

Seeking Alpha α

2011 Outlook: Economy Should Do Better Than Market Expects

by: Calafia Beach Pundit

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Predicting the future back in [late 2008](#) wasn't too difficult, because the market was priced to Armageddon; I thought we would survive, and I turned out to be right. Last year it was more difficult to predict the future, and while I got [most things right](#) I made some critical mistakes, mostly concerning the Fed and inflation. This year is going to be even more difficult, because the difference between what the market expects and what I expect to see isn't nearly as great as it was one or two years ago.

From an investor's perspective, the important thing about forecasts is not whether you get the exact number right (e.g., whether economic growth is going to be 3.5% or 3.8%), it's whether you get the direction right relative to what the market is expecting (e.g., whether growth is going to be stronger or weaker than the market expects). If the market expects 3% growth and you correctly forecast 3% growth, that isn't worth much since you are unlikely to make much money by betting with the market.

With those caveats in mind, my outlook for 2011 is shaped by a belief that the economy will do somewhat better than the market expects, that the Fed will be less easy than the market expects, and that inflation will be somewhat more than the market expects. I held the same general view a year ago and turned out to be wrong on the Fed and inflation, but I don't see any reason to change now. Monetary policy is notorious for acting with long and unpredictable lags, and policy has moved much further in the direction of stimulus in the past year, so at some point we could see the fruits of monetary ease come true with a vengeance. This is no time to get wobbly on the Fed's ability to get what it wants (i.e., higher inflation).

So here we go:

The economy will grow by 4% or more in 2011. I think the market is priced to the expectation that growth will be around 2.5-3%, slightly better than the "new normal" economy scenario that has been all the rage in the past year or so. I'm more optimistic, for a number of reasons. Most important is the 180° shift in the direction of fiscal policy that started with the November '10 elections—that's very good news for the economy. Washington is now much more friendly to capital and to the private sector, and those are the folks who create real jobs and real growth. Going forward, fiscal policy is likely to promote the growth of the private sector at the expense of the public sector.

Taxes are not going to rise as so many had feared, and we may even see some cuts along with a simplification of the tax code. Many worry that cutbacks in federal, state and local government spending will prove very painful for the economy as a whole, but I disagree. One reason the economy has experienced a very sluggish recovery is precisely because there has been way too much growth in the public sector in recent years. Feeding resources to the public sector is a recipe for disappointing growth, and the experience of the past two years is proof of that proposition. So it only stands to reason that reversing the tendency to fiscal profligacy should be stimulative: fiscal austerity is bad for the public sector but good for the private sector.

Given the improvement in unemployment claims of late, I expect to see an increasing number of new jobs over the

course of the year. And the improvements already evident in autos, exports, mining and manufacturing can generate a positive feedback that lifts most other sectors. The forces of recovery are alive and well, and growth can trump a lot of the lingering problems we still have (e.g., underwater mortgages, state and local insolvency, high unemployment).

Inflation will trend slowly higher. Inflation is already a mixed bag, with the CPI and the PCE deflator having trended lower in the past year and the GDP deflator having trended higher. I would expect to see more uniformity this coming year, with all inflation measures showing a rising trend, albeit only a moderate one. Nevertheless, inflation is likely to be more of a problem than the market currently expects. TIPS currently are priced to the expectation that the CPI will be about 1.3% next year, compared to 1.1% over the past year. I see lots of signs that money is in abundant supply, and that is a good indicator that inflation pressures are on the rise: gold and commodity prices are soaring, the dollar is very weak, and inflation in China—a canary in the coal mine since China is tied to the dollar and thus is experiencing the same monetary policy as we have—is on the rise.

The Fed will raise rates sooner than the market expects. Fed funds futures currently are priced to the expectation that the Fed will raise the funds rate to 0.5% next December. I think it will happen sooner. The combination of a stronger-than-expected economy and signs of rising inflation will motivate the Fed to reverse its quantitative easing program sooner than most expect. Ending and/or reversing quantitative easing does not, however, equate to monetary policy that is a threat to growth; it will be a long time before the Fed raises rates enough to choke off growth.

The housing market will be showing signs of life by the end of the year. Housing still looks weak, and the weakness will probably last a bit longer (e.g., a modest further decline in prices, and flat construction activity). But with the economy picking up speed, money in abundant supply, and ongoing growth in the population and household formations, I think the housing market could be on the mend by the end of the year.

Interest rates on Treasury bills, notes and bonds should be higher than they are today, and higher than the market currently expects. Treasury yields out to 10 years are driven by expectations of future Fed policy, so if I'm right about the Fed raising rates sooner than the market currently expects, this should result in higher rates across the yield curve. Currently, according to implied forwards, the market expects to see 3-mo T-bill yields at 0.85% by the end of next year, with 2-yr T-notes at 1.6% and 10-yr T-note yields at 3.9%. Betting that 10-yr yields will rise from their current level of 3.4% is not enough, however; shorting the 10-yr incurs a carry cost that must be made up by falling prices. 10-yr yields need to be at least 3.9% for a short position in the 10-yr to be profitable. Higher yields on risk-free Treasuries will not threaten the economy, since they will be the result of a stronger economy. Higher yields on cash will be a [net benefit](#) to the household sector, since it holds more floating rate assets than floating rate liabilities.

MBS spreads are likely to widen over the course of the year. The main impetus for wider MBS spreads next year is likely to come from an across-the-board increase in the extension risk of MBS as Treasury yields rise. Mortgages, which currently behave like intermediate-maturity bonds, are at risk of becoming long-term bonds as interest rates rise and refinancing dries up. It's possible, however, that MBS could still provide a reasonable rate of return, and/or beat the returns on comparable Treasuries if spreads fail to widen significantly.

Credit spreads are likely to decline gradually over the course of the year. Easy money and a strengthening economy add up to a perfect environment for borrowers. Easy money adds fuel to corporate pricing power, and improved cash flows are a boon to borrowers, especially the most indebted ones, and that in turn means lenders will be rewarded by today's still-relatively-high yields and lower-than-expected default rates. High-yield bonds should be the biggest beneficiaries of tighter spreads. If Treasury yields rise enough, however, spreads on higher quality bonds are not likely to be able to absorb the full brunt of rising market rates, meaning there is the risk of mark-to-market losses on corporate bond prices.

Equity prices are likely to register gains of 10-15% next year. I see no signs that the equity market currently is overvalued. Corporate profits have been very strong, and PE ratios remain relatively subdued. A stronger economy

should continue to boost profits, and enhance investors' confidence in the outlook for future earnings, resulting in at least a moderate rise in equity prices.

Commodity prices will continue to work their way higher over the course of the year, buoyed by ongoing improvement in global economic growth and accommodative monetary policy. In real terms, commodity prices are still far below the highs they reached in the inflationary 1970s. Oil prices are likely to drift higher as well, and at these levels still do not present [a serious threat](#) to economic recovery. Commodity investing, however, is fraught with perils, particularly the fact that commodity speculation can result in backwardated futures prices, and those act to limit the speculative returns to commodity investing.

Emerging market economies are likely to do somewhat better than industrialized economies. These economies tend to thrive in an environment of easy money, rising commodity prices, fiscal policy reform, and ongoing globalization.

Gold will probably move higher, mainly since monetary policy is very likely to remain accommodative. But the potential for a significant decline—should, for example, the Fed surprise everyone and tighten early—is enough to keep me out of the gold market. Gold is a highly speculative investment at this point and should be approached with extreme caution.

The dollar is likely to move higher against most major currencies, and hold relatively steady against emerging market and commodity currencies. Currently, the dollar is so weak against most major currencies, both nominally and in inflation-adjusted terms, that even modest upside surprises such as higher-than-expected U.S. growth and/or an earlier-than-expected reversal of quantitative could prove very bullish for the dollar. Put another way, so much bad news is already priced into the dollar that I think its downside potential is limited.

Full disclosure: I am long equities, short Treasury bonds, and long high-yield debt at the time of this writing.

Comments on this article

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[Indianalar](#)

Are you insane?

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[DL1947](#)

greatly overly optimistic is a better choice of words

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[primefool](#)

I generally agree with the author - it is an out of consensus view that is at least plausible - or at least more probable than the market thinks. I think there is a serious risk of a China hard landing pulling down commodity /oil prices - which would also help the US economy recover . However in this scenario one might be better off in the traditional blue chip stocks rather than too overweighted in commodities. Good quality junk bonds and corporates seem like a relatively good bet at current yields - might get a 50-100 bp treasury yield rise coupled with a 50-100 bp shrinkage in credit spreads - so basically one would expect to earn the current yield over the year.

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[User 467429](#)

I don't know how you can describe this view as "out of consensus." All every "expert" I hear or read says the market will have an excellent. Bullishness reigns supreme!

When the herd goes in one direction, I think it's better to do in another.

[primefool](#)

I am not sanguine as the author on emerging markets. The generally higher rates around the world might put an abrupt end to the property bubbles that are still thriving in many emerging markets. China hard landing is a risk to the commodity exporters. Also generally a crowded trade - and not cheap any more. US equities seem much safer.

[paynebb](#)

If you are right with your predictions, oil will be over \$140/barrell. This will kill the markets. Oil/Gas negatively affects every individual and corporation (excepts oil related companies). Profits will head lower because the consumer is not able to pay the higher prices. Demand will drop overnight just as it did in 2008. I sell products made of polypropylene, which is derived from oil. Prices are skyrocketing right now. However, demand for the products I sell have not increased. In fact, it is sig. lower when compared to 2008. Laws of Supply and Demand are not relevant right now. Eventually, the markets will make them relevant. Why can't people remember what happened 2 years ago?

[j-dub](#)

Before anyone thinks that these prediction hold any real value, go ahead and read:

[seekingalpha.com/artic...](#)

Everything is pretty much the same prediction and that is mostly wrong. Housing will moderate, gold will go higher, employment will blah, blah, blah. Mostly very ambiguos predictions that ultimately don't really predict anything. And those predictions that mention specific targets are ALWAYS wrong(housing for one), since they are based on simple arithmetic tha, when put to paper, simply doesn't add up.

So while some might celebrate this article as a set of very sober and likely outcomes by popping a bottle of champagne, I prefer to celebrate this hollow happy talk by opening up a can of Who Gives A #^(%.

[Ray Lopez](#)

The author's predictions for 2010 were not that bad. A bit rosy on GDP, a bit wrong on housing (he expected an upturn and it's still going down), he did get gold right (said it would spike), and a couple of technical indicators are mostly right, so all in all for crystal ball gazing I give the author a B+, not bad at all. One thing I like about this author: he is anti-Keynesian and anti-Big Government--that gets a TU from me every time.

[flash9](#)

J-Dub, but that is what passes for economic predictions. People actually get paid for that pablum. Hopefully he's better than Bernanke.

[John Bowman](#)

If we didn't have this incredible debt hanging over our head, I would sort of agree with the author. However, the stimulus packages are known to be worthless jokes, the Fed has no more tricks up their sleeve and

Obamacare will start affecting the economy in 2011.

Plus who believes the reported statistics on unemployment and the manipulated CPI?

Besides, when has the stock market ever been a true indicator of the well-being of our economy?

[Leftfield](#)

How can rising interest rates not further depress the housing markets? And, the dollar is largely levitated by its relative "status" in the ugly contest of fiat scrip.

Furthermore, the author expecting "taxes are not going to rise as so many had feared" appears to focus on Washington who can still roll its own scrip. "Taxes" include levies by many localities who are already overtaxing their subjects and who are also recklessly in debt, not just income taxes. I have more faith in our politicians finding ways to stick it to taxpayers.

No mention is made of "stimulus" starting to run out of runway as everyone but Krugman seems to recognize that some limits are unavoidable. 2011 is more likely to be the year economic reality hits the fan.

[Ferdinand E. Banks](#)

Hello Mr Paynebb, because you took a comment away from my good self. The economy has got to walk a knife edge between growth and the price of energy, and as you and a few others on this site seem to understand, why does that seem so complicated to people who were around for the bad news two years ago. I just hope the decision makers saw your comment, and that they read English.

[Akhil Khanna](#)

The population in the developed world are suffering due to the hangover from excessive borrowings from lenders who lent to anyone on the street to maximise their own bonuses.

The problems have been compounded by Outsourcing and Rampant Speculation allowed in all the exchanges. The problems are hereto stay as till date no one in the political arena has even acknowledged the problems let alone find solution to them.

The too big to fail bunch of banksters have a lot of influence on the political class, the rule makers and the rule enforcers due to their enormous purchasing power. So irrespective of the position in the government, everyone works for the benefit of the banksters.

The rest of the population have to be dumped with lots of problems like unemployment, high cost of living (thanks to speculation in commodity exchanges), foreclosures, etc. so that they don't devote their thoughts to the root of all problems and revolt against the comfortable arrangement between the banksters, central bankers and the governments.

This too big to fail group has grown more powerful in size and influence in the last two years and is likely to end up being too big to bail bringing down complete economies of countries with them.

www.marketoracle.co.uk...

[DL1947](#)

the author paints the rosier of the 2011 scenarios that has a 3% chance of coming through ; the worldwide debt problem is not going away , it is getting bigger , the balloon is approaching the pin

[GregZw](#)

My concern is that the "tremendous bubble" that has developed in the Bond market might burst causing another crisis.

Big banks have borrowed trillions from the FED at 0-.25% and purchased Treasuries yielding .5-3.5% instead of making loans to business.

The FED has surpassed China as the largest holder of U.S. Debt (\$2.35 Trillion in Fannie, Freddie, Ginnie, FHLB, & Treasuries). The worry that China might stop buying our debt should be more focused on what happens when the FED stops buying our debt.

The dilemma will be as interest rates rise and the interest on the federal debt grows, how will it be financed? A 1% rise in rates will place an additional \$23.5 Billion per year burden on the FED to maintain their holdings of U.S. Debt.

The Treasury will have the same problem with increased financing requirements caused by rising rates.

The FED could offset it's needs for additional cash by printing more dollars or selling assets. Sales of these assets would force higher rates and printing dollars will spur greater inflation.

The Treasury however, will not only need China to keep buying its bonds but will need to find a new source to replace the FED.

I don't have much faith in the FED's ability to continue "walking a tight rope" as the rate pressures accelerate. I believe rates and inflation will reach double digits in the next few years.

[primefool](#)

Moral values have decayed, the youth are disrespectful, men speculate for greed and profit, values have been lost ... Oh dear Oh dear.

Lao Tsu 500 BC

How ever can real estate go up when interest rates rise (from 3% to 4% ??). No way Jose.

[John Galt](#)

I think this set of predictions is pretty consensus. The biggest disagreement I have is on housing...

To tell you the truth I don't even know what you are predicting...

Show signs of life by next year

Still looks weak

Will stay weak longer

modest declines

mending housing market

So will it mend or will it stay weak and decline longer? You sort of threw a bunch of thoughts out there. It will get better by next year, it will stay weak and go down, but it will mend? Look, I've seen people say housing will

recover next year for years.

In 10 years in many of those major markets you STILL won't see prices where they were in 2007.

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MarketGuy

I'm sure CBP ran to his mailbox to collect his shill check from the big houses after this sheeple-herding-wealth... write-up.

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Mikesss

You are a talking head Calafia.

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Geezer Bela in Exile

And that's what the world looks like through rose-colored glass.

Calafia ignored the following:

1. Mark to market is still in effect, depressing the economy AND sending more businesses into bankruptcy.
 2. The tremendous increase in money supply did little to increase economic activity and if it were not for 'mark to market' it would have ignited a roaring price inflation.
 3. Oil is going up in prices and WILL increase the cost of everything. It is like a tax.
 4. The Obama regime's efforts to increase energy costs (thinking that it will force people to conserve) will act as another tax, depressing economic activity.
 5. Many towns and some states are in fact bankrupt (California first of all) and this will drag down the economy.
 6. China will revalue the renminbi up and this will create further internal demand for them and an increased appetite for commodities and PM.
 7. Gold and silver will take off later in the Spring. We are still not in the mania phase.
 8. The FED raising interest rates? Are you on California medication?
 9. Corporations are making money because they laid off workers and shipping production overseas. Not a reason for economic growth at home.
 10. A 4% growth next year? That prediction proves you're smoking it.
 11. How about the coming political strife? Republicans will go after the documents Obama pays to keep suppressed. The prize is tempting. If it can be proven that Obama was not eligible to be President, all the laws he signed and all his appointments are null and void. What will that do to the price of gold?
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