

Market Flash

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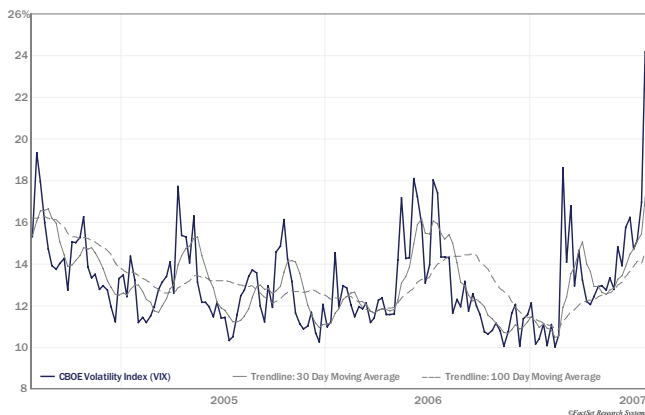
MARKET COMMENTARY

By Markus Schomer, Global Economic Strategist

A longer term shift in market fundamentals or just short market volatility?

The past few weeks have seen dramatic price declines and a sharp increase in volatility in U.S. and global financial markets. Credit spreads in the U.S. widened sharply, equity markets sold off violently and a number of high profile hedge fund collapses hit the headlines. The VIX index, a widely used measure of expected U.S. equity market volatility, rose to its highest level in three years (Figure 1). This comes at a time when investors were already getting nervous about the fallout from the U.S. subprime-mortgage crisis. No wonder risk aversion increased dramatically and investors sought the safe haven of government bonds, which in the last two weeks of July staged their biggest rally in almost three years.

Figure 1
Movement of the VIX Index



The two key issues for forecasters and investors alike is to assess whether the sharp re-pricing of risk in the U.S. credit markets is a reaction to changing fundamentals - in which case the adjustment could last longer and might not be over yet - and whether the price adjustment itself is causing any changes in the underlying economic fundamentals, in which case we would have to change our macro outlook for the next few quarters.

What started the recent market turmoil?

For the past few years we have been in a market environment dominated by a huge increase in financial leverage, which describes the ability of investors to gain large market exposure with only a fraction of owned capital. Leverage creation was driven initially by low interest rates in the U.S. and more recently by the availability of global carry trades, where investors borrow money in capital markets with low interest rates such as Japan or Switzerland, and invest the funds in markets with higher rates such as Australia or Brazil. The result was a dramatic increase in liquidity, which drove up asset prices around the world and depressed risk premia in all financial markets.

Cracks started to appear when the increase in U.S. mortgage defaults, itself the result of higher interest rates and irresponsible underwriting and origination, started to affect the value of U.S. mortgage-backed securities. The rapid accumulation of losses, exacerbated by the prevalence of leveraged investors, led to sharp price declines and a re-evaluation of the underlying fundamentals of the mortgage-backed sector. So far the story makes sense and investors in mortgage-backed securities with significant subprime exposure, who didn't assess the risk of the underlying assets correctly, will face significant capital losses. But as usual in an environment of heightened uncertainty and sharply rising risk aversion the increase in volatility in one asset class quickly spills over into other markets as investors try to reduce risk across the board.

Are the wider credit spreads in the broader U.S. credit and the sell-off in the stock market justified by market fundamentals?

We believe they are not. Granted, the global liquidity wave had also pushed credit spreads in the broader corporate market below long term averages, yet it seems the sell-off has already gone further than the fundamentals would suggest. The U.S. corporate sector remains in very good shape suggesting the overall sector risk is still low. Balance sheets are in excellent health, economy-wide profit



margins remain close to last year's 40-year high, business investment as a share of GDP is still below the long term average, internally generated cash flow covers more than aggregate corporate capital expenditure and a look at debt profile shows companies have very little short term interest rate exposure. The biggest difference between today's situation and 2001, when dramatic spread widening heralded an impending recession, is the absence of corporate leverage, which has a much more direct link to real economic activity.

What about the overall economic risk?

We still believe the underlying macro economic fundamentals remain strong. Highly profitable companies in an environment of increasing global competition create the need to constantly increase productivity, hence the need for continued growth in capital expenditure. Consumers have benefited so far through steady job growth, which has driven down the unemployment rate and boosted aggregate household income growth, which in turn is driving consumer spending. The recession in the construction sector has shaved a full percentage point off GDP growth in the past year, but not led to the wider slowdown many of the more bearish forecasters have predicted. We continue to forecast 2.5% to 3% growth for the next 4 quarters.

Can the market turmoil affect the underlying fundamentals?

The most important channel for financial market crises to affect real economic activity is through a credit crunch. We believe we are nowhere near such a situation. The banking system in the U.S. is sound and we are not seeing any evidence that would lead us to believe otherwise. In fact, if there was an increase in systemic risk the Federal Reserve would surely not remain focused on inflation. A more general tightening of credit conditions could also have a dampening effect on economic activity. Looking at the most recent Federal Reserve data, we see no evidence of a large scale change in lending standards.

Most importantly, corporate loan delinquency rates remain near record lows and charge-off rates have increased only modestly. Most of the direct fall-out will remain contained in the financial sector, with very limited impact of economic growth.

Bottom Line:

Episodes of extreme market volatility often spread indiscriminately across asset classes as investors scramble to reduce the risk in their portfolios. In the current case, risk was built up during periods with exceptionally low volatility. The widespread use of leverage exacerbates and accelerates the market adjustment to perceived changes in risk. However, a market risk premium reflects not only the fundamental riskiness of the underlying instruments but also the willingness of investors to hold those assets. With the exception of the subprime mortgage-backed sector, in the current environment the latter appears to dominate the former suggesting credit spreads will narrow again once the current market volatility subsides. To get there, it will take a few investors who can correctly value the new risk-reward trade off in the U.S credit market and in stock markets around the world and who are willing to hold those assets through a period of short term price volatility. ■