

Global Market Outlook

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- Despite the global economy losing steam, we continue to expect a moderately firm rate of global growth into 2007. We do not believe that broad macro conditions are consistent with either a sharp and sustained slowdown or a significant v-shaped growth rebound. Although US economic growth was weak in the third quarter, slowing to little more than 1.5% annualised from the second quarter, we expect a rebound back to 2-3% into 2007.
- We expect a low inflation environment to persist into 2007. Headline inflation rates are likely to drop sharply in the first part of next year - potentially back to 1.5% for a period in the US - if the recent fall in the oil price is sustained. Ex-oil rates are expected to be more stable, with the early year acceleration in the US not being sustained. The US core rate is not expected to increase much beyond 2.75%. Although we believe that the Fed has completed its tightening cycle, a fall in US fed funds rates is not expected for a considerable period of time. European short-term rates are expected to reach 3.5% over the next twelve months, and potentially to increase to 4%. A consumer and housing mini-recovery mean that the UK rate outlook is now more skewed to the upside, but a pronounced tightening cycle is improbable. The Bank of Japan is likely to follow its initial rate hike with further rises, but only very gradually as inflation is still at the bottom end of the target range of 0-2%. Short-term rates in Asia outside Japan are also likely to continue to increase slightly. Taken together, these moves would represent only modest monetary tightenings, and we would not expect them to have a major impact in slowing economic growth.
- From an asset allocation point of view, we tend to favour the more cyclical regional markets - Japan and emerging markets - as our strategic bets although we acknowledge that relative performance is more likely to improve once the global growth slowdown more clearly bottoms out. However, there are secular factors which we believe will provide medium-term support for these regions. Japanese companies have more headroom to grow profits given a lower starting point than Western counterparts. There is also scope for greater participation by retail investors. Although emerging markets have delivered substantial absolute and relative performance in recent years, the asset class is not expensive relative to developed markets. This absence of a deterioration in the valuation position, despite marked outperformance, reflects the strong profits recovery in recent years. Indeed, the return on equity within emerging markets is now broadly in line with developed markets, but emerging markets still trade at a valuation discount. There has also been a decline in domestic macro risk in emerging markets, which could warrant some valuation re-rating over historic averages. However, until such time that global economic activity has clearly stopped decelerating, cyclical assets are unlikely to perform as strongly as in recent years. Hence in recent months our exposure to emerging markets and Japan has been reduced, and we have also raised our exposure to the US market, which is no longer relatively expensive, is less likely to be penalised by rising rates, and has a more defensive sector structure.

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