

# U.S. Market Watch

May 14, 2009

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## OVERVIEW

- The view that we have reached an inflection point in the current U.S. business cycle is starting to gain broader support. Federal Reserve chairman Ben Bernanke asserted in his most recent Congressional testimony that “the pace of contraction may be slowing,” and that there are “tentative signs that final demand, especially demand by households, may be stabilizing.”
- During recent weeks, the government published results of the banking-sector “stress test,” which did not produce any sensational or particularly surprising results. However, the findings did quantify the extent of future capital needs and removed another significant source of uncertainty from investors’ minds.
- Stock markets experienced another very strong month in April and continued to rally in May, although the tech-heavy NASDAQ seems to be taking a breather so far this month. While the Dow Jones is still down about 4% year-to-date, the broader S&P 500 has already erased its losses for the year, and the NASDAQ is up almost 9% so far in 2009.
- The Treasury yield curve steepened dramatically in April. 10-year yields jumped 45 basis points last month, the second largest monthly increase in 5 years. That bearish trend has continued thus far in May, pushing 10-year Treasury yields to their highest level since November of last year.
- A broader increase in investor risk appetite is also driving stronger performance in the U.S. corporate credit markets. High Yield credit posted a 12% return in April and is up almost 5% in May. For the year to date, U.S. High Yield credit is matching the surging performance in emerging market equities.
- With riskier assets classes rallying, safe-haven flows into the U.S. dollar are reversing, weakening the dollar vis-à-vis most other developed world and emerging market currencies. Main beneficiaries over the past six weeks included the Korean Won, the Brazilian Real and the Australian Dollar.

## ECONOMY

- The U.S. first-quarter GDP report showed that the economy continued to contract at a depressingly rapid rate, yet the composition of growth drivers reflected significant changes. Consumer spending rebounded,

growing at the fastest pace in two years, and the accelerated inventory liquidation is triggering an improvement in manufacturing activity. All of that is occurring before fiscal stimulus programs are really starting to stimulate economic growth.

- A government website ([www.recovery.gov](http://www.recovery.gov)) allows us to track the weekly disbursement of funds appropriated under the American Recovery and Reinvestment Act. So far, only \$28 billion has been paid out; a number that will increase dramatically in the coming months. The greatest impact on the economy is expected to be in the second half of the year.
- It’s not all smooth sailing, however. The latest employment report may have reported a slowdown in the pace of payroll declines, but the 539,000 jobs lost were still worse than any in the previous seven recessions. Moreover, the ongoing restructuring in the Auto sector is poised to create more misery among both production workers and dealers.
- Consumer confidence is improving, helped by strong stock market performance, but most of the brighter sentiment is based on expectations, versus actual economic improvements. Meanwhile, the dramatic decline in Consumer Credit is a reflection of the cutbacks in demand, rather than sign of a deepening credit crunch. However, this trend does reflect the ongoing weakness in demand for durable goods.

## POLICY

- While the economy is exhibiting signs of improvement, policymakers are adopting a more wait-and-see approach and focusing on monitoring the plethora of programs instituted in the past 12 months. As funds from the fiscal stimulus package start to flow into the economy, other programs such as the Term Asset-backed Loan Facility (TALF) and the Public-Private Investment Program (PPIP) are still struggling to make an impact.
- Loans disbursed under the TALF program picked up in May and the sectors involved broadened, yet the total amount has barely reached \$20 billion so far. The Treasury Department is still working on details to make the PPIP program – designed to take toxic assets off bank balance sheets – work effectively.

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- Meanwhile “stress test” results showed that the 19 biggest U.S. commercial banks had total capital needs of about \$185 billion. That additional cushion, combined with existing capital and expected profits, should enable the major banks to withstand any renewed deterioration in the economy; something that most forecasters are no longer predicting.
- Not surprisingly, some banks have criticized the government’s findings. Yet with wholesale funding markets slowly reopening, and the FDIC’s Temporary Liquidity Guarantee Program still available, banks should be able to raise the necessary funds in the coming months. However, this still does not resolve the issue of how to stimulate renewed bank lending.

## INVESTMENT OUTLOOK

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- The gradual improvement in investor risk appetite has fueled strong performance in both the equity and High Yield credit markets, vindicating our marginal overweight in both asset classes within our equity and fixed income strategies. There is legitimate concern that both markets have outpaced fundamentals and might be due to at least pause.
- However, with further economic improvements on the horizon, especially the increased disbursement of fiscal stimulus funds, it’s difficult to time a short-term market correction. We maintain a more medium-term asset allocation approach and are continuing with our marginal overweight in equities and High Yield credit.

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