Global Economics
April 23, 2008

GLOBAL COMMENTARY

David Malpass
212 272-4293
dmalpass@bear.com

Sandy Batten
212 272-8428
sbatten@bear.com

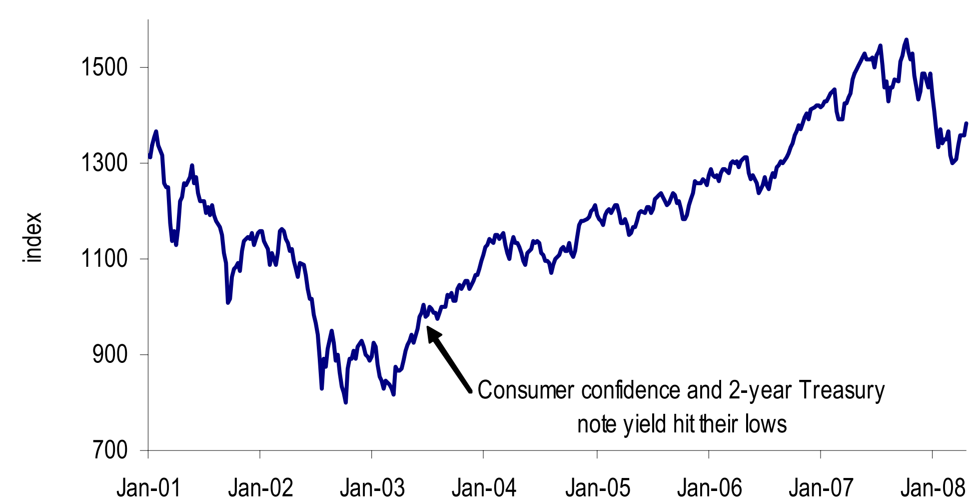
Investment Implications of Liquidity-Driven Recovery

As recent Washington stimulus actions begin to take effect, credit spreads are narrowing and equities rising. We think the growth outlook will improve, creating a liquid investment climate somewhat similar to 2003.

- The general environment in June 2003 was of pessimism, particularly in the bond market, media and consumer confidence indices. As today, there were underestimates of the Fed's powers -- to address this, Fed staff papers in 2003 delved into deflation strategies if the Fed funds rate approached zero and in 2008 examined options if the Fed depleted its Treasury holdings. Other similarities: angst over the huge losses in household wealth from the bursting of the dot-com bubble (much bigger than today's housing losses); and cautious investment plans by corporate chieftains. Helped by Fed rate cuts and the Bush tax cuts, the mid-2003 result was a strong economic expansion.

- Treasury-market pessimism in 2003 was as deep as it is today, with the two-year Treasury yield at 1.1% in June 2003 (it fell to 1.5% in mid-March). It wasn't announced until July 2003 that the recession had ended in November 2001. GDP grew 5.1% annualized in the second half of 2003 and equities gained 9.4% in the subsequent six months.

S&P 500 Equity Price Index (last obs. April 23, 2008)



Source: Haver; Bear, Stearns & Co. Inc.

- The latest stimulus measures should again generate a recovery, though we expect a smaller rebound in 2008 than in 2003 unless there's a growth-oriented tax cut or a change in the Administration's weak-dollar policy. We expect more problems from balance sheet losses at financial institutions and the untangling of complicated financial instruments, part of a necessary transition from unsustainably narrow credit spreads in 2007 to wider, more sustainable credit spreads.

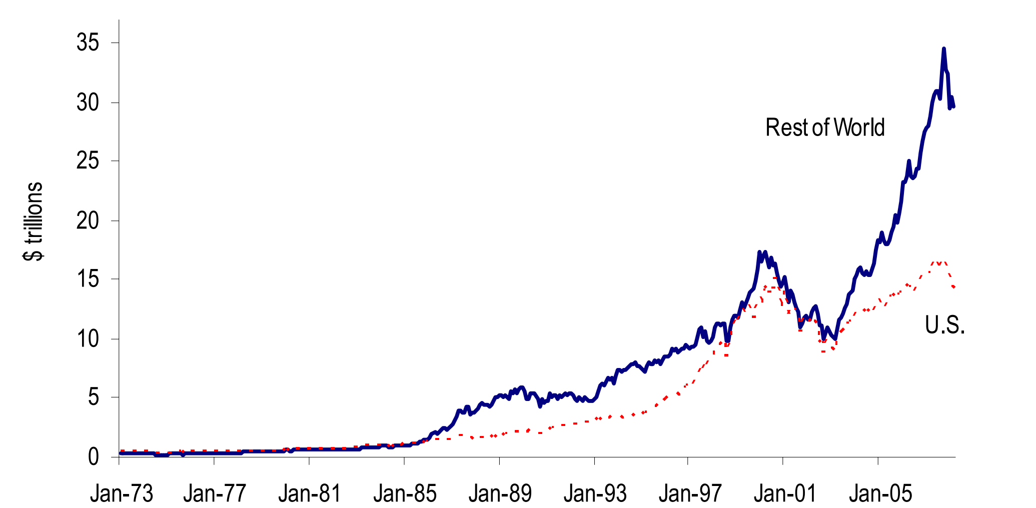
Investment Implications

- As in 2003 and 2004, emerging markets, Japan, and U.S. durable goods should benefit from plentiful liquidity conditions.

- We expect reasonably favorable conditions for consumption. Despite the recent loss of housing wealth, we note the dramatic rise in housing wealth in previous years, and high levels of household net worth in the U.S., Japan and Europe. The condition of the labor market (one key measure is jobless claims, which remain moderate) has been a better predictor of consumption than have wealth, consumer confidence, or house prices.

- We think the weak dollar trend is still intact, damping U.S. equity gains and pushing commodity prices higher. If the U.S.'s weak-dollar policy improved, either by choice, by G-7 actions, or by presidential election politics, we think it would have a major positive impact on the U.S. growth and equity outlook.

Equity Market Capitalization: U.S. and Rest of World (last obs. March 2008)

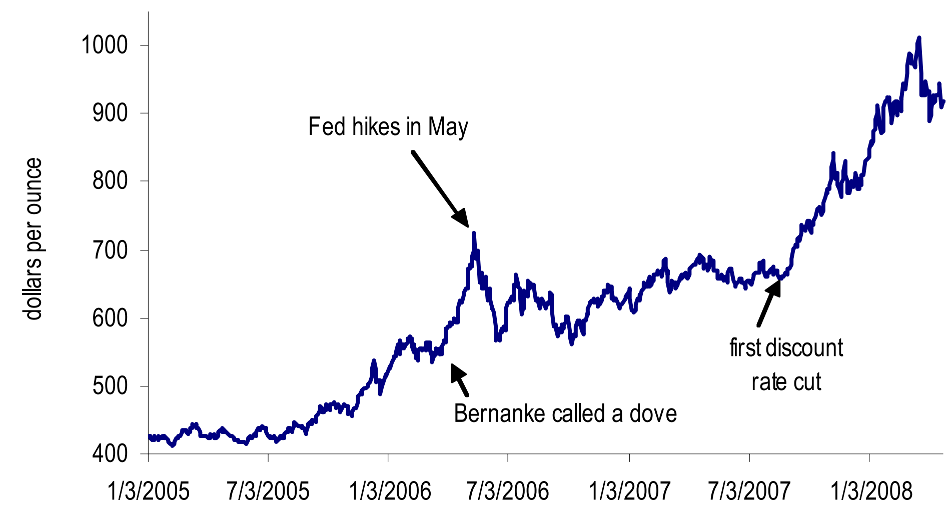


Source: DataStream; Bear, Stearns & Co. Inc.

- We expect rising U.S. core inflation during 2008, leading to a Fed rate hike by year-end. The Fed noted in the minutes from its January 29-30 meeting: "Members were also mindful of the need for policy to promote price stability, and some noted that, when prospects for growth had improved, a reversal of a portion of the recent easing actions, possibly even a rapid reversal, might be appropriate."

- Gold, oil and other commodities have jumped since the Fed's change to an aggressive rate-cutting stance with the August 17 discount rate cut. We think the weak-dollar trend and the uptrend in commodities would both reverse if the Fed shifted to an inflation-fighting mode.

Dollar Price of Gold (last obs. April 22, 2008)



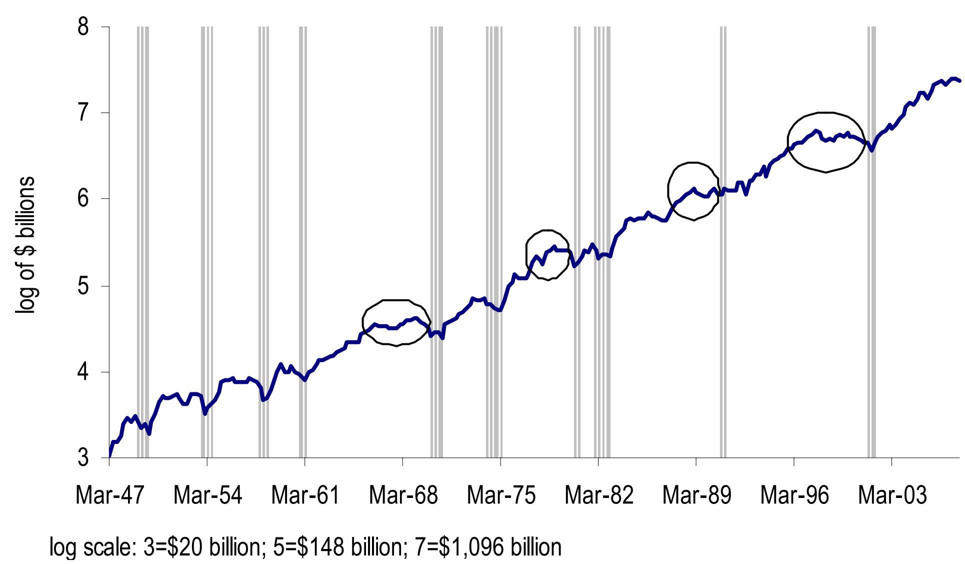
Source: Haver; Bear, Stearns & Co. Inc.

Earnings Not So Weak

Fourth-quarter GDP data showed that business profits rose 2.5% from a year earlier versus a 1.8% y/y increase in Q3. On quarter-over-quarter basis, profits fell 3.3% (not annualized) in Q4 and 1.2% in Q3.

- While profits of financials have slumped, the high level of non-financial profits reduces the likelihood of a long or deep recession. U.S. recessions are preceded by relatively long periods of stagnant or falling corporate profits. Also arguing against a deep recession, we note low inventories and very low real interest rates.

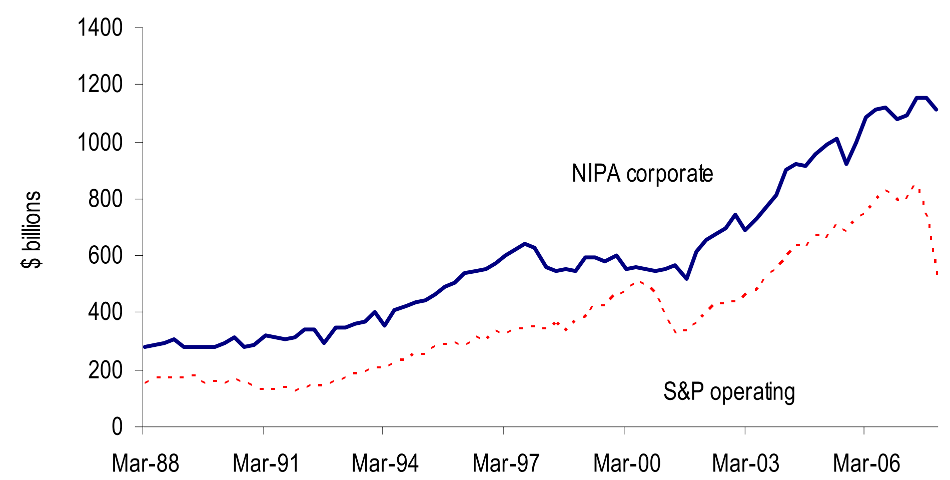
U.S. Pre-Tax Corporate Profits (last obs. 2007 Q4)



Source: Haver; Bear, Stearns & Co. Inc.

- From an equity valuation standpoint, the financial write-offs, mark-to-market losses and bad debt expenses don't directly impact NIPA-based earnings (part of GDP calculations). Earnings in the National Income and Product Accounts were much weaker than S&P earnings in 1999 and 2000, and gave a more accurate signal of equity market overvaluation . NIPA earnings will likely be stronger than S&P earnings for several quarters (starting with the third quarter of 2007), signaling a more attractive valuation than S&P earnings do. In the graph, we've contrasted NIPA earnings with operating earnings for the S&P 500, showing the weaker NIPA performance in 1998-2000 (signaling recession) versus the stronger NIPA performance so far in this slowdown.

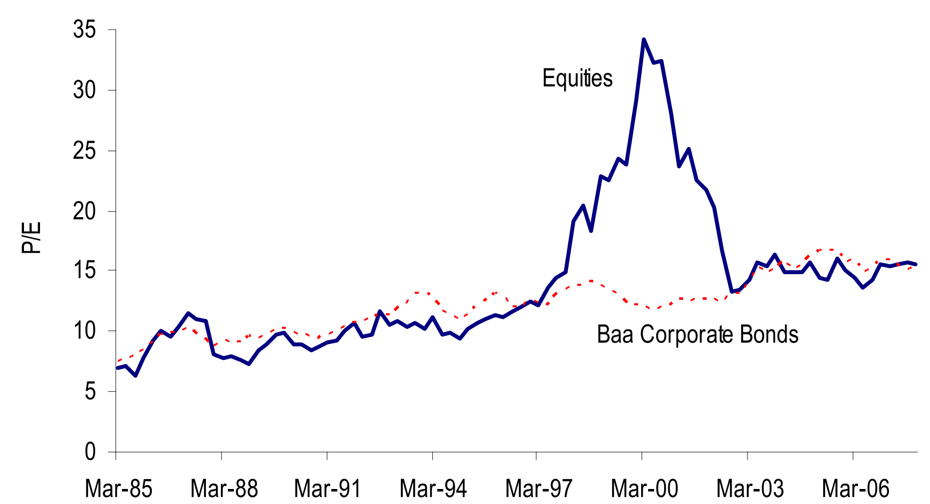
NIPA Corporate Profits and S&P Operating Earnings (last obs. 2007 Q4)



Source: Haver; Bear, Stearns & Co. Inc.

- NIPA describes the concept as follows: "Bad debt expenses are not deducted in calculating the NIPA profits measures, because these charges represent a rearrangement of assets and liabilities in the Nation's balance sheet rather than costs of current production." In short, financial losses for one party are gains for another and therefore do not impact GDP. Our NIPA-based P/E model shows attractive equity valuations relative to corporate bonds.

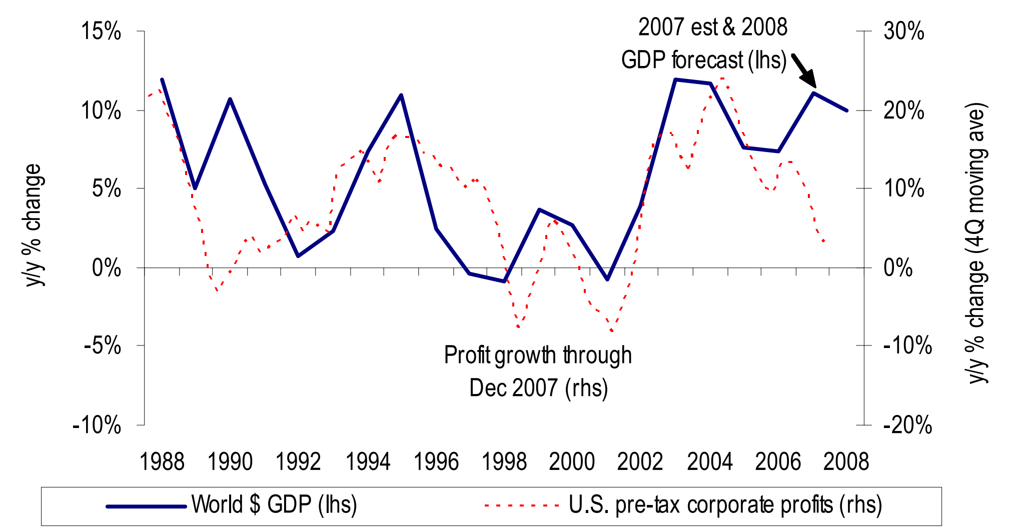
Equity and Corporate Bond P/Es (using NIPA profits, last obs. 2007 Q4)



Source: Haver; Bear, Stearns & Co. Inc.

- Global dollar GDP has been a good predictor of the strength in NIPA-measured U.S. corporate profit growth in recent decades. Both measures are nominal, with U.S. corporate profits aided by globalization and foreign growth. U.S. profit growth slowed in 2007 without a corresponding slowdown in global nominal dollar GDP, reflecting in part the U.S. weakness in housing and autos and perhaps an underweighting by U.S. companies in the global commodity boom. We expect reasonable gains in U.S. profits in 2008 as the recovery takes hold.

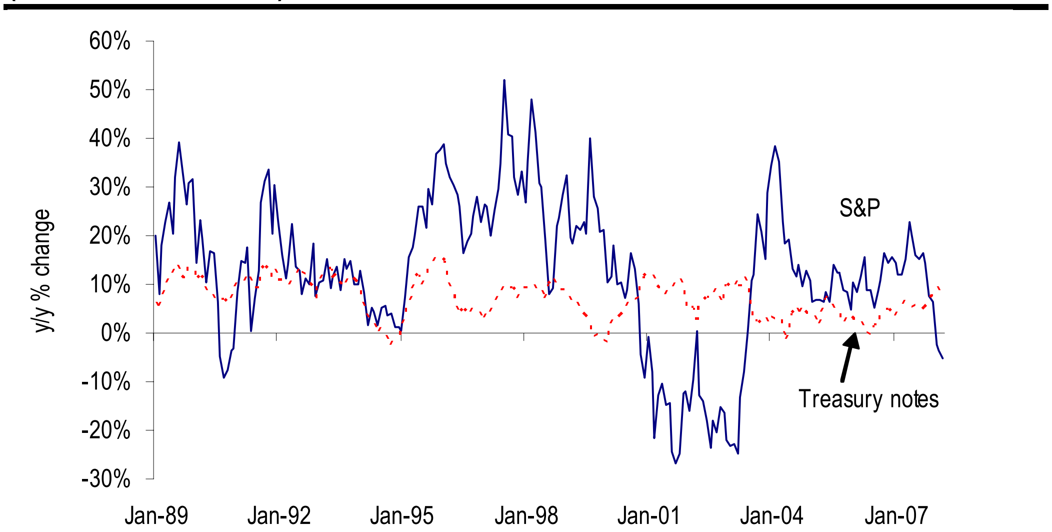
World Nominal Dollar GDP and U.S. NIPA-based Pre-tax Corporate Profits



Source: Haver; Bear, Stearns & Co. Inc.

- Given our view that plentiful liquidity will encourage an economic recovery, we don't expect the U.S. equity correction to turn into a bear market. We think equities will outperform bonds in coming quarters (though not necessarily credit spread investments).

Total Return on S&P 500 Index and 10-year Treasury Notes (last obs. March 2008)



Source: Haver; Bear, Stearns & Co. Inc.

- We expect Treasury yields to rise as the economy recovers. We think the rising pattern from the 2003-2005 may reassert itself -- a sharp increase in the yield when it becomes clear that the economy has exited the slowdown/recession, followed by a flattening of the yield curve (the "conundrum") as short-term rates rise.

Yields on 10-Year Treasuries (last obs. March 2008)

Source: Haver; Bear, Stearns & Co. Inc.

ADDENDUM

Important Disclosures

The costs and expenses of Equity Research, including the compensation of the economist(s) that prepared this report, are paid out of the Firm's total revenues, a portion of which is generated through investment banking activities.

This report has been prepared in accordance with the Firm's conflict management policies. Bear Stearns is unconditionally committed to the integrity, objectivity, and independence of its research. Bear Stearns economists and personnel report to the Director of Research and are not subject to the direct or indirect supervision or control of any other Firm department (or members of such department).

This publication and any recommendation contained herein speak only as of the date hereof and are subject to change without notice. Bear Stearns and its affiliated companies and employees shall have no obligation to update or amend any information or opinion contained herein, and the frequency of subsequent publications, if any, remain in the discretion of the author and the Firm.

OTHER DISCLAIMERS

This report has been prepared by Bear, Stearns & Co. Inc., Bear, Stearns International Limited or Bear Stearns Asia Limited (together with their affiliates, "Bear Stearns"), as indicated on the cover page hereof. Responsibility for the content of this report has been accepted by Bear, Stearns & Co. Inc. for distribution in the United States. If you are a recipient of this publication in the United States, orders in any securities referred to herein should be placed with Bear, Stearns & Co. Inc. This report has been approved for publication in the United Kingdom by Bear, Stearns International Limited, which is authorized and regulated by the United Kingdom Financial Services Authority. Private Customers in the U.K. should contact their Bear, Stearns International Limited representatives about the investments concerned. This report is distributed in Hong Kong by Bear Stearns Asia Limited, which is regulated by the Securities and Futures Commission of Hong Kong. Recipients of this report from Bear Stearns Asia Limited should contact representatives of the latter in relation to any matter referred to herein. Additional information is available upon request.

Bear Stearns and its employees, officers, and directors deal as principal in transactions involving the securities referred to herein (or options or other instruments related thereto), including in transactions which may be contrary to any recommendations contained herein. Bear Stearns and its employees may also have engaged in transactions with issuers identified herein. Bear Stearns is affiliated with a specialist that may make a market in the securities of the issuers referred to in this document, and such specialist may have a position (long or short) and may be on the opposite side of public orders in such securities.

This publication does not constitute an offer or solicitation of any transaction in any securities referred to herein. Any recommendation contained herein may not be suitable for all investors. Although the information contained in the subject report (not including disclosures contained herein) has been obtained from sources we believe to be reliable, the accuracy and completeness of such information and the opinions expressed herein cannot be guaranteed. This publication and any recommendation contained herein speak only as of the date hereof and are subject to change without notice. Bear Stearns and its affiliated companies and employees shall have no obligation to update or amend any information or opinion contained herein.

This publication is being furnished to you for informational purposes only and on the condition that it will not form the sole basis for any investment decision. Each investor must make their own determination of the appropriateness of an investment in any securities referred to herein based on the tax, or other considerations applicable to such investor and its own investment strategy. By virtue of this publication, neither Bear Stearns nor any of its employees, nor any data provider or any of its employees shall be responsible for any investment decision. This report may not be reproduced, distributed, or published without the prior consent of Bear Stearns.

This report may discuss numerous securities, some of which may not be qualified for sale in certain states and may therefore not be offered to investors in such states. This document should not be construed as providing investment services. Investing in non-U.S. securities including ADRs involves significant risks such as fluctuation of exchange rates that may have adverse effects on the value or price of income derived from the security. Securities of some foreign companies may be less liquid and prices more volatile than securities of U.S. companies. Securities of non-U.S. issuers may not be registered with or subject to Securities and Exchange Commission reporting requirements; therefore, information regarding such issuers may be limited.

NOTE TO ACCOUNT EXECUTIVES: For securities that are not listed on the NYSE, AMEX, or Nasdaq National Market System, check the Compliance page of the Bear Stearns Intranet site for State Blue Sky data prior to soliciting or accepting orders from clients.

CIR 230 Disclaimer

Bear Stearns does not provide tax, legal or accounting advice. You should consult your own tax, legal and accounting advisors before engaging in any transaction.

In order for Bear Stearns to comply with Internal Revenue Service Circular 230 (if applicable), you are notified that any discussion of U.S. federal tax issues contained or referred to herein is not intended or written to be used, and cannot be used, for the purpose of: (A) avoiding penalties that may be imposed under the Internal Revenue Code; nor (B) promoting, marketing or recommending to another party any transaction or matter discussed herein.