Is The Real Global Recovery Finally Underway?

Chris Probyn

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If It Is, The US Will Lead

- Positive Forces Abound in the US Economy:
  - Excessively easy monetary policy
  - Reduced geo-political uncertainties
  - Fiscal stimulus
  - A lower dollar
  - Demand momentum
  - Low inventories

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US Growth Has Already Accelerated

- Growth averaged 6.0% in second half of last year
  - Consumers spent their tax cuts
  - Business investment revived

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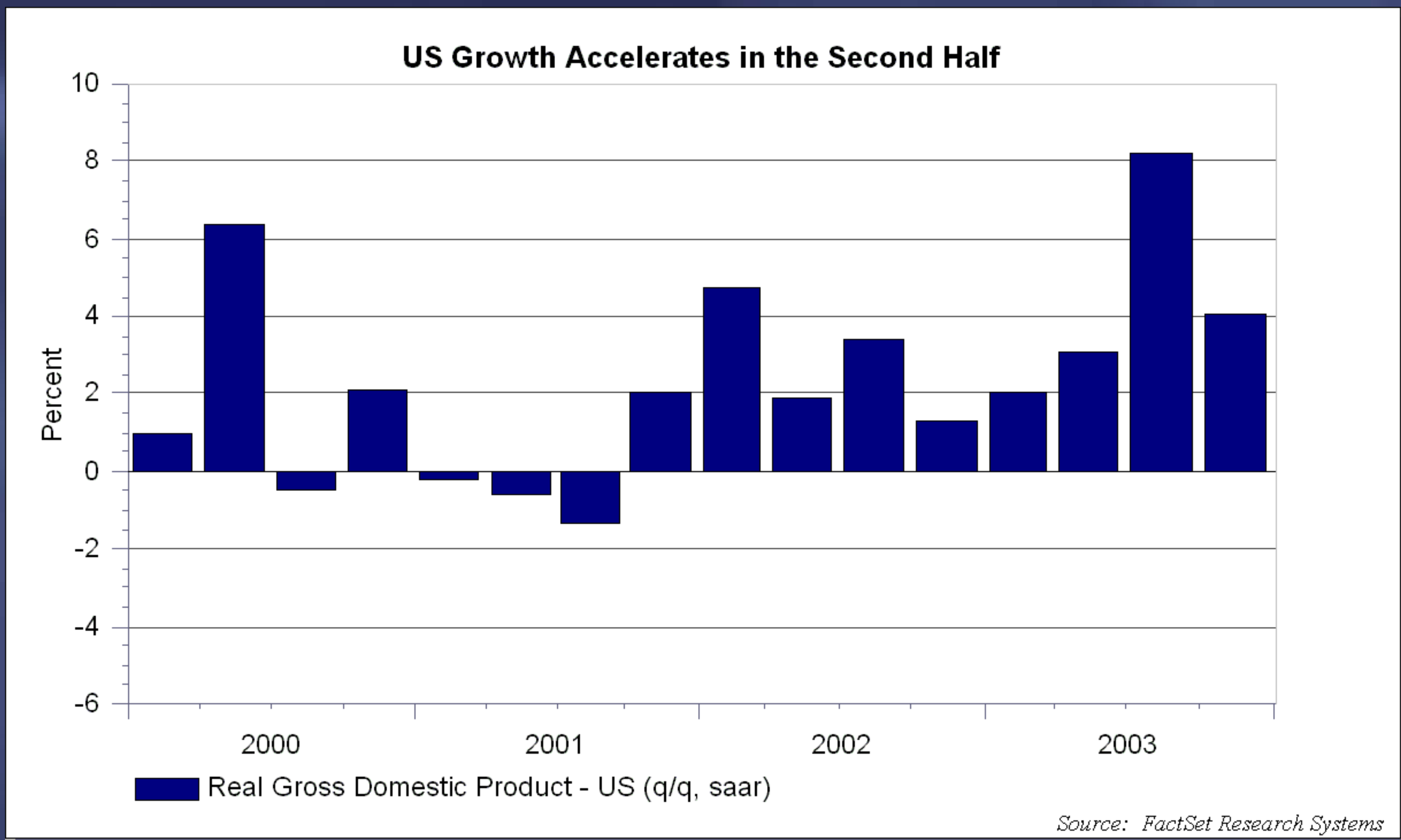
US Growth Has Accelerated



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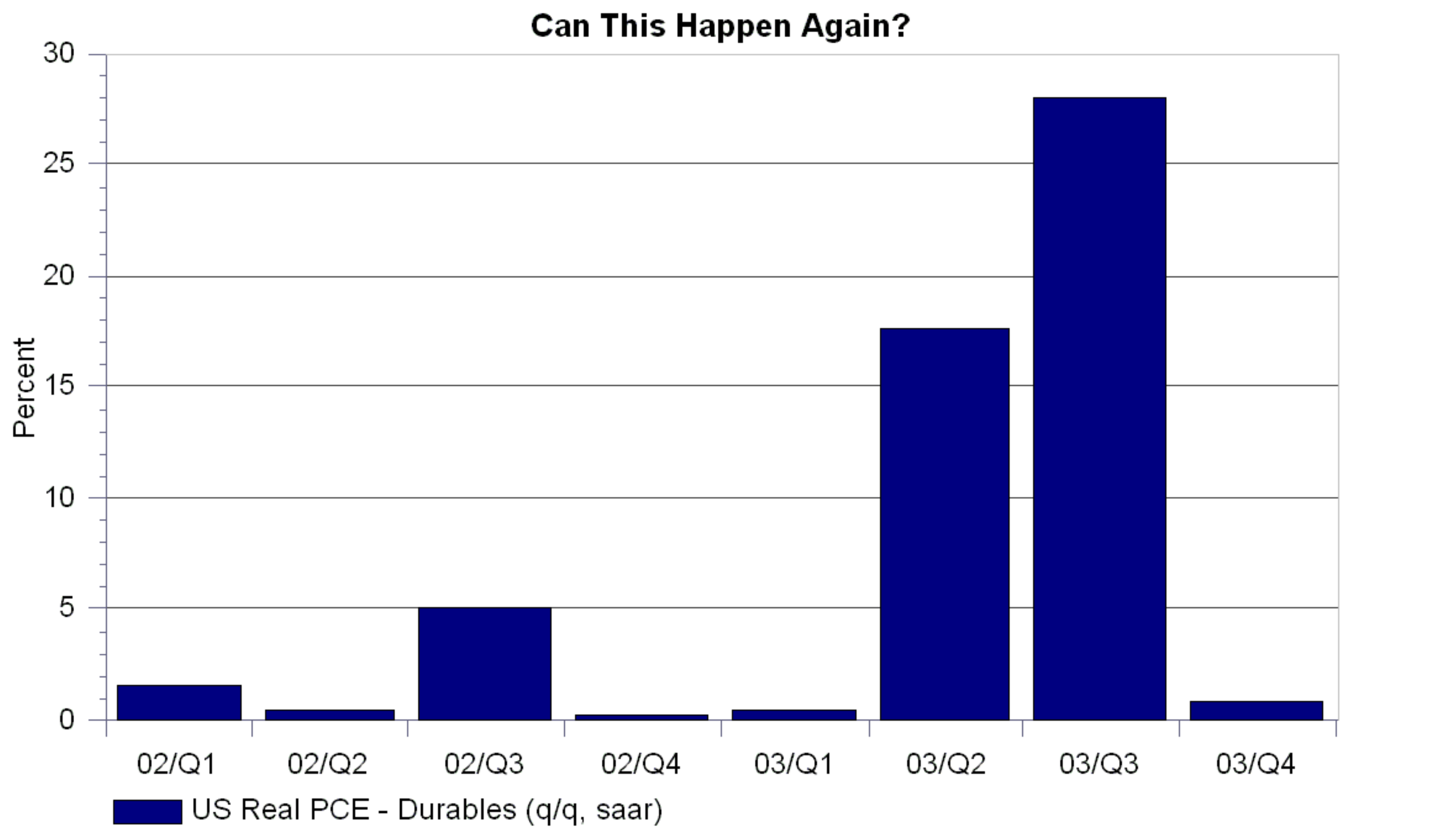
Consumers Spent Their Tax Cuts



Source: FactSet Research Systems

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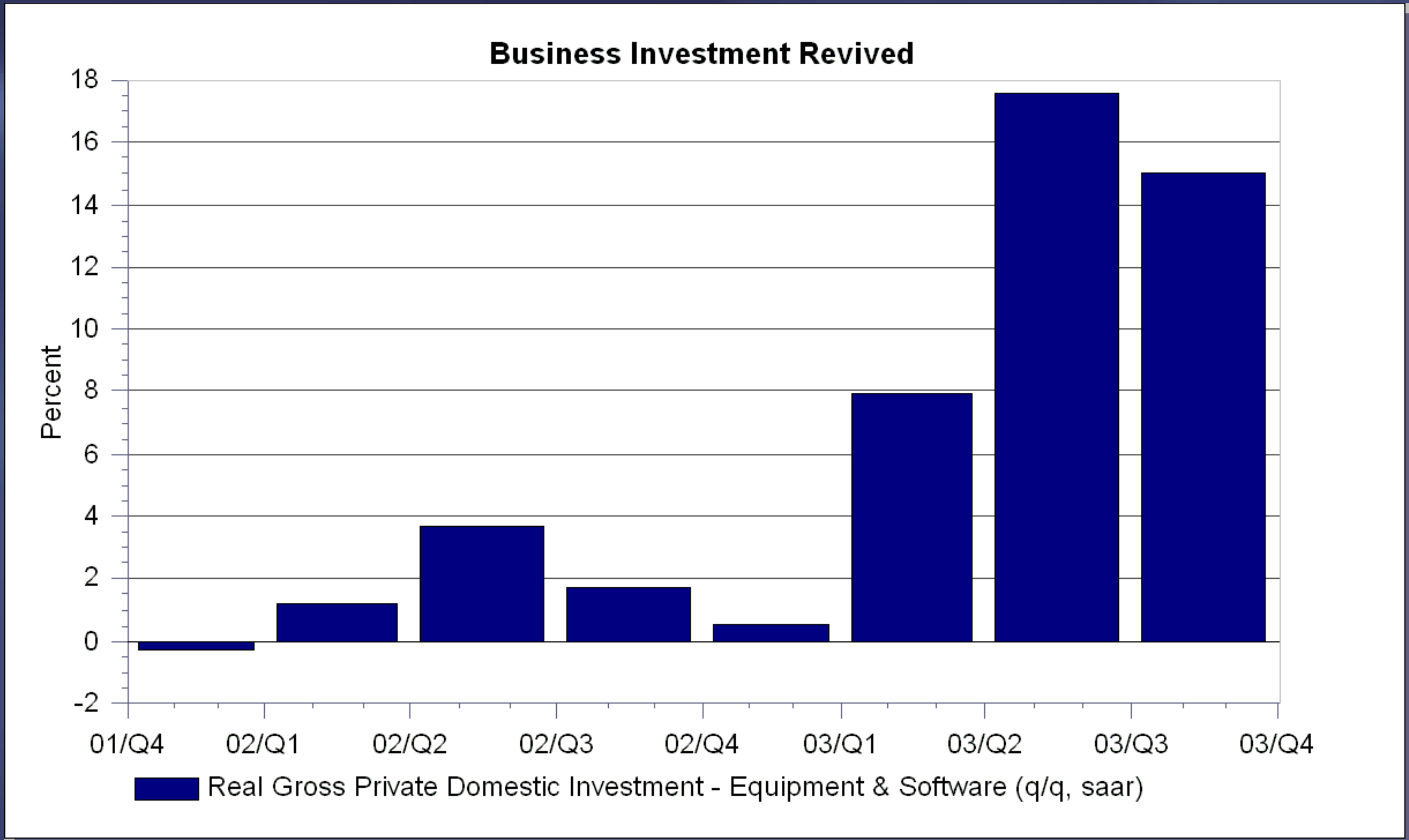
Investment Revived



Growth Should Stay Strong

- Expect near-5% growth in first half
- Some slowdown in second half
- Possible late-year investment “pop”
- Fed Expects:
  - 4.5%-5.0% growth q4/q4
  - Unemployment rate at 5.25%-5.5% by Q4

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Despite Growth Acceleration…

- Inflation will remain benign
  - Positive Output Gap
  - Robust Productivity Growth
  - One negative: OPEC is so far managing to keep oil prices up
- Fed will be patient
  - Inflation is low
  - Lingering doubts about sustainability of recovery
  - Expect only 50 basis points of tightening this year

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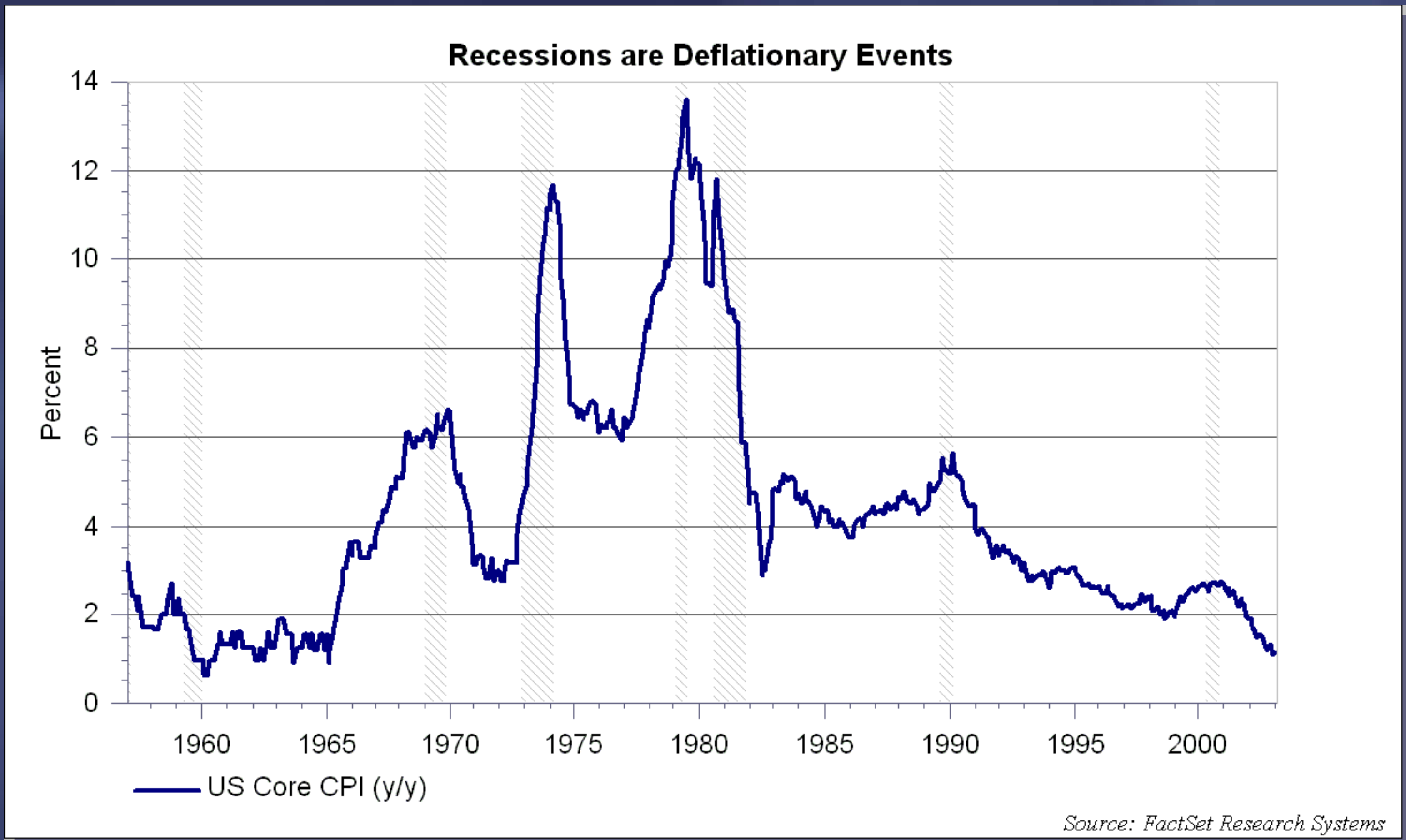
Inflation is Benign



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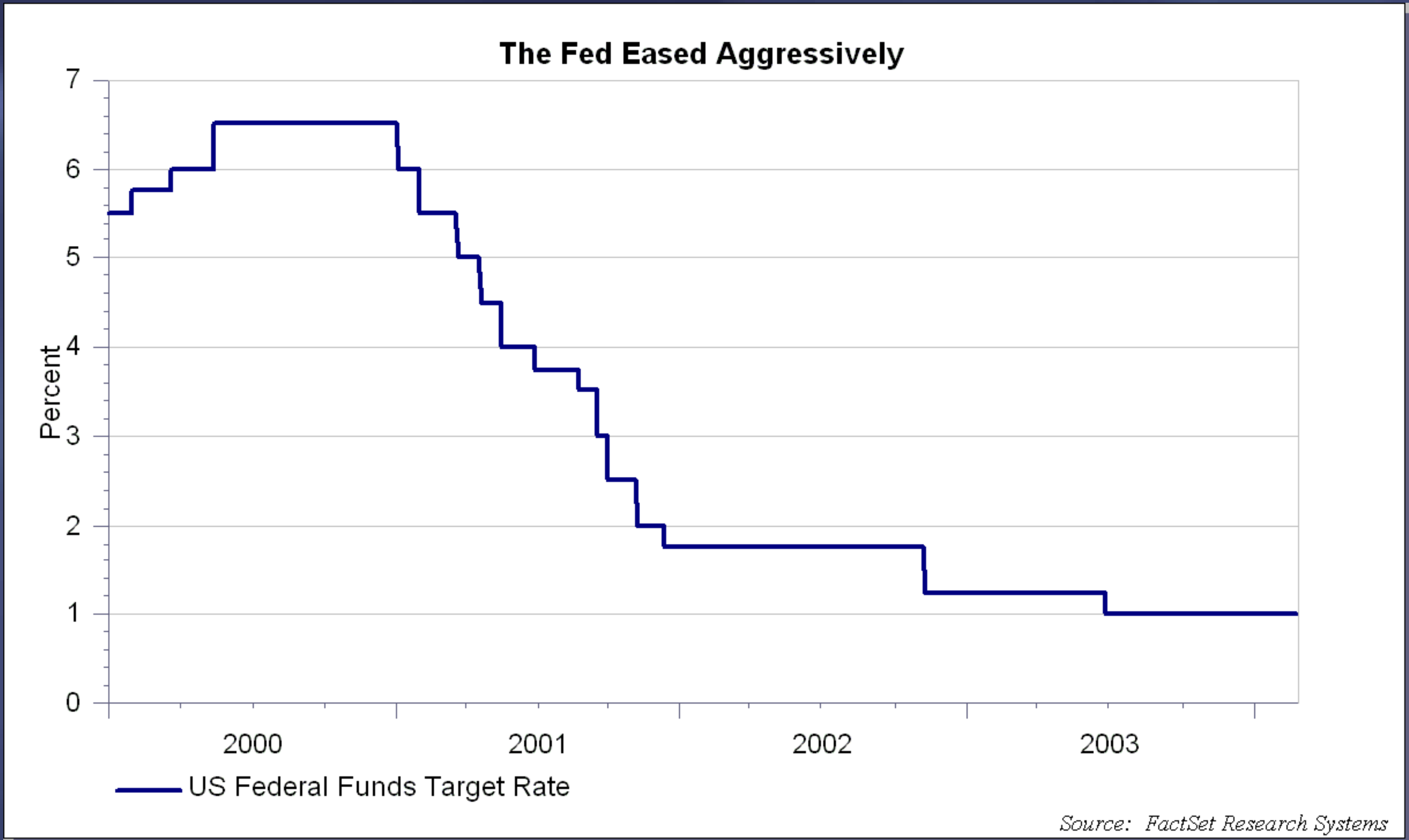
The Fed Will Be Patient



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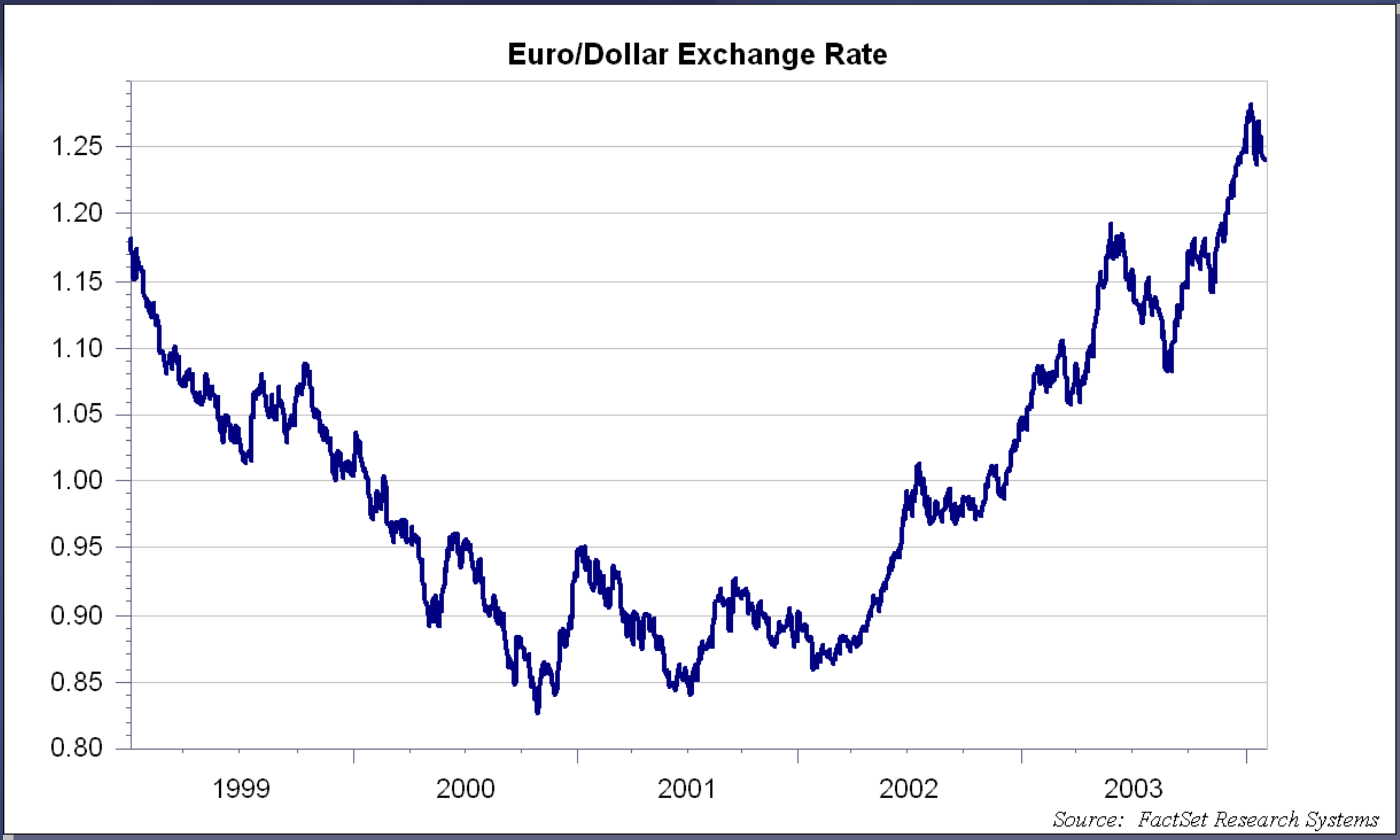
Implications for the Dollar

- Few grounds for outright optimism on the dollar until concrete signs of Fed tightening emerge
- But, how pessimistic should we be?
- The lower dollar is “pulsing” deflation abroad
- There are three possible responses:
  - Accept (Eurozone, UK, Australia, New Zealand)
  - Resist (Japan via intervention, China via peg)
  - Compensate (Canada)

The Stronger Euro Was Welcomed



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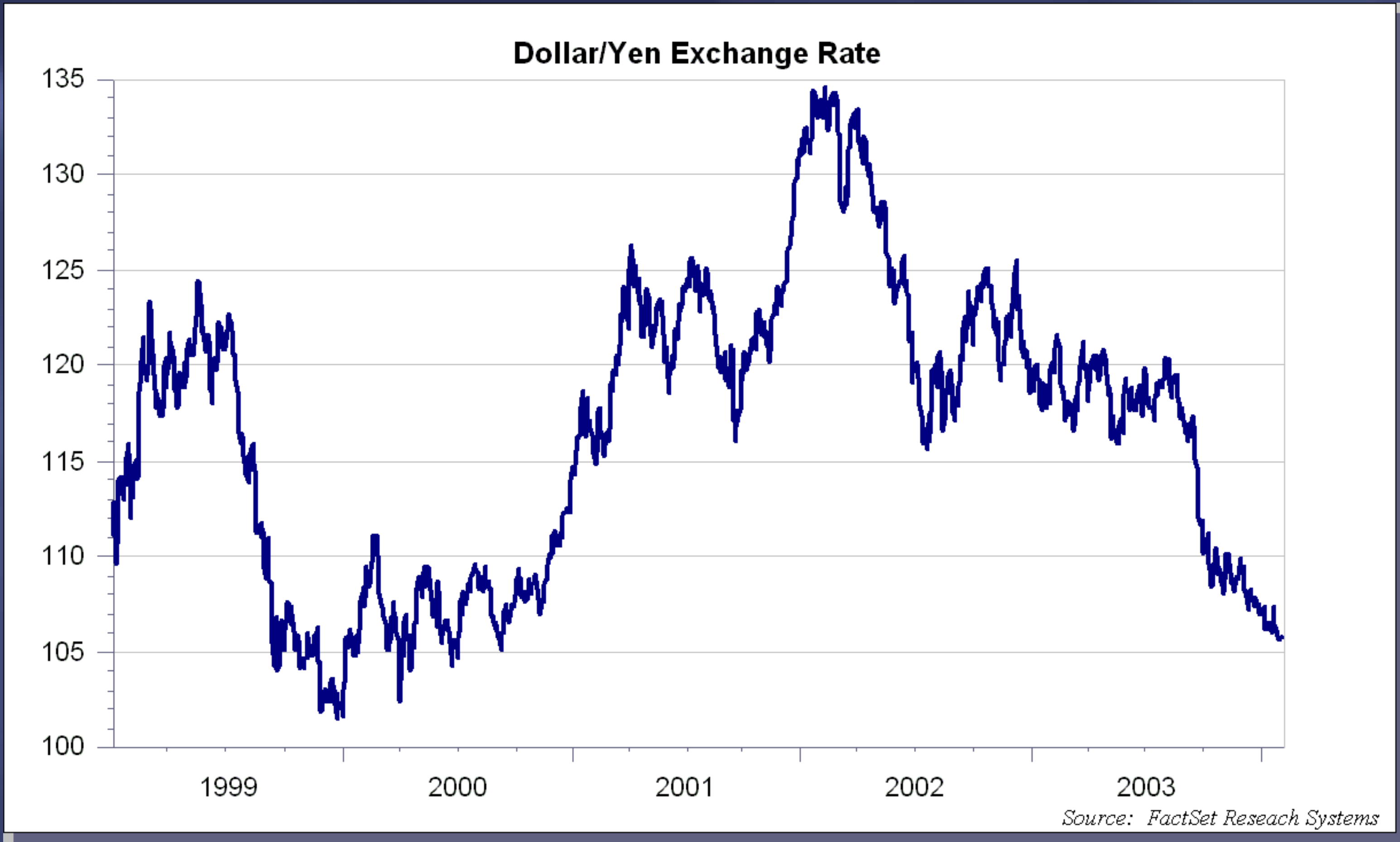
The Stronger Yen Was Not



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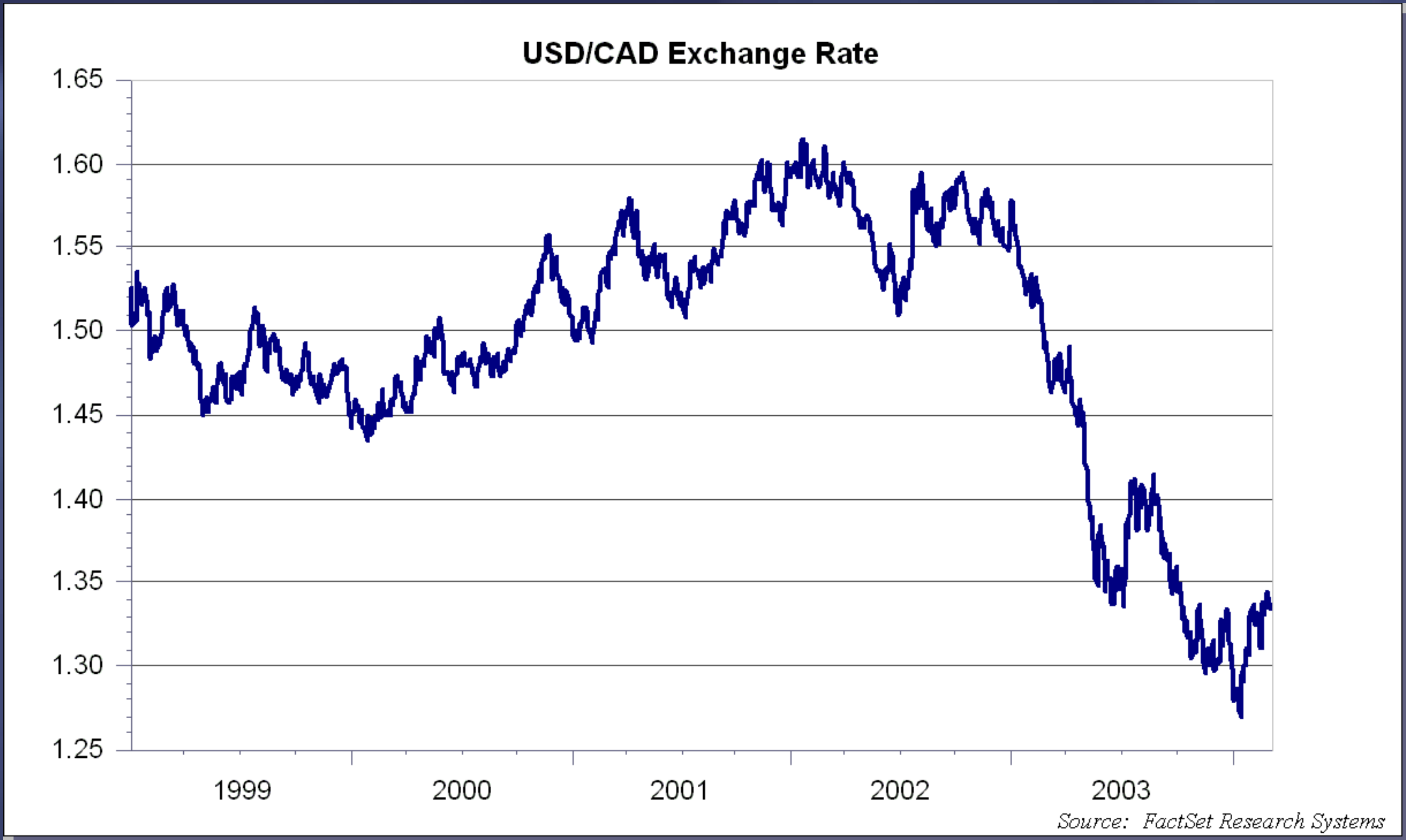
The BoC Took Decisive Action



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The Dollar May Not Weaken Too Much More

- The BoC has already cut interest rates
- The Japanese remain committed to further intervention, perhaps on a massive scale
- The Chinese are unlikely to remove the peg this year
- Signs that Eurozone "acceptance" is breaking down:
  - "Brutal" comment
  - Modified G7 statement out of Boca Raton
- So, ECB intervention or even rate cut possible

Overseas Markets--Global

- In mid-1990s, US domestic demand grew robustly
- Other countries relied on exporting to the US
- When US economy slipped into recession, world went along with it
  - Japan could not step up
  - Eurozone would not step up
- Anemic US recovery => anemic global recovery
- US domestic demand now picking up
- Much of rest of world still relying on exports

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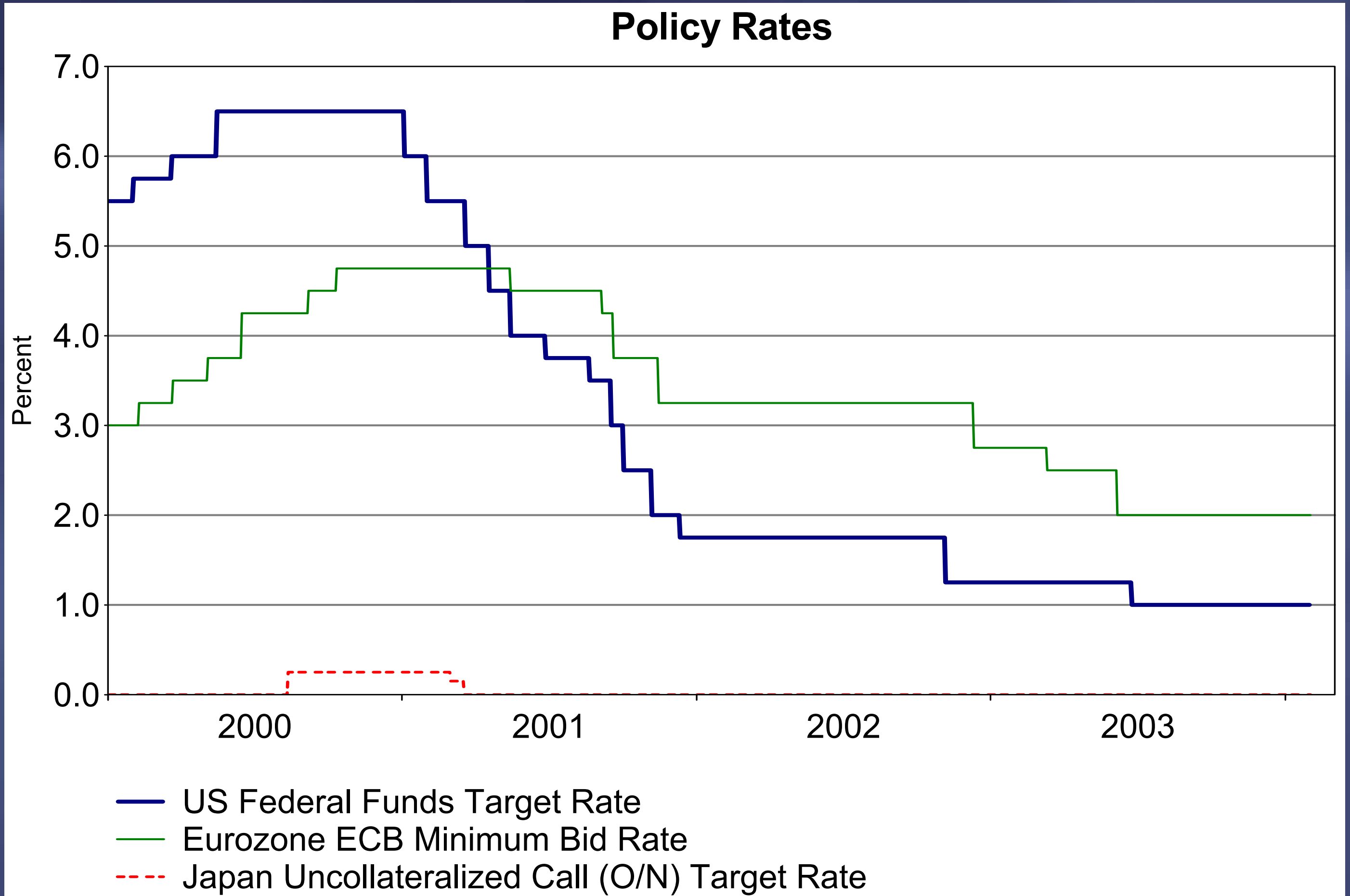
Japan Couldn't, Eurozone Wouldn't



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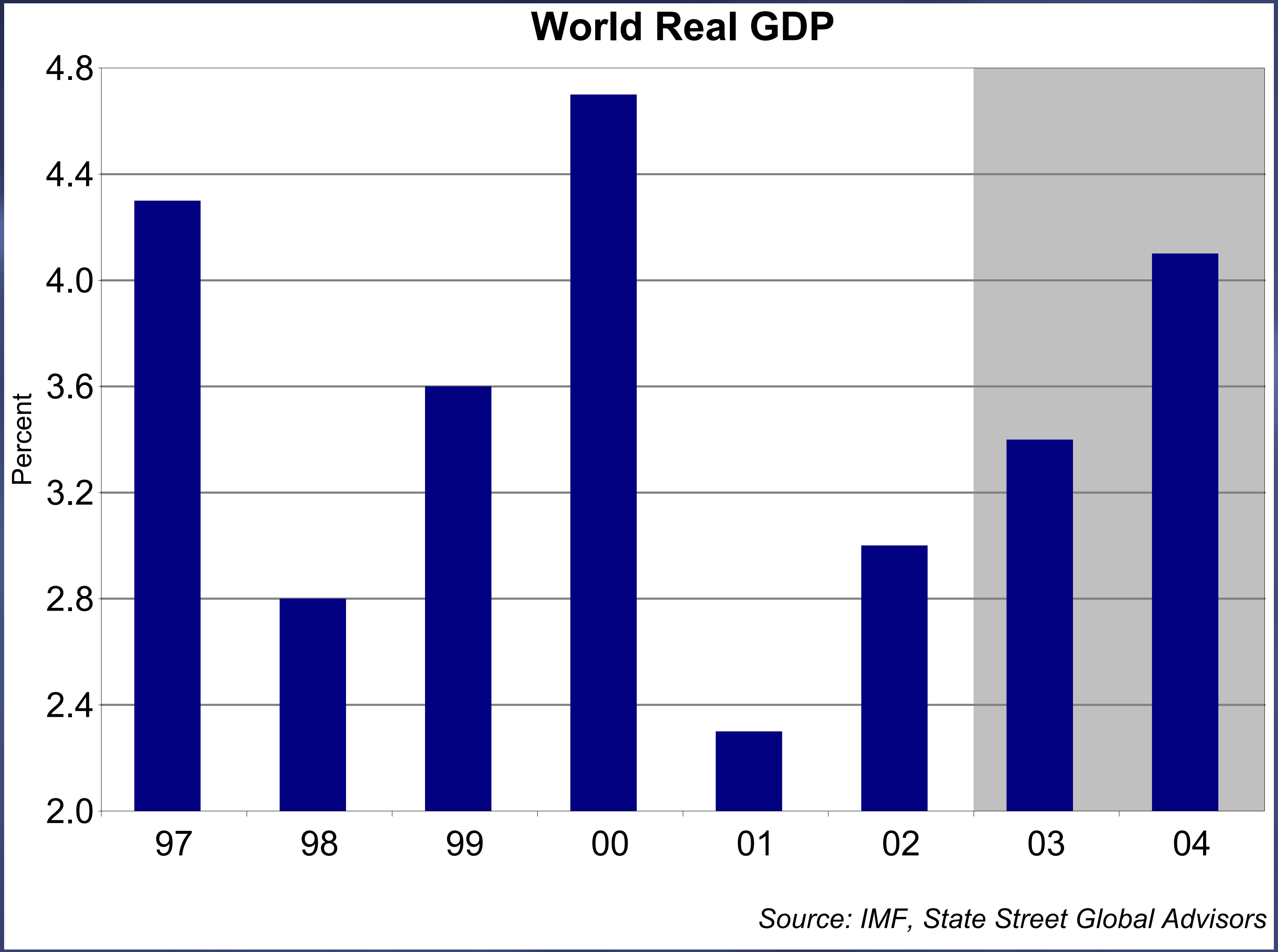
World Real GDP
4.8
4.4
4.0
3.6
3.2
2.8
2.4
2.0
Percent
97
98
99
00
01
02
03
04
Source: IMF, State Street Global Advisors

Overseas Markets--Canada

- Domestic Demand Remains Firm
  - Low interest rates boosting housing
  - Effects spilling over to consumption
  - Which is helping business capital spending
- Net trade subject to opposing forces:
  - US improvement helping
  - Stronger CAD hurting
- Monetary Policy Easing
- Growth expected to hit 3.0% this year

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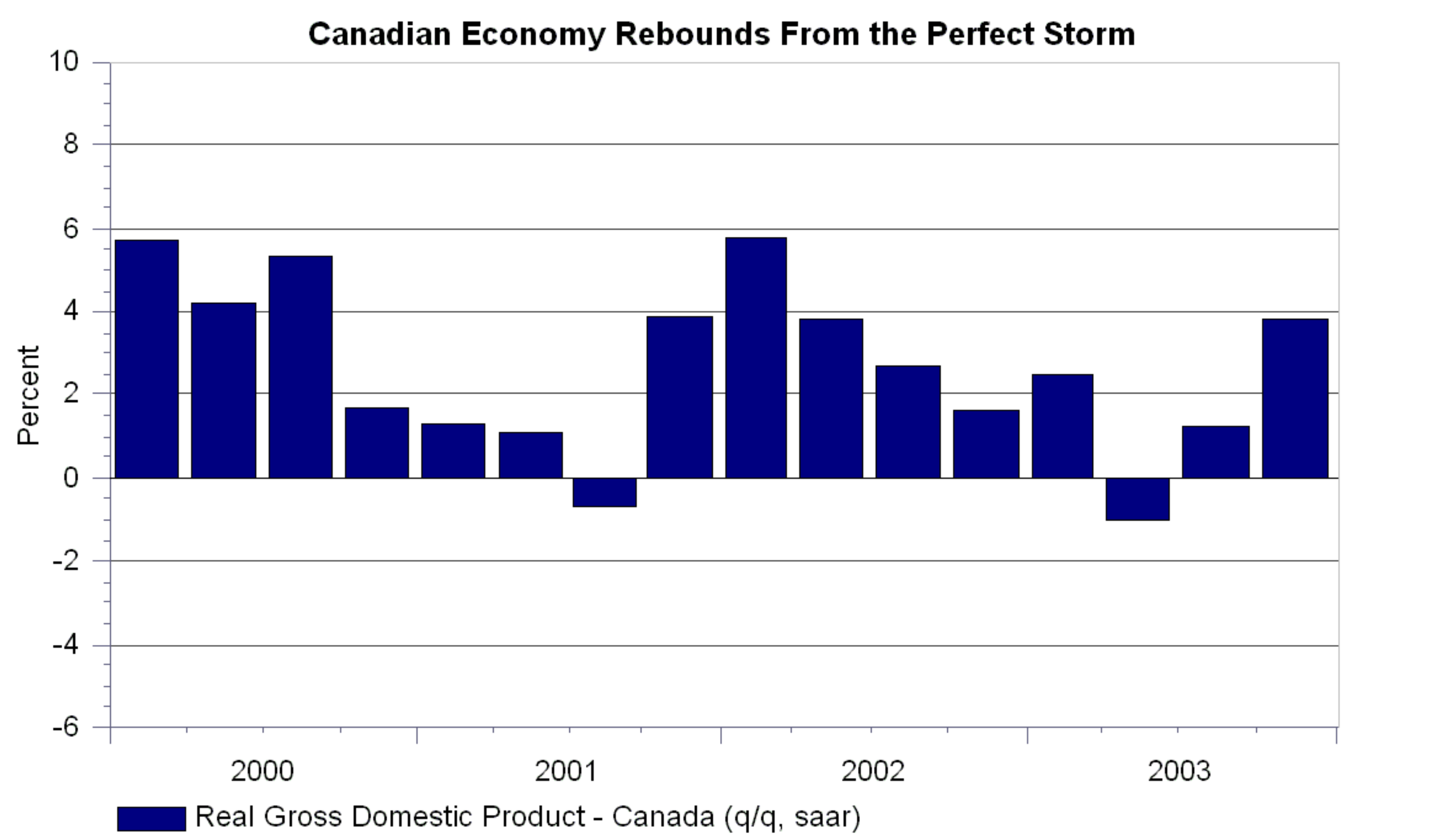
Improving After The Perfect Storm

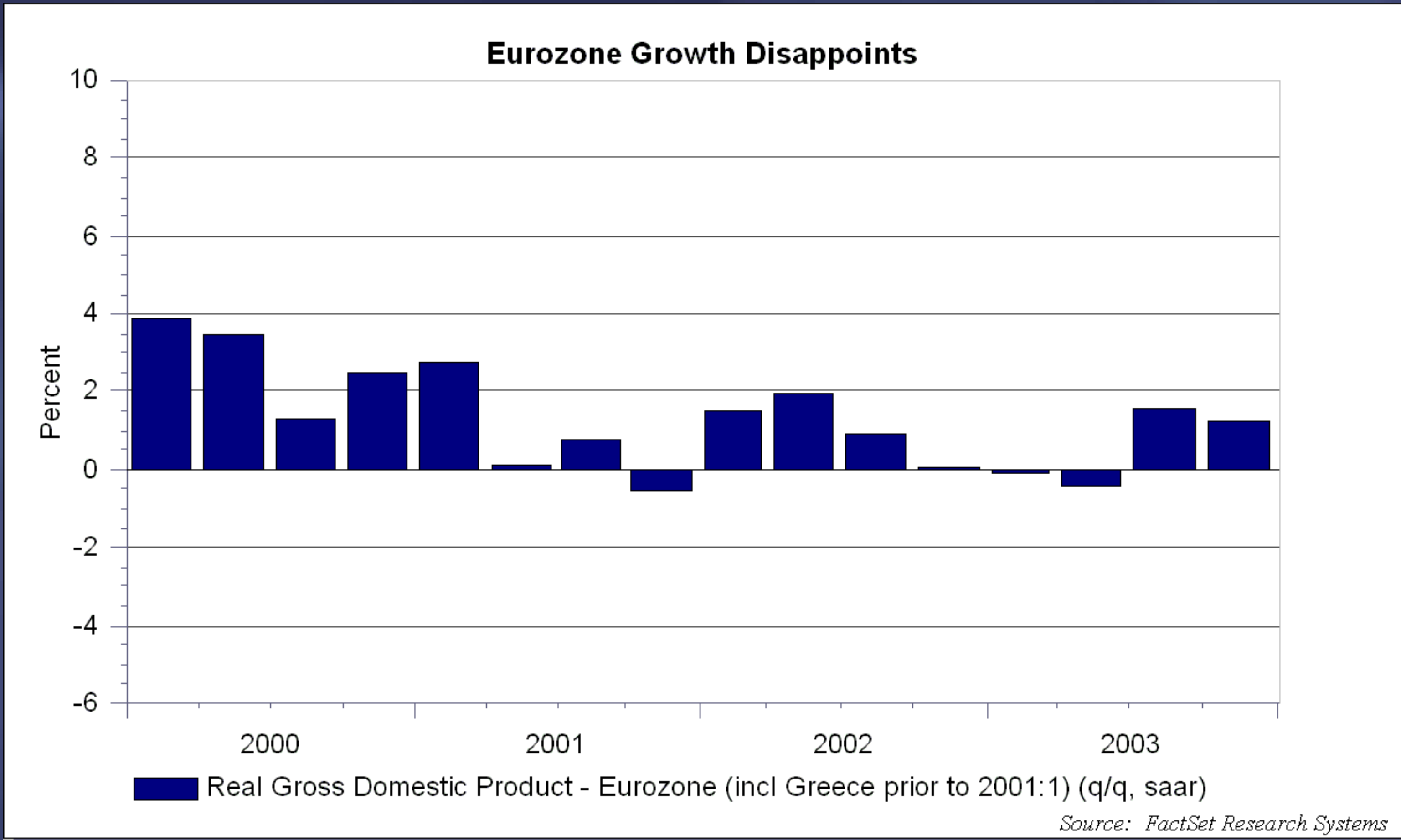


Source: FactSet Research Systems

Overseas Markets--Eurozone

- Domestic demand weak
- Counter-cyclical policy not being employed
  - Fiscal policy is hampered by GASP
  - Monetary policy has been backward looking
- So, the eurozone remains dependent on an export-led revival, which has been undermined by the stronger euro
- Further underperformance, only 0.5% growth last year, and 1.8% this

Barely Advancing



Overseas Markets--UK

- Twin Speed Growth
  - Strong consumption & services
  - Weak foreign demand and manufacturing
- Signs of transition to full-speed growth (near 3.0%)
  - Manufacturing improving
  - Consumption remaining firm
  - Government investment strong
- BoE tightening: unemployment is low, consumers are borrowing, and house prices are soaring

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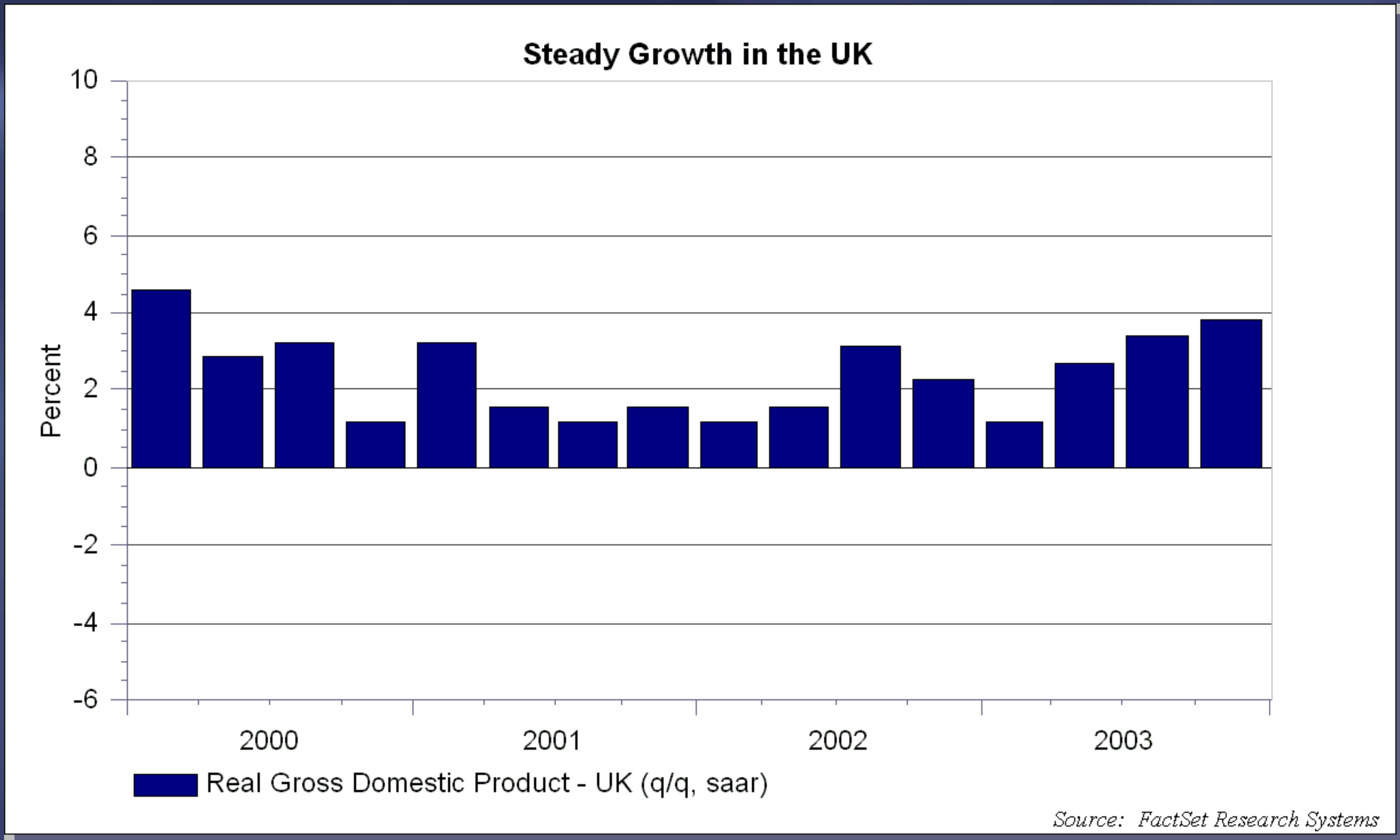
Solid Domestic Demand



Overseas Markets--Japan

- Worst fears were not realized, as growth remained positive through first half of last year
- Exports are now trending higher, which will boost corporate profitability, investment, worker bonuses and ultimately consumption
- Growth hit 2.7% last year, maybe 3.0% this
- Even some grounds for optimism on structural reform with Koizumi's re-election

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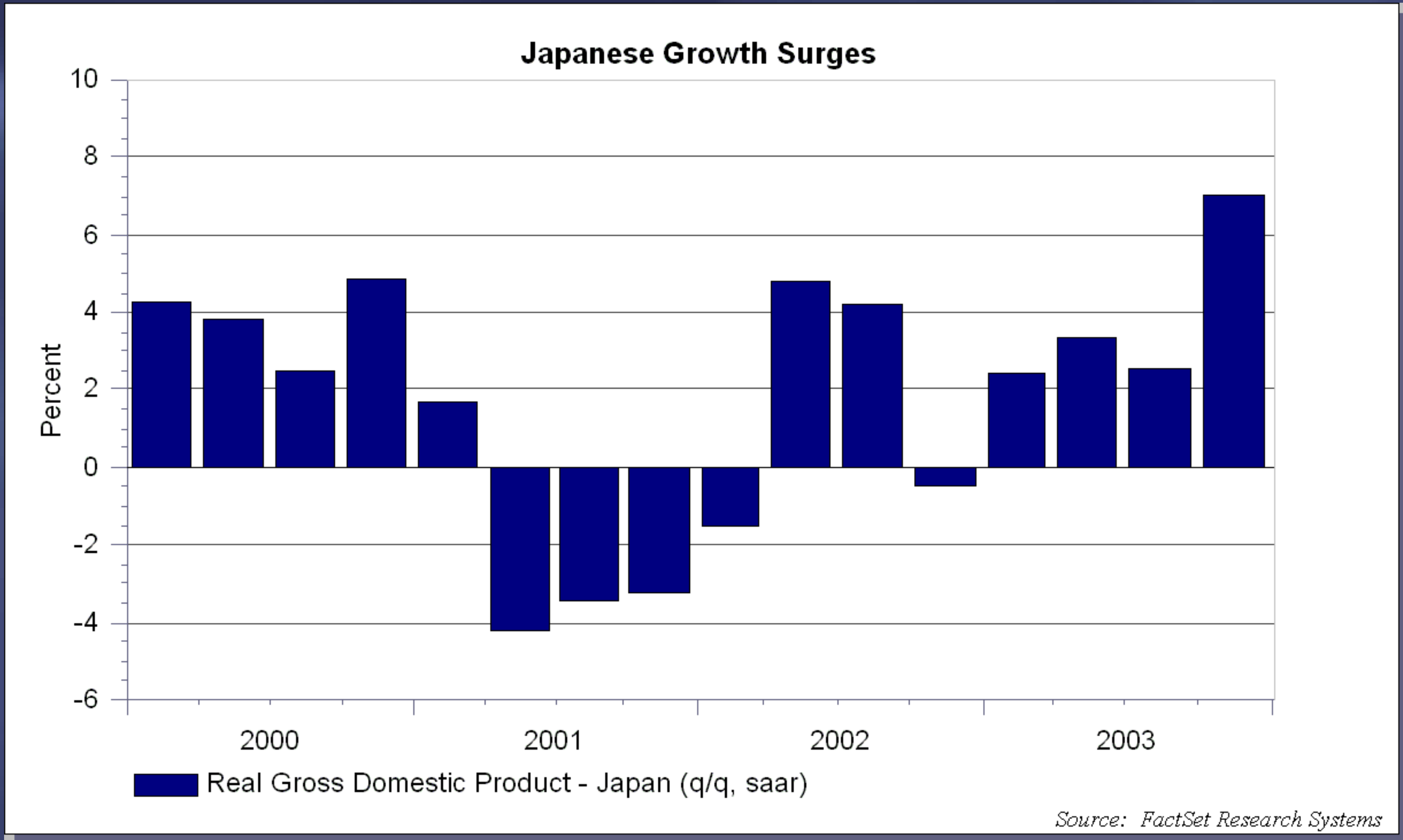
Positive Surprise



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Overseas Markets--China

- China provided a global growth cushion during the recession and early recovery years
- Chinese authorities eased credit conditions, causing a rapid expansion of bank lending, business capital spending and GDP growth
- Authorities are now attempting to reverse course and engineer a soft-landing
- Timing remains unclear

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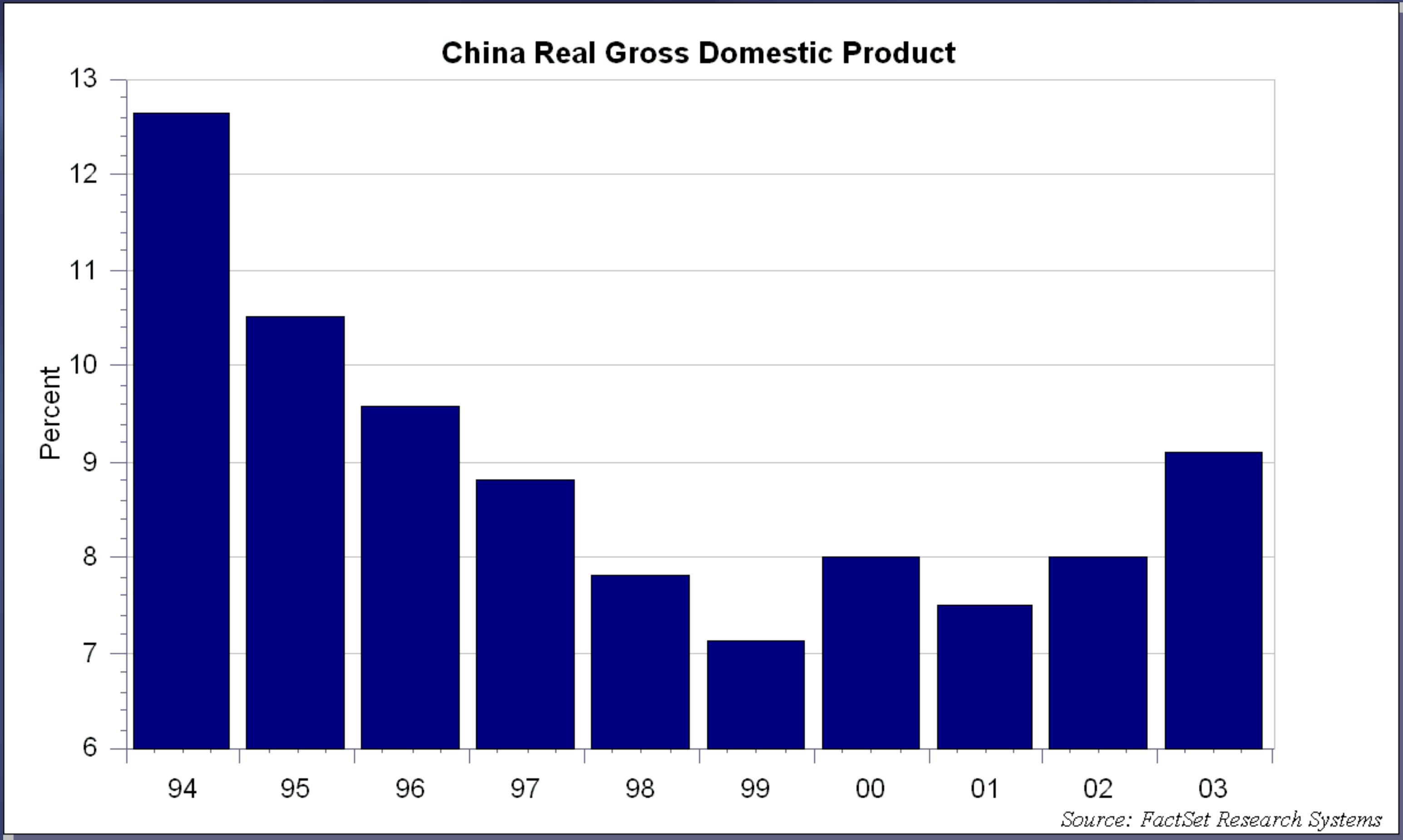
China Has Grown Robustly



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Two Causes For Concern

- The Sustainability of the US Recovery
  - Fiscal Reversal
  - Joblessness
- The Pattern of Global Growth
  - US Centricity
  - Ever-widening Current Account Deficit

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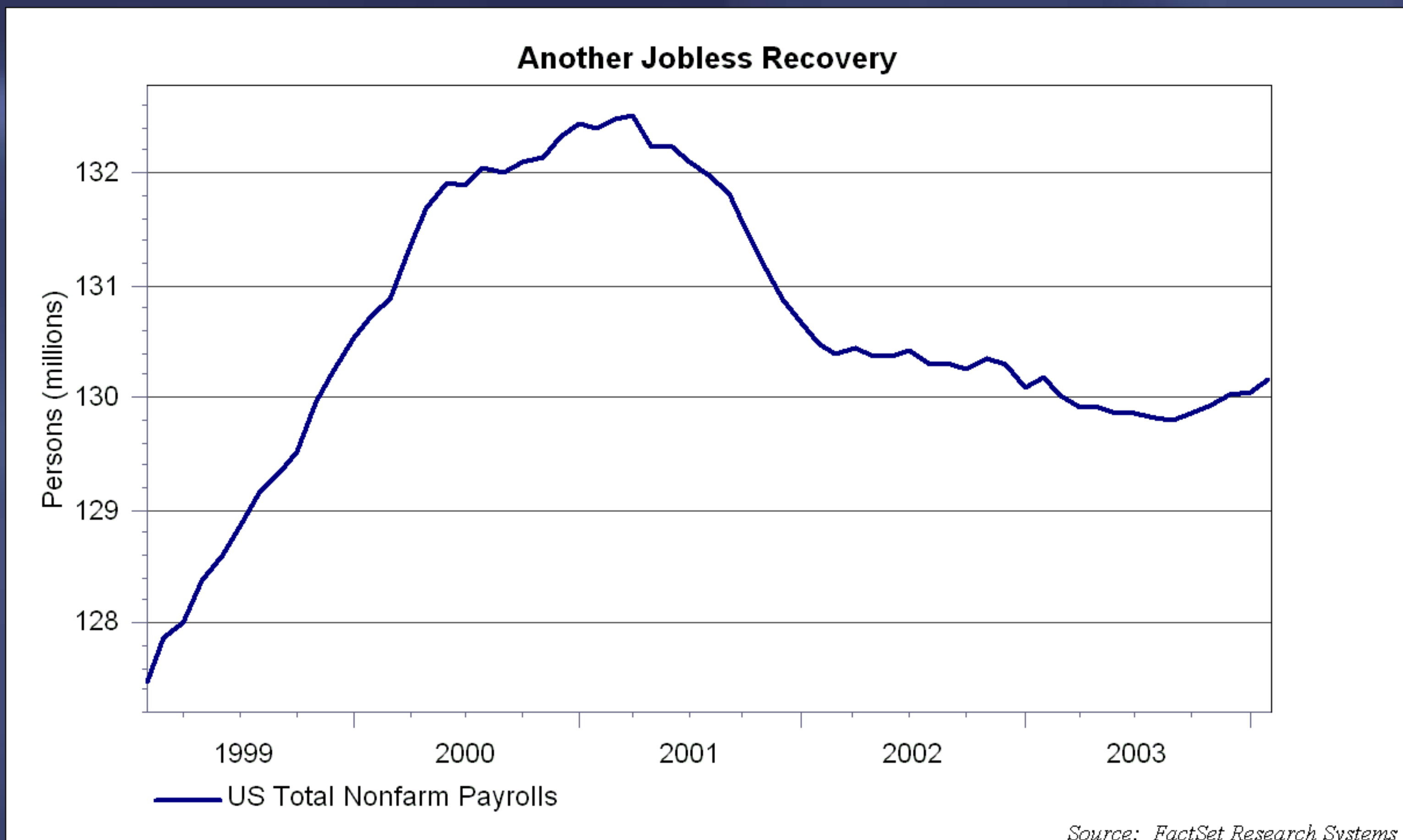
Jobless Or Even “Job-Loss”



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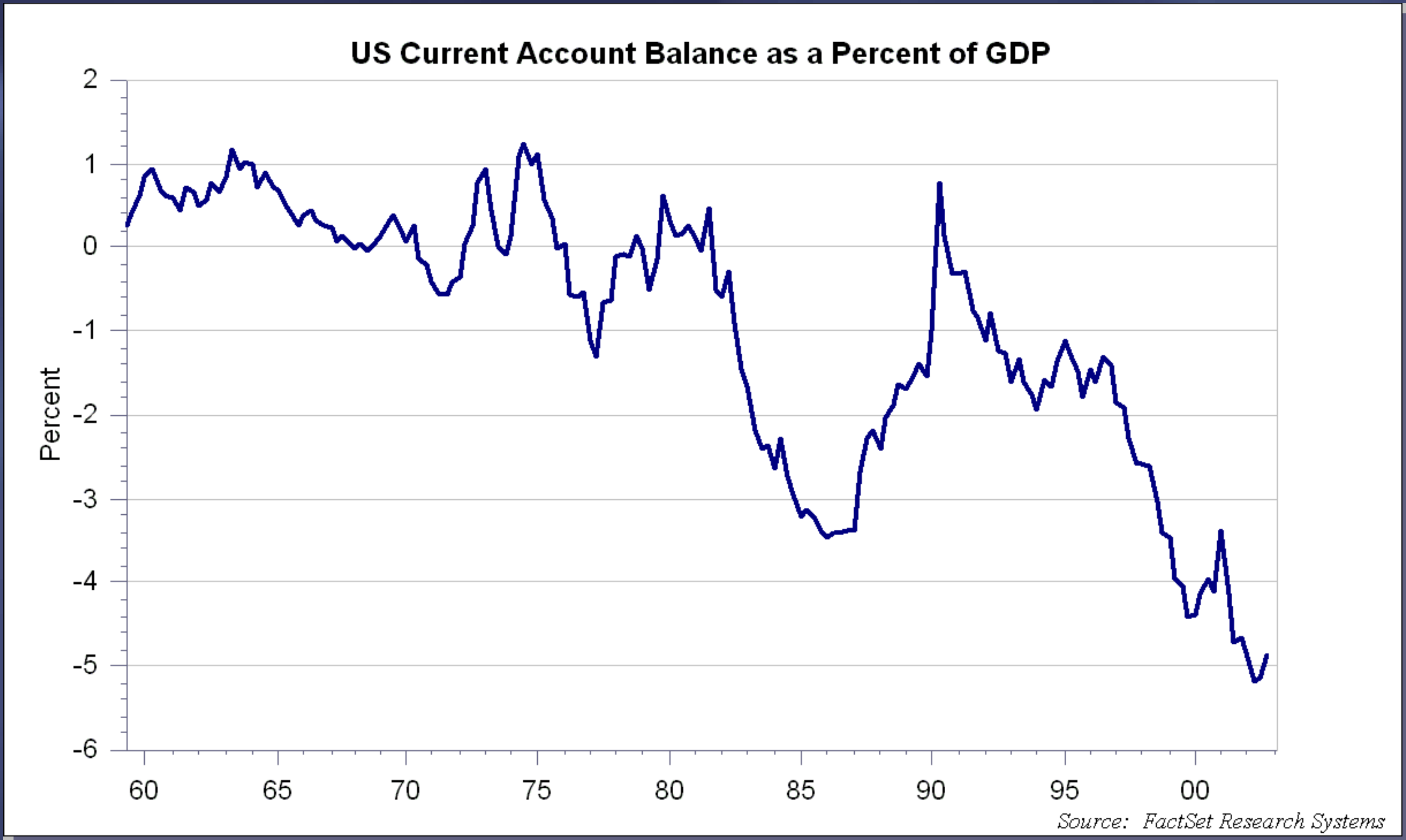
Growing Ever Wider!



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