The U.S. mortgage credit problems and resulting financial crisis took North America’s stock market indexes down starting at the end of July. The central banks responded quickly, injecting massive amounts of liquidity so as to first stabilize the interbank market and then the other markets. The U.S. Federal Reserve took things one step further in order to prevent any kind of a skid, lowering the target rate for federal funds by 50 basis points. The stock markets, which had already rebounded, took advantage of the move to climb further toward their July peaks.

In this issue of Economic Viewpoint, we will show that, like the situation that prevailed in 1998, this situation is conducive to the stock market continuing to ascend. In addition to the current monetary easing, which will give new energy to the stock market’s advance, the relatively sustained growth by corporate profits, the balanced appreciation of North American markets, substantial stock buybacks, low interest rates in real terms and the global economic context, should allow the stock markets to reach new peaks. Movement by the indexes should remain volatile in the near future, and there are still downside risks.

Money market distortion

The heightening of fears about defaults on payment in the subprime mortgage market created real commotion in the globe’s money markets this summer. Liquidity problems associated with investors’ loss of confidence in asset-backed commercial paper (ABCP) and worldwide resurgence of risk prodded many market players to opt for safe haven securities, taking Treasury bill rates and bond rates down sharply.

Conversely, concerns about bank and corporate credit quality pushed swap rate and corporate bond spreads up (Graph 1).

Faced with a clear shortage of liquidity, the major central banks had to step in to ease the upward pressure on interbank overnight financing rates. Substantial amounts of liquidity were injected, and the list of and terms for repurchase agreements were, in many cases, broadened (Graph 2). In a flash, what had been seen as a problem specific to the American economy developed into a worldwide systemic risk.
Stock market correction and volatility

The stock markets were not spared. Of course, the indexes’ rapid rise in the first half of 2007 suggested that growth would be much more moderate in the second half, with risks of a correction. However, it was hard to picture a summer with this much upheaval (Graph 3).

July had gotten off to a positive start, and most North American indexes set new peaks on July 19. At the time, the S&P 500 was up 9.5% from the beginning of 2007. In Canada, the S&P/TSX was performing even better, with gains of more than 13%. The mounting news confirming the problems with the U.S. housing market and the financial difficulties faced by mortgage lenders and some hedge funds, however, put the risks associated with lower quality mortgages back in the spotlight. The stock exchanges began a pullback that deepened as the mortgage crisis led to an acute liquidity shortage on the money market and concerns about much tighter credit (Graph 4).

In the middle of August, North America’s stock market indexes fell below where they started the year. Along with pulling back, the stock markets became highly volatile during the crisis (Graph 5).

The situation has calmed a little in recent weeks. Note that the extent of the problems triggered by the mortgage loan crisis has changed the game for U.S. monetary policy. Following an initial prompt response in which it cut its discount rate by 50 basis points and released a statement in which the fight against inflation took a back seat to the concerns raised by the mortgage loan crisis, the U.S. Federal Reserve (Fed) demonstrated its firm intention of preventing the least sign of a skid by cutting its key rates by 50 basis points on September 18. The news was well received by market players, allowing the stock market indexes to climb further toward pre-crisis levels.

The crisis changed the financial context

We now need to wonder how the recent financial crisis changed the outlook for the stock markets. First, it is clear that companies that were benefiting from lower quality mortgage
credit are now in a more difficult situation. The crisis has primarily hurt the financial sector. In addition to having to absorb a major share of the losses arising from defaults on mortgage payments, financial institutions will have to deal with the liquidity crisis and resurgent risk. Their earnings will thus certainly be lower than forecast prior to the crisis. However, financial institution stock prices have already fallen substantially to reflect the new situation. The S&P 500’s financial sub-component retreated by over 8% between mid-July and mid-September (Graph 6).

The recent financial crisis also caused credit conditions to tighten. The size of the rate spreads between corporate and government securities is a clear indication that it is now harder and more expensive for companies to take out loans. The increase in financing costs could cut into corporate profits and restrict expansion plans. However, in the current context, the effects on the stock exchanges should be fairly limited, as a number of companies will use their substantial cash flows as a source of financing (Graph 7).

Tighter access to financing, however, also put the brakes on the wave of mergers and acquisitions that had helped drive the stock market indexes up in recent years. In August and September, the value of this type of deal tumbled by about 65% in the United States from the average for the first seven months of 2007 (Graph 8). This situation could last a while, as the financial climate has become much less favourable to mergers and acquisitions, especially to leveraged buyouts.

1998 vs. 2007

The mortgage crisis has had repercussions for the stock market but, in our opinion, it has not changed the fundamentals that govern its movement. As a result, the rising market probably still has a ways to go before making way for a soft patch. This, at least, is what we can conclude based on past episodes. In particular, the current liquidity crisis is reminiscent of the period that saw the crisis in Asia and collapse of the LTCM (Long-Term Capital Management) hedge fund in 1998. At the time, an initial 25 basis point cut to federal funds to 5.25% on September 29, 1998, followed by a second cut only two weeks later that took it to 4.7% on October 15, and a final cut on November 17 allowed the main North American stock market indexes to soar (Graph 9).

The current situation could be no different. First, the global economic context is much better. Unlike 1998, in which many countries were hard hit by the Asian crisis, the emerging economies are now in enviable health (Graph 10). The main contribution to growth will continue to come from Asian countries excluding Japan—with China and India front and centre—where growth continues to boom. The euro zone nations are starting to show signs of flagging, but growth is still strong enough to offset the U.S. slowdown. In 2008, the performances of the two regions will be almost neck and neck. Under these circumstances, the world’s economy should grow by about 4.9% in 2007 and 4.8% in 2008.

Also, the July-August 2007 correction was smaller than the 1998 correction, and followed more restrained stock market euphoria (Graph 11). With two more 25 basis point cuts to the federal funds rate expected by the end of the year, everything points to North America’s stock markets staying on a rising trend.
The fundamentals are still positive

What’s more, the low price/earnings ratios show that the stock markets are very attractive, historically speaking. Contrary to the bursting of the tech bubble in 2001 and the Asian financial crisis of 1998, the recent correction occurred when the stock markets did not seem in the least overvalued (Graph 12). This is one reason for the indexes’ fairly limited dip during the crisis, and the subsequent rebound.

In the same vein, the stock market’s growth is in line with corporate profits (Graph 13). North American corporate earnings growth should continue in 2007 and 2008. In the United States, the national accounts are showing a marked rise in profits in the second quarter, and financial analysts continue to call for a sustained increase in corporate earnings.

Our own forecasts are now for S&P 500 earnings to rise 7% in 2007 and 8% in 2008, while the increase could be as high as 11.2% in 2007 and 10.4% in 2008 for profits for Canada’s S&P/TSX (Table 1). This type of profit growth will soothe investors.

A more uncertain factor involves stock redemptions. In recent years, companies have used their substantial profits to buy back more and more of their own shares, helping drive the indexes up. Sound corporate financial health should allow companies to continue to make substantial redemptions, although the summer’s crisis may have decreased the practice’s popularity and encouraged some companies to retain more of their liquidity (Graph 14).
Some risks remain

The current situation holds several risks for the stock markets. First, the U.S. economy’s growth outlook has darkened somewhat lately. The housing wealth effect had sustained much of household spending in recent years. Now, given the ongoing real estate correction and the potential impacts on consumer and investment spending of credit condition tightening by financial institutions, the risks of a slowdown seem larger. Our model also shows that the likelihood of a recession has recently increased from 25% to 40% (Graph 15). Circumstances have thus prodded us to downgrade our growth outlook for U.S. real GDP from 2.2% to 1.9% for this year and from 3.0% to 2.5% for 2008 (Graph 16). In our opinion, the Fed’s rate cuts will allow the economy to stay on track, but the risks that growth will disappoint again are substantial.

The liquidity crisis could also last longer than forecast, leading to deeper, more long-lasting credit tightening. Despite their sound financial health, companies cannot do without outside financing forever. A major credit crisis would definitely cut into profits and reduce stock prices. Given the monetary authorities’ stated intention of avoiding this kind of skid, the risk appears to be fairly low.

Lastly, note that the summer’s financial crisis did not call a halt to the Shanghai Stock Exchange’s surge—it reached new peaks. In mid-September, the composite index was almost 4.5 times higher than when it opened 2006. There is thus a real

### Table 1

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<th>Stock markets: History and forecasts</th>
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<tr>
<td><strong>End of period</strong></td>
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<td><strong>2006</strong></td>
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<td><strong>United States</strong></td>
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<td>Earnings of S&amp;P/TSX</td>
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**f:** forecasts

Sources: Datastream, I/B/E/S and Desjardins, Economic Studies

### Graph 15

**The risk of a recession in the United States is high**

- **Probabilities in %**

- **Probabilities in %**
  - 2006: 0, 2007: 0, 2008: 0, 2009: 0

Sources: Desjardins, Economic Studies
risk of a brutal correction by the Chinese stock market, which could affect international investor confidence (Graph 17).

**Forecasts**

Under these conditions, we continue to believe that the stock market indexes will, overall, be on the ascent over the coming quarters, and we are maintaining our year-end targets. The S&P 500 should thus climb 9.3% this year and 8.1% in 2008, while the Dow Jones is expected to go up 12.3% in 2007 and 7.1% in 2008. In Canada, our year-end targets for the S&P/TSX are now 14,500 points (+12.3%) in 2007 and 16,000 points (+10.3%) for 2008 (Table 1).

After that, stock market growth could start to slow as the stock market’s lengthy expansion phase gives way to some consolidation.

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