



Market Watch

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OVERVIEW

- The rollercoaster ride of expectations regarding the direction of the U.S. economy continued last month. Investors and market commentators are once again sounding more optimistic about the future following November's bout of recession jitters.
- What triggered the more optimistic outlook was a set of economic data showing much stronger-than-expected consumer spending last month, which suggests that economic activity is picking up again in the current quarter after a summer slowdown.
- The main gauge of economic sentiment, the U.S. Treasury market, saw the 10-year bond yield trending higher from an 11-month low at the start of December back toward the 4.6- to 4.8-percent trading range that persisted between mid-August and mid-November.
- Unfazed by the volatility in economic expectations, equity markets continued their strong performance. As a result, the S&P 500 Index was within striking distance of an all-time high, something the Dow Jones Industrial Average already achieved in October.

ECONOMY

- In November, a number of weaker than expected economic reports – especially a whopping 14-percent drop in new housing starts and a sharp slowdown in durable goods orders – indicated that the weakness in the housing market was indeed threatening a more meaningful slowdown in overall U.S. economic growth, which in turn was validating expectations the Federal Reserve was going to cut interest rates.
- The main reason for the more optimistic outlook was evidence that consumers were out in force in November, generating a much stronger-than-expected Thanksgiving sales increase. Stronger household spending is the most obvious sign that the weaker market has not had a negative impact on the consumer sector.
- The main reason for the strong consumer backdrop is the increase in real (inflation-adjusted) income growth, which has accelerated from a meager 1.2-percent pace in 2005 to a 2.3-percent pace so far this year and an even more impressive average of 3.7 percent in the past three months.

POLICY

- Evidence of a more robust growth backdrop is exactly what Federal Reserve Chairman Ben Bernanke predicted at the start of the year. Not only does it appear he is getting the growth forecast right, his call on inflation is also playing out as expected.

- November core consumer price inflation (which excludes food and energy) slowed to a six-month low of 2.6 percent. This is still above the Federal Reserve's comfort zone of its one- to two-percent range, yet the trend has been heading in the right direction in the past two months.
- Not surprisingly, the Federal Open Market Committee left interest rates unchanged at its December meeting and made only a few changes to the statement published along with the rate decision. The committee acknowledged the substantial slowdown in the housing market, yet reiterated that "the economy will continue to expand at a moderate pace in the coming quarters."

INVESTMENT

- The prospects of moderate U.S. growth, slowing inflation, stable interest rates and still very buoyant global activity paint a very favorable backdrop for equity markets around the world. There are a few clouds on the horizon, namely the renewed oil price increase and the weaker dollar. This environment puts pressure on a number of Asian economies, yet there has not been any change in the very bullish investor sentiment.
- U.S. Treasury bonds continue to be pulled in opposite directions by two opposing forces. On the one hand, the improving growth backdrop should reduce the chances of interest-rate cuts in the United States, making it harder to sustain longer-term bond yields significantly below Treasury bill yields.
- On the other hand, the continued abundance of global liquidity, coupled with the remaining uncertainty about the economic backdrop among less optimistic investors, is channeling significant capital flows into the perceived safe haven of the U.S. Treasury market.

Outlook:

- The data flow so far is consistent with the approximate 2.5-percent U.S. gross domestic product growth in this past quarter. The key trend of note for early 2007 is the pace of job growth, which is critical to support household income growth and, in turn, consumer spending.
- In the coming months, we continue to expect inflation to moderate further, which should enable the Federal Reserve to stay on the sidelines for most of next year. Given the increasing evidence of a more robust growth backdrop, we are not expecting a rate cut in early 2007 (as noted in the last Market Watch issue).

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