

## Strategy Matters

Issue 2007 - 3

### Will the Federal Reserve bail out equity markets?

**Equity markets appear to be assuming that the Federal Reserve will come to their rescue if US output growth weakens further, threatening recession. They may only be right if the inflation environment is favourable.**

#### Equity markets expect US interest rate cuts

Equity markets appear to have recovered their poise since the falls of late February and early March and are close to their highs for the year. But there are still potential dangers ahead, in particular the possibility of cutbacks in US household spending. The general presumption amongst investors seems to be that the Federal Reserve would come to the rescue of equity markets in such a scenario, if necessary, by cutting interest rates. Indeed, markets are already discounting two or three cuts in US interest rates before the end of the year. Are they right to be so sanguine?

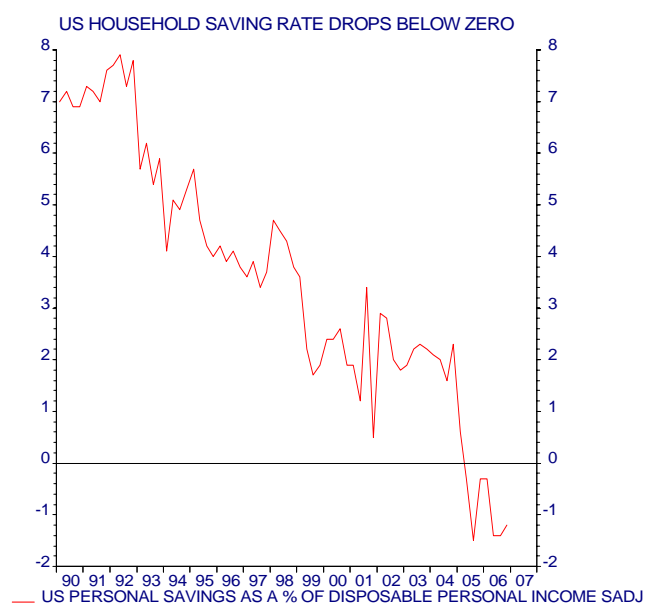
Evidence is mounting that developments in the US economy are less important now for the global economy than they were a few years ago. Demand in Europe and Asia appears to be strong enough to support global growth while the US economy goes through a weak patch. But few would deny that things would be different if the US economy went into recession. That would probably lead to a severe slowdown in global economic activity.

#### Economic risks in the US

At present the US economy is still expanding, though at a pace closer to 2% a year, rather than its trend rate of 3%; the main areas of weakness being residential investment and business spending on machinery and equipment. Crucially, household spending is

holding up well and over the year to the final quarter of 2006 it expanded by 3½%.

It has to be said that weakness in US consumer spending has been wrongly forecast more than once in recent years, but the current outlook is, perhaps, as uncertain as it has been at any time over that period. True, incomes are still growing at a healthy pace and – assuming the oil price does not go much higher – the squeeze on spending power caused by higher inflation may be fading. But consumers have only been able to maintain spending growth in recent years by dipping into their wealth – the rate of saving out of their current disposable incomes having dipped below zero in mid-2005 and stayed negative ever since (at the end of 2006 it was -1.2%). In effect, they have been borrowing at record rates against assets whose value has been increasing.

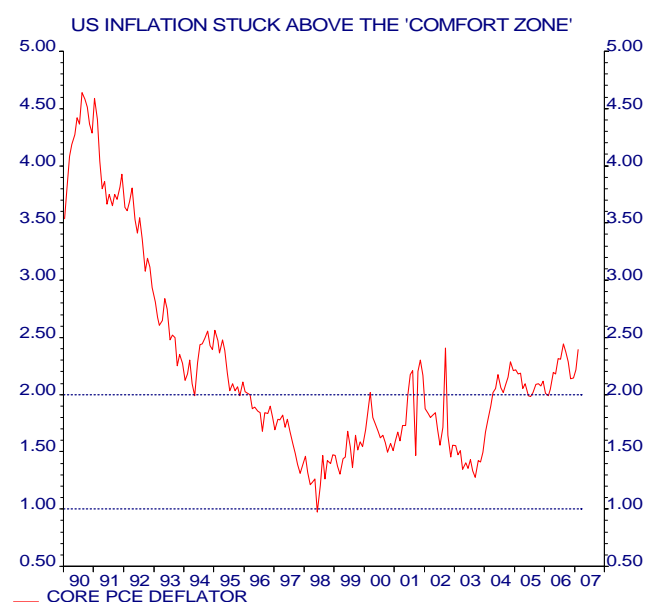


The risk is that households will no longer be prepared to (or able to) dip into their wealth now that house prices in the US have started to fall (the house is most American households' major asset). Borrowing may fall, the saving rate rise and the growth in household spending ease, even if income growth remains strong initially. This alone could be enough to drag US output growth below even its present sluggish pace. The danger then would be that employers react by cutting jobs, households become even more worried about the outlook and cut their spending further, and the US economy spirals into recession.

### The Federal Reserve's likely reaction

If this point is reached, there is no doubt that the Federal Reserve would respond by cutting interest rates aggressively. They have a dual mandate to ensure that inflation in the US remains low and that output growth is sustained at a healthy pace and in near-recession circumstances the outlook for growth is likely to dominate their thinking.

But it is less clear how they would react in the short-term if the growth of household spending begins to slow in coming months and output growth drifts a little below 2% as a result. They might like to cut interest rates in response, but could be slow to do so if inflation is proving stubbornly high.



Source: DATASTREAM

The Federal Reserve has no formal inflation target, but its Chairman, Ben Bernanke, has said that he is comfortable when inflation, as measured by the deflator for personal consumer expenditure, is in the range 1 to 2%. Just recently, William Poole, President of the Federal Reserve Bank of St Louis, reiterated that his personal inflation objective was 1½%. On the latest reading, inflation on this measure was 2.4% in February, having been 2% or above since April 2004, and not at 1½% since December 2003.

If the Federal Reserve decides that achieving the inflation target is of overriding importance – and in the statement issued after its last rate-setting meeting it said ‘the Committee's predominant policy concern remains the risk that inflation will fail to moderate as expected’ – it may be reluctant to cut interest rates. As a result, the economic situation could deteriorate further, to the point where the Federal Reserve was too late to prevent a recession.

### Conclusion

Of course, this is just one possible scenario. But it highlights the risk to the view commonly held in equity markets that the Federal Reserve will bail out investors if weak growth threatens stock prices. If inflation is still above the Federal Reserve's ‘comfort range’ and there is no good reason to believe it will fall, then interest rates may not be cut quickly enough to prevent recession fears building and equity prices falling. The bail out will only occur in a favourable inflation environment.

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