

GLOBAL MARKET COMMENTARY

Most global stock markets generated very good returns in the second quarter as a positive outlook for corporate profits continued to be supported by strong economic data. Sectors and regions more exposed to global growth generally outperformed and emerging markets – particularly Latin America – registered very strong returns. Japan was a notable underperformer as good local gains were swamped by the dramatic decline in the Yen, which continued to fall on a lack of monetary policy tightening by the Bank of Japan. From a sectoral perspective, interest rate sensitive and non-cyclical sectors such as utilities, financials, health care and consumer staples were the weakest performers on the back of the jump in global bond yields while cyclical sectors such as industrials, materials and information technology outperformed.

Stocks rose and bonds fell during the second quarter as economic growth continued to exceed expectations – particularly outside North America. Companies, sectors and regions with exposure to stronger growth generally outperformed their less cyclical counterparts as investors shrugged off developing credit concerns in U.S. real estate and the further increases to administered interest rates by many overseas central banks. Merger and acquisition activity continued at a torrid pace which, together with the strong performance of emerging markets and the general tightness of fixed income credit spreads, reflected continued investor optimism over the outlook for global economic growth. The highlight of the quarter was the initial public offering (IPO) of private equity firm Blackstone, which was the largest U.S. IPO since 2002. The growing size of leveraged buyouts contributed to the shares of larger companies finally outperforming smaller and midsize issues in most markets.

U.S. economic growth rebounded in the second quarter after posting the softest economic growth in more than four years in Q1 — just 0.6% at an annual rate. The combination of firm consumer spending owing to a tight labour market, a pickup in capital spending, inventory re-stocking and robust exports suggest growth of around 3% in Q2 when the number is finalized. In addition, bond yields spiked sharply higher in Q2 alongside this uptick in economic growth as financial markets reassessed the outlook for Federal Reserve (Fed) monetary policy, no longer expecting rate cuts in the quarters ahead.



The main drag on the U.S. economy continues to be housing. Construction activity remains soft and homebuilders are extremely downbeat. Elevated levels of unsold homes have caused prices to decline on a nationwide basis, while tighter lending standards in the wake of the troubles in the subprime mortgage sector are also prolonging the down phase of the housing cycle, as will the recent rise in mortgage rates. Growth is expected to slow in the second half of 2007 as the continued weakness in housing and high gasoline prices impact consumer spending. Key leading indicators point to economic growth returning to a 2%-2.5% pace going forward.

U.S. inflation trends turned favorable in the second quarter, resuming a downtrend begun last September. Core inflation—as measured by the personal consumption deflator excluding food and energy—has returned to the Fed’s so called 1%-2% “comfort zone” for the first time since 2004.