

Global Market Watch

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OVERVIEW

- Inflation is clearly the most dominant global macro theme right now. We believe that the erosion in real household income growth, resulting from rising inflation, is the main driver of weaker economic growth in the U.S. since the end of last year. Thus far, the slowdown has been gradual. However, with oil prices up a whopping 30% in the last three months, the pressure from soaring energy prices is getting more intense and is putting more downward pressure on real consumer spending and corporate profits.
- Higher-than-expected inflation has also reduced the policy options available to central banks and caused us to delay forecasts of further rate cuts in the Eurozone, UK and Canada further out towards the end of the year. Meanwhile, fiscal policy is becoming a more important growth contributor. In the U.S., the \$150 billion stimulus package is just hitting the economy and Congress is moving closer to agreeing on a \$300 billion mortgage support program. In the UK and New Zealand, authorities have cut taxes. Lastly, more expansionary fiscal policy is likely in many of the Eurozone economies.
- Following the Federal-Reserve-managed Bear Stearns rescue in March, investors have gradually shed their risk aversion and financial markets have seen a strong rebound in the performance of risk assets. World stock markets are up more than seven percent, with emerging markets once again outperforming developed market indices. Credit spreads narrowed sharply, led by high yield bonds, which had one of its best months ever in April. The U.S. dollar gained ground, especially against the euro and Japanese yen.

NORTH AMERICA

- The growth momentum in the U.S. economy has not improved from the 'stall-speed' pace we have been on since the end of last year. In fact, the ongoing surge in oil prices is adding greatly to the pressures on the economy and raising the downside risk to our forecast of a moderate growth rebound in the second half of the year.
- Despite improving affordability, housing data continues to disappoint and a bottom in demand is still not evident. Retail sales recovered in April, contrary to expectations. This occurred without the benefit of tax rebates, which started to arrive in May.
- However, consumer sentiment continues to erode. The good news is that we do not see the economy slipping into the red, though there is still no convincing evidence

of a rebound in activity. Meanwhile, the Federal Reserve has clearly communicated its intention to leave interest rates at their current two percent level for the foreseeable future, putting more pressure on fiscal policy to continue its support of the adjustment process in the housing and banking sectors.

- Inflation is now also showing up on the agenda in Canada. While inflation trends accelerated in most developed economies in the past six months, Canada experienced a surprising slowdown in measured inflation, which allowed the Bank of Canada to be proactive and cut interest rates after the first signs of weaker economic growth. With about 30% of Canada's GDP dependent on exports to the U.S., the bank's haste to provide a timely monetary stimulus is not surprising. The domestic economy actually still looks quite robust. Housing prices are still growing at a decent five percent clip and strong job growth is supporting robust consumer spending. However, we expect the weakness in manufacturing to gradually spread to the consumer sector in the coming quarters and, lacking the same fiscal stimulus we expect in the U.S., Canada is likely to underperform its Southern neighbor this year.

EUROPE

- Slowdown? What slowdown? The 15-member Eurozone reported a much stronger than expected three percent increase in GDP growth in the first quarter. While we don't have a detailed break down yet, at the time of writing, we know the main driver was an outsized 6.3% growth rate in Germany. We expect that, in addition to exports, stronger construction, helped by a mild winter, played a major role. Outside of Germany, things are not looking as rosy; the past few months brought further evidence of a more serious slowdown in Italy and Spain. Against this backdrop, monetary policy is becoming increasingly difficult for the ECB. Inflation, at 3.3%, is still running too high for a change in the bank's neutral stance on interest rates. Consequently, we have moved back our forecast of lower policy rates in the Eurozone and are now looking for the ECB to cut rates for the first time this year at the end of the third quarter.
- Another central bank struggling with rising inflation is the Bank of England. A few weeks ago, we had a reasonably high degree of confidence in forecasting further rate cuts in the UK. The domestic economy is increasingly impacted by a weakening housing market, where prices have started to decline nationwide, and the fall-out from the financial markets crisis on the UK's large financial sector. However, with inflation accelerating again towards three percent it

seems the window for further rate cuts has closed for now. Three percent is the threshold at which the Governor of the Bank of England has to write a letter to the Chancellor explaining why inflation is running more than one percent above target and what the bank intends to do to get inflation back towards the target.

ASIA

- Japan also recorded surprisingly strong GDP growth in the first quarter. After a period of weakness in the middle of last year, the world's second largest economy rebounded in the last two periods, on the back of stronger consumer spending and stronger net exports (exports minus imports). Not surprisingly, Japanese stocks posted a particularly impressive rebound in April – the Nikkei had its best month in 13 years – and are still trending higher thus far in May. The economic outlook remains clouded, though. Most commentators expect a slowdown in the current quarter. The yen appreciation since last summer, notwithstanding the small reversal in the past few weeks, could slowly erode Japan's international competitiveness.
- I spent a week traveling in Asia last month and was again amazed by the extent of visible infrastructure investment in China and other parts of the region. We continue to believe domestic infrastructure spending will be a significant tool for countries to offset potential weakness in the export sector. Meanwhile, China, like most emerging economies, is wrestling with the specter of growing inflation pressures from surging energy and food prices. The devastating earthquake in Sichuan province, which killed more than 50,000 people, caused wide-spread damage currently estimated at about US \$20 billion. The Chinese government is trying to redirect financial resources to the reconstruction effort, but undoubtedly the result will be additional fiscal spending and increased demand for construction material during the rebuilding process, which could exacerbate the commodity inflation problem.

INVESTMENT OUTLOOK

- After the strong bear market rally in equities and aggressive

spread tightening in fixed income credit markets in the past two months, we are expecting a more difficult market environment in the next few months. Yes, we probably won't have to worry about the worst-case scenario of a broad-based meltdown in the U.S. banking sector. Yet, significant economic and financial markets risks remain. Corporate profits are likely to remain under pressure and equity markets are more likely to see renewed weakness than to continue their recent rally. Consequently, we increased our equity underweight in our balanced portfolios again this month, following a reduction in April. While we missed out on the equity rally, within our fixed income strategies we have been increasing allocations to higher-risk asset classes such as Investment Grade and High Yield over the past three months, allowing us to benefit from the rally in credit spreads.



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