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Market Update

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With the credit crisis nearly a year old and many financial instruments in the United States looking cheap by historic standards, is now a good time to be adding to exposures?

Our assessment at the beginning of 2008 was to refrain from adding risk to portfolios then, because the risk of recession had increased; however, we were hopeful that economic and financial conditions would improve in the second half of the year. Now, six months later, we find ourselves less sanguine about the prospects for a quick recovery. Our call is that economic growth is likely to remain sluggish into 2009, despite aggressive monetary policy easing and a timely package of tax rebates. At the same time, unexpected increases in oil and food prices have left us more concerned about inflation risks. This combination of weak economic growth and higher inflation represents a milder version of the so-called “stagflation” that prevailed in the 1970s, when financial assets fared poorly.

Our revised view mainly reflects three considerations. First, problems in the housing and credit markets are proving to be more intractable that we previously believed. The key to an economic turnaround is stabilization of the housing market, but this still appears a way off. Home prices in the major metropolitan areas already have fallen by 18% from their peak, and many forecasts call for additional price declines of 10%-15%. This development, in turn, is likely to hamper efforts to improve conditions in credit markets, and there is still no end in sight to write downs of securities by financial institutions – which already exceed $400 billion. Consequently, share prices of investment banks and commercial banks – which have fallen more than 40% in the past 12 months – may remain depressed for a while longer.

Second, the recent spike in oil prices is taking an added toll on the economy. Consumers, who collectively account for 70% of overall spending, are feeling the pinch of higher energy and food expenses that leave them less income to spend on other items. With home prices falling, credit becoming scarce and wages growing only modestly, consumer confidence has fallen to its lowest level in 15 years. For their part, non-financial businesses have done a good job of managing expenses and maintaining profit margins at fairly high levels. However, their task has also become increasingly difficult as costs of energy and raw material inputs have surged.

Third, the range of options available to policymakers has narrowed considerably. With headline CPI inflation expected to reach 5% this summer and energy price increases beginning to be passed along, the Federal Reserve cannot allow inflation expectations to rise significantly. Accordingly, Fed officials have signaled that the risks of inflation and weak growth are now more evenly balanced, and we expect the Fed to keep rates steady through the remainder of this year. Meanwhile, the implementation of the tax rebate program is proving effective in bolstering consumer spending during the current soft patch. The problem, however, is that the stimulus is only temporary, and consumers may have to pare back spending on non-essential items further later this year and into 2009.

Weighing these considerations, we believe it is prudent to protect capital and to refrain from adding to portfolio risks at this time. While the carnage in debt markets and various sectors of the stock market undoubtedly has created some long-term buying opportunities, we prefer to wait until there is clearer evidence that housing and credit markets have bottomed.

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