



# Market Watch

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## OVERVIEW

- The macro backdrop for U.S. financial markets remains volatile. Only a few weeks ago, investors were adjusting expectations to mounting evidence of stronger economic growth. Now, the general tone of the latest U.S. data releases has turned more bearish again. We all look at the same evidence, but the sharp divergence between economists forecasting weaker growth and those with a more bullish outlook remains as wide as ever.
- The U.S. Treasury market most clearly reflects the volatile macro backdrop. The yield on 10-year U.S. Treasuries reached a five-month high of 4.89 percent in January, peaking the day after the release of the first estimate for 2006's fourth quarter gross domestic product (GDP) growth. This activity showed that the economy rebounded strongly at the end of last year. Since then, yields have rallied below 4.70 percent, validating our call that yields would not reach five percent.
- Equity markets seemed unfazed by the changing macro environment. The S&P 500 Index continued to trend higher and is closing in on the 2000 all-time record of 1,527. The NASDAQ didn't do quite as well, reflecting a preference for more liquid investments in a more uncertain environment.

## ECONOMY

- The tone of the economic news flow turned more bearish again in February. Only a few weeks ago, economists were cheering a report indicating that the U.S. GDP increased 3.5 percent in the fourth quarter of last year. Yet, weaker inventory data and stronger import growth now suggest that the Bureau of Economic Analysis, which publishes official GDP data, will have to significantly revise its first estimate.
- News from the U.S. housing market remains mixed. The 11-percent rebound in housing starts in November and December never looked realistic, and a 14-percent drop in January restored the sharp downtrend that started at the beginning of last year. Clearly, homebuilders are still aggressively cutting back on new supply as long as inventories of unsold homes remain high.
- However, the inventory correction should accelerate in the coming months. Compared to the plunge in new housing starts, the number of newly completed homes that come to the market has so far declined modestly yet will likely slow more significantly in the coming months. In addition, a more stable trend in housing sales should help reduce inventories to a level in which homebuilders start new projects again by the summer.
- Manufacturing also remains a drag on overall growth. What we are seeing here is the perfect storm of a housing recession that impacts producers of building material and construction machinery and a sharp downturn in the auto sector as part of a structural downshift

in vehicle domestic production. Both headwinds should ease once housing supply stabilizes and auto producers complete their supply adjustment.

- Supported by falling energy prices, robust employment gains, and accelerating real income growth, consumer spending started 2007 on a strong note. We do not anticipate a repeat of last quarter's 4.4-percent increase in real personal spending, but consumption should maintain a 2.5- to three-percent pace in the first half of the year, enough to keep overall GDP growth at approximately the same pace.

## POLICY

- Federal Reserve Chairman Bernanke presented a fairly positive outlook on growth and inflation at his latest semi-annual Congressional testimony. The Federal Reserve revised its forecast for 2007's GDP growth from its former three- to 3.25-percent range to a 2.5- to three-percent range. Its inflation forecast remains unchanged at a two- to 2.25-percent range by the end of the year and a 1.75- to two-percent range by the end of 2008. Clearly, Chairman Bernanke forecasts a perfect landing.
- However, the chairman also made it pretty clear that the risks to the Federal Reserve's inflation forecast were mainly to the upside. In fact, we are concerned the Federal Reserve is ignoring growing inflation risks later in the year. If we are correct and economic growth rebounds back above three percent in the second half of the year, then rising wages could quickly threaten the current positive inflation trend and trigger further interest-rate increases before year end.

## INVESTMENT OUTLOOK

- Looking ahead, economic news will remain bearish in next few weeks. The main impact of the colder February is yet to come. However, while coincident indicators, such as job growth and manufacturing output, are likely to soften, forward-looking data releases such as new manufacturing orders or housing inventories should start to point to a stronger growth momentum down the road.
- The U.S. Treasury market has priced in the current weaker economic trends. A renewed focus on more bullish forward-looking data, such as stronger consumer confidence and falling housing inventories, should lead to a rebound in bond yields. Yet, continued uncertainty about the U.S. growth outlook will likely prevent a more serious Treasury selloff until a stronger consensus emerges on the direction of growth in the second half of the year.
- The fundamental backdrop for equity markets should remain difficult, but we wouldn't throw in the towel yet on the current valuation-driven rally. Riskier asset classes, such as emerging markets and high-yield bonds, are likely to experience more volatility in the coming weeks. However, if we are correct with a forecast of stronger economic growth in the second half of the year, those asset classes will benefit from a stronger global growth momentum.

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