



Market Watch

Markus Schomer, CFA - Global Economic Strategist

OVERVIEW

- After a prolonged period of disagreement between the major Wall Street economists about the direction of the U.S. economy and monetary policy, the framework of a new consensus is emerging, and the bulls seem to have the upper hand. The bearish forecasters of weaker U.S. growth and multiple Federal Reserve interest-rate cuts have thrown in the towel faced with overwhelming evidence that, outside of the housing market, the economy is doing well.
- U.S. Treasury bonds bore the brunt of the adjustment in investor expectations this month. After a period of excessively low yields, which among other things represented concerns about the direction of the U.S. economy, the yield on 10-year U.S. Treasuries rose 35 basis points in the first two weeks of June to its highest level in nearly five years. The yield curve, the difference between 10- and two-year bond yields, steepened sharply as yields on longer-term bonds rose faster than those with shorter maturities.
- Stock markets held up better than expected this past month. Rising bond yields initially caused a sharp sell-off across most markets, but calmer conditions in the second half of the month helped U.S. stocks erase their initial losses, ending the month in the black. The U.S. dollar also had a mixed month, initially strengthening across the board as U.S. bond yields soared but losing ground again against higher-yielding (carry) currencies later in the month.
- Most important for the longer-term outlook is the continued lack of spill-over from a weak housing market to the rest of the economy. We believe this will remain the case, provided job growth remains positive and real household income continues to grow at about a 3% pace. In such an environment, the impact of mortgage-rate resets is likely to limit the rebound in consumer spending but will not by itself cause a recession or a more significant growth slowdown.
- Another part of the new consensus is that investors have largely priced out the probability of interest-rate cuts by the Federal Reserve for the remainder of the year. While the growth consensus has significantly brightened, Federal Reserve Chairman Bernanke appears to have become more contemplative. In a recent speech on the "housing wealth effect," he focused on the impact of falling housing prices on consumers, which not only impact the financial wealth of homeowners, but also their cost and availability of credit.

INVESTMENT OUTLOOK

ECONOMY

- The biggest shift in the consensus affected the short-term outlook for the U.S. economy. Evidence in the past few weeks has pointed to a strong rebound in real gross domestic product (GDP) growth in the current quarter to about 3%, after reaching a mere 0.6% in the first three months of the year. Manufacturing and international trade, which had faced significant headwinds in the first quarter of the year, are rebounding convincingly, and the drag from residential construction eased sharply in the last few months.
- However, we are not out of the woods yet with regards to the housing market. The most recent reports on new housing starts and surveys on home sales show more weakness, and the rise in interest rates will increase the pressure on those households facing mortgage-rate resets in the coming months. We are still looking for a sharp drop in newly constructed homes coming to the market combined with stable home sales to drive down home builders' inventories, a condition necessary to restart new construction by the fall.
- Despite higher bond yields, the prospects for U.S. equity markets remain positive for now. The improving U.S. growth outlook should support profit growth, especially if productivity growth rebounds in the second half of the year and the ongoing trend of stock buybacks and merger and acquisition activity support further price gains. The prospect of higher bond yields and eventually rising policy rates should make for a more difficult stock market backdrop later in the year, triggered by a turn in the inflation trend.
- In the short term, the sharp bond market adjustment appears overdone, and the higher-yield level is attracting buyers again. Over the next three months, however, we continue to expect yields to drift higher towards the current Federal Funds rate of 5.25%. The next chapter will be the turn in the U.S. inflation trend, which we expect to see by the fall. The result will be rising expectations interest-rate hikes and, consequently, further upward pressure on bond yields.
- Finally, the outlook for the U.S. dollar is a lot brighter in a market still dominated by so-called "carry" trades. The greater certainty about the U.S. macro backdrop has triggered a more bullish dollar trend mostly against lower-yielding currencies such as the Euro and the Canadian dollar. We are still looking for further dollar gains in the coming months as rates in the United States start rising and confidence in the strong global growth backdrop wanes.

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