



Market Watch

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U.S. OVERVIEW

- September 18, 2007 will likely be remembered as the day the Federal Reserve announced its intention to do whatever is necessary to avoid a systemic crisis in the U.S. banking system. Most market participants expected a quarter-point cut in the Federal Funds rate. This would have been a logical next step in the Fed's gradual approach to addressing the ongoing liquidity crisis, without creating further problems by bailing out investors and home buyers. Yet, in a surprise move, the bank lowered its benchmark rate by 50 basis points. Whether this will come at a price in terms of higher future inflation or damage to the Fed's reputation, as some economists already argue, remains to be seen.
- Not surprisingly, stock markets jumped higher on the news. The Dow Jones registered its best day in 4-½ years, and equity indices around the world followed U.S. markets higher. Bond market reaction was more mixed. After rallying initially, longer-term U.S. bond yields trended higher. This reflected several factors from the reversal of flight-to-safety investment flows and fewer worries about the U.S. growth backdrop. It may also have indicated concerns that easier U.S. monetary policy might lead to higher inflation in the coming years.
- The reaction in the currency markets was also fairly predictable: The U.S. dollar fell sharply against most other major currencies. The Euro reached a new all-time high, and the Canadian dollar traded at parity with the U.S. dollar for the first time since the end of 1976.
- It remains to be seen whether the September rate cut was enough to unclog financial markets around the world. This is especially true for asset-backed Commercial Paper, which has been at the core of the liquidity crisis that has threatened a number of major financial institutions in the U.S. and abroad. There are signs that liquidity in the fixed income credit markets is improving. A small amount of the still very large overhang of bond financing, which is part of the recent private equity buy-out wave, have now been issued. This relieves banks of capital committed to holding those deals on their own balance sheets. In addition, the U.S. government has started to take on the mortgage crisis, with a multitude of proposals on the table. This will help dampen the overall impact of mortgage rate resets and home foreclosures on the economy.
- Other news last month included weaker August Retail Sales and another sharp drop in Home Sales. Yet, on the positive side, we noted a stabilization in consumer confidence in September, despite the bad jobs report. This suggests the Wall Street panic is not impacting Main Street, as of yet. The biggest near-term risk is still a broader tightening of credit conditions affecting other consumer businesses, such as auto loans and commercial and industrial loans to U.S. companies.
- So far, evidence that this credit crunch will actually occur is mixed. The cost of debt financing had clearly increased. Yet, surveys of credit conditions show only a very limited spillover from the subprime mortgage market – where credit has dried up – to other parts of the economy.
- While we still believe the direct impact of the housing crisis will not cause a more severe slowdown in the U.S. economy, the liquidity crisis will clearly dampen growth in the near term. Nevertheless, we still expect the U.S. economy to generate about 2.5% growth in the next four quarters, which is down from the 3% pace we were forecasting just a few months ago. The recent Fed rate cut will help alleviate some of the borrowing cost increases, and, by encouraging banks to increase lending again, help credit flow more freely to consumer and corporations.
- After giving the markets more than they expected, the Fed is likely to sit back in October and watch the evolving macro backdrop, before deciding whether further rate cuts are necessary. We expect no further rate action and are looking for a reversal of the September rate cut by the middle of next year.

U.S. INVESTMENT OUTLOOK

- Reducing risk remains the primary, underlying investment theme going forward. Following the sharp post-Fed cut stock market rally, we are inclined to pare back our equity overweight and adopt a more balanced position between stocks and bonds for the next few weeks.
- Since transparency is major issue, U.S. stocks appear to be a better investment compared to European stocks, at present. After all, no financial institution in the U.S. had to be rescued. On the other hand, Germany already suffered two small regional bank insolvencies, and the Bank of England had to bail out a major mortgage lender in the past few weeks.
- Valuation in many fixed income credit markets has improved considerably, yet we expect a bumpy ride in the coming weeks, as long as market liquidity remains restricted. Finally, we are also looking for further dollar weakness in the coming months, as long as the uncertainty about the U.S. growth outlook persists and investors position themselves for further Fed rate cuts in the near term.
- Finally, the U.S. dollar is likely to hold onto its gains, as long as markets remain in risk-averse mode.

THE ECONOMY

- September brought more bearish news on the broader U.S. macro outlook. A highlight (or perhaps a lowlight) was the first outright decline in employment in four years. The outlook for job growth remains crucially important to forecasting U.S. economic growth in the coming quarters. The reason behind our more constructive outlook is continued job and household income growth, which helps consumers cushion the adverse impact of rising mortgage rates and tighter credit conditions. If home owners start to lose their jobs and with it their main source of income, mortgage defaults will skyrocket.

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