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Welcome

As we have now entered the Year of the Rabbit, according to the Chinese horoscope, which is known as a year of reflection, change and renewal in preparation of the next 12 year cycle that begins in 2012, it is a good time to look back but more importantly to look towards the future and what it may have in store for us economically and financially.

A lot of lessons can be learned from 2010, and very valuable ones as well.

Let us use that as a base to determine what is in store for us in the New Year.

Content

The US Economy

In general, 2010 was a turbulent year for the US economy and actually more disruptive than the previous two years due to international and global influences.
The steady and rapid growth in the East and the turmoil in Europe certainly had an impact on US economic growth and the first three quarters dealt with the surrounding issues in a slow but sustainable way.
The fourth quarter of 2010 showed signs of stronger GDP growth which may be a sign of a steady recovery for this year although we need to see whether this is sustainable for the next two quarters before we draw any definitive conclusions.
The signs are there and that is positive but that does not mean that our economic system is healthy and ready to hit the road.
Many obstacles remain to be resolved but we should breathe a sigh of relief that we made it through yet another turbulent year without too much damage and with hope for better times although I remain very cautious and I am not rejoicing just quite yet.
The biggest concerns are the lack of private capital, lack of production expansion, high unemployment, budget deficits and the debt/GDP ratio.
All of these issues will have to be tackled over time and 2011 may be a good year to start.

Lack of private capital
The private sector is currently sitting on $3 trillion waiting for an opportunity to invest and put capital to work.
The uncertainty about applicable corporate tax laws is what is holding the capital down in the vaults so to speak.
Add to this $1 trillion in non-repatriated revenue that is stored in offshore bank accounts through the use of SPVs (Special Purpose Vehicles) because of the prevailing tax rates in the US and one can easily envision what can be accomplished and how such an investment would affect large parts of the US economic engine.

Lack of production expansion
US exports have been lagging and stagnating since the start of the financial crisis for the simple reason that we have not invested in product development let alone production capacity.
If there is one thing the US needs it is more manufacturing and the production of quality products the rest of the world demands and needs.
In order to achieve that we obviously need the above private capital injection that now sits idle, waiting for an opportunity to be put to work.

High unemployment
The latest figures of job creation were encouraging but are very slow to reduce the large and realistic number of unemployed Americans.
Employment has to become the result of both capital investment and infrastructure projects that contribute to and enhance the future of the US economy (more about that later).
The drop in unemployment to 9.4% is not a realistic picture and is mainly due to how the count is being done rather than the 103,000 jobs created last month.

Budget deficit and debt/GDP ratio
This should be a major concern from a long-term perspective but should not be in our rearview mirror for 2011 given the slow economic growth and the investments we need to make somewhere else.

My view is that we may be able to weather the first six months with sustainable GDP growth of 4.5% but such also has to be accompanied with serious capital investment in durable production and manufacturing in order to have the desired effect.
Funds that are meant to reduce the current budget deficit should simultaneously be redirected to support much needed infrastructure improvements and should primarily be directed towards energy grids.
Our Pacific and Atlantic power grids have not been updated for the past 30 years and require serious funding.

2011 will be the year of reflection and hopefully a year of stabilization with modest growth but still one that may provide a solid foundation to start thinking about absolute and net growth for the coming years.
It may be rocky and it may not be glorious but as long as we can lay the foundation then we may be able to build a house again.

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The Currency Markets

The inter-currency markets certainly defined the financial year of 2010 and that may be an understatement. Needless to say that this market was not for the faint of heart except maybe for those that get an adrenaline rush from extreme volatility.

The euro has been the talk of the town ever since March 2010 and continues to be a major concern for the international financial markets.

One can easily point out that maybe the euro was too fast and too furious or one can refer to the Maastricht Treaty and the Lisbon Treaty to find the exact cause of the near collapse of a member such as Greece.

The fundamentals however go a lot deeper than that and there is no easy solution other than a continued bailout and rescue plan for those that need it: Greece, Ireland and Portugal for starters.

The problem would not be as severe as it looks were it not for the fact that Spain and possibly Italy is also in the mix and that paints a very different picture going forward.

What sets both apart from the early sovereign debt woes is that both represent the fourth and third largest economies in the Eurozone respectively and therefore the impact is more than just a simple crack in the wall that can be patched up.

The volatile movement of the euro versus the dollar, the yen and the Swiss franc has left its mark on the global economic growth and it has also clearly shown that neither of the two largest world economies, the US and China, are immune to the European disease.

The New Year will bring another volatile year for Europe as I don't believe that a joint bailout between the ECB and the IMF will really bring the much needed stabilization.

The US remains on the sideline but China has already stepped in by buying large amounts of Greek and Spanish debt just to bring the spreads back into an acceptable range versus the Deutsche Bund (the euro benchmark).

The euro will remain weak throughout 2011 and its fair market value versus the dollar will have to center around 1.21 in order to keep the European economy growing and keep inflation rates at or below 2% annually.

The currency will continue to lose ground versus the yen and the Swiss franc, but such an event will largely go by unnoticed.

In the grand scheme of things, Europe is the weak link for two reasons.

1) The proposed austerity packages, although commendable, are not the only solution to the euro problems and are very unpopular, causing social unrest and a

slowdown of economic activity in countries that are in dire need of GDP growth to keep Europe thriving.

2) The ECB/IMF rescue package is not sufficiently structured to have a true and lasting effect because it lacks vision for the future.

Both reasons will make Europe look weaker than it should be and will negatively impact its currency.
That may work in favor of Germany, the largest Eurozone economy and largest exporter to China, but will cause an extra drag on the other 16 members (Estonia being the latest addition since January, 01).

The Aussie and Kiwi dollar continue to perform strong, as expected, and such is justifiable because of their natural resources and their export activity throughout Asia.

The yuan-renminbi continues to strengthen versus the dollar which is primarily fueled by Beijing's efforts to increase the convertibility of their currency and cannot be attributed to the efforts of Timothy Geithner to de-peg the Chinese currency from the dollar.
China has made tremendous steps towards following their own long-term monetary vision and has opened the currency market to foreign investors through free trade agreements, direct yuan-denominated purchases by foreigners, swap agreements with Africa and South America and a large secondary currency market via Hong Kong.
All these measures, barely reported in the news, contribute to the increase in convertibility of the yuan-renminbi and its importance in the inter-currency markets overall.
Add to this the fact that the World Bank issued its first loan ever in yuan and one can get the total picture of how competitive the yuan will become against the dollar as a world currency to reckon with going forward.
As much as we have seen the majority of the carry trades taking place between yen/USD, this scenario has now been replaced with large carry trades between yuan/USD/euro and this will continue to grow for the next 5 years.

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The Housing Market

One would think that by now there would be nothing left to say about the housing market and its condition, but 2010 was yet again a troubling year.
The number of short sales and large amount of foreclosures not only overshadowed the housing market but also pushed home values lower.
While this was certainly not good news for existing homeowners, it is part of the pain and recovery process that we desperately needed since 2008 and now that we have swallowed our much needed medicine we may be able to look at a healthier housing market in 2011.
I am not calling the New Year a year of positive recovery given that shadow inventories are still lurking and will continue to find their way to the real estate market, but the high volumes of 2010 will temper off over time.
I call it a year of stabilization where the real estate market can find solid ground to use as a new and hopefully stronger foundation to build on going forward but such will not materialize until 2012.
The second thing to take into consideration is that the recovery will be slow and very careful, as it should be when we remember the reasons for the frontal crash that occurred in 2007 and how an entire primary and secondary market came tumbling down like a house of cards.

The residential market
The primary residential market will suffer from two phenomena that are the direct result of the financial crisis and this will continue well past 2011.
The number of potential buyers has been reduced due to new Financial Regulations and stricter lending rules.
The real estate market has caused a shock wave because of the title breach that became obvious in the foreclosure process in the 27 judicial states.
Both have a negative impact on the American Dream and have therefore turned away a large section of the buyer's market we were used to see prior to 2007 and certainly among first-time home buyers and I do not believe that this will change in the next few years.
That means we should get used to less volume and less turnover until such time as confidence in the market has been fully restored.
However, it also means that those that enter the market will be more financially stable and over time that is a positive thing for the market overall and its potential revaluation.

It also means that the rental market will largely benefit from this occurrence and that the current national vacancy rate of 7.5% will get reduced further to the benefit of investors and landlords.

The commercial market

Last year started with a serious concern that the CMBS market was on the verge of collapsing given the lack of liquidity and the sharp drop in prices but in the end the market held its ground although adjustments had to be made in order to survive.

A sharp decline in occupancy rates led to a voluntary reduction of rental prices to try to keep some sort of balance.

Commercial real estate will continue to rent at extremely low rates in comparison to the previous three years but those who chose to make the adjustments will weather through the storm for the next two years.

I do not foresee a change in purchase price or rental income in this market segment any time soon but a solid foundation will be built in 2011 that should compensate for what otherwise would or could have been lost.

As businesses start regaining confidence in a tedious and still treacherous economic climate, the returns on commercial real estate will solidify but prices will remain below par until the existing inventory in both the real estate market and the rental market have closed the gap and are back to normal, expected and sustainable levels.

In a nutshell, I strongly believe that both markets were and are capable to adjusting themselves to an environment that has clearly changed since 2007.

I also believe that now that Government intervention comes to an end, that this is where the markets can breathe and implement their own solutions.

Looking in hindsight may give all of us a 20/20 vision but I have always believed that if the Government would have let the housing market fall to a realistic and sustainable level that we would currently be in a recovery period rather than a stabilization period and even today I still hold on to that thought, but let’s not thrive on that, let’s reflect and look forward now that some hurdles have been cleared.

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Agricultural Commodities

History has proven many times that when a zero percent monetary policy is being implemented to fight deflation and when such intervention lasts for several years that the end result is always an inflationary bubble somewhere within the financial system.
Our monetary policy is no exception to the rule and this time it is clearly visible in the commodities market and specifically the agricultural commodities.

The sudden spike in food prices in 2008 was largely overshadowed by the peak in oil prices but such will not be the case in 2011.
Agricultural commodities prices have risen by double digits in 2010 with corn rising 70% followed by sugar, soybeans and cacao.

This occurrence is fueled by several factors:
-US crop yields have been reduced by 10% each year starting in 2008 and the forecast for 2011 predicts a continuation of this trend.
-Global demand for grain and dairy commodities continues to grow and outweighs the supply side.
-Grain, corn and soybean inventories in the US are at an all time low.

Food inflation, first reported in China during the summer months, has now been recorded in India, Russia, Brazil and Mexico as well.
Europe and the US are not immune to the possibility of a hyperinflation caused by commodities prices and therefore sharply rising food prices.

The dramatic rise has put pressure on the PPI and ultimately the profit margins of US food producers.
This year we will see the extra production cost being passed on to the consumer and expect food prices in grocery stores to reflect this natural adjustment.
The reason for US food producers to absorb the production cost instead of passing it on the cost to US consumers is because they have already seen a shift in buying behavior from their customer base towards white labeled products which tend to provide the same quality but at a deep discount.
Passing on the extra cost may further erode their revenue stream, which they can absorb through higher margins, but the question is whether the US consumer can afford high food prices while spendable income is low and unemployment is still high.

In my opinion, most American families will not be able to absorb such hike given their current budget woes.

In essence it is the financial crisis coming home to Main Street now that Wall Street has been fixed.

As much as consumers had a solution during high oil and gasoline prices by driving more efficiently or exchanging gas guzzling cars for more fuel efficient transportation, one cannot eat less or more efficient.
Food is a daily necessity and it will be a storm or potentially a tsunami that we will have to weather for the next two years.

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The Global Economy

The global economy saw some signs of a slowdown last year that have led to some concerns about current growth rates and whether they will be sustainable in the current year.
China and India continue to grow at a steady pace of 10% and 8% respectively but both show early signs of high inflation which may dampen their desire to sustain their heated economies.
China is already taking serious intervening steps by either raising their interest rates and/or increasing the reserve requirements for their banks, both intended to control the current 5.3% inflationary pressure from spiraling out of control.
India, Thailand and Indonesia are battling high food inflation and are either hiking up their interest rates or impose high taxes on foreign capital to control currency pressures.
Still, 2011 will continue to see growth in the East given that this is where the production and manufacturing engines are right now and will be for the next decade to come.

South America is doing reasonably well except Brazil who struggles with high foreign capital inflows and a strong currency that negatively impacts their export driven economy and was the worst market performer in 2010.

Russia battles high inflation but has been able to effectively reduce the pressure from 13% to 5.1% in 2010. However, the country struggled with a less than stellar crop yield which will again put inflationary pressure on an otherwise smooth running economy.

In total and judging the BRIC countries, Brazil, Russia, India and China, only China seems to be able to pull the bandwagon in 2011 as the other three partners deal with their own economic problems and potential woes.
Maybe we should change the acronym to CRIB so we accurately reflect who the Clydesdale is that does the hard work.

Europe is still a problem in the making with serious sovereign debt issues and slow economic growth but the most important aspect is whether the Eurozone can tame the inflationary pressure and keep such within the desired range of less than 2%.
I believe that a rate increase in Europe will be needed in order to achieve that, which in turn may further weaken GDP growth and strengthen the Euro that will hamper exports, primarily in Germany.

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The US has shown early signs of slow but steady growth but the first half of 2011 will have to prove that an annual growth rate of 3-4% is sustainable.

What 2010 has shown us or taught us is that our economies are so inter-dependent that a minor shift on the other side of the world can cause a new slowdown somewhere else.
If the East starts overheating, then such will cause the West to cool off and vice versa so it becomes more important to watch the temperature of the global economy than local or continental economies to get a clear picture.

In 2011, we will need to see a reduction of inflation in the East and a reduction of deflation in the West unless we want to exchange diseases with each other and we will all still be sick in the end.

That is not a simple and easy task because both will have to occur at the same time, the same speed and the same fashion.
That means that we need to align individual monetary policies to complement each other rather than contradict.
The West has to unwind its monetary easing, the US most certainly, and Europe will have to redirect its austerity plans towards investments rather than savings, while the East needs to sustain its growth rate and temper inflation.
In essence that means flipping the current global policies around where the West implements monetary tightening while allowing the East to do monetary easing.
That is a very controversial proposal and there are not many supporters but I expect to see the first signs of this contrarian view late 2011 and well into 2012.

After all, this is the Year of the Rabbit and the year of reflection and change and we should not expect the same old if we wish to see the light at the end of the tunnel for a new global economic model that will place all of us in a better and brighter place.

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