Prudential International Investments Advisers, LLC.

Global Economic Outlook – July – August 2010

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Global Summary: Solid Growth in Q2, Slower H2 Growth. Rate Tightening Pushed Out into 2011

John Praveen's Global Economic Outlook **sees the global recovery remaining on track in Q2 with solid GDP growth in the U.S. and Japan. Growth remains strong in the emerging economies, though moderating from the above-trend pace in Q1. Even Eurozone and U.K. are on track to improved growth in Q2 after the weak Q1.** ***Looking beyond into H2 2010, the unresolved Eurozone debt crisis, the tightening of financial condition and the European fiscal squeeze are likely to slow global growth, modestly. However, we do not expect these problems to lead to a double-dip recession.***

Headline inflation continues to trend lower in the developed economies, but remains volatile with swings in oil prices. Core CPI inflation has fallen to record lows in the U.S. and Eurozone and is expected to remain well below 1%. Inflationary pressures remain in emerging economies with prices trending higher in China, and remain elevated in India and other economies.

The Fed, ECB, BoE, and BoJ continued to remain on hold in June/July. With the unresolved Eurozone sovereign debt crisis leading to tightening of financial conditions, the developed central banks have pushed out tightening into 2011. In its June statement, the Fed sounded a more cautious note on the growth outlook. The ECB continues to limit its bond purchases to the riskier Greek and Portuguese debt, resisting expanding bond purchases on German opposition. Some emerging central banks continue to tighten policy despite concerns about a global slowdown as the Eurozone crisis remains unresolved. However, the People's Bank of China appears to have paused after tightening earlier in 2010.

Global Economic Outlook

Solid Q2 Growth. Benign Inflation. Developed Central Banks on Hold into 2011

Growth: Solid Growth in Q2 Driven by Consumption & Investment. Eurozone Crisis Carries Risks to H2 Growth

- The global recovery remains on track in Q2 with solid GDP growth in the U.S. and Japan (>3%). Growth remains strong in the emerging economies, though moderating from the above-trend pace in Q1. Even Eurozone and U.K. are on track to improved growth in Q2 (>2%) after the weak Q1.
- ***Looking beyond into H2 2010, the unresolved Eurozone debt crisis, the tightening of financial condition and the European fiscal squeeze are likely to slow global growth, modestly. However, these problems are unlikely to lead to a double-dip recession.***
- U.S. Q2 GDP growth is currently tracking around 3.3% with growth drivers broadening beyond inventory build-up. Consumption, business investment spending and housing are all expected to contribute to Q2 growth. U.S. business confidence remains strong and despite the pullback in May/June the current level of business confidence points to a solid contribution from investment spending to Q2 GDP growth. U.S. consumer spending was off to a soft start in April, but picked up in May.
- In Eurozone, despite the debt crisis and the resulting tightening of financial conditions, GDP growth is on track to improve in Q2 as a German rebound lifts Eurozone growth to around 2.5% annualized rate. Strong German industrial production and new orders indicate that German GDP is on track to rebound to over 3% annualized growth in Q2, with risks to the upside. Even in Southern Eurozone, survey data indicates that Q2 GDP growth is tracking over 2% in Spain, Portugal, and Ireland.
- Japan's GDP growth is expected to remain solid in Q2, around 3%, moderating from the strong 5%, pace in Q1. Exports remain the key driver of growth. However, the export recovery appears to be percolating into domestic demand through a rebound in corporate profits and investment spending, and modest improvement in labor and income conditions supporting consumption. Chinese GDP growth is on track to moderate in Q2 to around 10.5% after the strong 11.9% growth in Q1. In India, GDP growth is expected to remain strong in Q2 around 8% after rebounding to 8.6% in Q1 with strong industrial activity and robust investment spending.

Inflation: Inflation Low in Developed Economies. Prices Remain in an Uptrend in Emerging Economies

- Headline inflation continues to trend lower in the developed economies, but remains volatile with swings in oil prices. U.S. headline consumer price inflation eased further to 2% YoY in May from 2.2% in April. Eurozone headline inflation edged up to 1.6% YoY in May from 1.5% in April and a low of 0.9% in February. U.K. headline inflation corrected in May, easing to 3.3% from 3.7% in April. Japanese Nationwide headline prices fell -0.9% in May, a moderation from -1.2% in April and -1.1% in March and a five-year low of -2.5% in October 2009.
- Core CPI inflation has fallen to record lows in the U.S. (0.9%), Eurozone (0.8%) and Japan (-1.2%). U.S. core inflation is expected to decline further during H2 to around 0.5% with plenty of slack in the economy. In Eurozone, the elevated output gap and the aggressive fiscal tightening in Southern Europe should exert deflationary pressure on core inflation.

- Inflationary pressures remain in the emerging economies with prices trending higher in China, and remain elevated in India and other emerging economies.

Interest Rates: Developed Central Banks Push Out Tightening into 2011. Some Emerging Central Banks Pause Tightening

- The Fed, ECB, BoE, and BoJ continued to remain on hold in June. With the unresolved Eurozone sovereign debt crisis leading to tightening of financial conditions, and deflation concerns also emerging in the U.S. and Eurozone, developed central banks are expected to remain on hold through 2010 and push out tightening into 2011.
- In its June statement, the Fed sounded a more cautious note on the growth outlook with the Eurozone debt crisis turning “financial conditions less supportive of growth” and housing softening after the expiration of the homebuyer tax credit. Given the Fed’s more cautious growth outlook, the benign inflation outlook and concerns about tightening of financial conditions due to the unresolved Eurozone crisis, the Fed is unlikely to raise rates in 2010 and the first rate hike is pushed out into 2011.
- The ECB provided few new details regarding its bond purchase program at the June meeting. The ECB has thus far restricted its bond purchases to the riskier Greek and Portuguese debt, resisting expanding bond purchases on German opposition. With the Greek debt crisis mushrooming into a Eurozone debt crisis and the fiscal tightening measures depressing growth and raising deflation fears, the ECB is likely to remain on hold through 2010 and tightening pushed out into 2011.
- The Bank of Japan (BoJ) left its target rate unchanged at 0.1% in its June 15 monetary policy meeting. In addition, the bank has also detailed the measures for the fund provisioning program to improve corporate funding.
- Emerging central banks have been tightening policy, especially in China, India and Brazil. However, the unresolved Eurozone debt crisis and fears of global slowdown have forced some emerging central banks to put tightening on hold and/or softened their hawkish tone. The People’s Bank of China (PBC) remained on hold in late May/early June after hiking the required reserve ratio in early May for the third time in 2010. The Bank of Korea (BoK) kept its policy rate unchanged at 2% in May/June. Mexico’s central bank (Banxico) continues to hold overnight rates steady at 4.5%.
- However, some emerging central banks continue to tighten policy despite concerns about a global slowdown and tightening of financial conditions. The Reserve Bank of India (RBI) raised rates in July on inflation concerns and strengthening GDP growth. The Taiwanese Central Bank (CBC) surprised markets by raising its key interest rates by 0.125% in June, its first rate hike since September 2008. In Brazil, the Banco Central do Brasil (BCB) hiked rates for a second straight meeting in June with inflation remaining above target.

Currencies: Dollar Remains Firm Against Euro After Surging in April-May

- In June, the dollar was flat against euro after surging in April/May, but the pound appreciated 2% against the dollar and the yen.
- The dollar is likely to remain strong against the euro irrespective of the end-game in the Eurozone debt crisis. If the debt crisis is resolved with the ECB monetizing the debt with quantitative easing, the euro is likely to weaken due to the expansion in ECB balance sheet. If the EU/ECB fail to resolve the crisis, the euro is likely to remain under pressure due to weaker macro outlook.

Regional Outlook - USA, Eurozone, UK, Japan, China

USA: Solid Q2 GDP Growth. Falling Core Inflation. Fed Dovish. Tightening Pushed Out into 2011

Growth: Solid Q2 GDP Growth with Strong Business Spending. Eurozone Crisis Impact on H2 Growth?

- U.S. Q2 GDP growth is currently tracking around 3.3% with growth drivers broadening beyond inventory build-up and consumption, business investment spending and housing are all expected to contribute to Q2 growth.
- U.S. business confidence remains solid but the ISM manufacturing index slipped to further to 56.2 in June from 57.9 in May. The ISM non-manufacturing index fell to 53.8 in June from 55.4 in May. Despite the pullback in May/June, the current level of business confidence points to a solid contribution from investment spending to Q2 GDP growth. Overall investment spending in Q2 is currently tracking around 9% QoQ annualized with spending on equipment and software tracking around 14%, based on the strong gains in core capital goods shipments in May.
- U.S. consumer spending in Q2 was off to a soft start in April, but improved in May. Further, the momentum in income growth suggests that consumption spending will be around 2.5% in Q2 after being revised lower to 3% in Q1. Even housing, which was a drag on Q1 GDP growth, is expected to make a positive contribution to Q2 growth. The recent expiration of the housing tax credit boosted housing sales and construction in April. While home sales and housing starts corrected in May, the strength in early Q2 should enable housing to make a modest contribution to Q2 growth.
- ***Looking beyond Q2, the financial backdrop has turned less supportive of growth following the Eurozone crisis, while housing activity appears to have weakened more than expected following the expiration of the tax credit in April. These factors are raising concerns about the U.S. growth outlook for H2, prompting the Fed to strike a more cautious tone in its June Statement.***
- U.S. Q1 GDP growth was revised down to 2.7% QoQ annualized from 3% in the preliminary estimate. The annual pace of GDP improved to 2.4% YoY from 0.1% in Q4. The key contributions to Q1 GDP growth were PCE (2.1%), inventories (1.9%) and business investment (0.2%). These were offset by drags from net exports (-0.8%) and government spending (-0.4%).

Inflation: Headline & Core Prices Remain in Downtrend with Weakness in Housing & Labor Markets

- Headline consumer price inflation eased further to 2% YoY in May from 2.2% in April. Headline prices fell -0.2% MoM. Core inflation held at 0.9% YoY in May, unchanged from April, the slowest pace of core inflation since January 1966. Core inflation rose 0.1% MoM with both core goods and services prices up 0.1%. Core inflation has slowed to a 0.3% annual rate thus far in 2010.
- U.S. core prices remain in a downtrend, pushed lower by the sustained slowing hourly labor costs, the weakness in housing costs and the unwinding of special factors that pushed goods prices higher in 2009. These forces should continue to push core inflation lower to around 0.5% pointing to disinflation persisting for now. However, risk of outright deflation remains low.

Interest Rates: Fed on Hold in June, Sound Caution on Growth Outlook. Tightening Pushed Out into 2011

- The Federal Reserve continued to leave rates unchanged in a range between 0 and 25bps at the June meeting. The Fed reiterated that "economic conditions… are likely to warrant exceptionally low levels of the federal funds rate for an extended period." In its statement, the Fed sounded a more cautious note on the economic outlook with the Eurozone debt crisis turning "financial conditions less supportive of growth" while housing is softening after the expiration of the homebuyer tax credit.
- Given the Fed's more cautious growth outlook, the benign inflation outlook and concerns about tightening of financial conditions due to the unresolved Eurozone crisis, the Fed is unlikely to raise rates in 2010 and the first rate hike is pushed out into 2011.

Currencies: Dollar Remains Firm Against the Euro. Further Dollar Gains Likely

- In June, the euro and yen have been flat against the dollar, but the pound appreciated 2% against the dollar and the yen.
- The dollar is likely to remain strong against the euro irrespective of the end-game in the Eurozone debt crisis. If the debt crisis is resolved with the ECB monetizing the debt with quantitative easing, the euro is likely to weaken due to the expansion in ECB balance sheet. If the EU/ECB fail to resolve the crisis, the euro is likely to remain under pressure due to a weaker macro outlook.

Eurozone, U.K. GDP Rebound in Q2. ECB & BoE on Hold. Rate Hikes Pushed into 2011

Growth: Eurozone GDP on Track to Improve with German rebound. Investment Spending Lifts U.K. Q2 GDP

- Despite the deepening debt crisis and the tightening of resulting financial conditions, Eurozone GDP growth is on track to improve in Q2 after the weak Q1 as the export and investment driven economies of core Europe, especially Germany, ride the strengthening global manufacturing cycle.
- Strong business confidence and strengthening industrial production points to solid investment spending in Q2. The sharp fall in the euro also suggests a more favorable outlook for European trade, offsetting the impact of fiscal tightening. Eurozone GDP growth is expected to strengthen to around 2.5% in Q2.
- Germany is expected to lead Eurozone growth higher in Q2. Strong German industrial production in April and new orders indicates that German GDP is on track to rebound to over 3% annualized growth in Q2, with risks to the upside. Even in Southern Eurozone, survey data indicates that Q2 GDP growth is tracking over 2% in Spain, Portugal, and Ireland.
- U.K. GDP growth in Q2 is on track to improve with a lift from strengthening investment spending and as the headwinds from the bitter winter fade. Business confidence remains firm pointing to further growth in industrial production and investment spending. However, U.K. consumer confidence has weakened substantially in recent months as consumers brace themselves for a hit to income from tax rises and cuts in public sector employment and wages. U.K. GDP is on track to rise around 2.4% in Q2, but slow again in H2 with fiscal tightening measures introduced by the new Conservative-Lib Dem government.

Inflation: Eurozone Core remains Low, Deflation Risk from Fiscal Tightening. VAT Hike Pressure on U.K. Prices

- Eurozone inflation remains below the ECB target. Headline HICP inflation edged up to 1.6% YoY in May from 1.5% in April and a low of 0.9% in February. Headline prices rose 0.1% MoM in May after 0.4% in April. Core inflation edged up to 0.9% YoY in May from 0.8% in April. Further, the elevated output gap and the aggressive fiscal tightening in Southern Europe should exert deflationary pressure on Eurozone prices, indicating only modest increases in prices through the summer.
- U.K. headline inflation eased modestly in May to 3.3% YoY from 3.7% in April. Prices rose 0.3% MoM after 0.5% in April. Core inflation also edged down to 2.9% YoY from 3.1%, despite prices rising 0.3% MoM. Base effects should continue to put downward pressure on inflation, but the latest VAT hike should keep inflation above the BoE's 2% target.

Interest Rates: ECB & BoE on Hold. Rate Hikes Pushed out into 2011. ECB Resists Bond Purchase Expansion

- The European Central Bank (ECB) left interest rates on hold in June, but provided few new details regarding its bond purchase program. The ECB has thus far restricted its bond purchases to the riskier Greek and Portuguese debt and resisting expanding bond purchases on German opposition. With the Eurozone debt crisis and the fiscal tightening measures depressing growth and raising deflation fears, the ECB is likely to remain on hold through 2010 and tightening pushed out into 2011.
- The Bank of England (BoE) left rates unchanged in June, as expected. The BoE is expected to keep rates on hold through at least early 2011 in order to offset the fiscal tightening introduced by the new Cameron government.

Currency: Euro in Tailspin as Greek Crisis Defies Resolution. Pound Falls Sharply on Election Uncertainty

- The euro went into a freefall during May, falling -7.7%, with financial markets skeptical of a resolution to the debt crisis. So far in June, the euro has been on a bit of a roller coaster ride, continuing to depreciate to a new low of $1.19/ € in early June but then recovering back to around 1.22 by the end of the month due to a short squeeze as risk aversion began to return.
- The British pound sunk -5.1% against the dollar in May after edging up 0.9% in April. In June, the pound appreciated 2% against the dollar with improving economic data.

Japan's GDP remains solid in Q2. China restarts RMB float. GDP growth strong

Growth: Japan Q2 Growth Solid on Robust Exports. China Growth Moderating in Q2 After Strong Q1. India Remains Solid

- Japan's GDP growth is expected to moderate to around 3% in Q2, still driven by continued strength in exports. Further, the export recovery appears to be percolating into domestic demand through a rebound in corporate profits and investment spending, and modest improvement in labor and income conditions supporting consumption. Recent data shows that both private capex and consumer spending are likely to surprise on the upside in Q2.
- Earlier, Japan's GDP growth was strong in Q1 primarily driven by a robust recovery in net exports. However, all major components of domestic demand including capex, consumption and housing investment showed positive growth for the quarter. Real GDP grew at a strong 4.9% annualized pace in Q1 after rising 4.2% in Q4 2009.
- China's GDP growth remains strong but is expected to moderate to around 10.5% in Q2 with tightening measures and as base effects reverse. Investment spending, especially real estate, is likely to moderate with slower loan growth and tightening measures. Recovering exports and resilient consumption are likely to contribute solidly to GDP growth.
- Earlier, Chinese economy posted strong growth in Q1 2010, rising 11.9% YoY after 10.7% in Q4 2009 and 8.9% in Q3. The strong recovery was driven by investment spending, while consumption remained solid. Net exports were weak.
- In India, GDP growth is likely to remain strong in Q2, around 8%, after rebounding strongly to 8.6% in Q1 as industrial activity remains strong and investment spending remains robust. The recovery in agriculture is also expected to contribute positively to Q2 GDP growth. Consumption spending remains supported by rising income. GDP is expected to rise around 8% during calendar year 2010, driven by the strong domestic demand.

Inflation: Japanese Inflation Remains Negative, But Improving. China Inflation Moderates Temporarily

- Japanese inflation remains in negative territory after plunging to record lows in October 2009, largely driven by domestic deflationary pressures. Core inflation fell -1.2% YoY in May after -1.5% YoY in April. Japan is likely to remain in the deflation zone in the coming quarters despite the improvement in output. The government and the Diet have been pressuring the BoJ to take more aggressive actions to fight deflation. Prices are likely to improve later in 2010.
- China's consumer inflation continued to trend higher in May rising 3.1% YoY after 2.8% in April and just 1.5% in January. Inflation is likely to rise further in coming months as base effects are expected to peak in June/July. Pressure from rising food prices and plentiful liquidity are also likely to push prices higher before moderating in H2 2010.
- India's Wholesale Price Inflation (WPI) rose a higher than expected 10.2% YoY in May from 9.6% in April, driven by a 16.5% rise in food prices. Inflation is likely to remain elevated in coming months driven by food prices, fuel prices (both market based & adjustments to controlled fuels) and rising manufacturing prices. While base effects are likely to provide some relief to inflation, strong demand and supply side problems are likely to keep inflation under pressure.

Interest Rates/Currency: BoJ Remains on Hold in June. PBC Restarts RMB Float Ahead of the G-20 meeting

- The Bank of Japan (BoJ) left its target rate unchanged at 0.1% on June 15 as expected. The BoJ is expected to keep rates at 0.1% through early 2011 as domestic deflationary pressures continue. The Bank has also started to provide further liquidity support to domestic financial institutions to encourage them to increase lending.
- The People's Bank of China (PBC) remained on hold in late May/ June after hiking the required reserve ratio in early May for the third time in 2010. The PBC appears to have put its rate normalization plan temporarily on hold as it has turned cautious regarding the negative fallout from the Eurozone slowdown and euro collapse.
- The Reserve Bank of India (RBI) hiked the repo and reverse repo rates by 25bps to 5.5% and 4% respectively in early July. The RBI rate hike was largely expected, with WPI inflation remaining high and GDP growth getting entrenched. While a RBI rate hike was expected, and perhaps justified on domestic growth and inflation concerns, the unsettled global conditions raise questions about the timing of the RBI rate increase.
- The yen rallied against the dollar, rising 2.8% in June after 3.3% in May. Since Japan is relatively less exposed to the European debt crisis, the yen has had appeal as a safe haven.
- The PBC announced that it will take further steps to reform the RMB exchange rate mechanism and enhance RMB exchange rate flexibility. The RMB is expected to resume its appreciating trend against the U.S. dollar in coming months. However, a sharp appreciation is not expected given the PBC's cautious approach.