

Global Market Watch

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REVIEW

- Traffic in Manhattan is terrible this week with the UN General Assembly in town, which is also the time of year both World Bank and IMF hold their annual meetings down in Washington. Already the headlines coming from the two big multilaterals aren't good. The IMF released its bi-annual World Economic Outlook, which significantly reduced the Fund's expectations for the global economy and cut 2011 World GDP growth by half a point to 4%, highlighting recession risk in the US and Europe. Meanwhile, World Bank President Robert Zoellick was quoted saying, "...the world economy is entering a new economic danger zone this autumn".
- For much of the past year, the debate in the US and Europe has focused on the unsustainability of public debt burdens, which are largely the result of government support following the "Great Financial Market Crash" of 2008. However, the spotlight is now increasingly turning on the "Global Growth Crisis," caused largely by rising inflation and fiscal austerity in the US and Europe. Trying to reduce public sector debt burdens by cutting spending only works if other policies offset the growth headwind from tighter fiscal policy. If everybody is doing the same thing at the same time, austerity cannot work.
- Financial markets remain in severe risk-aversion mode, but the consensus among our portfolio managers and analysts is that a global recession is not priced in - yet. In US dollar terms, the MSCI World equity index was down more than 10% year-to-date in mid-September, with emerging markets now more meaningfully underperforming developed markets. The US remains the least worst performing market, while Europe - despite its debt crisis is holding up better this year than Asia or Latin America, which highlights the global nature of the current financial market slump and the vulnerability of emerging markets to global growth crises. Not surprisingly, the US dollar is benefiting from "flightto-safety" flows, especially against currencies that were buoyed by strongly growing economies in the past. An additional element that will accelerate the dollar rebound is the beginning monetary easing cycle in emerging markets. So far, only Brazil and Turkey are on that page, but more central banks are expected to follow in the coming months. Finally, the one market that is not consistent with the expectation of a global recession is the commodity market. The GSCI Commodity Index is down only marginally since the end of last year and its energy component is still in positive territory. A deeper decline in commodity prices would be evidence of investor capitulation, but at the same time might also be the first step out of the current growth recession.

NORTH AMERICA

- The economic backdrop in the US remains bleak. Business and consumer confidence continues to remain weak, though it didn't deteriorate any further in September after a sharp drop in the prior month. The economic news flow in August was pretty bad: overall job growth ground to a halt in August, Retail Sales posted no growth, and the annual trend in CPI inflation accelerated to a 35-month high. I believe the underlying fundamentals remain healthy enough that a modest stimulus and a resolution of our political problems may get us back on a recovery track. President Obama proposed a US \$447 billion job creation scheme, consisting of extensions of existing measures, tax cuts, and infrastructure spending, however, Congress is unlikely to pass anything anytime soon. It's not that inaction means no additional stimulus, however inaction would also lead to the expiration of temporary stimulus measures introduced last year, which could create a 2% fiscal drag on 2012 GDP growth; that's a recession trigger right there. I am still forecasting 1.6% growth for next year, which includes extension of all of expiring measures plus an additional, albeit very modest, stimulus.

The gloss is coming off of Canada's recovery. True, the slowdown in the second quarter was mainly caused by temporary factors such as a sharp drop in exports, possibly related to the supply-chain disruptions in Japan. However, Canada is now feeling the global growth slowdown. Already in July and August, job growth slowed significantly and Retail Sales declined, weakening the strong domestic demand backdrop that had been the driver of the Canadian recovery. Inflation remains elevated, but the Bank of Canada interrupted its rate normalization cycle early and is likely to stay on the sidelines until the current crisis blows over. The Canadian dollar fell 5% since the start of August, providing a monetary buffer for the deteriorating external demand backdrop. It remains to be seen whether the Harper government can continue its deficit reduction policies, but Canada is far from getting infected by the debt crisis bug as a result of prudent policies in the past decade.

EUROPE

- The Eurozone Debt Crisis is increasingly looking like the 2008 financial market crash in slow motion. Government bond markets are not the sole problem anymore; the focus is now shifting to the banks and the gradually eroding inter-bank market liquidity. Already, US banks have become so concerned about European counterparty risk that the Federal Reserve had to reopen its currency swap facility to provide international funding markets with sufficient dollar liquidity. In addition to the growing banking crisis, Europe is now also facing a growth crisis. The periphery is already in an austerity recession, but conditions in the core Eurozone countries, such as France and Germany, have also deteriorated significantly. Purchasing Managers Indices for September show that the contraction in French manufacturing deepened further this month, and industrial and service sector activity in Germany ground to a halt. Weaker growth will slow the deficit reduction process and possibly trigger more austerity, which will further depress growth prospects. Absent an improvement in global growth conditions, the pressure on Eurozone leaders to take more drastic actions, such as declaring a Fiscal Union or at least authorizing the issuance of Eurobonds, will continue to grow.
- The lack of growth is also threatening to pull the rug from under the UK deficit reduction process. The biggest change in the past few months is the deterioration in the jobs market. The number of people claiming unemployment benefits has increased by 125,000, or 8%, in the past 5 months, ending a period of relatively stable unemployment numbers that started last summer. Meanwhile, in the three months through July, employment declined by the largest amount in more than 2 years. And all that while many of the fiscal austerity measures enacted this year have yet to bite. The Bank of England has stayed on the sidelines this year, but discussed policy options at the last Monetary Policy Committee Meeting. The range of options is very similar to the Fed's toolkit, but members expressed a preference for more asset purchases (or QE) if further easing was deemed necessary. It appears further easing does indeed look necessary, so watch out for UK QE2.

ASIA

- Growth prospects in Asia remain stronger compared to the developed world. Healthy domestic economies have allowed much of Asia to weather crises in the US and Europe so far. However, economic processes are never static, and the continued currency overvaluation and the erosion of Asian export demand are threatening growth prospects for next year. Making matters worse, central banks in the regions have largely been ineffective at controlling inflation. Hence further monetary tightening is likely in countries such as India, but also in China and South Korea.
- In contrast, growth prospects in Latin America and Eastern Europe have been more directly impacted by the crises in the nearby developed regions. Following surprise rate cuts in Brazil and Russia, markets are starting to look for further rate cuts, especially in Latin America and Eastern Europe. Geographical proximity to a big developed world economic block used to be an asset; today it's a liability.
- Japan is the odd one out in a fairly scary macro story this summer. The impact of the Great Tohoku Earthquake has created a more dominant domestic cycle, which should allow Japan to miss the general deterioration in global economic conditions. Business Confidence posted a strong rebound in September, and Japan's Purchasing Managers Index has rebounded in recent months. The rebound activity is, of course, in reaction to the sharp contraction earlier in the year, and the reconstruction effort will provide a timely economic stimulus this year and next. However, even here the economic prospects have deteriorated somewhat. The main reason is the stronger Yen, which is slowing the normalization in Japan's trade balance.

INVESTMENT STRATEGY

- We are not likely to experience a renewed credit market freeze, which made the 2008 recession such a destructive experience. Central banks have learned the lesson of not just being a lender-of-last-resort to the banking sector, but a dealer-of-last-resort, and more broadly support market liquidity; the latest evidence is the Fed's recent reopening of its currency swap facility. However, the current risk-averse market backdrop is unlikely to improve anytime soon. Eurozone politicians will continue to lag in their response, which will continue to cause market distress. Meanwhile, in the US, a solution to the growth crisis looks equally unlikely due to the loss of confidence in activist fiscal and monetary policy.
- Fixed income markets have held up much better than equities and should continue to offer better performance characteristics, despite the attractive valuation of equity markets. Corporate fundamentals have remained strong and default rates low, which should support corporate credit markets in the near term. Risk-aversion is also supporting the US dollar rebound, which justifies our preference for US assets and will actually be beneficial for the US economy by reducing import price inflation and supporting real household income. The top down macro picture looks gloomy right now. However, as long as the bottom up fundamentals remain strong, equity markets will find buying interest every time the macro crisis eases, which will make for a volatile end to the last quarter of the year.



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