



OVERVIEW

- Financial markets staged a strong rebound in April, on the back of receding fears of a major meltdown in the U.S. banking system. Although it's still too early to call it the end of the current equity bear market, the in-tandem moves in Treasury yields (higher), credit spreads (narrower), and the dollar (stronger), suggest this is more than just a temporary bear-market correction.
- The main catalyst for improved investor sentiment was the decisive Federal Reserve action following the Bear Stearns collapse in March. This expanded the bank's safety net – traditionally reserved for deposit-taking banks – to include the nation's brokerage firms.
- As a result, the S&P 500 rose almost 6%, its best performance since April 2003. Treasuries underperformed significantly, driven by the short end, where two-year yields rose 75 basis points in the biggest monthly gain since April 2004. 10-year yields increased 42 basis points, resulting in a notable flattening of the yield curve.
- The rebound in investor sentiment was most evident in the U.S. credit markets, where high yield bond spreads rallied 132 basis points. Finally, the dollar had its best month since January 2007, gaining just over 1% against its major trading partners. The increase was greatest against the Japanese yen and the Swiss franc, which are traditionally safe-haven currencies; another sign of greater risk appetite among investors.

ECONOMY

- Although stocks and the dollar rose on the back of improving financial market conditions, the U.S. economy continues to teeter on the brink of recession, although the latest GDP report for the first quarter confirmed our call that growth would hold above 0%.
- Clearly, the larger-than-expected job losses in the past few months have added another headwind for consumers, who desperately need the government's tax-rebate checks to stabilize the dramatic erosion of confidence that occurred in recent months. Ambiguous signals are coming from the housing market with new home sales falling dramatically; although home resales are stabilizing. It's too early to call for an end of the U.S. housing recession, but housing demand has improved notably in recent months, and affordability is back to pre-crisis levels.
- Where do we go from here? Much depends on the impact of tax rebates in the coming months. Strong export growth has prevented the U.S. from slipping into a recession, but is insufficient to trigger a recovery. The government has accelerated the tax-rebate payment schedule with more than one third of the checks hitting households in the first three weeks of May and the rest spread out over the following eight weeks through the middle of July. Even if households spend only a fraction of the total \$109 billion, consumer spending will jump

significantly in May, June and July, boosting GDP growth in the coming quarters. We are also paying close attention to business investment, which should benefit from accelerated depreciation provisions in the stimulus package.

POLICY

- As expected, at the end of April, the Federal Reserve lowered interest rates for the seventh time since the crisis began in the summer of 2007, bringing the total amount of rate cuts to 325 basis points.
- Clearly, the period of decisive rate cuts to shore up confidence in financial markets is over for now, and the Federal Reserve's attention is shifting back to the real economy. While growth is still a major problem, the Fed seems content to allow the fiscal stimulus to work its way through the system, before deciding whether additional monetary stimulus is needed.
- Inflation trends are likely to accelerate again in the coming months on the back of fast-rising energy and food prices. This would reduce the bank's flexibility and might force the FOMC to adopt more hawkish rhetoric, similar to that of the European Central Bank.
- Actual rate increases are unlikely, until the stress in the banking sector has abated more convincingly, and the economy returns to a more broad-based growth trend. This shift would also need to include growth in both the housing and labor markets. Only then can the Federal Reserve safely start to address inflationary pressures in the economy.

INVESTMENT OUTLOOK

- We had moved to a more positive stance in our fixed income portfolios in the last few months, which proved to be the right decision. High yield markets had their best month since November 2002, producing over 600 basis points of excess return, and the Lehman Aggregate Index outperformed Treasuries by about 1%. We reduced our equity underweight last month, but U.S. stocks significantly outperformed bonds in April, greatly exceeding our more cautious expectations.
- Going forward, the equity market will look to the economy and corporate earnings for further directional guidance. The growth slowdown clearly poses the biggest risk to stock markets, yet earnings continue to surprise on the upside, with only Financials and Telecoms disappointing expectations thus far in Q1. We expect both stock and bond markets to trend sideways in the next few weeks, as we await new information on how the tax rebates will alter the current, still fairly bearish, macro backdrop.

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