

# Global Market Watch

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## Overview

- “If there ever was a week for putting the world to rights, this is it,” wrote the British newspaper *The Guardian* in an article previewing the upcoming United Nations General Assembly meeting and the G20 Summit in Pittsburgh.
- Global financial markets show little evidence of waning optimism. Global equities are up more than 17% since the end of June, with emerging markets only modestly outperforming their developed world counterparts.
- Among the major developed regions, Europe posted the strongest performance, helped by a rising Euro, while Japanese stock markets weakened notably since the recent general elections.
- While the UN Delegates will have to deal with the prevailing geopolitical risks, the G20 proclaims on its website that it will attempt to “lay the foundations to move beyond the crisis to a sustainable recovery.”
- Less than a year ago in Washington, there was broad-based agreement among the leaders to counteract the crisis with expansionary monetary and fiscal policy. The London Summit earlier this year built on the consensus for coordinated action and reaffirmed the group’s commitment to avoid raising new barriers to trade or investment. The participants also pledged to establish greater consistency in financial market regulation and systemic cooperation between countries. It remains to be seen whether all those involved will maintain a cooperative spirit now that the gloom is lifting.
- Interestingly, among the three emerging market regions, there is very little differentiation in performance, suggesting the current rally is driven more by a broad-based increase in risk appetite, than by specific regional fundamentals. Despite the stock rally, 10-year government bond yields drifted lower in most regions, with U.S. Treasuries outperforming European and Japanese bonds.

## North America

- Although some are still hesitant to accept it, the U.S. economic recovery remains on auto pilot. Manufacturing production continues to rebound, helped by stronger exports, government spending and a recovery in business investment. Companies remain cautious, however, and have not increased employment, which is boosting productivity and corporate profitability.
- Consumers are still lagging behind, but wage and salary income has stabilized in recent months and should start to support a modest increase in consumer spending in the months ahead. Add to that the strong rebound in housing, the result of the recent surge in home sales, and all sectors of the U.S. economy are on track to contribute to GDP growth in the next few quarters.
- The key argument for a sustained recovery centers on a turnaround in the U.S. labor market, and we continue to believe that we are getting very close to that point in the cycle. Already, price pressures are increasing in the producer sector, proving that supply is lagging behind the recovery in demand. This should at least halt the prevailing downward trend in employment and soon lead to a rebound in hiring, adding a second stage to the U.S. economic recovery in 2010.
- Canada was one of a few economies that did not show a rebound in the second quarter, reporting a 3.1% annualized decline in GDP growth, nor did it experience a meaningful slowdown in the recessionary trend, as the U.S. did.
- Recent economic data, however, points to a more notable improvement in economic activity over the summer. The Manufacturing Purchasers Managers Index has jumped back into expansionary territory, and Retail Sales, despite suffering a setback in July, continue to expand at a 5% annualized pace over the past three months.

- Where progress is still lacking is in Canada’s labor markets. Contrary to the U.S., we have already seen two months of growing employment this year (April and August), yet the Unemployment Rate is still trending higher. Hence, the rather erratic recovery in consumer spending is not surprising. Spending should strengthen if job growth can rebound more consistently. Although Canada was lagging behind Europe and Asia in the second quarter, we expect that, similar to the U.S., Canada will experience a stronger, more vigorous rebound in the fourth quarter of 2009.

## Europe

- Looking back at the second quarter, one of the biggest surprises was a return to outright positive GDP growth in Germany and France. However, the rebound was more a reflection of the depth of the preceding decline than an indication of the strength of recovery drivers in the Eurozone. While most other major economic regions are on course for a substantial bounce in real GDP in the current quarter, Eurozone growth is tracking much closer to our forecast of virtually no growth during the third quarter.
- Adding to the sense of uncertainty is the prospect of a significant change in the political landscape as a result of the upcoming general elections in Germany, the Eurozone’s largest economy. For the past five years the country’s two largest parties governed in a “Grand Coalition,” which provided the political stability needed to weather the worst post-war recession in Europe. Yet, new ideas are needed to move Germany and the Eurozone out of the crisis. German voters are being asked to choose between the more business-friendly recipes of a center right coalition, which has a slight lead in the polls, and the more government-interventionist ideas of the center left.

- A change in government seems inevitable in the UK as well, although elections here are not due until the spring of next year. The Conservatives are well ahead in the polls. Therefore, the two largest European economies could move to the right within the next eight months, which could have significant implications for the direction of economic policy during the recovery, with less reliance on government spending and more emphasis on tax cuts. It could also reduce Europe's appetite for more stringent financial market reform. This is all the more reason for the G20 Summit to try its best to reach an agreement on concrete steps that will help improve the global regulatory infrastructure.
- After lagging behind most of the rest of Europe in the second quarter, when UK real GDP declined at an annualized rate of 2.6%, Purchase Managers indices are now, surprisingly, pointing to a rebound in UK Service sector activity, whereas the Manufacturing sector is not yet out of the woods. Second-half economic performance in the UK should be stronger compared to the rest of Europe, yet also more erratic, given the reliance on consumer spending amid still-rising unemployment.

## Asia

- The sluggish equity market performance in September suggests that investors are not sure what to expect from Japan's new government. The center-left Democratic Party of Japan (DPJ) won a stunning victory in the August 30 elections, raising its number of seats in the House of Representatives by almost 270%, and narrowly missing a two-thirds majority. Meanwhile, support for the center-right Liberal Democratic Party (LDP), which ruled the country since 1955, collapsed, as voters punished the incumbent for the deep recession.
- Financial markets are adverse to uncertainty and probably want to see more concrete policy proposals from the new government before making up their minds. Looking ahead, we don't expect dramatic changes in Japan's major policy settings – fiscal or monetary – especially because most of the party's leading members are former LDP politicians, including new Prime Minister Hatoyama. One change, however, could be a greater focus on stimulating household spending directly and de-emphasizing the role of public works in Japan's fiscal stimulus packages, which should boost the overall economic outlook.
- Meanwhile, Japan's economy is benefiting from the global manufacturing rebound, which should extend the current growth recovery through the next few quarters. The potential for stronger consumer spending next year could provide a crucial second stage in Japan's economic recovery.
- China's growing profile as a key player in the global economy will again be on display at the G20 Summit in Pittsburgh at the end of the month. China has implemented the biggest stimulus, recovered the quickest from recession, and positioned itself at the head of the economies transitioning to the next stage of the business cycle.

- However, trade frictions with the U.S. may disrupt a meeting that would otherwise likely focus on the successful efforts to combat the global recession. The Obama administration decided to slap tariffs on Chinese-made tires for passenger cars and light trucks in response to complaints by the United Steel Workers Union that cheaper Chinese imports have cost about 5,000 jobs in the industry in the past few years. The decision seems ill-advised, given the negligible impact on the overall economy, the risk of alienating a key buyer of U.S. Treasury bonds, and the embarrassment for the U.S. government using trade restrictions so shortly after enthusiastically endorsing the pledge to reject protectionism at the previous London G20 Summit in April. In that context, the rather muted Chinese response should be applauded.

## Investment Outlook

- As the summer draws to an end, we are still enjoying the fruits of our investment convictions in our current portfolio strategies. The rebound in risk appetite continues to drive equity markets higher, fixed income credit spreads tighter and the dollar lower. We have yet to see confirmation of the strong rebound in GDP growth and in profits that is driving the improvement in investor sentiment.
- The almost simultaneous surge in all asset cases, including government bonds, suggests the massive increase in central bank liquidity is a key driver behind the rebound in asset prices. That could change once central banks start to move towards policy normalization, which we expect will happen before the end of the year.
- In anticipation of such a regime shift, we are already focusing on more defensive stock and bond picks within our portfolios. We will re-evaluate our current strategy convictions in the coming weeks, as we prepare our portfolios for the next phase of the global recovery. The long-term growth prospects in emerging markets are likely to persist as a dominant theme, but fixed income credit markets seem better-suited to weather a renewed bout of uncertainty than equity markets.



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