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# Market Comments

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Until very recently we have been reasonably optimistic about global growth prospects for 2010 and 2011, but recent severe financial shocks from Europe have now clouded the outlook. Although most consensus economic forecasts continue to call for global economic growth of more than 4% in both 2010 and 2011, risks of a considerably weaker outcome will grow if international policy makers are not able to engineer a significant improvement in financial conditions.

We have found the Bloomberg Financial Conditions Index (BFCIUS Index) to be a helpful, broad-based gauge of how trends in money, bond, and stock markets are likely to impact growth over the next several quarters. When that index started to recover markedly in the first quarter of 2009 it correctly pointed to a better-than-expected economic growth outcome over the next few quarters. Based on market turmoil in recent weeks, the Bloomberg index has deteriorated by around 2 standard deviation points since it peaked at a level of 0.658 on April 14, 2010. We have found that both changes in the index and the level of the index itself are reasonably good leading indicators of growth in the United States since deteriorating financial conditions adversely affect both consumer and business behavior. As a rough rule of thumb, we estimate that a 2 standard deviation decline in financial conditions could subtract nearly 2 percentage points from annualized GDP growth in the U.S. over the next several quarters. So if this shock is not reversed quickly, it may already be sufficient to deliver substantially below-consensus growth in the U.S. in the second half of 2010, with negative implications for employment growth, corporate profits and commodity prices.

Moreover, since the shock is emanating from Europe, the implications for European growth seem likely to be even more pronounced even though there should be a significant positive effect on Europe's export prospects due to the sharp weakening of the euro against most major currencies. The benefit of the weaker euro seems likely to be felt most strongly in core European economies like Germany and France. In contrast, uncompetitive wage levels and productivity in many peripheral European nations will make a turnaround in exports more difficult to achieve even as many of those nations are being forced to adopt severe fiscal tightening almost immediately. Accordingly, the shock in Europe seems likely to result in a moderate downward revision to the entire Euro zone growth outlook, but with a significant redistribution of growth within the region.

It is important to keep in mind that the financial shock, so far, is significantly less pronounced than the 10-standard deviation shock following Lehman's bankruptcy in 2008. And due to fears of the crisis evolving into a "Lehman 2.0" international financial panic, we believe that policy makers will try to err on the side of large-scale intervention to prevent that type of severe economic crisis from developing. While there is clearly implementation risk, especially due to political constraints, we view the risks of a Lehman-style outcome to be relatively modest. One important difference between now and then is that the Lehman shock came against the backdrop of recessions that had already begun in most of the G-7 nations whereas the current shock is coming against the backdrop of a broad-based global economic recovery with full participation

by both developed and emerging markets. Global purchasing managers indexes (PMIs) currently point toward global growth of about 4%, even if they do not yet fully reflect the impact of the very recent deterioration of financial conditions. It is also worth pointing out that there are some other positive aspects of recent market movements for many businesses and consumers, including lower oil prices and lower long-term interest rates. It is also helpful that banks are now generally better capitalized than they were at the time of the Lehman crisis (UK banks, for example, now have triple the liquid assets and double the Tier-1 capital they had pre-Lehman).

Although market jitters may well continue in coming weeks, we remain constructive on global equity markets on a six-to-twelve month view. If policy makers aggressively work to contain this crisis, with the European Central Bank perhaps resorting to quantitative easing, we believe that the underlying broad-based global expansion will remain intact. So the net effect of the European crisis might be to knock global growth down from 4.0%-to-4.5% this year and next to something closer to 3.5%-to-4.0%. Against this backdrop, we expect monetary policy authorities in most major nations to be very cautious about monetary tightening until well into 2011. Depending on how long it takes to calm markets, this could contribute to a delay in monetary tightening in key emerging market nations like Brazil, China and India, although much will depend on upcoming data on the pace of economic activity and inflation in those nations as the world continues to experience a multi-speed recovery led by emerging market economies.

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