

Global Market Watch

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GLOBAL OVERVIEW

- The financial market crisis that swept around the globe in the past few months is still impacting investment decisions in a significant way. However, the decisive action by the Federal Reserve Bank in the U.S. has restored market confidence, clearly evident in the global equity markets. This has resulted in impressive rallies during the past few weeks, which pushed the Dow Jones to a new record high. World equity markets overall erased about 90% of their decline between the middle of July and August, while emerging stock markets are already trading about 5% above their mid-July highs.
- While equity markets around the world rally in unison, trends in global currency markets are driven by the different policy response from major central banks. The surprisingly aggressive interest rate cut by the Federal Reserve in the U.S., and expectations of further easing, have driven the trade-weighted U.S. dollar index to new record lows. The primary beneficiaries were currencies supported by higher interest rates, such as the Australian and New Zealand dollar, as well as currencies in countries with greater certainty concerning the economic outlook, including Canada and those in the Eurozone.

UNITED STATES

- There is still a large degree of uncertainty about the future path of economic growth and interest rates in the U.S., and the majority of economists are still forecasting weaker growth – or even a recession – in the coming quarters. Clearly, the housing situation is still getting worse. However, it has become harder to differentiate whether the recent drop in home sales is due to a lack of demand, which would suggest further problems in underlying consumer fundamentals, or a lack of available financing, which should come back once market conditions normalize.
- We have maintained a more constructive outlook on the U.S. economy, and we are encouraged by recent evidence of strong household income growth and better-than-expected consumer spending data in August. Business activity appears to have weakened somewhat, yet there is no evidence of the broad-based credit crunch that preceded the last recession. In fact, the U.S. economy should record about 2.75% growth in the 3rd quarter, and we expect growth to remain between 2% and 2.5% in the current quarter.

EUROPE

- While strong global growth (especially among emerging economies), and the resulting boost to export demand has been a major offset for the U.S. economy, there are signs other regions are also shifting to slower growth. The most obvious case is Europe, where a combination of housing woes and a strong Euro are weighing on economic activity. Yet we believe underlying fundamentals remain strong, and structural reforms such as reductions in unemployment benefits in Germany continue to drive employment growth and consumer spending.
- The UK economy is probably most exposed to the dual headwind from domestic housing and financial market crises. The UK housing market is demonstrating a similar degree of overvaluation and household leverage to that in the U.S., while the importance of the financial sector to overall economic growth makes the UK more vulnerable to cutbacks among financial services firms.

ASIA

- After losing the recent Upper House election, Japanese Prime Minister Shinzo Abe resigned at the end of last month, after only a year in office. He stumbled over a bungled response to revelations of millions of lost pension documents. His successor, Yasuo Fukuda, will head a more weakened government that may find it much harder to get further reforms through a divided parliament.
- Meanwhile, the Japanese economy is sending out mixed signals. GDP growth in the 2nd quarter was revised from an already paltry annualized 0.5% to a 1.2% decline – the worst result in more than four years. The main driver behind the disappointing GDP report was a sharp downward revision to business investment. However, other indicators, such as rising machine-tool orders or the most recent quarterly business sentiment survey, which showed a steady expectations of future business activity, do not signal a deterioration in underlying business activity. This suggests the negative GDP report is not a true indication of growth momentum in Japan.

GLOBAL OUTLOOK

- Much of the investment outlook depends on the action central banks will take in the coming months. In the U.S.,

the Federal Reserve should be encouraged by the gradual improvement in financial market conditions. We are not out of the woods yet, as evidenced by the large losses reported by major banks and brokers, and the Fed might well decide to cut rates again, as long as inflation remains under control. The futures market is pricing based on a 60% chance of an interest-rate cut at the next Federal Open Market Committee (FOMC) meeting at the end of October.

- Following the most recent equity market rally, stocks once again appear to have advanced faster this year than the fundamentals would suggest. However, they are vulnerable to setbacks, either from policy disappointments or further negative company announcements. Government bond markets, on the other hand, are still pricing based on excessive risk aversion and are equally vulnerable to policy disappointments and evidence of stronger economic growth. Against this backdrop, we are maintaining our neutral stance between stocks and bonds.



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