In recent weeks, equities markets have taken a tumble. Although falling stock prices are nothing new, the scope of the recent downturn makes it noteworthy. Since the beginning of May, the S&P 500 has slipped about 5%, the English and European markets have fallen about 7% and 8%, respectively, and the Japanese market has dropped more than 10%. It is also surprising that during the same period, commodities markets, which typically move in the direction opposite to equities, have also fallen. Silver has slumped almost 20%, while gold has decreased more than 10%; even oil is off about 5%. Do these declines in equities and commodities prices mean the world is headed for a period of slow economic growth? Not according to recent forecasts: World output is expected to expand at a rate close to 5% this year; the euro area, the U.K., and Japan are all expected to grow at a faster pace this year than last.

However, inflation, which can have a negative impact on growth, has trended up slightly in the past few months. Even Japan, which has experienced deflation in the recent past, has shown signs of inflation in 2006. In response, central banks have been raising their discount rates. The European Central Bank raised rates on June 15, and the FOMC announced the seventeenth consecutive rate hike at its June 29 meeting; although the Bank of

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Japan’s discount rate remains effectively zero, it is expected to begin tightening soon.

The behavior of equities prices over the past couple of months is a bit of a puzzle. These prices are determined by the present value of expected future dividend payments, so they will drop if expected dividends fall and/or the interest rate that discounts dividends increases. In May and the first part of June, however, interest rates did not change appreciably, nor did private forecasters’ views of future growth. A weaker growth forecast could lower expectations of future dividend payments.

The U.S. economy represents another concern for global markets. A slowdown could affect U.S. consumer spending, which has been a major force for global economic growth over the past few years. Concerns that higher interest rates could push the U.S. into a period of slower growth are beginning to take hold. The yield spread between two-year and 10-year U.S. securities has recently become inverted, an indicator that often—but not always—precedes a period of slower growth. However, many expect global growth to be healthy, even if the U.S. faces a slowdown. Robust growth in Europe and Asia over the last few years should allow consumers there to pick up some of the slack should U.S. consumer spending taper off. All in all, this would produce a period of more balanced economic growth and a global economy that is less dependent on U.S. consumers.

SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; Board of Governors of the Federal Reserve System; Bank of England; Bank of Japan; European Central Bank; International Monetary Fund; World Economic Outlook Database, April 2006; Organisation for Economic Co-operation and Development, OECD Main Economic Indicators, 2006; and Bloomberg Financial Information Services.