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Investment Outlook

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1. **The main themes this month are: (1) the global economy continues to expand at annualized rates of 4 to 5 per cent, no longer mainly driven by emerging economies; (2) monetary policies will remain expansionary in the OECD area, in spite of rising headline inflation rates; (3) in major emerging markets policies will be cautiously tightened as strong liquidity growth threatens to drive up inflation and asset prices; (4) thanks to last weekend's huge rescue operation euro area country defaults are no near-term risk any more – there will thus be no Lehman no. 2 effect on the financial sector and the real economy; (5) the fear of sovereign defaults of peripheral countries supports core bond markets and leads to an increase of credit spreads; (6) equities are under pressure near-term but are fundamentally sound and not seriously overpriced; (7) the depreciation of the euro has ended; (8) commodities will correct further.**

2. There has been a tectonic shift in the world economy: for several years, and perhaps forever, **the largest contribution to global growth will come from emerging markets**. Living standards are still extremely low there. I estimate that nominal GDP per capita in India will be 2.5% of Germany's this year, 13.4% in China, 22.5% in Brazil, and 25.1% in Russia.

3. This suggests that the catching-up potential of these countries is huge. Since their savings and investment ratios as well as the growth of spending on education are high, the **key determinants of the growth process are in place**. Moreover, structural stumbling blocks such as central planning and an intrusive bureaucracy have largely been removed or reduced over the past twenty years. The world economy is thus no longer dependent on the US consumer.

4. **The real GDP of emerging markets has expanded at an annualized rate of 7 ½% in the first quarter.** Leading indicators point to a continuation of robust growth, i.e. of something like 5 ½ to 6% well into 2011. **Industrial production in particular is very buoyant.** In countries such as China, India, Turkey, Brazil, South Korea, Taiwan, Singapore or Thailand it exceeds its year-ago level by more than 15%. World trade continues to recover, and so does the cost of shipping. The Baltic Dry Index has gained steadily since its early 2009 low (+475%) – even so, freight rates are still depressed (68% below the May 2008 highs) and are not posing any inflation risks.

5. Things have considerably improved in the OECD area as well. **In the US ultra-loose fiscal and monetary policies have brought about a recovery which is now apparently self-sustaining**. Real GDP will exceed last year's level by about 3 ½%. Overly-indebted households and an unemployment rate of 9.9% remain a drag on consumer demand, but

firms are earning good money again and managers get more optimistic by the day. Analysts are forecasting that employment will increase by about half a million a month throughout the summer. I admire the Americans: they are already reducing their savings rate again, from a near-term high of 6.4% of disposable income in May 2009 to just 2.7% two months ago. After all, the stock market has been firm, and house prices have stabilized. So where is the problem?

6. In the **euro area, leading indicators have been pointing steeply upwards for a little more than one year**: monetary conditions are benign, not least because of this year's weakness of the euro. Real money market rates are negative (3-month LIBOR is just 0.62%). The key factor though is the strength of the world economy and the opportunities this provides for euro area exporters.

7. **In Germany, real foreign orders to the manufacturing industry – which account for about half of total orders – have been up no less than 28.7% y/y in Q1**, and up 28.3% Q1 / Q4 annualized (while private consumption shrinks!). It is the old pattern that continues to drive policy makers in most other euro countries crazy. Germans must stimulate domestic demand they keep insisting! But how, when labor unions have no negotiating power and voters are opposed to tax cuts, i.e. larger deficits? In any case, it is fairly certain that real GDP will increase by somewhat more than 1½% y/y in 2010, not bad but really as anemic as ever.

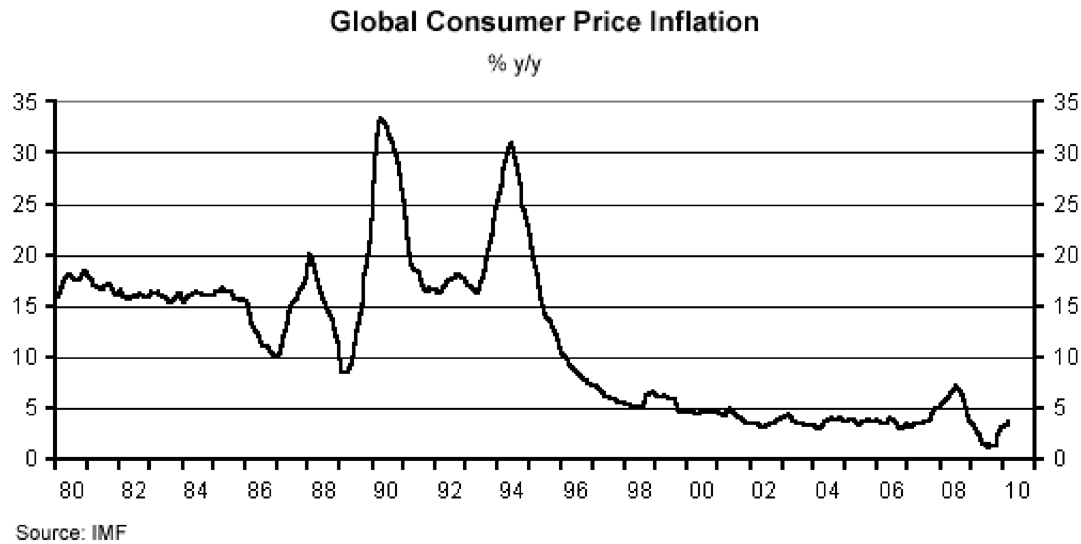
8. **Today's miracle economy is Japan! The country benefits even more from the boom in emerging markets than Germany.** Firms have the right products (capital goods, consumer electronics) and low prices to boot (weak yen plus deflation). Industrial production has increased 30.7% in the year to March, and real GDP has probably increased at an annualized rate of 5.0% in Q1, following +3.8% in Q4. As impressive as these numbers are, deflation simply cannot be eradicated, it seems. Nominal GDP is still lower than it was in 1993, 17 years ago!! Note that this is in spite of record large budget deficits, record government debt (much higher than Greece's in relation to GDP) and policy rates of 0.5 to 0.0% for almost 15 years.

9. **Inflation is on a clear uptrend in emerging countries; Russia is the major exception**. The main reason is that in spite of rapidly growing capital stocks capacity utilization rates are fairly high by now. Again with the exception of Russia, recessions have been brief and shallow. The decoupling from industrialized countries is obviously well advanced. Consumer prices are rising at rates of about 5%.

10. **While central banks have changed course, overall monetary conditions are still quite easy, though. They are not yet a genuine brake on growth.** Exchange rates are mostly undervalued, and policy rates are well below nominal GDP growth rates. The question is how long policy makers can stay on the sidelines – some major property markets look rather bubbly and thus set for a crash. Asset price crashes are costly in terms of lost output, as everybody has just learned, and must therefore be avoided. Sometimes markets may be cooled down by simply announcing that interest rates will be rising from here on, without actually tightening in earnest. Such a strategy seems to work in China right now.

11. **In the OECD area, the outlook for inflation is quite different. Headline inflation averages about 1.5% y/y**, and ranges between –1.1% y/y in Japan, +2.9% in Australia and +2.1% in the US. But output gaps are still very large, unemployment is near record highs, and wage inflation is thus more than moderate. Core inflation which strips energy and

seasonal food from price indices is still on the way down and presently in the order of 1% (Japan's is negative!). Core inflation is a fairly reliable predictor of headline inflation. In other words, there are no genuine inflation risks in the group of advanced economies.



12. **The Fed, the Bank of England and the Bank of Japan will keep policy rates close to zero well into 2011**.

13. **For a long time it had looked as though the ECB would tighten first, perhaps in November 2010. This is off the table now**: liquidity provision will remain very generous, quality standards of collateral securities in repo deals have been lowered, and board members have stopped hinting at near-term rate hikes. Since the main concern is to keep the bond markets of Greece, Ireland, Portugal, Spain and Italy functioning and to prevent a melt-down of euro area and global financial markets, it is near-impossible to tighten the reins. It is, incidentally, not difficult to sell such a policy to the public - inflation is far below the ECB's target of somewhat less than 2%.

14. **Markets are presently not really convinced that the €720bn rescue package of May 9**, most of it in the form of guarantees and including a €220bn commitment from the IMF, **will prevent an eventual default of shaky countries such as Greece, Portugal and possibly Spain and Italy.** They are safe near-term, but the combination of very restrictive fiscal policies and a deep recession will inevitably result in very heavy debt burdens which will be difficult to serve, especially if the economy is shrinking or growing only slowly. The transfer of income to foreign creditors is bound to hit real disposable income in the debtor countries in a major way. Market participants can be forgiven to think that a default would be the plausible way out. This is why the euro exchange rate has not responded favorably to the new back-stop facility whose size is not smaller than that of similar packages in the US and Britain.

15. **In the aggregate, the fundamentals of the euro area look rather sound,** if only in relative terms, and should be supportive of the euro exchange rate: the balance on current account will be near zero in 2010 (US -3.3% of GDP, UK -1.0%), and the budget balance is forecast to be -7.1% of GDP (US -11.1%, UK -12.8%).

16. Moreover, **the decisions of last weekend are de facto a large step in the direction of a common euro area fiscal policy.** There is no one yet in Brussels who could rightfully be called a finance minister of the 16-country group, but another chunk of sovereign power has certainly been ceded to a central institution (the EU Commission), in this case the power to issue bonds. The ECB, as a central institution of the euro area, is now also involved in solving fiscal problems: the system of central banks is buying bonds of weak borrowers in the secondary market. Germans (not me) are up in arms but cannot do much. "We are once again Europe's jerks!" said BILD.

17. **The fear of sovereign defaults has exposed the fault lines of the continent**. In a serious crisis, investors shift rapidly into government bonds of Germany, Holland, France, Austria, Finland – whose yields decline - and out of Greek, Irish, Portuguese and, to a lesser extent, Spanish and Italian bonds – whose yields shoot up. Yields of Greek governments reached 12.5% at the height of the panic. Safe haven markets outside the euro area are Switzerland, Sweden, Denmark, Norway, but also the US and Japan. The yield of 10-year German bunds dropped to a record low of 2.79% at some point last week, and is still below 3% today.

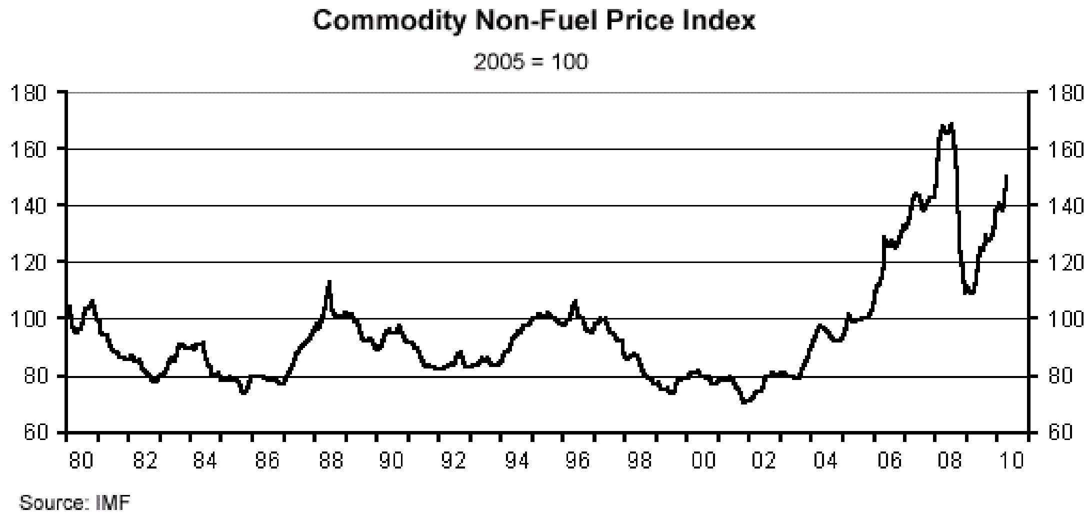
18. **Investors cannot assume any longer that profligate euro area borrowers will be bailed out no matter what** and thus belong in the same category as the issuers of bunds or French OATs. This is a positive development. The market does what it is supposed to do: differentiate according to actual risk and impose fiscal discipline.

19. **Government yield spreads will remain above pre-crisis levels**. Sovereign defaults will not occur in the near-term, but the writing is on the wall. This has implications for corporate credit – spreads have widened significantly and are also likely to stay wide. The risk of a corporate default is directly correlated with the risk of the sovereign where the firm is headquartered.

20. **Globally, equities had a good run this year, stimulated by a positive news flow from the real economy.** Russian, Australian and Canadian stocks benefited additionally from strong commodity prices. They all moved pretty much in step: April 15 marked the high point, followed by a mid-sized correction of 10 to 20%. May 7 marked the lower turning point. The euro area rescue operation had a very positive impact on markets worldwide, but the highs of the year were not reached again. **The odd man out this time is China**. Markets there had raced ahead strongly last year but have since been on a one-way street: down. It seems that, globally, all the good news has been anticipated by now and investors do not see the additional kickers that could seduce them to increase exposure even more.

21. **In the near-term, the downside correction will probably resume again.** Risk aversion has risen because of the specter of sovereign defaults and thus the increased probability of a new global recession. Stocks are risky securities, after all. They are not particularly expensive, but also not attractively cheap. Bloomberg reports the following trailing price-to-earnings ratios: 17.0 for the S&P500, 13.6 for the EuroStoxx50, 16.6 for the DAX, 45.1 for the Nikkei225, 12.6 for Russia's RTSI$. Unsurprisingly, Greece is the cheapest market on that measure: 9.7.

22. **In general, we are entering a period where the positive expectations will be confirmed by good corporate earnings reports.** Economies where the rate of capacity utilization is still very low are likely to surprise most. This group includes the euro area, Russia, Sweden and Japan.



23. **Commodity prices have lately come down in lockstep with stock markets.** The oil price has fallen 13% from its recent high, copper 12%, aluminum 14.1%. This may look like a lot, but it follows a strong run which had brought key commodity prices half way back from the lows of early 2009 to the highs of spring 2008. **Sentiment is presently negative**, but as the economies of the US, Japan and the euro area are finally taking off as well, the scope of the global recovery will broaden. In the not-too-distant future commodity prices will therefore begin to rise again – barring a major accident such as a sovereign default. The chance of this happening is rather low, though, after the determined intervention of the European Union, the IMF and the ECB.