CAPITAL MARKETS PERSPECTIVES

Weekly Market Review

Week ended **February 5th**

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.

European Debt Fears Roil Global Markets

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

A fresh wave of volatility swept through financial markets around the world last week, as concerns mounted that growing debt problems in several European countries—particularly Greece—could spread, potentially threatening the global economic recovery. We all tremble when we hear the word "contained."

Global equity markets had been factoring in a continued recovery, so concern over a potential slowdown in Europe has now dragged markets lower. Fourth quarter earnings generally support global equity market stability and valuations do not appear to be overextended. In the U.S., the S&P 500 Index closed the week at 1066, trading at only 14 times Wall Street's estimates of $75 earnings per share for 2010, below the long-term average of 16.5 times earnings. Productivity gains at U.S. businesses reported this week suggest further improvements in corporate profits. The biggest winners being companies that can finance themselves internally and can out-earn the improving expectations for the index averages. Although the household employment improved during January and other domestic economic reports were more upbeat, somewhat discouraging U.S. job creation data last week cast fresh doubt on the strength of the U.S. economic recovery.

Most financial markets chose to balance last week's news negatively. Investors fled to the relative safety of U.S. Treasury bonds, and stocks fell globally. Commodities such as oil and gold fell, as the euro zone's deficit woes continued to drive the U.S. dollar and Japanese yen higher against the euro.

Response to deficits could curb recovery

Fears are mounting that Greece, and potentially other countries, including Spain and Portugal, will not be able to finance large, growing budget deficits. Market participants worry that these countries could default, need a rescue by more fiscally sound euro zone partners like Germany or require drastic austerity measures.

Due to the intense political desire to preserve the integrity of the monetary union, a default appears very unlikely. On the other hand, a rescue, which European Union laws explicitly forbid, could create moral hazard, and may be unfeasible in the case of a larger economy like Spain's. The most likely course of action is for these countries (as Ireland has already begun) to undertake severe deficit reduction programs—likely a combination of large spending cuts and tax increases.

Unfortunately, these countries' economic recoveries are still so fragile that such programs could tip them back into recession, with potentially harmful side effects on the rest of Europe and other economies around the world. In other words, just when increased spending is necessary to help support economic growth, the debt crisis may force governments to cut back sharply—a hugely unpopular prospect among populations used to generous social spending programs. Note the public sector strikes that have already filled Athens's streets with protesters.

Other factors particular to the euro zone complicate the issue. Unlike, for example, the United States, the 16-member euro zone is a monetary union, but not a political

one. Whereas the U.S. government controls the national budget and oversees fiscal and monetary policy, each euro zone member state controls its own budget and fiscal policies. So, while Washington, D.C. can respond to a major crisis by directly siphoning resources from one geographic area of the country to help support another, no such mechanism exists in Europe. On the other hand, as a member of a monetary union, an individual country cannot shift monetary policy to fit its economic circumstances.

Investors should note that all sovereigns are not created equal. Investors may benefit from widening sovereign debt yields among developed market countries. As what began as a synchronized global recovery starts to sort out winners and losers, so must investors.

Emerging markets offer distinct advantages

It's a sign of the times that while many developed nations are struggling with deficit problems, certain emerging economies, having avoided the worst effects of the banking crisis and used pre-crisis prosperity to build surpluses, are on more solid fiscal ground. Brazil, for example is growing strongly, and its public sector debt is about 40% of GDP. Greece's debt, in contrast, is well over 100% of GDP. Many developing nations also have the advantage of having greatly improved their policy-making institutions and tax regimes in recent years.

Unemployment rate shrinks, but U.S economy still not producing jobs

U.S. **payrolls** shrank by 22,000 in January, and sharp downward revisions to the job data in the earlier months of the recession brought the total number of job losses since December 2007 to 8.4 million. The **unemployment rate** actually fell to 9.7% in January from 10.0% in December, most likely the result of revisions to population estimates. Construction jobs declined sharply, while manufacturing and services jobs rose. Companies added a strong 52,000 temporary positions, suggesting future gains in full-time employment. Overall, labor conditions remain weak—much weaker, at least, than one would normally expect to see at this stage of a recovery.

More positively, **productivity**, a measure of business efficiency, remains strong. Productivity rose 6.2% in the fourth quarter of 2009, following a revised 7.2% rise in the third quarter. Output rose and unit labor costs fell. The results bode well for corporate earnings, as companies continue to become more efficient. The question for the next few months is whether US business will have the confidence to reinvest these earnings in further capital investment and, most importantly, into expanded job creation.

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