



# Market Watch

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## OVERVIEW

- January proved to be another month of extreme market volatility, and the Federal Reserve was right at the center of it. After lowering rates by 50 basis points at the start of the financial market crisis last September, the Fed tried to steer a more steady course, lowering rates at a more moderate pace and directly addressing liquidity problems in the inter-bank market. The latter strategy seemed to work, but, as the new year began, investor concern shifted from the liquidity crisis in the banking sector to outright fears of a recession. The ensuing stock market sell-off in the first three weeks of January eventually forced the Federal Reserve to adopt a much more aggressive easing policy.
- U.S. stocks started 2008 with their worst performance since 1990, losing 6.1% for the month. Much has been written about the significance of such a bad start to the year, but looking at the S&P 500, 2008 was the fifth year in the past eight that started in the red, and only two of those resulted in an eventual full-year loss.
- Nevertheless, stock markets have lost confidence in the economy and are priced for a more serious economic slowdown. One of the key drivers is a deterioration in earnings. However, a closer look at the data reveals a “bi-polar” economy with financials, home builders and consumer discretionary reporting losses, while many energy, technology and industrial companies still experiencing robust profit growth.
- U.S. Treasuries rallied sharply in January on the back of the 125 basis points in Fed rate cuts. Two-year bonds outperformed longer-term bonds, and the (10-year/2-year) yield curve steepened to 150 basis points; the highest level in more than 3 years.
- LIBOR rates dropped significantly during the month, signaling an easing in liquidity conditions in the inter-bank market. However, fixed income credit markets continued to deteriorate, and credit spreads widened further. Finally, the U.S. dollar fell 1.1% against a broad basket of currencies. Carry trade unwinding and risk aversion benefited some currencies, especially the Japanese yen and the Swiss franc.
- What is certain is that the economy slowed in the last quarter of 2007 from a very strong 4% average growth rate in second and third quarters, to an underlying pace that we believe is somewhere between 1.5% and 2%. What skewed the most recent GDP numbers was a hefty decline in inventories, which shaved 1.2 percentage points off the quarterly growth rate. Weaker inventories are probably a sign that companies are becoming more cautious in an environment of tightening financial conditions. But this also points to a potential rebound in production in the coming months.
- Our more optimistic outlook for the economy is largely based on expectations of steady job and income growth, which will allow households to maintain a moderate 2% pace of consumption growth. Higher inflation has slowed real income growth from 3.5% last summer to just 2% in December. However, easing energy prices and slower, but still positive job growth, driven by government and business services, should stabilize income growth and consumer spending. Exports will remain the other pillar of growth, driven by the weak U.S. dollar, but this area is still buoyant, albeit with slower growth abroad.
- The increasing system response to growing recession fears should not be underestimated. The Federal Reserve cut interest rates by 125 basis points in just 10 days at the end of January to counter the slump in global equity markets. The very aggressive policy easing – the largest rate cut in 25 years – shows the Federal Reserve has shifted its target and is now very focused on supporting the banking sector and preventing a broader recession. Taken together with a potentially sizable fiscal stimulus package, which could conservatively add about 0.5% to GDP growth in the second half of 2008 alone, this policy response should ensure a stronger rebound in economic growth.

## ASSET ALLOCATION

- We have not changed our risk management approach to asset allocation. In the current uncertain market environment, we maintain a slightly negative tilt in our equity allocation and focus on sectors with international exposure that will benefit from the weak dollar and the relatively stronger growth backdrop abroad. Within our bond portfolios, we continue to expect further curve steepening as a result of further Federal Reserve rate cuts. There are clearly sectors in both equity and bond markets that start to look attractive, but market conditions, especially in the fixed income markets, continue to deteriorate. A turnaround in market liquidity will be necessary to shift our focus back towards taking advantage of attractive valuations.

## ECONOMY AND POLICY

- Fears over a U.S. recession took center stage last month, driving the majority of financial market performance. A weak jobs report and a decline in a key manufacturing index in December triggered a wave of forecast downgrades, and a number of economists had started to forecast the U.S. economy would slip into a recession in first quarter. We continue to focus on the evidence at hand and point to the dangers of building a forecast around too few arguments. These predictions ignore the offsets that prevented the economy from slowing more meaningfully last year and an increasingly powerful system response that will ensure a stronger rebound in the near term.

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