



OVERVIEW

- After November's turbulence, U.S. financial markets are closing the year on a quieter note. There are still concerns about liquidity at year-end, but recent action by central banks around the world have at least halted the ongoing deterioration in the financial markets. However, the level of uncertainty remains high, and further negative headlines about losses and asset write-offs among the major U.S. banks and brokers remains likely. Still, there is also encouraging news, such as continued foreign investment in U.S. financial firms, which helps to replenish the bank equity affected by the collapse of the subprime mortgage-backed securities market.
- Stock markets started December on a strong note, but have already given back most of those early gains. For the year, U.S. stocks are still showing a small increase. However, whether they end the year in the black or post a small loss similar to 2005 remains to be seen. Following a sharp rally in November, Treasury yields staged a tentative rebound in the past few weeks. Fixed income credit markets have also shown signs of stabilizing after the Lehman Credit Index experienced one of the worst months in its history in November. Finally, the U.S. dollar benefited from weaker economic news abroad, as well as rate cuts in other developed markets, extending November's positive returns into December.

ECONOMY AND POLICY

- The main economic event in December was the concerted action by a number of major central banks to address the sharp deterioration in global liquidity conditions, which rattled financial markets in November. Following a third cut in both the Funds and the Discount rate since the crisis started in August, the Federal Reserve decided to make billions of U.S. dollars available, not just to U.S. banks, but also to foreign institutions that need dollars. These institutions would otherwise tap into the U.S. inter-bank market for their funding.
- While the Federal Reserve is addressing the tense liquidity situation on Wall Street, the real economy continues to produce positive surprises and has, thus far, failed to support the more bearish outlook taken by a number of economists. Retail sales rebounded strongly in November, job growth continued to expand at a moderate pace, and even home sales posted a tentative rebound in October. More troublesome, however, was the surprise inflation pick-up in November in both the producer and consumer sectors, which was more broad-based than previously expected, and not driven solely by energy prices.
- The U.S. macroeconomic outlook for 2008 depends in large part on the short term evolution of the financial market crisis. A significant decline in bank lending as a result of their losses and balance sheet contraction could adversely impact business investment and consumer spending, which are otherwise supported by lean

inventories, growing capacity utilization and tight labor markets. While we see this as the single greatest risk to our macro outlook, we believe there is still an abundance of global capital, and the Federal Reserve has demonstrated the willingness to ensure the proper functioning of the financial system.

- Another challenge for the U.S. economy in 2008 will be the housing market crisis. We expect new construction activity to continue to contract through most of the year. However, demand should stabilize in the first half and rebound later in the year. Coupled with a sharp drop in newly completed homes coming to the market, this should help to reduce the excess capacity of unsold homes.
- Finally, business investment and consumer spending will hold up, so long as credit conditions ease next year. This should generate a 2% - 2.25% growth rate in the first six months of the year and an approximately 2.85% rate in the second half of the year.

ASSET ALLOCATION

- Given our baseline scenario for next year, we would expect U.S. equities to have a moderately positive 2008. Lower interest rates and a recovering economy should support higher stock prices. However, profit growth is unlikely to rebound to 2005 levels, and the eventual reversal of the most recent rate cuts will make for a more difficult equity market backdrop. We expect a more significant adjustment in the U.S. Treasury market, once financial markets return to normalcy. With inflation concerns back on the radar screen and the foreign appetite for U.S. Treasuries probably lower than before, we believe that Treasury yields will be under pressure for most of 2008.
- The main risks to our forecast are a continuation of the financial markets crisis into next year and an intensification of the housing crisis with even greater declines in both sales and new construction. The longer the two crises last, the more they undermine the offsets that have prevented a more serious slowdown in the U.S. As with so many things in life, timing is everything. We believe that the central banks are taking the right steps to address the issues still plaguing the financial system. Allowing for improved affordability to stabilize home sales should gradually ease the housing situation, preventing a further slowdown of the U.S. economy and a possible recession.

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