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Market Comments

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Global equity markets powered ahead in May with the MSCI All-Country World Index rising by about 10% during the month in U.S. dollar terms at the same time that the MSCI Emerging Markets Index rose by 17%. After a disastrous start to the year, the strong recovery in markets since mid-March now leaves the MSCI All-Country World Index up for the year to date by 9.8% and the MSCI Emerging Index up by 37.9%. Against widespread fears earlier this year that the world economy was headed for Great Depression II, the verdict in the equity markets appears to be that the risks of depression are now remote and that the world may be headed toward a meaningful cyclical recovery in the second half of this year.

The favored market cliché of recent months has been to refer to data suggesting economic stabilization as “green shoots” of growth, with optimists suggesting that the green shoots have given way to “daffodils” or “tulips.” In contrast, pessimists see green shoots rapidly turning into “yellow weeds,” prompted partly by the “black rain” of rising oil prices. To give the pessimists their due, it is the case that many nations’ purchasing managers indexes (PMIs) have merely improved from dire readings (in the 30s on a 100 point scale) to dismal readings (in the 40s). That would suggest that economies continue to contract globally, but at a reduced pace from what was seen in the fourth quarter of last year and the first quarter of this year. China is a notable exception in that regard, with its PMI having broken above the so-called “boom or bust” level of 50 in March and remained in that elevated state in April and May as well.

That said, there are numerous indications that aggressive actions by central banks to end the global recession are beginning to gain traction and raising the odds of a V-shaped recovery in the second half of 2009. For example, Bloomberg’s Financial Conditions Index, which tracks numerous indicators of the health of money, bond, and stock markets, has posted major gains in recent weeks as Libor rates and many credit market spreads reflect a significant normalization of credit markets. The Bloomberg index has now traced a complete V-shaped recovery since its catastrophic decline in the weeks following the Lehman shock last September, suggesting that economic activity should begin to normalize in coming months as well. The internal action of stock markets, which have been led since March by sectors such as financials, materials, energy and industrials are also suggesting substantial economic recovery in the second half of 2009.

We continue to believe that many analysts and asset allocators remain overly pessimistic about prospects for the world economy in coming months, suggesting further gains in markets as forecasts for economic growth and corporate profits are revised up following massive downward revisions late last year and early this year. The one fly in the ointment is likely to be inflation expectations, which have been moving up rapidly in recent weeks as the U.S. dollar has weakened and equities have soared. Based on the spread between nominal 10-year U.S. Treasury bonds and 10-year inflation-protected bonds (TIPS), inflation expectations for the next ten years have recovered from zero last December to 1.9% -- or very close to the Fed's comfort zone. Should those expectations move up too rapidly from this point, the Fed may perceive that it has no choice but to begin talking more forcefully about an exit strategy from its current radical policies of credit easing and quantitative easing. Accordingly, such measures of inflation expectations bear close watching in coming months.

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