GLOBAL ECONOMICS UPDATE

13th Aug. 2007

Seven reasons not to panic

- Talk of a market meltdown is wildly overdone. We still see troubles ahead for the US as a result of the housing slump, and remain concerned about carry trades. (See our *Global Economics Focus*, “What next for global markets?” published last Friday.) But here are **seven reasons why it is right not to panic.**

- 1. **This is the third sell-off since the start of 2006: markets recovered from the last two without any significant fall-out on the wider economy**. Admittedly, the latest sell-off is relatively severe. (See Chart 1.) But for all the talk of a crisis on Wall Street, the S&P actually *rose* by 1.4% over last week as a whole.

- 2. Equity market valuations (especially P/E ratios) were not outrageous before the sell-off. We will look at this in more detail this week in another *Focus*, but the short point is that developed market equities are now pretty close to fair value. Of course they may become *under*-valued for a long period of time (and profits now account for an unsustainably high share of GDP in many economies) but we are not starting from a position where equities are set up for a major bear market.

- 3. A key factor behind the sell-off is that risk premia on a wide range of assets had fallen to unsustainably low levels. However, **many measures of risk and market volatility are now back at more realistic (or even overly-pessimistic) levels**. These include the VIX measure of implied volatility in US equity index options (see Chart 2), the iTraxx crossover measure of credit default risk, and implied FX vols. This suggests that at an important part of a (long-overdue) correction is now complete.

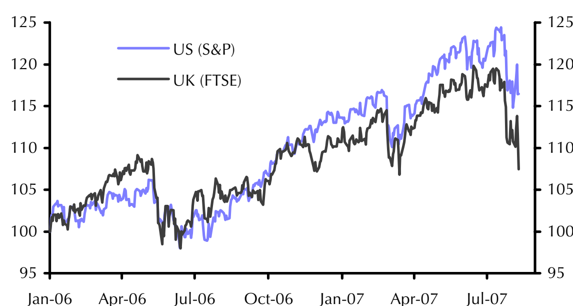
- 4. There is **more room for central banks to cut interest rates** if necessary now that rates are close to a neutral level in Europe and the US than if rates were still exceptionally low. In the event we do not think that lower rates will be required (at least in Europe) but the option is there if needed.

- 5. In the meantime, **bond markets are doing some of the central banks’ work for them**. The sharp fall in benchmark government bond yields means that borrowing costs for more credit-worthy companies and households have actually *fallen* in the last month or so, notably in the US.

- 6. Recent confirmation that the problems in the US sub-prime mortgage market are also affecting European banks should not be a surprise and may even be a positive development, as it means that the US financial system and economy is not going to have to bear the entire burden on its own.

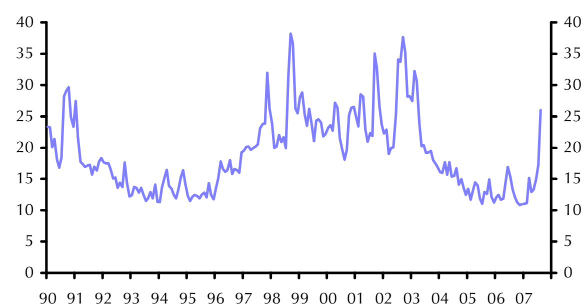
- 7. The fact that **the sell-off has taken place in August** (with the worst day being a Friday) also has a reassuring side. The usual decline in liquidity during the holiday season will have exacerbated the market moves, so we should read rather less into them. What’s more, there is normally less activity in areas like M+A at this time of year anyway, so fewer deals are being delayed or lost.

Chart 1: US and UK Equity Indices (Rebased Jan 2006 =100)



Source – Bloomberg. Last data are Friday’s closes.

Chart 2: VIX Implied 30-day vol. in S&P 500 Options (%)



Sources – Bloomberg, CBOE

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