

# Global Market Watch

MAY 2010 | Markus Schomer, CFA, Chief Economist

## Overview

- What we described last month as “dark clouds appearing over the global economy” developed into a full-fledged storm in May. The fiscal problems in Europe spread from Greece to the rest of the eurozone and are now hitting profligate sovereigns in Eastern Europe.
- In addition, a string of political crises weighed on investor sentiment last month. Japan’s Prime Minister resigned after less than nine months in office. In Thailand, the army violently ended a siege by anti-government demonstrators in the heart of Bangkok, and in Germany the country’s largely ceremonial President abruptly resigned from office, further weakening the ruling center-right coalition.
- These developments come at a time when government intervention is still critically needed to put the fledgling global recovery on more solid footing. So it shouldn’t be surprising to see investors question the underlying economic growth assumptions.
- Global equity markets dropped almost 10% last month, and the slide continued in the first week of June. Year-to-date, stocks are down more than 10% in US dollar terms, with both developed and emerging markets posting matching declines. Japan significantly outperformed Europe, validating our regional equity market bets. The worst-performing region was Australia/New Zealand, a clear financial-market vote against the global growth story.
- Government bonds were the beneficiaries of the dramatic equity market sell-off, with 10-year Treasury yields falling to 3.14%, their lowest level in more than a year.
- Clear evidence of the flight to safety is the fact that US Treasuries outperformed all other government bond markets — with the exception of the eurozone — where spreads between US and EU government bonds widened marginally in the past six weeks. Global fixed income credit markets also suffered losses in May and early June, although these asset classes have greatly outperformed stocks since the start of the year.
- Commodities are another asset class hit hard by doubts regarding the global recovery momentum. The Goldman Sachs’ Commodities Index (GSCI) lost almost 15% in the last five weeks, and the CRB Index is down about 10%. Oil was one of the bigger losers, down almost 20% since the end of April, while on the other end of the spectrum, gold prices surged to a new record high of US \$1,240 in early June.
- Finally, the market turmoil continues to benefit the US dollar, which has gained more than 13% so far this year against a basket of six major developed world currencies (DXY). Not surprisingly, the euro continued to slide, falling through US \$1.20 for the first time in more than four years. A bigger surprise was the weakness of the Australian dollar, which underperformed even the euro in the past five weeks. This is more evidence that investors are not only fleeing the fiscal crisis in Europe, but are also re-evaluating the global growth story.

## North America

- The price action in the US equity markets in recent weeks seems to suggest investors believe the recovery here is in serious trouble, and the chances of a double-dip recession are growing. Indeed, there is some evidence now that the initial recovery momentum is easing and that the second-half slowdown we have been discussing for awhile is looking more likely.
- Private-sector job growth slowed considerably in May; a month where temporary government hiring for the 2010 census distorted the overall employment picture.

In addition, housing sales are about to decline again, following the expiration of the “First-Time-Home-Buyer Credit” at the end of April.

- The renewed layoffs in the construction sector in May that followed two months of rising construction employment may be the first sign home builders are bracing for another sharp decline in activity. Exports contributed about 1.7% to real GDP growth during the three recovery quarters more than twice as much as business investment; about the same as private consumption; and only marginally less than the inventory

rebound. However, the problems in the eurozone, the slowdown in China and the stronger US dollar point to weaker export demand in the coming months.

- Another problem on the horizon is the expiration of the “Bush tax cuts” in 2011, which, if left unchanged, will raise the top marginal income tax rate, as well as taxes on dividends and capital gains.
- It seems the US may face automatic fiscal retrenchment, unless the administration acts to extend the tax-cut sunset provision. The prospect of rising taxes in 2011 is probably the biggest risk the US economy is facing right now, especially since it’s a new threat that households, businesses, and investors haven’t fully considered yet.
- Having listed a plethora of problems, we still do not foresee a double-dip recession happening in the US. Housing demand will likely resume its upward trend later this year. Unemployment will probably fall only gradually, but we expect about 2 million new jobs will have been created by the end of the year, which should support the continued expansion in consumer spending.
- Finally, businesses are sitting on a mountain of cash that will slowly revive investment spending. We see US GDP growth slowing to 2.3% next year, but accelerating again to 2.8% in 2012. If the economy can avoid another recession, the coming slowdown should merely extend the current sideways-trending market into the second half of the year, rather than marking the start of a new bear market.
- The macro backdrop in Canada is looking much better. The economy there expanded at an annualized rate of 6.1% in the first quarter, and most of the growth was driven by domestic demand (i.e., consumption, investment and government spending).
- Over the past three quarters, growth in domestic demand averaged 5%, compared to just 1.9% in the US. One of the main differences is the strong employment growth Canada is enjoying. Almost three quarters of the jobs lost during the recession have been recouped, compared to just over 10% in the US.
- The strength of the Canadian economy has forced the Bank of Canada to abandon its “Shadow the Fed” policy and start the process of policy-rate normalization. However, it balanced its June rate hike with a very dovish

statement, stressing the uneven global recovery, the dependence on monetary and fiscal stimulus in many advanced economies, and expectations of a slowdown in Canadian domestic consumption. In other words, don’t expect a series of rate hikes; this was just a demonstration that the Bank of Canada is willing to act independently of the Federal Reserve.

## Europe

- It has become clear in recent weeks that the massive US \$1 trillion EU rescue package, designed to end the liquidity crisis that had spread from Greece to Spain, Portugal and several other European countries, did not completely ease investor concerns. While it showed the EU’s ability to deal fairly swiftly with a crisis of this magnitude, the lingering problems cannot be addressed quickly.
- First, markets still question the willingness of governments in the most impacted countries to push through painful, deflationary, spending cuts and tax hikes. So far, governments in Greece and Spain are standing firm, and recent updates from Brussels suggest deficit reduction is on track. The real test will come next year, when most of the pain hits the population.
- The second risk concerns the local banking sectors. The EU package is big enough to cover all refinancing needs and all planned budget shortfalls for Greece, Portugal, Spain and Ireland for the next few years. However, the real risk lies within the banking systems. If deficits don’t improve as expected, if rating agencies lower sovereign ratings further, or if the deflationary shock of the austerity measures cause an unplanned increase in non-performing loans, governments could be forced to step in and provide backing for domestic banking systems. Those liabilities are not covered by the EU rescue package. So, the most important trend to follow in order to assess the direction of Europe’s debt crisis is the health of the local banking sector.
- The UK has, so far, gotten away lightly in the current European debt crisis. Financial market reactions have certainly favored the UK in recent months, relative to other European markets. The UK’s budget deficit was only marginally smaller than Greece’s last year, and, without drastic actions, it will be the worst among all 27 EU member states in 2010. The EU Commission forecasts the UK budget shortfall will actually widen to 12%, whereas all other problem countries will see at least small improvements in their balances.

- Rating agency Fitch recently commented that the UK's fiscal challenges were "formidable." It noted that the UK's debt/GDP ratio had deteriorated faster than in any other AAA-rated country since 2008 and demanded a more rapid pace of fiscal consolidation. Fitch didn't spell out their "or else" message, but the UK's AAA-rating may be in jeopardy.
- This is the backdrop against which the only-recently elected UK government will unveil its first emergency budget on 22 June. So far, a mere £6 billion in spending cuts has been announced. That won't be enough, and the risk of a serious run on Sterling is still on the table.
- Although this may be an overly optimistic statement after what we underwent in the past few years, we believe that the UK government will take the right actions and produce a credible deficit reduction plan. Failure to do so could trigger the next serious financial market crisis.

## Asia

- Political stability is a necessary condition to address the "formidable" challenges many developed world countries face in the coming years as debt crisis and demographic decline create an almost "perfect storm." While the governments in Greece or Spain could very well have fallen, the country with the weakest political backdrop is clearly Japan. Prime Minister Yukio Hatoyama and his Democratic Party of Japan started with such high hopes last September, ending the domination of Japanese politics by the LDP, a party that had ruled almost uninterrupted since 1955.
- However, the honeymoon didn't last long, and the new PM resigned last month after just 261 days in office. The new PM is the previous Finance Minister, Naoto Kan, who has the dubious honor of being Japan's 13th Prime Minister Japan in the past 20 years. The average duration of a government during that period was a mere one and a half years.
- Such instability doesn't lend itself to producing a government willing and able to undertake the drastic reforms the country urgently needs. For now, the new government is pledging fiscal restraint, which will put renewed emphasis on further monetary easing, probably through increased Quantitative Easing (QE), and the desire for a weaker yen.
- Meanwhile, the spring in Japan's recovery seems to have faded. After posting an impressive 4.9% annualized growth rate in the first quarter, most indicators now point to weaker growth in the second half of the year. Consequently, our equity team is looking to close our Japan overweight.
- China has proven another source for concern among global investors. The strong growth rebound in the past six months appeared to pull not only Asia – but the rest of the world – out of recession. Certainly, the country's Asian neighbors benefited enormously from its stronger rebound in global trade. China's recovery was so strong that authorities became concerned about the risk of overheating and inflation. The government started to tighten monetary policy and specifically targeted the housing market, which had experienced explosive sales and rapid price increases.
- The question becomes whether China engineers a soft landing, or if the government is running the risk of hitting the brakes too hard, which could push China into a de-facto recession? We remain in the bullish China camp. Recent data indicates a strong rebound in exports and expanded consumer spending is showing few signs of slowing down. Furthermore, the announced hike in the minimum wage would certainly strengthen that argument.
- Business activity should benefit from the gradual increase in foreign direct investment, and the government has ample financial means to provide additional stimulus should the private sector fail to generate sufficient growth.
- Housing remains the biggest risk in China, but the government-engineered slowdown in that sector occurs against the backdrop of strong growth in most other areas within the nation's economy. We don't think China will be a problem in the second half of the year.

## Investment Strategy

- In our internal strategy meetings, we look at the various asset classes in a Capital Markets Line (CML) framework that analyzes expected risk and return using the forecasts from our asset-class experts. The line is still fairly steep and convexly shaped, implying that investors are still getting paid for taking on more risk.

- It had been our strategy to reduce risk in our portfolios after the surge in equity and credit markets last year, and we went into the May sell-off fairly neutral on risk, i.e., balanced equities versus bonds and neutrally weighted in emerging markets in our equity strategies. Valuations are obviously more attractive now in both credit and equity markets after last month's sell-off and more commensurate with the weaker growth environment.
- As we hinted last month, we are looking to reverse our down-in-risk trade, and we are likely to start adding to our EM positions in both equities and bonds during the coming weeks.
- The fundamental backdrop is still littered with major problems, which should make for a very volatile investment backdrop. In such an environment, tactical asset allocation trumps longer-term strategic views, and we expect to remain on high alert to adjust our allocations to quickly changing fundamentals.
- If our base case of no double-dip recession in the US and Asia, moderate non-inflationary global growth and extremely low policy rates prevails, the gradual re-risking of our portfolios should pay off. We expect this process may take as long as the down-in-risk trade earlier in the year, but after the summer many questions surrounding the fundamental backdrop should have been answered.

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