

The Changing Dynamics of Growth

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The shape of U.S. economic growth is changing. While growth will remain sturdy and sustainable, further acceleration to a higher growth platform is limited. A more moderate view of our economic potential is the likely outcome. This has implications for earnings, inflation, and interest rates, and is potentially a major positive development for domestic equities.

Rising inflation is fading as an imminent threat to the financial markets. Core inflation, i.e., excluding food and energy, remains well below the fed's preferred level. Expectations for higher levels of inflation are based on a rising tide of worldwide growth led by emerging nations, but also including expectations for a higher growth trajectory in the U.S. and the euro zone. Some of the expected economic vigor is questionable. The Chinese Central Bank has increased rates five times this year and raised reserve requirements for mortgage loans. More rate increases are expected. These anti inflation policies are having an effect. Speculative real estate investments are declining and agricultural prices are falling. India is also taking increasingly aggressive steps to combat inflation in that country. The State Bank of India recently raised its benchmark rate by 0.75% to 9.25%, following upon a 0.5% increase just last

week. Economic growth in the euro area, heavily influenced by German exports, also appears to be waning, and the European Central Bank is backing off its tightening efforts. U.S. growth is solid and sustainable, based on an industrial resurgence, rising exports, and a more confident consumer. Still, growth will not be heated. Exports may moderate as the dollar strengthens and growth in emerging nations reaches a plateau. Domestically, housing will certainly be slow to recover with house prices under long term pressure. Residential construction will stabilize at a relatively low level. There remains a considerable amount of excess supply in housing, labor, and industrial capacity, which will continue to exert pressure on wages and goods prices.

The rise in the price of commodities has been driven by elevated expectations of further increases as the expansion continues to unfold and by speculation, mainly from hedge funds. With growth moderating in a large part of the world the incentive to pay higher prices for commodities becomes less of an imperative. Margin requirements are always and everywhere the Damocles sword over the head of speculators, and the doubling of margin requirements for a host of commodities in recent days effectively ends further speculative activity in commodities by those on the make for



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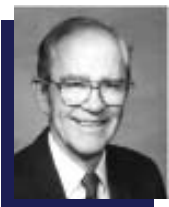
quick profits. The price of commodities will reflect economic forces which remain positive, but with the inflation premium compromised.

QE2 and zero interest rates are not helpful at this stage of our expansion. We believe the imminent demise of QE2 will be viewed positively by the financial markets. Some economists, including some influential Governors of the Federal Reserve, believe that our economy still needs the support of a very high level of government spending to sustain growth. QE2 has become increasingly controversial and has sewn widespread fears of inciting a new era of rising inflation. Removal of this threat as QE2 ends will enable the natural healing forces within our dynamic economy to breathe again. With inflation fears contained and steady if unspectacular employment and wage growth likely, the Fed will slowly turn its attention to the bloated liquidity and excessive debt creation of the past few years. Interest rates may increase but the increase will not threaten the expansion. In an era of satisfactory real growth not based on debt, this will be viewed positively by the stock market.

Fiscal policy also is undergoing radical change. Aside from the current controversy about

raising the debt ceiling, government spending will be significantly slower in coming years. No matter which side of the political spectrum a person is, it is clear that the U.S. has entered a new era of fiscal conservatism. A widespread recognition of our financial vulnerability has entered the public psyche. Deleveraging, spending restraint, attention to the growth of social programs left unfunded, skepticism about government imposed solutions, are now driving forces in the conduct of public policy. The trend is equally pronounced at all levels of government. Restoring balance to a one sided expansion of government is a healthy trend in a democratic society. A recognition that government has gotten too big, too dominating, too wasteful of resources, too detached and unaccountable, will bring renewal and rebirth and a healthy private sector. Skepticism and fear has kept speculation absent from stock market valuations at a time when earnings and balance sheet strength are at record levels and growing. As the threat of inflation increasingly wanes, consumers continue to gain confidence, and the private sector revives, U.S. stocks will be favored. Those who have avoided U.S. equities will be disappointed.

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