

GLOBAL OVERVIEW

- The financial market turmoil that started in the U.S. in July spread through most global financial markets in the past few weeks. Bond markets around the world have staged impressive rallies in reaction to a sharp spike in risk aversion and the increased downside to U.S. economic growth. Global equity markets experienced sharp corrections, with U.S. markets losing about 8%, while European and Japanese markets lost 9% and 10% respectively in August. Currency markets also saw sharp price movements. The U.S. dollar strengthened against most other currencies, as U.S. investors cut international exposures in their bid to reduce risk and shore up liquidity.
- The main reason for the extreme market conditions in August was a liquidity crisis in the U.S., triggered by investors concerned about the underlying quality of asset-backed securities. These investors stepped away in large numbers from the \$1.2 trillion asset-backed Commercial Paper market. With their access to short-term re-financing at least temporarily blocked, many issuers had to reach for emergency credit lines they had arranged with major investment banks. The banks originally thought those lines would only be needed if individual companies experienced a liquidity crunch, but they did not anticipate so many companies accessing them simultaneously. As a consequence, there was a significant strain on overall liquidity reserves in the U.S. banking sector.

UNITED STATES

- With most of the current key global macro risks in the U.S., all eyes are on the economic news flow in the coming weeks. This will help assess whether the current market turmoil is impacting what we thought were fairly robust underlying economic fundamentals. So far, we believe the storm will remain contained in the financial sector and will not hit the broader economy. We remain confident that strong corporate fundamentals, tight labor markets and buoyant global expansion will continue to support GDP growth of between 2.5% and 3% in the coming quarters. However, the housing recession is likely to last longer as a result of a significant increase in home foreclosures, which will further bloat already high inventory levels.
- Thus far, the Fed has done a good job focusing on stabilizing financial markets with confidence, supporting key measures rather than bailing out investors and

homeowners through aggressive rate cuts. Providing additional liquidity as part of regular open market operations helped ease liquidity concerns, while the 50 basis-point cut in the discount rate helped shore up investor confidence. If the extreme market conditions persist into September, a cut in the Federal Funds rate at their upcoming FOMC meeting in the middle of the month would be the next logical step to further increase confidence levels.

EUROPE

- Europe is also feeling the impact of deteriorating housing fundamentals. In the UK, the prevalence of variable rate mortgages and the increase in subprime origination during the past few years is creating a similar dangerous mix that contributed to the mortgage crisis in the U.S. Overbuilding on the Spanish coast has started to cause serious problems in the construction sector in that country, similar to the oversupply in new homes that is depressing demand in Florida and California. Looking at the European banking sector, not only are banks affected by deteriorating domestic housing fundamentals, banks also have exposure to the U.S. mortgage market through asset-backed investment vehicles.
- Like the Federal Reserve, the European Central Bank had to step into the fray and provide additional liquidity to support the inter-bank market, after hedge fund losses threatened to create a liquidity crunch in the European banking system. So far, the central bankers in the Eurozone have given no indication they might lower interest rates. However, plans for further rate increases (Eurozone interest rates are still below the long-term average) that were still predicted just a month ago have clearly been postponed, if not abandoned.

ASIA

- In a complete reversal of the 1997-1998 Asian financial crisis, when a strong U.S. economy bailed out the rest of the world, we are now looking to Asia, and to China, in particular, to support global economic growth. It is hoped that China's strong exports will also lend support to the U.S. economy. In fact, looking at China, signs are still pointing to a potentially overheating economy. Growth rate

in the first half of the year exceeded 11%, and domestic inflation rates have accelerated to more than 5%. In reaction, authorities in China are raising interest rates and implementing tax changes that discourage exports and stock market speculation to address the booming trade deficit and the equity-market bubble.

- The outlook for Japan remains mixed. The recent sharp yen appreciation certainly does not help an economy dependent on international trade, and inflation remains in negative territory. That is especially true when excluding food and energy; deflation is still not over in Japan. What is working better is employment and wage growth; a sign that business investment is starting to trickle down to improving consumer fundamentals. Nevertheless, growth forecasts for the second half of the year have been lowered, and prospects for Japanese markets will depend more on the direction of the Japanese Yen – and not so much on the underlying economy.

GLOBAL OUTLOOK

- Despite the recent volatility, we remain confident in the longer-term economic fundamentals. What we heard across the board from many of our investment professionals is that fundamentals in their asset classes – be they equities, or the U.S credit markets – remain strong and valuations have improved and look attractive, yet market technicals remain poor. The latter includes negative investor sentiment and issues, such as the large supply overhang in the U.S. and European high yield markets. This is a result of the private equity buyout wave in the recent months. We remain over-weight in risk assets (such as equities and high yield bonds), and we are looking for evidence that markets are starting to regain their smooth functioning. Issuers can once again access credit markets – including the Commercial Paper markets – to start taking advantage of improved valuations in the fixed-income credit markets.



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