The Michael Price Student Investment Fund provides NYU Stern students with real investment experience across the Small Cap, Value, Growth, and Fixed Income spaces. Presented below is a summary of the fund-wide economic strategy report used to shape the fund’s broad thinking on market trends and direction, prepared and presented to the class by MPSIF analysts Ahmet Nalcacioglu, Carlos Amaya, Shaun Wong, and Samuel Du.

The Domestic Outlook

Considering that consumer spending accounts for almost 70% of the US GDP, the condition of the labor markets is an important indicator of what to expect in the upcoming quarters. US unemployment has risen to 6.1%, which is the highest since 2003. The only job gains have been in mining & oil, health & education and government sectors. However, we think that the increasingly strained fiscal status will have an adverse impact in government, and government related sectors.

In the last 4 months, we have seen a 1.1% surge in unemployment. This level of fast growth has been seen only in the 70’s and 80’s, and leads us to believe that the delinquencies on mortgages will increase. We expect that the rising lay-offs and big drop in future hiring signals will continue in the coming months. We think that this trend will last for more than a year, leading to more job losses. All these signal one thing: consumer spending will worsen in the coming months. With the effect of the tax rebate quickly disappearing, this is a crucial factor to keep in mind when assessing the economic condition in the US.

The Bail-out Plan

The bailout plan should dampen the volatility and increase liquidity in the markets, by giving hopes of stabilization of the financial institutions. The possible reduction in risk aversion should positively affect valuations by bringing down risk premiums. However, its effects should be in reducing the tail risk rather than having a limiting effect on the downside risk of the economy. Financial institutions still have more issues ahead, as we expect de-leveraging, bad debt charge-offs and weak loan growth to continue. Consequently the credit channel will continue to weigh on the economy.
From the dollar view, we think that in the long term, the effects of bailout plan will be in favor of a stronger US currency, as it sets ground for a more solid economy. We should warn that the bailout plan by no means marks a bottom. Looking at the history, in the RTC case, the stock market has not bottomed until 1 year after the 1st RTC, and in Japan’s FSA case that was unveiled in 1997 it took stock market 5 years to bottom.

The markets believe that the next Fed move will be a rate cut. On the rate curve, the front end will show flight to quality, and will get bid up. We will see an initial steepening of curve, but given the history after 1st RTC, long-end has more upside given the risk of Fed cuts. The current low bank and household holdings of US bonds also strongly suggest that we should see a rally on the longer end.

Is the Credit Crunch Over?

The credit crunch is one of the biggest risks restraining an economic recovery. The counterparty risk, complicated by an intricate net of exposures through credit derivatives, written on and by financial institutions, has brought the credit markets to a halt. With the commercial paper market dried up for terms longer than 30-days, high grade bond spreads at decade wide levels (compare the current 407bp with the previous 281bp at the peak of the accounting scandal peak of October 02), and TED spreads, the 3-month LIBOR – 3-month T-bill spread, at historic highs since 1999 (compare current 225bp with 25bp ’99-’07 average), companies do not have access to credit. We look at the treasury-spread changes in company notes to gauge how the market evaluates the risks of the sectors. The largest increase has been in US Banks, Broker-Dealers, Finance companies, Life Insurance, and the P&C Insurance sector. The credit markets see the chemicals, food/beverages, pharmaceuticals/medical products and capital goods as the safer sectors by factoring in the least widening in spreads year-to-date.

Corporate profits have been declining since 2006, and we expect the slide to continue due to thinning profit margins, higher financial expenses, the global slowdown and a possibly stronger dollar. The durables orders have softened, with the main source of weakness in the transport sector (Autos/Aircrafts). The worsening credit conditions and weak growth expectations are resulting in cut backs in business expenditures.

Under these conditions, we do not see a rebound before Q2 of 2009, and think that there is a high probability that we might have to wait until the end of 2009 for a recovery. Our view is that when the rebound happens it will not be a V-shaped quick bounce, and that we are facing, probably already, a U or L shaped recession.
We suggest that the US fundamentals favor holding treasuries, especially the long end, despite the bailout. The analysts should screen stocks based on capital structure, and avoid the highly levered companies, with low interest coverage. They should bear in mind that the least affected borrowers are Chemicals, Capital Goods, Food/Beverages and HealthCare/Pharmaceutical sectors. The most affected borrowers are financial institutions.

**The Global Outlook**

The international outlook is not brighter with economic weakness spreading from US to the EU and emerging markets. With corrections in commodity prices, a relatively healthy non-financial corporate sector, and firm emerging market domestic demand, the global economy should still expand, albeit at a slower pace. The asset allocation strategy should stay with slow global growth and a recessionary theme.

In the Americas, the global slow down should reduce the demand for commodities, slowing down the economies of Canada and Latin America and reducing inflation risks. In Latin America, we expect weaker currencies due to a fall in trade surplus, and less foreign direct investment going forward, therefore suggest underweighting this market. In the Euro area, we expect weak growth in 2009, and see regional inflation declining by 1Q 2009.

The Middle East, still under the threat of all time high inflation, has no choice but to cut with the Fed since most currencies in this area are pegged to the dollar, and therefore will experience even higher inflation. In Asia, we expect Japan to be in a shallow recession, with the BoJ maintaining a low interest rate. China’s policy moves towards aggressively supporting domestic asset prices and we think it will let Yuan appreciate to curb inflation. We are bullish on Chinese equities and government bonds, with expected 9% GDP growth. In emerging markets except China, we suggest avoiding the export based manufacturing sector.