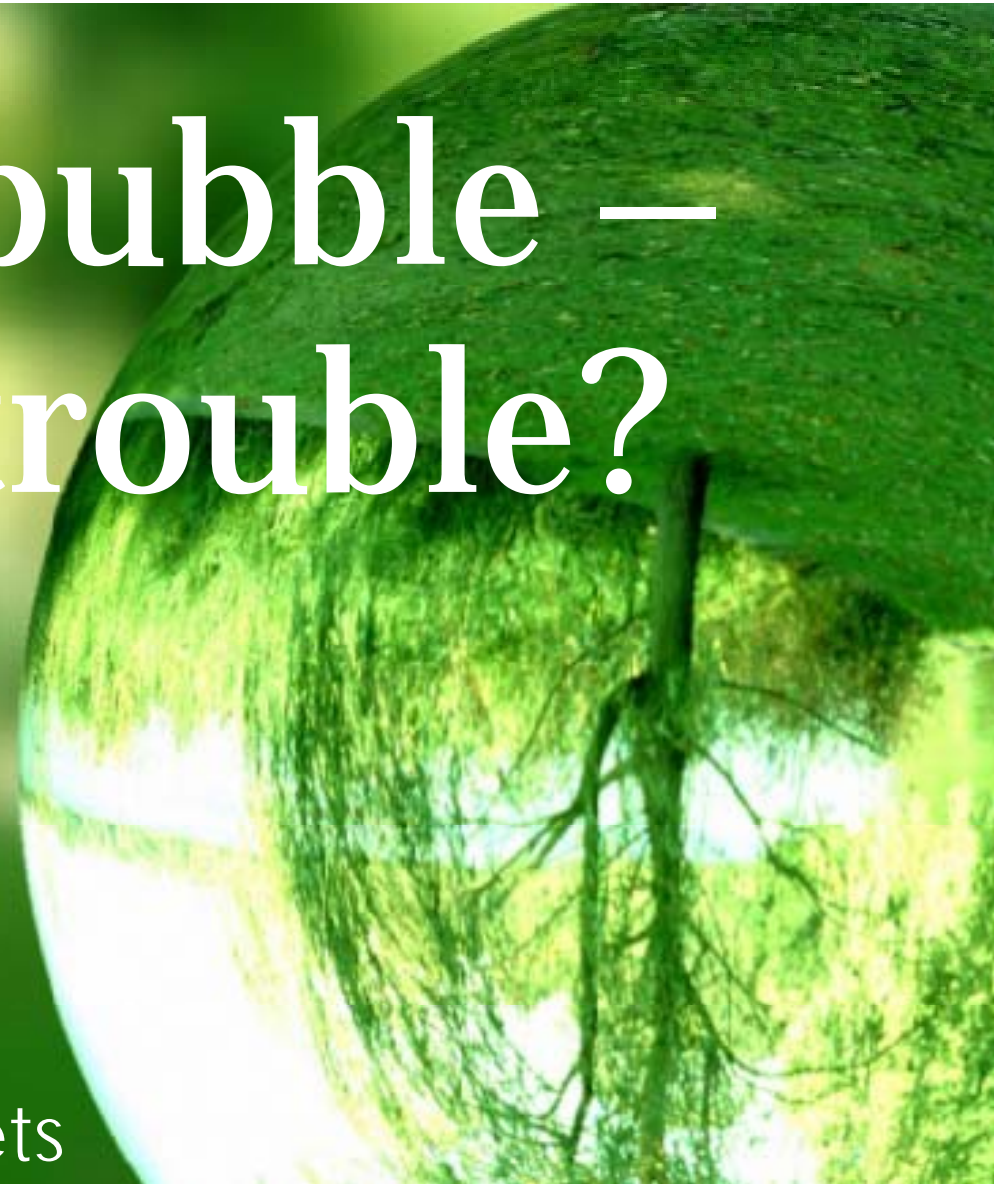


Bubble, bubble – toil and trouble?

15 February 2011

facilitating
debate on the
outlook for the markets





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The Story Has Changed

- **Recovery is over; expansion underway**
 - Could it be better and for longer?
 - Objects in motion tend to stay in motion...
- **Assess the risks**
 - ...Unless disturbed by an outside force
- **Themes for investors**
 - Adjust portfolios to those “outside forces”

- **Fundamentals building for faster growth**
 - U.S.: will the recovery no one believed in become the expansion no one thinks will last?
 - Spectacular profits
 - Consumers: pent-up demand, de-leveraging waning
 - Excellent exports
 - Improving job markets
 - Construction, state, municipal spending stabilizing

- **Fundamentals building for faster growth**
 - Euro area
 - More resilient than believer
 - Germany nearly booming
 - Fiscal austerity could help
 - Emerging markets: driven by China
 - 37% of world GDP
 - Rates rising, but still growing fast

Expansion Underway

- **Fundamentals building for faster growth**
 - China: tighter policy, but...
 - Wages rising fast
 - Consumer spending strong
 - More infrastructure building
- **World policy very accommodative**
- **Everyone's still a pessimist**
- **No signs of maturity**

- **Are there risks or bubbles?**
- **Twitterisings across the Middle East**
- **Double-dip in housing**
 - Faster household formation
- **EU debt crisis**
 - Believe contagion limited

Risks, Bubbles?

- **China: real estate bubble or slowdown?**
 - Policy still very accommodative
- **Washington D.C. policy**
 - December tax deal brought clarity
- **US government debt, deficits**
 - Spending is the real problem
 - Time, consensus to act
 - Some are acting

Risks, Bubbles?

- **Long term inflation risk**
 - World currency system: huge engine of liquidity
 - EMs buy dollars, keep currency undervalued
 - Inflation: natural rebalancing process
 - Distorts US interest rates, caused bubbles
 - Leads to US deflation
 - By combating deflation, Fed exports inflation
- **Inflation had not been a worry, because...**

- **Disinflation forces waning**
 - Deregulation, free trade, technology, end of Cold War
 - Asian currency crisis brought deflation
 - End of limitless Chinese labor
- **Too much debt means easy monetary policy**
 - Capital pouring into EM, perpetuates the system
 - Tight policy? capital controls? trade war? stop intervention?

- **Adjust portfolios to risks**
 - Reflation helps US, Japanese, German stocks
 - Growth, large cap, dividend payers, tech, materials
 - EM outperformance ending?
 - Bonds less attractive, especially vs. equities
 - Interest rates, inflation trending up
 - Real estate mending
 - Are US interest rates a trigger?

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