



Market Watch

Markus Schomer, CFA - Global Economic Strategist

OVERVIEW

- The rollercoaster ride in global financial markets continued in November. The Dow Jones index hit a new all-time high October 12th, buoyed by strong growth and Federal Reserve rate cuts in Q3. Yet, seven weeks later, on November 26th, the Dow had lost 10% and given back almost all the gains for the year.
- This occurred because risk aversion among investors increased sharply once again, amid fears about a deepening financial markets crisis. However, optimism returned after signals that the Fed would justify market expectations regarding further rate cuts in the near term. As a result, in the last week of November, the Dow regained 25% of the losses incurred since its peak.
- Looking at the renewed sharp increase in equity volatility, it's not surprising that Treasuries rallied dramatically in November. Yields on 2-year U.S. government bonds fell 96 basis points, the biggest monthly drop since October 1987. Yields on 10-year Treasuries also declined, but at a less dramatic pace of 36 basis points, and credit spreads continued to widen. High Grade spreads rose 46bp; the worst month in the history of the Lehman Credit Index, and High Yield spreads widened 135 basis points; the biggest monthly jump in more than five years.

ECONOMY AND POLICY

- The most recent data flow in the U.S. confirmed the slowdown in economic growth in the current quarter, after a period of very strong activity over the summer. Trade remains a positive contributor to GDP growth, while the strong headwind from housing is likely to remain about the same in the current quarter.
- The primary reason for the sharp swing in growth performance is consumer spending, which is slowing due to higher energy prices. Business investment remains sluggish, due to weaker profit growth and another round of inventory cuts. Nevertheless, the data is still consistent with our forecast of 1.6% growth in Q4 and provides very little concrete evidence about where the economy is heading next year.
- Overall, we have to acknowledge that recession risk increased last month, and some of the offsetting influences that supported our initially more optimistic outlook are fading. However, exports remain strong, and trade should continue to add significantly to overall GDP growth in the coming quarters.
- While the Asian macroeconomic backdrop remains strong, the momentum in Europe and Canada is clearly slowing. Non-residential construction activity has balanced a great deal of the weakness in the residential sector, yet tighter credit standards and eroding tax revenues should start to slow corporate and public spending next

year. We still believe we will avoid a recession, and are anticipating 2.6% growth in the U.S. next year, but the downside risk to our forecast has increased.

- The Federal Reserve is fully aware that its policy decisions are now mainly driven by financial market volatility, and less so by underlying macro trends. Shortly after its last FOMC meeting in October, the Fed tried to communicate that the economy might not require further rate cuts, yet investors didn't buy it and continued to price in a series of rate cuts in the coming months. The Federal Reserve had to acknowledge the facts, and, at the end of last month, Fed Vice-chairman Kohl all but confirmed that decision in a November speech, hinting strongly at another rate cut in December.
- Looking ahead, we believe financial markets will continue to pressure the Fed into further rate cuts, as long as systemic risks remain in the banking sector and the pickup in inflation remains unsustainable. Right now, it seems likely that the Fed will cut rates at both the December and January meetings, before receiving more concrete evidence about the growth momentum in Q1. However, a future easing of strains in the financial markets may open the door for the Fed to resist investor expectations regarding further rate cuts.

ASSET ALLOCATION

- Consistent with our macro view that the U.S. will avoid a recession, we maintain our neutral stance in balanced bond/equity strategies. Though we acknowledge that the risk of a recession in the U.S. has increased (certainly from an investor perspective), we expect continued support from monetary policy through lower interest rates, which will prevent a more serious stock market sell-off. On the other hand, if we don't slip into a recession, Treasury markets remain greatly overvalued.
- Corporate credit spreads look quite attractive, but market conditions have not normalized sufficiently to warrant a more positive view quite yet. Within our equity allocation, we continue to prefer North America and Emerging Markets to Europe and Japan. Finally, we expect the U.S. dollar to remain weak in the coming months, although more against Asian currencies and less so vis-à-vis Canadian and most European currencies.
- For the next few weeks as we approach year-end, the primary focus of our strategy remains on risk reduction, until we get a better sense of whether the financial markets crisis is deteriorating further or whether the markets will calm down at the beginning of the new year.

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