

Global Market Watch

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REVIEW

- Equity markets continued their current bull run in May, though index performance was less impressive than it was in April. The S&P 500 finally followed the Dow Jones Industrial Average into new record territory in May, exceeding its previous all-time high set in 2001. European markets, with the exception of Germany, lost some momentum, and Japan's stock market continued to lag other major developed stock markets. Global bond prices fell sharply in May, led by 10-year Eurozone and U.S. Treasury bonds, while bond markets in the United Kingdom and Australia saw spreads vis-à-vis the United States narrow as a result of smaller yield increases in those markets.
- Early evidence of a possible change was also seen in global currency markets. During May, the trade-weighted U.S. dollar index stabilized, and the dollar gained some ground against the Japanese yen, euro, British pound and Australian dollar. Two currencies stood out last month, recording significant appreciation against the U.S. dollar. The Chinese yuan gained 0.74 percent, not a significant gain compared to other currencies, yet it was the biggest monthly gain since the one-time revaluation in July 2005. As for the Canadian dollar, it ended the month at its strongest level versus the dollar in nearly 30 years.

UNITED STATES

- Over the past few weeks, evidence has gradually been accumulating that the U.S. economy is in a better state than many headlines or some of our more bearish colleagues suggest. Granted, the slowdown in gross domestic product (GDP) growth in the first quarter looked quite dramatic – it was the weakest performance since 2002. However, the main drivers were a short-term inventory cycle and an outright decline in U.S. exports. The latter is quite inconsistent with the strong global growth backdrop and the weak U.S. dollar.
- Looking ahead, there is growing evidence that the inventory adjustment in the manufacturing sector is over and we are looking for a strong rebound in U.S. exports in the coming quarters. Housing remains the biggest risk, but there is still no evidence of a negative impact on consumers. In fact, consumer confidence increased again last month. Soaring stock markets and steady job growth outweighed falling house prices, rising sub-prime home foreclosures and record-high gasoline prices.

EUROPE

- GDP growth in the 13-member Eurozone held up better than expected in the first quarter, putting the Euro-area on track to record faster annual growth than the United States for the first time in six years. Among the larger economies, Germany remains the main growth engine. Though consumer spending predictably declined as a result of a sales tax increase at the start of the year, business investment, government spending and inventories all increased at a very rapid pace.
- Looking ahead, we expect a loss of momentum in overall Eurozone growth as a result of higher domestic interest rates and a very strong euro. Monetary policy is likely to be less transparent going forward. Policy rates are approaching neutral, yet the economy is growing well above its long-term trend rate, and inflation remains close to the upper end of the bank's comfort zone. We are still looking for two more interest-rate increases during the remainder of the year.

ASIA

- The current macro backdrop in Japan is more difficult to assess. A sharp drop in machine orders earlier in the month raised fears that the economy might be weakening again. Indeed, the annual growth rate of both industrial production and service sector activity has slowed again in the past few months, suggesting a loss of momentum in overall GDP growth. However, recent labor market data showed a marked improvement in employment growth and a drop in the unemployment rate to a nine-year low.
- Overall, it appears that the Japanese economy remains on an improving trend, which is consistent with the Bank of Japan's assessment, yet it raises the risk that Japanese policy rates might increase earlier than we are forecasting. Meanwhile, in China, the issue is still how to cool the overheating economy. The government is using a plethora of policies from rate hikes, tighter credit controls, and faster currency appreciation to the most recent increase in stamp duty on stock sales. We expect growth to remain very buoyant in the coming quarters and are concerned about rising inflationary pressures in China.

INVESTMENT OUTLOOK

- We maintain a positive stance on global equities. The macro risks, mainly in the United States, have receded somewhat, and the very positive equity market backdrop of steady economic growth, strong earnings results and relatively stable interest rates continues. We see the risk shifting away from a potential housing recession in the United States to faster inflation and a broader trend of monetary tightening in the United States, Europe and Asia. Global bond yields could continue to drift higher in the coming months as growth prospects especially in the United States improve. Yet, we expect that the trigger for a more sustained upward move in bond yields will be faster global inflation later in the year.



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