Global Market Watch

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Overview

- A lot has happened in the global economic backdrop since our last edition. The result of the US mid-term election in early November will complicate decision making in the US even further and the Federal Reserve's QEII decision has brought much criticism and none of the intended financial market rewards.
- However, the dominating issue right now is once again, the European Sovereign Debt Crisis, which is the greatest threat to the fledgling global recovery; no wonder gold is currently trading at an all time high.
- Financial markets had a bad November, as investors took risk off the table in the face of increased uncertainty stemming from elections, debt crises and a flare up of military tension on the Korean Peninsula. The first few days of December though, have brought a strong rebound, suggesting the bullish macro fundamentals are regaining the upper hand.
- The MSCI World Equity Index lost 2.4% last month in US dollar terms, but has already regained more than that in the current month, with little differentiation between developed and emerging markets (DM and EM). Not surprisingly, Europe is trailing badly, while Japan and Canada were surprising outperformers. US government debt underperformed most other major sovereigns, with the exception of EM bonds, which were one of the biggest underperformers in the past six weeks.
- The Fed did not only fail to lower US bond yields, it also failed in its attempt to weaken the US dollar. The dollar gained significantly against its major trading partners since the start of November, as a result of safe haven flow, which regardless of the concerns about US fiscal policy, still flow this way. The Euro, yen and Swedish krona were the biggest losers, while currencies with rising policy rates, such as the Canadian and Australian dollars, posted gains in the past six weeks.

Americas

- The mid-term elections brought an end to activist-government stimulus policy in the US and the focus is quickly shifting to spending cuts and debt reduction. The biggest issue on the political docket, though, is the extension of the 2001/2003 tax cuts, which will test Congress' ability to compromise on one of the most pressing near-term issues.
- A second important governance test comes in the form of the President's nominally bi-partisan Fiscal Commission's report on how to deal with the country's long-term fiscal debt crisis.
- Failure on both fronts would greatly undermine confidence in the United States' ability to deal with any of the serious problems that will shape the credit-worthiness of the United States in the next few years. Some may disagree with the approach the European Union (EU) has chosen to deal with its fiscal crisis, but it is hard to fault the EU's ability to compromise and make tough decisions.
- Meanwhile, it is tough to understand why Federal Reserve chairman Ben Bernanke still believes that the US recovery may not be self-sustaining. Growth picked up more than expected in the third quarter and we are on course to reach a 3% rate as early as the current period, which would be well above the US economy's growth potential.
- Real consumer spending will exceed the pre-recession highs this quarter. Manufacturing output is expanding at a respectable pace and even housing is showing signs of life. What has been lagging is job creation. Yet, even here we saw an acceleration in the pace of private sector job growth between August and October, punctuated by a November payroll report that seemed very inconsistent with the rest of the data over the past few weeks. We continued to believe that QEII is unnecessary, largely unwanted (particularly among the new Tea Party Republicans) and is not working (10-year Treasury yields are up and the dollar is stronger since QEII started).

Europe

- It's hard to imagine Europe looking even more dichotomous than this year. The second chapter of the European Sovereign Debt Crisis, which started in May with Greece, now has Ireland as its central character. Burdened by heavy losses in a banking system that was allowed to grow to about five times the size of the Irish economy, the country's budget deficit this year is now expected to reach a whopping 25%.

- Predictably, the doomsayers are out in force, predicting the demise of the Euro and other, even nastier things. Meanwhile, the EU has not only put together a bailout package for Ireland, it is also working on a more systemic solution to prevent the spread to other debt-laden economies in the future. We continue to believe that this is not a systemic event, but an isolated problem in Greece, Ireland and possibly Portugal and will likely not go any further.
- What doesn't get enough attention is the positive growth story in the center of Europe. The greatest beneficiary of the market reaction to the Greek and Irish troubles is Germany. The competitive Euro has super-charged export growth which in turn, has brought about a rebound in job growth and domestic demand. Labor market conditions are tightening, which implies German wages will rise and the fruits of strong German growth will start to spread to neighboring economies.
- Strong growth is the best way to deal with the deficit crisis and we expect the Eurozone will manage about 2.3% growth next year. While not as much as the US economy, this is still significantly above what the consensus is predicting right now.
- The UK economy has escaped the limelight so far, proving that a credible fiscal exit plan matters. Meanwhile, it helps that the UK recovery has finally achieved take-off velocity in the second and third quarters of this year, after trailing the rest of the world earlier on. The key in the UK, like everywhere else, is job growth which slowed significantly over the summer and needs to pick-up steam in the coming months. The good news is that the most recent surveys of UK Purchasing Managers point in the direction of faster service sector and manufacturing activity.

Asia

- The Japanese yen may have lost a little ground in recent weeks after strengthening to an all time new record against the US dollar, but Japan remains the economy potentially most-impacted by the Fed's attempt to push down interest rates and the value of the dollar. The Bank of Japan increased its own Quantitative Easing program in recent months, yet Japan is a good example of the ineffectiveness of QE absent sufficiently stimulative fiscal policy. Even attempts to weaken the yen will be unsuccessful, as long as the Federal Reserve engages in the same type of policy easing. Japan's currency will only weaken once interest rate differentials start to widen again, but that requires rate increases in the US and in Europe, which are not in the cards anytime soon.
- In China the focus is less on monetary, but rather broader economic policy, which initially triggered a strong recovery through fiscal spending and government directed bank lending. Towards the end of last year the Chinese government started to take its foot off of the accelerator and tapped the brakes through a series of interest-rate and reserve-requirement hikes, which raised concerns of a more serious slowdown in the world's second largest economy. One of the most widely watched indicators of industrial activity in China, the PMI Manufacturing Index, seems to be giving the all-clear now after four consecutive monthly improvements. Monetary policy continues to tighten though. China's Central Committee which determines broad policy direction, indicated that the People's Bank of China's (PBoC) policy stance would move to "prudent" from "moderately loose," hinting at further policy normalization in the coming year.

Investment Strategy

- Despite the increased volatility in recent weeks, we have maintained the tilt towards risk in our portfolios. In an environment where the volatility emanates from what is usually the less risky portion of your portfolio – bonds – it is harder to reduce risk by moving between stocks and bonds. In fact, EM and DM stocks have performed similarly in the past few months, though EM is still up about twice as much as DM this year. Meanwhile, the Citigroup World Global Bond Index lost more than 3% in the past six weeks; US Treasuries lost about half that.
- Looking ahead to the start of the year, we still see a number of obstacles that need to be overcome before the bullish fundamental backdrop can reassert itself. In particular, the resolution of the pending expiration of past tax cuts in the US and the full implementation of a system-wide solution to Europe's debt troubles come with a serious probability of policy errors. However, the combination of productive and profitable corporate sectors in the US and other parts of the world, the high level of pent-up demand, the recovery in labor markets, low inflation and still fairly accommodative global monetary policy paint a very bullish outlook

for global equities next year. The recent increase in Treasuries notwithstanding, we don't expect too much upside for US government bond yields. The Fed will still be buying more than US $500 billion in Treasuries and inflation won't be an issue in 2011. Hence, a tilt toward risk in both equity and bond portfolios seems to be a good strategy to start the year with an eye on politics in Washington and Brussels.

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