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Remaining credit constraints suggest that growth will be slower than we have seen in a long time; but there should be growth.

The return of some risk appetite

We've seen quite a change over the last six to eight months, and not just in the equity markets. There is another important aspect to the global financial picture that deserves attention, one that helped cause the dramatic declines and has more recently begun to help conditions turn more positive. That is, the credit markets and the recent credit rally.

The performance of the fixed income market has been exceptionally strong over the last six to eight months. Why is this important? In a nutshell, the credit rally has brought improved liquidity, which is likely to translate into a stronger economy over the next six to 12 months. These conditions are then likely to bring stronger corporate profits, which ultimately should lead to stronger equity prices.

That process has yet to fully unfold, but let's step back and look at what got us where we are today. We have had a liquidity rally, which was brought on because the government, through a range of programs and guarantees, stepped in and offset the deterioration in liquidity caused by the banking crisis. That was step one.

But what truly has helped the financial markets is the credit rally, or step two. Credit markets have become exceptionally active, as confidence in the global economy has increased over the year. High yield bonds particularly have enjoyed a significant price rally, recovering most of the ground lost in the market turmoil of late 2008 and early 2009. The result of the bond rally is that credit spreads – the difference in market yield between Treasuries and comparable maturity bonds – have been cut approximately in half. Narrower spreads mean less expensive and more abundant money.

Gradually, investors have become more willing to take on additional risk, which is the opposite of what was occurring from the summer of 2008 until March, when investors abandoned risk regardless of price. What has led people to become more accepting of risk? A search for more return on their money. By the beginning of this year, most investors had fled to the safety of U.S. Treasuries and cash. But when fear subsided, as it became clear the government would not let the banking system fail, the focus shifted. With interest rates so low on cash, investors began to look for alternatives that could provide more yield. At that point, the amount of money "in hiding" approached several trillion dollars.

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Market Perspectives

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As money moved out the risk curve, it created the tremendous credit rally. Economies don't grow without credit expansion. When you have credit contractions, you have recessions. As you know, we had just such a contraction for nearly eight months. Now, however, a virtuous circle has begun as credit is expanding. While the majority of business is seeing better access to credit, some segments as yet remain stressed, specifically housing and small business. For housing, there is limited credit available outside of FHA-conforming mortgages. Mortgages for high-end housing remain scarce. Another challenge centers on small and mid-size business. Banks are not providing credit in this key area, and small business generally cannot access the bond market. Bank loans – a primary source of funding for small businesses – continue to decline.

Looking toward year-end and early 2010, we believe the economy should improve. Remaining credit constraints suggest that growth will be slower than we have seen in a long time; but there should be growth. Corporate efforts focused on rebuilding very low inventory levels will play a major role in recovery, as will improved foreign demand. The credit rally has been a big positive. We look for it to continue, and to play an important part in a continuing improvement for the financial markets.



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