

U.S. Market Watch

September 17, 2009

Markus Schomer, CFA - Global Economic Strategist

OVERVIEW

- It has been almost exactly a year since the collapse of Lehman Brothers triggered an unprecedented shutdown of the global financial system – the “Great September Crash of 2008.”
- Admittedly, the financial sector was already under increasing stress that summer, as falling house prices and rising mortgage defaults exacerbated credit losses in the banking sector. The collapse of Bear Stearns a couple of months earlier had seemingly passed without further aggravating the situation. But that experience, at least in part, precipitated the Federal Reserve’s decision to let Lehman Brothers go under in September.
- It appears now that the authorities misjudged the erosion of confidence within the banking system that had occurred over the summer, as well as the risk of a general run on virtually all wholesale-funded financial institutions. U.S. stock markets had fallen about 13% through the end of August 2008, and ended the year down almost 40%, with most losses coming in the final four months of the year.
- After finally bottoming in March of this year, the S&P 500 has since rebounded more than 50%, while the NASDAQ is up an even more impressive 65%. Stock-market performance has been particularly strong in the past few months. The S&P500 has posted six straight monthly gains, and half-way through September 2009, it seems the streak will remain intact.
- Today, in the fixed income markets, the rally in credit has slowed notably. High-yield spreads have drifted higher in recent weeks, yet with average yields still in excess of 10%, the asset class is still posting healthy positive returns. After more than doubling, high-yield spreads have fallen back to levels close to where they were just before the Great September Crash.
- Finally, the U.S. dollar initially rallied as domestic investors repatriated overseas investments. Yet, since stock markets bottomed in early March, the dollar has been on a steady downward trend, which pushed the trade-weighted index back towards pre-September 2008 levels.

ECONOMY

- The improvements in the U.S. economy have continued in September. Topping the list is still the manufacturing sector, where stronger domestic and international demand is lifting orders and business output. However, most measures

of inventories still point to an ongoing liquidation, which suggests that the pace of production increases continues to lag behind the current growth in demand.

- Evidently, businesses remain cautious in their decision to expand production. Yet with a large amount of unused and still costly capacity available, we expect to see a steady pick-up in industrial production in the coming months. Inflation measures are showing a gradual build-up in price pressures within the producer sector, another sign that supply is not keeping pace with the rebound in demand.
- Consumer spending also rebounded more than expected in August, but the outlook remains cloudy. The CARS program, better known as “Cash for Clunkers,” proved very successful in moving unsold autos off dealer lots, yet mainly led to a redistribution of spending away from other discretionary areas and towards motor vehicles. The broad-based pick-up in Retail Sales in August was the first sign that aggregate sales volumes are also finally starting to rebound again.
- However, the main headwind for a more meaningful consumer recovery is the still-ailing U.S. jobs market. You can be sure that we are looking hard for evidence to support our more constructive outlook for the American economy, but, other than signs of a gradual slowdown in the pace of job destruction, there is nothing on the radar right now. Losing “only” 298,000 jobs in August was better than the 691,000 average during the first three months of the year. But the growing ranks of the unemployed, which increased by almost seven million since the recession started, is preventing the bullish sentiment on Wall Street from trickling down to Main Street.

POLICY

- It is still a bit early to start talking about potential Federal Reserve rate hikes, but the slow, gradual shift towards an exit strategy from the unprecedented monetary easing has started. Granted, it is more obvious overseas, where the Bank of Israel was the first central bank to actually raise interest rates. Monetary authorities in Australia, Korea and Canada have upgraded their assessment of the economic backdrop and seemingly stand ready to begin the process of normalizing interest rates.
- We agree that the nascent global recovery needs continued policy stimulus and is not ready to stand on its own feet. Fiscal policy will provide this needed support, as many of the fiscal stimulus packages around the world are ramping up slowly. Additionally, the cost of credit will

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remain low even if central banks start pushing short-term interest rates higher, as it will take a while before rates are back to something more akin to fair value.

- The current policy debate about health care reform here in the U.S. touches on a broader challenge for governments around the world – regaining control of public finances. The U.S. government’s latest Mid-Session Budget Review projects deficits as far as the eye can see (actually the forecasts run through 2019).
- From about 13% of GDP this year, budget shortfalls are projected to ‘improve’ to about 3.5% in 2012, but will remain close to that level in subsequent years. Looking at the expenditure breakdown, discretionary spending is expected to grow at an annual average of 2.8%, while mandatory spending, which includes Social Security, Medicare and Medicaid, is expected to grow at almost 6% per year.
- It seems obvious where the problem lies and equally obvious the area where fiscal consolidation must focus. Health care reform that “bends the cost curve,” (i.e., slows the acceleration in health care inflation), is essential to engineering a return to a more balanced fiscal policy.
- We maintain an overweight in U.S. equities over bonds, believing that confirmation of stronger economic growth and corporate profit forecasts in the coming months will extend the current equity market rally. However, come November 2009, investor sentiment will undergo a “Stress Test” of its own, as the attractiveness of market valuations fades and the possibility of interest-rate hikes increases market volatility.

INVESTMENT OUTLOOK

- The main themes resonating in the preceding commentary describe financial markets that have staged substantial rebounds since March 2009. That month saw the beginning of stimulus withdrawal, starting with monetary policy, and long-term fiscal challenges resulting from the evidently successful efforts to stave off a more serious economic depression.
- As a result, we are gradually becoming more cautious in our domestic investment strategies. This is probably most evident in our fixed income portfolios, where we have a fairly neutral duration posture, believing long-term Treasury yields will remain broadly range-bound in the coming months, despite the improving economic data.
- Within our credit strategies, we continue to move towards more defensive credits within the various asset classes, but we are also looking to reduce our moderate overweight in U.S. high yield in favor of emerging market bonds, where we still carry a small underweight.

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