

Global Market Watch

DECEMBER 2011 | Markus Schomer, CFA, Chief Economist

REVIEW

- In many ways, 2011 was a lost year. It started out with much optimism that a global recovery was taking hold, however that bullish sentiment was quickly crushed: first by a harsh winter, then by the effects of the 'Great Tohoku Earthquake' in Japan, and then by the inflationary effects of the Fed's QE2 program. The negative sentiment reached a peak during the second quarter, when the US Congress botched the hitherto trivial issue of raising the federal debt ceiling, while Europe's leaders botched the ring-fencing of Greece and the creation of the European Financial Stability Facility. The assessment of the economic backdrop also hit bottom between June and August, when a key US employment report showed zero job growth for the first time in a year.
- That initial job growth estimate was revised to a gain of 104,000 within two months and European

Union ("EU") leaders have taken more decisive steps to halt the downward spiraling deficit crisis; both of which have been key drivers of the rebounding sentiment since late October. Better economic growth surely helped as well with global GDP growth averaging just 2.9% during the first six months of 2011, but accelerating to a 3.8% trend in the second half. In addition, central banks around the world have come full circle, from raising rates in the first half of the year in order to fight inflation to easing monetary policy on the back of a turn in the inflation cycle. Now, once again we are looking at improving sentiment and a stronger economic backdrop.

- Global equity markets have pared back half the strong gains from October in the past six weeks. Emerging Market stocks are once again underperforming developed

markets, losing about twice as much ground since October. However, over the past few weeks the performance difference has been driven predominantly by Europe, with both Western and Eastern European markets underperforming their respective peers. The US dollar continued to strengthen in December especially against European currencies. Finally, weaker global commodity markets complete a picture of increased risk aversion as we approach the end of the year. Despite the focus on sovereign debt crises this year, looking at the Barclays Capital and MSCI bond and equity indices, global government bonds have been the best broad asset class in 2011 ahead of global corporate bonds, with about 8% and 4% overall performance in US dollars, while global equities are down about 10% for the year.

NORTH AMERICA

- At the end of 2010 the Fed was looking at a 9.8% Unemployment Rate that had been rising for four months, and decided to embark on a second round of asset purchases. At the end of 2011 the Unemployment Rate has come down to a two-and-a-half year low of 8.6%. Some people are still calling for 'QE3', chief among them being Chicago Fed President Charles Plosser, who dissented to the last two Federal Open Market Committee ("FOMC") meetings voting for more policy easing. However, the improving growth momentum presents the prospect of no further Fed action in 2012. The biggest challenge for a better 2012 is the fractious political backdrop, especially in an election year. The current fight over extending expiring fiscal stimulus measures is an extension of the second quarter's acrimonious debt ceiling debate and is likely to result in somewhat tighter fiscal policy in 2012, thus possibly resulting in slower growth in the first six months of 2012: I am looking at 1.75% average GDP growth in the first two quarters and a pick up in the second half to a stronger 2.8% trend.
- In a world dominated by debt crises, some countries stand out and thus create interesting investment opportunities. Canada is one of those economies, barely scratched by the 'Great Financial Market Crash', with government spending slowing, but not contracting, and employment already well up from the previous cycle peak. Domestic demand rebounded strongly in the past two years, but the Bank of Canada has remained on the sidelines in 2011 not adding to the three rate increases from the second quarter of 2010. The main reason was the strong Canadian dollar that took care of much of the tightening of financial conditions. However, there is a dark side to Canada's story. While other countries were making headways in private sector de-leveraging, Canada's household debt-to-GDP ratio has remained at peak levels. Consumer Price Index ("CPI") inflation has also proven to be stickier in not allowing the Bank of Canada to reverse its rate increases. The lack of additional stimulus levers is one of the key reasons why I expect Canadian GDP growth will slow further next year to just 2% after 2.3% in 2011 and 3.2% in 2010.

EUROPE

- The big EU summit in early December has increased the chances of a break-up, though not of the Eurozone; but I am not talking about Greece leaving the currency union. No, the country on the way out may be the UK, obviously not out of the Eurozone, but out of the EU. All other 26 EU members agreed to a new 'Fiscal Compact' that is of course directed at the Eurozone, but affects other EU members as well. The deal includes greater budget surveillance, a new deficit limit of 0.5% of GDP (up from the old 3% Maastricht criterion), and the requirement of constitutional debt breaks. Financial markets were not impressed, but I believe this is the blueprint for a new EU treaty to address the institutional deficiencies of the Eurozone. Also not impressed was the UK government, which evidently did not agree to the deal and is now isolated and possibly on its way back to the European Free Trade Association ("EFTA"), joining other EU hold-outs such as Norway, Iceland and Switzerland.
- While the EU summit did little to relieve financial market pressure, the European Central Bank ("ECB")'s latest long term repo operation did. The ECB is not using outright asset purchases (QE) as its main tool to provide liquidity to the banking system, but offers repo tenders with significantly longer maturities than the usual two weeks and fully allocates what banks are demanding. The latest was a three year tender that drew almost 500 billion in interest, a massive injection of liquidity that will go a long way to reduce stress in the interbank funding market. On the economic front, the divergence between Germany, and a few other Northern European countries on the one side, and the generally weaker Southern European countries continues. Recent data showed Italy slipped back into a recession in the third quarter and continues to widen. Meanwhile, growth in Germany is holding up better than expected. The widely-watched Ifo Business Climate index indicates manufacturing output may not have slowed as much as the PMI indices suggest, and the generational low in the Unemployment Rate is bolstering domestic consumption; two trends that may at least temporarily insulate Germany from the recession in the rest of the Eurozone. For 2012, I expect the Eurozone will grow 0.6% overall, but all of the growth will essentially come from Germany; ex-Germany, Eurozone growth should be flat.

ASIA

- Japan's economy continues to run on a different growth path compared to its peers. Despite the worst deficit statistics of all major economies in the world, austerity is not the issue here, rather stimulus is. At first glance, the main reason for this paradoxical situation is of course the re-constriction effort following the 'Great Tohoku' earthquake last March. The economy rebounded strongly in the third quarter posting a 5.6% annualized growth rate, the second best among major developed nations (behind Sweden), and is on track for 2.5% growth in the current period. In 2012, we project 2.8% growth, which should keep Japan among the best performing developed world economies. Things could even be better, if it wasn't for the strong Yen, which has been the best performer against the US dollar among the developed and emerging world currencies in 2011. The Bank of Japan has increased its asset purchase program several times, but the Yen will only weaken, if interest rate differentials turn more negative again. That won't happen until the US and European central banks start raising rates, which is not in the cards for 2012.
- One of our key macro convictions is the slowdown in inflationary pressures in Emerging Markets and the subsequent possibility of rate cuts that would bolster domestic demand and financial markets. Looking at Asia, the evidence is mixed at best. This is especially true of the smaller developed Asian nations that have shown scant evidence of slowing inflation. In fact, Singapore just reported CPI inflation picking up again matching the previous cycle high of 5.8%. However, the most important economy to watch is China, where the evidence of receding price pressures is more convincing. The annual inflation rate averaged 6.3% between June and September, but slowed to 4.2% in November, the lowest in 14 months. China's authorities already started the process of easing monetary policy by cutting the Reserve Requirement Ratio in November. Growth is also coming off the boil in China. The manufacturing Purchasing Managers Index has been below the critical expansion/contraction threshold of 50 for the last two months and the service sector index fell sharply towards that level in November. All of that points to more policy action in 2012 to stabilize growth and engineer the 'Soft Landing' everybody is looking for. I expect China's GDP growth rate will slow from 9.3% this year to 8.5% in 2012.

INVESTMENT STRATEGY

- 2011 was clearly a year for bonds. In fact, global government bonds were the best performing broad asset class, returning about 7.5% for the year, ahead of global corporate bonds and way ahead of global equities, which are on track for a 10% decline this year. Looking ahead to 2012, we remain constructive on the macro backdrop and believe equities and corporate bonds have some catch up potential. However, the first half of the year is still full of possible pitfalls that could hold us back from adopting a more bullish risk posture in our portfolios. In addition, liquidity still remains a key consideration when designing investment strategies. Central banks continue to provide as much as possible, but their attempts are running head-on against a strong regulatory current that includes Basel III and Dodd-Frank here in the US, which will force banks to hold more capital and thus diminishing the efficacy of central bank actions. Furthermore, the death of Kim Jong Il and the subsequent possibility of instability on the Korean peninsula are reminders of the potential exogenous risks this year that may hit already nervous investors and create additional volatility. Overall, we prefer to remain slightly overweight risk in our portfolios to participate in the continuing economic recovery, but we remain cautious with regard to the continued fallout from the 2008 financial market crash that will still dominate the economic backdrop of 2012.



Markus Schomer is responsible for providing macro-economic forecasts, analysis and commentary for all PineBridge Investments groups, with a focus on global economic trends and their impact on financial markets. He holds degrees in Economics from the University of Bonn in Germany and the University of East Anglia in the UK. He also studied at the London School of Economics and is a CFA charterholder..

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