

Outlook- Third Quarter 2006

The second quarter was focused on raising interest rates and the potential negative outcomes on the world economies. The Federal Reserve increased their funds rate twice more during the quarter, to a level of 5.25%. This brings the total number of increases to 17 in a row. The futures market currently projects an additional 25 bps increase at the next Federal Reserve meeting on August 8th, 2006. Ten-year U.S. Treasury yields reached their highest level since June 2002 (above 5.24%) as the quarter drew to a close. Like the US, Canada's yield curve has come under significant upward pressure over the past month, but Canadian bonds have had a superior relative performance.

According to Merrill Lynch's North American economist David Rosenberg, "the entire yield curve (2, 5, 10 and 30 year bonds) is now below the Fed funds rate of 5.25%. This has only happened 4 times in the past 25 years (March 2000, August 1998, January 1989 and January 1982). Each of these episodes was preceded by either a downturn in the economy, a major financial strain, or both. What transpired on average over the next 6 months was a major rally in the bond market (thus yields start to drop), a 6% decline in commodity prices and in 3 of the 4 occasions a significant sell-off in the equity markets."

As we have written about in past market outlooks, there now appears to be little debate that the housing markets across North America has indeed peaked. The level of house sales has turned down; the growth in prices has slowed and the stock of unsold homes is rapidly expanding. Housing activity has tended to lead consumer spending and the sharp drop in activity points to a looming consumer retrenchment. This case for a consumer slowdown is further strengthened by the fact that real incomes are growing below a 2% annual rate combined with a savings rate at a record negative 1.6%.

The bottom line is that the conditions for a mid-cycle slowdown are in place. This means 2 to 3 quarters of near 2% growth down from the high 3% range it has been running. This would be the perfect economic outcome as it would be enough of a slowdown to maintain corporate earnings growth and cap inflation pressures. The Fed expects a similar outcome, but will not take anything on trust. It is prepared (and usually does) risk a policy overshoot on the side of raising interest rates too high in order to keep inflation expectations in check. With the new Fed Chairman, Ben Bernanke, at the helm he will want to prove his vigilance to the investment community. Equity markets will thus remain under threat until it is clear that the risks of painful monetary restraint have diminished.

However, the downdraft that the equity markets felt in the quarter was probably a result of another central banker. In late March the Central Bank of Japan announced that it might raise its benchmark interest rate for the first time since 1999. Cheap and abundant Japanese credit has fuelled hedge funds, investment banks and other speculators. Borrowing from Japan at near zero interest rates and then investing in higher return markets around the world seemed a “sure thing.” However this speculative money running after the same investments results in the Hotel California effect: “you can check in any time you want but you can never leave.” (borrowing from the Eagles song) Thus we saw tremendous volatility in the quarter in the commodity areas and related stocks. This will continue into the fall and perhaps beyond, until there are signs that the U.S. economy has “cooled enough” to greatly diminish the chance of further rate hikes by the central bankers around the world.

Bottom Line

A slowing in the pace of U.S. economic growth will present a challenge for this year’s investment environment. With this mid-cycle slowdown, volatility will increase as investors around the world try to second-guess the banks and the reading of the economy. Our focus will continue to be on preserving the value of our clients’ investment assets by opportunistically adjusting equity and bond allocations and utilizing hedging strategies.