

# U.S. Market Watch

July 2008

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## OVERVIEW

- Like “deja vu” all over again, financial markets are once again in a decidedly bearish mode. Concerns about further write-offs in the banking sector, increasing job losses and the drum-beat of almost daily new records in oil prices have more than reversed the bullish market reaction following the Fed’s decisive March rescue of Bear Stearns.
- The global liquidity crisis and the housing recession managed to slow the U.S. economy, but, with Federal Reserve support, it seemed likely we could avert a recession. However, “The Oil Crisis of 2008” now threatens to remove that critical monetary policy life support.
- U.S. stock markets ended the first half down more than 12% and now stand about 20% below their October peak, officially making this an equity bear market.
- Fixed income markets experienced two decidedly different quarters in the first half. In the Treasury market, 10-year bond yields registered a 61 basis-point decline in the first quarter, only to give back 56 basis points in the second quarter, on the back of receding recession fears and growing inflation pressures.
- Fixed income credit markets followed a similar story line. Spreads widened, in many cases to record levels, in the first quarter, followed by a rally in the second quarter that reversed about half the year-to-date spread increase. Hopes of further spread tightening have been dashed in recent weeks on the back of renewed concerns about the overall U.S. economy.

## ECONOMY

- Rising inflation has become the dominant risk, not just in the U.S., but in other parts of the world as well. Oil prices are up more than 50% this year alone and have doubled from a year ago. Most visible are price pressures in the producer sector, where inflation is already running at a double-digit pace more consistent with the inflationary late 1970s.
- The pass-through to the consumer sector remains limited, and headline consumer price inflation is running at only 4%. In fact, if you don’t include food and energy—where most of the pressure is coming from—we are left with a still remarkably contained core inflation rate of 2.3%.
- While rising inflation is chiefly responsible for slowing the economy, we are seeing evidence that the tax rebates, which have been distributed over the past six weeks, are boosting consumer spending. In addition, business spending is perking up a bit, after posting a decline in the first quarter.
- Additionally, exports remain a powerful tailwind, which continues to offset much of the weakness still coming from the housing sector.

- We have greater confidence in our forecast of 1.5% to 2% growth in the second quarter and about 2.5% growth in the third quarter, but the outlook beyond the summer is facing growing downside risks. The relentless rise in gasoline prices, the lack of a rebound in consumer confidence—despite the tax rebate checks—and growing job losses suggest the economy could slow more rapidly than we are forecasting.

## POLICY

- Rising inflationary pressures have changed expectations about future Federal Reserve policy. In April, the Fed Funds futures market was still pricing in a half-point rate cut by the end of the year. In May, that market was looking for no rate change this year and, at the end of last month, expectations changed again and it is now pricing in a rate hike as early as September.
- We are holding onto our forecast of a rate hike at the end of the year, believing that September will be too early for the Fed to gain enough confidence that the economy is not slowing abruptly again after the summer and that the liquidity crisis is contained.
- As expected, the Federal Reserve left interest rates unchanged at their last meeting on June 25, but adopted a slight tightening bias in its policy statement. The FOMC referred to diminished downside risks to growth and increased upside risks to inflation. After focusing on growth since last December, inflation is back on the Fed’s radar screen; a clear indication of reduced flexibility in supporting the economy and the banking sector at all costs.

## INVESTMENT OUTLOOK

- Not surprisingly, given our more bearish outlook, we maintain a more risk-averse stance in our investment strategies. In our balanced portfolios, we are sticking with our equity underweight and prefer the U.S. market—which enjoys greater monetary and fiscal policy support—to Europe and Japan, where such support is lacking.
- We maintain a neutral duration position, given the opposing forces affecting the Treasury market right now with inflation concerns pulling yields higher. At the same time, increasing risks to the medium-term growth outlook are pointing to lower yields. Finally, we maintain a neutral position on high yield, which offers adequate compensation for the prevailing credit risk, in addition to an overweight in relatively-safe, AAA-rated mortgage-backed securities.

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