MARKET PERSPECTIVES

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GLOBAL MARKETS: THE MONETARY RESPONSE

Risk assets sold off again yesterday and benchmark bonds rallied on the back of ongoing risks of escalation in the Japan nuclear crisis. Japanese authorities having warned against further Yen appreciation under the current circumstances has helped the $/Yen relationship find a bottom near term at 79.08 today. We would expect a coordinated intervention by the G7 to hold the Yen from appreciation at current levels, and is the likely scenario in prevention of a disruptive currency appreciation.

Up until late last year, the markets had the view that the policy stance on both sides of the Atlantic would remain equally accommodative. The large output gaps both in the U.S. and continental Europe mean that underlying inflation should remain low for some time. We don't believe the current situation alters this view. As a consequence, the market should not expect a policy shift on either side.

Since then, both economies experienced a significant growth rebound and considerably higher commodity prices. These higher prices have already started to feed through consumer prices and since October, year-on-year headline Euro zone inflation accelerated from below-target levels to 2.4% currently, while U.S. inflation is likely to have accelerated over the same period from 1.1% to 2%.

Yet, despite the concurrent shock of inflation, the markets have started to price a significant divergence in monetary policy paths. Back in October, the market's viewed rates by the end of 2012 would be at 0.9% and 1.5% for the ECB and the Fed respectively. However, these forecasted rates have risen sharply to 2.5%, yet the corresponding Fed Funds forward rate was notched up only marginally to 1.1%.

These diverging paths in rates closely match the official stance taken by the two central banks. the ECB has sounded incrementally more hawkish in recent months, and in the last policy meeting Jean-Claude Trichet, president of the European Central Bank, provided a 'soft' commitment for an April hike. Meanwhile, the Federal Reserve continues to hold a broadly dovish view on the inflation outlook, although the latest FOMC minutes acknowledged that core inflation has probably bottomed out.

WHY THE DIVERGENT VIEW:

At the heart of this policy 'divergence' is the risk associated with the effects of the current spike in food and energy inflation. In the FOMC minutes, Federal Reserve Chairman Ben Bernanke did acknowledge the rise in commodity prices but added that "the committee expects these effects to be transitory". However, while the ECB recognized that the effects of a second round of monetary accommodation has yet to show up in the economic data, it sent a loud message that it intended to proactively hike rates by restating the "strong need to avoid second-round effects".

The difference in these two approaches is partly predicated on different views on spillover risks to core inflation; the Fed is quite strongly convinced that risks of the second round of monetary response is very low, whereas the ECB is less convinced. The other explanation for the difference in approaches is more structural - the ECB is strictly tied to keeping inflation close to a target, which gives it no reason to weigh output losses against inflation risk. The Fed, on the other hand, has a dual mandate of promoting stable inflation and maximum employment, and so its 'tolerance' to second round risks is comparatively higher.

In the last oil shock, during the 2002-2008 period, when oil prices spiked from 20$/bbl to 150$/bbl, it showed that any spill-over to core inflation had been largely absent. Throughout most of this period the impact on headline inflation was short-lived and overall residual effects to core inflation, as well as wage inflation, was minimal. However, we would expect the ECB will support a gradual increase of policy rates vis-à-vis the U.S., hence the yield curve differentials.

INFLATION:

Recent inflation news has not been particularly friendly this past week, as import and producer prices point to a larger-than-expected headline inflation effect of recent surges in commodity prices. As a result, we would expect that economists will begin to revise their forecast modestly higher after tomorrow's Consumer Price Index (CPI) release.

Rising import and producer prices should matter less on the longer-term inflation outlook. Yet markets appear more concerned with core producer prices since they have historically been helpful in predicting core CPI inflation. However, the recent increase in the Reuters/University of Michigan measure of inflation expectations—which rose by 0.3 points to 3.2% in March—could give rise for concern, with the final version released on March 25th. The increase inflation expectations may itself be related to energy and food price pressures, and we expect this phenomenon to reverse later in the year. For example, long-term inflation expectations rose by half a point as crude oil prices surged in the second quarter of 2008, but then declined by almost a point in the following six months as oil prices plummeted. Finally, other measures of long-term inflation expectations—including the Philadelphia's Fed Survey of Professional Forecasters as well as breakeven inflation rates—have remained relatively stable in recent weeks.

IMPLICATIONS FOR THE FINANCIAL MARKETS :

We remain positive on the longer term outlook for the financial markets, despite the current uncertainties, and believe the global impact of the earthquake will be temporary. The combination of steady U.S. /global growth dissipating domestic inflationary fears, profit expansion through FY 2012 and reasonable valuations suggest that our market still has upside potential in the medium term. We fully expect the S&P 500 to exceed its prior peak some time this year, bolstered by some P/E expansion on the way. We are still expecting the U.S. GDP to hit 3.0-3.5% in 2011 and inch higher in 2012. Higher than expected oil prices in 2011 should have some negative impact on earnings in 2012 but should not exceed 5%.