MFC Global
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WEEK IN PERSPECTIVE

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Oh, the Places We'll Go*

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What a difference a week makes! Last month markets rebounded strongly from their lows of late June/early July. Gains of about 10% from the low on July 2nd are quickly being whittled away on renewed fears of a double-dip recession, fears of which were not eased by the Fed's comments last week. Markets started last week with optimism before it fizzled into disappointment after the Federal Reserve's comments on the economy. The S&P 500 fell 4.3% from Monday to the end of the week while the S&P/TSX Composite Index fell by 2.8% over the last four days of the week.

As we have mentioned in the past there have been four worries weighing on the markets for much of the year. These are a Chinese economic slowdown, US bank reform, the European credit crisis and a US double-dip/deflation scenario. Sentiment around a double-dip recession in the US picked up last week on Fed comments that included

"Information received since the Federal Open Market Committee met in June indicates that the pace of recovery in output and employment has slowed in recent months."

"Household spending is increasing gradually, but remains constrained by high unemployment, modest income growth, lower housing wealth, and tight credit."

"Business spending on equipment and software is rising; however, investment in nonresidential structures continues to be weak and employers remain reluctant to add to payrolls."

"Bank lending has continued to contract. Nonetheless, the Committee anticipates a gradual return to higher levels of resource utilization in a context of price stability, although the pace of economic recovery is likely to be more modest in the near term than had been anticipated."

"The Committee will maintain the target range for the federal funds rate at 0 to 1/4 percent and continues to anticipate that economic conditions, including low rates of resource utilization, subdued inflation trends, and stable inflation expectations, are likely to warrant exceptionally low levels of the federal funds rate for an extended period. To help support the economic recovery in a context of price stability, the Committee will keep constant the Federal Reserve's holdings of securities at their current level by reinvesting principal payments from agency debt and agency mortgage-backed securities in longer-term Treasury securities. The Committee will continue to roll over the Federal Reserve's holdings of Treasury securities as they mature."

Granted, the fears are not unfounded. Job growth in the United States is virtually nonexistent and without jobs it becomes more difficult to make a case for continued consumption growth. The business community hasn't made any overtones towards increased hiring which doesn't help the situation. In the meantime, the savings rate, which should perhaps be more accurately referred to as the dis-spending rate, climbs to higher levels, most recently to 6.4% while consumer credit continues to fall. Last week's

retail sales numbers compound the woes. Excluding autos and gas retail sales were marginally negative for the month of July at -0.1%.

We still hold that economic growth, while slowing, will remain positive. Bill Cheney, MFC GIM's Chief Economist comments, "The last week's data has brought estimates of Q2 US GDP down from the initial release of 2.4% all the way to 1.1%. This is a truly bad number (think 0% per capita). It's seriously discouraging, since while some of it represents less inventory accumulation, which could be good for future growth, the bigger influences were weaker construction and (mostly) lousy trade numbers. Trade can be volatile, and of course it could rebound, but it certainly suggests much less momentum of domestic production going into the second half of the year.

"I'm still holding on to the idea that job growth will pick up (especially since the productivity train may have slowed down), but if it doesn't happen very soon there will be nothing left to move us forward. Final sales are still rising, but they won't do so indefinitely without rising GDP & incomes."

However, on the bright side, the emerging markets continue to grow by high single digits, companies are flush with cash, household balance sheets are improving, and while there is a lack of job growth, companies are more willing to use that cash for share buy-backs, higher dividends and acquisitions. As well, US manufacturing is strong, as have industrial production and capacity utilization. All of which provides support for continued earnings growth, higher markets and a positive wealth effect which might help offset the impact of a weak labour market.

All in all we appear to be mired in a Goldilocks economy. No, not the one that is not too hot, and not too cold, but rather the one where someone goes into your house, eats your food, breaks your stuff and runs away leaving a mess to be cleaned up.

*Title with credit to Dr. Seuss from "Oh, The Places You'll Go"

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