Weekly Market Commentary

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The G20 and the Global Recession

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Highlights

Last week's better than expected U.S. data bringing new signs of economic stabilization helped to pull stocks higher around the world as investors increasingly look to the United States as a leading indicator of the global recovery.

While there are important U.S. economic reports coming out this week that will help to set the tone for the markets, the G20 meeting will also command attention, as it may reveal additional support to the emerging markets of Europe and their creditors in Western Europe.

The most likely outcome of the G20 meeting will be a substantial increase in the resources of the International Monetary Fund (IMF) from the current $220 billion. Additional money from the IMF is needed to avoid economic and political collapse among emerging market countries. Iceland, Latvia, Hungary, and the Czech Republic have seen their governments topple this year in the wake of the global recession. These countries have been among the worst performers of the Emerging Markets this year.

U.S. economic data was mostly better than expected last week across a variety of sectors including housing (new and existing home sales and mortgage applications), business spending (orders for durable goods), and consumer sentiment. However, last week's economic data from outside the United States continued to reflect deterioration.

- Japan's exports plunged 49% in February as shipments to the United States, the country's biggest market, tumbled an unprecedented 58% from a year earlier. The collapse signals that Japan's GDP may shrink this quarter at a similar pace to the annualized 12% contraction in the fourth quarter.
- German business confidence fell to a 26 year low, measured by the IFO survey, after manufacturing orders dropped 38% from a year earlier and industrial output declined the most on record.
- U.K. retail sales tumbled more than four times faster than economists forecast after unemployment rose and the recession deepened.

The evidence is accumulating that this is a FIFO global recession—that is, First In, First Out. The United States was the first to feel the downward pull and may now be the first to start to experience a trough in economic conditions. The better than expected U.S. data that brought new signs of stabilization helped to pull stocks higher around the world as investors increasingly look to the United States as a leading indicator of the global downturn. The S&P 500 index of U.S. stocks gained 6.2% last week, helping to lift the Japanese NIKKEI up 8.6%, the German DAX up +3.3%, and the UK FTSE 100 up 1.5%. However, this week the focus of investors may be outside of the United States as they turn to the G20 meeting for policy actions to address the global recession.

The G20 meeting in London on April 2 could bring good news for non-G20 countries—specifically the emerging markets. While some topics will be discussed at a high level, including financial re-regulation, the most likely outcome of the meeting will be a substantial increase in the resources of the International Monetary Fund (IMF) from the current $220 billion. The IMF has been pledging money to help out emerging market countries with the most systemic risk, such as Hungary and Turkey, but lacks sufficient resources to adequately address the crisis. Japan has already committed $100 billion, and contributions from China and Saudi Arabia are possible.

Central and Eastern Europe are likely to be early beneficiaries of these additional funds. In February, $31 billion in loans were made to the countries of Central and Eastern Europe from the World Bank, the European Bank

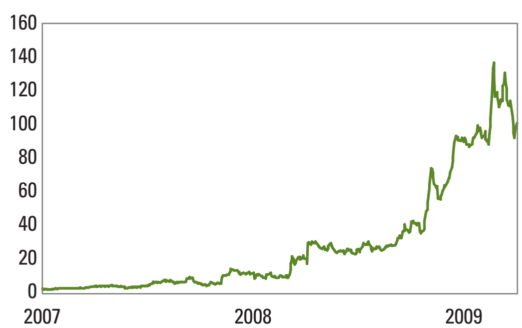
1 EMERGING MARKET PERFORMANCE

Country/Region	Year-to-Date Return in US Dollars
MSCI Emerging Markets Index	+5%
Iceland	-39%
Latvia	-27%
Hungary	-24%
Czech Republic	-15%
Lithuania	-15%
Greece	-11%
Estonia	-5%

Source: Bloomberg, LPL Financial

2 Credit Strains Pulling Eurozone Members Spreads Wider

Yield on 10-Year Austria Government Bond Minus Yield on German 10-Year Bond



Source: Bloomberg, LPL Financial

for Reconstruction and Development, and the European Investment Bank, with the intention of aiding western European banks' subsidiaries in these emerging markets countries. This amount is only one-fifth of what the World Bank estimates may be necessary for recapitalizing the banks. Currently, the European Central Bank (ECB) does not take non-Eurozone country bonds as collateral. Additional money from the IMF is needed to avoid economic and political collapse among these emerging market countries.

Iceland, Latvia, Hungary, and the Czech Republic have seen their governments topple this year in the midst of the global recession. The most recent to fall, the center-right government of Czech Republic Prime Minister Mirek Topolanek, lost a parliamentary vote of no confidence on March 24. The collapse in leadership is somewhat ironic given that the Czech Republic currently holds the European Union presidency. This is Central Europe's second change in government in a week. Hungarian Prime Minister Ferenc Gyurcsány confirmed on March 23 that he is resigning. A short list of countries that may be next in line for a change in government includes: Greece, Lithuania, and Estonia.

The Emerging Markets are looking increasingly attractive as rising commodity prices support balance sheets and exports may soon begin to stabilize; however, these geopolitical events make the point that not all emerging markets are the same. These countries have been among the worst performers of the Emerging Markets this year. [chart 1]

Addressing the building crisis in these Central and Eastern European nations is increasingly important to Western Europe, as well. Western European banks are the primary creditors to Eastern and Central Europe. Austria leads the list of creditors to Eastern Europe's emerging market economies. Italy is also among those significantly exposed. The result has been widening yield spreads and stock market performance among Eurozone members as the disparity in economic and market conditions widens. [chart 2]

TEN LARGEST CREDITORS OF EUROPE'S EMERGING MARKET ECONOMIES

Country	Credit Exposure to Emerging Europe in $billions	% of GDP
Austria	277.6	64
Germany	219.9	6
Italy	219.6	9
France	155.1	5
Belgium	136.7	26
Netherlands	122.2	13
Sweden	106.5	21
Switzerland	58.6	12
United States	53.6	0.4
U.K.	46.8	2

Source: Wall Street Journal, LPL Financial

Not only are these loans problematic because they were subprime in every sense of the word, but also because these troubled loans have the added dimension of exchange rates. Western European banks lent in euros and Swiss francs to Emerging European countries. Well over half of the loans were denominated in non-local currency—in Poland over 60% of the loans were denominated in Swiss francs and in Hungary that portion was over 80%. Defaults are rising, as loan payments rose by one-third in local currency terms in Poland where the zloty has declined by 36% versus the Swiss franc and in Hungary where the forint has fallen by 30%.

While there are important U.S. economic reports coming out this week that will help to set the tone for the markets, the G20 meeting will also command attention, as it may reveal additional support to the emerging markets of Europe and their creditors in Western Europe. Also, Asian emerging markets may benefit if China announces another stimulus package. China unveiled a huge stimulus package last November just days before the last G20 meeting.