

The Kiplinger Letter

FORECASTS FOR MANAGEMENT DECISIONMAKING

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Dear Client:

Washington, May 6, 2011

As the end of NASA's shuttle program nears... Commercial space business is set to take off.

The biggest rebooting in the history of U.S. space flight means NASA will cede manned flights to entrepreneurs and focus on science research and deep space probes.

SPACE FOR SALE

For now, NASA will rely on Russian launches to transport astronauts to the space station after the aging shuttle fleet is mothballed this summer. The fare won't be cheap...about \$63 million per seat.

Private launches will be seen by mid-decade.

Space Exploration Technologies may be first, by 2014. Its Dragon spacecraft will carry seven people at a cost of \$20 million per seat...about 68% cheaper. The California-based firm was founded by Elon Musk, who also co-founded PayPal and created Tesla Motors.

The new space race has other entrants, too.

United Launch Alliance (Boeing and Lockheed Martin) is building an Atlas V rocket for private launches. Blue Origin, created by Amazon founder Jeff Bezos, expects to use the alliance's rocket next year for a test of an unmanned pressurized crew capsule.

Sierra Nevada Corp. is counting on the same rocket design for a 2014 launch of an orbiter to ferry seven astronauts and material to the space station and back. Richard Branson's Virgin Galactic already is signing up tourists for suborbital rides. So far, more than 350 people have made \$20,000 deposits toward the \$200,000 fare.

Early successes may lead to lower costs for communications companies and other businesses that rely on satellites. Launching them will be less costly and much easier to schedule, especially if more than one company wants the work.

But there are potential downsides, too, especially in terms of safety issues.

Private firms may not be as rigorous as NASA, so expect new federal oversight. A major failure early in the program could cripple the entire private space industry.

Outsourcing manned missions will allow NASA to focus on other priorities.

They include a Mars probe designed to collect and return material from the planet and a new deep space telescope, which is scheduled for deployment in 2014 or 2015. NASA will also concentrate on developing materials that have potential business use, including ceramics and ultrastrong composites for use in airplanes and automobiles.

Without manned flight, NASA's budget is ripe for trimming by Congress.

The \$18.5 billion the space agency gets this year is likely to be pruned by 10% to 15% over the next few years. Cutbacks are also likely at some of NASA's 16 space centers. Operations in Florida, California and Texas are safe, though some smaller space hubs face cuts or closure, including those in Ohio, Mississippi, West Virginia, New Mexico. But those states and others may see new opportunities from the private ventures.

ECONOMIC FORECASTS

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|---|----------------------------|------------------------------------------------------------|
| ↑ | GDP | Increasing to 3% growth in '11 after averaging 2.9% in '10 |
| ↑ | Interest rates | 10-year T-notes modestly higher in '11; prime, no change |
| ↑ | Inflation | About 2.5% in '11, from 1.5% in '10 |
| ↓ | Unemployment | Bouncing a bit, but finishing '11 under 9% |
| ↓ | Crude oil | Settling into a \$95-\$105 trading range |
| ↑ | Consumer confidence | Rising job growth will buoy spirits |

Complete economic outlook at kiplingerbiz.com/outlooks

**THE
ECONOMY**

Another healthy rise in job numbers this April is part of a mixed picture. The jump of 244,000 is a modest pickup from the pace in Feb. and March, indicating that high energy prices and uncertainty over supplies from Japan aren't crimping hiring. It's especially positive because the growth is coming largely from private employers. State and local government payrolls continue to shrink.

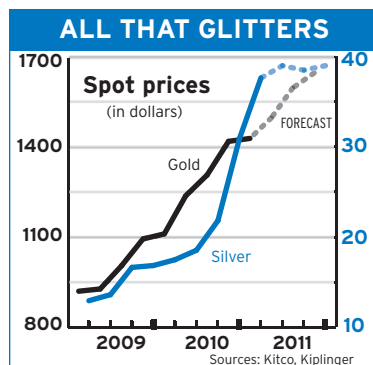
The bad news is that paychecks aren't keeping up with price increases, particularly for gasoline. To keep the economy humming at the same near-3% pace as last year, not only are about 2 million new jobs needed this year, but income also needs to show some improvement. You can't buy more if you don't earn more.

Worries about higher prices are spurring some stockpiling. Factory orders are strong, both in durable and nondurable goods...from turbines to chemicals.

But gains in manufacturing orders may not last if inventories become too fat. Some businesses are stocking up on plastics and rubber, for example, as hedges against price hikes. And some suppliers are trying to increase prices on orders placed but not yet fulfilled. Others aren't able to pass on their own higher costs to customers. They're seeing profits squeezed. Bottom line...a growing list of inflationary signals.

Inflation worries are likely to keep gold prices on a long-term upward trend. Short term? Not so much, with some major investors taking huge profits

after a two-year 70% run-up. Plus with current prices near record levels, any good news about oil, Libya, etc. would be likely to dampen enthusiasm for owning gold. The gains are sure to slow. But even at half the 30% pace racked up last year, that would still be a strong showing.



Helping to buoy prices: Demand from China and Russia. They're among the investors that see gold as a hedge against both a weakening dollar and rising inflation. U.S. consumers are also feeling the allure. The U.S. Mint ran out of the American Eagle gold bullion coin. And Utah recognizes gold coins as legal tender...a symbolic move, because the coins are worth more than their face value.

Silver is even riskier. Though prices will likely rebound from a steep drop in recent days, don't expect silver values to continue to appreciate in coming months.

The spectacular climb since 2008 is looking very precarious. Prices are up by nearly 30% since the end of 2010, even after accounting for this month's decline. Since the \$9 low in 2008, prices for the metal have soared by more than 300%.

It's more likely to be a slow leak than a bursting bubble that takes the air out of the silver market. Industrial uses provide a solid foundation for demand.

Commercial rents are starting to creep higher. Top-rated office space in cities along both coasts will pull in about 1% more this year than last. Washington, D.C., New York, Boston, San Francisco and Los Angeles are among the strongest markets.

But for metro areas between the coasts...flat, on average. Even that is an improvement, especially considering that the vacancy rate is only slightly lower than the 18% peak hit last year. Tenants and landlords anticipate greater demand for space next year as the economy improves, and are adjusting rents accordingly.

A slow, uneven uptrend is likely. With about \$300 billion in real estate loans for commercial properties maturing every year from 2011 to 2015, foreclosures and delinquencies will continue to keep the volume of distressed property sales high. And getting refinancing is still tough...lending standards haven't loosened up much.

Apartment buildings will lead the way, with solid demand for rental housing. Then...a pickup in warehouse and retail space, with hotel and office space last.



ENERGY

The bid to safely store nuclear waste takes a big step forward this summer, when a panel named by President Obama issues initial recommendations for handling spent fuel rods. The findings...coming after years of research... are likely to serve as a solid scientific foundation for any future policy decisions.

Look for a two-pronged approach from the panel: Using central facilities designed to hold depleted but still dangerous fuel rods for up to a century, and then transferring the radioactive waste to permanent underground storage.

The strategy allows for flexibility. Existing fuel rod recycling technology is too expensive to justify because an abundance of uranium is available. But if the process becomes economical, the government could retrieve the rods for fuel recycling. Intermediate storage, starting with waste from retired reactors, makes permanent disposal safer by reducing the levels of radioactivity and heat.

Political hurdles will remain. Local opposition and concerns about safety derailed plans for storage at Yucca Mountain, Nevada. To avoid a replay, the panel is expected to recommend creating an independent federal body that would solicit storage deals with state governments and willing communities.

GOING GREEN

The next way for consumers to be green: Refrigerators and air conditioners. Hydrofluorocarbons...used for insulation and refrigeration...are losing favor, being replaced by chemicals that give off fewer greenhouse gases. The alternatives already are required in a number of countries, including Japan and many in Europe. Companies doing business overseas also offer the products in the United States.

The shift from HFCs is a win for consumers as well as for the environment. Replacement chemicals such as cyclopentane tend to cost less and insulate better. A General Electric fridge using the new chemical uses 4% less energy, for example.

Next: General Motors will stop using HFCs in car air conditioners by 2013.

The share of compact cars in the U.S., up 14% since 2004, will keep growing. Rising gas prices are a reason. Sales of small cars have surged since January, when oil prices soared. Buyers can choose more models that get 40 miles per gallon than they could in 2008, when gas last topped \$4 a gallon. And not all are hybrids.

Demographics also play a major role in choosing the size of a vehicle. As Baby Boomers age, they have less need for larger vehicles to ferry families. And many younger folks settle in cities, where big cars are seen as an inconvenience. Buyers still want luxury add-ons...leather seats, fancy electronics and so on.

WORK RULES

It's getting harder to punish employees for comments they make on the job. Two recent National Labor Relations Board rulings expand protected activity in the workplace. In a case involving Wyndham Resort Development Corp., the NLRB said a worker received an improper warning after complaining about a new dress code. The comment to a supervisor, within earshot of others, was deemed protected speech. In the other case, the board said a company broke the law by dismissing a woman who discussed raises with colleagues, then told a boss she suspected discrimination.

Employers should review existing policies and tread carefully. An expansion of protected activity is likely to lead to more cases alleging unfair labor practices.

FINANCE

Elizabeth Warren may lead the new Consumer Financial Protection Bureau... But only because no one else wants the job. Others are cool to the role, including former Gov. Jennifer Granholm (MI) and others who were considered.

Warren won't be confirmed by Congress, requiring a recess appointment, which would allow her to serve until the end of 2012 without congressional approval.

Note that the Senate won't go along with a House plan to change CFPB rules to create a five-member oversight board and make it easier to veto bureau decisions.



**AFTER
BIN LADEN**

U.S. aid to Pakistan won't dry up because Osama bin Laden was found there. But that doesn't mean members of Congress won't fight about it all summer. They'll argue that Pakistan was either clueless or complicit in having the chief terrorist living in the nation, and that in either case billions in U.S. dollars went to waste.

The U.S. doesn't need another government in the region coming unglued, and cutting funding by up to \$3 billion in 2012 would make Pakistan even less secure. So the U.S. will pay, but don't be surprised if more conditions are applied.

Bin Laden's death also will bring calls for a faster U.S. exit from Afghanistan. That nation is no longer seen as a hotbed of al Qaeda plotting, training and recruiting. The U.S. is set to begin withdrawing troops from there in July, and the administration will find it hard to argue for keeping a big presence in the absence of a new threat. That's especially true given the push by lawmakers to find ways to cut the budget.

Watch for both parties to harp on the timetable during confirmation hearings for key members of President Obama's national security team: Gen. David Petraeus, in line to be CIA director, and current director Leon Panetta, tapped for Defense chief. They'll get a third shot when Joint Chiefs Chairman Mike Mullen leaves later this year.

**2012
POLITICS**

The lift Obama is getting from bin Laden's death won't be long-lived. Americans tend to give better marks to their leaders in times of crisis. The first President Bush saw his ratings soar after the U.S. drove Iraq from Kuwait, and the second President Bush saw major gains after the Sept. 11 terror attacks, and again after Saddam Hussein was captured. Now it's Obama's turn to benefit. But, in time, the polish tends to wear off and some of the goodwill starts to fade. So while Obama is in a good place now, he is by no means a shoo-in for a new term.

His overall ratings in the polls are tempered by doubts about the economy. The first polls since the raid show still low grades for his handling of that issue. The recovery is fragile and slow. A new attack by al Qaeda would likely panic markets. But given volatility in oil-producing regions, just some additional uncertainty may be enough to unsettle the economy and put a Republican in the White House.

**MIDDLE
EAST**

Violence in Syria will worsen, but the U.S. and others won't intervene. Sending U.S. or European troops is seen as too risky, given the key role that Syria plays in the Middle East. It keeps anti-Israel alliances with Iran and groups like Hezbollah and Hamas. It also shares a border with Iraq, so riling up Syrian leaders could lead to a slew of disruptions and cascading problems that may be destabilizing.

A United Nations resolution to use force to quell a crackdown on protesters? It won't happen. The Arab League opposes it. Lebanon, a League member, has a seat on the UN Security Council till the end of the year and will use it to object.

Instead, expect to see more U.S. economic sanctions put on the government. But Syria has few foreign investments, so it's less sensitive to having assets frozen.

Oil prices will remain volatile for some time, but will stay well off their high. The per-barrel price, which had neared \$115, briefly dipped under \$100 in early May. Traders say oil would be \$85 to \$95 without the \$15 to \$20 Mideast risk premium.

Yours very truly,

Knight/Kiplinger
THE KIPLINGER WASHINGTON EDITORS

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