

U.S. Market Watch

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OVERVIEW

- Concerns about the economy resurfaced in February. The further slide in housing activity, a sharp decline in consumer confidence and another rise in inflation raised the specter of a '70s-style stagflation environment. This impacted investor confidence, and even the Federal Reserve didn't seem to be able to reassure them.
- Not surprisingly, U.S. equity markets reacted negatively to the deterioration in the fundamental backdrop and posted another sizable decline in February with large-cap industrial stocks in the Dow Jones index outperforming smaller companies in the Russell 2000.
- However, based on the S&P 500, stocks are still up 2.5% from the current cycle low on January 22 and just under 20% down from the all-time peak in early October. The Treasury market was more differentiated, with 2-year yields falling another 28 basis points on expectations of further Fed rate cuts. 30-year yields increased 19 basis points, emphasizing concerns about the longer-term U.S. inflation outlook.
- Conditions in U.S. fixed income credit markets continued to deteriorate in February, showing no sign of an easing of liquidity conditions that have beset those markets in the past few months.
- Credit spreads in the high grade corporate bond market widened to 217 basis points, just 10% off the previous peak in 2002 and 260% off the average that persisted in the three years prior to the crisis. Spreads in the high yield market also widened further, reaching 712 basis points. The increase from the pre-crisis average at 223% is smaller compared to the investment grade markets, and spreads are still well below the 2002 peak, when high yield spreads briefly broke through the 1,000 level.
- Another market affected by the recent increase in recession risk is the currency market, where the U.S. dollar lost ground against most major currencies. The Euro and Japanese Yen both gained about 2.5%, with the former reaching a new all-time high of almost \$1.52.
- Meanwhile, dollar weakness, economic uncertainty and inflation risks are pushing up commodity prices. Oil closed above \$102 at the end of February, a 12% increase for the month, gold reached a new record and the CRB Commodity index is up almost 20% so far this year.
- Housing demand is not stabilizing as we had hoped. A key survey of major home builders pointed to a definitive bottom in sales, and even showed a pickup in sales show attendance and open houses. Still, all measures of actual sales continued to decline through January.
- Making matters worse, the steepening yield curve has reversed the decline in long-term mortgage rates, blunting the Fed's efforts to stimulate housing demand. Nevertheless, affordability has rebounded to the average seen during the 10-year housing boom between 1994 and 2003, which should at least stabilize sales at current levels.
- Consumer confidence took another dive in February on the back of more bearish housing news and weaker job growth.
- Nominal disposable (post-tax) household income has been growing between 5% and 6% for the past four years. However, adjusted for inflation, real disposable income growth slowed from a 3.3% average in the 12 months through October of 2007 to just 1.2% in January, highlighting the loss of consumer purchasing power as a result of the current pickup in inflation. We believe that is a main driver of the current slowdown in consumer spending.
- Against this backdrop, the Federal Reserve is increasingly between a rock and a hard place. The economy has slowed significantly and is arguably close to the start of an outright recession, while inflationary pressures are rising.
- In his recent testimony chairman Bernanke didn't offer any new insights into the Fed's thinking. We still expect another 50 basis point rate cut at the next FOMC meeting on March 18, which would take the Funds rate to 2.5%. If financial and housing markets remain weak, and banks continue to report massive write-offs, the Federal Reserve has almost no option other than continue to aggressively cut interest rates and ignore the growing inflation problem.

ASSET ALLOCATION

- There was no change in our risk management approach to asset allocation. We maintain a tilt towards bonds in our balanced portfolios and are focusing on risk reduction within our fixed income portfolios. The market conditions have not improved sufficiently to take advantage of attractive valuations in fixed income credit and equity markets. In addition, renewed concerns about the fundamental backdrop increasingly raise the probability for further significant earnings downgrades.
- However, while there is clearly a more downbeat tone in our assessment of the economy, we still believe the monetary and fiscal stimulus will bring about a rebound in economic growth in the second half of the year. If market conditions permit, riskier assets (i.e., unsecured investments) should react positively.

ECONOMY AND POLICY

- Financial markets quite accurately highlight the deteriorating fundamental backdrop in the U.S. right now. The month started out with a decline in new jobs, and the evidence since points to more weakness in the labor markets and a rising unemployment rate in the coming months. Manufacturing data has also been quite disappointing. We were looking for this sector to be more resilient, given the strength in export demand and the very low inventory-to-sales ratios. However, businesses remain very cautious, despite generally robust earnings growth in the first quarter.

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