



Market Watch

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OVERVIEW

- U.S. stock and bond markets are becoming more and more embroiled in the growing financial market fallout of the subprime mortgage crisis. We still believe the impact on the real economy will be fairly small and continue to forecast robust economic growth for the coming quarters. Yet, it is becoming obvious that the financial sector will go through a serious adjustment period, with significant losses among investors. The most recent implosion of two Bear Stearns' hedge funds with large, leveraged exposure to subprime mortgage backed securities highlighted the headline risk that will periodically impact financial markets more broadly.
- The U.S. dollar showed the biggest impact of increasing nervousness among investors in recent weeks, weakening significantly against most major currencies. Investors, foreign and domestic, appear to have lost some confidence in U.S. financial markets. The same de-risking also allowed U.S. Treasury bonds to gain ground again in July. The yield on 10-year government bonds, which had risen to a 4-year high 5.29% in June, drifted back below 5% last month, reflecting a general increase in risk aversion.
- However, drilling a little deeper and looking at the U.S. credit markets, the evidence so far points to a fairly contained problem. An increasingly popular index of BBB-rated mortgages issued at the height of the subprime bubble in the 2nd half of 2006 is indeed trading at just 55 cents to the dollar, highlighting the extent of losses in such assets. The high yield corporate bond index registered just over 110 basis points in spread widening. However, this was not caused by a significant increase in default rates, but rather a congested pipeline of new bond issues needed to finance the recent wave of leveraged buy-outs. Interest-rate spreads of higher rated U.S. companies – and indeed emerging market bonds – widened to a much lesser degree.

ECONOMY

- The theme in June was a new emerging consensus among Wall Street economists that growth was rebounding in the 2nd quarter, and the Federal Reserve was unlikely to lower interest rates in the next year and a half. Indeed, there is convincing evidence that the manufacturing sector has turned the corner and is again contributing strongly to economic growth. On the other side, the drag from the housing sector continues with further sharp cutbacks in residential construction expected until we see a stabilization in home sales and notable reduction in inventories of unsold homes.

- What still divides the bulls from the bears is the outlook for the U.S. consumer. We still believe the subprime crisis won't impact consumer spending noticeably. As long as employment creation remains positive and income grows at the current pace of 3% to 3.5% adjusted for inflation, real consumer spending should maintain a 2.5% to 3% pace, even allowing a gradual increase in the savings rate. The next few months will be critical for our outlook. We need to see steady retail sales growth in July and August, the important back-to-school season for U.S. retailers, despite a renewed increase in gas prices and more interest rates resets, to maintain our 3% growth forecast for the 2nd half.
- Amid the growing turmoil in the financial sector, the Federal Reserve continues to hold its ground. Chairman Ben Bernanke sounded a bit more concerned about housing at his most recent semi-annual Congressional testimony. He acknowledged the fact that the drag on overall economic growth might last longer than anticipated. As a result, the Fed lowered its 2007 and 2008 growth forecasts – yet by only a quarter point – and is still forecasting moderate growth in the next 18 months. Most of Chairman Bernanke's comments however, were again devoted to the risk to price stability. This suggests the Fed remains firmly focused on inflation, despite increasing risks to its own growth outlook.

INVESTMENT OUTLOOK

- While the subprime crisis remains the main risk to our overall quite constructive outlook, we try to keep our focus on the underlying market fundamentals. We remain optimistic about corporate profits in the next few quarters, which should support further stock market gains. Bond markets will probably experience more volatility from safe haven flows out of riskier Fixed Income structures into safer government bonds. Yet, if market conditions calm down over the summer, we expect a further gradual upward move in bond yields, as a result of stronger economic growth.
- We still expect the next major story that develops will be a re-acceleration in inflation in the Fall. If the economy can withstand the subprime fall out over the summer, then tight labor markets, higher energy cost, rising import prices and stronger service sector inflation are likely to increase the pressure on consumer prices. This change in the inflation cycle would trigger a new round of forecast adjustments regarding pricing through a Federal Reserve interest rate increase, which we still expect either later this year, or, at the latest, in early 2008.

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