

U.S. Market Watch

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OVERVIEW

- After a long and deep recession, it is difficult to define an economic recovery. We have written extensively about “green shoots” and continue to be heartened by indicators showing improvements from the steep rate of decline we experienced around the turn of the year.
- Wall Street has already bought into the idea of an economic recovery evidenced by its surging equity and credit markets. My fellow economists have generally revised forecasts for second half U.S. GDP-growth higher in recent weeks. The latest Bloomberg forecaster survey shows a notable 1.2% increase in third-quarter U.S. growth forecasts to 2%, getting closer to our call of a stronger initial growth burst, which we have experienced since March.
- After a pause in June, the pace of recovery in the U.S. equity markets has picked up again. The S&P 500 gained 7.4% in July and continued that trend in early August. Fixed income credit markets mirrored the increase in risk appetite with High Yield gaining 6.1% and Emerging Markets up 3.8%. 10-year Treasury yields averaged 3.54% in July, marginally down from the eight-month high of 3.70% hit in the previous month.
- Consistent with increased demand for riskier assets, the U.S. dollar continued its downward trend, losing 3.6% against the currencies of its major trading partners. The euro, Japanese yen and British pound posted only moderate gains, while the Canadian dollar and Swedish krona were the biggest gainers in July.

ECONOMY

- What are investors and economists so excited about? “Main Street America” is clearly not experiencing the recovery. Manufacturing has shown signs of improvement for several months now, yet mostly in the form of slower rates of decline. July was first month of outright U.S. production growth in 19 months, excluding the post-hurricane-related bounce in the Fall of last year. The main driver (no pun intended) was the auto industry, which saw output jump 20% as the major U.S. auto manufacturers emerged from bankruptcy and switched on idled production lines.
- Housing is another area where improvements have been tangible. Home sales are at their highest level in two years. Additionally, home prices are up on most measures and Housing Starts are hinting at a tentative rebound. However, while we predict a rebound in new construction activity, the problems of the bursting

housing bubble will continue to haunt us for years to come, even during a recovery. The most recent data on home foreclosures shows a new record high in July, up 32% from a year ago.

- Consumer spending is another area of concern. Retail Sales have been basically trending sideways in the past six months, following six months of, at times, dramatic declines in the second half of last year. The ongoing increase in unemployment and the lack of improvement in confidence surveys suggests that consumers will stay on the sidelines through the fall.
- The sharp increase in auto sales is good for that troubled industry, but has generated very little new spending. So what will drive U.S. GDP-growth in the second half? Significantly positive contributions from exports, government spending, a small tailwind from consumption and a slower decline in business investment should all help GDP-growth.

POLICY

- Fiscal policy has been given a central role in combating the worst U.S. recession in a generation, and the merits of the US \$787 billion stimulus package have been extensively debated. The size of the program is significant, but the tax provisions have not lifted consumer spending. But it has allowed households to rebuild savings rates from a low of 1.2% at the start of 2008 to a 10-year high 5.2% in the second quarter of this year.
- Discretionary spending was intended to provide a more immediate boost to aggregate demand, but the pace at which stimulus funds are disbursed still lags behind expectations. So far, only US \$77 billion – or 15% – of the non-tax-related funds in the American Recovery and Reinvestment Act have found their way into the economy.
- However, in recent weeks we have been reminded that less is sometimes more. While the American Recovery and Reinvestment Act attempts to address multiple problems at the same time, the government’s Car Allowance Rebate System, better known as “Cash for Clunkers,” which focuses only on the auto industry, proved to be an instant hit. Initially capped at US \$1 billion, but quickly doubled to US \$2 billion, the program seeks to provide incentives for U.S. consumers to trade-in an old, less fuel-efficient car for a brand-new, more efficient one.
- Depending on the improvement in gas mileage, the government provides buyers with a US \$3,500 or US \$4,500 rebate on the purchase. The advantages of the program include a great multiplier effect as consumers

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spend about four times the rebate amount on the new car purchase, the acceleration in vehicle inventory liquidation and the related effect of stimulating new auto production. Obviously, this program is only a stop-gap measure and cannot last long, but it hits the economy at the right time when consumers are evidently willing to take advantage of a great bargain.

- The Federal Reserve has remained very much on the sidelines over the summer. However, the Fed's balance sheet reveals interesting undercurrents. Demand for its liquidity facilities, set up after the "Great September Crash" has declined precipitously in recent months, highlighting the improving liquidity conditions in the U.S. financial system.
- Meanwhile, in its latest meeting, the Federal Open Market Committee (FOMC) announced the slowdown of Treasury bond purchases, and we expect a curtailment of other asset purchases in one of the next few sessions. Halting the balance-sheet expansion is the first step towards an exit strategy out of the current highly accommodative policy stance. We still expect that the Fed will be ready to raise rates by the first quarter of next year.

improving earnings backdrop and continued investment inflows into the market should support returns in the coming months. Similar story in Emerging Market fixed income, where spread levels have tightened to levels not seen since the Lehman collapse last September. Yet, as in High Yield, there is justification for the strong performance in the improving macro backdrop in Asia and Latin America.

- Looking forward, improving liquidity conditions and evidence of a global economic and profit recovery should extend the strong performance in equity and credit markets into the second half of the year. However, the prospects of rising policy rates around the world could lead to profit-taking and renewed portfolio risk reduction by the end of the year.

INVESTMENT OUTLOOK

- Looking at our current investment strategies, a few convictions stand out. While equity and credit markets have rallied strongly on the back of growing expectations of an economic recovery in the second half of the year, the confirmation of a more supportive economy should continue to fuel risk appetite as yet-unconvinced investors catch up with the rising market.
- As a result we continue to tilt our equity strategies further towards Emerging Markets in general, and Asia in particular, where the evidence of a recovery is most convincing. In the same vein, we believe the current normalization in risk appetite will continue to hurt the U.S. dollar as domestic investors increase their international exposure. Consequently, we are reducing our U.S. overweight in favor of Europe and Japan.
- Within our fixed income strategies, we maintained our exposure to corporate credit and our recent diversification into international markets. Valuations in the High Yield market are approaching fair value, but the

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