



Market Watch

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OVERVIEW

- In the last few weeks, the overriding theme driving financial markets was the resurgence of liquidity fears and concerns about the future path of U.S. economic growth. Catalysts included a string of reports detailing massive asset-value write-downs by major U.S. banks and brokers.
- More bad news from the housing markets and fears that tighter credit conditions would curtail consumer and business spending added to the sharp increase in bearish sentiment. The result was a sharp drop in equity markets around the world, a renewed rally in government bonds, and another round of U.S. dollar weakness against most other major currencies.
- The current market backdrop is once again dominated by uncertainty over banks' and brokers' exposure to subprime mortgage-related problems. The bungled attempt by Citigroup and other major U.S. banks to set up a new fund that would buy asset-backed Commercial Paper from Structured Investment Vehicles (SIVs) – to which Citi and others had previously extended emergency credit lines – highlights the pressures banks are facing on the liability side of their balance sheets. At the same time, banks and brokers are reporting massive write-downs on mortgage-related investments, such as CDOs, which highlights the pressure the institutions face on the asset side.

ECONOMY AND POLICY

- While the financial market crisis is clearly intensifying again, definite evidence of a spillover into the broader economy remains elusive. Although it's a backward look at the economy, the 3.9% growth rate in Q3 – which followed an equally impressive 3.8% rate in the preceding three-month period – surprised even the most bullish forecasters.
- Nearly every major economic sector contributed to growth in Q3, for reasons that ranged from personal consumption and business investment, to greater trade, government spending and inventory accumulation. This overshadowed the ill wind that was once again swirling due to residential investment.
- However, such a strong rate of growth is likely unsustainable, and we are looking for a much more moderate 1.8% growth trend in the current quarter. Yet, we remain skeptical that such an outcome would mark the start of the slowdown many economists are forecasting. Instead, we expect the economy will maintain a 2¼- 2½% growth trend amid greater quarterly volatility.
- Looking at the state of the economy at the start of the fourth quarter, we still see decent payroll and household income growth. Additionally, robust October auto sales didn't show any evidence of either a decline in credit availability for consumers or a falloff in demand for big-ticket items. This is a trend you would expect if consumers were actually translating lower recorded confidence into a pullback in spending.

- The Federal Reserve cut both the Funds and the Discount rate by another quarter-point at the end of October. Interestingly, in justifying the move, the central bank placed more emphasis on the potential negative impact from weaker housing on the broader economy, rather than blaming financial market conditions. In addition, the statement also indicated a shift back to a neutral stance, after adopting an easing bias after the surprise Discount rate cut in August.
- The latest moves are clearly an attempt to influence market expectations. However, in the current environment of unpredictable financial markets shocks, it is becoming increasingly clear that Federal Reserve policy is no longer driven by market fundamentals, but is reacting more to markets fears about the stability of the U.S. banking system.

ASSET ALLOCATION

- In the current market environment, we maintain a neutral stance between bonds and equities. We continue to believe government bonds look overvalued, given the element of fear that is driving safe-haven flows into those assets. Stock markets don't look particularly overvalued, and as long as Federal Reserve policy remains supportive, equity markets should not sell off more substantially.
- Among the major markets, we continue to prefer the U.S. market over Europe and Japan. In addition to the lack of policy support in Europe, there are also signs of weaker economic activity in the past few months, evidenced by deteriorating results from purchasing managers surveys. The Bank of Japan is likely to raise rates again before the end of the year, while Japan's overall growth trend has mostly been disappointing in recent months.
- We continue to like Emerging Market equities, given the evidence to date that the rest of the world can decouple from problems in the U.S. based on strong growth in China and India; however, these markets may experience more volatility in the near term. Fixed income credit markets have again experienced notable spread widening last month, due to further massive asset-value write-downs related to subprime mortgages.
- Barring further shocks, credit markets are starting to look more attractively valued. Finally, the U.S. dollar weakness continued last month. This was not really a surprise, since the Federal Reserve is still the only central bank cutting interest rates and considering the stream of bad news from the U.S. banking sector.

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