



Global Market Watch

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REVIEW

- June's main event was the sharp increase in government bond yields across most global markets. In the United States, ten-year U.S. Treasury bond yields rose earlier in the month to a new five-year high of 5.29 percent. In the second half of June, bond yields settled into a new trading range between five and 5.15 percent. Global bonds followed the U.S. market, closely matching the yield increase of approximately 20 basis points for the month.
- Higher interest rates made June a tough month for global equity markets. U.S. equities fell between two and three percent, while European markets fared a little better, falling about 1.5 percent. Japan once again provided evidence for its lack of correlation to most other developed equity markets by ending the month roughly unchanged. Most emerging market indices continued to post solid gains, with the exception of China, which posted a small index decline.
- The changes in interest-rate differentials also impacted currency markets. The U.S. dollar initially benefited from higher U.S. bond yields. However, "carry trades" (buying currencies with high interest rates funded by currencies with low interest rates) reasserted themselves at the end of the month with the Australian dollar and British pound again outperforming the U.S. dollar. On the flip side of the "carry trades," the Japanese Yen weakened further, reaching its lowest level vis-à-vis the dollar in about 4.5 years.

UNITED STATES

- Changing expectations about the near-term U.S. growth outlook was the main catalyst for the surge in global bond yields. Recent economic data provided convincing evidence that the inventory correction in the manufacturing sector is over. International trade is also expected to add significantly to gross domestic product (GDP) growth in the second quarter, while the drag from housing is likely to be significantly smaller compared to the previous three quarters.
- The main debate now focuses on the sustainability of the current growth rebound. Clearly, housing remains the biggest problem. The most recent data still does not point convincingly to a stabilization, and the sector is likely to

remain weak during the summer. The key problem is the ongoing overhang of unsold new homes, which need to fall sharply in the coming months to drive the rebound in the construction sector that we forecast for later in the year.

EUROPE

- The European growth backdrop remains fairly strong, yet the most recent reports point to a loss of momentum in overall activity. This is not really surprising, given the strength of the Euro and the eight policy-rate increases in the past 18 months. Still supporting growth is the structural improvement in the Eurozone labor markets, which is boosting household spending. However, higher interest rates and energy cost are likely to slow consumer demand later in the year, leading to weaker growth in 2008.
- The European Central Bank raised policy rates to four percent in June and softened its rhetoric, suggesting that with interest rates closer to neutral, the bank will pay more attention to the overall growth outlook and will take into account the lagged impact of monetary tightening on the economy. In the United Kingdom and Sweden, expectations of further interest-rate increases are also rising again as a result of stronger-than-expected economic growth.

ASIA

- China is still trying to slow the very strong pace of economic growth to avoid a more serious increase in inflation. Business investment growth re-accelerated this year, increasing 25 percent from a year ago in May, while industrial production is running at a very strong 18-percent pace. As a result, the authorities are likely to continue to tighten monetary conditions in the coming months and allow the Yuan to appreciate further to discourage export and investment growth.
- Japan's economic backdrop is looking a bit brighter again. Business investment remains strong and declining unemployment suggests a tightening in domestic labor markets, which should support faster household income growth in the coming months. While a more bullish growth outlook could strengthen the case for further interest-rate increases, the uncertain outcome of the upcoming Upper House elections suggests more patience.

INVESTMENT OUTLOOK

- Overall, we remain fairly positive on global equity markets. The growth backdrop across most major economies remains strong and corporate earnings are still growing at a decent pace. However, higher interest rates not only impact stock market valuations, but are also likely to weigh on economic growth especially in Europe. Bond yields should continue to drift higher in response to further policy rate increases in most economies. Finally, the period of broad U.S. dollar weakness is over, yet “carry trades” remain attractive supporting further gains in the Australian dollar and the British pound.



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