

## Global Markets Weekly

**The equity rally ran out of steam last week.**

**After a rally of almost two months, equity markets have shown further signs of fading momentum.** The S&P 500 is little changed over the past five days, with cyclical sectors no longer outperforming in a coordinated manner.

**The rally has translated into a weaker dollar...**

**In foreign exchange markets, the cyclical nature of the rally has shown up in dollar weakness.** The US equity market is relatively defensive, tending to outperform when risk appetite is weak. As investors have been attracted to higher-risk markets, the capital outflows have pushed the trade-weighted dollar index down almost 9% over the past two months. This is positive for US exporters, which is why lead indicators of manufacturing activity have increased more in the US than in regions with strong currencies, such as the eurozone and Japan.

**...even against sterling, despite the UK's fiscal problems.**

**In this pro-cyclical environment, the dollar has even weakened against sterling – a currency that has suffered its own particular bad news.** On top of the high government borrowing requirement published in the 2008-09 budget, the IMF this week issued a report urging fiscal consolidation, while Standard & Poor's gave the UK's AAA credit rating a 'negative outlook'. This is not the same as an actual downgrade, nor is it as serious as being placed on 'negative watch'. Nevertheless, one-third of credits given a negative outlook are ultimately downgraded. A downgrade would be highly controversial, and it's unlikely that any credit agency would consider doing this before the next government outlines its plans to reduce the structural deficit. After all, a UK general election has to be held some time before June 2010.

**Japan's woes continue, with nominal GDP back to early-1990s levels...**

**In Japan, government indebtedness over the past two decades rose far more than is considered likely in the UK,** with the associated ignominy of credit ratings agencies scrutinising Japan's public finances. In addition, because the Japanese economy is so export-oriented, its recent growth numbers have been some of the worst in the developed world. GDP declined by 2.9% in the first quarter of 2009 and is now down an annual 8.6%. After the past year's declines, Japanese nominal GDP is now at the same level as it was in the early 1990s. Previously, commentators called the 1990s Japan's lost decade of growth. Now, all Japanese growth during the upswing in global trade from 2002 onwards has been lost all over again.

**...which highlights the urgent need for the unprecedented global policy action.**

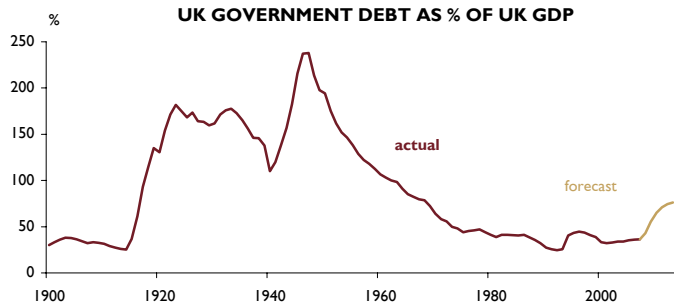
**The spectre of a Japanese perma-recession being repeated across the global economy has been one of the driving forces behind the monetary expansion of the past year,** unprecedented in both method and scale. Thanks to near-zero interest rates and quantitative easing, excess money growth has been at roughly the same rate as at the start of the previous bull market in equities (see chart on next page). In 2003, the increase in liquidity stemmed from easier lending standards and a positive fundamental outlook for corporate earnings; by contrast, the 2009 gush of liquidity has been officially sponsored. Although it may not be as long-lasting as that from a self-sustaining recovery, it has already assisted the recent rally in equity and commodity prices.

**Yet liquidity alone cannot sustain the rally's momentum.**

With risk appetite now showing signs of declining, however, the force of liquidity is finding it hard to maintain momentum for riskier assets all by itself. **As with most good plays, the second act of the economic and market recovery is likely to prove longer and more complex than the first.**

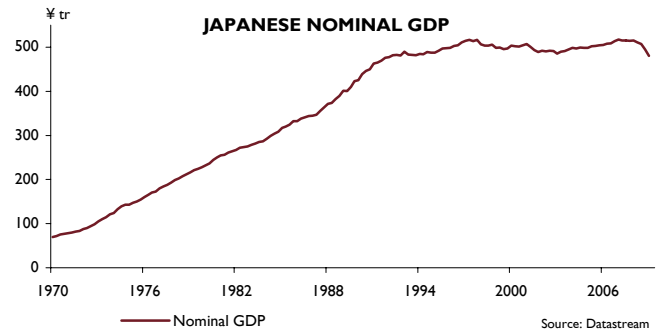
# Charts of the Week

UK debt to GDP levels remain low by historical standards, but the structural deficit is a problem that needs to be addressed.



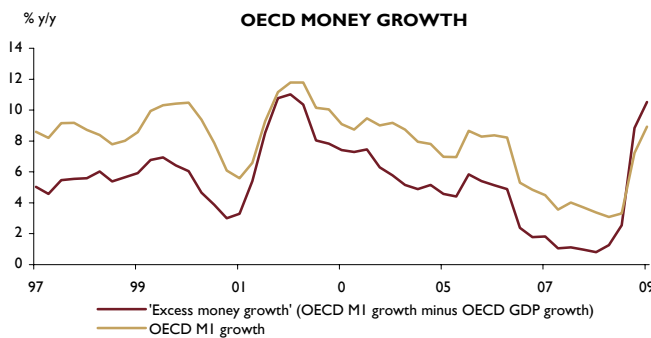
Source: B.R. Mitchell, HM Treasury

Japanese GDP has now been static for almost 20 years, with the gains of the past decade being wiped out over the past year.



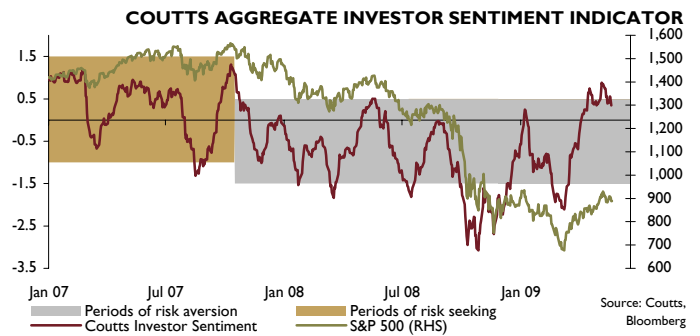
Source: Datastream

Excess money growth in the OECD is now at the same level as at the start of the last bull market, but this time it is officially sponsored.



Source: Datastream

With risk appetite already high and declining, liquidity alone is struggling to maintain upward equity momentum.



Source: Coutts, Bloomberg

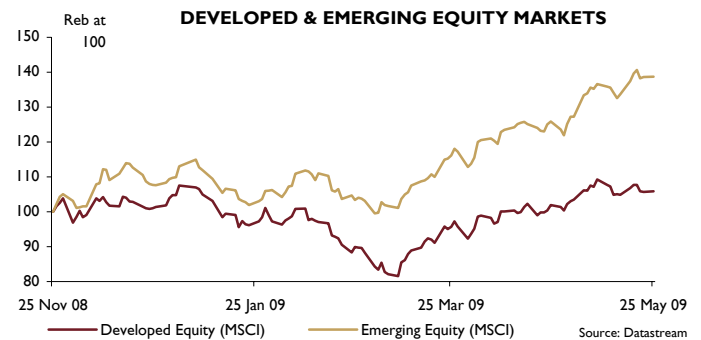
# Market Performance

Equity Markets As of: 25-May-09	Performance (% local)					
	Current	-1W	-1M	-3M	YTD	08
<b>Developed Equity (MSCI)</b>	<b>685</b>	<b>-0.8</b>	<b>3.9</b>	<b>18.1</b>	<b>1.0</b>	<b>-40.1</b>
FTSE All Share	2,228	-1.6	4.7	15.0	0.9	-32.8
FTSE 100	4,365	-1.8	5.0	13.4	-1.6	-31.3
S&P 500	887	-2.5	2.4	16.0	-1.8	-38.5
Nasdaq Composite	1,692	-2.3	-0.1	18.7	7.3	-40.5
DJ EuroStoxx	227	0.7	5.1	23.7	1.8	-46.3
Nikkei 225	9,347	3.4	7.3	25.3	5.5	-42.1
Hang Seng	17,122	0.6	12.2	31.7	19.0	-48.3
<b>Emerging Equity (MSCI)</b>	<b>34,376</b>	<b>0.9</b>	<b>10.2</b>	<b>33.3</b>	<b>26.4</b>	<b>-47.2</b>
BRIC (MSCI)	419	0.1	12.0	38.5	31.9	-55.0

Source: Datastream

10-Year Bond Yields As of: 25-May-09	Change (basis points)					
	Current	-1W	-1M	-3M	YTD	08
US Treasuries	3.4	23	45	50	119	-178
UK Gilts	3.7	25	23	27	63	-141
Euro Bonds	3.5	19	34	55	59	-139
Japanese Bonds	1.4	4	3	15	27	-33

Source: Datastream



Source: Datastream

Commodity Markets As of: 25-May-09	Performance (%)					
	Current	-1W	-1M	-3M	YTD	08
<b>Commodities (TR)</b>	<b>242</b>	<b>0.7</b>	<b>8.7</b>	<b>14.6</b>	<b>3.0</b>	<b>-35.6</b>
WTI Oil Price (Spot)	61	3.1	18.3	42.6	55.6	-59.2
Gold Bullion (Spot)	957	2.7	5.2	-1.7	11.0	3.1
Industrial Metals (TR)	227	-0.6	2.8	23.7	16.9	-48.3

Source: Datastream

# Interest Rates & Inflation

Inflation & Interest Rates		Current Inflation (%)	RBS Interest Rates Forecast (%)			Rate Announcement Next Date
			Current	Jun'09 (F)	Sep'09 (F)	
United States	(Fed Funds)	-0.7	0 - 0.25	0 - 0.25	0 - 0.25	24-Jun
United Kingdom	(Base Rate)	2.9	0.50	0.50	0.50	04-Jun
Eurozone	(Repo Rate)	0.6	1.00	1.00	1.00	04-Jun
Japan	(Call Rate)	-0.3	0.10	0.10	0.10	16-Jun

Source: Coutts, RBS, Datastream

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