



Global Asset Management Inc.

Market Insight



SEPTEMBER 6, 2005

The Longer-Term Market Implications of Hurricane Katrina

Hurricane Katrina will likely act as a catalyst for change in capital market trends. The upside for equities now seems more tenuous and the downside for bonds looks more questionable. For currencies, the U.S. dollar's cyclical rally now appears at risk.

Economic Impact: This Time It's Different

Early reports suggest Hurricane Katrina will be the worst natural human tragedy in U.S. history since the 1906 San Francisco earthquake. But the economic impact could differ from past disasters for two reasons.

First, the hurricane has temporarily shut down a significant proportion of global oil and gas production and refining capacity. This effect will only be temporarily alleviated by the release of strategic energy stockpiles from both Europe and the U.S.'s own strategic petroleum reserve, as these stockpiles will eventually need to be replenished. As a result, the world in general and the U.S. in particular will have to cope with higher energy prices for several months.

How high will energy prices go, and for how long? "Until we have further notice, the effects of the hurricane are a bullish signal for oil stocks because it adds a degree of uncertainty to supply," Frank Settino, Assistant Vice President Of Global Equity Research, and TAL's energy analyst, says. "Longer-term, I still expect oil prices to move higher until we have some kind of reaction in terms of consumption. It does put additional pressure on supply and short-term prices will probably move higher than I expected. Katrina doesn't change my long term outlook".

This disaster may be different in a second respect. The widely held view is that natural disasters first depress and then boost macroeconomic activity, because of the rebuilding activity that surrounds the aftermath. Katrina may prove to be the exception to the rule, because the loss of wealth and income will be more lasting and the effect it will have on energy supplies." This introduces the probability that there will be a pause in the business cycle, or that the cycle ends sooner," says Maxime Tessier, vice president of currency management for TAL. "The U.S. consumer has already drawn down savings over the past four years, and there is little pent-up demand in the economy."

Policy Response: Little Ammunition Left

So how will this affect U.S. Federal Reserve policy? First and foremost the Fed will likely try to preserve and ensure financial stability in global markets. This is a human tragedy and an economic shock, but not a financial crisis. The next Federal Open Market Committee (FOMC) meeting is on September 20th. The hurricane came at the end of August, so it is unlikely to show up in most of the economic indicators the Fed will look at, and it might simply be too soon for a policy pause on interest rates on September 20th. However, there is the risk of a pause at subsequent meetings depending on the financial market fallout.

"I felt that the expectations for the Fed were getting too bearish," says John Braive, TAL Vice Chair and a member of the global fixed income team. "Expectations for long-term U.S. interest rates ran as high as 5.5%. The hurricane's aftermath slams the door shut on that idea and I expect we won't go higher than 4.5%, and that will be it. The hurricane and oil prices are forces that will make 2006 a weaker year. And I think the bond market will play off this weakness and that the curve, which has become exceptionally flat, will start to steepen."

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Equity Outlook: Sector Strategy and Overall Market Direction

For the equity markets Hurricane Katrina will likely bring adverse effects to the United States, and may be only somewhat gentler on Canada. While the overall direction of the market is uncertain, the sector implications are more straightforward and are summarized in the table below.

Sector	Relative Performance	Comment
Oil and gas servicing	Positive	Repair of infrastructure
Construction and building Materials	Positive	Residential and commercial repair and reconstruction
Consumer staples	Positive	Especially food and drugs
Consumer discretionary	Short-term Positive	Replacement of household goods, but potentially weaker sales longer-term
Telecom	Negative	Lost revenue and costly infrastructure rebuilding
Insurance	Negative	Record claims that will take time to assess
Hotels and restaurants	Negative	Consumers cut back
Transportation	Negative	Damaged equipment, infrastructure and decline in consumer travel

So far, consumers have largely responded to higher energy prices by reallocating discretionary spending. The risk is that, as consumers brace for substantially higher heating bills this winter, the spike in energy prices following Katrina could become the proverbial straw that causes a slowdown in total consumer spending and not just a reallocation of discretionary spending.

“Until we have a clear idea of the fallout from the hurricane, which probably won’t be before Christmas, speculation and uncertainty will persist,” Maxime Tessier says.

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