

Global Market Watch

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Overview

- Financial markets swooned over the summer as investor confidence in the global recovery ebbed and flowed. One contributing factor is the growing divergence in global monetary and fiscal policies.
- China outright tightened policy last year to slow an already overheating economy and central banks in Australia and Canada have started to normalize policy rates. Others, most notably the Federal Reserve and the Bank of Japan (BOJ), are instituting further policy easing.
- On balance, funding rates for banks remain extremely low and the prospect of additional asset purchases will further ease already extremely accommodative liquidity conditions. While that was necessary a year ago to prevent a financial collapse, rebounding investor confidence is now starting to channel a growing portion of that emergency liquidity into global asset markets.
- Equities reacted with a strong rally in September, gaining almost 10% in US dollar terms, with emerging markets only marginally outperforming the larger developed indices. In fact, Asia, Latin America and Europe all enjoyed about the same stock market performance.
- A significant part of the international equity market performance resulted from stronger currencies versus the US dollar. The Euro, Australian dollar and Swedish krona were the best performers, while the 15-currency Trade-Weighted Dollar Index declined almost 4% last month.
- 10-year US Treasury yields were little changed in September, while government bond yields in other major economies pushed generally higher. Commodities also saw broad-based price increases; and not just in oil and gasoline prices, which jumped about 9%. Gold prices are setting new all-time highs, rising above US \$1,330 per ounce and most industrial and agricultural commodities trended higher as well, with many posting double digit price gains.
- The broad-based nature of last month's asset price rallies, in the face of continued concerns about the sustainability of the global recovery, suggests that central banks are certainly succeeding in fueling global asset price inflation.

Americas

- Despite anecdotal evidence of liquidity-driven asset price rallies, the Federal Reserve seems to be moving closer to implementing another round of "Quantitative Easing" (QE). The FOMC's latest policy statement noted that inflation was below levels that would be consistent with the Fed's mandate, implying that the bank is ready to increase its stimulus in order to boost the rate of inflation. However, subsequent speeches by senior Fed members hint at a lack of consensus within the committee, which may delay a decision on additional QE.
- In a recent speech, Chairman Ben Bernanke said that additional asset purchases should further ease financial conditions. While this is true, it is not clear if anyone actually believes that the main impediment to a faster economic recovery is the high price of credit. Banks already get all of the funding they want at quasi-zero cost, but rather than lending, they invest in financial assets. The Fed's actions are fueling a new "Race-to-the-Bottom" in the currency markets. In a low-inflation world, currency depreciation becomes a less-risky policy tool and it seems that this is what the Fed and the BOJ have in mind.
- Another country in the headlines this month is Brazil, which is facing crucial Presidential elections a few weeks from now. President Lula, whose two terms as Brazil's President started with much trepidation, but ended with

one of the best economic track records in the emerging market world, is looking to hand over the reins to Dilma Rousseff from his own Workers' Party. Rousseff won the first round in early October, but is facing a run-off at the end of the month. She is still the favorite and it is widely assumed that her victory would leave most of Lula's growth-oriented policies in place, which would strongly support a pro-EM stance.

Europe

- Senior European Central Bank (ECB) officials have frequently talked about possible strategies to reign in the current set of emergency monetary policy programs. In fact, the bank has replaced its main 12-month refinancing tender with shorter-term operations. However, the ECB still provides unlimited liquidity to Europe's banking sector and buys the government debt of weaker Eurozone member states under the guise of ensuring the smooth functioning of financial markets.
- Complicating the ECB's job are extremely divergent economic prospects within the Eurozone. Germany recorded 9% annualized GDP growth in the second quarter and its unemployment rate has fallen to a 16-year low. Meanwhile, Europe's debt crisis flared up again in Greece and Ireland in recent weeks. The Greek economy contracted again in 2Q as austerity

measures (and strikes) hit aggregate output, once again threatening the country's solvency. Meanwhile Ireland is facing a renewed liquidity crisis, as the cost of bank bailouts is swelling the country's budget deficit to a new record. The ECB may talk tough, but unless we see a more significant pick up in inflation, European monetary policy will remain extremely accommodative to give the "Irelands" throughout Europe more time.

Asia

- The thrust of economic policy in Japan is currency-focused, looking to stifling Yen strength. The Japanese currency fell to just ¥83 against the US dollar in early September, a level below which the yen has traded for only three days in 1995. As a result, the Bank of Japan intervened in the currency market for the first time in six years, in September and followed up with a set of new policy easing measures in early October.
- The bank's success rate in combating deflation is not ideal and current measures seem to lack the decisiveness needed to stimulate economic growth sufficiently to do so at this point. The impact on the yen is equally questionable, as long as the Federal Reserve engages in the same type of policy easing. Japan's currency will only weaken when interest-rate differentials start to widen again, requiring rate increases in the US and in Europe, which is unlikely to happen anytime soon.
- In China the focus is less on monetary policy, but 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 the foot off of the accelerator, tapping the brakes and raising concerns of a double-dip recession in the world's second largest economy.
- One of the most widely watched indicators of industrial activity, China's PMI index, seems to be signaling that all is clear now. The index has turned the corner in the past two months, suggesting that the Chinese economy is picking up speed again at the start of the fourth quarter.

Investment Strategy

- When looking at broad asset allocation, the shift towards more monetary easing in the US and Japan, coupled with our fairly constructive outlook for global economic growth next year, points to rapidly improving prospects for equity markets around the world.

- We have been long EM for a while and believe that is still the place to be. This is especially true in light of the new Fed policy that is likely to further weaken the US dollar. Abundant liquidity, low inflation and ongoing central bank commitments to keep rates near emergency lows suggest that government bonds will only face limited downside risk, which should provide a strong underpinning for global fixed income credit markets.
- How you want to benefit from the improving liquidity and growth backdrop depends on your time horizon. The US mid-term elections are still a formidable obstacle to improving consumer and business confidence. In Europe, the unresolved debt crisis is still a major source of potential market risk and the "soft landing" in China may have burdened the banking sector with a new wave of non-performing loans. However, if we are right and the second half slowdown is giving way to a gradual acceleration in economic growth towards the end of the year, then equities are the best way to participate in a possible liquidity driven asset price rally next year.

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