



Markets Turn As Recovery Hopes Rise

What a week.! Financial markets (fx, equity and interest rate) now firmly believe that an economic recovery in the US and, by implication the rest of the world, is in sight. Over the past week we have moved from a situation where the market was pricing in additional rate cuts of up to 0.50% in the US to one where the market thinks rates have bottomed and is anticipating that policy could be tightened as early as next summer. Similar movers have been seen in the UK and Europe. The question is, why have we seen such a fundamental turn in sentiment?

The stock market generally bottoms well before the economy. Driven by hopes that the Fed's aggressive action will secure a sharp recovery, stocks are up an average 25% from their September lows. The fx market in particular takes its cue from equities and the dollar is once again overpowering its main rivals. In addition to stock market gains, most of the economic data released this week have been less grim than expected. Wednesday's retail sales report has certainly helped to feed the recovery story, signaling the resilience of the US consumer. Instead of the expected 2.0% rise, retail sales rose an amazing 7.1% in October, aided by spending on cars due to zero-financing incentive packages. This highest monthly rise on record is clearly an indication that lower interest rates are working. Growth in underlying sales (ex auto) also came in well ahead of expectations.

Other data also suggest that the worst is over. September's inventories were slower than expected. With the pace of inventory liquidation accelerating, restocking could become a source of growth more quickly than anticipated. The Philly Fed index contracted for the 12th consecutive month but still showed an improvement on September's reading. In the week to November 10, weekly jobless claims declined for the third week running. The ABC News/Money Magazine consumer confidence index improved slightly, while low interest rates also kept mortgage applications high.

We saw more tragedy in New York on Monday with an American Airlines plane crashing into a residential area. Fears of another terrorist attack saw the dollar sold off and bond markets rally. However, moves were quickly reversed when it became apparent that the crash was a tragic accident. Also military victory in Afghanistan has boosted market confidence that the war against terrorism will not be a protracted one. Furthermore, talk of a price war between OPEC and non-OPEC countries has pushed oil prices below \$18 a barrel. This can only be positive for consumers.

Our central forecast has always been that the US and global economy would recover next year. However, we can't help but wonder has the market got somewhat ahead of itself, especially as we believe that unless we see a string of positive data there is still a very real risk that the Fed will reduce rates by another 0.25% at its meeting in December. Certainly there were some fledgling signs of a bottoming in this week's data but we do not believe that the Fed will start to increase rates until it sees signs of a sustained recovery. The retail sales data were encouraging but it is too early to say that this signals the start of a trend. September's report was extremely weak so October's report had to be positive. It is also likely that the very attractive zero financing packages enticed many to bring forward purchasing decisions. Despite the decline in weekly jobless claims, the labour market remains very weak, which should impact on spending going forward. Furthermore, Friday's industrial production data was anything but positive with activity down 1.1% on the month. So far this year industrial production has fallen 4.6% and capacity is now at an 18-year low. This must cast some doubt on positive sentiment.

<i>Based on midday levels on Friday 16th Levels are an indication only</i>	% Change Over Last Week		% Change Over Last Week
Dollar/Euro Exchange Rate	+1.02%	2 Year Rates	+0.46%
US 3 Month Futures		10 Year Rates	+0.40%
- Dec '01	0.19%	30 Year Rates	+0.29%
- Mar '02	0.34%	Nasdaq	+3.98%
- June '02	0.49%	Dow Jones	+2.97%
- Sept '02	0.65%	Oil Prices	-14.29%
- Dec '02	0.68%		

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