for the best deals are likely to act more quickly the next several months. The government has both extended and expanded the tax credit to purchase a home through April--- but it is highly unlikely the program will be renewed beyond that date. The National Association of Realtors estimated that 2 million first-time buyers took advantage of the tax credit last year, and that an additional 2.4 million will do so in 2010.

Aside from the tax credit, home prices are also bottoming out, which means those sitting on the fence now have several reasons to jump off and take action.

Perhaps the biggest motivation to lock in a deal now is that mortgage rates are expected to climb this year. With the Federal Reserve ending its mortgage bond purchase program at the end of March, there is uncertainty whether private investors will pick up the ball and support a secondary market in mortgage-backed securities. Investors are still quite jittery about these instruments and the lack of demand could drive rates higher. Adding to that pressure will be rising Treasury yields. Now that the economy is on the move, bond traders will demand a higher premium to protect against future inflation, and that will influence the cost of mortgages too. We're projecting 30-year mortgage rates to climb from 5% at the end 2009 to 6.3% by mid 2010 and near 7.5% year end. Each additional increase in financing costs will reduce home affordability and likely force banks to adopt tougher standards in screening applicants.

Our forecast calls for existing home sales to peak at a 5.6 million unit annual rate by June, and then drop back to a 4.6 million pace at the end of the year. The market should recover again in 2011, albeit slowly.

Business:

With the economy growing, profits on the rise, and corporate cash at multi-decade highs, conditions are ripe for higher business capital spending in 2010. When you operate in a low inflation environment, where pricing power is limited, profit margins can be protected (and enhanced) by operating as efficiently as possible. That means replacing antiquated equipment and investing in productivity-enhancing technology and software. This process is underway based on the latest GDP release. Total business outlays --- even if you include the precipitous drop in commercial real estate investments --- rose at a 5% rate in the third quarter --- the first increase in two years!

Another source of strength from business will be new home construction. Residential construction accounts for 22% of total business expenditures and that proportion will increase during the year. Because builders slashed new construction since 2006, the current inventory of new homes for sale has shrunk to the lowest in 40 years (since 1971)! With demand expected to rebound now that employment is improving, the tax credit extended, and banks under increasing pressure by Washington to provide more financing, home builders will increase the pace of new construction. There is already fresh evidence of that. Permits filed for future home construction shot up in November to the highest level in a year. As permits go, so goes new housing starts three months later.

A third source of business activity will be the inventory rebuilding cycle. For the last two years, companies have satisfied demand by drawing down from existing stockpiles. The collapse of the U.S. economy and the meltdown in banking forced inventory managers to be extremely conservative when placing new orders. After all, such goods are typically financed with credit. But now that stocks are nearly depleted and global demand has picked up, new orders have jumped across the entire supply chain. Retailers, wholesalers and manufacturers are rushing to refill their stockrooms. The additional output will add to GDP growth.

Lastly, we assume spending on drilling and exploration will also rise as oil prices climb. The global economic expansion along with renewed geopolitical tensions will make drilling for oil and gas, both on land and offshore, more economically feasible. Even in the absence of geopolitical shocks, our forecast calls for crude to hit $125 a barrel by the end of 2010.

Federal stimulus:

Less than a third of the $787 billion federal stimulus program was spent last year. Another large tranche will make its way through the economy this year and add about 1.5% to GDP growth.

There is talk in Congress of passing a new jobs bill to bring the unemployment rate down faster. We understand the political pressure to take such action, but it's hard to justify it on economic grounds. In the final analysis what prompts employers to hire workers are not government subsidies, but a genuine increase in demand for products AND greater access to credit.

We'll be even more specific. If you want to hasten a decline in the jobless rate, go right to the source that generates faster employment. Small and midsize business typically account for 75% of all new hiring during a recovery. With the economy now growing, you should see these businesses ramp up hiring. But one big obstacle to greater employment remains the scarcity of credit available to small and mid-size firms. This forces them to preserve what cash they have for paying bills, rather than on hiring new workers. Given the improved economic backdrop, we believe additional pressure on banks to lend to these companies would result in more employment than a makeshift jobs bill or a tax subsidy.

A related aspect to this debate is what happens when the stimulus program begins to fade in the second half of the year? Will the recovery go limp next fall and winter?

Not in our opinion. Barring a major geopolitical eruption, we expect the private sector economy to achieve enough critical mass this year to make a second Obama stimulus program unnecessary. Indeed, now that the recession is over, the focus should shift to reducing the U.S. budget deficit, which is projected to cross $1 trillion in 2010 (even with a 3.5% GDP growth rate!!), after a record $1.4 trillion in 2009.

Exports:

Exports will play a key role in the U.S. recovery this year. More than $1.8 trillion worth of goods and services (13% of US GDP) were sold to foreign buyers in 2008. Net exports, the gap between exports and imports, narrowed enough that year to contribute 1.2 percentage points to growth. Though sales to foreign markets were more depressed in 2009, it has picked up markedly in the final months of last year because of the global economic upturn. That trend should continue through 2010 as more economies come back online and a weakened dollar keep U.S. products competitively priced.

The biggest foreign customers will be the emerging countries in Asia, led by China (3rd largest US export market), which is expected to overtake Japan this year as the world's second largest economy. Non-Japan Asia as a group is projected to grow about 8% this year and thus remain a major destination for US shipments. Sales to Latin America will also jump in 2010, especially to Brazil (9th largest export market) and Mexico (ranked 2nd).

This is not to say the international economy will be trouble free in 2010. Late last year, investors were taken aback by the Dubai World default and credit problems in Greece, Spain and Ireland. There may have one or two more aftershocks this year. But we do not expect these surprises to reach a magnitude where it once again threatens the viability of the world financial system. These aftershocks are temporary setbacks in the recovery process and thus have only limited macroeconomic impact.

One final note. Since U.S. economic growth will exceed those of Europe and Japan in the first half of the year, we're expecting the trade deficit to widen this period and detract from GDP growth. Not to worry. The inventory build-up in the U.S. and the rebound in consumer spending will initially result in import growth accelerating faster than exports. But once the inventory cycle is complete and as foreign economies pick up speed, the US trade deficit should narrow again later in the year and be a net contributor to GDP.

Monetary Policy and Interest Rates

No action will be taken to raise the federal funds rate until late in the third quarter, in our view. So long as there is ample labor and industrial resources in the economy and with inflation expectations well anchored, there is no urgency for the Federal Reserve to tighten. We expect the Fed will begin to lift rates during the September 21st meeting, with the benchmark rate to climb to 1% by the end of 2010.

However market rates have already begun their cyclical climb as investors brace for stronger economic activity, rising inflation in the out years (2012, 2013), and on concerns of an eventual clash between private and public credit demands.

The last factor is particularly worrisome. In the last few decades, the U.S. has relied on foreign investors to help finance domestic consumption and investment. But foreigners now fear the record supply of new US debt and the Treasury's half-hearted support of a strong dollar will only end up dragging the U.S. currency downward. The danger here is clear. To protect their portfolios from suffering more losses on dollar-denominated assets, foreigners have begun to quietly and systematically diversify by buying other currencies and even precious metals.

Such foreign disenchantment with the greenback can pose a risk to the US economy. Although there has been an increase in private savings the last two years as consumers and business stopped spending, this pool of funds will rapidly diminish as economic growth accelerates and credit demands increase. However, if foreigners choose to scale back their investments in US dollar assets and re-route their excess savings elsewhere, the growing competition between the private and public sectors for capital in this country will catapult interest rates to levels that can impair recovery. For these reasons we will be monitoring closely the changes in net foreign capital inflows in 2010.

We do foresee a bear market in bonds this year. The question becomes how serious of a rout will it be? Our assessment is that while yields will drift upwards this year, it will have a greater constraint on economic activity in 2011 when 10-year Treasury yields are forecast to approach 7%.

The Dollar

The dollar lost value against all 16 of its most-traded counterparts (except for the yen) in 2009. It did manage to stage modest rebound in the final month of the year, an upturn we expect will continue in the first quarter of 2010. But the greenback will resume its orderly decline by mid-year.

There is a paradigm shift underway in how foreign investors view the dollar. A growing number of countries have expressed disenchantment with the greenback as a world reserve currency. The worry overseas is that Washington's profligacy and its rush to print as many dollars as necessary to aid the U.S. economy, will end up debasing the currency. That concern has led countries like China, Russia, Brazil, and many in the Persian Gulf region to consider an alternative to the dollar as a reserve currency. Not only has this dialogue begun in earnest, many countries have already taken discreet action by diversifying into a basket of currencies, as well as into gold and other precious metals. The dollar now accounts for 61.6% of the world's $4.4 trillion in known currency reserves (from a peak of 72.7% in 2001), while the euro has grown to 27.7%. That is the smallest margin ever for the greenback.

It is true that certain events, such as a global economic or geopolitical crisis, will have foreign investors rushing back into dollars. Any major threat to international stability will trigger capital flows to the U.S. simply because it's the world's leading military superpower and its markets are viewed as the safest and most liquid in times of stress. But such moments of extreme tensions are rare, do not last long, and will not affect the longer term trend of a currency, which is driven more by economic fundamentals.

The underlying shift away from dollars reflect what many see is a diminution of US economic dominance in the world. Capital will flow to economies that exhibit the most dynamic growth and promise the highest risk-adjusted returns. There is a growing perception that the best investment opportunities will not be found in the slow growing, maturing economies of the U.S., Europe or Japan, but in Asia and Latin America. And so as the global economy recovers, foreign investors will attain a higher level of comfort committing capital to these developing regions. Bear in mind the emerging nations avoided most of the $1.7 trillion in credit losses and writedowns that caused the global recession, and this will allow them to bounce back faster than the industrialized countries.

Our forecast calls for the dollar to slip to 1.58 for the euro and 88 against the yen by the end of this year, and depreciate to 1.65 and 85, respectively, by the final quarter of 2011. The continued erosion in the dollar's value will help push gold prices higher this year. We expect to see the metal climb to $1,500 an ounce in the second half of the year.

Top Risks To Our Forecasts In 2010 And Their Probability:

Domestic:

1. Commercial real estate losses turn out to be much larger than first projected and wipe out the progress made so far on fixing bank balance sheets. The lending window slams shut again and brings the recovery to a halt.
Probability = 20%

2. Foreign investors lighten their portfolio of dollars and place their capital elsewhere. This shrinks the domestic pool of funds available to finance consumption and investment, and raises market rates to painful levels. The result: the higher cost of capital disrupts the recovery late in 2010 and in 2011.
Probability = 25%

Foreign:

3. China's credit-fueled real estate bubble suddenly bursts. Given that steel, cement, furniture, construction equipment, banks are all tied to real estate, the collapse in property prices dramatically slows China's economy. That in turn, triggers an Asian economic crisis which quickly trips up the global recovery.
Probability = 30%

4. A war erupts with Iran and disrupts the flow of oil. The price of crude climbs and remains above $150 a barrel for an extended period of time.
Probability = 40%

5. An attack by terrorists inside Saudi Arabia, either directly on the Royal family or the Kingdom's major oil fields. Oil prices surge above $130.
Probability = 35%

6. The Pakistani government collapses and insurgents take control over large swatches of the country. U.S. troops are compelled to enter and secure Pakistan's nuclear arms.
Probability = 30%

2010 Forecast Summary Below

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- **Actual**
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UNITED STATES

QUARTERLY

	I 2009	II 2009	III 2009	IV 2009	I 2010	II 2010	III 2010	IV 2010	I 2011	II 2011	III 2011	IV 2011
Real GDP %:	-6.4	-0.7	2.2	3.8	4.0	4.2	2.8	2.9	2.8	3.2	3.1	2.5
Personal Consumption Expenditures:												
PCE	0.6	-0.9	2.8	3.3	3.3	3.5	2.7	3.0	2.7	3.1	3.0	2.8
Inflation, end of period, year-over-year												
CPI %	-0.4	-1.4	-1.3	1.0	1.9	2.0	2.0	2.5	2.2	2.5	2.5	2.7
Unemployment Rate (end of period):												
%	8.5	9.5	9.8	10.2	10.0	9.4	9.1	8.8	8.5	8.2	8.0	7.9
Non-farm Payrolls, monthly avg, thousand:												
	-691	-428	-226	-65	70	100	115	150	145	185	180	165
Treasury 10-Yr Note Yield % (end of period):												
	2.7	3.5	3.3	3.8	4.5	5.1	5.7	6.1	5.9	6.3	6.5	6.7
Federal funds rate % (end of period)												
	0.3	0.3	0.3	0.3	0.3	0.3	0.5	1.0	1.8	2.5	3.0	3.0

GDP - Global Economy

	2007	2008	2009	2010	2011
US	2.0	1.1	-2.5	3.5	2.9
Eurozone	2.6	0.7	-4.0	0.8	1.5
United Kingdo	3.1	-1.9	-4.6	2.0	4.2
Japan	2.1	-0.7	-5.7	1.0	2.0
Canada	2.7	0.5	-2.3	2.6	3.2
India	8.9	6.7	5.4	7.4	7.7
China	13	9.0	8.3	9.8	9.0
Brazil	5.7	5.1	0.7	4.8	6.0
Australia	4.0	2.3	0.5	2.3	3.7
Russia	8.1	5.6	-8.7	3.9	4.3
World	4.9	3.7	-2.2	2.6	3.3

Key Currency Values

	End 2008	End 2009	End 2010	End 2011
USD/Yen	91	93	88	85
Euro/USD	1.40	1.43	1.55	1.62

Oil (NYMEX Future) & Gasoline (Average retail unleaded,$)

	End 2008	End 2009	End 2010	End 2011
Crude oil per/l	43	80	125	100
Gasoline	1.61	2.57	2.85	2.75

Major Stock Indexes

	End 2007	End 2008	End 2009	% Change '09	End 2010	% Change '10
DJIA	13265	8776	10428	18.8	11,500	10.3
S&P 500	1468	903	1115	23.5	1250	12.1
NASDAQ	2652	1577	2269	43.9	2,490	9.7
RUSSELL 2000	766	499	625	25.3	700	12.0

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