a positive outlook for growth

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While deepening debt problems in Europe have unsettled investors in recent months, the global economic recovery remains on track. **Rupert Watson** provides further details of SIG's current economic outlook and asset allocation views.

Economic data released in recent months has remained consistent with ongoing economic growth. Global manufacturing remains strong: the US ISM manufacturing index remained firm at almost 60 in May (see graph), higher than any level seen in the 1990s, while the manufacturing PMI* is at its highest ever level in the UK and back to mid-2008 levels in China.

Importantly, there have been further signs that the recovery is broadening beyond the manufacturing sector, to services, global trade and even the labour markets, which is good news for the sustainability and longevity of the recovery. The US ISM non-manufacturing index has held at a four-year high of 55.4 for the past few months, while service sector PMIs in the eurozone and the UK have recovered substantially and are consistent with strong growth. The US has begun to create jobs (although not yet at a

US manufacturing has recovered strongly

Source: Bloomberg, ISM Manufacturing Index 31 May 2004 to 31 May 2010.

pace that will have a significant impact on the unemployment rate), while the UK reported a fall in jobless claims in May. We expect this labour market recovery to pick up further in the next few months.

Meanwhile, global trade is booming. In the US, both imports and exports are rising sharply, with exports in particular very strong compared to previous post-recession recovery phases. Buoyant domestic consumption in emerging economies, notably China, has driven a surge in demand for goods from countries such as Germany, the US and Japan. The rebalancing of China's economy away from exports/investments towards domestic consumption is likely to be a multi-year development of benefit not only to China but also to the broader global economy. Domestic demand is also strengthening in parts of the developed world, with retail sales improving globally.

The key risk is that the weakness in some parts of Europe undermines the global banking system and leads to weakness elsewhere. The creation of the European stabilisation fund and the decision by the European Central Bank to buy government bonds should enable the problems to be contained within the countries most affected.

global inflation outlook benign

Two distinct trends are emerging in inflation data. On the positive side, core inflation is falling in the developed world, particularly in the US where core CPI is close to an all-time low. Unemployment is likely to remain elevated for the next few years, which should help keep inflation at bay. In contrast, inflation in emerging markets is rising, notably in parts of Asia and South America. This has been fuelled by food, which makes up a large proportion of the inflation basket. Excluding food, however, the trend is rising but not sharply and overall, we expect global inflation to remain relatively benign.

So what does that mean for interest rates? We expect rates to stay on hold in most parts of the developed world for some time. The recent problems in Europe are likely to lead central bankers to err on the side of caution and a rate hike in the US, UK, eurozone or Japan in 2010 seems unlikely. In a number of emerging markets, interest rates have risen as policy makers seek to reduce monetary stimulus in the face of strong economic growth and rising inflation. Even so, interest rates are likely to remain at levels that still encourage economic activity.

risk assets to rally further

While the risk has increased that debt problems in Greece and elsewhere in Europe will spread and undermine the global recovery, on balance we do not expect this to be the case. Over the next few years we expect the economic recovery to continue, the banking sector to stabilise further, fiscal positions to improve and corporate profit growth to continue, all of which should be positive for equity markets. While uncertainty remains high in the short term, we expect further gains from equities in 2010, supported by very low interest rates in the US and elsewhere, and attractive valuations.

Within equities, we favour emerging markets over developed ones, as emerging economies are growing at a much faster pace, have less debt and are less likely to suffer the problems currently being faced by countries such as Greece. In addition, very low interest rates in the developed world are likely to encourage flows into emerging market assets. Within emerging equity markets, we prefer the Asia Pacific ex Japan region, where growth and corporate earnings growth remain strong. Concerns about the extent of monetary tightening have weighed on the region's equity markets in recent months but once the end of the hiking cycle is in sight, we expect Asia Pacific equities to outperform. We are also positive on Japanese equities, where the recovery is gathering pace. While we are underweight Europe, we are perhaps less bearish than the consensus. The recent sharp fall in the Euro may be beneficial for European companies. In terms of style, we expect value to outperform growth while small caps should continue to outperform large caps as financing conditions improve and investors increase their exposure to riskier assets.

We remain positive on non-government bonds. While government finances are in poor shape, corporate sector finances continue to improve. Credit spreads remain wide relative to history and we expect further spread compression over the course of the year as the economic recovery boosts corporate profits and investors seek higher-yielding assets. We also like emerging market debt. As noted above, emerging economies are growing strongly, generally have low debt and deficit levels, and are benefiting from improving terms of trade. Meanwhile, the outlook for commercial property is also relatively favourable, as the corporate sector recovery should lead to increased demand while very low interest rates provide support.

*Purchasing Managers Index.