



## REVIEW

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- The consensus among financial market participants is coming around to our view that global growth is accelerating again. Led by the United States and Europe, developed market economies are registering stronger domestic demand, helped to some extent by lower energy prices. There are some concerns that the extreme weather conditions might increase the volatility in economic data in the coming weeks, yet the underlying trend is clearly improving.
- Not surprisingly, most financial markets had a mixed start to the year. Stock markets have recovered their initial losses from early January, yet bond yields were generally higher across the board with the exception of Japan, where they actually declined a few basis points.
- The U.S. dollar started the year on a bullish note, buoyed by signs of stronger economic growth and fading expectations of interest-rate cuts. The dollar gained ground against most European currencies and the Japanese Yen. The British Pound was the one exception. The U.S. dollar weakened against the Pound due to the Bank of England's surprise interest-rate hike.

## UNITED STATES

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- Despite the weather-related issues that are currently clouding the true strength of the U.S. economy, there is enough evidence to conclude that the pace of economic activity increased quite significantly at the end of last year. The main driver is increased consumer spending, which was partly driven by falling energy cost, but mostly a result of stronger employment and income growth.
- The good news is that despite the acceleration in growth, inflation trends continue to moderate, and the recent decline in gasoline prices bodes well for the next few inflation reports. However, recent comments by several Federal Open Market Committee members suggest that further inflation moderation is necessary to validate the Federal Reserve's current policy stance.

## EUROPE

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- The big issue in Europe is the impact of Germany's tax increases on the overall growth in the 12-member Eurozone. So far, very little actual data is available to gauge the degree of slowdown in consumer spending at the start of the first quarter. The only evidence so far are a number of sentiment surveys, which indicate that businesses and investors have faith in continued robust domestic demand growth.
- The European Central Bank left interest rates unchanged at their first meeting of the year. Clearly, the bank is also waiting for more evidence on the tax hike impact. Statements following the meeting suggest that the bank still plans to push interest rates higher in the coming months, though it seems likely the bank will wait until March or April for its next move.
- Gross domestic product growth in the United Kingdom accelerated at the end of 2006 to the fastest pace in 2.5 years. This activity confirms the positive impact of the housing market rebound. It also highlights the potential for further interest-rate increases by the Bank of England, which surprised investors in January with another quarter-point interest-rate increase to counter the persistent upward trend in headline inflation.

## ASIA

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- The big story in Japan last month was the public relations disaster surrounding the Bank of Japan's first meeting of the year. In the weeks prior to the meeting, bank officials had readied the market for a second interest-rate hike. Yet, increased criticism by the government, which faces crucial elections this year, persuaded the Bank of Japan to abandon its rate hike plans and maintain its current interest-rate level.
- China recorded another quarter of strong economic growth at the end of 2006. The 10.4-percent growth rate in the fourth quarter followed a slightly stronger trend over the summer, indicating that the economy is not showing any adverse impact from the gradual currency appreciation last year. In fact, the increase in domestic inflation implies that China could benefit from a stronger currency.

## INVESTMENT OUTLOOK

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- Based on strong macro fundamentals, we continue to believe that global equity markets should perform well in the coming months. However, the increased uncertainty regarding the U.S. economic backdrop and the growing consensus that the Federal Reserve will not cut interest rates anytime soon could make for a more volatile backdrop for stock markets in the short term.
- Among the major equity markets we maintain our positive outlook for Japan based on cheap relative valuation and continued low interest rates. Emerging market equities are potentially more susceptible to changes in interest-rate expectations and, with valuations not as cheap as six months earlier, it might also be harder for this asset class to outperform developed markets.
- The U.S. Treasury market already reacted to the stronger macro backdrop and the change in interest-rate expectations by reversing the bullish trend from two months ago, when the 10-year U.S. Treasury bond yields were pushed to a low of 4.42 percent. Since then, yields increased to a five-month high of 4.87 percent. Looking forward, we expect bond yields to stabilize and trade between 4.95 and 4.75 percent.



Markus Schomer, Global Economic Strategist

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