

# Global Market Watch

JANUARY 2011 | Markus Schomer, CFA, Chief Economist

## Overview

- *“2010 was all about what could go right, 2011 will be all about what can go wrong,”* an apt description of the difference between last year and the coming 12 months by one of my colleagues in a recent strategy meeting. Our bullish outlook for 2011/12 was the minority view last summer, today it's the consensus and now lets look beyond the growth story to the next stage in the current cycle. The next major theme that we are focusing on is the increasing divergence of monetary policy between developed and emerging economies and the impact on the
  - growth gap between the two regions. Basically, faster growth and rising inflation pressures are forcing central banks in Asia and Latin America to raise policy rates, which will slow growth and narrow the growth differential between developed and emerging economies.
  - Financial markets ended last year in a 'risk-on' mode. The MSCI World Equity index gained another 7.2% in US dollar terms in December, with developed markets outperforming emerging markets for the third consecutive month. This trend has continued so far in the first few weeks of January.
- Benchmark government bond yields have increased significantly across all major markets in the past few months with the US leading the sell-off. Currency markets have been surprisingly volatile. After a strong November, the Trade-Weighted Dollar Index gave back most of the gains in December, only to be on the up again in the first few weeks of January. The key drivers here are changing expectation about US monetary policy. A stronger US growth outlook implies a greater chance of earlier rate hikes, which will strengthen the US dollar.

## North America

- The main story in the US is the acceleration in the recovery momentum at the end of last year. Consumer spending has been particularly strong during the November and December holiday shopping season and manufacturing activity, as measured by the ISM index, has clearly rebounded from the temporary summer slowdown. The two trends that don't seem to fit the bullish story are employment and housing. On the first issue we believe the Bureau of Labor Statistics continues to underestimate the true pace of job creation as it had done in 11 of the 12 months last year. We estimate that, US payroll growth should have averaged 150,000 per month in the fourth quarter and we still expect a further pick-up to 250,000 per month in the first half of this year. The second issue, housing, is more troubling. The decline in house prices has gathered steam again over the fall, and the most recent evidence on sales suggests demand is not picking up, leaving only a negative wealth effect as a result. Nevertheless, we have upgraded our US GDP forecast and we are now looking for 4% growth through the middle of next year.
- The Canadian economy posted disappointing growth numbers in the middle of last year after initially leading the global growth recovery, the main culprits were a renewed decline in residential investment and weaker exports. Looking ahead in 2011 there are three reasons

why GDP growth in Canada will pick-up again. First, although job growth has slowed from the record pace earlier last year, steady job creation will continue to drive income growth and with that consumer spending. Second, the stronger recovery in the US should stimulate Canadian exports to its largest trading partner. Third, the surge in commodity prices has so far not benefited Canadian resource production, which is likely to change with the recent rebound in energy prices. Canadian GDP should not be far behind the 4% we are forecasting for the US in the first half of 2011. We expect the Bank of Canada will continue its policy normalization, raising rates by another 50 basis points in the first half of the year.

## Europe

- The outlook for Eurozone financial markets continues to be dominated by the "Sovereign Debt Crisis." Fears peaked again in early January in run up to major bond auctions in Portugal, Spain and Italy. All three were highly successful, though, at fairly elevated yield levels. Helpful to the process were remarks from German politicians suggesting European leaders are working on further strengthening the support mechanism, which may include an increase in the size of the 'European Financial Stability Facility' beyond the current €750 billion. The crisis won't go away until the peripheral Eurozone economies start to show hard evidence that

deficits are coming down. Until then Greece, Ireland, Portugal and Spain will bear the brunt of financial markets speculation.

- Meanwhile, the best way to solve the debt crisis is through stronger economic growth and to that end, the bullish story in Germany remain, key to a successful crisis resolution. The German economy grew about 2.5% in the fourth quarter for an overall rate of growth of 3.6% in 2010, the fastest pace in more than 20 years! Strong growth at the core of Europe, plus faster commodity price inflation has started to push up Eurozone-wide CPI inflation above the ECB's comfort zone. Rate hikes are unthinkable right now, but ECB President Trichet adopted a more hawkish rhetoric after the recent January policy meeting, reminding central bank-watchers of the importance of price stability. We don't see the ECB raising rates until 2012. We need significant improvement in investor confidence in the Eurozone sovereign debt market before the ECB can switch policy targets away from stabilizing the financial system through the provision of unlimited liquidity for both Eurozone sovereigns and financials towards normalizing Eurozone monetary policy.
- After finally posting stronger growth rates last summer, activity data in the UK has been more mixed in recent months. Manufacturing rebounded in line with stronger global growth, yet activity in the service sector has slowed further as indicated by the Purchasing Managers' Indices. This would suggest real GDP growth is likely to ease further towards 2%, which would push the UK back towards the bottom of the major developed economies growth tables. Meanwhile, inflation remains stuck above 3%, but the Bank of England is unlikely to act anytime soon especially in the face of the ongoing fiscal austerity underway in the UK. The pressure on the bank will increase if growth slows further this year. In that case another round of 'Quantitative Easing' in the UK is not out of the question.

## Asia

- The data continues to show a fairly weak growth backdrop in Japan. Household spending continued to decline and unemployment continued to drift higher in November, suggesting private consumption will be a drag on Q4 GDP growth. The external outlook is also worsening. China's continued policy tightening is clearly designed to slow economic growth, which will hurt Japan's exporters and reduce the growth support from net exports. The Bank of Japan is busy implementing its most recent Asset Purchase Program, which should

support domestic financial markets. However, we don't believe Japan's macro outlook will improve significantly until the Yen weakens against dollar, Euro and Reminbi, which won't happen until the Fed starts raising rates later this year.

- The main story impacting the outlook for Australia is the devastating flood that has hit the Eastern state of Queensland, affecting an area the size of California and Texas combined. Economic activity around the city of Brisbane, Australia's third largest city, has ground to a halt, which should have an impact on domestic demand. In addition, Queensland is responsible for about one-third of Australia's agricultural output and is a major coal producer. There are two issues relevant to the global outlook here. First, Australian GDP growth will likely go through a period of temporary weakness. Second and more important is the additional boost to commodity prices. Food prices are already at record highs. The production decline in Australia coupled with the dioxin scandal in Germany will only serve to exacerbate the upward pressure. Inflation, which is already the main policy problem in many Emerging Markets could become a bigger and broader issue this year.
- China continued to tighten policy to fight inflation before it becomes a real problem. Consumer price inflation broke through 5% in November, but is still quite a distance away from the pre-crisis peak of 8.7% in 2008. We think the Chinese government deserves praise for its actions, rather than the panic that engulfs the financial markets every time China raises rates. Nevertheless, continued policy tightening increases the probability of policy error, a risk worth watching. So far, activity data suggests the economy is slowing only gradually. However, surging food prices could aggravate the inflation problem and raise the stakes for the Peoples Bank of China. Allowing the Reminbi to appreciate at a more rapid pace would help the country deal with the problem of rising global commodity prices. We still expect China will engineer a soft landing with growth slowing to 9% towards the end of the year. Policy tightening will continue and remain a source of market volatility, but we expect the Chinese currency will become a more widely used tool this year in restraining inflation.

## Interest Rate and Investment Strategy

- Government bond yields across most major markets have turned sharply higher at the turn of the year partially in response to the improving growth outlook, partly due to concerns about sovereign credit risk.

We believe the rapid increase has re-adjusted bond yields to the stronger backdrop and yields will be range-bound for the first half of the 2011 after all the Federal Reserve continues to purchase US \$75 billion in Treasuries every month. However, if our growth forecasts are right, the debate over rate hikes will begin in earnest over the summer, which will push bond yields higher.

- In our overall investment strategy we have dialed down our risk exposure and continued to gradually shift the emphasis back to US markets both in equities as well as in fixed income. We continue to have a strategically bullish outlook for Emerging Markets. Yet, for the next few months we believe developed markets, led by the US are likely to continue their catch up. Fundamentals in the developed world are improving, while Emerging Markets will experience more policy tightening. In our fixed income strategies we are implementing this view through a shift out of Emerging Markets and international sovereign bonds towards US High Yield, which preserves our risk stance but reduces our non-US exposure. In our equity strategies, we are maintaining an underweight in Europe but are increasing our US exposure. We are optimistic that strong growth coupled with low inflation and supportive monetary policy will boost returns in US financial markets at the start of 2011.



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