

OVERVIEW

- The rebound in financial markets fizzled out in May, as investor focus shifted away from the improving financial market conditions to growing problems in the U.S. economy.
- The financial market crisis is still far from over, but the risk is now more firm-specific, as shown by the latest troubles at Lehman Brothers, and less of a systematic threat to the stability of the broader U.S. financial system. Headlines are now dominated by concerns about a possible recession coupled with a more pronounced pick up in inflation.
- The large-cap Dow Jones Index led the recent stock market correction and then started to retreat at the end of May. The S&P and NASDAQ posted positive gains in May, but have since followed the Dow Jones downwards in early June.
- Treasury yields continued to trend higher in recent weeks and the yield curve flattened dramatically, as investors started to price in the potential of higher U.S. policy rates in the second half of the year. In the fixed income market, credit continued to outperform Treasuries last month, but the pace of spread-narrowing slowed notably from the record set in April, showing that future gains may be more difficult to come by. Finally, after gaining modestly in April, the U.S. dollar lost ground again in May and is now extending that losing streak into early June.

ECONOMY

- The U.S. growth backdrop remains largely uneven. The latest look at first quarter GDP growth suggested that the domestic economy is in a shallow recession. Only strong foreign demand is preventing a broader decline.
- However, recent economic data supports our view that the recession risk is gradually diminishing. Housing activity remains depressed, home prices are still falling and foreclosures are still increasing, but home sales appear to be stabilizing. Businesses are still reducing payrolls, but at a very gradual pace and the recent spike in the unemployment rate greatly exaggerates the pace of deterioration in the U.S. labor market. Finally, consumer confidence has started to rebound and the tax rebates have appeared to boost consumer spending in May.
- Exports continue to offset much of the weakness in housing and cushion the impact of weaker domestic demand on the broader corporate sector. In fact, U.S. Factory Orders continued to grow at a moderate pace last month, which is inconsistent with an economy in, or slipping into, a recession.
- Looking ahead, we are still expecting a modest rebound in economic growth over the summer, which should further deflate recession fears. The tax rebates are already boosting income and sentiment. The next few weeks will show whether consumer spending is getting the expected lift that will raise overall GDP growth back to the 2% to 3% level from the current, very sluggish, 0% to 1% pace.

POLICY

- The story would read more cheerfully if it wasn't for the surge in inflation. Rising commodity prices are fuelling a broad-based increase in prices that is most visible in the producer sector. Oil prices are up more than 70% from a year ago, materials prices are running 34% above last year's level and Producer Price Inflation stood at 6.4% in April. Against this backdrop, it's not surprising that attitudes within the Federal Open Market Committee are beginning to harden against further rate cuts.
- A few months ago our forecast of a fourth quarter rate hike looked quite bearish vis-à-vis a consensus that was, then, still looking for more rate cuts. Today, the futures market is pricing in a 50% chance of a rate hike as early as September. So far, the consensus seems to favor steady policy rates, but the Fed might soon be forced to make the difficult choice between slowing economic growth and accelerating inflation.
- The Fed's dilemma is the fact that the U.S., where domestic demand is already in recession, is not the source of inflation. Why push the U.S. into a deeper recession, if strong growth in other parts of the world are driving commodity prices, which are the fuel behind the current surge in consumer prices? There is no right or wrong answer to this question, yet central bank policy will be a very important driver of financial market performance in the coming months.

INVESTMENT OUTLOOK

- We remain cautiously optimistic in our fixed income strategies, but we have halted our gradual re-allocation back towards riskier asset classes such as high yield bonds, where we maintain just a modest overweight. The surge in inflation is increasing the risk of higher Treasury yields and the still prevailing recession concerns in the market will make further spread performance more difficult to come by.
- Cautious is also the right word to describe our equity strategy. In fact, we increased our underweight in equities versus bonds again at the end of May, fearing a renewed stock market correction following the strong performance in April and early May. Clearly, fragile economic fundamentals and the prospects of rising interest rates are a perilous mix for equity markets still reeling from huge losses in the banking sector and we want to see a broader consensus of a rebound in U.S. economic growth, before shedding our bearish equity stance.

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