STATE STREET GLOBAL ADVISORS

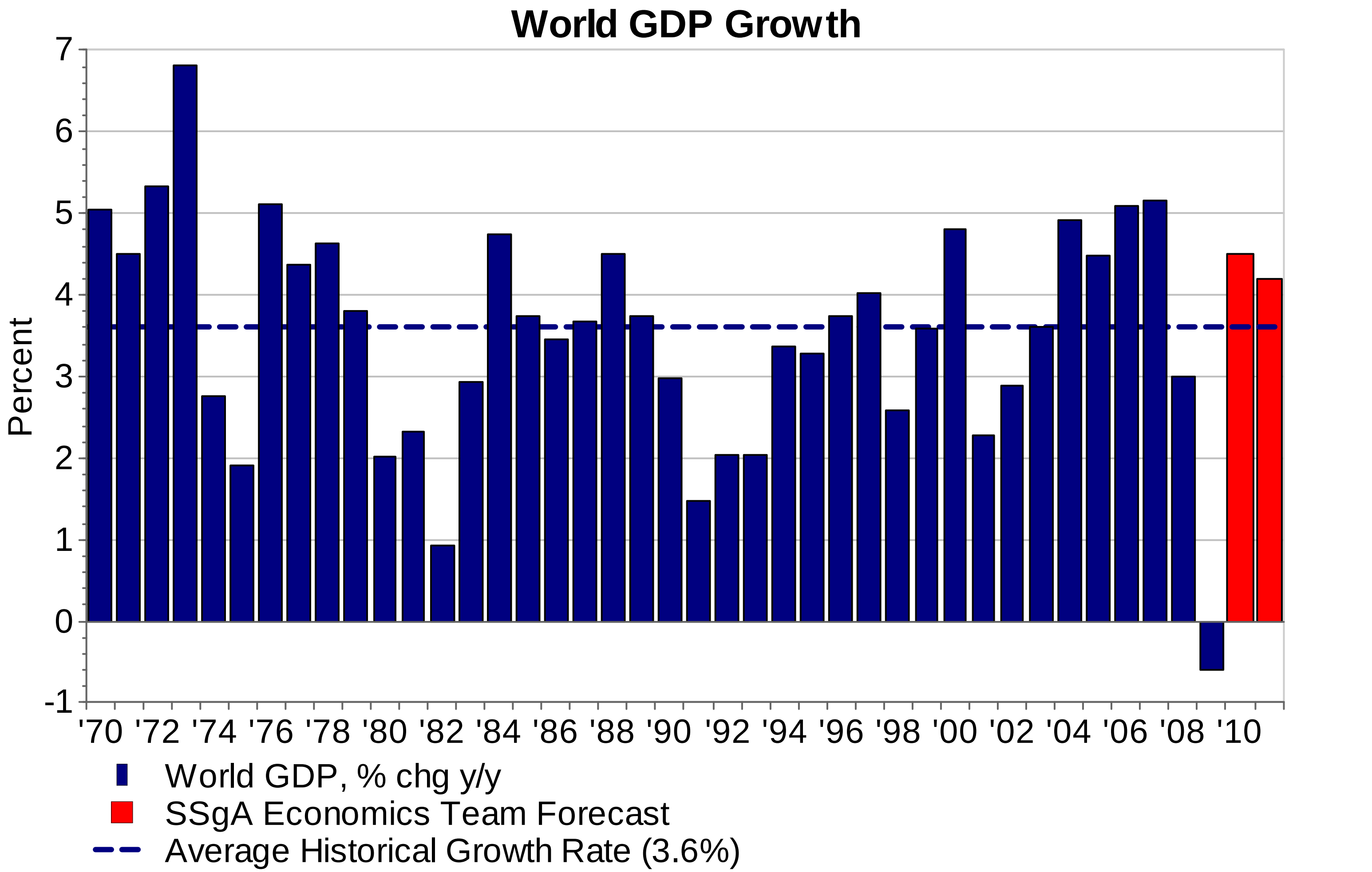
# Economic Fundamentals & Financial Markets: Prospects for 2011

**December 2010**

Christopher J Probyn

SSgA

# Global




*Sources: IMF, SSgA Economics Team*

# Global

- The recovery got underway in mid 2009.
- Growth should reach 4.5% this year, before slowing to 4.2% next year
- However, the world is split:
  - Advanced economies are growing slowly, inflation is low, policy is loose
  - Developing economies are growing robustly, inflation is accelerating, policy is tightening
- The risks to the recovery are skewed to the downside
  - Chinese policy mistake
  - European Debt Crisis
  - US economic fundamentals and Fed policy response

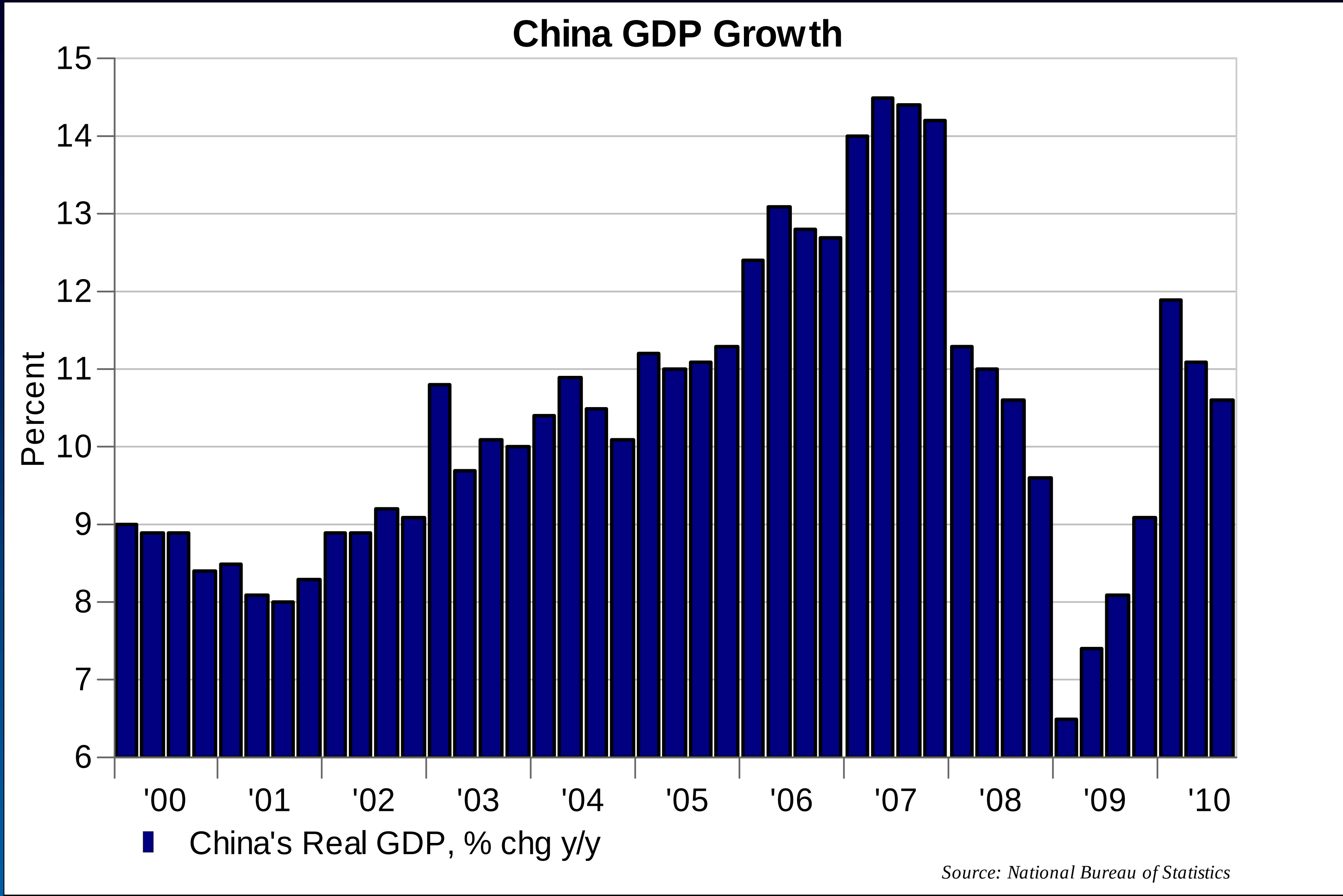
# China

- Policy tightening is underway:
  - The Government has taken direct action to cool the real estate market
  - Last year, the PBoC began raising reserve requirements
  - Most recently, the PBoC has raised interest rates
- There is a fear that these measures will be too successful, slowing growth and derailing an important locomotive of the global recovery
- However, rapid growth remains a priority and there is plenty of policy ammunition available to boost growth if necessary
- We believe that growth should hit 9.9% this year, stay around 9.0% next year, and average 8.7% over the next five years

# China


*Source: People's Bank of China*

# China


China GDP Growth
Percent
15
14
13
12
11
10
9
8
7
6
'00
'01
'02
'03
'04
'05
'06
'07
'08
'09
'10
China's Real GDP, % chg y/y
Source: National Bureau of Statistics

# Europe

- First the good news…
- The European sovereign debt crisis is not another sub-prime crisis:
  - It is smaller.

    (In 2009, the total amount of government debt outstanding in the four high-deficit nations was €1.1 trillion (or $1.4 trillion). So even assuming a 25% haircut, total losses would reach only $0.4 trillion compared to an estimated $3.0 trillion for sub-prime)
  - It is less opaque.

    (Government bonds provide for greater transparency than the ABS, CDOs and CDSs at the heart of the sub-prime crisis)
  - Leverage is not an issue

# Europe

- Unilateral sovereign default makes no sense:
  - The perfect candidate for a unilateral default is a country that is saddled with high levels of debt, but is running a primary budget balance (or surplus) and therefore does not need access to financial markets to finance government spending.
  - None of the high-deficit countries are in that situation

# Europe

Figures are for 2009

| | Greece | Portugal | Ireland | Spain | Total | Italy |
|---|---|---|---|---|---|---|
| GDP (€ bln) | 238 | 164 | 164 | 1,051 | | 1,520 |
| Gov. Debt (% of GDP) | 116% | 77% | 64% | 55% | | 115% |
| Level of Debt ( € bln) | 277 | 126 | 105 | 578 | 1,086 | 1,750 |
| Deficit (% of GDP) | 13.0% | 9.4% | 14.3% | 11.4% | | 5.3% |
| Primary Deficit | 7.4% | 6.6% | 11.9% | 10.1% | | 0.6% |
| Net Interest | 5.6% | 2.8% | 2.4% | 1.3% | | 4.7% |

Source: EIU

# Europe

- In the near term, the existence of the eurozone is not threatened
  - There is no mechanism for removing a country from the ‘zone
  - It makes no sense for a weak country to leave voluntarily
    - The benefits of a devaluation to a departing country are typically short-lived as structural rigidities limit the long-term gain in competitiveness
    - Re-denominating debt from euros to a legacy currency would be an act of default, so a country might as well default on euro-denominated debt
    - New borrowing in a legacy currency would be more expensive than in euros because of higher sovereign and exchange-rate risk
    - There would be considerable disruption to the balance sheets of domestic banks
- (In the longer-term, the outlook is less clear as fiscally strong countries may tire of bailouts and choose to leave)

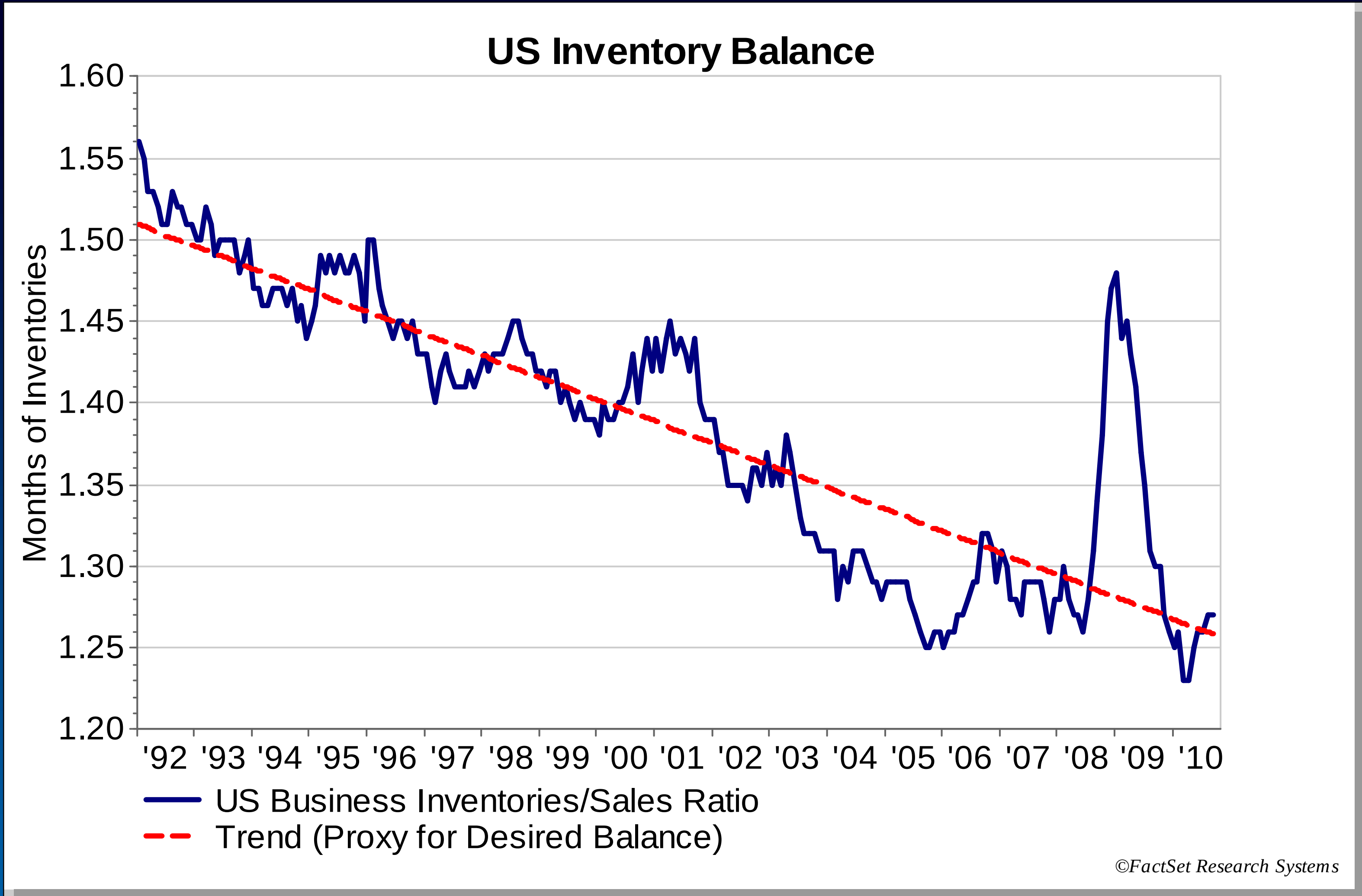
# Europe

- Now, the bad news…
- However, the problem does not seem to be solved
  - The EU/IMF package has only bought time
  - The ultimate outcome depends on the progress countries make in reducing their budget deficits
  - The more progress made, the more likely a country will be able to return to the market and obtain affordable funding
  - Given the daunting arithmetic and economic environment, “orderly restructurings” remain a possibility
  - This would create contagion to other indebted countries, and refocus investor attention on the European banking sector as the recent stress tests omitted the possibility of such restructurings
- But while a replay of the spring 2010 crisis would disrupt the global recovery, it should not derail it completely

# US

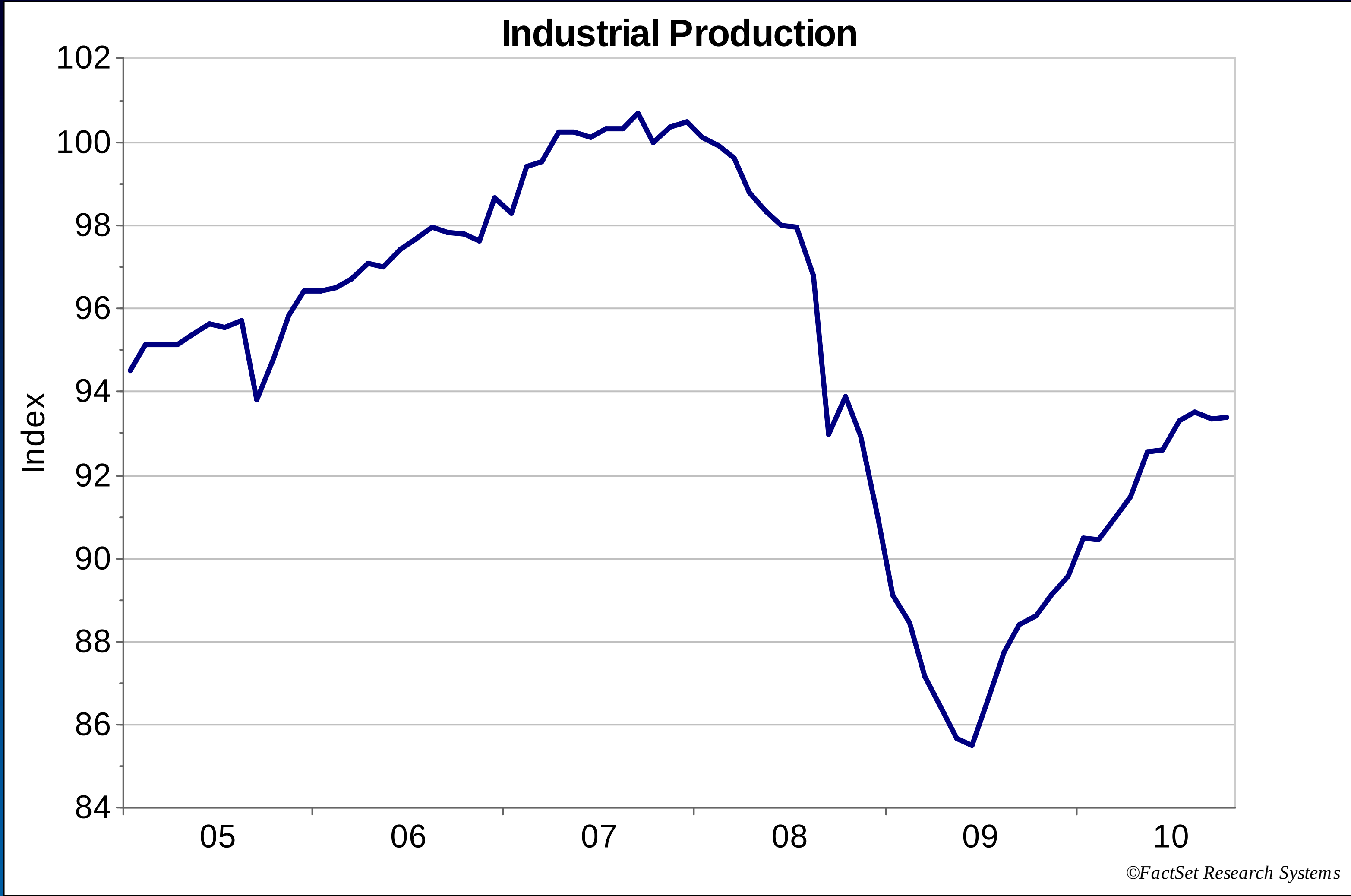
- In the great recession, GDP fell 4.1% peak to trough
- Growth resumed in the third quarter of 2009
- The early stage of the recovery followed the usual pattern:
  - Inventories stopped declining
  - Industrial production bounced

# US



US Inventory Balance
1.60
1.55
1.50
1.45
1.40
1.35
1.30
1.25
1.20
Months of Inventories
'92 '93 '94 '95 '96 '97 '98 '99 '00 '01 '02 '03 '04 '05 '06 '07 '08 '09 '10
US Business Inventories/Sales Ratio
Trend (Proxy for Desired Balance)
©FactSet Research Systems

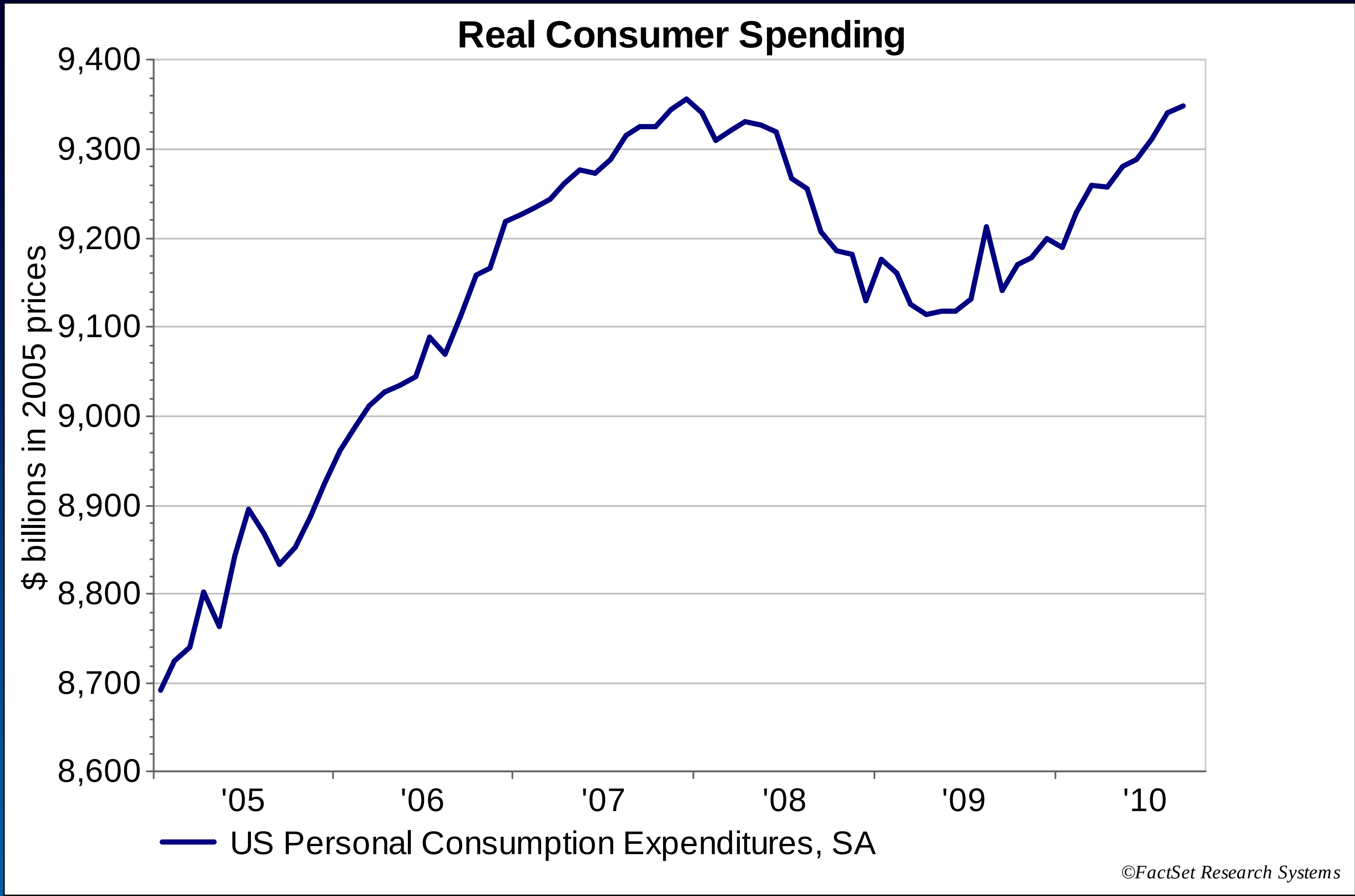
# US


Industrial Production
Index
102
100
98
96
94
92
90
88
86
84
05
06
07
08
09
10
©FactSet Research Systems

# US

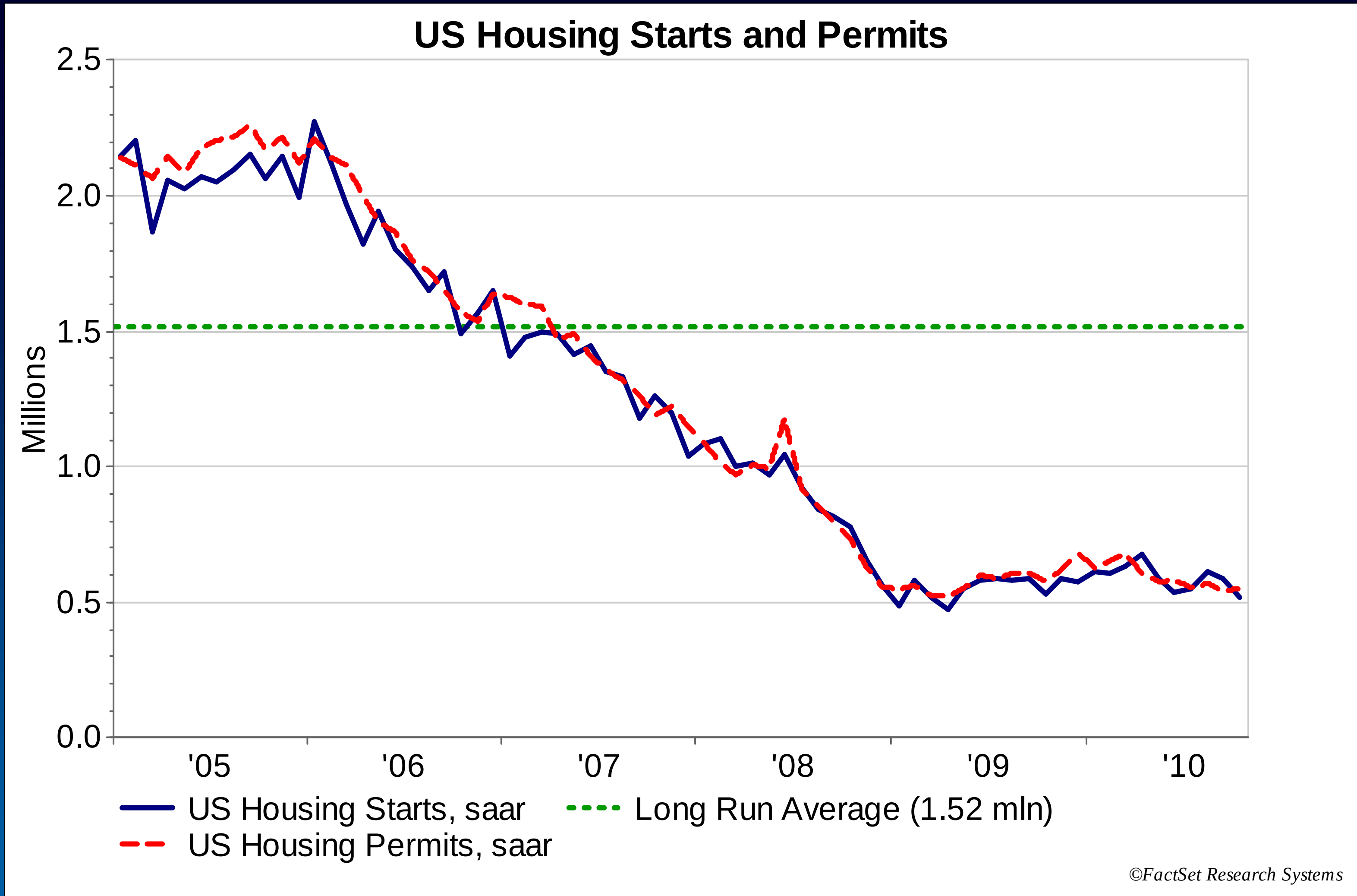
- But then it all went wrong
- The typical second stage of recovery—robust rebounds in consumer durables and residential construction—never happened
- Consequently, growth slowed almost to a standstill

# US



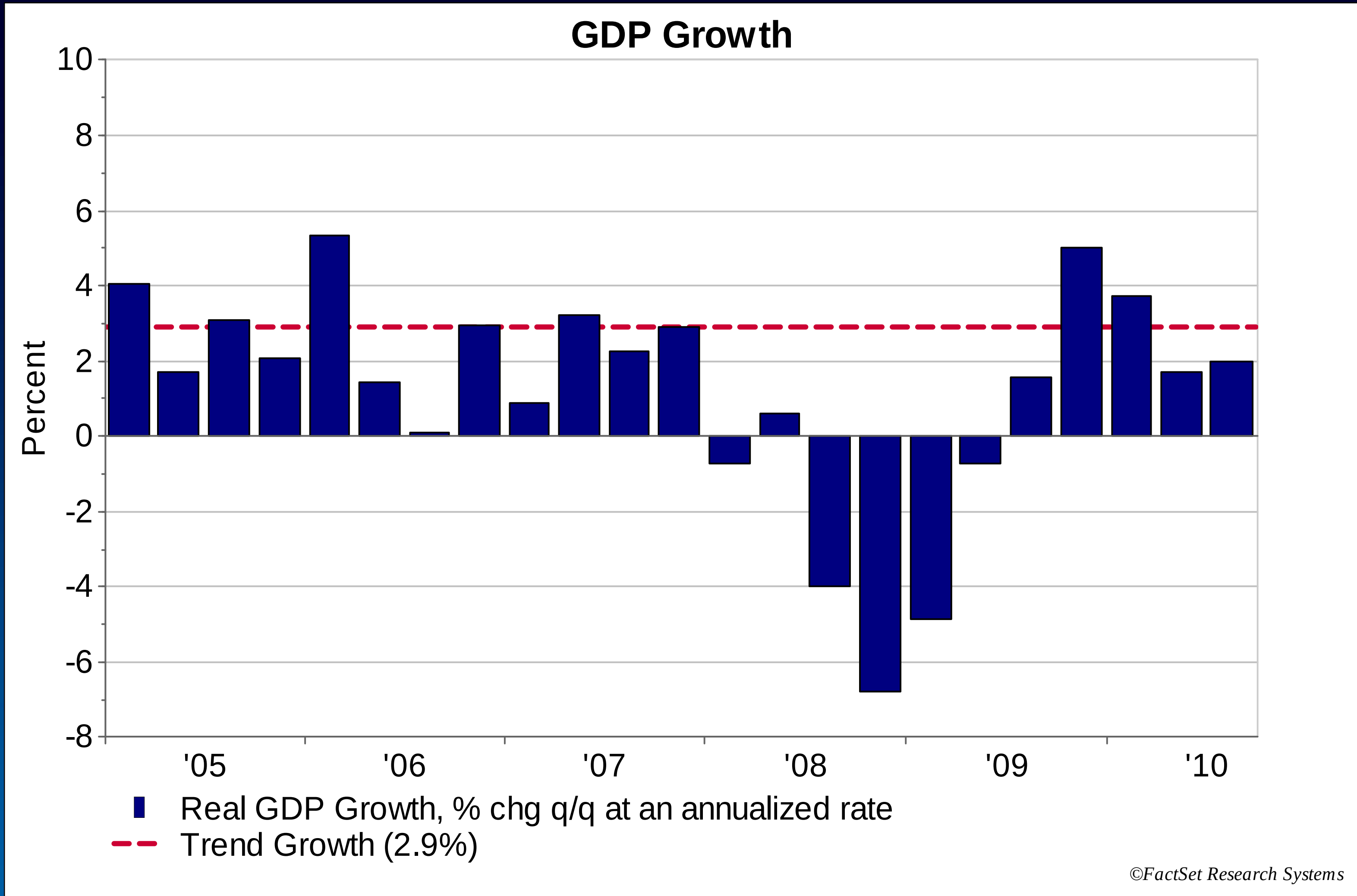
Real Consumer Spending
9,400
9,300
9,200
9,100
9,000
8,900
8,800
8,700
8,600
$ billions in 2005 prices
'05
'06
'07
'08
'09
'10
US Personal Consumption Expenditures, SA
©FactSet Research Systems

# US



US Housing Starts and Permits
2.5
2.0
1.5
1.0
0.5
0.0
Millions
'05
'06
'07
'08
'09
'10
US Housing Starts, saar
Long Run Average (1.52 mln)
US Housing Permits, saar
©FactSet Research Systems

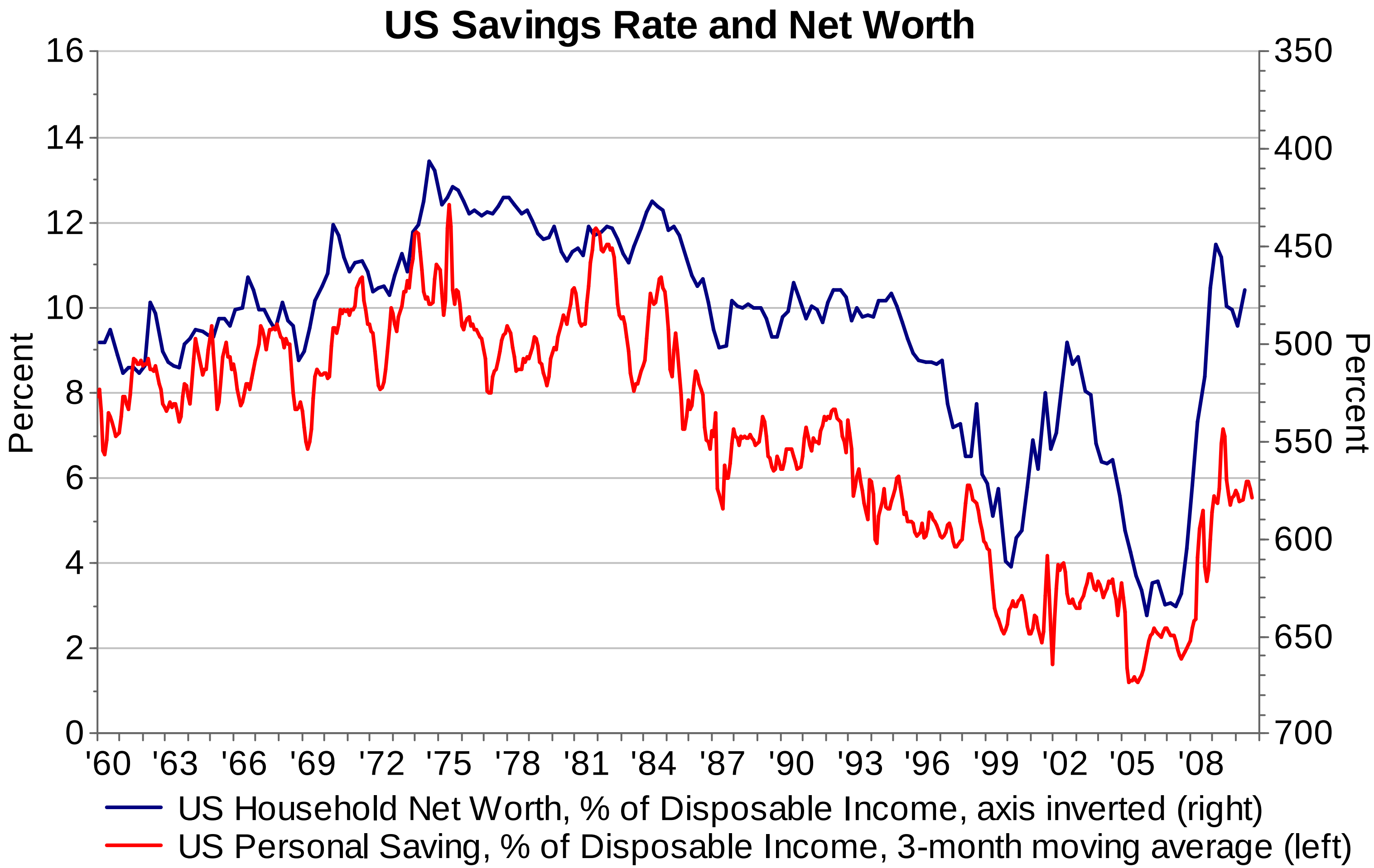
# US


GDP Growth
10
8
6
4
2
0
-2
-4
-6
-8
Percent
'05
'06
'07
'08
'09
'10
Real GDP Growth, % chg q/q at an annualized rate
Trend Growth (2.9%)
©FactSet Research Systems

# US

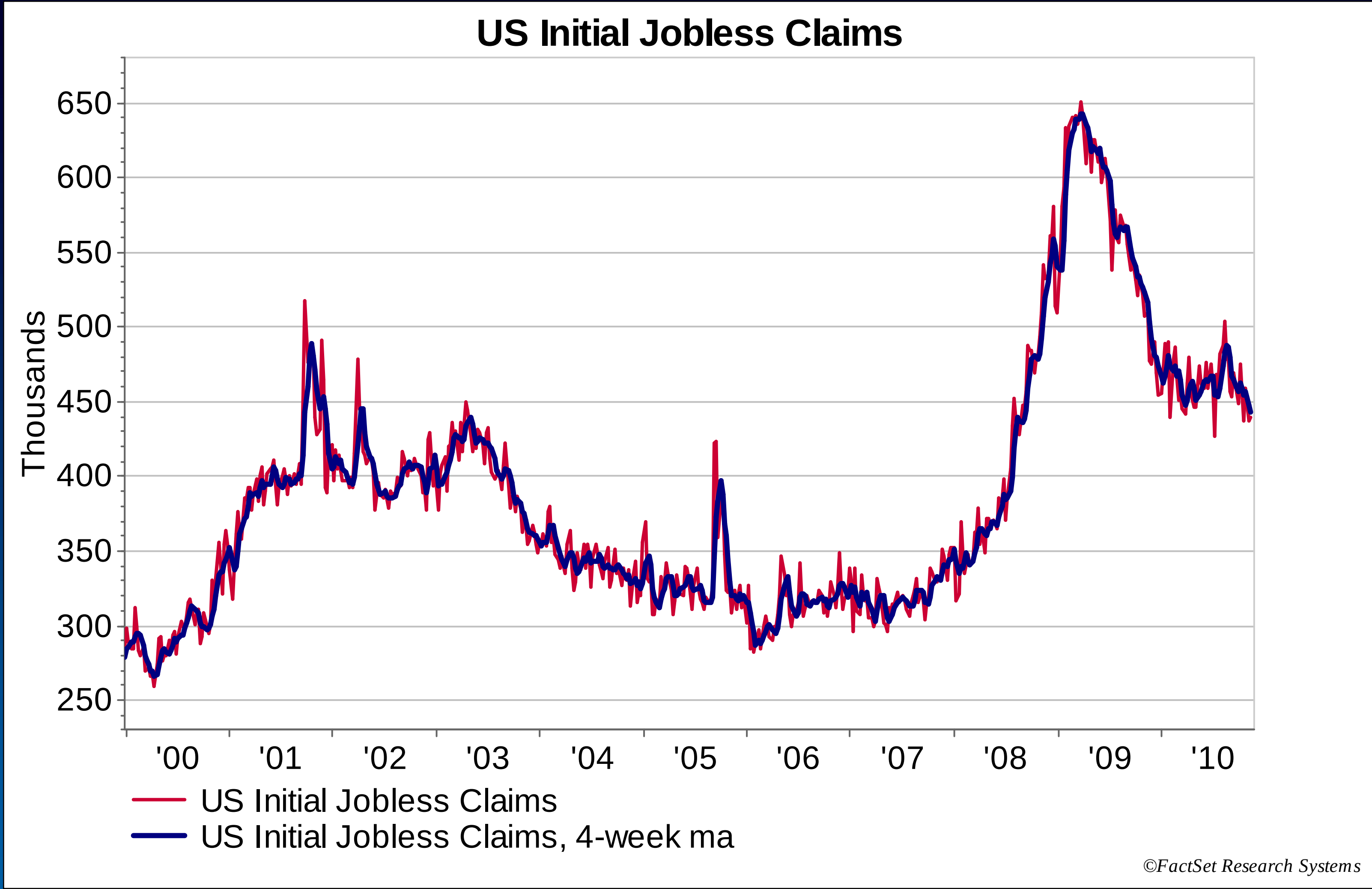
- The focus now is on what shape the recovery will take?
  - W… double dip or L… bounce along the bottom
  - U… sustained but relatively gradual improvement
  - V… robust rebound
- Indicators are not pointing to a double-dip
- But, there are headwinds facing the US economy
  - State and local governments continue to retrench
  - Household wealth was lost and the saving rate has jumped
  - Lending to consumers and businesses continues to fall
  - Corporations continue to shed workers

# US



*Sources: Federal Reserve, US BEA*

# US



US Initial Jobless Claims
Thousands
650
600
550
500
450
400
350
300
250
'00
'01
'02
'03
'04
'05
'06
'07
'08
'09
'10
US Initial Jobless Claims
US Initial Jobless Claims, 4-week ma
©FactSet Research Systems

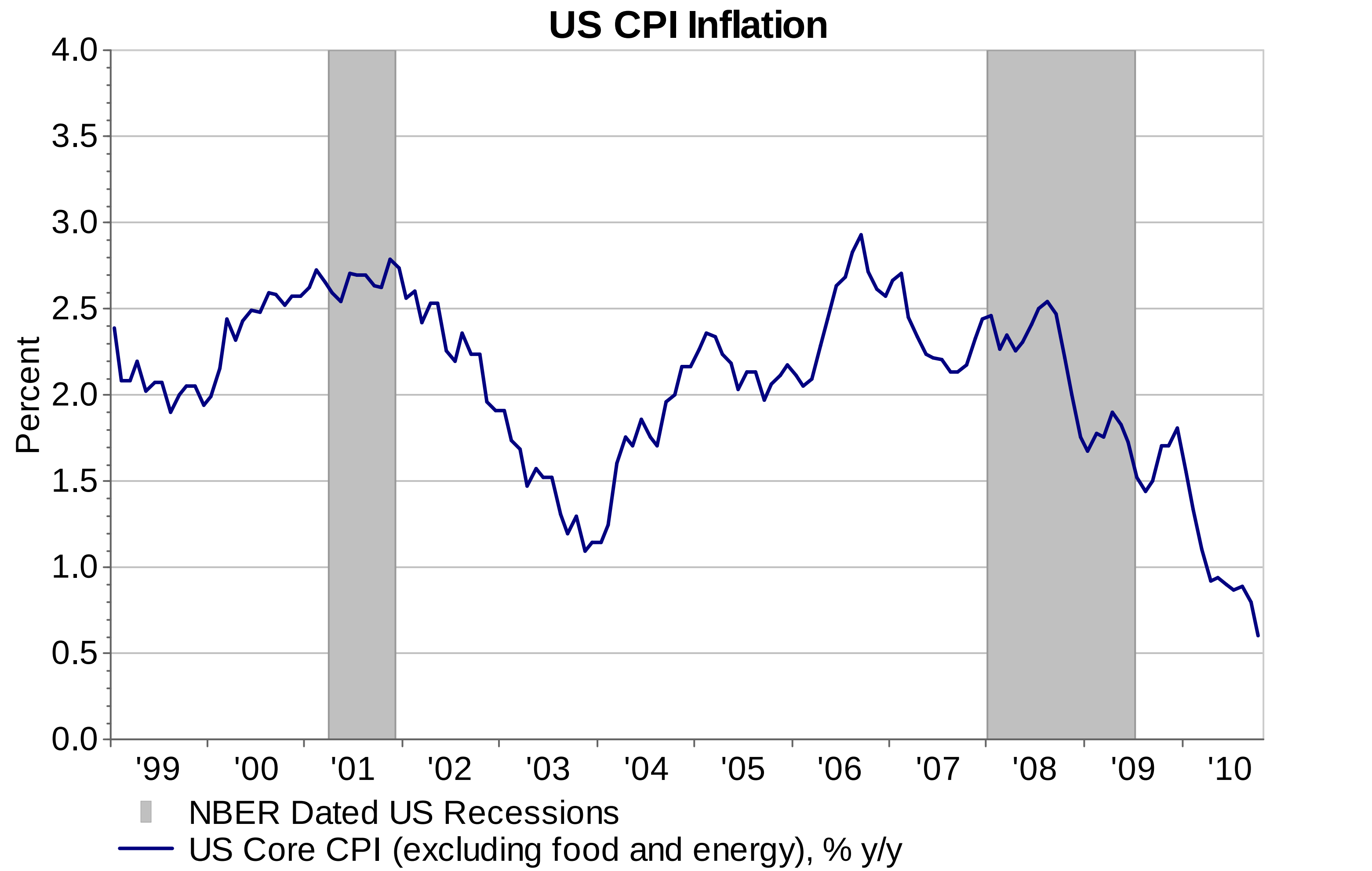
# US

- **Hence, we expect no better than a U-shaped recovery, with GDP advancing 2.7% in 2010 and 2011, well below the historical norm**

- **Moreover, this assumes that the Bush tax cuts are extended in their entirety. If they expire, 2011 growth could be as low as 2.2%**

- Based on this scenario
  - Unemployment will remain elevated for some time
    - The unemployment rate may not fall below 6.0% until 2014
  - US (core) inflation is already low and should fall further
  - Deflation is a legitimate threat
  - The Fed has already loosened, and will not tighten for a long time

# US

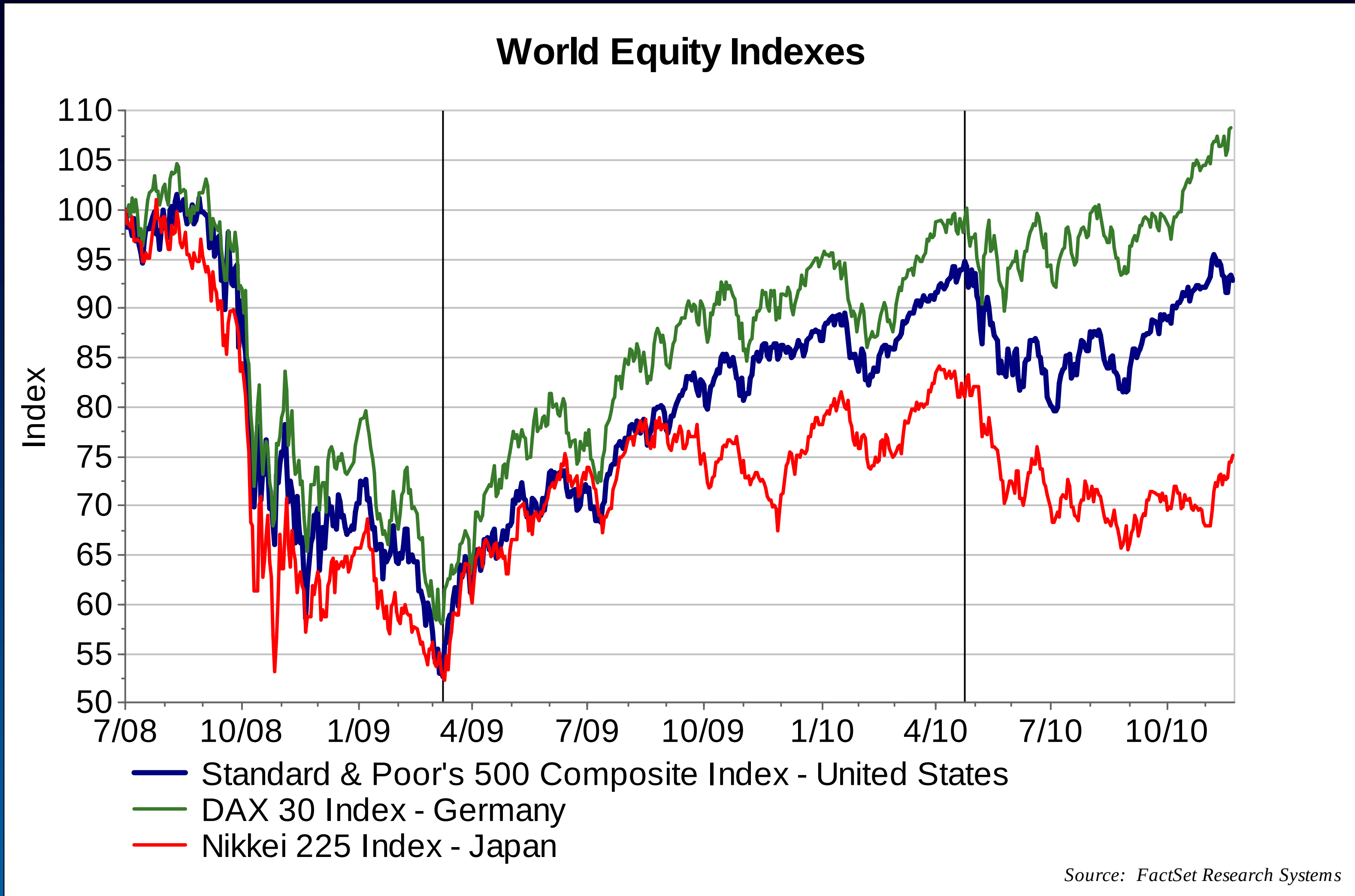



*Sources: BLS & NBER*

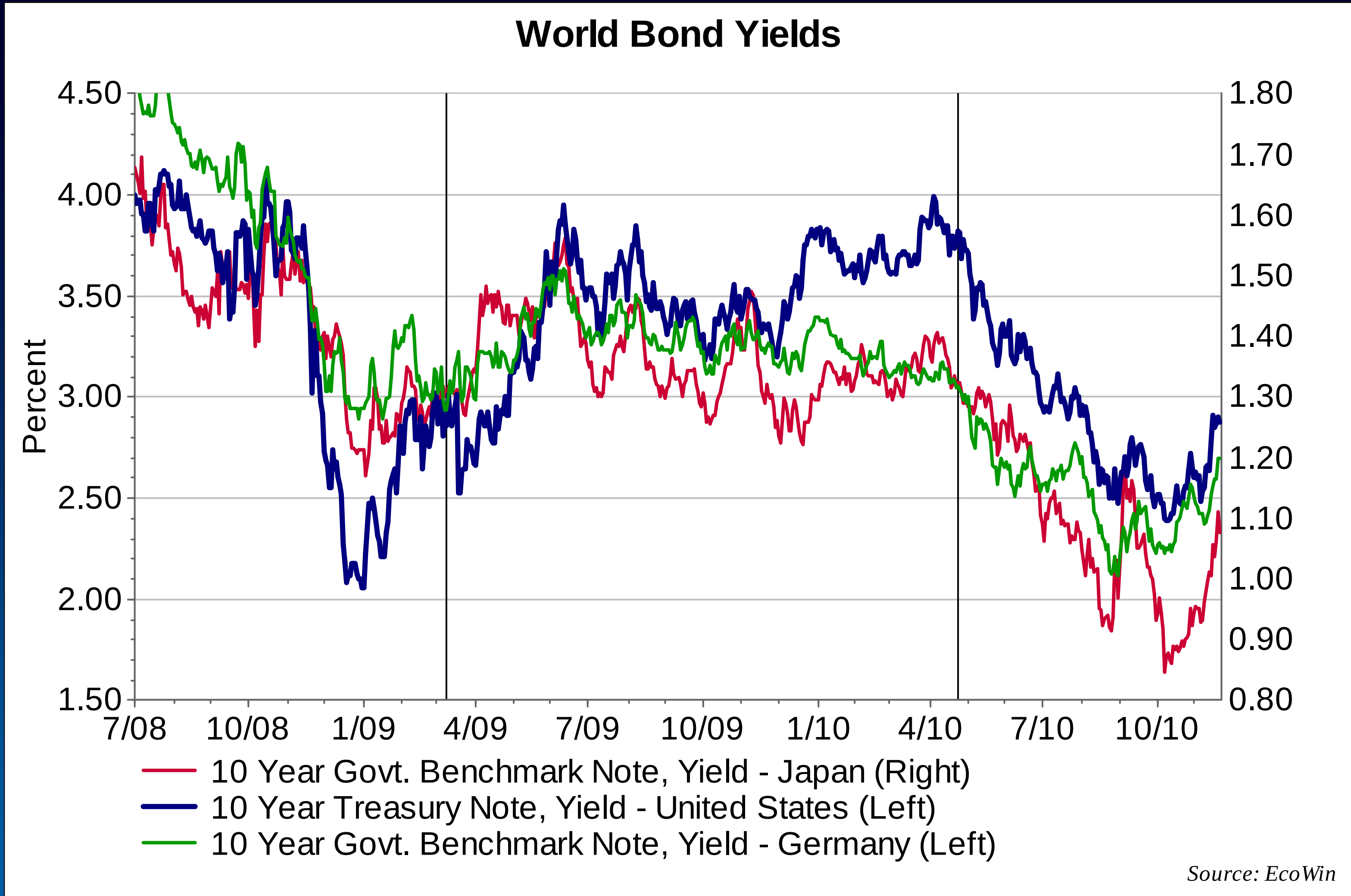
# Financial Markets

- For past two years, price Action has reflected “risk-on, risk-off” trades
- Fall 2008: “Acute Risk Aversion” on Lehman bankruptcy
- Spring 2009: “Risk Appetite Revival” on signs economies are stabilizing
- Spring 2010: “Market Swoon” on concerns about Chinese policy mistake, European sovereign debt crisis and softer US economic data
- Recent rally: “Market Rebound” on Fed policy easing

# Financial Markets



# Financial Markets



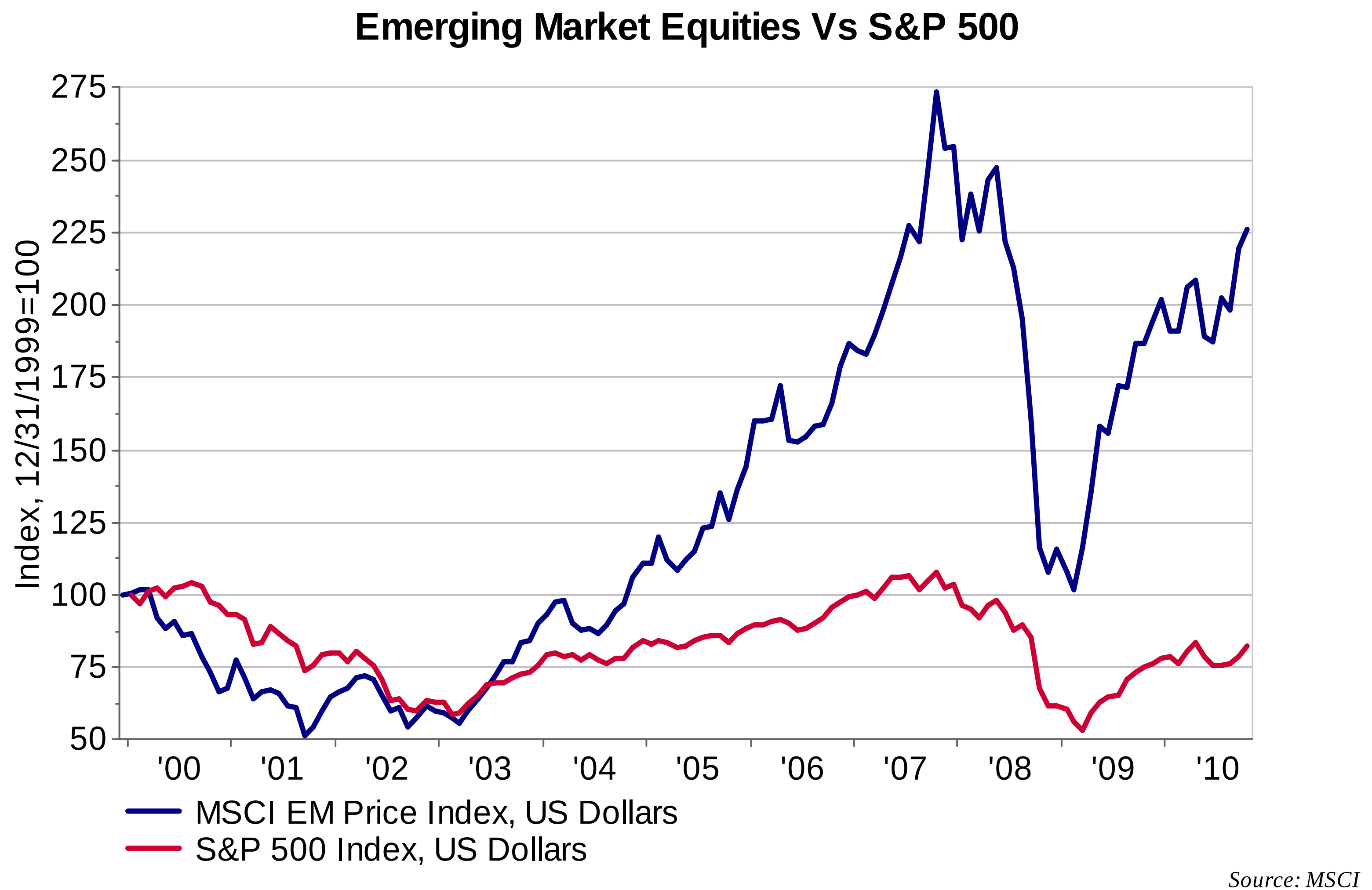
# Financial Markets

# Financial Markets

- If we are correct that the global recovery is sustainable:
  - Equities should grind higher
  - Sovereign yields will rise, but only moderately
  - The dollar will remain weak

- In addition:
  - Emerging market equities will outperform
  - Credit spreads will stabilize
  - Oil prices will rise steadily

# Financial Markets



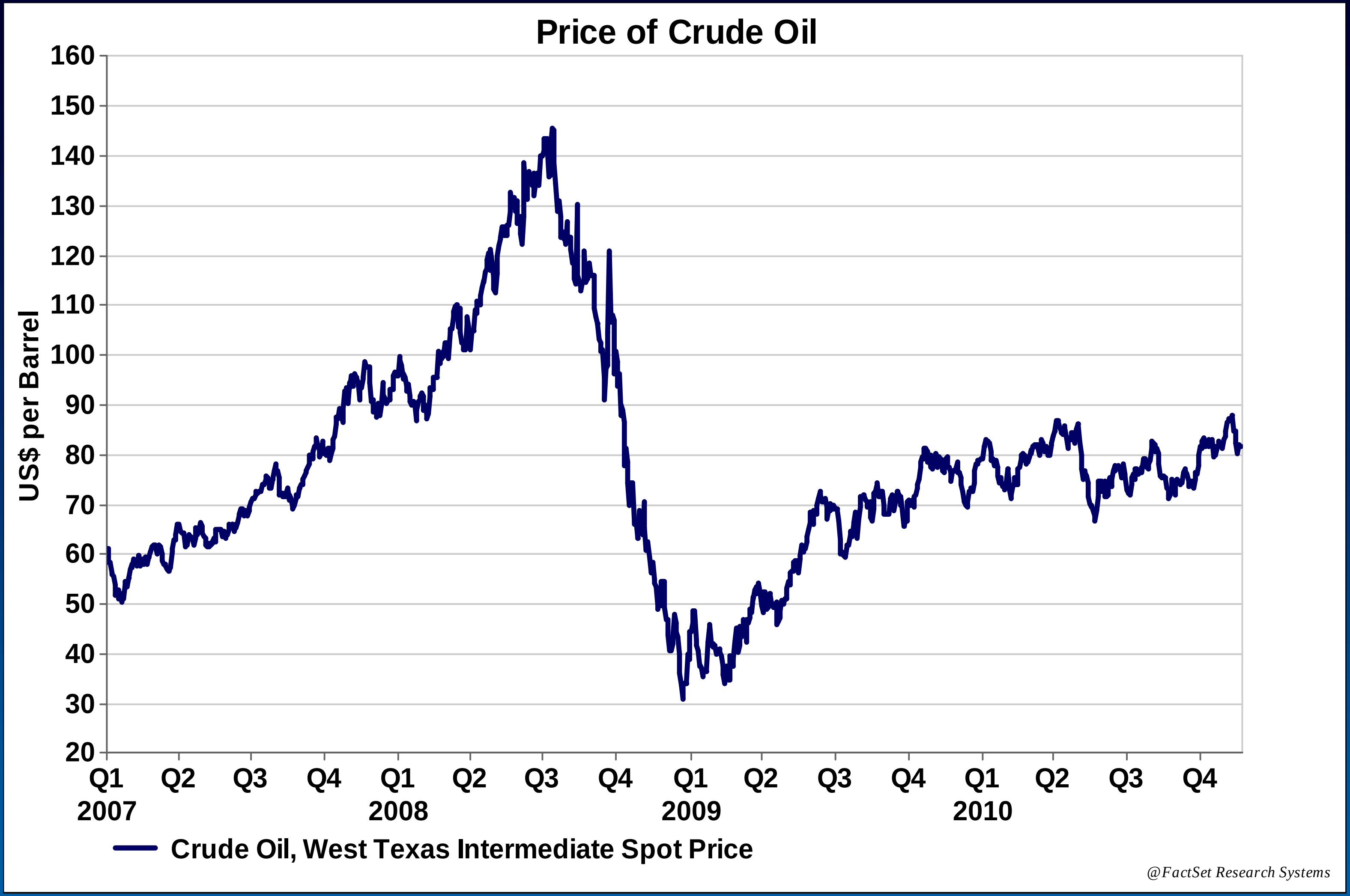

*Source: MSCI*

STATE STREET GLOBAL ADVISORS

# Financial Markets


*Source: Merrill Lynch*

# Financial Markets



STATE STREET GLOBAL ADVISORS®

# Thank You

SSgA®

# Disclosures

The views expressed in this material are the views of SSgA through the period ended November 21, 2009 and are subject to change based on market and other conditions. All information has been obtained from sources believed to be reliable, but its accuracy is not guaranteed. There is no representation or warranty as to the current accuracy, reliability or completeness of, nor liability for, decisions based on such information.

This document contains certain statements that may be deemed to be forward-looking statements. All statements, other than historical facts, contained within this article that address activities, events or developments that SSgA expects, believes or anticipates will or may occur in the future are forward-looking statements. These statements are based on certain assumptions and analyses made by SSgA in light of its experience and perception of historical trends, current conditions, expected future developments and other factors it believes are appropriate in the circumstances, many of which are detailed herein. Such statements are subject to a number of assumptions, risks, uncertainties, many of which are beyond SSgA's control. Readers are cautioned that any such statements are not guarantees of any future performance and that actual results or developments may differ materially from those projected in the forward-looking statements.

The information contained herein does not constitute investment advice and it should not be relied on as such. It should not be considered a solicitation to buy or an offer to sell a security. It does not take into account the specific requirements of any person, including his/her/its investment objectives, strategies, risk profile, tax status and investment horizon.

Past performance is no guarantee of future results.