

# Global Market Watch

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## REVIEW

- Are we moving towards a more supportive global macro backdrop? It seemed we hit bottom in August when the US reported no net job growth for the first time in a year, an acrimonious IMF/World Bank meeting ended in disagreement over how to tackle the Eurozone Debt Crisis, and global inflation proved more resilient than policymakers had expected. Just a few weeks on, we have seen better economic data in the US, including an upward revision to that “zero” US jobs number, outlines of a comprehensive Eurozone rescue package and the first – albeit small – wave of rate cuts from central banks in emerging markets such as Brazil, Israel and Indonesia.
- Not surprisingly, risk assets rallied last month and bond yields bounced off of their record lows. The question going forward is whether we are through the worst of the “Macro Risk Storm” or whether there is more to come; I am still in the latter camp.
- Nonetheless, global stock markets rebounded sharply in October. The MSCI Global Equity index had jumped more than 6% mid-month, reversing about a third of the 18% drop in the third quarter. Developed markets outperformed emerging markets during the recent rebound, as well as during the selloff, indicating the important role liquidity flows play in global equity markets.
- Year-to-date, the US remains the best major equity region, with Japan and Europe about on par with each other in second place. Among the emerging markets, Latin America and Eastern Europe share last place honors.
- Government bond yields rebounded in October, but are still down more than 100 basis points for almost all major developed countries – except, of course, Japan. The US dollar rebounded almost 6% vis-a-vis its main trading partners during the third quarter, but has given back about a third of those gains in October so far. Oil prices also rebounded, which may prevent a more significant slowdown in global inflation trends.

## NORTH AMERICA

- Beware the Ides of November. It seems financial market participants have adopted a more sanguine view of the US macro backdrop. Indeed, expectations probably overshoot reality when some pundits predicted an imminent recession — that didn’t happen. In fact, the economic news flow has improved in recent weeks, with job growth settling back in the 50,000 to 100,000 range, ISM activity surveys showing small improvements in September and Factory Orders and Auto Sales rising more than expected.
- However, underneath all of this are two problems that haven’t gone away. First, the Federal Reserve continues to downplay the ongoing pickup in inflation. To argue that inflation will soon be “at or below levels consistent with its mandate,” while headline CPI is close to 4% and core CPI at 2% is further straining the Fed’s credibility and will only embolden the split in the FOMC between the doves, who want to ignore inflation as long as unemployment is high, and the hawks, who understand that even a little more inflation can have destructive side effects.
- The second problem markets are underestimating right now is the US deficit crisis, which will raise its ugly head again next month. It seems as unlikely that the US “Super Committee” will present a viable solution to reduce the US long term debt trajectory without damaging the US growth prospects in the next few years as it is for Europe to solve its debt crisis. Get ready for more acrimonious debates in Congress and another government shutdown threat when the current Continuing Resolution, which finances the government, expires on 18 November.
- Canada’s economic outlook has more in common these days with China than with its neighbor to the South. Canada did not have a debt crisis and growth rebounded strongly, boosted by looser fiscal policy and record low interest rates. Domestic demand and, most critically, job growth rebounded instantly and Canadian employment is already well ahead of its pre-recession peak — sounds just like China.
- However, the same inflation surge that slowed US growth also depressed Canadian consumption and growth slowed sharply over the summer. Exacerbating the recovery disruption were the surge in the Canadian dollar and the Japanese earthquake’s effect on US auto production; the resulting dramatic decline in Canadian exports alone shaved three full percentage points off the annualized third quarter growth rate.
- Meanwhile, the Bank of Canada has steered a calm course through the extremely volatile policy environment this year, keeping policy rates steady at 1% after three rate hikes last year. Still, the bias is for higher rates if the economy were to rebound faster than expected. In the meantime, Canada’s healthy domestic sector should continue to buffer the economy against a more serious global growth slowdown.

## EUROPE

- The momentum in the Eurozone Debt Crisis is picking up, which can be both good and bad. The good news is that after some public scolding from fellow heads of state at the IMF/World Bank annual gathering in Washington last month, German and French leaders agreed that bank recapitalization has to be part of a comprehensive package to reduce financial market turmoil, which will also include a Greek debt restructuring and an increase in the European Financial Stability Facility's lending capacity. Hence, some financial market participants believe the outlines of a broader solution to the crisis are coming into focus.
- The bad news is that time is running out to agree on the myriad of details necessary to present a document that heads of state can sign before the next G20 meeting in November. Rating agencies continue to cut the sovereign ratings of Italy and Spain, which reduces their governments' and banks' access to private sector financing.
- Meanwhile, the main question of where is the capital coming from to restructure Greece's debt and prop up the banks still exists? Major IMF shareholders, such as the US and the UK, already stated their categorical opposition to any further IMF capital increase, a necessary condition for a bigger IMF commitment. While we can see what a broader solution could look like, the chances of an agreement among all 17 Eurozone nations any time soon still looks like a long shot.
- Across the Channel, the UK remains mired in a domestic demand recession that seems to be getting worse. Real consumer spending has fallen for four straight quarters and real domestic demand hasn't grown in 15 months. The latest round of bad news came from the UK labor markets, where employment declined for the first time in a year and the Unemployment Rate crept up to a new recession high.
- The government isn't relenting from its austerity path, but the Bank of England responded in early October with a second round of asset purchases — QE2 — to support the banking system and stimulate economic growth. The Bank is easing, while inflation just reached a 20-year high 5.2%.
- Essentially, rather than opting for outright debt restructuring, which gets countries in trouble with the rating agencies, the UK is defaulting on its debt in small steps by keeping real interest rates deeply negative. The UK has quasi-nationalized its banking system and is indirectly guaranteeing assets worth about four times the UK GDP, which is more than what's at stake in France. Yet, the specter of growing government guarantees for French banks has prompted Moody's to declare France the weakest AAA rated sovereign. It's time the agencies wake up and penalize not just countries trying to cut spending and repay their debts, but also those defaulting on their obligations in small inflationary steps.

## ASIA

- Economic data in Asia's developed economies has been mixed in recent months. Most business surveys have been quite bearish, with Purchasing Managers Indices in Singapore, Hong Kong, and Taiwan well below 50 for the manufacturing sector.
- Service sector activity and Retail Sales growth, on the other hand, have remained very robust, highlighting the strength of Asian domestic demand. However, Asia won't be able to decouple from the growing weakness in the US and in Europe. The best example was the latest Chinese GDP report, which disappointed expectations and showed a clear loss of recovery momentum in the world's second largest economy.
- At the same time as growth is slowing, which was part of my global outlook earlier in the year, inflation isn't cooling as fast as I had expected. Chinese consumer prices are still rising at an annual rate of more than 6%, inflation in Hong Kong surged to almost 8% in August and Korea, which I had labeled a leading indicator in Asia's inflation cycle, reported no noticeable improvement in its CPI inflation trend the past five months. Consequently, the monetary easing I was looking for as a trigger to turn more bullish again on Asian equity markets has been postponed into next year.
- Japan's post-earthquake rebound hasn't gathered as much momentum as we thought. After a strong recovery in service sector activity in late spring/early summer, domestic demand has slowed again in July and August.
- However, the reconstruction effort should still provide a welcome growth stimulus at a time when the rest of the global economy is slowing. In fact, the government recently announced a spending package worth 3.5% of GDP. Yet, the concurrent yen appreciation over the past year has weakened net exports, a key pillar of Japanese GDP growth.
- Japan's trade balance slipped deeper into deficit again in August after gradually improving from the post-earthquake bottom in May. The new government of Prime Minister Noda announced measures to reverse the yen's strength, which focuses on boosting domestic activity. However, with record low interest rates and record wide fiscal deficits, Japan has no real policy options available to counter the effects of extremely accommodative monetary policy in the US and Europe. Looking ahead, the loss of momentum is worrying, but I still believe the fiscal stimulus will be large enough to prevent a more serious slowdown in Japan

## INVESTMENT STRATEGY

- Throughout the past few months, the bottom-up analysis of the US equity market prospects remained more bullish compared to the top-down macro assessment. Consequently, our Listed Equity team had not shifted to an outright bearish stance, which is paying off nicely so far in October.
- However, I remain concerned that the time is not right to adopt a more bullish strategy. We haven't seen convincing evidence that US policymakers understand the danger of allowing fiscal policy to contract even more next year. We haven't seen convincing evidence that European policymakers are ready to implement a comprehensive approach to reduce debt and spur growth. And we haven't seen convincing evidence that inflation in Asia is slowing, which would allow central banks to ease monetary policy and stimulate financial markets. I want to see progress on all three fronts before the tone of my comments will get more constructive.



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