

Global Market Watch

APRIL 2011 | Markus Schomer, CFA, Chief Economist

Overview

- Is the global recovery being threatened? Well, the economists at the International Monetary Fund (IMF) don't seem to think so. In its latest "World Economic Outlook" the IMF summarized, "[the] recovery has become more self-sustaining, risks of a double-dip recession in advanced economies have receded and global activity seems set to accelerate again." I guess the fund agrees with our assessment that the wave of crises won't derail the recovery so early in the new cycle.
- However, there is more to come. In the US, a government shutdown, which surely would have roiled financial markets, was averted at the last minute, but more battles over next year's budget and the debt ceiling loom. In Europe, the debt crisis continues to evolve; it is less a systemic problem now, but at least one of the bailed-out states, Greece, is believed to require more than "bridge financing." In Asia, policy makers have kept their calm and are fighting inflation at a fairly deliberate pace yet, monetary policy is a blunt instrument and continued rate hikes raise the risk of policy errors, something the global economy can't afford right now.
- Bottom line: we agree with the IMF that the global economic recovery remains on track, but financial markets are set to remain much more volatile this year than we had expected when we closed out 2010.

NORTH AMERICA

- In the US, it's all about "jobs vs oil." Most indicators still track the acceleration in employment over the past few months. Household employment, the jobs measure underlying the Unemployment Rate, has averaged 238,000 in the last four months, close to our forecast of a 250,000 average in the first half of the year. However, payroll data is lagging, showing a far less buoyant pace.
- Business surveys still show growing hiring intentions and job openings in February increased at the fastest rate in almost nine years. While new employment boosts personal income, rising gasoline prices are taking a bite out of that purchasing power increase. US Consumer Confidence and Retail Sales have disappointed in March, suggesting that the US economy is starting the year with much weaker momentum than we had expected.
- In fact, three months ago we were still looking for 4.25% real GDP growth in the first quarter. The data now suggests the economy is tracking closer to a much more muted 2.25%. If oil prices peak and the jobs recovery continues, our forecasts for the rest of the year should remain unaffected. The bullish investment case for the US remains intact, but it comes with a lot more volatility.
- We have been getting mixed signals from Canada with regards to the macro backdrop "north of the border." The IMF just raised its growth forecasts for Canada by the largest margin among the major global economies. Meanwhile, the latest Jobs showed a surprise decline in employment and a nudge up in the Unemployment Rate.
- Canadian equities have been lagging behind US stocks this year, yet when taking into account the strength of the Canadian dollar, which is up slightly more than 3.5% this year, Canada beat the US. In fact, the Bank of Canada specifically mentioned the strong Canadian dollar as a major headwind to domestic growth and one of the reasons the Bank has been on hold for the past six months. Headline inflation slowed again in February and the core index, excluding volatile food and energy prices, is heading back towards the lower end of the Bank's 1% to 3% inflation target zone. We are with the IMF and expect growth to rebound again in the coming months, especially if the Bank of Canada can remain on the sidelines.

EUROPE

- Clearly, the Euro Debt Crisis is not going away. Portugal became the third country to ask for financial assistance after government funding rates rose to unsustainable levels. The EU facilities set up to provide loans to countries experiencing liquidity crises have sufficient fire power to deal with another case. However, the speculation about "who is next" is likely to start pretty soon.
- The good news is the crisis is moving further away from a systemic event. Indeed, the credit default swaps (CDS) markets have shown Spanish risk spreads falling more than 100 basis points in the first quarter, whereas Greece, Ireland and Portugal are at or near all time highs. The main transmission channel from the periphery to the core is still the fragile European banking sector. The

European Central Bank's (ECB) decision to raise policy rates in early April hasn't helped to ease funding concerns and the result from yet another stress test are scheduled for publication at the end of the month.

- While the systemic risk is receding, the idiosyncratic risk in the bailed out countries is going the other way. "Debate Over Greek Debt Restructuring Shifts to Timing" wrote the *Wall Street Journal* recently, referring to a broad consensus among economists that default in Greece is inevitable. Even German Finance Minister Schaeuble referred to the possibility of such an event. If an EU report due in June shows that that Greece's debt level cannot be stabilized, he is quoted as saying, "other steps might need to be taken." What does that mean for investors? Euro zone fundamentals remain strong and the risk of contagion has decreased notably. However, the increasing likelihood of a sovereign debt restructuring in Greece will remain a significant source of market volatility.
- Inflation in the UK may have peaked, which would ease the pressure on the Bank of England to raise policy rates against a very weak domestic growth backdrop. The evidence for the latter is that the IMF downgraded its 2011 UK growth forecasts more than Japan's – though, to be fair, the IMF economists probably finalized their numbers right as the earthquake hit. *The Daily Telegraph* called the start of the 2011 tax year on April 6, which brought a wide array of tax increases, "Worse-off Wednesday." Consumer confidence already fell sharply in January as a VAT hike hit UK consumers; April's changes are mainly targeted at higher income earners. It's obvious, in our book, that UK GDP growth will trail the stronger euro zone economies for much of this year. Not surprisingly, UK stocks have underperformed the rest of Europe. However, sterling has remained remarkably strong vis-à-vis the dollar, such that the MSCI UK index in dollar terms is outperforming faster growing US, Canada and even China.

ASIA

- The first signs of the coming contraction in Japan are starting to show up in the flow of economic data. The March Purchasing Managers Index, equivalent to the ISM index in the US, fell back below the critical "50" level, and the Cabinet Office's "Economy Watcher Survey" reported a decline in March that was three times larger than the hit to confidence in September 2008. Many forecasters have slashed predictions for second quarter GDP growth following the earthquake disaster and the latest Bloomberg survey shows an average -1.7% forecast with a number of economists looking for declines closer to -4%. However, the anticipated rebuilding phase is likely to generate a significant growth spurt later in the year; the

same survey shows expectations of about 2% growth in the third and closer to 5% in the fourth quarter.

- Clearly, Japan's financial markets are going through a rollercoaster ride. Equities are down almost 10% since the beginning of March and bond yields are rising in anticipation of increased debt issuance to pay for the reconstruction. We have seen estimates ranging between US \$125 billion and US \$250 billion or between 3% and 6% of GDP. Undoubtedly, such a stimulus will boost economic activity for a while and should help turn Japanese stocks around. The Bank of Japan reacted quickly with another round of "Quantitative Easing" worth about US \$250 billion and adding a new program that allows the Bank to lend directly to corporate borrowers in the affected regions. Greatly increased liquidity, the prospects of a growth spurt as a result of reconstruction and the weaker Yen, courtesy of last month's G7 intervention, suggest we could see a sharp recovery in Japanese risk assets in the second half of the year.
- The rest of Asia is still battling inflationary pressures, mainly with tighter monetary policy. China increased lending and deposit rates again last month. Yet, inflation, which had stabilized for a few months, is still set to accelerate again in March and April. The good news is that food prices seem to have peaked and the combination of better harvests and Fed liquidity withdrawal hint at lower commodity prices, and with that slowing inflation pressures in the second half.
- Not all Asian central banks are moving in unison. The Bank of Korea left rates unchanged last month, whereas Taiwan's central bank raised rates again. In both cases, real policy rates are still negative, suggesting monetary policy has yet to adopt an outright tightening stance. A turn in the inflation cycle with generally still accommodative economic policy and strong economic growth suggests the bullish case for Asian equities is likely to return over the summer.

INVESTMENT STRATEGY

- Uncertainty abounds; against such a backdrop we maintain a more cautious view on risk assets. Yes, the outlook for equities is still quite strong, with improving macro trends and cheap valuations and our "Capital Markets Line" model shows not only an upward sloping, but also a convex relationship between risk and return. However, markets are extremely choppy right now and we expect that to remain the theme in the coming months. We are still bullish on the global growth trajectory, but the lack of fundamental progress in the US, the ongoing

policy tightening in Asia and the beginning of monetary stimulus withdrawal in Europe, while fiscal policy remains contractionary has diminished the outright prospects for stocks and supports a more balanced risk stance.

PineBridge Investments Global Growth Forecasts

	2011	2012	2013
Global	4.4	4.7	4.5
US	3.1	3.5	3.5
Eurozone	2.0	2.0	2.2
Japan	0.3	1.8	1.2
Developed Asia	5.1	5.5	6
Emerging Markets	6.9	6.8	6.5

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