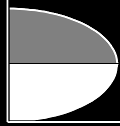


LAFFER ASSOCIATES

February 17, 2011

10-yr T-Note: 3.57% DJIA: 12,317.69 NASDAQ: 2,831.58 S&P 500: 1,340.32

TAKING STOCK: A U.S. RISK ASSESSMENT

By Arthur B. Laffer, Ph.D., and Ford M. Scudder, CFA

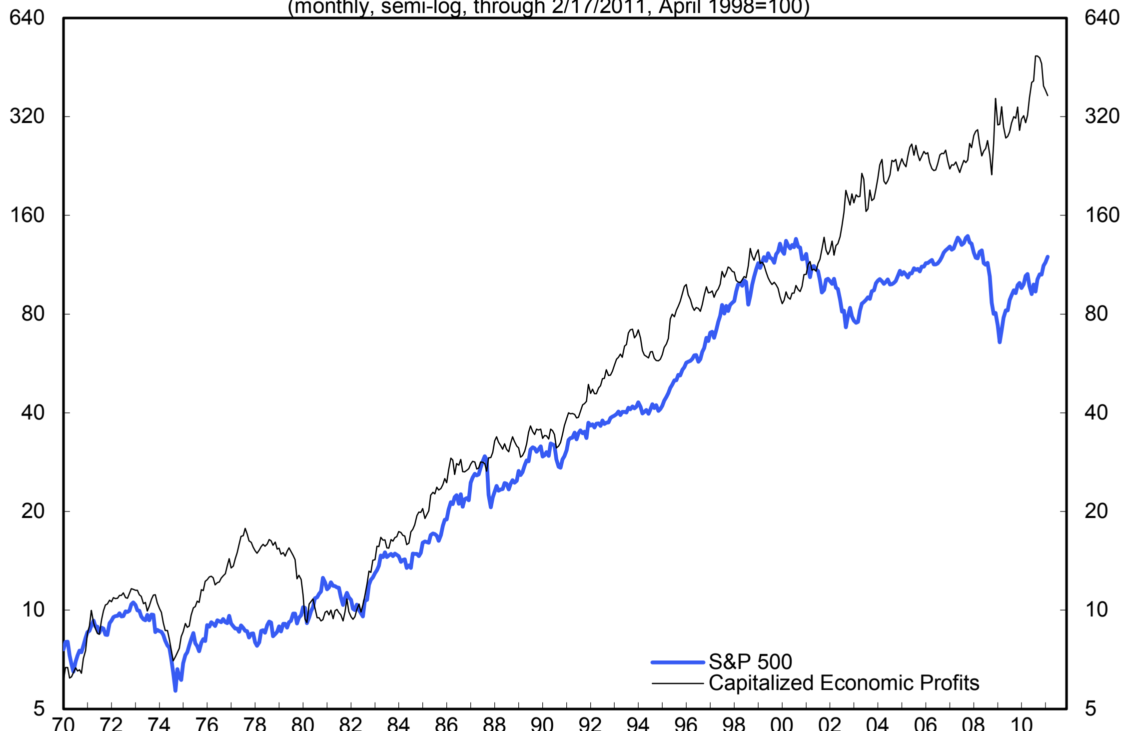
Summary

- The U.S. economy is set for slow positive growth over the next few years, with the outlook in 2013 and beyond turning decidedly positive given the potential for pro-growth economic policies.
- We expect the U.S. equity markets to have an upward bias over the next few years with intermittent volatility.
- There are a number of threats to the U.S. economy and equity markets, yet positive solutions exist to many of the known risks—particularly via improvements in U.S. fiscal and monetary policy.

As we look ahead at the future macroeconomic picture, we are decidedly more bullish on the long-term outlook for the U.S. economy than we were at this time last year. While there are a number of cyclical factors in play that will put an upper limit of approximately 3 percent on real economic growth over the next two to three years, the outlook in 2013 and beyond is much more positive. The election last fall, combined with the administration's movement toward the center and the math surrounding the 2012 election, make the outlook for economic policy quite pro-growth. The market's increasing realization of that fact, the rising faith in the vibrancy of the economic recovery and continued Fed asset purchases are currently working in concert to drive the U.S. stock market higher.

While we gauge the direction of markets, we like to use capitalized economic profits as a guidepost. Since the gap between capitalized economic profits and the S&P 500 has shrunk markedly as the market has run over the last two years, the market remains incredibly undervalued in historical terms (Figure 1). The gap could close through a number of factors: higher stock prices, higher interest rates, decreased pre-tax corporate profits or increased tax rates.

Figure 1
Capitalized Economic Profits* vs. S&P 500
(monthly, semi-log, through 2/17/2011, April 1998=100)



*Capitalized economic profits are after-tax corporate profits (NIPA basis) with the inventory valuation adjustment (IVA) and capital consumption adjustment (CCAdj), divided by the 10-yr T-Note yield. Q4-10 & Q1-11 Cap Profits are Laffer Associates Estimate. Past performance is no guarantee of future results.

Source: BEA, UST, S&P

Given the administration's move toward the center, the increased power of fiscal conservatives in Washington and the extension of the Bush tax cuts, we no longer believe that we'll see higher taxes going forward, regardless of what is put forth in President Obama's budget. So that eliminates one option. Of the remaining three ways for the gap between stock prices and capitalized economic profits to close, we believe the gap will close via a combination of each of the three factors.

- Interest rates are the biggest driver of the divergence between stock prices and capitalized economic profits. We continue to believe rates are set to rise due to the huge increase in the monetary base.
- National Income and Product Accounts (NIPA) corporate profits are at all-time-high levels when taken as a percentage of GDP. Given our assumption of a slow growth economy over the next two years, total after-tax NIPA profits will be flat to down as corporate profits as a percentage of GDP reverts to its mean.
- Finally, we believe stock prices will continue to rise. While stock prices have recovered a great deal from the start of the financial crisis, they are still very low by a variety of historical measures.

At the same time, however, there are a number of challenges for global markets that must be worked through, all of which either affect U.S. markets and/or are affected by the state of the U.S. economy. A positive resolution of any of the following issues should drive equity markets higher, while further bad news will work in reverse. Accordingly, we anticipate the next few years will see the U.S. equity market on an upward trend, but marked by spikes of volatility in both directions as the following issues play out. As you'll see, a number of the issues are interrelated.

1. European Sovereign Debt/Fiscal Crisis

Problem: Developed nations across the globe have dramatically expanded the size of government relative to the private sector over the past decade, with much of this increase coming from worshipping at the altar of Keynesian economics during the financial crisis. Unfortunately, this has caused budget deficits and government debt to soar and credit ratings to fall.

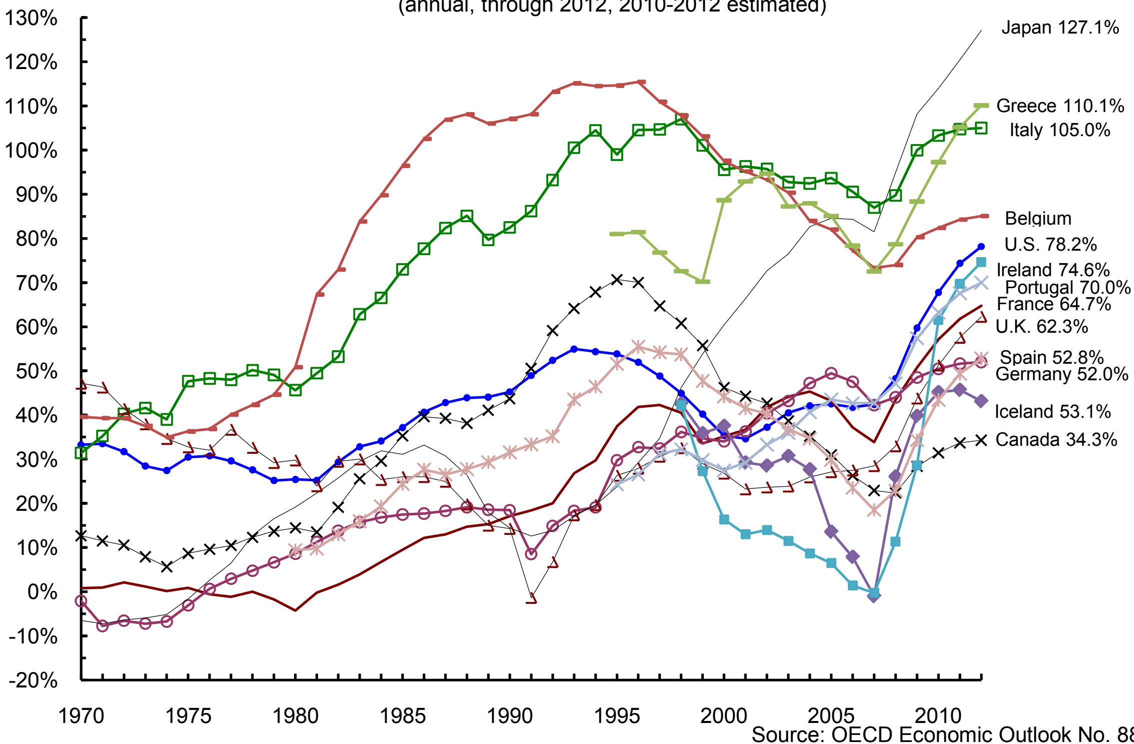
Every time the bond market has questioned the ability of a sovereign to fund its deficits via an upcoming auction, the financial markets have experienced significant turmoil. Typically, yield spreads and CDS spreads have risen on the debt of the country in question as well as all the weak sovereigns, including to a greater or lesser degree Belgium, Greece, Iceland, Ireland, Italy, Portugal and Spain. Equity markets around the globe have suffered as well.

There is no magical number for debt accumulation beyond which investors lose confidence in a country's ability to repay its debt and all of a sudden demand much higher yields. Yet as the last two years have vividly shown, deteriorating views on a country's budget deficit, accumulated government debt, required short-term borrowing, and the long-term budget and economic outlooks eventually can cause a fiscal crisis to develop seemingly out-of-the-blue.

Figure 2

Government Debt (Net) as a Percentage of GDP

(annual, through 2012, 2010-2012 estimated)



Source: OECD Economic Outlook No. 88

The current path of bailing out countries—and investors—that are not fiscally solvent will not sustainably fix the problem. Continued bailouts that do not require the necessary fiscal reforms are a recipe for continued volatility and crises.

Positive Solution: There are two components to a positive solution that would put the sovereign debt issue to rest. First, much like in the mortgage-backed securities market of several years ago, investors across the globe have chased yield and purchased government debt without performing proper due diligence to ensure that the sovereigns would be able to repay. Rather than ensuring that these investors remain whole while the country's citizenry suffers, the investors should bear the losses from poor investment decisions on European bonds when appropriate.

Second, as we outlined last summer, the effected countries must implement effective austerity packages that focus on pro-growth economic reforms coupled with reduced spending. Our suggestion would be to cut spending and enact pro-growth tax, trade and regulatory policies. The countries that come closest to that model will perform the best as they exit the financial crisis.[1]

2. Potential Longer-Term Unwinding of the Euro

Problem: The euro has been tremendously successful in increasing trade in goods and services, harmonizing financial markets and eliminating currency risk throughout the eurozone. Yet the eurozone is not an optimal currency area (as illustrated by the European debt crisis discussed above). In the midst of questions surrounding the ability of European sovereigns to repay their debts, further questions have arisen over the viability of the euro as a common monetary unit for the eurozone. In large part, these questions result from the different circumstances facing larger, more stable eurozone members like Germany as opposed to smaller, debt-laden members like Greece.

The countries with the worst fiscal problems argue that their deficits are the result of the global recession rather than their own mismanaged budgets. Because the monetary union prevents those members from devaluing to stabilize the economy, countries facing large deficits (in their view) are being unnecessarily forced to put in place quite drastic austerity measures in order to balance their budgets, which proves to be very unpopular politically. This engenders an anti-euro bias in the crisis countries, creating an incentive for the least stable eurozone members to want to leave the euro.

Meanwhile, the member states have instituted the European Financial Stability Facility (EFSF), which is essentially a slush fund designed with the mandate to "safeguard the financial stability of the eurozone by, if necessary, raising funds in capital markets to finance loans for euro area member states."[2] Such an arrangement flows directly counter to the "no bailout" clause of the Maastricht Treaty, which states explicitly that neither the European Community nor any member state may assume the liabilities of another member state. This clause was put in place to limit moral hazard, yet, as often happens in times of panic, "don't just sit there, do something" became the mantra for the day.

There are two problems with this response. First, it encourages moral hazard such that the chances of member states running unsustainable budget deficits are higher going forward. Second, you can't bail someone out of trouble without putting someone else into trouble.[3] Already, countries like Portugal that are on the brink of needing assistance from the EFSF have pledged significant support to the facility. This arrangement thus creates an incentive for the most stable eurozone members to want to leave the euro, as when the music stops they'll be the only ones left to clean up the mess.[4]

As long as questions linger about the future of the euro, volatile exchange rate movements will be the result. Such volatility, particularly in the value of one of the world's reserve currencies, fosters uncertainty, reducing the productivity of capital and ultimately reducing economic vibrancy. Continued exchange rate volatility is a key concern and, should it continue, will ultimately be felt in reduced economic growth for members of the eurozone, in addition to countries linked to the euro or relying on it as a reserve currency.

Positive Solution: In our view, the future of the euro will remain on shaky ground until European sovereigns shore up their fiscal situations, embrace pro-growth reforms and the eurozone as a whole returns to the principles of the Maastricht Treaty.[5] The treaty, which specifies the terms under which a nation is eligible to adopt the euro as its currency, allows only occasional deficits in excess of 3 percent of GDP and does not allow government debt to exceed 60 percent of GDP. As seen in Figure 2 on the previous page, the government debt provision has long been ignored, and the deficit provision has as well. Moreover, in the midst of the crisis, the "no bailout" clause has also been flagrantly violated. Without these provisions in place, the eurozone cannot overcome the fact that it is not an optimal currency area.

[1] Laffer, Arthur B., and Ford M. Scudder. "Global Austerity: The Good, The Bad, and the Ugly." Laffer Associates, August 12, 2010.
[2] "About EFSF." European Financial Stability Facility. *http://www.efsf.europa.eu/about/index.htm*.
[3] Winegarden, Wayne, and Mark A. Wise. "The EU Goes All In." Laffer Associates, May 11, 2010.
[4] Petersen, Kenneth B., and Wayne Winegarden. "The 'PIIGS' Got the Flu!" Laffer Associates, December 2, 2010.
[5] Laffer, Arthur B., and Kenneth B. Petersen. "The European Central Bank Celebrates Its 10th Birthday: Performance Lessons for the Federal Reserve." Laffer Associates, June 25, 2008.

Putting these policies in place will shore up faith in the future of the euro and stabilize its value in the foreign exchange markets. When exchange rates are more stable, the valuation risks across political boundaries are reduced, fostering increased productive investment and economic growth.

3. Inflationary Pressures in the U.S.

Problem: The Fed's massive expansion in the monetary base since late 2008 has sown the seeds for significant inflation.[6] The Fed has since doubled down via the second round of quantitative easing (QE2).[7] Accompanying the huge surge in the monetary base are large increases in M1 and M2. While inflation has not yet kicked in based on traditional indices, commodity prices have risen to all-time highs, the dollar has declined on the foreign exchange and inflation expectations (as derived from the TIPS yield) have risen.

While updates to the tax code since the 1970s have made inflation less destructive of wealth than it was at that time, the threat of inflation still has negative consequences for economic growth.[8] A stable currency is necessary to maintain for planning and facilitating production and trade. There can be no prosperity without price stability. Moreover, if inflation rises, interest rates will rise as well, increasing the cost of capital.

Further, as will be discussed in more detail later on, because commodities are priced in dollars in the global markets and so many countries use the dollar as a reserve currency and/or link their currencies to the dollar, the weak dollar is causing inflation in other countries around the world.

Unfortunately, Chairman Bernanke has shown no signs of concern about the increases in the money supply. Moreover, even if the Federal Open Market Committee wanted to change its policy direction, the Fed would have to go from being a net buyer of treasuries to a net seller of more than $1 trillion of treasuries to return the monetary base to the level it would now be if the Fed had not engaged in massive asset purchases. Such a large pivot at the Fed at the same time the Treasury has to finance record large deficits would surely send interest rates soaring.

Positive Solution: The solution here is easier said than done: one way or another, the Federal Reserve must shrink the monetary base. Although this would have negative short-term consequences for both bonds and equities, it will help set the stage for dramatic improvements in economic and stock-market performance over the long-term.

Longer-term, the Federal Reserve should serve one mandate—that of price stability—and preferably be put on a monetary rule. Moves to strip the dual mandate of the Federal Reserve are growing, and to the extent that this movement gains traction, a more stable dollar would be the result.

4. Slow U.S. Growth

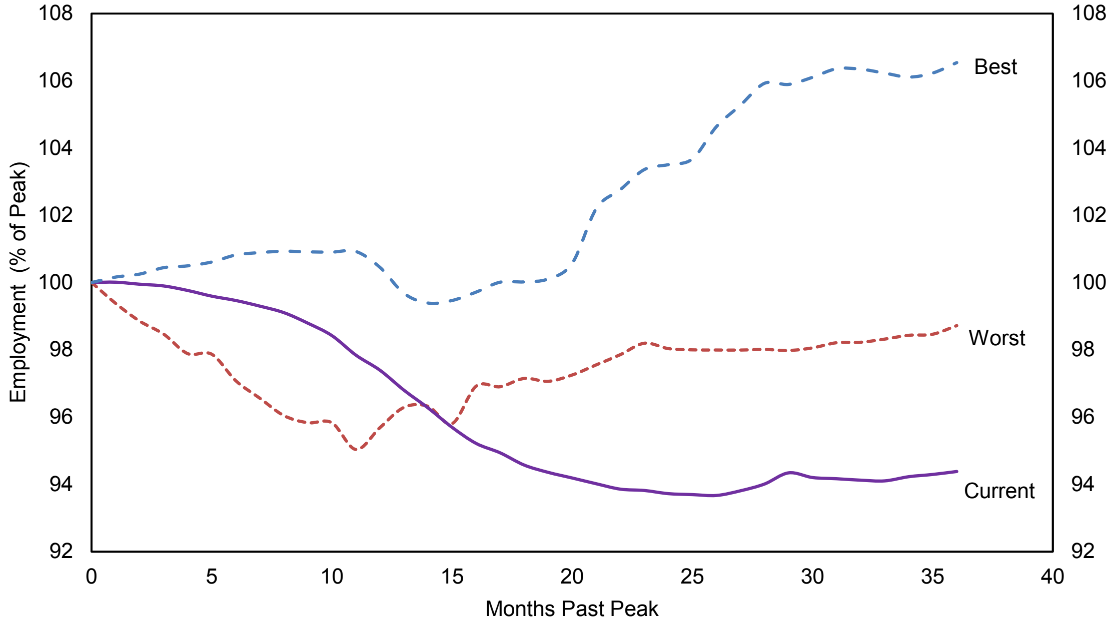
Problems: While the outlook for U.S. economic growth has improved, the U.S. economy still faces a number of headwinds that are weighing on growth. Cyclically, corporations and individuals accelerated profits into 2010 ahead of the scheduled tax increases on January 1, 2011. Although the Bush tax cuts were eventually extended, much of the acceleration was already baked into the cake by the time the tax compromise was reached in December. This should exert some negative pressure on economic growth over the first half of the year.[9] A number of demand-focused stimuli like cash-for-clunkers and the homebuyer tax credit also shifted demand forward and are still working their way through the system.[10] Additionally, the U.S. banking system is likely to remain weakened following the financial crisis for another three to five years, particularly as the housing market takes another leg down and a giant wave of 2006 and 2007 vintage adjustable-rate mortgage loans reset. As the banks work their way back to healthy balance sheets, lending growth will remain anemic, which will put an upper limit on U.S. economic growth.[11]

Meanwhile, there is a much larger problem of a secular nature. Namely, a country literally cannot prosper if government is 1) way overspending, 2) raising tax rates, 3) printing too much money, 4) over regulating business enterprise and 5) restricting the flow of goods and services over its national boundaries. Our government is doing exactly the opposite of what should be done if prosperity were its goal.

[6] See, for instance: Laffer, Arthur B. "1970s Redux, Inflation Back from the Dead." Laffer Associates, June 4, 2009.; Laffer, Arthur B., Kenneth B. Petersen, and Scott Vaughn, "Ben Bernanke's 100% Confidence." Laffer Associates, December 20, 2010.
[7] Wayne Winegarden. "Some Unpleasant QE2 Arithmetic." Laffer Associates, December 14, 2010.
[8] For instance, in the 1970s tax brackets were not indexed for inflation, so individuals could move into a new tax bracket at a higher tax rate even though their real income fell. That is no longer the case. Additionally, illusory capital gains were commonplace in the 1970s, particularly on homes. The capital gains tax cut of 1997 all but exempted owner-occupied homes from capital gains taxes, meaning illusory capital gains would not be a problem for homes at this juncture.
[9] Laffer, Arthur B. "Laffer Associates Economic Outlook, 2010 and Beyond." Laffer Associates, January 6, 2010.
[10] Laffer, Arthur B., Ford M. Scudder, and Mark A. Wise. "One Step Forward, Two Steps Back, The Road Ahead for U.S. Housing." Laffer Associates, March 31, 2010.
[11] Petersen, Kenneth B., and Jacob Walters. "Slow Economic Growth Ahead? You Can Bank On It!" Laffer Associates, September 30, 2010.

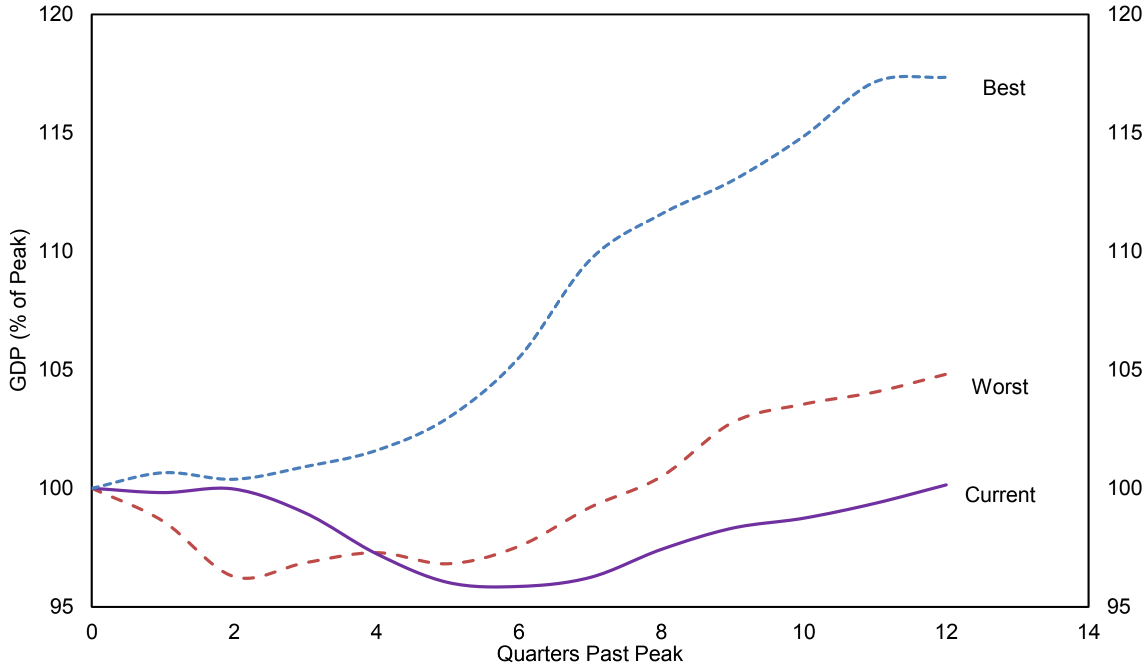
We've documented these problems *ad nauseum*, so we'll save you all the gory details this time around.[12] But the effects of these policies are best shown in a series of charts. Figures 3 and 4 below trace the path of the economy from the pre-recession peak in GDP and employment for each recession following the Great Depression. As the figures make clear, we are currently experiencing the worst recovery since the Great Depression.

Figure 3
Employment - Path from Peak
(2007.12 – 2011.1 vs. Max & Min For All Recessions, By Month, Since 1947)



Source: Federal Reserve of St. Louis, BLS

Figure 4
GDP - Path from Peak
(2007Q4 - 2010Q4 vs. Max & Min For All Recessions, By Quarter, Since 1947)



Source: Federal Reserve of St. Louis, BEA

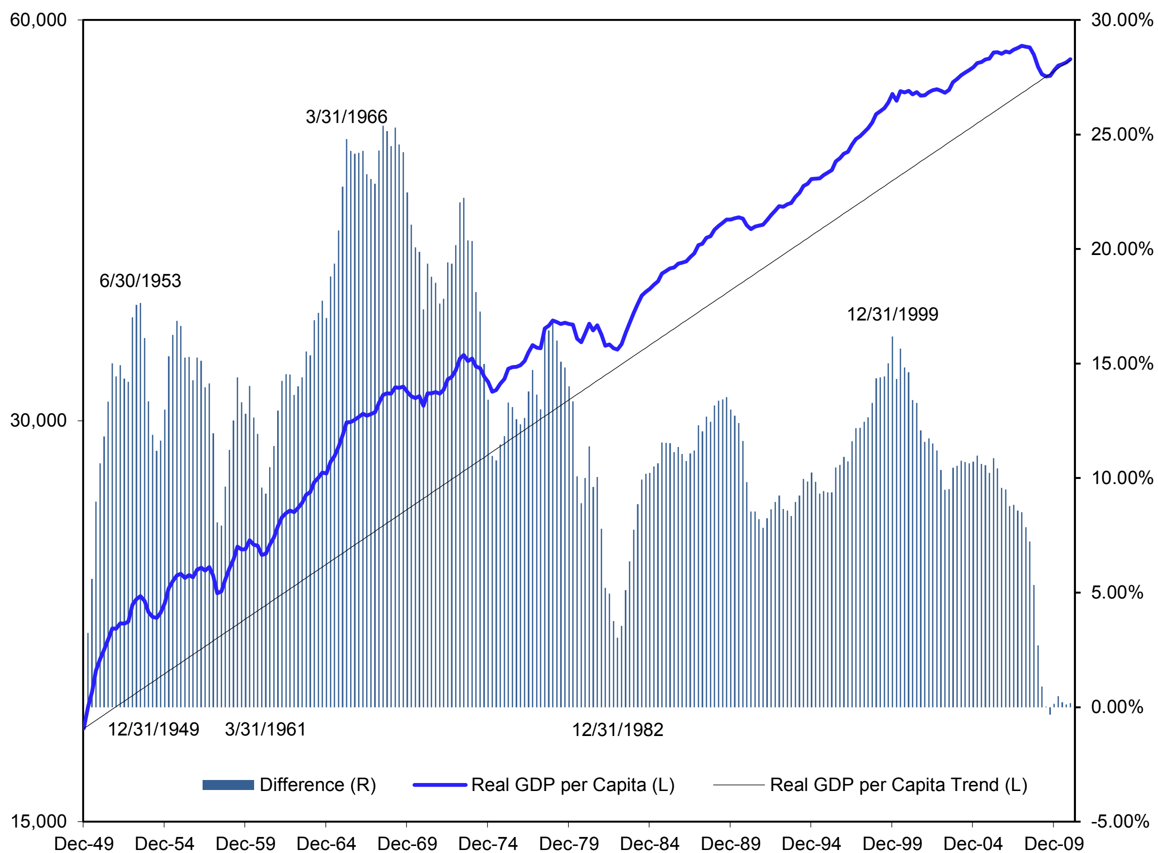
[12] See, for instance: Laffer, Arthur B. "Money, Growth & Politics." Laffer Associates, August 3, 2010.; Winegarden, Wayne, Kenneth B. Petersen, and Mark A. Wise. "Crowding Out, The Effects of Government Debt on the Private Sector." Laffer Associates, February 26, 2009.; Laffer, Arthur B. "Conference Call Summary, We're All Keynesians Now." Laffer Associates, March 10, 2009.

Figure 5 below displays a plot of the log of U.S. real GDP per adult (population 16 years of age and older) from the fourth quarter of 1949 to the present, and is our preferred measure of the secular performance of the U.S. economy. We use the log of real GDP per adult rather than per capita because having lots of children would artificially lower the GDP per capita measure while few children (as is the case today) would artificially inflate that measure of success.

Next, we've connected with a straight line the first quarter's real GDP per adult (first quarter of 1950) with the last quarter's real GDP per adult. The slope of that line represents the average growth per quarter of real GDP per adult over the past 60 years. Finally, we've plotted the deviations from the trend line of the level of real GDP per adult for each quarter. In essence, each of these plotted deviation points represents how much higher (or lower) real GDP per adult is from where it would have been had real GDP per adult grown at its trend rate from the first quarter of 1950.

The shocking realization from observing these points of deviation from trend over the past 60 years is that each and every observation of real GDP per adult, save the first and the last, is above trend. This means that over this long secular period, U.S. real GDP per adult growth rates have been declining. This is a classic pattern exhibited by societies that are in states of senescence.

Figure 5
Real GDP per Capita, Trend Real GDP per Capita and Difference
(quarterly, semi-log, through Q4-10)



Source: BEA

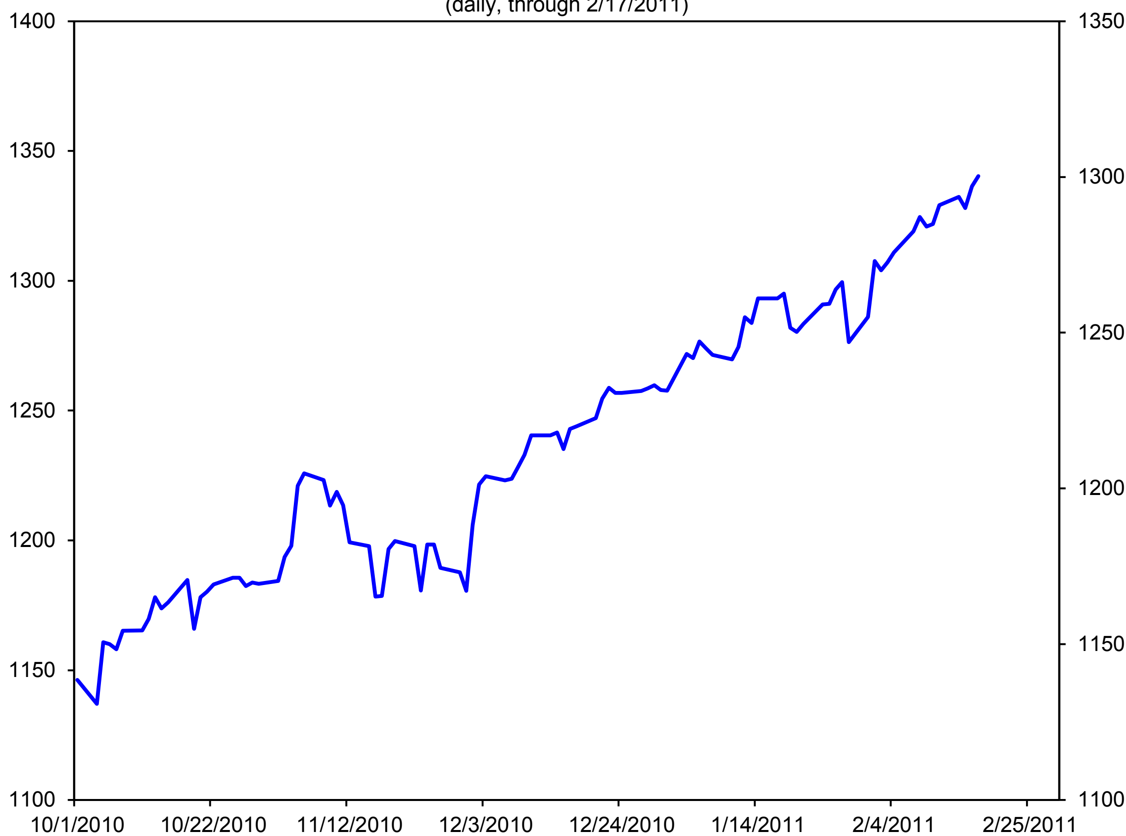
Slow U.S. growth has repercussions around the globe as well, as we'll touch on in a few other segments.

Positive Solution: Other than time, there is no real solution to the cyclical factors resulting from decisions already made. The most important sign that these are working their way through the system would be to see lower losses on bank lending portfolios. Additionally, a positive first step would be for the administration to recognize publicly that the stimulus has not worked and prevent any further damage by curtailing Keynesian stimulus programs.

Following that, Washington should commit to pro-growth economics going forward. The November 2010 election was a positive sign that the electorate understands the tremendous importance of economic policy at this juncture in U.S. history. It remains to be seen whether the politicians in Washington have reached the same conclusion. We are optimistic that the Republicans in the House and Senate have learned from their mistakes during the George W. Bush presidency. We also believe that there are a number of Democrats on the Hill who understand the importance of pro-growth economic policies.

We thus anticipate that policy over the next two years will be much less aggressively redistributionist, that the election in 2012 will yield further representation in Washington for fiscal conservatives, and that we will have a window to put in place truly pro-growth policies in the United States starting in 2013.[13] The market seems to have a similar viewpoint (Figure 6).

Figure 6
S&P 500
(daily, through 2/17/2011)



Source: Bloomberg

Yet, markets are forward-looking. We believe that the market is rising on expectations of future policy enhancements that will increase economic performance and asset values in the United States. We will be vigilantly watching to see if these expectations seem to have potential to come to fruition, but we would be disappointed without seeing some combination of the following.

Over the near-term, Congress and President Obama should focus on the pro-growth agenda for which they have publicly declared their support. First, this includes enactment of the negotiated free-trade agreements with South Korea, Columbia and Panama. While full repeal of Obamacare is unlikely, revisions to remove the most anti-growth parts of Obamacare and the Dodd-Frank financial reform bill should be considered. Finally, a budget that doesn't put U.S. spending levels at 2008 levels or below should be rejected.

Longer-term, the U.S. requires a number of changes to its current policy mix in order to once again become the world's engine of economic growth. At the top of the list is federal tax reform. In our view, this would be a flat tax with one flat rate on personal income and business net sales, but a simplification in the tax code accompanied by a flattening of the structure at lower rates would be a welcome start.[14] On the spending side of the equation, there needs to be restraint on spending. Ideally, we would first see a dramatic reduction in the level and growth of spending, followed up with a modified system of pay-go that allows increased spending in one area only if spending is decreased in another area.

[13] Laffer, Arthur B., and Ford M. Scudder. "Through the Laffer Lens: The Election Results." Laffer Associates, November 10, 2010.
[14] Laffer, Arthur B. "The Complete Flat Tax." Laffer Associates, February 22, 1984.

5. State Fiscal Problems: Looming Crises in Municipal Debt and Unfunded Pensions

Problem: As we have highlighted on several occasions, states and municipalities across the country are facing budget problems similar to those faced by developed nations across the globe.[15] The problem is that state and local governments overspent in the good times, both on government services and future entitlements, and those decisions are now coming home to roost.

State financial statements, like those of sovereign government, are incredibly difficult to navigate. Municipal finances are equally difficult to comprehend and also face the added difficulty of thousands of issuers being spread across the country. Additionally, the process for municipal defaults is often messy. States must grant municipalities within their borders the authority to file for bankruptcy under Chapter 9, which can require municipalities complying with a number of requirements. Alternatively, the state can forbid the municipality from filing for Chapter 9, and some projects become the responsibility of larger jurisdictions or the state upon default.[16] Meanwhile, states face balanced budget requirements. And, while states have defaulted in the distant past, there is no set process for state default.[17]

In short, it's just about impossible to be familiar enough with the municipal market as a whole to say whether analyst estimates of 50+ defaults over the next year is a wild exaggeration or a conservative estimate. All of this creates a great deal of uncertainty in the municipal debt market, which has caused yields to rise fairly dramatically for this typically boring market, as credit analysis has become more important. Moreover, the fact that the largest states are those that are in the worst financial shape means how the municipal debt issues play out will likely have far-reaching consequences. For instance, a default by California, New York or Illinois would likely have a negative impact throughout the debt and equity markets. Meanwhile, a state bailout by the federal government would place an implied federal guarantee on hundreds of billions of dollars of additional debt, certainly causing treasury yields to rise.

Positive Solution: What is clear is that the state and local fiscal threat is very real, as budgets across the nation are strained and pensions are incredibly underfunded.[18] States need to react to the situation just as we suggest sovereigns do: cut spending, including modification of pension plans, and institute pro-growth reforms. Just as at the country level, those states that address the situation proactively should outperform those that attempt to close their budget deficits through tax increases.

6. Currency Wars

Problem: The return to Keynesian policy missteps is not limited to fiscal policy. Currency devaluations and other restrictions on the free flow of assets across international borders are once again on the rise, as well.[19] Unfortunately, basic economics 1 principles, and decades of empirical evidence, illustrate that the proliferation of competitive currency devaluations, trade restrictions and capital controls disrupt financial markets, lead to increased inflationary pressures across the globe, severely diminish the economic growth potential of the U.S. and global economies, and increase geopolitical risks.[20]

As an example, following the implementation of the Smoot-Hawley Tariff in 1930, along with the retaliatory tariffs implemented across the globe, the volume of U.S. trade with the rest of the world plummeted (both imports and exports) along with the growth in the U.S. economy. Our late friend Jude Wanniski further chronicled the pattern of stock market collapse as this tariff legislation wended its way through the U.S House and Senate in his classic book *The Way The World Works*. What followed this massive intervention against free trade was the biggest stock market crash in history, a period of unimaginable economic contraction and ubiquitous misery called the Great Depression. While there were a number of other factors,[21] the length and depth of the Great Depression was extended by competitive devaluations and further trade restrictions, which caused global trade to plummet.

Positive Solution: Responsible monetary policy in the United States, focused on maintaining a stable value of the dollar, would go a long way toward eliminating the perceived need for corrective currency actions or capital controls. In addition, general restraint on the part of the governments from any disruptions to the free flow of goods, services and people across international boundaries would make this threat disappear.

7. An Overheating Chinese Economy

Problem: Fears of an overheating real estate market and increasing domestic inflation are both leading the People's Bank of China to tighten monetary policy. Thus far, China has raised interest rates, raised reserve requirements, is allowing the yuan to appreciate and has put in place some capital controls. The fear is that China will tighten too quickly, stifling Chinese

[15] See, for instance: Laffer, Arthur B., and Mark A. Wise. "The State of the States." Laffer Associates, February 22, 2010.; Wayne Winegarden, "State Tax Revenue Stability and Pro-Growth Tax Policies." Laffer Associates, October 20, 2010.
[16] "Municipal Bankruptcy: State Authorization Under the Federal Bankruptcy Code." Public Law Research Institute. *http://w3.uchastings.edu/plri/fal95tex/muniban.html#IIC*.
[17] We will be detailing the history of state defaults and what that might tell us about how the process would unfold today in an upcoming paper.
[18] Winegarden, Wayne. "Location, Location, Location—The Changing Municipal Bond Market." Laffer Associates, February 11, 2011.
[19] Winegarden, Wayne. "Dangers From the Rising Currency and Trade Wars." Laffer Associates, January 13, 2011.
[20] Laffer, Arthur B. "Devaluation: A Fool's Errand." Laffer Associates, December 10, 2009.
[21] Laffer, Arthur B. "Lessons from the Great Depression." Laffer Associates, September 10, 2009.

economic growth and exerting negative pressure on the rest of Asia, one of the few areas of the world that has truly weathered the financial crisis in good standing.[22]

Like many of the potential problems facing markets, we believe U.S. monetary policy is at the root of the problem. Asset purchases by the Federal Reserve have increased demand for high-yielding assets, and China, as the world's engine of growth and a country continuing to liberalize its economy, is an attractive market. Additionally, with the yuan pegged to the dollar, China has imported U.S. monetary policy and inflation along with it. This also plays back into the threat of currency wars, as most of the anger is directed at the United States and China for artificially keeping their currencies weak.

Positive Solution: First and foremost, responsible monetary policy in the United States would go a long way toward solving China's inflation problem. Meanwhile, we believe China has responded appropriately for the most part. While increased reserve requirements is a rather blunt policy tool, it certainly serves to remove liquidity from the system. Additionally, allowing the yuan to appreciate is exactly what needs to be done to prevent the yuan from devaluing against global currencies along with the dollar.[23] Our main area of disagreement, going back to the problem of currency wars, is that China should avoid the use of capital controls and simply allow the yuan to appreciate as it should based on terms of trade.

8. Geopolitical Risks

Problem: Geopolitical risks seem as high now as they have been since the end of the Cold War. The United States is carrying on two lengthy, expensive military operations in Iraq and Afghanistan. Iran seems to be inching ever closer to nuclear weapons. There is also the potential for armed conflict on the Korean peninsula.

Meanwhile, the unrest throughout northern Africa puts on display several threats to world and market stability. First, rampant inflation is leading to major upheaval in the developing world, particularly food price inflation (the CRB Food Index is up 39 percent since July 2010). While the huge food price run-up is not yet moving the needle much in our CPI, in developing countries food makes up a much larger percentage of consumer purchases, thus straining low-income populations across the globe.

While world commodity demand is rising following the worldwide financial crisis, in our view the commodity price rise is directly linked to U.S. monetary policy. As described above, inflation is a purely monetary phenomenon and over the past two-plus years the Federal Reserve has increased the monetary base at a rate unlike anything we've ever seen, with broader monetary aggregates M1 and M2 increasing at rapid rates as well. As commodities are priced globally in dollars, the tanking value of the dollar (only held up on the broad index by the simultaneous collapse of the euro, the world's second-largest currency) has caused commodity prices to soar, particularly in nations with a direct or indirect currency link to the dollar.

Second, the political unrest also reflects on U.S. foreign policy. While foreign policy is far from our area of expertise, we aren't stepping far afield to say that an economically weakened U.S. (in addition to being militarily spread thin) has led to a loss of global influence. Moreover, we would hazard to guess that the Israeli news daily *Haaretz* is correct in positing that President Obama's "good intentions are interpreted broadly as expressions of weakness."[24]

While we don't have any idea how things will play out, the potential for the unrest in northern Africa to inure to our detriment is heightened by the combination of our weak economy and perceived weak foreign policy. For instance, the possibility of the re-emergence of an Islamist Egypt seems far more plausible today than it did five years ago. Such an outcome would have wide-ranging effects, including 1) undermining Western efforts against global terrorism, particularly against al-Qaida; 2) further destabilizing the Middle East, particularly putting Israel and Iran in precarious positions; and 3) possibly destabilizing global trade by disrupting the Suez Canal.

Unfortunately, these are just possible results from the revolution in Egypt, which was barely on anyone's radar just one month ago. We still have the known problems with unknown outcomes in North Korea, Iran, Afghanistan, etc., let alone the unknown unknowns that are both more likely to occur and more likely to result in negative outcomes while the U.S. economy is weak.

Positive Solution: An improvement in U.S. monetary policy would have profound effects across the globe. A stable value of the dollar (based on commodity prices and the value of the dollar on the foreign exchange) would allow for easier planning and trade and relieve inflationary tensions in developing nations. Furthermore, some combination of the pro-growth policy changes detailed above will put the U.S. on more stable ground economically, making destabilizing geopolitical events much less likely.

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[22] Laffer, Arthur B., and Mark A. Wise. "Global Winners and Losers Part I: Fiscal Policy." Laffer Associates, May 28, 2009.
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Conclusion

The U.S. economy is slowly shaking off the effects of four years of Keynesian stimulus designed to increase demand. While that will put an upper bound on growth for the next few years, the outlook in 2013 and beyond is decidedly more positive. As markets are forward-looking, the optimism for growth combines with continued quantitative easing and low stock prices as compared to capitalized economic profits to provide the U.S. equity market with a strong tailwind.

At the same time, there are more foreseen potential shocks to the system than we can remember in a long time. Fortunately, there are positive solutions to each of these risk factors, and each positive solution reached should help drive equity markets higher. Taken in the aggregate, the majority of the known potential negative events could be averted with improved fiscal and monetary policy in the United States.

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