

Global Market Watch

SEPTEMBER 2010 | Markus Schomer, CFA, Chief Economist

Overview

- In August, investors downgraded growth expectations for the US, worried about China, and marveled somewhat disbelievingly at the stellar second-quarter growth performance in Europe, but September already has a decidedly different feeling.
- US economic data has surprised on the upside, albeit fairly mildly, Japan is once again facing a severe political crisis and the early summer growth spurt in Europe is losing steam as we enter the third quarter. In addition, China has managed a soft landing and is starting to rebound from its policy induced slowdown.
- Politics will be moving to center stage in the US in the coming weeks, with potentially game-changing mid-term elections on the calendar in November. Also, President Lula of Brazil will hand over the reins of one of the key emerging market economies to a new administration in October.
- Financial markets have reflected the mood change by reversing the August sell-off of risk assets in the early days of September. Global equities are up 5% in just the first week of the month, after losing 3.9% in August. Developed markets, the source of many growth concerns, have fared much worse than emerging markets, but are now outperforming as risk appetite returns.
- Performance across regional equity markets was quite similar, reflecting the general swing in risk appetite, rather than specific macro drivers. Currency markets confirm the recovery in global growth expectations.
- The Australian and Canadian dollars, the Swedish krona and most major EM currencies, all appreciated against the US dollar in early September, after losing ground in August. The Japanese yen is unchanged so far this month, despite its lack of correlation with general investor risk appetite.

North America

- The most recent data flow in the US has surprised on the upside, which should put to rest concerns that the US economy may be facing a double-dip recession. Businesses continued to hire through the current slowdown, supporting our view that payrolls were slashed well in excess of typical employment losses during past recessions. Manufacturing, which had been a key early driver of the recovery, also posted better numbers in August, suggesting activity might not slow much further.
- Even housing data is mildly encouraging. Applications for new home purchases have increased steadily since bottoming in early July, which points to gradually increasing home sales in the coming months. We have not changed our forecasts of below-two-percent growth in the second half of this year, but evidence thus far points to growing upside pressure on those numbers.
- The Federal Reserve, at its last FOMC meeting, announced that maturing bonds from its earlier asset purchase program would be reinvested to prevent shrinking the bank's balance sheet – and with it US money supply – prematurely. This does not really qualify as further easing, but it does show that the Fed intends to, at least, maintain the current level of stimulus, despite four consecutive quarters of economic growth.
- Across the border in Canada, the Central Bank raised rates for the third time since June, and the rate now stands at 1%. Canada has much better domestic demand conditions, but its strong trade linkages with the US puts

pressure on its decisions with regard to the Canadian dollar. So far, currency appreciation has been surprisingly subdued, despite the rate increases, but the Bank of Canada will be weary to push its luck. We do not expect another rate increase this month and feel encouraged by the bank's statement, which basically shut the door on further rate increases this year,

Europe

- The Eurozone's outlook is still glowing from its stellar second quarter performance. However, that pace is clearly unsustainable and growth will likely slow down in the second half. The European Central Bank (ECB) raised its 2010 forecasts substantially, reflecting the growth surprise in the second quarter, but lifted 2011 assumptions only marginally. Orders and exports in Germany moderated in July, suggesting that slower global growth and a rebound in the Euro are combining to push the recovery pace back to trend.
- In addition, news that the new "Basel III" capital requirements could force European banks to raise another US \$150 billion in new capital, raises concerns about whether the European banking system is ready to support a stronger recovery. Not surprisingly, while the ECB talks exit strategy, its actions are still focused on providing liquidity, as evidenced by the three-month extension of its unlimited repo operations. A moderation in Eurozone growth will close the gap between the region and the US.

- Growth in the UK finally rebounded convincingly in the second quarter, but surveys of manufacturing and service sector activity continue to lag behind Eurozone trends in general and look far less dynamic compared to the boom in Germany. The pace of decline in UK unemployment has slowed significantly in recent months and may pose a new threat to growth in the second half.
- Meanwhile, the Bank of England has remained very much on the sidelines this year, yet pressure may be building to add another round of “Quantitative Easing” similar to actions already taken in Japan. The UK economy is likely to remain a laggard in the developed world in the second half.

Asia

- The current political uncertainty about the continuation of the current administration in Japan is coming to a head this month. Barely a year after its historic election victory, the ruling Democratic Party of Japan (DPJ) has already switched Prime Ministers once and may do so again, if current incumbent Naoto Kan loses a party leadership challenge in mid-September. Political turmoil is nothing new for Japan, but the prospect of a significant change in policy as a result of a new administration could change the outlook for Japan.
- Even if Japan’s current prime minister can hold on to power, it is likely he will be forced to adopt some of the more radical ideas his challenger, Ichiro Ozawa, has pledged to implement, including massive debt-financed fiscal stimulus spending and intervention in the currency markets to weaken the yen. This could all have a significant impact on other financial markets, so we will watch out for potential policy announcements in the second half of the month.
- A few months ago, investors looked with some degree of concern at a steady stream of economic data pointing to a significant slowdown in China’s growth momentum. The best indicator of the pace of activity, in what is now officially the second largest economy in the world, is the Manufacturing Purchasing Managers Index, which, after peaking in December of last year, declined to within a hair of the critical “50%” expansion/contraction threshold in July. The index perked up again in August, suggesting that production will continue to expand in the second half. Even more encouraging is the fact that service sector activity is still running well above the previous three-year average, suggesting that consumer spending

is holding up well in this recovery, which should provide a solid underpinning for strong economic growth in China for the next few years.

Investment Strategy

- The main theme of our recent strategy meeting was reducing risk without adopting too bearish a view. We never subscribed to the double-dip case and saw the current slowdown as a natural reaction to very strong growth at the end of last year and early in 2010. In our strategies, we reflected that view through reduced overweights in emerging market equities and high yield credit. We are already looking ahead and expect upside economic surprises to continue. Hence we are likely to maintain the current risk postures in our portfolios for now.
- Low inflation, uncertainty about US politics, and the massive liquidity overhang should prevent a significant increase in Treasury yields, allowing credit markets to maintain their attractiveness. However, with 2011 prospects brightening, more forward-looking equity markets are becoming interesting. Depending on your time horizon, it may be worth dipping your toes back into the stock market with an eye on stronger recovery in 2011.

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