Review and Outlook

MID CYCLE SLOWDOWN OR RECESSION?

Equity markets have corrected on fears of higher interest rates and/or a slowdown in the economy which, in the worst case, could result in a recession. The correction has been most dramatic in cyclical stocks, particularly resources, which are most exposed to changes in global growth and demand. Our review of the data suggests that while growth is slowing, the risks of a recession are low and this is likely a mid cycle correction.

Economic Data

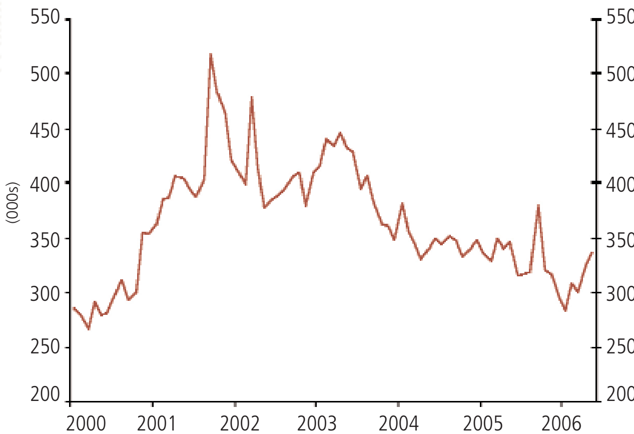
Over the past three years, U.S. consumer confidence has been high. This is largely consistent with the jobless claims and help wanted index over the same period.

Part of this strength has also come from the rising values of homes and the strong real estate market which has enabled individuals to withdraw equity from their homes. More recently, consumer confidence has come off its highs corresponding to a slowing housing market in the face of rising interest rates.

The consumer's ability to spend has been further undermined by high energy prices. While growth is slowing, leading economic indicators are still constructive, including capacity utilization, low inventories, and strong labour markets. Housing prices are the one area of concern.

Consumer Confidence

Weekly Jobless Claims



U.S. Consumer Price Index – YOY

The Federal Reserves Role and Response

The Federal Reserve's mandate is price stability and growth. The new Fed Governor Bernanke has indicated that a "data dependency" approach will guide monetary policy which has recently been focused on rising inflationary pressures and a progressive rise in the Fed funds rate. The debate at this time centers around whether the Fed will go "too far", given the lags in response to monetary policy, and trigger a material slowdown, or recession. Mr. Bernanke has made it clear that he is aware of the "lag effect" and that monetary policy is set "looking forward" based on the current data and the anticipated response to monetary policy.

In spite of legions of highly trained economists to gather data and advise the Fed governors, the reality is that the Federal Reserve has historically often "over shot" the correct policy response, resulting in slower growth than desired.

Equity Markets

Major equity markets have corrected 7-10% off their highs with cyclicals and emerging markets correcting even more. This reflects a higher risk premium associated with rising rates and slowing earnings. As to whether the markets have corrected enough for investors to be more confident from here is dependent on interest rates and future earnings. Corporate balance sheets are strong, ROE's are rising on earnings growth and stock buy backs. Equity valuations are fair with earnings reliability and interest rates the central issue. If interest rates can stabilize at around these levels (i.e. one more Fed Fund's increase to 5.25%), given the current consensus on future earnings, the market is probably up to 5 – 10% undervalued. If further interest rate increases are required to quell anticipated inflation, then earnings may suffer and further downward pressure on equity markets is likely.

Conclusions

While painful in the short run, we view this current market correction as healthy as it removes some of the speculative froth that was evident, particularly in some of the resource stocks. Valuations are currently fair to undervalued, corporate balance sheets are strong and the global economy is reasonably robust. The U.S. consumer has high debt and a heavy reliance on real estate as a store of wealth. This remains the primary risk if interest rates continue to rise.

We view monetary policy as neutral, and expect a pause in interest rate increases after the June 29th meeting. We anticipate slowing economic growth for the remainder of this year, and view the risk of a recession to be low. Portfolios are positioned relatively defensively at this time but could get more so if the market rallies materially on anticipation of an end to interest rate hikes.

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