

# Global Market Watch

MAY 2010 | Markus Schomer, CFA, Chief Economist

## Overview

- Dark clouds are weighing on the economic backdrop for global financial markets. Stocks swooned sharply at the end of April, driven by fears of contagion from the Greek fiscal crisis, and there are concerns the Chinese government may be hitting the brakes too hard in trying to cool its red-hot economy.
- Add to that the devastating oil spill in the Gulf of Mexico, which may not have an immediate economic impact (unlike hurricane Katrina), yet could increase upward pressure on oil prices by virtually eliminating the chances of increasing off-shore oil production in the US.
- We have argued for a while that equity markets looked overly exuberant. Stock investors need a steady diet of good news day-by-day and evidently remain highly sensitive to event risk emanating from any corner of the world.
- Financial markets experienced a violent swing in risk appetite last month. Global equities lost more than 5% in US dollar terms since the middle of April. The decline was led by Europe, which lost more than 10% during that time. There was not much difference between developed and emerging markets, supporting our claim the sell-off is mainly driven by broad, indiscriminate risk reduction.
- The main beneficiaries of greater risk aversion among equity investors were, of course, government bond markets. The yield on 10-year Treasuries rallied almost 30 basis points since the middle of April, reaching the lower end of the 3.5% to 4% trading range that has held since mid-December.
- The fact that Treasuries outperformed most other government bond markets is more evidence of the flight-to-quality argument and should allay fears that the US may lose its role as a safe haven for capital flows in times of crisis.
- April wiped out all of the gains in global equities for the year, so far. However, in the fixed income credit markets, US High Yield produced the 14th consecutive monthly gain in April, pushing its year-to-date return to 7%. Last month we wrote that stocks had now moved decisively ahead of credit. Yet April reminded us of the greater volatility in equity markets.
- Finally, and not surprisingly, the US dollar continued to strengthen compared to other major developed world currencies. The DXY dollar index jumped 4% since mid-April, and is up almost 8% for the year so far.
- Among the major currencies, the euro is facing the biggest downward pressures. Europe's common currency has lost 10% since the start of 2010 and broke through the critical US \$1.30 level for the first time in a year. I suspect we are nowhere near the bottom in the euro/dollar exchange rate.

## North America

- While event risk is clearly rising aboard, the US is enjoying the sweet spot of the currency recovery. The economy just recorded a third consecutive quarter of growth, manufacturing activity indicators show the industry is booming, exports are growing rapidly, and the strength in consumer spending is surprising many economists.
- However, we continue to believe this picture overstates the strength of the recovery. Too much it is still based on a rebound in inventories, which will fade over the summer. In fact, while real GDP growth in the past three quarters is running slightly ahead of the average recovery in the previous six business cycles, domestic demand – consumption, investment and government spending – is growing well below the typical recovery pace.
- Perhaps the Federal Reserve is looking at the same issue. How else to explain the fact that the FOMC still believes economic conditions are so weak that they warrant exceptionally low interest rates for an extended period? Therefore, rates won't rise from the current quasi-zero level for at least another six months.
- The crucial piece in the recovery story is still the jobs market. In the past two recoveries, employment didn't pick up until a year after the end of the recession. As a result, growth rates during the initial phase of the recovery remained well below average. This recovery is so far somewhere between the jobless, slow-growth recoveries of the early '90s and '00s, and the job-rich, strong growth recoveries of the '70s and '80s.
- The hiring behavior of US businesses is probably the most important area economists are focusing on right now. I believe we will see steady job growth in the coming months, but at a much less buoyant pace compared to the job-rich recoveries of the past.

## Europe

- Europe is dominated right now by the growing fiscal crisis in Greece and the threat of contagion to other European economies. The fact that concerns didn't subside with Greece's bailout reflects doubts whether the country can implement the drastic cuts in government spending the eurozone and the IMF are demanding. The US \$147 billion bailout should lay to rest any immediate solvency issues.
- However, the risk remains that Portugal and Spain may be next to face a liquidity crisis. A lot will depend on credible deficit-reduction plans. I think Spain has addressed its fiscal problems aggressively enough that a bailout can be avoided. Portugal, however, has suffered under the deflationary consequences of tight fiscal policies for seven years prior to the recession averaging just 0.8% growth per year during that time. It seems unlikely that further fiscal tightening will eventually restore the country's competitiveness, which raises the probability that Portugal may need a bailout, too.
- With market attention focused on the fiscal crisis, the improving economic backdrop has almost gone unnoticed. It is most evident in manufacturing surveys, which show that Europe is clearly participating in the business-spending rebound around the world. Germany is the biggest beneficiary, but even the UK has seen a sharp acceleration in manufacturing activity, which should boost the current, fairly anemic recovery pace.
- Two key elections are on the docket this month in Europe, which may have a significant market impact. The UK is electing a new parliament in early May, and, for the first time since 1974, is looking at the potential of a coalition government with all the instabilities that come along with it.
- Meanwhile in Germany, the ruling center-right coalition is facing defeat in a key state election, which could severely restrict the government's ability to push through Parliament further economic reforms. We expect both events will weigh on Europe's recovery prospects in the coming months.

## Asia

- Japan continues to improve on our internal watch list. We are still quite bearish on the country's long-term prospects, given the perilous state of Japan's public finances. Yet, the booming Asian economies have clearly lifted Japan out of its initially very lethargic recovery and stimulated a strong rebound in production and even household spending.

- Real GDP has been growing at an annualized rate of 3.2% in the three quarters through year-end, yet falling prices have masked a much weaker trend in nominal activity, which declined at a 0.3% rate during the same time. Deflation is still a problem, but the trend is improving, and the pick-up in household spending should help boost nominal GDP growth in the first half of the year.
- If that's not enough, the Bank of Japan is still easing monetary policy, just recently increasing the amount of liquidity provided to the banking system through its regular open market operations. The main result of this could be a further reduction in Japan's interbank rates and possibly a weaker yen, which would add more fire to Japan's export sectors. Clearly, the outlook for Japan is improving.
- It seems China is as much a source of concern for global equity investors these days than Greece, but the emphasis here is not on past mistakes as in Greece's case, but the risk of future policy errors. The problem: Real GDP growth jumped to an annual rate of 11.9% in the first quarter, inflation in the producer sector is running well above 10%, and the most recent data on house prices showed the nationwide trend rising above the government's target of 10%.
- In response, China central banks raised the reserve requirement – the amount of funds banks need to keep with the People's Bank of China (PBoC) – for the second time this year. Most economists now expect a rate increase over the summer and possibly a resumption of the managed renminbi appreciation compared to the US dollar.
- The risk here is that authorities will overdo it and cool the economy too much at a time when the global recovery still depends crucially on China. We personally think such fears are overdone, and the government is well aware of the risk of slowing growth too much. However, fine tuning an economy is not easy, and the risk must not be underestimated. At the end of the day, this is another reason why investors are skittish about risk assets.

## Investment Strategy

- Changes in risk appetite are the key driver of the current global financial market volatility. Stock markets seem caught between improving economic conditions, surging corporate profits, extremely accommodative monetary policies around the world and the specter of another financial crisis. This time the situation has been triggered by overleveraged sovereigns, and a more serious slowdown in China as a result of policy tightening there.

- Against this backdrop, we continue to reduce risk in our balanced portfolios, where we still carry an albeit small equity overweight. Within equities, though, we maintain a more defensive bias with our overweight in Japan balanced by an underweight in Europe. Naturally, we wished those positions would have been bigger, but the 16-point performance differential so far this year between the two markets validates the bold Japan call our equity team made in January.

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