A word about global financial markets based on the preceding world view

Reflecting the strength of global economic growth has been rising equity markets where the MSCI World index has risen 13.60% in the last 12 months. The main disappointment has been Japan where the broad market had risen but 5.84%, a number masking devastation among small and micro caps. Where investors were cautious and somewhat negative there has been a measured advance, the S&P500 rising 10.79%. European markets where there had also been some caution rose 13.77% on average. The healthier UK market managed to lag rising only 7.62%.

The highlight of the year was Asia ex Japan. Philippine and Indonesian markets gained over 40% but Asian quality markets such as Singapore and Hong Kong also managed returns of over 28%. Despite some extreme volatility in May, India rose nearly 45%. It was China that stole the show, however, as China listings in Hong Kong gained 54% and Shanghai and Shenzen listings rose by over 120%. Here an artificial construct – listing A shares at discount to H and then awaiting convergence- has been responsible for the outperformance. The market price of risk has diminished, itself a warning sign. In addition the price of insurance, implied volatility has also sunk back to levels not since for 12 years, despite a short spike in May 2006.

The prognosis for equities is favourable. While equities have risen against caution, it is the caution that makes the rise measured and sustained. Valuations are slightly stretched in the US but in Europe remain within historical limits. In Asia ex Japan, even Hang Seng valuations are undemanding. In China, however, valuations have run ahead of themselves and risk is no longer well priced. The extent of over valuation is by multiples of multiples and is indicative of an asset bubble. Lessons can be taken from Japan at the end of 2005 when a healthy market began to run ahead of itself. Japanese equities started the year in high expectations yet managed to underperform most of the major developed markets as well as Asian and other Emerging Markets as well. 2007 could well spell the same for China.

In US fixed income, as in the UK, anti-inflationary measures have lifted the short end of the curve. The long end has lagged as demand from liability matching investors has competed for yield. That said, inflationary pressures and expectations are likely to build. The US Fed has returned real rates into their 1990s neutral band and is unlikely to move any more in either direction, thus a steepening curve is to be expected. In the UK, however, real rates remain relatively low, near 2002, 2003 levels and further rate action may be expected and the curve is unlikely to steepen.

Inflation is expected to rise from 1.9% current to 2.1% for 2007 in the Euro area and from 0.3% to 0.4% in Japan so curve steepening is also likely in EUR and JPY. ECB policy remains hawkish but is unlikely to go too much further as real rates have returned unto mid 1990s range. In Japan, the BoJ is unlikely to raise rates soon given past history.

Credit spreads actually tightened through 2006 and continue to compress. Demand for yield, healthier corporate balance sheets and robust earnings growth underpins the credit markets. The level of caution resulting from the immense growth in the CDS market has also worked to focus attention on risk and prolong the credit bull market.

On almost every front, the outlook is benign. In the absence of some major disruption on the geopolitical front, current trends are likely to continue. Any changes in direction are likely to be smooth. It is a feature of major trend reversals that they are unforeseen and that the reasons for their happening are not well understood until well after the fact. What risks are at the forefront of investors attention rarely precipitate substantial disruptions. Let’s list some of them.

• Imbalances in US current account versus the rest of the world but particularly with China and Opec.

• The state of the US housing market and the impact on consumption.

• The size of the credit derivatives market.

• The impact of hedge funds on financial markets.

• The weight of capital flowing into private equity.

• The rich poor divide which cuts between but increasingly across countries.

• The eerie calm that greets geopolitical events of late