

# Global Market Watch

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## REVIEW

- AOne of my themes earlier this year was “Economics vs. Politics,” and that is still very much the case. The impact of the two major debt crises on financial markets is crowding out the effect of underlying macro trends. The inability to agree on comprehensive deficit reduction in the US and the inability to agree on a comprehensive bail-out package in the Eurozone are weighing on investor confidence and the economic outlook. The grand bargains – entitlement reform versus tax hikes in the US, and socialization of Eurozone debt versus German-style Fiscal Union in the Eurozone – inevitable in my view, have not been struck. We know what the endgame looks like; what we can’t see is the path to get there. Meanwhile, the third quarter GDP reporting season is in full swing and a couple of interesting trends are emerging. First, the US growth backdrop looks better than expected and the most recent data

points to further strength in the fourth quarter. Second, European growth did not deteriorate as much as feared, but the fundamentals point to more weakness at the turn of the year. Third, Asia’s smaller, more developed economies have seen sharp growth slowdown since the summer, while the larger, less developed economies have been better able to maintain a robust recovery momentum.

- Financial markets suggest investors are as divided over the outlook as are economists and political pundits. Hence, markets have been extremely volatile since the summer. Global equities staged a sharp rally in October; the MSCI World Free Index gained more than 10% in US dollar terms. However, in the first three weeks of November half those gains have eroded again, and for the year so far stocks are still down almost 11%. Emerging market equities continue

to underperform in down markets, having lost twice as much this year compared to developed markets. Despite the fact that sovereign debt crises are fueling the uncertainty, government bonds are still the best broad asset class, as evidenced by the Citi World Government Bond Index, which naturally lagged greatly behind stocks in October, but whose 8% year-to-date gain exceeds global equity returns by about 20 percentage points. Commodity prices are a mixed bag this month, with oil going against the trend and extending the price appreciation into November, while most other commodities posted lower prices. Finally, the US dollar lost ground during the October risk rally, but has regained much of that in the current month. In fact, year-to-date, the dollar is about flat measured against a tradeweighted basket of currencies.

## NORTH AMERICA

- The economic outlook for the US remains uncertain; just look at the two crosscurrents that we are seeing right now. On the one hand, the economy is improving – quite surprisingly in my view. Third quarter GDP growth accelerated to a 2.5% clip, Retail Sales excluding gas stations, autos, and housing increased at the fastest pace in eight months in October, and Housing Starts and Home Builder Confidence both improved towards the upper end of their post-recession ranges. All that suggests GDP could strengthen further in the current quarter. Countering the signs of improving economic fundamentals is the deteriorating tone of US politics. The “Super Committee” is unable to agree on another \$1.2 trillion in deficit cuts; this one is not a surprise to me. The committee’s failure will also prevent a quick deal on extending expiring fiscal stimulus measures in early 2012, which is still the main reason I have kept my US growth forecasts for the first half of next year well below the consensus. Even bigger risks loom in 2013, when automatic spending cuts and the possible expiration of the so-called “Bush Tax Cuts” threaten to push the economy back into recession.

Bottom line: In the near term, I remain quite bearish on the impact the US macro trends will have on financial markets and don’t see any real improvement until after the 2013 elections.

- It is fair to say that Canada has also experienced the peak in the most recent inflation cycle. The annual growth rate in headline inflation fell back below 3% in October, which opens the door wide for a possible rate cut by the Bank of Canada early next year. Canada has less room for error in monetary policy given the fact that the output gap has virtually disappeared and above trend growth is more likely to push up inflation in Canada compared to its developed market peers. Nevertheless, slower inflation allows the bank to weaken the Canadian dollar, which should offset some of the downturn in global export demand. Bottom line: Canada has the policy options to address the sources of weaker growth and should weather the current storm better than most developed countries.

## EUROPE

- The Eurozone Debt Crisis seemingly manages to get worse every month. In the latest chapter, the crisis is now fully engulfing Italy. Benchmark 10-year government bond yields have broken through the critical 7% level at which point Greece and Portugal had to ask for EU bail-outs. The crisis has forced out Italy's controversial Prime Minister Silvio Berlusconi, who has been replaced by a caretaker Prime Minister, who - similar to Greece - is a former EU official; I guess one could argue the EU is taking control of the political situation in its most seriously affected members. The debate about leveraging the European Financial Stability Facility ("EFSF") has proven to be irrelevant. The key question now is whether the European Central Bank (ECB) will step in and drive down sovereign bond yields in Italy and the rest of the EU periphery. Clearly the ECB is the most powerful institution in the Eurozone right now, evidently able to decide the fate of governments: defy the pressure to reform and unchecked market pressure will push you out of office. It's a dangerous game the ECB is playing; yet, to date, it has been able to control the pressure. What is still missing, though, is a broader vision of how to move towards a permanent solution. Bottom line: the Eurozone Debt Crisis as a source of volatility is not going away.
- GDP growth in the Eurozone held up fairly well in the third quarter, though at an annualized rate of 0.6%, it was hardly robust. On top of that, growth came almost entirely from Germany and France, which posted 2% and 1.6% annualized growth rates, respectively; excluding the two largest economies, the rest of the Eurozone saw GDP decline at a -0.7% rate. Across the Channel, the UK managed to grow at a surprisingly strong 2% rate last quarter, despite other reports showing falling real income, rising unemployment, and depressed consumer confidence. The UK may have avoided the market pressures that are sweeping through southern Europe. Yet, more austerity is in the cards that will keep growth near zero for the coming quarters. The Bank of England reacted to the deteriorating growth backdrop by increasing its asset purchase target, essentially going for QEII. The ECB was also in action last month, surprisingly cutting policy rates by a quarter point in Mario Draghi's first meeting; I incorrectly assumed he would wait at least one month into his term before reversing his predecessor's policy. Here is one of our off-consensus macro calls: watch out for more policy easing in the Eurozone and the UK once attention shifts to the weaker growth momentum in 2012.

## ASIA

- One of our key macro convictions is a turn in the global inflation cycle and the resulting prospects of further monetary easing. We are still only at the start of the trend, but as China, Singapore, and South Korea, three major Asian economies, reporting slower CPI inflation, and with GDP growth down significantly from the first half of the year, further reductions in headline inflation are likely. The only Asian rate cuts so far have come from Thailand, which is battling a major natural catastrophe, and Indonesia. Developed Asian central banks have so far refrained from rate cuts, but we expect that to change as we head into 2012.
- I know some people don't like the expression, but China remains on track for a "Soft Landing." Growth is slowing, driven by weaker exports and the domestic housing market. The country's PMI indices continue to show robust domestic service sector activity, but a fairly stagnant manufacturing sector. It appears the government has halted the renminbi appreciation again, amidst the growing financial markets volatility, which should help exporters. However, the main reason to remain unconcerned about weaker growth in China is the government's ability to turn on the credit taps and stimulate housing and fixed investment. Question about China's ability to turn off the taps will increase scrutiny of China's growing shadow banking system in the future. It's time the government started to reign in off balance sheet lending. Bottom line: For the time being, China is a source of stability in the region, able to sustain domestic demand despite weaker growth in the US and in Europe.
- Third quarter GDP reports confirmed the weak growth momentum in the developed Asian economies, but it quelled the risk of a regional recession, instead showing a moderate pickup in the recovery momentum. South Korea looked the strongest, posting a 3% growth rate, Hong Kong and Singapore reversed declining growth during the second quarter, while Taiwan's economy suffered a 2.7% annualized drop in GDP growth. Weaker growth should accelerate the slowdown in inflation and open the door for policy easing next year.

## INVESTMENT STRATEGY

- Successful asset allocation depends on correctly synthesizing micro and macro analysis. Our more optimistic bottom up view has prevented us from falling into a bear trap by underweighting global equities over the summer. Our more pessimistic top down analysis is now holding us back from potentially embracing the next bull market too early. We remain very much in a trading market, which makes it hard to adopt a strategic risk-on or risk-off position in our portfolios. However, there are three themes that drive our current portfolio allocations. First, we still prefer regions with superior growth prospects; hence, in our global equity strategies we remain overweight to emerging market equities, which have greatly underperformed developed markets this year and are now attractively valued. Second, we still like the bullish US corporate sector fundamentals, evidenced by strong productivity and profitability; hence, in our global credit strategies, we remain overweight US corporate credit. Third, our main concern right now is not a global recession, but a further deterioration in global market liquidity, especially as we approach year-end; hence, we have reduced risk especially in our fixed income strategies by lowering exposure to less liquid high yield bonds in favor of more liquid investment grade corporates.



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