



Market Flash

January 2007

WORLD FINANCIAL MARKET OVERVIEW

The world economy has developed very favorably during 2006. When the final numbers have been compiled, it is likely that growth will prove to have been considerably above average in a multi-decade context. At the same time, inflation continues at a pace that is markedly below long-term averages.

The Benefits of Globalization

We are clearly witnessing the benefits of globalization. With the reduction in barriers to the free flow of goods, services, labor and capital, resource allocation is becoming more efficient in the global dimension, allowing full utilization of relative comparative advantages.

In spite of the intense global competition, corporate profits are at record levels. While corporate pricing power is very limited in most industries, companies have proven that they can protect margins and profitability through improving productivity. These favorable conditions on both the macro and the micro level should be viewed as structural and are likely to be with us for some time.

While the structural factors are positive for financial markets over the long term, it must be recognized that the cyclical factors have also been supportive over the last few years. Therefore, markets would be vulnerable to any deterioration in the short-term cyclical outlook.

Of key importance is the development of the U.S. economy. Earlier in 2006, there had been concern that U.S. growth would be pulled down, or even go into reverse, as a result of falling consumer demand associated with rapidly falling housing prices. These fears have now abated. Housing prices have recently displayed a negative trend, but the impact on overall consumer demand has been muted so far.

The main factor offsetting this trend has been household income, which has been accelerating. Currently, we forecast only a mild slowdown in U.S. growth and, given this scenario, 2007's global economic activity is likely to be maintained at a sustained level.

Investor Sentiment

From a tactical point of view, investor sentiment is seen as a key indicator to monitor. In a situation with both structural and cyclical factors being supportive of financial markets, it is not surprising to have periods of excessive optimism followed by a swing of the pendulum toward the pessimistic extreme.

Market developments during 2006 can be described in this way. Early in the year, investors displayed very high risk tolerance on most measures. This was followed by a significant correction within

both equities and credit markets around the half-year mark. Since then, a rebound took us back to a high risk-tolerance level. The new year may very well see more of these swings in sentiment around a generally positive trend.

2007 Economic Outlook

Our baseline macro view for 2007 is calling for global economic growth to remain on solid footing. We are not in the recession camp; in fact, we believe a re-acceleration in global growth is likely in the second half of the year. That outlook puts us on the more optimistic side of the current consensus.

Not surprisingly, the U.S. economy is the main source of disagreements among forecasters. Further weakness in residential construction and the production of automobiles are posing a risk to our forecast, but we believe the economy will attain real gross domestic product (GDP) growth of approximately 2.5 percent in the next two quarters. We remain confident that stronger household income growth and steady increases in employment will support consumer spending during that period.

The second half of 2007 should then push GDP growth back above the economy's long-term potential, which will rekindle inflation and eventually force the Federal Reserve to resume its policy of interest-rate increases by the end of the year.

Outside of the United States, prospects are also fairly optimistic. The European economy is expected to weather the headwind from expected tax increases in Germany. Though growth is likely to decrease at the start of the year, the ongoing recovery in employment growth should lead to a re-acceleration in GDP growth by the summer.

We expect Japan's recovery to further solidify in 2007. Exports and business investment will remain the main pillars of growth, but, as in Europe, the recovery in employment growth and a pick-up in household income should boost consumer spending after some unexpected weakness in the second half of 2006.

2007: The Year of Equities or Fixed Income?

In terms of overall asset allocation, we favor equities over fixed-income instruments going into the new year. This position is based mainly on valuation arguments; equities are seen as attractively valued on conventional measures and interest-rate based metrics. But the solid fundamental backdrop also supports further gains in global stock markets.

The yield on government bonds, on the other hand, is low in most markets even when adjusted for inflation. In addition, the yield curves — the difference between yields on bonds with longer and

shorter maturities — are flat in most developed markets and inverted in some markets, such as the U.S. Treasury market. Clearly, global bond investors have been looking for further deterioration in the global macro backdrop.

The significant inversion of the U.S. Treasury yield curve indicates that investors expect the Federal Reserve to cut interest rates in the next few months. However, the improving U.S. macro backdrop suggests that there is less of a need for lower rates, and the Federal Reserve is more likely to remain on the sidelines for most of this year.

Spreads in fixed-income credit markets are currently at very low levels. This can be justified by a recent and very positive credit experience. Ever since the recession earlier this decade, corporations in general have been quite cautious in the way they manage their balance sheets. However, we recently witnessed more aggressive behavior, in terms of increased capital expenditure and corporate acquisitions. In addition, we have the considerable build-up of leverage through private equity activities.

In an environment with a positive trend for equities overall, it may be difficult to add a lot of value through regional allocation, since most areas could have good arguments for continued strong performance. This is indeed the situation as we view it today. The positive structural factors as well as the favorable cyclical situation are arguments favoring global emerging markets.

At the same time, profitability is improving throughout Europe and in Japan as companies engage in restructuring and better cost control. This factor should lead these markets higher over time. The room for profitability improvement is probably more constrained in the United States. On the other hand, the U.S. market may benefit from a more relaxed monetary policy than in other major regions as 2007 progresses. ■

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