

Q2 2007 Economic Review

What, Me Worry? Alfred E. Neuman, Mad magazine's fictional mascot, coined the phrase over half a century ago yet it seems to describe the mindset of many investors these days. Coming off a quarter of very good returns, the stock market appears to have absorbed another wall of worry and seems impervious to any new signs of anxiety that abound. The question now is, can this performance continue?

Because of strong gains in April and May, the Dow Jones Industrial Average finished the quarter ahead 8.5%, its best quarterly gain since the fourth quarter of 2003, although the index has fallen about 2% since June. The Standard & Poor's 500-stock index was up 5.8% for the quarter and the NASDAQ Composite index climbed up 7.5% though both also suffered June swoons.

The engine that drove the Dow Jones Industrial Average up from mid-June last year through early last month has begun to sputter. The culprits: a booming world economy that has raised the specter of inflation, and a sagging U.S. housing market that is fueling fears of blowups at hedge funds that invested in securities linked to home mortgages.

During the past year, stocks have surged higher than nearly anyone forecast, amid hopes that the Federal Reserve would achieve what economists call a soft landing. The hope is that the Fed has raised interest rates enough to stave off inflation, but not so much as to cause a recession. People became so optimistic earlier this year that interest-rate futures reflected hopes that inflation would be low enough this summer for the Fed to start lowering rates.

That "Goldilocks" scenario – an economy not too hot, not too cold - seems less and less likely these days. Interest-rate futures no longer forecast a rate cut anytime soon and many investors worry that a hotter economy will keep inflation high enough that the Fed could be forced to raise rates, which would be bad news for stocks.

An increase in rates would cause consumer spending and business investment to suffer, hurting corporate profits. Higher rates also would make bonds and money markets an attractive alternative to stocks. Meanwhile, corporate buyouts by private-investment funds, which have been fueling a good part of the market rise, would be set back as loans that make the buyouts possible become more expensive.

Indeed, one of the most important engines of the current bull market, if not the most important, has been the exceptionally low level of world interest rates. Low rates have fueled investment and consumption, and made it highly attractive for private investors to use borrowed money to arrange corporate buyouts.

Increased access to cheap capital has, in turn, reduced the risk premiums people are willing to demand from their investments. Credit spreads -- the difference between yields on ultra-safe Treasuries and on junk bonds -- have capitulated from nearly 1000 basis points (bps) 5 years ago to less than 300 bps today. That means that junk-rated companies can borrow money at relatively inexpensive rates. It's also a warning sign for investors who may not be sufficiently compensated for their riskier portfolio assets and who may suffer larger than anticipated losses when, not if, some of these risks come to light and the access to cheap capital comes to an end.

The yield on the 10-year Treasury note hit nearly 5.25% last month, its highest yield in five years. Because other borrowing costs are tied to Treasury yields, the rise pushed up mortgage rates, exacerbating another potential hazard for the bond market. High rates for home loans could make it harder for cash-strapped borrowers to make their payments as adjustable-rate mortgages click upward. That could produce more defaults and increase chances that sub-prime's problems could spread as the value of securities backed by these mortgages falls.

Add to this the fear of many that the ailing housing market could further cause a financial shock to upset markets. These investors worry that more hedge funds, in addition to the two at Wall Street's Bear Stearns Cos. that nearly collapsed last month, could be forced to acknowledge big losses in mortgage-related investments and other hard-to-trade securities.

Not everyone expects a sharp stock pullback now, of course. Many money managers still believe in the soft-landing scenario, noting that the strong world economy and low interest rates have helped the U.S. economy avoid a much-feared recession. Corporate profits have kept rising, although no longer at the double-digit rates that had wowed investors in previous years. As long as profits keep rising and inflation and interest rates don't soar, and as long as the world avoids a geopolitical crisis, these money managers say, global economic strength should keep any stock pullback temporary.

One reason investors haven't abandoned stocks in greater number is that many believe stocks remain reasonably priced, measured against corporate-profit gains. The price of the broad Standard & Poor's 500-stock index is about 17 times member companies' earnings over the past 12 months, only slightly above the average of about 16 in recent decades. As a comparison, during the technology-stock bubble of 1999, that price/earnings ratio was close to 40.

Simply put, the endgame for the financial markets will depend largely on how well consumer spending holds up. The stock market has been a powerful offset to the housing drag this year, enabling households to retain a comfortable sense of financial well-being even as home values have plummeted. As long as these two primary asset holdings do not deflate together, there is little reason to fear a sharp consumer retrenchment that would send the economy into a tailspin. Still, it would be foolhardy to expect the stock market rally over the first half of the year to be replicated in the second half, particularly with

profits growth undergoing a normal cyclical slowdown. Hopefully, however, when the profits cycle turns negative, as it surely will, the housing downturn will have run its course.

As was widely predicted, stocks have turned more volatile in recent weeks, with the kind of sharp up-and-down moves that seemed almost to have disappeared last winter. Investors are hoping to get reassuring news which would help temper the market lurches. But just in case, they are bracing for trouble. Well, maybe just a little. No real need to worry...right?

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