Perspective on the Latest Market Events

Commentary from Jim McDonald, Chief Investment Strategist

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The second quarter came in like a lion, and went out like a lamb. But unlike weather forecasting, this meant a gloomier outlook as we enter the third quarter. Equities, as measured by the Standard & Poor's (S&P) 500 index, gained 16% for the quarter, but have fallen 7% since the middle of June. Commodity prices, as captured by the Dow Jones UBS Commodity index, have followed a similar pattern, with a 12% decline over this time period. Reflecting this selling of riskier assets, the yield on the 10-year Treasury has fallen from an intra-day peak of 4% to 3.30% currently. The sell-off has been fairly orderly, with the CBOE measure of volatility (the Volatility Index or VIX) relatively unchanged at 29, and the dollar index is similarly unchanged on a trade-weighted basis at 80. So what has led to this retreat from risk taking, and how serious are the threats to expectations for a sustainable economic recovery starting later this year?

The traditional aspects of business cycle analysis are still generally supportive of an impending economic upturn. Leading economic indicators, which declined ahead of this downturn, have stopped declining, have increased sequentially for the last two months, and look set to increase again for June. The Institute for Supply Management (ISM) manufacturing index is exhibiting a similar pattern, with a significant cyclical improvement in recent months. Manufacturers have slashed production over the last nine months so inventory levels are lean – setting the stage for a production bounce with a continued improvement in orders. The June ISM report did include a drop in new orders back below the 50 level, which does warrant some attention. Finally, we expected emerging markets to lead a global rebound, and recent evidence has increasingly supported this view. The most recent U.S. trade data, for the month of May, indicates that our imports fell 0.6% while exports increased 1.6%. This is not only an indication of near-term cyclical strength outside the United States, but is also likely a preview of the longer-term rebalancing the global economy needs.

But any analysis of this business cycle has to acknowledge the fact that this is not your garden-variety recession and recovery scenario. Severe financial crises tend to generate long recovery periods. Reinhart & Rogoff's study, "*The Aftermath of Financial Crises*," shows that historically there have been significant, extended declines in production, employment and asset prices after financial crises. Additionally, post-World War II financial crises episodes have led to an explosion in government debt issuance, as we are projected to experience. U.S. policymakers are facing a major task in addressing our long-term budget problems along side social issues such as universal health care coverage. This particular financial crisis is unique with respect to how much of the credit creation system was outside of the traditional deposit-taking banking system, and this portion of the system needs rebuilding. Current developments with CIT Group, a significant lender to small businesses, are the most recent reminders that there is continued work to do on this front. We remain of the view that the economy that will emerge from the current crisis will be a slower-growth economy held back by higher household savings and seeking to grow increasingly through exports.

So what near-term indicators will we pay particularly close attention to over the next several months? Labor market indicators have been high profile, and the downturn in the June payroll report contributed to the recently weaker equity markets. However, we think the weekly employment claims are a better measure of the job markets, and we will focus on whether they can continue the pace of improvement demonstrated over the last three months. We will also focus on the leading indicators of economic growth and look to see whether the June drop in orders reported in the ISM report is confirmed by companies as they report second quarter earnings over the next several weeks. We'll also focus on continuing policy developments coming out of Washington – the Obama administration has successfully engineered speedy bankruptcy processes for Chrysler and General Motors. How will any new challenges of large financial firms be handled, and will it give investors comfort that the rules of the road are regaining predictability?

We have gradually added to risk positions this year as we gained evidence of some repair in the credit markets and forecasts of economic recovery gained credibility. But we are also sensitive to valuation metrics and have reduced policy recommendations in some areas that have seen significant appreciation or normalization of valuations. Overall, we remain somewhat defensively positioned, with a focus toward those assets potentially benefiting from the recovery in emerging markets. For us to expand that risk appetite more in the developed markets, we'll need increased confidence in the sustainability of the economic recovery. Our base case remains an inventory-led production bounce in the fourth quarter this year, but the strength and durability in 2010 and beyond remains the wild card.