

Monday Night Report – July 2, 2007

The Monday Night Report is written on Monday night, after market close. Subscribers receive the newsletter every Monday or Tuesday morning before the markets open again. Subscribers may at all times log into their account in order to review it. It is published 3 days later on StockTargets Website on a public at <http://www.stocktargets.com/newsletters.html> for anyone to read.



The StockTargets "Monday Night Report" by Philip Coutaz

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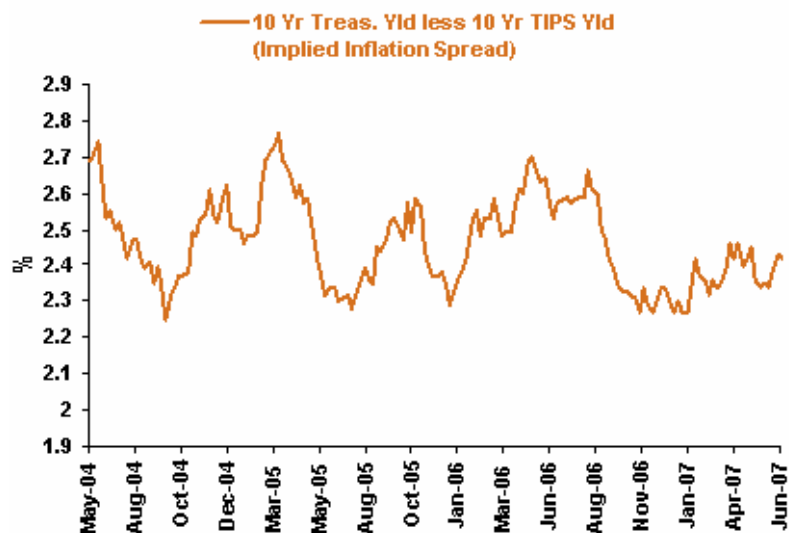
Imagining the Good Scenario !

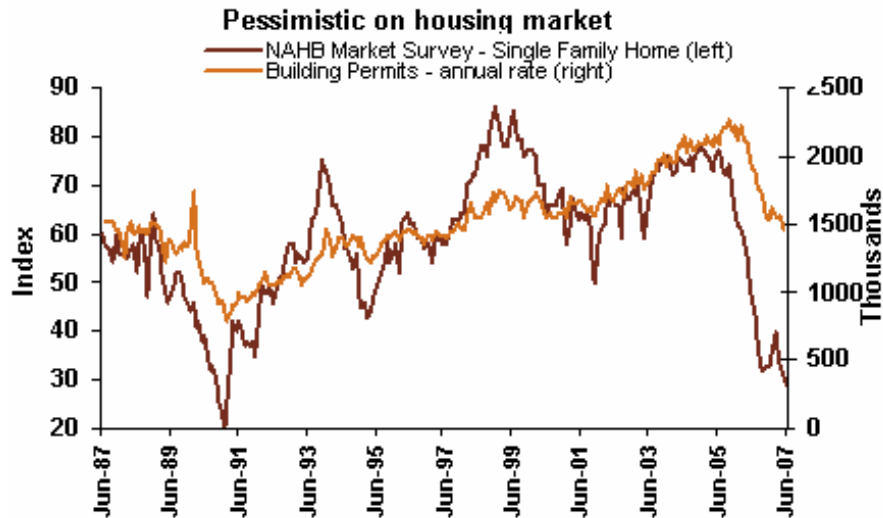
Several well-known interest rate cut advocates on Wall Street have recently renounced their forecasts: Merrill Lynch, Goldman Sachs and PIMCO. Back in January, they all were predicting that the Fed would begin cutting rates in May or June and that the Federal Fund Rate would begin to decline towards 4.25% before yearend. Of late, they all threw in the towel on their rate-cut forecasts for 2007.

Imagine they are wrong for the second half, just as they were for the first half. Imagine instead the beginning-of-the-year Fed's "Goldilocks" outlook now becomes reality. In other words, the combination of low inflation, moderate economic growth and neutral monetary policy is finally falling into place. Here is how we can describe this.

1. Low Inflation: If bond yields moved so violently upward of late, it is certainly not because of inflation. Inflation has been moderating - with or without food and energy - and market implied inflation expectations remain tame, as shown below.

Implied long-term inflation expectations remain tame





2. Moderate Growth: The housing market shows no sign of relief. After stabilizing earlier this year, it began caving again following the surge in mortgage interest rates, tougher lending standards and the near implosion of the sub-prime mortgage market.

3. Neutral Monetary Policy: Fed rates have now been pegged for quite a while and the long-end of the curve - 10-Year Bond Yield - has been driven by other dynamics, mostly by the problems within the US credit markets - subprime, CDOs, Bear Stearns High Yield Fund, etc. All these credits and extensive leverages have now compelled investors to re-allocate their portfolios in order to price in the risk with the sharper-than expected deterioration in the housing market. Bill Gross, manager of the world's biggest bond fund, said the Federal Reserve will keep interest rates steady until inflation declines. This amounts to saying that bond vigilantes are now back in the driver seat of managing (active) future inflation risks and that the Fed sits pat (passive) waiting for their signal to reduce short-term rates.

As a result, during the summer period, bond yields and soon corporate spreads could display some unusual volatility not as a result of renewed inflation pressure but rather because we are at the end of a credit boom, when debts, mortgages, CDOs and the like accumulated over the past decades now become unsustainable and the rise in yields - the cost of debt - reflects the increase in default risk.

Before yearend, things should look increasingly more favorable for stocks because the Fed goldilocks outlook will finally materialize implying that inflation scares will be behind, moderate growth will be the norm and the Fed will begin to lower rates, thus paving the way for P/E expansion.

Bottom Line:

- Until all segments of the US credit market show more evidence that the clean up is over, long-bond investors could be penalized by sharp volatility swings.
- The outlook for stocks is good, as inflation fears will be behind us.