PINEBRIDGE INVESTMENTS

Global Market Watch

MARCH 2010 | Markus Schomer, *Chief Economist*

Overview

- One of the key themes in our global outlook is the change in economic policy in Europe and the US, which includes a shift to tighter fiscal policy and a longer period of extremely accommodative monetary policy.
- The policy change is more involuntary in Europe, with Ireland, Greece and Spain – among others – forced to implement dramatic spending cuts to keep up with more fiscally sound Germany and France.
- The discourse here in the US has also turned sharply in the direction of an earlier withdrawing of fiscal support, while the actions of the Federal Reserve suggest it is willing to maintain the current, extremely loose policy stance for a while longer.
- The biggest implication of the shift in policy is a downgrade in growth expectations for developed economies, which are already lagging behind their emerging market counterparts.
- JP Morgan published some handy numbers in one of their recent research pieces, pointing out that the US has rebounded just 2% from its recent cycle low, and Europe has posted a barely noticeable 0.5% increase, so far.
- Meanwhile, emerging economies, including China, have already seen an 18% increase in economic activity from the bottom.
- Equity markets posted a tentative rebound last month after a very weak start to the year. Global equities measured in US dollars were up just over 1%, with developed regions outperforming emerging markets, proving that investors remain fairly risk averse.
- The US actually fared much better than the average, which was weighed down by continued declines in Europe, where markets are off almost 7% so far this year.
- 10-year US Treasury yields were little changed last month, while Eurozone and Japanese bond yields fell slightly, widening the yield difference between the US and the other two major government bond markets. The US dollar enjoyed another fairly good month, gaining a bit more than 1% against a basket of six key global currencies.
- The main losers in February were European currencies, lead by a 5% drop in the British pound. Meanwhile, the Japanese yen and both the Canadian and Australian dollar appreciated slightly compared to the US currency.

North America

- The current winter weather is throwing economists a major curve ball. We have seen a number of indicators showing surprise deterioration in activity at the start of the year, but it is hard to say how much of that is weather-related, as opposed to a true slowdown in recovery momentum.
- The US economy did grow at an annualized rate of 5.9% in the fourth quarter, yet almost two thirds of that was accounted for by a slower decline – not an increase – in inventories. The pace of growth in domestic final sales (GDP minus inventories and net exports) actually slowed last quarter.
- The Fed seems in no hurry to normalize interest rates, despite the fact that its extremely accommodative monetary policy is doing very little to stimulate growth. Bank profits are surging, but due to financial investments, not lending activity. In addition, the US government is hamstrung by the populist surge against fiscal deficits.
- All we can look forward to now is a modest rebound in job growth, which should bolster consumer spending, but is unlikely to trigger a new boom in consumption. Hence, we continue to look for a second-half slowdown, when many of the initial growth stimulants fade.
- We wonder whether Canada will experience an additional economic boost in the first quarter after successfully hosting the XXI Winter Olympics. If nothing else, winning the hockey gold medal in dramatic fashion on the last day should boost Canadian consumer confidence.
- Already, the economy posted a much-stronger-than-expected rebound in GDP growth in the fourth quarter. And here, we have no qualms with Canada's reported 5% annualized growth rate. Inventories and net exports accounted for just 0.4 percentage points, leaving real final sales growing at a very impressive 4.6%.
- In fact, Canada's disappointing 0.9% growth rate in the third quarter already masked a strong recovery in domestic demand, which increased at a very robust 4% annualized rate in the second half of last year.
- A key driver of the strong rebound up north is a much earlier turnaround in employment, which bottomed last July. Since then, the Canadian economy has created the

US equivalent of over 1 million new jobs. It's no surprise that domestic consumption is one of the key drivers of the recovery.

Europe

- The main story in Europe is still the fiscal debt crisis engulfing Greece. An attempt by the Greek government to access the bond market last month had to be postponed, and EU officials are pressuring Greece to commit to further deficit reduction. However, in the last few weeks Greece has committed to dramatic cuts in public spending and sharp increases in taxation, while in Brussels everything is on the table, from direct guarantees of Greek debt issuance to credit lines between governments. The political process of implementing the deficit reduction measures will surely generate further negative headlines, but the political establishment in Greece knows that there are no alternatives.

- Meanwhile, first-quarter GDP growth in the Eurozone ground to a halt again in the fourth quarter of last year after a tentative rebound in the third quarter. France was the only bright spot, with growth accelerating into year-end. However, Germany produced no growth, the Italian economy contracted again, and Spain has yet to emerge from the recession, which stretched into its seventh quarter there.

- The recovery momentum across the Channel in the UK remains fairly anemic, too. The economy finally produced positive economic growth in the fourth quarter, but the 1.1% annualized increase in real GDP was entirely due to inventories. In fact, final sales (GDP minus inventories) declined 0.7% in the fourth quarter, after no change in the prior period.

- Purchasing Managers Indices (PMIs) in the UK paint a more constructive picture. The manufacturing index has rebounded to about the same level as the US equivalent, while the service sector index stands at the highest level since the start of 2007. Eurozone PMIs are less bullish, but also point to a faster growth momentum compared to the national accounts. The EU's strict focus on budget deficits is taking further fiscal stimulus measures out of the equation, leaving monetary policy to carry most of the burden of stimulating the economy.

- We expect the European Central Bank (ECB) will not raise rates at all this year, given the deflationary fiscal policy and the virtually zero percent broad money supply growth. The only bright spots in the European outlook are the weakening currencies in the Eurozone, the UK and other peripheral European economies, which could provide a stronger export boost.

Asia

- We remain extremely bearish on Japan's macro prospects. The long-run fiscal outlook is dire, and I believe this is a crash waiting to happen. Even the current economic prospects are much worse than the headline data suggest.

- Take Japan's fourth-quarter GDP report, for example. At first glance, 4.6% GDP growth looks great and is not far off the growth pace here in the US. However, reminiscent of the 1990s, almost all the real growth can be attributed to falling prices. Nominal GDP -- which is what company sales and earnings are based on – increased at a much less impressive annualized rate of 0.9%, and that was the first increase in seven quarters.

- Japan's economy today is about the same size it was in 1991 and down about 8.5% from its peak in 1997. Falling nominal growth means falling nominal tax revenues against a backdrop of a debt-to-GDP ratio of more than 200%. While this is a recipe for disaster in the long run, Japanese exporters can do very well in this environment. They sell to the global market, which grows at a much faster rate than the domestic economy, while deflation at home means falling unit labor cost, relative to their international competitors.

- Japanese companies and the stock markets they trade in can perform fairly well, despite the gloomy Japan macro view. As long as one is aware of the slowly simmering domestic crisis, Japan can be an attractive investment, especially in an environment where traditional growth markets, such as the US and emerging markets, are trading sideways.

- Meanwhile across the South China Sea, policymakers in the soon-to-be second- largest economy in the world are starting to remove last year's highly successful policy stimulus. Beijing is lowering bank-lending targets, and the Bank of China has raised bank reserve requirements, all in an effort to cool down excessive investment growth.

- China's inflation is expected to reach 5% to 6% by the middle of the year – too much for the government's liking – which may trigger a resumption in the managed Renminbi appreciation compared to the US dollar. Such a move would also help other Asian economies that are thinking about normalizing interest rates, but are unwilling to absorb the impact of a strengthening currency.

- China's monetary policy is now attracting almost as much attention as the Fed's policy announcements, and one of the key investment risks for this year is whether China's policymakers can engineer a soft landing after the strong growth spurt at the start of the year. The most important indicator to watch is the Chinese Consumer Price Index (CPI). The faster it increases, the more drastic the policy response will be, and the greater the risk that policymakers may overdo the tightening.

Investment Strategy

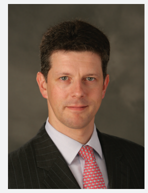
- We dialed down the risk posture in our portfolios at the end of last year, correctly expecting a more difficult period for risk assets. While emerging markets continued to lose ground to the bigger developed markets, we believe the better long-term economic prospects and the lack of fiscal deficit overhang ought to generate stronger growth, especially in Asia and Latin America.

- We remain slightly underweight Europe, given the unresolved fiscal crisis and the greater deflationary impact of tighter fiscal policy. Finally, we have increased our exposure to Japan, not as a long-term investment, but taking advantage of the Japan's competitive exporters and the fact that many global investors are severely underweight Japanese equities.

- In our fixed income strategies, we maintain a fairly neutral duration stance, though the outlook of a less vigorous recovery and the Fed's commitment to keeping policy rates at record lows reduces the risk of rising long-term Treasury yields. We see the latter range-bound for most of the year, probably peaking over the summer and trending lower again during a period of slower growth in the second half. In fact, we believe an eventual increase in the Fed Funds rate could flatten the Treasury yield curve, if the bank successfully sells such a move as a pre-emptive strike against rising inflation expectations.

- Our preferences among the major government bond markets have seen very little changes in recent months. Eurozone and Japanese government bonds should continue to outperform the US, while the UK may already be feeling the colder winds of covering a large budget deficit without the support of a major currency union, and is paying for it with rising bond yields.

- Finally, policy-rate expectations should continue to dominate currency trends in the near term. We still see the Fed move well before the ECB, while the Bank of Japan surely cannot contemplate a move in policy rates in the foreseeable future. Hence, the US dollar should remain well-supported this year and continue its gradual come-back.



Markus Schomer, Global Economic Strategist for PineBridge Investments, is responsible for providing macro-economic forecasts, analysis and commentary for all PineBridge Investments groups, with a focus on global economic trends and their impact on financial markets. He holds degrees in Economics from the University of Bonn in Germany and the University of East Anglia, in the UK. He also studied at the London School of Economics and is a Chartered Financial Analyst.