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# Market Memo—Look Back, Look Ahead II: Some 'wild' predictions that we think will happen in 2011

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As we assess market and economic conditions in the waning weeks of 2010, there's clearly grist for the bears to chew on. At 1,258 on the S&P 500, we're sitting up 89% from the market low just 21 months ago—a daunting run. Future tax rates for the economy remain uncertain, although the promise of at least a temporary two-year extension of all cuts following the Obama-Republican compromise earlier this month is comforting. The landscape of the health-care industry is changing, but we are still uncertain as which direction. Corporate profit margins are near all-time highs, raising concerns as to how much higher they can go. And while profits are strong, the much-awaited jobs recovery is still awaited. Europe's rolling sovereign debt crisis seems to roll on, while closer to home, state and local governments face deficit issues that are daunting at best. In Asia, commodity inflation is taxing the patience of the region's central banks, led by China, which has been inching up rates and is threatening worse. And on the geopolitical front, there's North Korea, Iran, Afghanistan, Iraq—all present seemingly intractable problems.

Despite these worries, in fact in part because of the wall of worry they present, we remain firmly in the camp that the markets continue to grind higher next year, while the economy moves into a reacceleration phase following the mid-2010 soft patch. And while equities have had a big move so far, they're still 25% below their all-time peak. Corporate liquid asset balances are near all-time highs at 7.1%. Valuations at 12 to 13 times projected earnings, while not single-digit cheap, are historically inexpensive relative to bonds, particularly at this stage of the economic cycle. With the Fed focused on avoiding the second Great Depression and the European Central Bank trying to keep the peripheral economies afloat, we believe we are in a "Goldilocks II" scenario for stocks. We expect real GDP growth next year to reaccelerate to 3.5% at least (with risk to the upside), and take the S&P by year-end 2011 above 1,400.

Against this backdrop, we are maintaining our equity overweight in our benchmark stock-bond portfolio model at 80% of maximum relative to bonds. Within equities, we remain overweight the more cyclical areas of the economy, including consumer discretionary stocks such as restaurants, retail, autos, and housing, as well as the technology sector and financials. Overseas, we believe selectivity is more important than ever, and to that end, we like economies and markets with strong sovereign-credit positions combined with attractive valuations and exposure to the global economic cycle. Markets of note that we like include, Germany, Norway and Denmark in Europe, and Korea and Taiwan in emerging. And we are warming to long-neglected Japan as our favorite value play globally.

Here are our Top 10 most out-of-consensus calls that lie behind this recommended equity positioning:

**1. Nonfarm jobs hit 300,000 by late spring, perhaps June.** Although the bears whine that the jobs recovery has been anemic, in fact the move from losing 700,000 jobs a month at the

### Potential wrinkles to our forecast

Three issues could douse our outlook for 2011, led by jobs. We've been expecting payroll growth to ramp up for some time, but every time we think we've had a breakthrough, we get kicked in the shins. Basically, with the future too uncertain to make longer term hiring decisions, business managers have instead made due with less, partly by selling off pre-crisis inventory. But as future uncertainties are now declining, and inventories are low, we expect pent-up demand for labor to begin evidencing itself in employment growth. Given the importance of employment growth to other elements of our forecast, we'll be watching the monthly nonfarm payrolls data carefully for evidence that the recovery is unfolding as projected.

Another wrinkle, or worse, could be Europe and its evolving sovereign-debt crisis. While we're expecting a relatively benign debt rollup to the stronger European sovereign credits, a more negative outcome—or at least headlines—could happen, too. Failure to satisfy Europe's bond vigilantes, and even accelerated talk about a euro breakup, could be punishing for markets. Not our base case, but a scenario to watch for carefully.

A California financial earthquake is another negative surprise to keep the seismometers

height of the crisis to November's gains of a non-seasonally adjusted 217,000, or even the seasonally adjusted 39,000, is actually ahead of the average of previous recoveries since 1970. In fact, job losses continued 13 months following the end of 1990-91 recession and 19 months following the end of the 2001 recession. By contrast, nonfarm payroll growth, however meager, turned positive six months after the end of the most recent recession. With the uncertainties that we think slowed hiring last summer now fading (Europe stabilizing perhaps, Bush tax cuts being extended in full, the Obama administration/Washington shifting to a more pro-growth, pro-business tone, the stock market higher, etc.), we anticipate healthy U.S. businesses will begin to accelerate the hiring process as spring unfolds. A jobs recovery is a key lynchpin to our outlook, as outlined next.

trained on. We're expecting that despite its much publicized economic and fiscal problems, California will muddle through. Its exposure to the global cycle could help a lot, and the incoming administration of Jerry Brown seems at least to have the fiscal mess as a top priority. On the other hand, the state has benefitted enormously from federal support by Nancy Pelosi's Congress, and her office will be moving to the basement of the congressional office building come January. Assuming the Republicans are less supportive with federal largesse, California could end up with Hobson's choice between more drastic fiscal reforms or some form of debt restructuring. We're assuming the former but are watchful for the latter, which would be ugly for equity markets.

• How we did with our 2008-2010 predictions

**2. Annualized auto sales rise 20% to about 14 million.** For the past two years, U.S. auto sales have been in the doldrums, buffeted by high unemployment and extremely pessimistic consumers whose outlook for the future was all gloom-and-doom and whose willingness to spend was shot. Auto sales have ranged between 10 million to 12 million the past two years—basically rock-bottom replacement demand as the nearly 250 million U.S. auto fleet grays—and virtually all truly discretionary auto upgrades have been put on hold by beleaguered consumers busily repairing their own over-levered balance sheets. With that process now at least half through and with the jobs environment improving, we think a sharp pickup in auto sales is coming—and soon. And to those who think +20% sounds nuts, remember that this would still only take us to level that's roughly 20% below what was viewed as "normal" during the past decade, when the population was smaller than it is today.

**3. Housing starts rise 50%, with more on the way.** Here's another number that sounds nuts, but is actually very doable once jobs pick up. On a trend basis, the country needs about 1.4 million new houses built each year just to match trend population/household growth of 1.1 million and to replaces the 300,000 houses in the housing stock that fall down each year (yes, even houses "age.") For the last three years, we averaged about a quarter of that level as we've worked off the excess bubble housing stock and as Johnny and Mary moved back in with the parents, waiting for the job market to improve (creating "reverse household formation," much to the chagrin of some parents!) We believe that with the housing excess now worked off in all but the largest bubble markets, and with jobs recovering, housing starts next year will begin a multiyear run back to a "normal" 1.5 million pace, about triple their current level. Our forecast for a 50% move next year may sound crazy, but that would still leave us at about only 50% of trend demand.

**4. Corporate profits continue to surge, perhaps above $95 on the S&P, a new all-time high.** Up until now, this corporate profit story has been largely a cost-cutting/productivity/margin-recovery story. We think in this stage of the recovery, with corporate spending accelerating, hiring and jobs expanding and consumer spending following suit, profits will be driven more by top line growth than margin expansion. Margins at 7.6% are already near all-time highs, and may not move that much higher. But with nominal U.S. GDP growth at 5%, international GDP growth even higher and the kind of normal GDP multiplier on corporate sales, we think revenue growth on the S&P next year could be 7%. If margins expand modestly, particularly in the nonfinancial sector, that could push S&P earnings even beyond our $95 target by year-end.

**5. State governments begin to rollback pension and health benefits for state workers.** A key linchpin of the bear case is that our governments, particularly at the state and local level, are giant Ponzi schemes, with off-balance sheet liabilities in the form of pension and health-care promises that are bound to bankrupt them and leave our economy in slow or even negative growth mode for an extended period of time. An old market sage I knew once told me, "If it can't happen, it won't." That's where we believe we may be with government worker compensation. Led by governors such as New Jersey's Chris Christie, we expect state governments to begin the climb back to fiscal health not by anti-growth tax measures or crisis-inducing municipal bond defaults, but rather market-friendly rollbacks of the compensation and benefits packages that have led them into the current crisis and which have increasingly garnered negative media coverage. These moves will be incremental not dramatic, but enough to allow the markets to develop more confidence about the direction we're heading in collectively, particularly as tax receipts

rise with the improving economy.

**6. Europe moves toward a de facto rollup of individual sovereign debt to a euro-wide issuance, resulting in an increasingly centralized fiscal policy and abetting dollar's move to near euro parity.** We think the lesson of 2010 for Europe is that although collectively, its debt level to GDP and its operating fiscal deficits to GDP are similar to the United States, its multi-sovereign structure for issuing debt and implementing fiscal policy leaves its weakest links exposed to punitive market action. This, in turn, threatens the entire continent given the cross-holdings of European sovereign and bank debts throughout the euro zone. Although nominal issues of state sovereignty make it impossible for Europe formally to collectivize its debts and its fiscal policies, in practice, this is exactly what they're doing. One outcome of this push is that the fiscal straitjacket the peripheral EU countries are being forced to wear will hold down growth for the entire euro zone, just as growth in the U.S. economy shifts to higher gear. The upshot: the dollar will move closer to parity with the euro, perhaps hitting $1.15 by year-end, down from its current level of about $1.31.

**7. 10-year Treasury goes to 5%.** While this sounds dramatic, this would only bring the yield to pre-global financial crisis 2007 levels. A primary driver of this move would be the growth recovery, which should increase equity returns and reward investors for selling bonds (driving bond yields up) and buying stocks. A secondary driver of higher yields should be the perception that, with a firm recovery now in place, the Fed's massive liquidity injections of QE1 and QE2 will now result in excess money in the system, driving up inflation. Indeed, once the recovery hits full throttle, as we expect in 2011, fading fears of a double dip will be supplanted by fears of inflation spawned by all the money the Fed has printed.

**8. The Fed begins shrinking its balance sheet by Q3 '11.** This is part and parcel with the macroeconomic forces described above. Put simply, growth should be self-sustaining by mid-summer 2011, not only erasing the need for further stimulus from the Fed but freeing it to began pulling back to try to keep inflationary pressures at bay. This would represent a return to normalcy that is vital to the Fed maintaining credibility with the markets. The Fed won't do this until the key measure of excess capacity in the economy that they watch, the unemployment rate, begins declining substantially. Once we hit 300,000 jobs a month in June, this will start to happen.

**9. China maintains its floating peg to the dollar.** Despite talk throughout the summer of allowing a more flexible yuan, Chinese authorities will keep their currency pegged to the dollar. Stronger growth in the domestic U.S. economy will make this less of an immediate issue for the White House, and maintaining the dollar peg also will act to keep inland Chinese peasants with pitchforks at bay by keeping their export-oriented economy in full gear. But longer term, the result of such a policy will serve to feed structural imbalances that have erupted in the credit markets in painful ways over the past decade and a half.

**10. Japan enjoys a bounce.** Japan's been in the doldrums for years, and our international funds have done well by avoiding it, often with no positions at all in the country. That has begun to change. We think Japan's export sectors will enjoy a bounce as the global recovery picks up steam; global investment sentiment towards the country has gone from bad to worse (a contrarian positive); and valuations of a key basket of Japanese stocks we follow are now very attractive.  Our favorite measure for cross-country comparisons is price to cash flow, and our Japanese basket is currently trading at 6.3 times, vs. 9.2 times for the U.S. market.

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Views are as of December 29, 2010, and are subject to change based on market conditions and other factors. These views should not be construed as a recommendation for any specific security.

Bond prices are sensitive to changes in interest rates and a rise in interest rates can cause a decline in their prices.

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S&P 500 Index: An unmanaged capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. Indexes are unmanaged and investments cannot be made in an index.

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