CAPITAL MARKETS PERSPECTIVES

Weekly Market Review

Week ended **January 29th**

Dr. Jerry Webman is Chief Economist for OppenheimerFunds, Inc. In this capacity, Dr. Webman provides strategic viewpoints on the overall financial and economic markets to investment management and the financial advisor and investor communities.

For over 20 years, Dr. Webman has been involved in the investment and economic markets—as a researcher, financial advisor and portfolio manager.

Dr. Webman holds a B.A. in political science, with honors, from the University of Chicago where he graduated Phi Beta Kappa, and a Ph.D. in political science from Yale University. He is also a Chartered Financial Analyst.

U.S. GDP Strong Though Uncertainty Rattles Markets

By Dr. Jerry Webman, Ph., CFA
Chief Economist, OppenheimerFunds, Inc.

During a week in which global financial markets were roiled by everything from the reappointment of Fed Chairman Ben Bernanke, to China's policy tightening, to the growing budgetary concerns of Greece and other countries of the European Union, to U.S. President Obama's State of the Union Address, the Bureau of Economic Analysis provided some positive news in reporting fourth quarter 2009 real Gross Domestic Product growth of 5.7% in the United States. The American economy, now two quarters into the recovery, is growing at a much stronger clip than the weaker recoveries of 1991 and 2002 though not as strongly as the previous robust recoveries of 1975 and 1983.

A Closer Look at GDP

Let's go back to our old equation GDP = **C**onsumption (C) + **I**nvestment (I) + **G**overnment spending (G) + Net Exports (NX) for a closer look at the 5.7% jump in growth in the last quarter of 2009.

- Consumption (C) increased 2.0%, representing a modest decline from the prior quarter—impressive given that the government's Cash for Clunkers program propped up third quarter consumption. Nevertheless, 2.0% consumption growth is consistent with a very modest recovery and is indicative of the ongoing headwinds U.S. consumers face, not the least of which is the stubbornly high unemployment rate.

- Investment (I) represented the biggest contribution to growth in the quarter, driven by a sharp slowdown in the rate at which U.S. businesses were depleting inventories. Concerns that an inventory buildup would be a one-quarter affair are misplaced, and businesses, in order to be more in line with final demand, will be restocking their shelves for much of 2010. Encouragingly, capital expenditures surprised to the upside with a 13.3% rebound in spending on equipment and software, helping to offset a sharp decline in commercial real estate spending. I'm encouraged because a business-spending-led recovery presages eventual employment improvement.

- Government spending (G), surprisingly, declined for the quarter. The fourth quarter drop in defense spending will likely prove to be a timing quirk though ongoing efforts by state and local governments to adhere to restraining spending will surely continue. Nevertheless, fiscal stimulus, with spending from the American Recovery and Reinvestment Act set to ramp up, will be additive to growth in the first half of this year.

- Net Exports (NX) surprised to the upside, as U.S. exports of goods and services to the recovering economies of the world outpaced a 10.5% rise in imports.

All this said, the recovery is still tenuous, and there is nothing in this report to suggest that the economy will be able to sustain this rate growth as we head further out into 2010. There is simply not enough borrowing and lending

or job creation to generate the growth we've learned to expect during periods of economic recovery. I expect growth to continue to be strong in the first half of the year with the greatest boost coming from the inventory re-stocking and the fiscal stimulus. If, as I expect, those factors contribute to a virtuous cycle of increasing employment, consumption, and production in the second half of the year, moderate growth will continue.

More on "Exit Strategies"

January's **Federal Open Market Committee (FOMC) statement** showed slightly more optimism as the committee, in contrast to a "weak" outlook in its December statement, pointed out that activity "continued to strengthen" and is likely to be "moderate" for a time. As expected, the Fed kept the Fed Funds Rate in its zero to .25% range and confirmed that it will maintain low levels for an "extended period." The Fed's various tightening tool will most likely remain in on the shelf until normal banking practices support business expansion and job creation. This week's **Employment Cost Index (ECI)** provided greater cover for the Fed's current dovish policy, as the report showed the ECI increasing 1.5% over the past year—the lowest rate of change since 1960. The shape of the short-term interest rate curve implies a probability of less than 10% of a rate change before mid-year, and I believe that likelihood of a rate hike in 2010 is now less than one in two.

The FOMC reaffirmed the timelines for asset-purchase programs with the purchases of mortgage-backed securities ending this quarter. The Fed has already begun to scale back those purchases, but mortgage rates have actually declined. The average 30-year, fixed-rate mortgage once again fell below 5% this week.

On the fiscal front, President Obama pledged to freeze non-defense discretionary spending for three years, amounting to what would likely be approximately $30 billion per year. Even if Congress agrees, this mostly symbolic move would have little impact on this year's $1.4 trillion deficit and will be offset over the next three years by growing defense and entitlement expenditures.

To borrow a phrase from hockey parlance, U.S. policymakers "pulled the goalie" in late 2008 and early 2009 in a last-ditch effort to save the financial system and reflate the broad economy. Only now are we finally beginning to advance the puck into the offensive zone, but the goal, in this case full employment, remains stubbornly out of reach. Nonetheless, the noise has already turned to when and how the goalie would be put back into the net. I believe that such chatter is premature and is unlikely to be a U.S. story in 2010.

Emerging Markets

A clear divergence in policy actions has emerged around the world. While a move to ease credit conditions roughly a year ago was nearly unanimous, as countries' economic recoveries are occurring at differing rates, the timing and the pace of the unwind has varied. While policy in the U.S. remains highly accommodative, other countries are beginning to tighten the purse strings. For example, China has scaled back bank lending quotas, India has hiked its cash reserve ratio, and the markets are forecasting a rate hike in Brazil by as early as March.

Investors have responded to the beginning of the stimulus unwind with trepidation, sending the MSCI Emerging Markets Index down nearly 9% off of the January 11 high. One of my themes for 2010 was a pullback in emerging market equities that would represent longer term buying opportunities. With valuations less compelling, we doubted that China could continue to grow at its current breakneck pace without being derailed by asset bubbles, banking sector concerns or that countries such as Brazil would have to tighten policy to keep inflationary pressures at bay.

Our long-term enthusiasm for emerging markets remains, but 2010 remains a year to approach these markets cautiously.

Western Europe

The dollar appreciated to $1.39 against the euro from a low of $1.51 on November 25, 2009, as concerns over how Greece will correct its 12.7% of GDP deficit revived concerns about the common currency's viability. Several unattractive choices now face Athens in its struggle to whittle its deficit down to EU requirements. While stronger

economies like Germany's could bail Greece out fairly easily, this could create a serious moral hazard, especially considering the precarious fiscal positions of several other eurozone countries, such as Ireland (deficit to GDP of 11.7%) and Spain (deficit to GDP of 10.0%). More likely Greece and the other debt-ridden countries of the EU will tighten spending significantly, a move that could tip these smaller economies back into recession.

Oppenheimer funds are distributed by OppenheimerFunds Distributor, Inc.
Two World Financial Center, 225 Liberty Street, New York, NY 10281-1008

JGK-1-2-1-10 February 1, 2010

OppenheimerFunds®
The Right Way to Invest