



OVERVIEW

- A new source of uncertainty and potentially increased market volatility emerged in the form of extreme weather conditions in the past few weeks, which have affected most parts of the United States. Much warmer-than-average weather in November and December was followed by a much colder January.
- The impact is already evident in some economic data showing surprising strength in December reports, such as housing starts and industrial production. Seasonal adjustment problems are likely to cause that data to overstate the growth momentum at the end of last year and understate growth in January and possibly February (depending on how long the cold snap lasts).
- Not surprisingly, most financial markets had a mixed start to the year. U.S. equity markets have recovered the initial losses from early January, bond yields have generally trended higher across the board, and the U.S. dollar started the year on a more bullish note, buoyed by signs of stronger economic growth and fading expectations of interest-rate cuts.

ECONOMY

- Despite the weather-related issues that are currently clouding the true strength of the U.S. economy, there is enough evidence to conclude that the pace of economic activity picked up notably at the end of last year. As a result, economists have been scrambling to raise their forecasts to keep pace with the string of better-than-expected economic data reports.
- The main driver of the improved growth picture is once again consumer spending, which benefited in the fourth quarter from declining energy costs, stronger employment and healthy income growth. We estimate that real (inflation-adjusted) consumption will accelerate to a four-percent pace in the fourth quarter of 2006, pushing the overall gross domestic product growth to a very respectable 3.2 percent.
- We are skeptical about the strong increases in housing starts and industrial production. Housing starts showed the biggest increase in the northeast and on the west coast, where the weather was extremely mild for this time of the year. In addition, industrial production was boosted by a surprise increase in auto production, which is inconsistent with anecdotal reports of production cuts among the three major U.S. producers.
- Despite the increase in growth, however, consumer price inflation (CPI) continued to moderate in December, and the recent decline in gasoline prices bodes well for the next few inflation reports. Even though core CPI growth remained at 2.6 percent from a year ago in December, the three-month annualized rate fell to a 19-month low of 1.4 percent, indicating further moderation in the year-over-year trend in the coming months.

POLICY

- Is the Federal Reserve trying to tell investors they are still too sanguine about the future direction of monetary policy in the United States? Several Federal Open Market Committee members commented that further moderation in U.S. core inflation is necessary to validate the current policy stance, suggesting that as long as core inflation remains above two percent, even a stabilization in inflation trends could move the Federal Reserve back toward a tightening bias.
- In addition, in his latest Congressional hearing, Federal Reserve Chairman Bernanke commented on the long-term fiscal challenges facing the United States, which led to a negative reaction among bond investors who are worried about the prospect of significantly larger budget deficits. However, this is nothing new. Perhaps Bernanke was simply trying to shake bond investors out of their overly bullish state and help flatten the U.S. Treasury yield curve.

INVESTMENT OUTLOOK

- U.S. stock markets are facing a more difficult time in the coming months. We believe stocks are more fairly valued now compared to six months ago, so the argument for further price increases cannot be simply based on cheap valuations anymore. The improving fundamental backdrop should help stocks, yet changes in investor perception regarding the next Federal Reserve interest-rate decision could increase market volatility in the next few months.
- Bond yields have already reacted to the fading chances of interest-rate cuts in the coming months and have returned to a 4.75- to 4.80-percent range. Last fall, we believed the market was fairly valued around those levels. However, at that time, we were expecting an interest-rate cut in the first quarter, and the economy had slowed to a two- to 2.5-percent trend.
- In the next few months, we believe that 10-year U.S. Treasury yields will trade around 4.85 percent. Continued strong international capital flows into the United States, the always present geopolitical risk and the increased macro volatility (as a result of the extreme weather) should prevent a more decisive increase in the first quarter.
- Stronger growth and fading expectations of interest-rate cuts have already helped the U.S. dollar recover some of the losses from last December. However, against the Euro, the dollar has not yet traded back down into the range that persisted between May and November of last year, and the British Pound already set a new 15-year high that exceeded its recent December peak. This suggests that the dollar is likely to remain on the weaker side in the coming weeks.

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