Review and Outlook

IS THE AMERICAN CONSUMER TAPPED OUT?

Reading today's newspapers might lead some people to think that the American housing market is ready to implode. Additionally, poor lending practices and ultra-low, short-term 'teaser' rates which are now being reset at much higher rates on adjustable rate mortgages have affected a good portion of the American public. Since roughly two-thirds of the economy depends on the strength of the consumer, the question everyone is worried about is whether today's consumer has the remaining confidence and the means to keep up their spending.

Do we need the U.S. Federal Reserve to save the day?

While overall confidence and morale have taken a hit, it's not always the best policy for central banks to simply cut short-term interest rates. Large interest rate cuts are needed to restore immediate confidence and given the long lags with which interest rates impact the economy, these run the risk of creating new asset bubbles. For instance, the fact that the Federal Reserve lowered interest rates to 1.00% in 2003 is generally credited with allowing the U.S. to recover from the liquidity crunch of 2001 and preceding asset bubble in equity markets. It is also credited, however, with leading in part to the recent housing bubble.

Today, the Federal Reserve is in the position of trying to provide additional liquidity in the short-term while still containing inflationary expectations in the medium-term. Nevertheless, we expect that they will likely concede today's battle, and cut interest rates by three-quarters of one percent over the next three meetings this fall. Inflation measures will likely remain somewhat volatile, but weaker employment growth should resolve the threat of wage inflation (Chart 1) and reduce capacity constraints.

Fixed income returns will likely resemble the coupon

While the fundamental picture for bonds is a little hazy, we believe that any further price appreciation would require a much greater slow down in economic growth than we currently expect and would imply a more aggressive easing campaign by the Fed. We just don't foresee that.

It is interesting to note that the current difference between the Fed Funds rate (at 5.25%) and 2 year treasury yields is close to -135 basis points (bps). Historically, this spread would typically be positive and even with 75 bps of forecasted rate cuts, the resulting contraction of the spread will simply take us back to the average of the past 12 months.

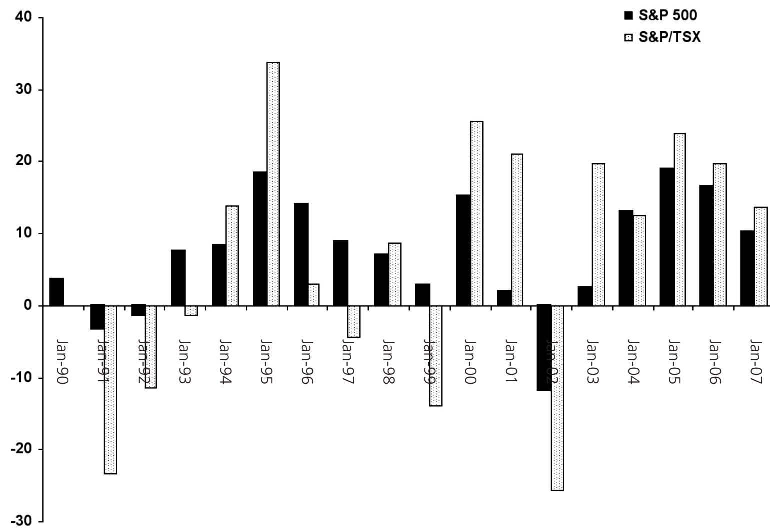
Inflationary Pressures

We are currently seeing more value within the corporate bond market where, in some cases, the proverbial baby has been thrown out with the bathwater. There appears to be a disconnect between very evident troubles in the U.S. mortgage market and credit quality in the corporate world. Global corporate defaults are low, economic growth appears fairly stable and operating earnings in both Canada and the U.S. are on track for solid gains this year and high single digit growth in 2008.

Equities still look good

Although we have seen a few pullbacks since this bull market began in mid-2002, the bullish case remains very compelling as equity valuations look attractive on expectations of solid earnings growth (Chart 2), along with below average levels for interest rates and inflation. While there will undoubtedly be further volatility as the current liquidity crunch is absorbed into the market, strong fundamentals should be recognized in improving share prices as time goes on. In light of all the news, rumours, reports and speculation, this type of uncertainty in the overall market underscores the value of maintaining a diversified portfolio.

Earnings Growth



Conclusions and Outlook

Ultimately, consumer confidence is rooted in employment. While September's employment report shocked analysts when it was announced that the economy shed 4,000 jobs in August, the first decline in more than four years, we do not believe that this is the beginning of a long-term trend. The U.S. economy remains fundamentally sound, based on solid underpinnings driven by growing demand for exports and global economic growth which is still tracking at more than 5%. In the end, we believe the American consumer will weather these 'bumps in the road' and continue to spend, albeit more modestly. While our focus here was the U.S., it's also worth noting that in relative terms, the Canadian consumer is in much better shape.

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