

Global Market Watch

April 2007

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OVERVIEW

- Equity markets around the world posted a tentative rebound in March following the sharp sell-off in late February. However, investors remain nervous. Elevated volatility in both equity and fixed-income markets is the best indicator of the increased level of risk aversion that could threaten further market corrections in the near term.
- The next few weeks could be a critical inflection point for financial markets around the world. The main reason for the market volatility is the uncertainty about the U.S. economic backdrop and, more specifically, concerns about the state of the U.S. housing market. Add to that the most recent increase in tensions between Iran and the West, and the move towards safer assets such as U.S. Treasury bonds starts to make sense.

UNITED STATES

- It's all about housing. Will the credit crunch that is unfolding in the so-called sub-prime mortgage sector spill over to the rest of the economy? So far, there is no conclusive evidence to support that argument. Yes, foreclosure rates are rising fast among weaker borrowers, while lenders that are exposed heavily to the sector are experiencing solvency problems.
- So far, however, deterioration in the availability of credit in the prime mortgage sector or in other credit markets, such as auto loans or credit cards, is not apparent. Critical for the positive resolution of the current crisis is the continuation of positive job growth. Only the loss of income will force a large enough number of mortgage holders into defaulting on their payments.
- Despite the negative headlines, the Federal Reserve is sticking to its view that the economy is fine and that inflation remains the bigger risk. However, the most recent Federal Open Market Committee (FOMC) meeting produced subtle changes to the policy statement, suggesting that the Federal Reserve is acknowledging the fact that other factors – in addition to inflation – could trigger a change in interest rates, which is an implicit recognition of the increased growth risk.

EUROPE

- In contrast to the United States, the European growth backdrop remains strong. The latest data on gross domestic product (GDP) growth in the fourth quarter of last year showed the 12-member Eurozone growing at the fastest pace in more than six years. The main driver is a very buoyant German economy, whose annual growth rate of 3.7 percent outpaced the United States for the first time since the U.S. recession in 2001.
- A key driver of Europe's robust growth performance is still the strong growth of exports to Asia in general and China in particular. However, stronger domestic employment growth has become an even more important driver of GDP growth as the steady increase in consumer spending indicates. Fears of tax increases in Germany might disrupt the rebound but appear unfounded, as demonstrated by the most recent European economic confidence surveys.
- The European Central Bank (ECB) had been lagging behind other central banks in normalizing interest rates and is expected to be coming to the end of that process in the next few months. Inflation has been fairly contained. Yet, with economic growth well above the Eurozone's growth potential and money supply growth in excess of 10 percent, the ECB is likely to maintain a fairly hawkish stance.

ASIA

- Japan was the only major stock market that did not participate in the global equity market rebound in March. While the United States and Europe recorded small positive returns, Japanese stocks lost 2.2 percent. The Yen has not made further progress vis-à-vis the U.S. dollar after the February rally lost ground again versus the Euro.
- It's true that the 5.5-percent growth rate in the fourth quarter of last year was the best quarterly performance in three years. Since then, however, the data has shown weaker consumer spending and slower income growth. In addition, inflation is again standing still and is likely to fall back below zero percent in the coming months, which should prevent further interest-rate increases by the Bank of Japan this year.
- Meanwhile, authorities in China continue to slow the fast pace of economic growth, which has started to stoke up inflation. In response, the Peoples Bank of China raised

interest rates in March, and an accelerated Reminbi appreciation versus the U.S. dollar seems likely. It is probably too early to forecast that faster inflation in China could also negatively impact price trends in the United States, another reason for the Federal Reserve to remain vigilant.

INVESTMENT OUTLOOK

- The argument that recent bearish U.S. data was significantly impacted by extremely cold February weather will be tested in the coming weeks. So far, we stand by our forecast that the U.S. economy is in better health than the current headlines suggest. However, further deterioration in the U.S. economic data in the coming months could force us to downgrade our macro forecast and abandon our call for an interest-rate increase before the end of the year.
- While it seems prudent in the current uncertain macro environment to reduce risk and favor safer investments such as government bonds, we believe that stronger underlying fundamentals – both in the United States and abroad – will come to the forefront again in the coming weeks. These stronger fundamentals will likely push bond yields higher and improve the outlook for global equity markets.



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