

THE ECONOMIC OUTLOOK GROUP



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SUMMARY ECONOMIC FORECASTS FOR 2011

- **GDP Growth in 2011 Will Be The Best in Six Years**
- **Stocks and Interest Rates To Climb As Well --- But Economic And Geopolitical Threats Promise A Wild Ride For Financial Markets**

- The U.S. economy will grow by 3.5% in 2011, its fastest pace in six years. Prospects for a double dip recession has now diminished to barely 15%.
- The outlook for 2012 has improved as well, with the economy projected to expand 3.8%. The big difference next year will be the additional contribution from housing.
- The positive economic backdrop in 2011 will ensure another solid year for stocks, with US equities significantly outperforming bonds. U.S and emerging markets will be the best performers, with Europe and Japan lagging. However, volatility will be unusually high as investors confront a wide range of uncertainties this year, including possible municipal defaults, the European sovereign debt crisis, a politically reconstituted Congress, the efficacy of QE 2, rising oil and gasoline prices, a belligerent North Korea, and heightened tensions in the Middle East, Iran, Pakistan, and with China.

UNITED STATES - ECONOMIC OUTLOOK

The U.S. economy will expand a robust 3.5% in 2011. This contrasts sharply with the consensus forecast* which projects growth this year to be even slower than 2010. We clearly disagree. Conditions are firmly in place for consumer and business spending to accelerate. Indeed, our asset allocation model has been positioned to gain from faster economic activity, both here and abroad.

Two key factors account for our forecast of stronger growth.

I. Two years of unprecedented fiscal and monetary stimulus from Washington.

- A record low federal funds rate of 0% to 0.25% since December 2008, plus the Fed's \$1.7 trillion purchase of mortgage-backed securities, agency debt and Treasuries during QE 1 are *finally* having an impact. The money supply (M-2) has now been climbing for four straight months, the longest streak since the start of 2010. Moreover, a new round of quantitative easing was launched late last year.
- Adding more fuel to the economy will be the \$858 billion tax compromise passed in December. It should contribute nearly a full percentage point to GDP growth in 2011. The biggest impact will come from the 2 percentage point decline in payroll taxes and the ability of firms to write off 100% of new capital spending in the first year.
- With the economy showing fresh vigor, we expect the Federal Reserve will pull back from fully implementing the \$600 billion purchase of Treasuries in QE 2. To do otherwise would risk agitating bond investors, cause market rates to spike and reverse the progress made so far in this recovery.

II. A rejuvenated private sector will make economic growth self-sustaining.

Consumers

- Household balance sheets have improved significantly. Americans have shown an unusual degree of frugality the last two years by cutting back spending and by deleveraging on a scale never seen before. As a result, their debt service burden (the ratio of debt payments to disposable personal income) is now the lowest in more than a decade. With household finances in better shape, we expect consumers to increase borrowing in 2011, but at a pace largely commensurate with income growth. That is, we do not see households leveraging up in a manner that helped trigger the last recession.

(*Blue Chip Economic Indicators - November survey)

- Americans are also feeling more secure about their jobs and future income. This, too, will encourage more spending. Companies have been hiring workers every month in 2010. With the economic expansion to gain more speed and credibility this year, the growth in payrolls will accelerate. Government reports show that employers are already posting more job openings than at anytime in the last two years.
- With inflation to remain low in 2011, wage increases are likely to translate into greater purchasing power.
- A rising stock market in 2011 will more than offset the lateral movement in real estate values. This will add to household net worth, which also correlates with greater consumer expenditures.
- Lenders, seeing the advantages of a steeper yield curve, will be more accommodating in providing credit to individuals.
- Finally, recession fatigue, years of pent-up demand, the need to replace aging appliances and autos, and the introduction of innovative new consumer products will help unleash more household spending.

Business

- Corporate balance sheets have rarely looked better. Historically low interest rates prompted companies to refinance their debt and improve their capital structure.
- Business profits are at record levels. Margins should continue to expand as top line revenue growth picks up in 2011.
- Companies have accumulated nearly \$2 trillion in liquid funds. More of this money will be put to work now that the recovery has gained momentum.
- Growing domestic and international demand will encourage business capital spending.
- Since bank net interest margins are expected to widen next year, more credit will be available to finance spending by small and mid-size businesses.

Exports

- U.S. exports are currently running at the highest level in more than two years. With the global recovery to stay on track and the dollar to remain relatively weak this year, foreign demand for U.S. products will keep growing. The largest percentage increase in exports will go to emerging countries where an ascending middle class and major infrastructure projects should keep U.S. exporters busy. As a result, the net export deficit will be smaller in the first half and subtract less from GDP growth. We do

expect the volume of imports to pick up materially in the second half, however, and that will lessen the contribution trade will have on GDP.

Weakest Sector in 2011?

No question, it's going to be housing. But we have to make a distinction between sales and new construction.

Home sales will show a temporary upswing this spring as Americans rush to lock in low mortgage rates during the home buying season. The latest reading by the National Association of Realtors shows housing affordability is at a record high. But sales and prices will limp along the rest of the year, largely because mortgage lenders will deal with only the most creditworthy borrowers. Other issues will continue to depress sales, such as conservative appraisals on home values, lack of clear title on foreclosed properties, and the difficulties of selling one's own property to purchase another.

One countertrend will be housing starts. The pace of new home construction has been just one-third that of new household formation. Consequently, the inventory of unsold new homes has now shrunk to the smallest in nearly half a century! But with the outlook for the economy and jobs looking better, we expect builders of single-family homes to resume construction at the fastest pace in three years in 2011.

FEDERAL RESERVE POLICY AND INTEREST RATES

Fed funds will remain at its current 0% to .25% level in 2011. The Fed will wait until 2012 before lifting the benchmark rate for overnight funds.

Longer-term rates, however, will inch higher this year --- though the path will be irregular. How yields will perform day-to-day depends on what irks bond investors at any particular moment. For instance, faster growth in the U.S. and a loose monetary policy can whip up fears of inflation and drive yields higher. But if the focus turns to the worsening financial crisis in Europe (or some other global shock), investors will promptly seek out the safe haven of U.S. Treasuries, which will lower yields. Nevertheless, by year-end we expect the 10 yr Treasury yield to climb above 5%.

GLOBAL ECONOMY

- World economic growth will also pick up, despite the weakness in Europe and Japan. Sources of strength will come from China, the U.S., Brazil, Canada, India, Singapore, Indonesia, Australia, South Africa, Israel, Chile, Columbia, as well as other nations in Latin America and Southeast Asia.

EUROPE

- The critical test for Europe this year is whether the sovereign debt crisis infects Spain. We believe Spain will be able to avoid default in part because of the preemptive steps the country has taken to shore up its finances. The other key factor is its sheer size. Spain's economy is twice that of Greece, Ireland and Portugal combined, and thus too big to fail. It's our view that the European Union, the European Central Bank, and the IMF have essentially decided to place all their chips on the table to keep Spain from defaulting and to preserve the integrity of the Eurozone.

Not everyone shares this opinion. There has recently been a spate of independent research reports arguing that the current sovereign debt mess is proof the single-currency system in Europe is unworkable and thus inevitably doomed. We disagree. If history is any guide, the 16-nation Eurozone will survive this crisis.

Remember, financial traumas are not new to Europe. The entire effort to formally integrate the economies of Europe is not something that began with the formation of the euro in 1999. It started at the end of WWII when a few countries realized it made more sense to establish an economic union. That process has been underway ever since and it has progressed in fits and starts. No one expected it to be seamless. Prior to the current debt crisis, Europe agonized over how to unify the two Germanys and their respective currencies. The decision to exchange their coinage at parity, with one East German mark for a West German mark, evoked howls of disbelief as well as dire warnings that it would spell disaster for the Continent. While the transaction did slow European economic growth for a short while, Germany and Europe as a whole survived the unification challenge and have since prospered. Our bet is the Eurozone will successfully work through its latest financial problem, though it might ultimately entail re-opening the Maastricht Accord to include tougher fiscal reforms.

CHINA

- Another concern often heard is that rising inflation in China may lead policymakers to accidentally over tighten and cause the world's second largest economy to stall in 2011. Such an event would worsen domestic unemployment and possibly trigger civil unrest. It's a disturbing scenario, to be sure --- but also an improbable one. We have assigned just a 20% probability to it.

Chinese policymakers are much more likely to achieve a soft landing and ease inflation down this year. Just look back over the last 30 years and you see how its leaders have adroitly steered the economy out of trouble when most other countries were swept up in the economic storms of the Asian financial crisis, the Russian debt default, the dot.com bust, and even the latest 2008-2009 recession. Throughout it all, an unruffled China has been able to grow at an average annual pace of 8%. We expect they will succeed again this year to cool inflation and engineer a slightly slower growth rate.

Nevertheless, it would be a mistake to extrapolate that China will keep up this 8% pace the next three decades. That's because the country faces some daunting challenges ahead. The core problem is that Communist China is finally bumping up against the limits of Capitalist China. Their hybrid system, which combines a

command economy with market forces, worked well, if awkwardly, since Deng Xiaoping introduced economic reforms in 1978. But this incongruous mix has probably run its course since the domestic economy faces new and unprecedented stresses and strains.

Clearly, something will have to give if they are to sustain robust growth and maintain political and social stability. The implication is we could soon see a tectonic shift in how they will manage their economy in the future. The transformation will likely include faster appreciation of the RMB, smaller trade surpluses, a fundamental shift in resources from coastal cities to the rural communities, more rapid privatization of state-owned enterprises, greater outsourcing of work from China to lower wage countries, and a much more assertive foreign economic policy. The last will be particularly nettlesome for the U.S., India, and Japan. We may even be seeing a peek of that right now in China's build up of naval forces in the western Pacific and how they are manipulating supplies of rare earth elements. In any event, we should get a better understanding of the changes to come when China's 12th Five-Year Plan (2011-2015) gets approved by the National People's Congress this spring.

DOLLAR

The U.S. currency will appreciate in value the first months of 2011 as the economic expansion gains credibility. Higher investment returns here will lure foreign investors to dollar-denominated assets.

Barring any economic or geopolitical shocks, the dollar will likely resume its long term decline in the second half of the year when the trade deficit swells again. Foreign investment capital will also flow back to Europe in the second half of 2011 as confidence firms that their sovereign debt crisis has become manageable.

INFLATION OR DEFLATION?

The risk of deflation is virtually non-existent. The combination of stronger global growth in 2011, higher commodity prices, faster job creation and an expansive fiscal and monetary policy will push up headline consumer price inflation during the course of the year. CPI is expected to reach 2% in the final quarter of 2011, double the year-end rate in 2010. The greater risk to this scenario is that prices may accelerate even more, rather than fall. With deflation extremely unlikely, we expect the Fed will turn to the critical task of reassuring the public, and specifically bondholders, that the central bank is determined to keep inflation expectations well anchored.

POSSIBLE SHOCKS IN 2011 AND THEIR CHANCE OF ERUPTION

(1) Massive defaults by states and municipalities will trip up the economy and disrupt growth this year. (Probability: 20%)

A few states may well default on certain kinds of debt, but nothing on the scale of 50 to 100 sizeable defaults recently projected by a well-respected analyst. Aside from the legal questions on whether certain municipalities can file for bankruptcy,

the fact the U.S. economy is improving has already boosted tax receipts to states, a trend that will continue throughout the year. In addition, state and local governments will find ways to raise new revenues and pursue more steps to cut costs. Conclusion: The chance of macroeconomic damage or a financial market meltdown stemming from wide scale state and local bond defaults is very remote.

(2) North Korea has recently cooled its rhetoric against South Korea. Nevertheless, the risk of another military confrontation between the two is still quite high. In that event, global equities will sell off temporarily with investors rushing to U.S. dollars and Swiss francs for safety. China toughens its stance against North Korea. (Probability: 65%)

(3) Iran focuses blame on Israel for launching the Stuxnet computer virus, which has crippled Iran's computers at its Natanz and Bushehr nuclear plants. Under orders from Teheran, Hamas and Hezbollah intensify terrorist and military attacks against Israel. Israel counters with an invasion into Gaza and/or southern Lebanon. (Probability: 60%)

Global stocks will retreat as the Middle East descends into violence. The magnitude of the pull back will depend on whether the hostilities degenerate into a wider conflict, one that embroils Syria or leads to direct combat with Iran.

(4) The government of Pakistan shows more signs of crumbling. Concerns are raised about the security of its nuclear arsenal, which number 60 to 100 bombs. (Probability: 45%)

A brewing foreign policy crisis here could unnerve global financial markets, especially if insurgents penetrate the security around Pakistan's nuclear installations.

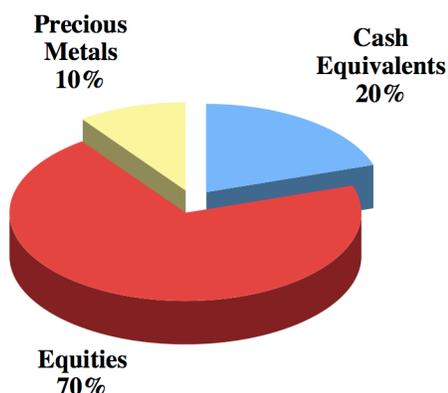
(5) The combination of stronger global growth and rising international political tensions push oil prices over \$100 in 2011. (Probability: 90%)

Its impact on the economy will obviously depend on how high prices go and how long they remain at triple-digit levels. While the U.S. is a much more efficient user of energy than it was a few short decades ago, there is a price point where businesses and consumers will retrench out of fear that high energy costs may cause the economy to stumble. By our estimate, this red zone is \$120 a barrel if sustained for at least two months, and with gasoline prices in excess of \$4.50 a gallon. We have assigned a 25% probability for such a scenario.

Below:

- **Main Asset Allocation Model Entering 2011**
- **How Did Our Forecasts of the Financial Markets Perform in 2010?**
- **Summary Economic Forecast Table For 2011 and 2012**

The Economic Outlook Group's 2011 Global Asset Allocation Model



20% Cash and cash equivalents = Cash, short term Treasury securities, banks
CODs, money market instruments

70% Equities = Equities will significantly outperform bonds in 2011. Half of the equities are to be invested in US firms with global markets. The other half should focus on foreign ETFs, specifically those exposed to emerging consumer markets, metals mining and petroleum.

10% Precious metals = Primarily gold and silver ETFs

HOW DID OUR FORECASTS MEASURE UP IN 2010?

We look back at our projections for the financial markets published a year ago and list below the results:

**Forecasts made on January 4, 2010
for Yr. End**

Actual Year End 2010

Dow = 11,500 (+10.3%)

11,577 (+11%)

S&P = 1,250 (+12.1%)

1,258 (+12.8%)

NASDAQ = 2,490 (+9.7%)

2,653 (+16.9%)

Russell 2000 = 700 (+12.0%)

784 (+25.4%)

10 yr. T-Yield = 6.1%

3.3%



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● Actual
 ● Forecast

UNITED STATES

QUARTERLY

	I 2010	II 2010	III 2010	IV 2010	I 2011	II 2011	III 2011	IV 2011	I 2012	II 2012	III 2012	IV 2012
Real GDP %:	3.7	1.7	2.6	3.4	3.1	3.8	3.6	3.8	3.3	4.2	4.0	3.2
Personal Consumption Expenditures:												
PCE	1.9	2.2	2.4	3.5	3.5	4.2	4.1	3.7	3.1	3.9	3.8	3.0
Inflation, end of period, year-over-year												
CPI %	2.3	1.1	1.1	1.3	1.7	2.0	2.1	2.2	2.5	2.5	2.8	2.8
Unemployment Rate (end of period):												
%	9.7	9.5	9.6	9.8	9.9	9.5	9.0	8.5	8.2	7.7	7.4	7.2
Non-farm Payrolls, monthly avg, thousand:												
	87	190	-30	123	235	250	275	310	190	265	185	270
Treasury 10-Yr Note Yield % (end of period):												
	3.8	2.9	2.5	3.3	4.0	4.4	4.6	5.1	5.2	5.4	5.2	5.1
Federal funds rate % (end of period)												
	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.5	1.0	1.5	2.0

GDP - Global Economy

	2007	2008	2009	2010	2011	2012
US	1.9	0.0	-2.6	2.8	3.5	3.8
Eurozone	2.6	0.6	-4.1	1.6	1.8	1.9
United Kingdom	3.1	0.6	-4.8	1.7	2.1	2.5
Japan	2.1	-0.7	-5.1	1.8	1.0	1.5
Canada	2.7	0.4	-2.5	3.0	3.1	3.4
India	8.9	6.1	6.7	9.0	8.3	8.8
China	13.0	9.0	9.1	9.7	8.8	8.5
Brazil	5.7	5.1	-0.6	7.2	6.3	5.9
Mexico	3.3	1.4	-6.6	4.2	3.8	3.5
Australia	4.0	2.3	1.0	3.0	3.7	4.1
Russia	8.1	5.6	-7.9	3.9	4.3	4.1
World	4.9	2.0	-0.6	3.7	4.2	4.6

Key Currency Values

	End 2008	End 2009	End 2010	End 2011	End 2012
USD/Yen	91	93	81.15	95	87
Euro/USD	1.40	1.43	1.34	1.42	1.47

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

	End 2008	End 2009	End 2010	End 2011	End 2012
Crude per/bbl.	43	80	91.40	100	105
Gasoline	1.61	2.57	3.00	3.10	3.12

Major Stock Indexes

	End 2007	End 2008	End 2009	End 2010	% Change '10'	End 2011	% Change '11
DJIA	13265	8776	10428	11,577	11.0	13,007	12.4
S&P 500	1468	903	1115	1,258	12.8	1,485	18.0
NASDAQ	2652	1577	2269	2,653	16.9	2,963	11.7
RUSSELL 2000	766	499	625	784	25.4	887	13.1