

Global Market Watch

MAY 2011 | Markus Schomer, CFA, Chief Economist

Overview

- The arrest of Dominique Strauss-Kahn, the head of the International Monetary Fund (IMF) in New York, in May has opened up debate over who should take his place at one of the world's most powerful international finance institutions. Historically, the US and Europe had divided the leadership positions of the 2 Bretton Woods institutions - the other being the World Bank - with the US heading the bank and Europe the IMF. That accord is now in question and leaders of the increasingly powerful emerging markets are rightfully demanding a piece of the action.
- Similarly, in Europe, the search for a replacement for the retiring European Central Bank (ECB) President Jean-Claude Trichet has ended with the European Union (EU) Finance Ministers agreeing on Mario Draghi, the head of the Bank of Italy. Draghi's personal qualifications are impeccable, but his Italian citizenship caused some euro zone leaders to initially hesitate to agree to his nomination. In both cases, the focus on personalities underestimates the strong internal cultures in both institutions. Concerns about policy changes with respect to the IMF's involvement in the Euro Debt Crisis and the ECB's hawkish inflation focus are unwarranted. What the two cases illustrate is the shifting center of gravity in the global economy and the broadening of the club of countries able to run the affairs of some of the most influential financial institutions.
- Volatility in financial markets increased markedly in recent weeks. The MSCI World Index gained 4% in April, but gave back most of those gains in the first half of May. Emerging markets underperformed developed world indices significantly, as global investors turned more risk averse again. The US was the best performing major developed world market aside from Japan, where markets are rebounding from the sharp earthquake-driven crash in March.
- US Treasuries rallied hard in the past few weeks with yields on 10-year bonds falling as low as 3.12% in mid-May. Commodities experienced a sharp sell off in May, as investors started to get positioned for the end of QEII. Oil prices took the spotlight with a 20% decline from their recent peak in April, but the losses stretched across the whole commodity spectrum, suggesting the anticipated liquidity withdrawal was a major driver here.

NORTH AMERICA

- The lack of a convincing employment rebound makes the US economy more vulnerable to the negative effects of rising energy prices. It seems the weak US dollar is now causing more damage to consumer spending than it is stimulating US exports. The reversal in commodity prices, therefore, is good news and may help revive domestic demand in the second quarter.
- The Federal Reserve has made it clear that we are still some time away from a reversal of the extremely accommodative policy stance. The Fed itself estimates that the effect of Quantitative Easing is equivalent to another 200 basis points in rate cuts, putting the effective policy rate closer to -2%. Still, chairman Bernanke is in no hurry to remove some of the policy accommodation, despite the steady upward trend in both headline and core inflation. All that aside, I still expect the profit-employment relationship to boost job creation in the coming months and lift US GDP growth back to the 3% to 3.5% pace we have been forecasting for a while. However, a decline in oil prices is now a necessary condition for these forecasts to hold.
- The main story in Canada was the surprisingly convincing election victory for Premier Harper's Conservative Party, which will bring the first majority government to Ottawa in seven years. Minority rule didn't seem to have affected the Canadian economy much, but the election outcome is likely to speed up the formulation of a fiscal exit strategy. After twelve straight years of balanced budgets, the government ran deficits of more than 5% of GDP in 2009 and 2010 and the IMF, in its recent April World Economic Outlook update, estimates it will take until 2015 for the deficit to disappear. The new government is likely to raise market confidence in achieving that target earlier. Strong job growth is still powering the recovery in Canada, with total employment already exceeding its pre-recession peak. However, inflation is also still a problem, with headline Consumer Price Index (CPI) at 3.3% and real policy rates at -2.3%, among the lowest in the developed world. The Bank of Canada will have to accelerate the tightening process, which would benefit bonds, but may weigh on the outlook for stocks.

EUROPE

- Evidence of a significant acceleration in euro zone economic growth was one of the biggest surprises in the first quarter. The data also validated one of my themes that strong growth in the euro zone core will trickle down to neighboring economies. Germany posted a 6.1% annualized growth rate, France grew almost 4% and the euro zone overall grew 3.3%. Even debt-crisis ravaged Spain and Greece managed positive growth.
- This strong performance surely won't last, but it demonstrated the strong growth momentum in the euro zone, validating the ECB's rate hike in April. Inflation is running at about the same pace as in the US and the Unemployment Rate has not improved from its recession-high of 10%. Still, the ECB felt it is necessary to demonstrate its inflation fighting credentials, something the Federal Reserve has passed on so far.
- The focus in the UK has been on issues un-related to the economic backdrop in the past few weeks. However, now that the Royal Wedding is over – and changes to the UK's voting system rejected – the attention will shift back to the ongoing stagflation. The Bank of England was expected to follow the ECB and administer its first rate increase to re-establish its inflation fighting credibility. So far, the bank has chosen the "Bernanke" path of ignoring inflation in the wake of economic weakness. The most recent inflation report showed a further acceleration in CPI inflation to 4.5%, the fastest pace in the currency recovery, while the economy has essentially shown no growth in the past six months. With all of these factors in place, it is hard to understand why Gilts and Sterling are holding up well against the backdrop of stagflation in the UK.

ASIA

- The full extent of the economic damage from Japan's earthquake disaster is only now becoming evident in the regular data flow. The Manufacturing Purchasing Managers Index (PMI) has fallen back to below 50. Service sector activity and industrial production slumped hard in March, suggesting the economy is likely to contract in the first quarter. Both supply and demand side indicators show the damage. Auto production for example fell more than 50% in March, compared to the previous month and total workers' income declined again for the first time since the recession. All eyes are now on the reconstruction effort, which is expected to kick in over the summer, but the ongoing energy shortages suggest that the economy won't feel the full thrust of the rebound until next year.

- The main story in China is the ongoing fight to slow inflation without risking too much of a slowdown in the economy. The Peoples Bank of China (PBoC) continues to tighten financial conditions gradually, mainly through increases in reserve rate requirements. This is the right tool, as it targets the growth in bank lending, which has a direct impact on construction and investment activity. I haven't seen conclusive evidence of a change in momentum in the housing market, but the most recent data releases showed a notable slowdown in industrial production and at least no further acceleration in the pace of retail sales growth. The bank's main target, however, CPI inflation, has not slowed yet, but the latest report at least showed a stabilization just above 5%. I guess the PBoC will want to see inflation back near or below 4% before taking their foot off the brakes.

INVESTMENT STRATEGY

- The main impact of the various crises that have hit the bullish global economic outlook has been a sharp increase in investor uncertainty and risk aversion. The rally in US Treasuries is just one example, the shrill bidding up of commodities is another. I have never been a Gold bug and still see very little value in an asset that thrives on fear alone. In fact, the surge in commodity prices this year was the main reason for the slump we are seeing right now. Triggered by the approaching end of QEII in the US, asset markets that benefited from the liquidity surge are now reversing that trend. Commodities are an obvious target, but other risk assets may also be affected. Hence, the changing technicals suggest caution for those looking to jump back into emerging market equities.
- As a result, we maintain neutral risk positions in our strategies for a little while longer. The European Debt Crisis has flared again, the political fight over the US debt ceiling has not been resolved and investors are starting to anticipate the end of QEII; all potential sources for more volatility. However, the fundamentals suggest that going back into EM equities is the right trade. Growth remains very buoyant in Asia and Latin America, market valuations have improved in recent weeks and the possible peak in the inflation cycle could remove concerns over policy errors and widening currency misalignments. What could trigger investment flows back into EM is an eventual sign that the Fed is getting ready to end its Zero-Percent-Interest-Rate-Policy; so, chairman Bernanke still holds all the cards.

PineBridge Investments Global Growth Forecasts

	2011	2012	2013
Global	4.3	4.7	4.5
US	2.7	3.4	3.5
Eurozone	2.0	2.0	2.2
Japan	-0.2	1.8	1.2
Developed Asia	5.1	5.5	6.0
Emerging Markets	6.8	6.8	6.5

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