

United States

Market Overview

During the month of January, the Federal Open Markets Committee (FOMC) moved from a limited loosening mode designed to mitigate the impacts of the market turbulence on the economy to an aggressive-loosening approach, aimed at stimulating growth. On January 22, the FOMC cut the funds target rate by 75 basis points to a target level of 3.50 percent stating "a weakening economic outlook and increasing downside risks to growth." The committee was influenced by the sell-off in global equity markets on January 21 when the U.S. markets were closed for the Martin Luther King holiday. The Fed decided it was too dangerous to delay until the regularly scheduled meeting on January 29-30, as falling equity prices threatened to erode consumer confidence and impart a negative wealth effect on consumer spending. On January 30, the FOMC cut an additional 50 basis points to a new target rate of three percent. The accompanying statement was slightly less dovish than the one issued on January 22, but still left the easing bias in place: "...downside risks to growth remain. The committee will continue to assess the effects of financial and other developments

on economic prospects and will act in a timely manner, as needed, to address those risks."

The December unemployment rate jumped to a two-year high of 5.0 percent in December. Payrolls rose by 18,000, the least since August 2003, after a 15,000 revised gain in November that was larger than initially reported by 21,000. Service industries added 93,000 workers after gaining 160,000 in November, while retail employment declined by 24,300 after increasing 32,000 in November. Factory payrolls decreased by 31,000 after falling 13,000 a month earlier.

Existing home sales fell 2.2 percent in December to a 4.89 million unit annual pace on broad-based weakness. Although sales remain on a downtrend, home prices have not collapsed. The median price remained essentially unchanged during the month, leaving it down 6.0 percent on the year. Housing starts fell 14.2 percent in December to a 1.01 million unit annualized pace, the lowest since May 1991. In addition, single and multi-family permits fell in the latest month, suggesting no immediate turnaround in residential construction activity.

Consumer confidence continued to erode in January. The Conference Board index fell another 2.7 points to 87.9 and recorded its fifth decline in the last six months. The University of Michigan index slipped just over 2.0 points during the second half of January to 78.4, but remained above its December level.

On the inflation front, consumer prices (CPI) rose 0.3 percent on a 0.9 percent jump in energy prices, 0.1 percent gain in food and a 0.2 percent increase in the core. On a year-over-year basis, headline CPI inflation rose to 4.1 percent and continues to be buffeted by swings in energy prices. Core CPI inflation rose a much more benign 2.4 percent year over year, but appears in an uptrend, having accelerated by 0.3 percent over the last three months. Producer prices (PPI) unexpectedly fell 0.1 percent in December, as a 1.9 percent plunge in energy offset a 1.3 percent jump in food prices and a 0.2 percent gain in the core. On a year-over-year basis, the PPI rose 6.3 percent, but the core PPI rose a benign 2.0 percent and appears to be trending sideways.

Europe

Market Overview

At the European Central Bank's (ECB) January 10 council meeting, the refinance rate was left unchanged at four percent for the seventh consecutive time. There were no big shifts in stance either way, with the ECB still sounding hawkish. There were dovish comments made by Mr. Trichet which expressed concern for the economic situation in the U.S. and downside risks to European growth. However, these comments were offset by remarks from the ECB stating: "we are certainly not neutral." and "they remain ready to act preemptively if wage inflation picks up."

January was a roller coaster month for the credit markets. Spreads in term asset backed

securities tightened with especially good demand for Dutch and GBP RMBS. This did not last long, however, with credit spreads widening to all time highs on the combined events of weak bank earnings and mono-line insurer downgrades. Global equity markets collapsed with concerns over the wider implications these events may cause. On January 22, in an inter-meeting move, the Fed stepped in and slashed rates by 75 basis points in an effort to calm markets. The Fed then followed up with another 50 basis point cut on January 30 at its regularly scheduled meeting.

In short term markets, investors have been keen to put cash to work against the backdrop

of declining Libor rates due to the continued dual central bank support which relieved some funding tensions. Euribor levels have fallen 10 basis points in one month, 30 basis points in three months and 40 basis points in twelve months from year end. With mixed dovish comments on growth from certain ECB members, the Fed cutting 125 basis points and Trichet on the wires, but not changing his rhetoric, Euribor forward rates have been volatile (mostly to the downside) and now price in rate cuts for the first time.

There are already signs the European economy is weakening, which is likely to intensify. The property price declines in Spain and Ireland

Europe (continued)

may soon cause real pain and the increase in the value of the Euro will hit Europe's exporters. French consumer confidence is at a ten year low and European economic confidence is at a two year low. Consumer and industrial confidence declined, along with Euro area retail sales. M3 growth also declined below

expectations. The German economy however gives the ECB hawks ammunition with falling unemployment and an unexpected rise in the December IFO index which measures German Business Sentiment. Growth is now running below trend—which the ECB may tolerate to keep a lid on inflation—but still remains

elevated (yet stable) at 3.1 percent and a 1.9 percent core. All expectations are for inflation to ease in the later half of 2008. The market is also awaiting the outcome of unions demanding "mega wage deals" and an indication of whether the ECB will continue to fight inflation or start to look toward growth.

Canada

Market Overview

On January 22, the Bank of Canada lowered its target rate by 25 basis points to four percent, the second reduction in two months. The Bank also signaled it will act again to shield the economy from the threat of a recession in the U.S. with more cuts "in the near term."

The Canadian economy expanded in line with expectations of 0.1 percent, declining from October's value of 0.2 percent growth. Consumer demand continued to buoy the rest of the economy as retail sales expanded faster than expected to 0.7 percent (month-over-month). This was compared to expectations of 0.2 percent and the prior month's 0.1 percent result. Retail sales (less autos) also outperformed in November with results of 1.7 percent month-over-month compared to 0.4 percent. However, it appears the Canadian economy is still feeling some effects of the slowing U.S. economy and strengthening Canadian dollar.

The housing market took an abrupt turn in December as housing starts came to 187,500 units (annualized) compared to expectations

of 222,000 units and the prior month results of 227,900 units. Ontario seemed to be the largest impacted, but the effect was believed to be weather related as the province received higher than average snowfall. Single family homes saw a drop of 13 percent, while multiples fell 34 percent. Despite this, expectations are this is not the beginning of a trend as the factors driving the Canadian housing market are very different than those in the U.S. A commodities boom, low unemployment and increasing hourly wages are expected to keep this market level, if not growing.

The labor market in Canada took an unexpected downturn—losing the most jobs in just over four years—as worries increased that the Canadian economy was now being impacted by the U.S. slowdown. Employment data released for December showed the Canadian economy lost 18,700 jobs. This was particularly concerning given the fact that expectations were for an increase of 15,000 new jobs. These results were also poor compared to the prior month's results of an increase of 42,600 jobs. Again,

manufacturing was the hardest hit, losing 33,200 jobs for the month and bringing total losses for 2007 in the sector to 131,600 jobs. The unemployment rate however, was in line with expectations and the prior month's level of 5.9 percent.

Inflation seemed to subside in December as prices for various consumer goods fell. Month-over-month and year-over-year, the CPI was in line with expectations of 0.1 percent and 2.4 percent, respectively. Both dropped from the November results of 0.3 percent and 2.5 percent, respectively. The core rate—excluding volatile components like gasoline—actually declined more than expected, coming in at a 0.3 percent decline vs. a 0.1 percent expected decline. Some of this decline could be attributed to the strengthening Canadian dollar relative to the U.S. greenback, making imported goods cheaper. The Canadian dollar has appreciated 15 percent against the U.S. dollar in the past year, making various consumer goods like books, televisions and electronics cheaper than in the past.

Asia/Pacific

Market Overview

Japan

The Monetary Policy Board of the Bank of Japan (BoJ) left its overnight cash rate unchanged at 0.50 percent in January. The BoJ opined weaker construction will lower gross domestic product growth (GDP) to below the 1.5–2 percent trend in fiscal 2007, rather than the 1.8 percent pace projected last October. Officials continue to argue the “virtuous circle of production, income and spending remains basically intact,” confirming the BoJ’s desire to continue to raise rates.

December employment fell 40,000, however the decline follows an outsized 510,000 gain in November. The average work week plunged over two hours and the overall and new jobs-to-applicants ratios fell, with the latter remaining below 1.0 for the second consecutive month. The unemployment rate remained unchanged at 3.8 percent, only two ticks off the cyclical low hit last July. Industrial production rebounded 1.4 percent in December, as output continued to follow a saw-tooth pattern. The latest gain reflected

strength, in general, and export strength, in particular. On the inflation front, domestic corporate goods prices (DCGI) rose 0.4 percent in December. Manufacturing commodities rose just 0.2 percent and agricultural commodities jumped 2.8 percent. On a year-over-year basis, DCGI inflation accelerated another 0.2 to 2.6 percent. It has doubled over the last three months, providing some (limited) grounds for optimism on inflation. Consumer prices rose 0.2 percent in December largely because of a surge in oil prices. Excluding food and energy, the inflation rate is still negative, -0.1 percent year over year, and has only accelerated by 0.2 percent since September.

Australia

The Reserve Bank of Australia (RBA) did not have a meeting in January and thus, left its cash rate target at 6.75 percent. The next meeting is February 5.

During January, the economic data remained upbeat, signaling continued momentum. Employment rose 20,100 in December, meet-

ing expectations for another solid month of job creation. For 2007, employment rose just over 260,000, the 15th straight year of annual job growth and one of the stronger years this decade. Building approvals jumped 8.9 percent in November, the largest gain in nine months and permits are 14.6 percent above year earlier levels. Similarly, retail sales rose a stronger than expected 0.8 percent in November, the largest gain in three months. Consumer prices rose 0.9 percent in the final quarter of 2007 in line with expectations. Excluding volatile items such as fuel, the consumer price index (CPI) rose 1.0 percent quarter over quarter, matching the growth in the RBA’s preferred metric of central tendency in prices—the trimmed mean—which also rose 1.0 percent quarter over quarter. On a negative note, the Westpac consumer confidence index dropped 8.3 percent in January, the largest decline in 14 months. Although a sizeable drop, the metric is merely returning to its long term average.

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