

Global Market Watch

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REVIEW

- April was another good month for global equity markets. In the United States, the Dow Jones Industrial Average broke through the 13,000 level to set an all-time high of nearly 13 percent higher than the previous 1999 record. In addition, the S&P 500 crept within three percent of its all-time high set in 2000. European and overseas equity market performance was more mixed with Germany and France outperforming the United States, while Italy, Japan, Sweden and the United Kingdom fared less well.
- European bond markets saw yields increase much faster than in the United States, lowering the U.S. yield advantage in 10-year government bonds to the lowest level in 2½ years. The U.S. dollar lost more than 1.5 percent versus the British Pound, more than two percent against the Euro, and nearly four percent against the Canadian dollar. Among the major currencies, only the Yen was again unable to benefit from the broad dollar weakness, losing almost 1.5 percent in April.

UNITED STATES

- The high degree of uncertainty about the U.S. macro outlook continued throughout April. The first quarter gross domestic product (GDP) report showed that the economy was growing at the weakest pace in four years. Consumer spending and business investment remained strong, while the main headwinds came from housing, inventories and exports. Housing remains a problem although there are signs that the drag on overall GDP growth is diminishing. Inventories typically have short cycles and should not detract from growth any further this year. Exports are likely to rebound given the strong global growth backdrop and the weak dollar.
- We maintain that the Federal Reserve is doing the right thing in an environment of increased uncertainty by leaving interest rates unchanged. While the risk of contagion from housing remains, there is so far no evidence to support that conjecture. Inflation risks in the form of rising oil prices and survey evidence of rising price pressures in the producer sector suggest that the risk to the inflation outlook remains on the upside. If we are correct in our forecast that growth will increase in the second half of the year, then the Federal Reserve's next move will be an interest-rate increase, most likely before the end of the year.

EUROPE

- Fears that a tax hike in Germany might derail the strong rebound have long disappeared, and recent data from both the manufacturing and service sectors indicate a relatively steady growth momentum in the Eurozone. However, there are signs that France and Italy are losing more ground vis-à-vis Germany, which is enjoying a stronger growth backdrop helped by buoyant exports and strong domestic employment growth. Higher interest rates and the steady appreciation of the Euro, especially versus the Japanese Yen, are likely to slow the strong Eurozone momentum in the coming quarters.
- Inflation and monetary policy were in the spotlight in the United Kingdom last month. The consumer price index rose to 3.1 percent, the highest level in almost 17 years. This increase required that the central bank governor write a letter to the Finance Minister explaining why inflation is running more than one percentage point above the bank's target. It is still widely expected that inflation will moderate significantly in the coming months as a result of announced utility price cuts. Nevertheless, the inflation surprise has raised the chances of another rate increase this month.

ASIA

- The last few months have yielded more negative news about Japan's economy. Specifically, consumer spending appears to have slowed, while business investment and exports maintain a much stronger momentum. Inflation has slowed below zero, suggesting that a temporary lapse back into deflation. Consequently, the Bank of Japan is on hold again after raising rates in February, and we don't expect the next interest-rate increase to occur before the fall.
- China's economy, on the other hand, appears to be gathering more steam. First quarter growth exceeded 11 percent, its stock markets are surging higher, and inflation is increasing. The Bank of China raised rates in March and has pushed up the level of reserves that banks are required to hold with the central bank, indicating the government's attempt to slow down rising price pressures. It is a different story in Australia, where a surprise moderation in inflation in the first quarter eased pressure on the central bank to raise interest rates. As

a result, the Australian dollar has started to lose some of the recent gains vis-à-vis the U.S. dollar.

INVESTMENT OUTLOOK

- A strong consensus about the bullish global growth backdrop, the tentative signs of accelerating global inflation, and the tightening mood of central banks around the world indicate that equities remain a good investment in the coming months. Macro risks remain concentrated in the United States, which should result in further dollar vulnerability and the potential for foreign equity markets to outperform their U.S. counterparts.



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