



Perspective on the Latest Market Events

Commentary from Jim McDonald, Chief Investment Strategist

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To great expectations, this past week the Federal Reserve started the communication process around its Supervisory Capital Assessment Program (the “bank stress tests”) through the release of the test methodology. While the general direction of the stress tests was well known, investors were left in the dark about key components such as assumed loss rates or acceptable capital ratios. The Fed does appear to be “looking through” recent changes to mark-to-market accounting (taking a more conservative view), as well as accounting for off-balance sheet financing vehicles. We don’t expect this process to uncover much bank-specific information that the individual bank’s stock prices haven’t already forecast. What will really matter is the level of capital the Fed will require, and how the affected banks will choose to raise it. A likely solution for some of these banks will be the conversion of their Troubled Assets Relief Program capital into common equity, resulting in substantial U.S. government ownership. We think the concurrent process of the stress tests and the launch of the Public-Private Investment Program (P-PIP) will be a critical development to improving the stability of the U.S. banking system.

This week finds us in the middle of earnings season – the quarterly checkup on corporate profitability and CEO confidence. With around 35% of the Standard & Poor’s (S&P) 500 having reported earnings, we are finding companies clearing a hurdle that had been dramatically lowered since the start of the year: estimates for first-quarter earnings had fallen by 27% since January 1. Current forecasts call for a 36% decline in first-quarter earnings, with the most cyclical names showing the biggest declines. Industrial earnings are forecast to decline 38%; energy earnings look to drop 61%, and materials earnings are expected to fall 77%. We expect poor earnings from the non-financials to continue through the third quarter, with the chance to see positive growth in the fourth quarter if the economy starts to rebound by the fall.

The outlook for economic growth, while stabilizing somewhat of late, remains of great debate. Our internal economic forecast calls for negative growth through the third quarter of this year, with a return to growth of 2% in the fourth quarter. Full-year growth in 2010 is estimated at 1.6%, but with the year ending on a stronger note with a growth forecast of 2.7% for the fourth quarter. Central to our growth forecast is an accounting for the potential for some snap-back in consumption after the considerable shock-effect of the financial market turmoil and constraint in credit. However, the economic outlook is one of unusual uncertainty, with the International Monetary Fund just last week cutting its forecast for U.S. growth in 2010 to 0%. Interestingly, the same report forecasts 4% growth in emerging markets in 2010, buttressing our case for a regionally specific global economic recovery.



The dour growth picture has led to significant jumps in unemployment over the last six months, although there are tentative signs this may be slowing. We view stabilization in the labor markets as critical to improving the outlook for housing, which we continue to believe is essential to setting the stage for a sustainable recovery in both the financial markets and the U.S. economy. Current housing affordability is at record levels, thanks to a combination of low mortgage rates and price declines. However, voluntary abeyances of foreclosure programs by major banks over the last 90 days may have contributed to a false sense of stability in housing activity – data over the next two months will tell if that was the case. A study by Reinhart & Rogoff (2008) shows that the average duration of housing price declines in the aftermath of financial crises has lasted five years – with U.S. housing prices peaking in mid-2006, we are about 32 months into this price downturn.

Progress in stabilizing housing prices, along with evidence of some success from the Treasury's Term Asset-Backed Liquidity Facility and P-PIP, will help advance a financial system and economic recovery. With our tactical asset allocation guideline published last month to invest roughly one-half of our cash overweight in a combination of high yield, emerging markets and commodities, we started to reduce the defensiveness of our recommended policy. The key catalyst for this change was the Fed's announced plan to purchase Treasury, mortgage-backed and agency debt (quantitative easing), which we believed would significantly reduce the odds of a further systemic shock. An improved outlook for housing, with a resulting increased confidence in the economic growth outlook, is a likely catalyst for a future increase in risk.

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