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Market Comments

August 1, 2010

Global equity markets staged an impressive rebound in July, with the MSCI World Index rising by 8.1% in U.S. dollar terms even as the U.S. dollar gave back some of its gains from earlier in the year. Both developed and emerging markets benefitted from resurgence in risk appetite as investors responded favorably to banking stress tests in Europe backed by considerable public-sector support. Unsurprisingly, the European exercise showed that only seven out of ninety one banks failed the easy-to-pass tests. Strong double-digit gains were posted in peripheral European markets like Greece, Italy, and Spain which had been hardest hit by Europe's sovereign debt crisis, while European markets overall benefitted from a July gain of more than six percent in the euro's value against the U.S. dollar.

Economic data flow also favored European markets and the euro in recent weeks as a slew of purchasing managers surveys showed stronger than expected results across Europe, while U.S. data confirmed a soft patch in U.S. economic activity. Most impressive among European reports was Germany's closely watched IFO survey which approached its all time high in July as it posted its largest monthly increase since unification. Other indicators of business and consumer confidence were also strong across Europe. The Euro Flash Purchasing Managers Index report retraced nearly half of the decline from its April high and regional consumer confidence surged to a cycle high. In contrast, the U.S. reported weaker-than-expected consumer confidence in July along with a preliminary estimate that GDP in the second quarter expanded at a sluggish annual rate of only 2.4% as households boosted their savings rate to more than 6%.

Although we believe fears of a double-dip recession in the U.S. have been overdone, recent U.S. data have reinforced deflation fears since the current tepid pace of growth is expected to do little to bring down the unemployment rate or reduce excess capacity any time soon. And despite the better tone of data from Europe in recent weeks, the global economy appears to be in a transition phase. We believe early-cycle manufacturing catch-up growth of more than 10% in the year ended May 2010 may give way in coming quarters to a more normal pace of growth in line with mid-single digit growth in final demand.

This mixed picture for the global economy has pushed the likelihood of any monetary tightening by the U.S., Europe, or Japan well off into the second half of 2011, while also giving key emerging market nations reason to tread cautiously with respect to monetary tightening. Brazil, for example, hiked rates by only 0.5% in July rather than the 0.75% that had been widely expected as the central bank issued a dovish assessment that suggests a

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pause in monetary tightening may be in prospect. China's central bank also recently reiterated the need for an "appropriately accommodative" monetary policy stance during the rest of the year while fiscal authorities announced 23 major infrastructure projects costing 682 billion yuan. By contrast, the Reserve Bank of India is expected to continue tightening monetary policy for some time to come after hiking interest rates by 1% so far this year in response to surging inflation.

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