



# ECONOMIC OUTLOOK

bounty management

*unique investment insight*

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## WHISTLING A HAPPY TUNE

As we enter the New Year, governments everywhere are humming “I Whistle A Happy Tune” from *The King and I*. The first lines go: “Whenever I feel afraid, I hold my head erect, And whistle a happy tune, So no one will suspect, I’m afraid.” We advise governments everywhere to keep whistling a happy tune since the problems of our unbalanced economic world are structural and defy easy solution. We continue to struggle with debt deleveraging and restructuring while providing massive monetary (low interest rates) and fiscal (government spending) stimulus to the economy. The result that is hoped for in the developed world, the most damaged by the 2007-2009 credit crisis, is a resurgence in confidence that will bolster spending and investment by consumers and businesses to create a more sustainable and fiscally constructive business cycle. In emerging markets, hardly touched by the crisis, governments are hoping to quell the outbreaks of inflation based on escalating food, energy, and raw material costs which are the legacy of the developed world's massive stimulus. We question whether raising interest rates and tightening credit will quiet inflation before sparking popular unrest over prices. Eventually, governments will wake up to the need for a fundamental world-wide currency reform to underpin the world's economy, a move which by itself would create stability.

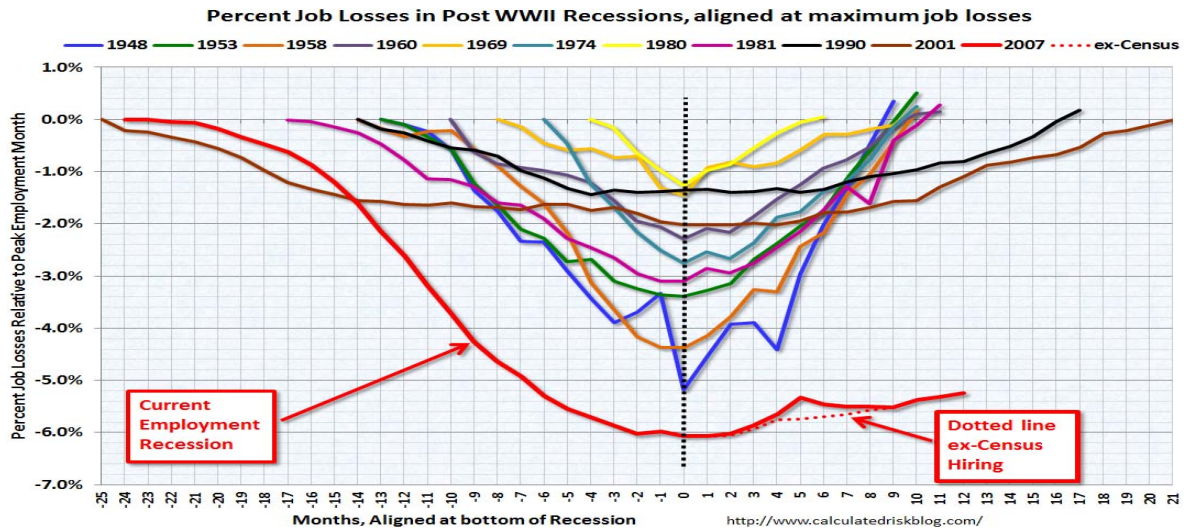
### Domestic economy

In the U.S., the structural issues include employment levels, income, real estate prices, state finances, federal stimulus sustainability, and ultimately, confidence. The numbers imply that the economy is growing: 3<sup>rd</sup> quarter GDP was +2.6% and 4<sup>th</sup> quarter GDP will likely be about +5.0%. The issue is the composition of growth. Since 2007, the federal government portion of GDP has increased from 21% to 25% due to stimulus spending. If you add state and local spending (the federal sector provides 32% of state spending and states fund 40% of local spending) then total government spending is 40% of the economy. Real final demand (demand excluding inventory and trade) grew at a paltry 0.9% for the second quarter in a row. So 3<sup>rd</sup> quarter GDP was largely stimulus plus inventory accumulation. 4Q 2010's large GDP number will likely be more of the same: stimulus plus inventory building plus some consumer savings spent for the holidays. In 2010, government at all levels issued new debt amounting to 13% of GDP to create growth for the year of 2.7%. Since the 3<sup>rd</sup> quarter of 2008, \$4.2 trillion in new debt/stimulus has created only an additional \$100 billion in GDP. The recovery since 2009 has been 50% slower than the average recovery from a recession.

### Unemployment

A key part of the slow recovery is related to continued high unemployment. Workers laid off in 2008 and 2009 have not found new jobs and companies have been slow to hire, particularly in the small business

sector, the biggest growth creator. Six million workers have been unemployed for over 26 weeks. 35% of unemployed workers have been out of work for more than two years. U6, the measure of unemployed plus involuntary part-time workers, has been stuck near 17% for months. Hours worked, a measure that will indicate when the part-timers become full-time, remain at rock bottom levels. This is the slowest post WWII employment recovery and the Fed says it may take 4 to 5 years to recover (see chart):



During 2010, overall consumer income was only up 1.8% yr/yr while inflation increased 1.5% in 2010 based on CPI, but +48% for food, +23% energy, and +7 to 8% for health care costs. The consumer continues to pay down debt or default and it is unlikely that the consumer, historically two-thirds of GDP, will be a factor for growth in 2011.

### Real estate

To add insult to injury, real estate, probably due to the consumer's situation, is moribund and had signs of renewed deterioration in the 4<sup>th</sup> quarter. The Case-Shiller Home Price Index shows 4<sup>th</sup> quarter prices falling at a 10% annual rate after a pickup in mortgage refinancing costs due to rising interest rates. Buyer traffic is very low and inventory continues at a high 8.5 to 10.5 months not including the massive shadow inventory held by banks. Housing starts at 500,000 to 600,000 per month are still too high and are adding to inventory. And, to top it off, there is another very large wave of adjustable rate mortgage resets due in 2011.

### State and local finance

State, local, and federal deficits are also major structural impediments to growth going forward. Fiscal year 2011's projected deficit is \$140 billion nation-wide and 31 states have borrowed \$41 billion just to pay unemployment benefits. States have over a trillion dollars in unfunded pension liabilities as well as health care costs. Finally, federal stimulus is winding down and the municipal bond market has raised borrowing costs. States have had to resort to raising taxes and cutting spending which pinches consumers and localities further. One guesses that after a few more years of \$1 trillion (or greater) deficits, the federal government will have to take similar actions. The Feds, however, have the power of the printing press. The federal

government and the Federal Reserve may be forced to support the states further as part of a new stimulus program or a third wave of quantitative easing or “QE” (e.g., purchasing government bonds).

### **Glimmer of hope**

Given the above, it is not surprising that confidence has not recovered on Main St. and for small business. Without confidence and risk taking, there can be little sustained growth. There are a few small glimmers of hope for GDP. Business spending and exports have both been good. Profit margins are high due to the income from cost cutting in prior years. This has helped equities and gives some promise of business capital spending to come, especially as they see market niches pick up and as the government dishes out new incentives.

The administration continues with more stimulus. In December, the Bush tax cuts and unemployment insurance were extended, a 2% payroll tax cut for 2011 was put in place, and 100% expensing for business investment was instituted for 2011. The total cost is \$900 billion over two years. We see first quarter 2011 GDP at 2% and 2 to 2 ½ % for 2011 as a whole. Further stimulus for the states and quantitative easing part III will probably start in the second half of the year.

### **World Economies**

**Japan:** The economy in Japan continues to deflate with CPI -0.5% yr/yr in November. Consumption from an older population is poor. The rate of export growth dropped from September to November. Business is reluctant to invest in new capital given the level of trade competition. The government has a budget of \$1.1 trillion for 2011. Only \$489 billion is funded by tax revenue. \$525 billion must be borrowed. A total of \$3.8 trillion must be borrowed or rolled over in the next year, at a time when the pension system is cash flow negative and the savings rate has fallen to 2%. This limits bond buying from these sources and may lead to a funding and currency crisis. Japan has begun quantitative easing by the central bank.

**Europe:** The U.K. is belabored by an insolvent banking system, a huge government deficit, large austerity cuts in spending, and a sinking housing market. The Bank of England has a massive quantitative easing program underway. The EU is in shabby shape except for Germany (which grew 3.9% in 2010 mostly on exports to Asia) and a few of the Northern tier countries. Overall EU GDP was less than 2% last year. The banking system holds \$1.5 trillion of assets of the weak members and has \$700 billion in derivatives based on them, held in such a way that a problem for one is a problem for all. Greece failed long ago and continues to deteriorate. Ireland failed in November and continues to dive drastically. It would appear that Portugal is certainly next and then Spain. Italy and Belgium are also suspect. The funding crunch period is March to May in 2011. We feel that Europe, through the EU Commission and the European Central Bank (ECB), will soon present a more comprehensive workout containing a large rescue fund, ECB bond purchases, restructured debt, fiscal transfers to the weak countries, and finally some kind of gold backing. The effort could be successful. Because the EU's overall deficit was only 6.3% of GDP (vs. 11.3% for the U.S. and 11.5% for the U.K.) it has no trade deficit in aggregate. Household debt is moderate, and importantly, it has the backing of its biggest trade partner, China, for the plan. China may feel that longer-term, the euro is a firmer asset than the dollar. While we see Europe growing only 1.5% in 2011, growth is not the point here, reform and stability are.

**Emerging Markets:** And now to the growth engine of the world, the developing nations. Growth is still very strong, but all the stimulus of developed nations, in a hunt for real value, has flowed into emerging nations and into commodities. Real estate, overall lending and expansion have combined with supply shortages to boost prices of food, metals and energy above the 2008 levels and create vast inflation problems for the emerging countries. Food prices have soared in India +18.3% yr/yr and in China +11.7% yr/yr. There has been unrest in many countries in Africa and the Middle East over this issue. Governments have resorted to raising minimum wages, hiking interest rates, and putting controls on imports of capital, but without much effect so far. China, after 10.1% GDP growth in 2010, has been proactive in raising interest rates and tightening liquidity. It must aim to do more soon if it is to target only 8% growth in 2011. Evidently, China is worried about its own rise in property values and the sustainability of export growth in a world where trade is still down about 10%. Wages have been rising with food prices and consumer spending remains robust in retail and car sales. Foreign investment in China is still strong and December exports rose 17.9% yr/yr. Lending in China for 2011 will be about the same as 2010 (\$1.1 trillion) with growth of 16.2% yr/yr. Corporate profits in 2010 were up 49% so there is room for some margin compression. While China may slow, it is still relatively healthy. Elsewhere, other resource, manufacturing, and trading countries also did well on GDP measures: Brazil +7.3%, Chile +6.2%, Mexico +3.7%, S. Korea +6.2%, Singapore +15%, India +8.9%, Indonesia +6.0%. If they continue to grow at this pace, there will be more upward pressure on resource prices.

### **Investment Expectations**

The markets have been difficult these past two years. Investors, in general, have been too much in cash, too negative and are unable to bring themselves to hedge against purchasing power and dollar losses. All through this period, the Fed has used quantitative easing to explicitly raise equity prices to try to increase confidence and start a wealth effect. To date, this has worked for some assets, but not for others, including bonds of all types and financial stocks. Stocks subject to margin squeezes on earnings due to upward input cost pressures, have not done well this year and have not preserved purchasing power. We see this process continuing. The economy and earnings may disappoint in 2011, but the Fed will be there with quantitative easing. As we have said in the past few updates, harder, real assets such as gold, energy, chemicals, manufacturing, and rails will continue to do relatively well over time despite periods of market volatility. Energy looks especially attractive this year as global demand bumps up against spare supply. The International Energy Agency (IEA) forecasts world oil demand growing 1.6% in 2011 driven by emerging markets. Groups moving out of favor due to margin compression include restaurants, services, consumer goods, furniture, and staples. Non-inflation protection bonds are to be avoided since the world is skeptical of the U.S. and \$6.2 trillion of plain vanilla U.S. Government debt alone must be sold or refinanced this year. They will have to keep pretending all is well and whistle especially hard so no one suspects they are afraid. We remain vigilant.

December 31, 2010

DJIA: 11,577.51

S&P 500: 1,257.64

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### **About Bounty Management**

Bounty is an investment firm based in Boston that provides personalized, professional management of investment portfolios. Since 1971, we have successfully managed investment, trust and retirement portfolios for clients including individuals, families, non-profits, and endowments. Our primary goals are to preserve purchasing power and to produce long-term appreciation of capital.

We believe that:

- Global macroeconomic analysis of world-wide trends is valuable
- Security and sector selection are a key part of investing
- Unique business models and good management teams generate better returns
- A valuation discipline can help avoid mistakes

If you would like to learn more about our investment management services, performance, and how we can help you, please give Ray Bligh a call at (617) 357-8285 or access our web site at <http://www.bountymanagement.com>.

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