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Reflation Ends Abruptly; Investment Implications of Slower Growth

We think the credit market turbulence of recent weeks marks the end of the U.S. and global reflation begun after 9/11. We think the environment will now go through a long process of “stabilization” following the excess liquidity of recent years. This would complete the credit cycle which began with the “irrational exuberance” tightening in December 1996 and passed through strong-dollar deflation, then reflation after the 9/11 shift to prolonged monetary policy accommodation, then excess reflation related to low real interest rates and the weak dollar, and now stabilization. **The immediate issue is the hardness of the landing.**

- We think the U.S. will slow materially, but not fall into recession. Fourth-quarter growth could slow to 1.5% from 2.5% in the third and an upwardly-revised 4% plus in the second, putting 2007 growth (fourth-over-fourth) at 2.2% (was 2.5%). Growth in 2008 could be 2% (was 2.7%), a marked slowdown from the 3.1% average growth in 2003-2006. Growth in business investment, inventories, residential investment, commercial investment and consumption may all feel the slowdown. We think the unemployment rate will bottom at roughly current levels, then rise a little above 5% (well short of a recession), preceded by weaker job growth and higher jobless claims in coming months. **Rather than a V-shaped slowdown, we think the landing could be softer, a saucer-shaped weakness extending from mid-2006 through mid-2008.**
- Abroad, **the global boom should moderate**, especially in Europe and the UK. Asian growth, while still strong, should soften from recent rates. We think other emerging markets will be more country-specific than they have been, with certain commodity prices (iron, oil, food grains) causing part of the differentiation.
- Even if more normal trading activity returns to mortgage and commercial paper markets, possible now with the Fed’s energetic encouragement to banks to resume trading, this is a major inflection point in the investment climate. We had thought the inflection point would come later, through the Fed gradually taking the punch bowl away. Instead, the seizure in credit markets is having that effect abruptly. We expect a stabilization rather than a full snapback in credit spreads or a return to the earlier “global boom” trends. Those were partly dependent on excess liquidity.

We emphasize the unique nature of the economic and investing climate. Massive dollar strength and deflation pressure in 1999 and 2000 gave way to a long period of negative real interest rates earlier in the decade and a much weaker dollar. Hyper-liquidity coincided with a particularly powerful cut in tax rates on capital and labor. The combination triggered a global boom. **Many outcomes are possible – from recession to soft landing to snap-back -- as the environment shifts abruptly from reflation to stabilization.**

- **The key near-term variable is the damage to the financial system from the credit market seizure.** In particular, the value of mortgage debt and therefore of new mortgage underwritings is uncertain due to problems in the rating process over the meaning of AAA. We think mortgage rates will fall partway back toward Treasury rates relatively quickly, helping avoid a hard landing. Still, the weakness in U.S. residential investment and home prices will be more drawn out due to the changes in U.S. mortgage markets.
- The longer-term unknown is the global split between the liquidity that went to productive uses versus less productive uses. We think a majority of the global growth, investment and innovation in recent years was constructive rather than simply excessive. If so, aggregate corporate earnings shouldn't dip severely.
- While the global boom allowed pockets of intense leverage, it has also created tremendous gains, reservoirs of liquidity that can gradually be invested more aggressively. This argues against an asset-price deflation and a hard landing. The current turbulence is not so much a credit crunch as an overdue testing of prices and risk assessments

Investment Implications

We think the environment has shifted from reflation based on plentiful liquidity to stabilization based on a careful testing of value and risk. Some investment themes:

- More balanced equity performance. We think corporate earnings growth will slow but remain positive in most quarters. We don't expect a bear market in equities, but volatility should be higher than it was, especially in the first few months of this stabilization process. We think the equity outperformance by small caps and foreign stocks over larger-cap U.S. stocks was in part a response to the excess reflation process and should give way to more balanced global equity performance going forward. However, we think Asia's growth will remain well above the global average, arguing for continued Asian equity exposure.
- Average credit spreads. We expect credit spreads to remain relatively wide by the standards of recent years, though narrower than their long-term averages. This is a key marker of the shift from reflation to stabilization rather than to a hard landing.
- Neutral bond outlook. We think Treasury yields could stabilize after their multi-year increase. Current sovereign bond yields in Europe and the UK may also be roughly appropriate for this growth and inflation environment.
- Weaker commodities, more stable currencies. We expect gold and commodities to weaken some on average and the dollar's value to stabilize against foreign currencies. We look for the euro to weaken to \$1.30 as prospects for European growth and interest rates moderate. The dollar's weakness in recent years was largely due to Fed accommodation and rising foreign growth prospects, both of which have ended in our view. Changes in the credit market have probably lowered the "neutral" level for the Fed funds rate -- the level of interest rates needed to keep the value of a currency stable.
- Global monetary tightening winding down. The rate hikes in Europe and the UK will probably stop at current or only slightly higher levels. The U.S. may begin cutting rates some, though we think the Fed would prefer not to cut in September and instead let weakening growth prospects (like rising jobless

claims) justify the cuts. However, Japan will probably hike substantially from its current 0.5% as part of the stabilization process, and China will continue using certain aspects of monetary policy to try to restrain its growth and inflation.

- De-emphasizing inflation. U.S. inflation may remain above target but should have less importance during this stabilization process. The Fed should be able to point to the declining growth prospects in downplaying the near-term inflation data.
- Some positives. If the global economy achieves a soft landing after this period of excess reflation, we think it has positive implications for infrastructure spending (both U.S. and foreign), agricultural land (especially relative to urban land), and global consumption growth. The world gained a lot during the boom (lower unemployment, better government balance sheets, bigger middle class), and will probably retain many of those gains.

Some Related Pieces and Major Inflection Points

Smaller, Slower-Growing World, Deflation; 2001

Seeing the Economic Bottom; November 2001

From Deflation to Reflation 2002-2003;

Bullish on America, the “Sweet Spot” 6/7/02 [Wall Street Journal](#)

From Reflation to Mild Inflation; 2003-2004

Durable Expansion, Moderate Inflation, “Free Lunch”; 2004-2006

Global Growth Engine, 11/3/04 [Wall Street Journal](#)

Economy Still Being Underestimated 5/11/05; So This is a Weak Economy? 6/28/05 [Wall Street Journal](#)

Sturdy, Profitable Economy and Higher Rates 11/25/05

Don’t Fret Inverted Yield Curve; Economic Outlook Solid 12/28/05

Seeing the Economic Top: Fed Concerns Merit Market Caution 5/11/06

Landing Scenarios: Soft, Hard or Late? 9/8/06

Market Sell-Off: Not May 2006 2/27/07

Economic Outlook: Growth with Inflation 3/19/07

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