

Prudential International Investments Advisers, LLC.

Global Economic Outlook – September/October 2009

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Global Summary: Faster, Stronger Rebound from Recession. Inflation Trough. Rates on Hold

[John Praveen's Global Economic Outlook – September/October 2009](#) sees the global recession ending faster than earlier market expectations and the rebound stronger than expected. GDP growth has already turned positive in Japan, Germany and France in Q2, while the U.S., U.K., the rest of Eurozone and several emerging economies are on track to positive GDP growth in Q3. In addition, GDP growth is set to accelerate in China, India and other emerging economies. The U.S. posted a much smaller GDP decline in Q2 (-1%), and is on track to post positive GDP growth in Q3, around 3.5% annualized. Eurozone GDP growth is on track to turn positive in Q3, around 1.5%, accelerating to over 3% in Q4 with stronger GDP growth in Germany and France. Earlier, positive GDP growth in Germany and France lifted Eurozone almost out of recession in Q2. The Japanese economy was the first major economy to exit the recession with GDP rebounding 3.7% in Q2. Japanese GDP is on track to strengthen further in Q3, rising around 3.2%, with the massive fiscal stimulus and continued recovery in exports. China's GDP growth is expected to accelerate in Q3 to around 9% YoY, and further to over 10% in Q4 as investment spending remains solid driven by still ample liquidity and government's commitment to support growth, while consumption remains solid.

Headline inflation fell deeper into negative territory in the major economies in July/August but has begun to trough as oil price base effects reverse. Headline inflation is expected to turn positive in late 2009. However, the large slack in the output and labor markets are likely to dampen inflationary pressures. Core inflation remains stable, easing concerns about deflation.

The Fed, ECB, BoE, and BoJ remained on hold in August/early September with policy rates close to zero in the U.S. and Japan and around 1% in Europe. While the global economy is exiting from the recession, central banks are not about to exit from the low interest rate policies. With inflation remaining low, global central banks are expected to remain on hold through the first half of 2010. However, the central banks appear to be wrapping up their purchases of assets that were part of their "Quantitative Easing."

Key Changes in Macro Views

	View/Forecast	Reasons
GDP Growth	<p>Recession winding down faster than expected</p> <p>Q3 GDP turns positive in U.S. and Europe</p> <p>Positive GDP growth in Japan in Q3</p> <p>China GDP strengthens further in H2</p>	<ul style="list-style-type: none"> The global recession appears to be winding down faster than expected with GDP growth turning positive in Japan, Germany and France in Q2, while the U.S., U.K. and the rest of Eurozone are on track to positive GDP growth in Q3. Leading Economic Indicators (LEI), business and consumer confidence indicators, production and other activity data all continue to improve. Further, inventory rebuild and trade rebound are expected to boost Q3 GDP growth. After posting a much smaller GDP decline in Q2, the U.S. economy is on track to post positive GDP growth in Q3, around 3.5% annualized, with LEIs turning positive, ISM manufacturing index rising above the critical 50 level and strong readings on consumer spending, home sales and prices, and durable goods orders. Eurozone GDP is on track to turn positive in Q3 after Germany and France lifted Eurozone Q2 GDP to an almost flat reading. While stronger GDP growth in Germany and France are likely to lead Eurozone out of recession in Q3, weakness in Italy and Spain will remain a drag on Eurozone GDP. The Japanese economy is on track to recover further in Q3 with the massive fiscal stimulus and continued recovery in exports. GDP is expected to rise around 3.2% QoQ annualized in Q3. Earlier, Japan's economy rebounded in Q2 with GDP rising 3.7%. China's economy is expected to strengthen further to around 9% YoY in Q3, after a strong 7.9% rebound in Q2, driven by continued support from solid investment spending and consumption boosted by the massive fiscal stimulus.
Inflation	Inflation near trough	<ul style="list-style-type: none"> Headline inflation has begun to trough in major economies as base effects begin to reverse. In the U.S. headline inflation fell to -1.9%, while in Japan inflation fell to -2.2%. However, prices have begun to reverse in Eurozone to -0.2% and have held up in the U.K. at 1.8%. Headline CPI is expected to turn positive in the U.S. and Eurozone in late Q3 and Q4 2009 with oil prices expected around \$75 in Q4 2009 versus \$60 in Q4 2008. Core inflation remains positive and stable in most major economies, relieving concerns about deflation due to negative headline inflation.
Interest Rates	Rates on hold. Central banks wrapping up asset purchases	<ul style="list-style-type: none"> The Fed, ECB, BoE, and BoJ remained on hold in August/early September with policy rates close to zero in the U.S. and Japan and around 1% in Europe. These central banks are wrapping up their purchases of assets as part of their "Quantitative Easing." ECB and BoJ cautious on growth outlook beyond the stimulus-induced bounce in H2 2009.

Global Outlook

Recession Ending Faster than Expected - Positive Growth in Q3. Inflation Close to Trough

Growth: GDP Growth Turning Positive in Developed Economies in Q3, Accelerating in Q4. Further Growth in EM

- The global recession appears to be ending faster than expected with GDP growth turning positive in Japan, Germany and France in Q2, while the U.S., U.K., the rest of Eurozone and several emerging economies are on track to positive GDP growth in Q3. In addition, GDP growth is set to accelerate in China, India and other emerging economies.
- The U.S. posted a much smaller GDP decline in Q2 (-1%) and GDP growth is on track to turn positive in Q3 (around 3.5%) with consumer spending getting a boost from the “Cash for Clunkers” program and inventory rebuilding after the sharp draw down in Q1 and Q2 2009.
- Eurozone GDP is on track to turn positive in Q3 after an almost flat reading in Q2, led by Germany and France. Eurozone Q3 GDP is expected to rise around 1.5% annualized, accelerating to around 3.2% in Q4. In U.K., the continued improvement in business confidence and stabilization in industrial activity suggest that GDP will turn positive in Q3, around 1%, improving to 2% in Q4.
- The Japanese economy is on track to strengthen further in Q3 to around 3.2% QoQ annualized with the massive fiscal stimulus and continued recovery in exports. Earlier, Japan was the first major economy to exit the recession with GDP growth rebounding to 3.7% in Q1, the first positive GDP reading in five quarters.
- China’s GDP growth is expected to accelerate in Q3 to around 9% YoY and further to 10% in Q4 led by investment spending.

Inflation: Headline Negative but Beginning to Trough as Base Effects Reverse. Core Remains Stable

- Headline inflation fell further into negative territory in the major economies but has begun to trough as base effects reverse. U.S. headline fell to -1.9% YoY in July from -1.2% in June, while core inflation eased to 1.6% YoY in July from 1.7%.
- Eurozone headline inflation improved to -0.2% YoY in August from -0.7% in July. Headline inflation remains negative in France (-0.8%) and Spain (-0.8%). However, inflation rose to 0% in Germany and 0.2% in Italy. U.K. inflation held steady at 1.8% YoY in July.
- Japanese nationwide headline inflation fell to -2.2% in July while core inflation also fell to a new record-low of -2.2%.

Interest Rates: Central Banks on Hold, Wrapping Up Asset Purchases. Rates on Hold through H1 2010

- The Fed, ECB, BoE, and BoJ remained on hold in August/early September with policy rates close to zero in the U.S. and Japan and around 1% in Europe. While the global economy is exiting from recession, central banks are not about to exit from the low interest rate policies. With inflation remaining low and lingering concerns at the ECB and the BoJ about the sustainability of the GDP recovery, global central banks are expected to remain on hold through the first half of 2010. These central banks are wrapping up their purchases of assets that were part of their “Quantitative Easing.”
- In August, the Fed reiterated that “economic conditions are likely to warrant exceptionally low levels of the Federal Funds rate for an extended period.” The Fed signaled that it would not expand its Treasury buying program beyond the current \$300bn, but would extend the program to the end of October. President Obama also nominated Fed Chairman Bernanke to a second four year term.
- At the September meeting, the ECB revised up its GDP growth forecast but remains cautious on the sustainability of growth. President Trichet noted that key “interest rates remain appropriate.” Given its cautious growth outlook, the ECB is expected to remain on hold through early 2010. The BoE decided to increase its QE program by £50bn to £175bn after Q2 GDP growth disappointed.
- At the August meeting, the Bank of Japan expressed optimism that the economy will start recovering from H2 but remained cautious on the downside risk stemming from future developments in the global financial and economic situation.

Currencies: Dollar Weakness on Increased Risk Appetite, Global Recovery

- The dollar was mixed against most currencies in August: nearly unchanged against the euro (-0.6%), appreciating against the pound (2.7%), and depreciating against the yen (-1.7%).
- The dollar is likely to remain in a modest downtrend against most currencies given the increase in risk appetite, economic recovery and the ballooning U.S. fiscal and current account deficit.

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

U.S. Exiting Recession with Positive Q3 GDP Growth. Inflation Near Trough. Rates on Hold

Growth: Recession Winding Down – U.S. GDP Growth Turns Positive in Q3

- After posting a much smaller GDP decline in Q2, the U.S. economy is on track to post positive GDP growth in Q3 with Leading Economic Indicators (LEI) turning positive, ISM manufacturing index rising above the critical 50 level and strong readings on consumer spending, home sales and prices, and durable goods orders. We have revised up our forecast for Q3 GDP and now expect GDP to rise around 3.5% annualized (from earlier forecast of 2%), with risks to the upside.
- The improvement in business confidence, IP, and durable goods point to business investment turning positive in Q3. The sharp draw-down of inventories in Q1 and Q2 sets the stage for a boost to production as firms rebuild inventories. Meanwhile, consumer spending is getting a boost from the “Cash for Clunkers” program which was extended into August. Strong housing data suggests that residential investment is likely to make a positive contribution to Q3 GDP for the first time in twelve quarters.
- Earlier, U.S. GDP posted a much smaller decline in Q2, down -1% QoQ annualized, a significant improvement over the -6.4% QoQ annualized decline in Q1. The YoY pace of growth decelerated to -3.9% in Q2 from -3.3% in Q1. The Q2 GDP decline was driven by negative contributions from business investment spending (-1.2%), inventories (-1.4%), housing (-0.7%), and consumption (-0.7%).

Inflation: Headline Turns More Negative but Near Trough. Core Under Control

- U.S. headline consumer prices were unchanged in July after jumping 0.7% MoM in June. However, base effects pushed the YoY rate further down to -1.9% from -1.2% in June.
- Headline CPI should hover around -1.9% to -2.1% in August before beginning to turn around sharply as the base effect of oil rising to \$145 in July 2008 begins to fall out of the calculation. Headline CPI is expected to turn positive in late Q3 and Q4. However, the level of slack in the economy is likely to keep inflation in check in 2010.
- U.S. core inflation rose 0.1% MoM in July, after rising 0.2% in June. The YoY rate of core CPI eased to 1.6% in July from 1.7%. With core prices still elevated, it becomes more clear that deflationary fears are overblown. Core PCE eased to 1.4% in July.

Interest Rates: Fed Keeps Rates Around Zero, Extends Length of Asset Purchases. Rates on Hold into 2010

- The Federal Reserve left rates unchanged in a range between 0 and 25bps at the August meeting and reiterated that “economic conditions are likely to warrant exceptionally low levels of the Federal funds rate for an extended period.” The Fed signaled that it would not expand its Treasury buying program beyond the current \$300bn, but would extend the program to the end of October to “promote a smooth transition in markets as these purchases of Treasury securities are completed.”
- President Obama nominated Chairman Ben Bernanke for a second four year term as the head of the Federal Reserve. Bernanke’s knowledge and grasp of the QE programs should provide continuity and help in an orderly shrinking of the Fed’s balance sheet.
- On balance, the Fed’s cautious outlook for the economic recovery and its sanguine outlook for inflation suggests that the Fed is unlikely to start tightening policy until well into 2010.

Currencies: Dollar Weakness on Economic Recovery, Increase in Risk Appetite, & Growing Fiscal Deficit

- The dollar weakened modestly in August as the stronger global economic recovery boosted risk appetite. The dollar was mixed against major currencies: nearly unchanged against the euro (-0.6%), rising against the sterling (2.7%), but falling against the yen (-1.7%). The dollar effective exchange rate depreciated by -0.9% in August after falling -2.7% in July and rising 2% in June.
- The dollar is likely to weaken against most currencies given the increase in risk appetite, economic recovery, and the ballooning U.S. fiscal deficit.

Europe: Eurozone & U.K. GDP Turning Positive in Q3. ECB & BoE Remain on Hold

Growth: Eurozone GDP Turning Positive in Q3 and Accelerating in Q4. U.K. Recovers in Q3

- Eurozone GDP is on track to turn positive in Q3. While stronger GDP growth in Germany and France are likely to lead Eurozone out of recession in Q3, weakness in Italy and Spain are likely to be a drag on Eurozone GDP. Eurozone Q3 GDP is expected to rise around 1.5% annualized, accelerating to around 3.2% in Q4.
- The Eurozone almost came out of recession in Q2 as positive GDP growth in Germany and France lifted Eurozone GDP to an almost flat reading. Eurozone Q2 GDP surprised on the upside, coming in at just a -0.5% annualized decline, -4.7% YoY, well ahead of consensus expectations of a -1.5% annualized decline, and a sharp improvement from the -9.7% plunge in Q1.

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- In the U.K., the continued improvement in business confidence and stabilization in industrial activity suggest that the economic contraction will be ending and GDP is expected to turn positive in Q3. The rebuilding of inventories is expected to contribute to Q3 growth. We expect Q3 GDP to increase around 1% QoQ annualized, improving further to around 2% in Q4.
- Earlier, U.K. Q2 GDP growth was revised up to a -2.6% QoQ annualized (-3.2% originally) decline, after the sharp -9.3% plunge in Q1. The YoY pace worsened to -5.5% in Q2 from -4.9% in Q1, the lowest since records began in 1955.

Inflation: Eurozone Headline Inflation Improves in August. Core Falls. U.K. Headline Holds

- Eurozone headline inflation improved to -0.2% YoY pace in August (flash estimate) from -0.7% in July. Headline inflation remains negative in France (-0.8%) and Spain (-0.8%). However, inflation rose to 0% in Germany and 0.2% in Italy. Meanwhile, Eurozone core inflation eased to 1.3% in July.
- U.K. headline CPI inflation held steady at 1.8% YoY in July. Headline prices were also unchanged MoM, after rising for five straight months. U.K. core inflation rose to 1.8% YoY in July, but were unchanged MoM, suggesting that base effects pushed up the YoY inflation rate.

Interest Rates: ECB and BoE on Hold. ECB Raises Growth Forecast, BoE Expands QE Program

- The ECB held rates at their record low of 1% at the September meeting. The ECB made only minor changes to its policy, like removing a penalty from the refi operation at the end of September. Further, the ECB also revised up its GDP growth forecast but remains cautious on the sustainability of the GDP recovery. President Trichet noted that “key ECB interest rates remain appropriate.” Given its cautious growth outlook, the ECB is expected to remain on hold through H1 2010.
- The BoE again held the bank rate at 0.5% at their August meeting. In addition, the BoE decided to increase its Quantitative Easing program by £50bn to £175bn. The expansion of the QE program was mostly as a result of a sharper than expected Q2 GDP decline in the U.K. The BoE voted 6-3 to expand the program by £50bn, but some members wanted the program expanded by £75bn.

Currency: Euro Gains on Dollar with Increase in Risk Appetite, But Pound Falls Due to QE Program

- After rising 1.5% against the dollar in July, the euro gained a modest 0.6% in August. The increase in risk appetite as global equities rose helped the euro appreciate.
- The pound sterling fell 2.7% against the dollar in August after gaining 1.5% during July. Q2 GDP disappointment and an expansion of the BOE asset purchase program were likely key factors driving the pound weakness against the dollar. The pound fell -3.2% against the euro, with the euro more attractive on a relative interest rate basis.

Japanese Q2 Rebound Led by Exports. China Recovery Driven by Investment Growth

Growth: Japan to Recover Further in Q3 Driven by Exports. China Recovers, Driven by Investment Spending

- The Japanese economy is on track to strengthen further in Q3, rising around 3.2% annualized after the strong rebound in Q2 with the massive fiscal stimulus and continued recovery in exports. However, consumer fundamentals remain weak with unemployment at a record high, while private capex remains anemic, given record low capacity utilization.
- Earlier, Japan’s economy emerged from recession in Q2 with GDP rising 3.7% QoQ annualized, the first positive GDP reading in five quarters, after the -11.7% annualized plunge in Q1. Net exports were the major driver of the Q2 recovery.
- China’s GDP growth is expected to accelerate in Q3 to around 9% YoY and further to 10% in Q4 as investment spending remains solid driven by the still ample liquidity and government’s commitment to support growth, while consumption remains solid. Given the faster recovery in imports relative to exports, net exports are likely to remain as a drag on the GDP growth.
- Earlier, China’s economy recovered strongly in Q2, with GDP rising 7.9% YoY after slowing to 6.1% in Q1 and 6.8% in Q4 2008. There was significant pickup in investment spending and consumption boosted by the massive fiscal stimulus. However, net exports remained a drag on GDP growth despite some stabilization in external demand.

Inflation: Japanese Inflation Plunges to New Record Low. China Inflation Remains Deep in Negative Territory

- Japanese nationwide core inflation plunged to a new record-low of -2.2% in July, largely driven by domestic deflationary pressures from large economic slack, while headline inflation continued to sink deeper to -2.2%. Inflation is likely to remain in negative territory over the coming months with the wide output gap.
- Chinese consumer prices fell to a new low of -1.8% YoY in July mainly due to base effects. Although inflation is likely to remain negative YoY in the coming months, prices are likely to recover in late 2009 with fading base effects, strong money supply growth, the fiscal stimulus, and the rise in commodity prices.

Interest Rates/Currency: BoJ Remains on Hold in August. PBC Reiterates Support for GDP Growth

- The BoJ remained on hold in August, and expressed optimism that the economy will start recovering from H2 but remained cautious on the downside risk stemming from future global financial and economic developments.
- In China, the PBC reiterated its pro-growth stance in August after markets became concerned about the government's exit strategy and any premature shift in PBC policy. The Bank is expected to remain on hold well into 2010 as inflation remains negative, and the GDP recovery is still underway.
- The yen weakened in early August, falling to ¥97.5 per dollar. However, the yen rallied in late August on stronger Japanese GDP data, and on expectations that the opposition DPJ party would win the elections, ending the ruling LDP's 50 year hold on power. The yen ended the month at ¥93, rising 1.8%.
- The Chinese RMB continued to trade flat against the dollar during August, around 6.83 RMB/USD after gaining 7% in 2008. However, in trade-weighted terms, the RMB continued to depreciate, down -0.2% MoM in August. Since March 2009, the RMB has depreciated nearly -8% after appreciating sharply by 17% in the previous 11 months.

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