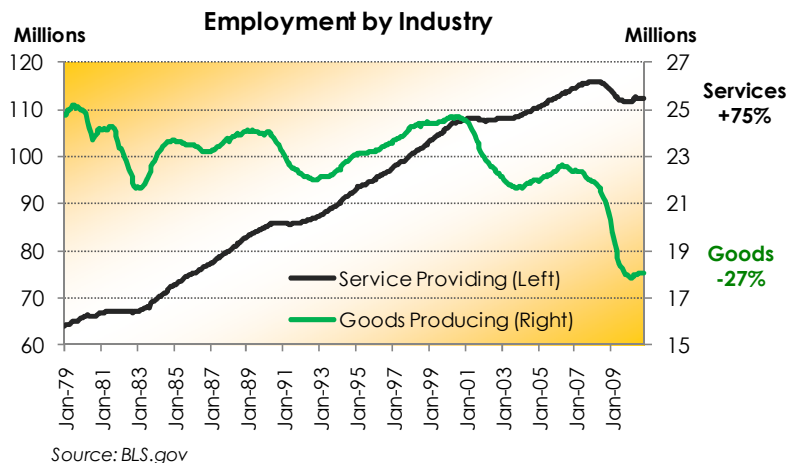
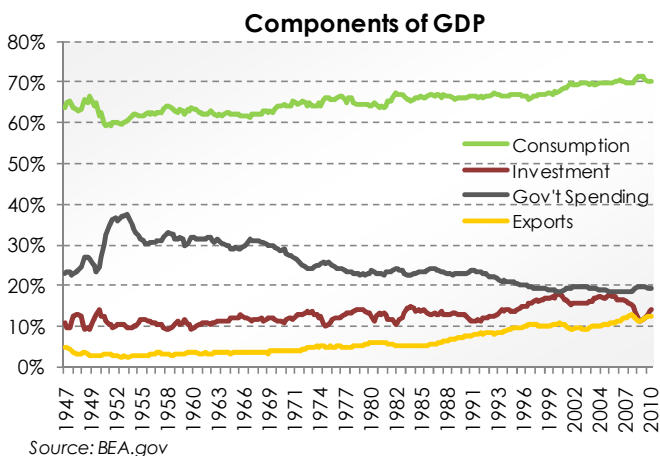


The current administration has set an ambitious goal of doubling the size of U.S. exports over the next five years as an attack against the economic malaise in this country. Since the beginning of the 2000's, the goods-producing workforce shrank by more than 25%, while service-sector employment grew by almost 6%. The chart below shows an even more extreme divergence since the 1980's. This trend has left a glut of American manufacturing workers either unemployed, or re-employed in lower-wage, service-providing industries. Our belief is that while reversing this decline may be one piece of solving the puzzle in the long run, what we really need now is a consumer recovery. In this month's piece, we examine some of the pitfalls that lie ahead if we make manufacturing, foreign trade, and a weak dollar a cornerstone of economic recovery.



Sharing is Caring, But Consuming is Better

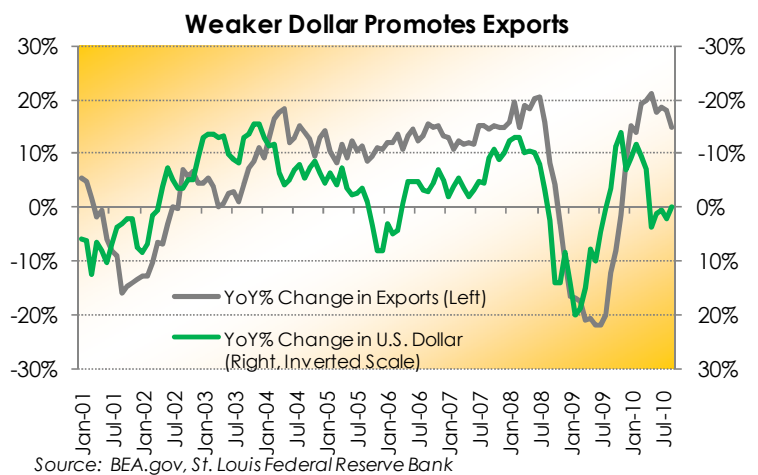
As we wrote about in our September research piece, "Employment: Ready to Take Off or Still Delayed," there is a growing debate over whether the current unemployment problem is cyclical or structural in nature. The cyclical camp argues that anemic consumer demand is to blame, and we need to stimulate and spend our way out of the employment hole. The structural camp argues that imbalances between available jobs and workers' skills are the main problem, and additional spending will be both ineffective and inflationary. Our belief is that the problem has a foot in each camp. The challenge facing this country is that solving these two sets of problems will require different, and possibly conflicting, actions.



The U.S. economy is a consumption machine. In fact, over 70% of U.S. GDP is derived from consuming goods and services, while only about 12% of our output is derived from Exports. The remainder is Government spending (20%) and Investment (14%), with Imports subtracting the difference from Gross Domestic Product. Common sense tells us that stimulating the largest portion of GDP, consumption, would have the

greatest immediate impact. Expanding the manufacturing/export sector could help diversify our economy over the longer term, but it would likely produce less immediate results.

The idea of relying on emerging consumer markets to buy our goods and support our growth is attractive. We believe that the “emerging middle class” story in China and India is compelling, and probably will exceed the growth experienced in the U.S. during the post-WWII boom. These new consumers could support more skilled, higher-paying jobs in the U.S. than the current service-sector-focused economy. Over time, a shift of this sort could sustainably (and substantially) improve consumer confidence and help bridge the income gap that has been steadily growing in this country. The problem we see is that the ingredients that go into boosting exports – in particular weakening the U.S. dollar – could be detrimental to the fragile economic recovery in the short run.



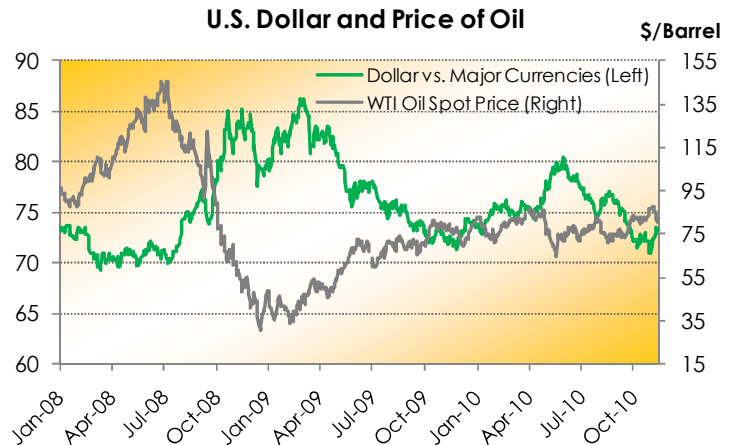
I'm Just a (Dollar) Bill

Despite dollar-supportive rhetoric from Treasury Secretary Geithner, many signs point to the administration encouraging a depreciation of the U.S. dollar. The U.S. has lobbied China to loosen its dollar peg and allow the yuan to appreciate. Doing so would effectively increase the prices of Chinese exports, while making U.S. products relatively less expensive. That would make our goods more attractive to foreign buyers, but it would also increase the price of everything Americans buy from abroad. It is unlikely that consumer appetites would adjust quickly enough to offset the price changes.

Another prong of attack against the dollar is the latest round of quantitative easing (QE2) initiated by the Federal Reserve in early November. The goal of quantitative easing is to drive down interest rates by buying up Treasury bonds – a methodology of last resort for the Fed given that policy rates are already as low as they can go. The likely result of more QE is lower interest rates, increased inflationary pressures and a depressed U.S. dollar. The inflation/deflation debate is still bubbling, and some argue that priming the pump may be one of the only ways to avoid a deflationary double-dip. Although we believe that erring on the side of inflation at this point is probably “less-bad” than deflation, this is not the kind of inflation that could promote growth.

Many commodities, such as oil, are priced in dollars, and therefore a weaker currency means higher raw materials prices, all else equal. Higher commodity prices mean a higher cost of living for U.S. consumers, and a smaller portion of disposable income available for discretionary spending. **Higher prices without wage growth spells even more trouble for the consumer.**

Even outside of the U.S. this type of cycle could impact demand. If central banks in high-growth countries (i.e. China) see inflation picking up, they will raise policy rates even more quickly. Already the U.S. is at odds with many other countries as we continue to lower rates and they attempt to tame growth. An inflationary cycle in commodities could put our goals even further at odds.

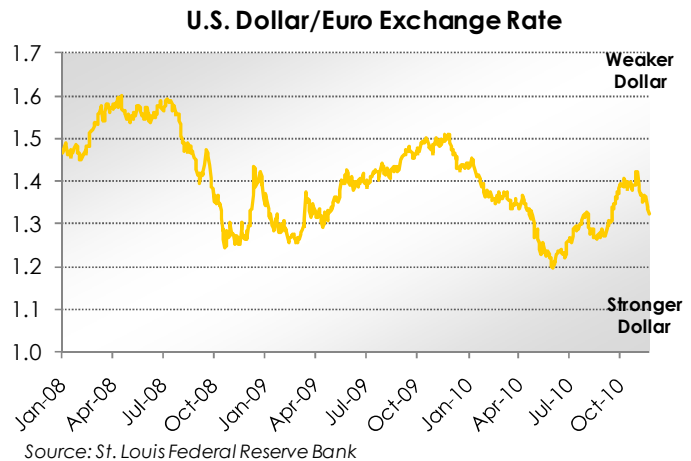


Source: St. Louis Federal Reserve Bank, U.S. EIA.

The Training Wheels Are Off

Although promoting manufacturing could potentially create jobs and increase aggregate income/spending in the U.S., it would take years. Depressing the dollar to do so could prove even more detrimental by making Americans' cost of living higher. The elephant in the room is that the U.S. needs to stimulate spending (and likely income to do so), but nobody knows how to make that happen. During the past few decades, Americans relied on their homes, credit, and employment incomes (probably in that order) to fuel spending. Now we are in deleveraging mode, and a resurgence of **supply or demand** for credit is unlikely in the near term. A solid recovery in home prices would buoy consumer confidence, but again unlikely to happen in short order. Government spending helped make up for the weak consumer in the depths of the recession, but those days are numbered. With the Republicans taking over the House of Representatives – and riding a populist wave of fiscal conservatism – it is highly unlikely that additional government spending will occur. Meanwhile, stimulus measures put in place earlier in the recession are coming to an end. This leaves us with jobs as the only engine to drive wages higher, fight deflation, support consumption and neutralize deleveraging. Companies must hire. Corporate profits are in great shape, but cash on the balance sheet is still king. U.S. corporations are clearly reaping the benefits of stronger growth outside of this country – more than 40% of profits are derived abroad; however, these corporate profits are not being used to hire additional workers. It is no wonder we have seen such a divergence between the strength of the stock market and the health of the overall economy.

Even if the administration forges ahead with a weak-dollar strategy, the markets may have other plans. Exogenous macro and geopolitical events could throw a wrench into the plans. Despite the new round of quantitative easing, the U.S. dollar has actually strengthened recently against the euro in light of renewed fiscal problems in Europe. The dollar hit a 2-month high against the euro last week as Ireland's debt woes



took center stage. With Spain and Portugal still on the verge of their debt crises, it is likely the dollar will maintain strength against the euro. Geopolitical tensions in Korea have also created another reason for dollar safe-haven status.

Time to Grow Up

The U.S. is now out of synch with the rest of the world on a policy front. Unlike during the credit crisis when central banks were easing in lockstep, emerging countries are now in tightening mode trying to stave off inflation. Currency appreciation is not an attractive option for these countries. The re-emergence of European debt problems and the recent clash between North and South Korea have reminded investors of the potential for crisis, and the safe haven status of the dollar. Investigations of insider trading at several hedge funds and asset managers could also be a catalyst for investors to seek less-risky assets. Inflation and deflation remain almost equally-likely outcomes. Corporations still operate under a cloud of uncertainty despite solid profits. Given these circumstances, we believe that a weak dollar is not only harmful, but unlikely.

Over the longer term, we support the idea of diversifying beyond the current U.S. economy and capitalizing on the emerging markets growth trend. This is a strategy, however, that will take time and requires fertile ground to take root. We are not positive on long term prospects for the dollar. The U.S. will need to address its own fiscal problems eventually, which could slow growth.

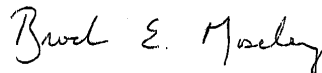
In the short term, the U.S. must stimulate the largest portion of its economy, domestic consumption. At this point in the fragile recovery, the consumer cannot battle any additional headwinds in the form of reduced spending power. We are also aware that a change in the power balance in Washington could be precarious; we are cautious of how a removal of the government backstop could change investors' expectations.

In our portfolios we continue to favor U.S. equities based on the strength of companies' balance sheets, and improving economic data that is appearing almost under the radar. We remain significantly underweight in Europe. We expect continued dollar strength in the near-term as the greenback is the lesser-of-evils compared to the unstable euro. As always, we continue to survey the global macro landscape looking for pitfalls as well as better investment opportunities for our clients.

November 30, 2010



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