

Global Market Watch

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Overview

- A few weeks ago, commenting on the global outlook, I wrote: “Looking ahead it’s politics vs economics and I hope the latter will win.” Today it’s increasingly obvious that politics is gaining the upper hand with disastrous effects for the global recovery and financial markets.
- As I am writing this, the continuation of the global recovery is now in serious doubt and financial markets are in full crisis mode. Investors are grappling with three major policy issues. In the US, the increasing inability of Congress to devise a credible debt reduction plan brought the country to the brink of default and triggered a ratings downgrade by S&P.
- The inability of the European Union to stem the run on peripheral sovereigns has allowed the crisis to spread to the “too-big-to-bail-out” Italy, which now requires the Union to make much more drastic and sweeping changes to the economic management of the euro zone. Finally, the inability of Asian policy makers to rein in inflation has increased the possibility that interest rates will have to be raised further, increasing the risk of a more serious growth slowdown in the region. I think that is enough of a lethal cocktail to scare off any investor and that’s exactly what is happening. The question is, can the damage be repaired, or are we facing an, at least for a while, uncontrollable run on leverage, which could mean a re-run of the “Great Financial Market Crisis” in 2008?
- World equity markets are down an astonishing 10% in US dollar terms since the start of July and there is not much differentiation between developed and emerging markets, suggesting that the sell-off is a broad investor withdrawal from risk assets. Among the major regions, Japan is still holding up the best, justifying our overweight in that market. Worst performers are Europe and Latin America, both of which are down about 14% in the past six weeks alone. Obviously, such a sharp stock market sell-off always benefits bonds. Despite the US debt problems, yields on 10-year Treasuries have rallied more than 65 basis points since the beginning of July and most major developed world bond markets report similar declines, behind the US and Germany.
- In fact, Citibank’s World Government Bond Index is up 6.5% year-to-date, outperforming global equities by more than 13 percentage points. The only currency gaining against the US dollar in August is the Swiss franc. All other currencies have lost ground, partially on risk reduction and partially on growth concerns. Finally, commodities are also under increasing pressure led by oil, which lost 13% in August alone. In times of fear, investors are running to gold whose performance mirrored that of oil, but to the upside.

NORTH AMERICA

- US Congress played the debt ceiling game so badly that the result was the first US credit rating downgrade in history. Not only did the political infighting lead to a greatly watered down debt deal that is unanimously considered inadequate to reduce the unsustainable debt trajectory the US finds itself on, but it was the main reason S&P took the unprecedented rating action. The rating agency stated “the downgrade reflects our view that the effectiveness, stability and predictability of American policymaking and political institutions have weakened at a time of ongoing fiscal and economic challenges;” that really says it all.
- The underlying US economics pale in significance to the political crises, but the outlook is not as bad as the headlines suggest. The latest US jobs report showed a small rebound in private sector job creation, but also more public sector lay-offs, as the fiscal austerity intensifies. Most encouraging are signs that growth in real US household income is increasing again, which together with the slightly better jobs numbers could lift consumer spending in the coming months.
- Canada’s economic outlook continues to deteriorate. The ongoing weakness and the reassessment of the strength of the US recovery is clearly one reason to be less optimistic. But we are also seeing weakness in domestic demand, which in the past had buffered Canada against macro volatility in its most important trading partner. Retail sales and employment growth have been disappointing and the most recent Purchasing Managers Index for manufacturing showed a virtual collapse from a bullish 61 to 46.8, the lowest level in more than two years.
- The good news is that inflation is also slowing, which will take the Bank of Canada out of the equation for a while. The Canadian dollar has lost about 3% so far in August, giving back most of its gains year-to-date,

which should help reclaim some of the lost international competitiveness. Nevertheless, Canada is very much dependent on a rebound in global macro expectations, highlighted by the fact that Canadian stocks are down about twice as much as US markets this year.

EUROPE

- The escalating debt crisis in the euro zone is another major source of uncertainty. The latest country dragged into the crisis spotlight is Italy, which demonstrates the EU's efforts to prevent contagion aren't working. Italy's situation is similar to Portugal's; the budget deficit is not a problem at a projected 4.3% of GDP this year, especially with its primary balance (budget deficit excluding interest payments) already in surplus. However, with a total debt load over 120% of GDP Italy's sluggish growth rate threatens the country's debt servicing ability. The government is rushing through more austerity measures and more market reforms, which may boost growth down the road, but will also exacerbate the near term recession threat.
- 10-year Italian bond yields have surged 100 basis points since the start of July and the spread to German Bunds gapped out to almost 400 basis points highlighting the increasing danger of a liquidity crisis in the third largest euro zone member state. Meanwhile, reminiscent of the US debt ceiling debate, the EU is unable to forge an agreement on a bolder approach to tackle the crisis, such as a significant increase in the size of the current €750 billion bail-out fund or the issuance of euro zone bonds.
- While the politicians are wrangling, the European Central Bank (ECB) is stepping up its bond purchasing program, which now includes Spain and Italy and amounts to QEII in the euro zone. Looking at the latest macro trends, growth is holding up so far – even Italy reported another expansion in GDP in the second quarter – but the momentum is clearly slowing, which will increase the pressure on indebted countries. Only a bigger deal among the 17 euro zone members will ease market concerns and stop the vicious cycle.
- The UK continues to stay out of the debt crisis spotlight. Its fiscal austerity program has laid out an apparently credible path towards eliminating a budget deficit that last year was on par with the US and more than twice as large as Italy's. However, the economy is paying a heavy price with tax increases and spending cuts depressing growth. Latest data showed the recession in domestic demand, which started last October, is likely to have stretched into a third quarter. Inflation remains much higher compared to other developed world economies and the Bank of England has

kept interest rates at record low levels.

- Yet, despite all this, UK equity markets have held up better than Germany's in the past six weeks. Its credit default swap (CDS) spread is trading almost on par with Germany and 10-year Gilts have outperformed Bunds since the start of July. The key for the UK is to demonstrate further deficit reduction, despite the weak growth backdrop. If that can be achieved, then the country will remain out of the crisis spotlight and off the ratings agencies' radar screens. However, if fiscal consolidation starts to slip, the UK's AAA rating will be coming under scrutiny as well.

ASIA

- In synchronous risk asset sell-offs, like the current one, investors always look for markets that are different; Japan is such a market. Its fiscal numbers look far worse than anything we see in the US or Europe, but almost all of its government bonds are owned locally, which explains the extraordinary stability of the JGB market. The currency has appreciated against the US dollar on the back of asset repatriation and equity markets have held up well because of expatriation of a significant post-earthquake stimulus.
- The Bank of Japan already increased its asset purchase program, which includes equities, and the government is working on a series of large fiscal spending packages to finance the rebuilding of the earthquake devastated regions. While most of the developed world is walking down the fiscal austerity road, Japan is going in the opposite direction. It's GDP growth rate is expected to rebound strongly in the second half, making it one of the few developed world economies likely to report an improving macro backdrop. All that supports our overweight in Japanese equities, a trade that will work even better the longer the global uncertainty lasts.
- In the rest of Asia, we see more signs of slowing economic growth and a lack of improvement in inflation trends. China's manufacturing PMI index continues to hover just above the critical 50 level, which demarcates expansion from contraction; Singapore and Taiwan have already fallen through that level.
- And it's not just the surveys. Industrial Production across Asia has slowed in the past three months; in some cases such as Malaysia and Taiwan output growth is contracting rapidly. Meanwhile, inflation is still generally trending upwards. China's CPI inflation, for example accelerated to an annual rate of 6.4%, while Korea and Singapore's inflation indices rebounded to 4.7% and 5.2%, respectively, after three improving monthly readings.

- Taiwan continues to stand out with a much lower rate of inflation, which slowed surprisingly in July to just 1.3%. The market turmoil may deter some central banks from taking further actions, but the threat to growth in Asia may now come from two sources, tighter monetary policy and a slowdown in the economies of its main trading partners; all that points to a difficult second half in Asian equity markets.

INVESTMENT STRATEGY

- It is very difficult to formulate investment strategy in such a volatile environment. I believe reacting to a market panic is never a good reason to buy or sell. We have been risk neutral in our portfolios for a while and are happy to remain so.
- The issues weighing on financial markets are mainly political in nature and could be solved quickly with sufficient will among US and euro zone politicians. Meanwhile, the economic trends underneath the policy-provoked crisis remain robust. There is still enough pent-up demand in the consumer and business sectors around the world, corporate balance sheets flush with cash and interest rates are low, which should force companies to invest in productive capacity rather than financial assets.
- I also still believe that developed markets can outperform emerging markets for a while as growth prospects in EM wane with further policy tightening. However, it's too early to implement a more bullish investment strategy. In the current volatile market environment, a more balanced allocation to equities and corporate bonds is one way to dampen volatility in portfolios.
- Looking ahead, I want to see signs that the US debt reduction process can lead to a credible long term deficit reduction strategy and that EU member states are taking bolder actions to prevent further contagion of the liquidity crisis in the euro zone. Once we can see light at the end of the current "political tunnel," investment strategy can tilt back toward robust fundamentals and cheap valuation; in the meantime event risk rules.



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