Investment Outlook – August 2011

Global Equities

Throughout August growing fears of a slowdown and possible outright recession pervaded the US markets. The Eurozone sovereign debt crisis and the stability of the weaker Eurozone members had a negative effect on global equity markets too.

The likelihood of a double dip recession in the US may be as high as a 50-50 likelihood, although it is more likely that the US will record anaemic growth at best. Weak employment data for August showing no US job growth plus rising poverty levels, has led to increased negative sentiment.

The Fed announced in September it would buy an additional $400bn of US bonds to help reduce long term interest rates. Despite Obama's pleas to sign a new jobs bill, it is highly unlikely that his proposed legislation will pass both houses of Congress. The political divide is growing and little will be achieved before the November 2012 presidential election – as both sides stake out their turf for the upcoming election.

With the growing flight to safety away form the Euro and a retreat from higher risk emerging markets who depend on a robust developed world – it is not surprising to see the US dollar record its best month in August. The dollar is up by at least 6% or more on a trade weighted basis against the Euro, Pound and many other leading currencies.

Growing concern that the sovereign debt problems in Greece, Portugal and Ireland may spread to Italy and Spain became increasingly acute when Italian and Spanish government debt saw yields rise to extreme levels – near double digits. With European leaders and regulators continually one-step behind the sovereign debt crisis – markets remain nervous that Europe will not get to grips with the massive debt overhang suffered by some of its members. Calls for the issuance of Eurobonds and a new Euro-wide super-Finance Ministry are growing. The IMF is expected to assist the ECB and Eurozone leaders to help restructure sovereign debt levels amongst the PIIGS.

The shudders out of the Eurozone has affected most international banks which have suffered downgrades and seen their share prices come off by at least 10%. French banks have been particularly severely affected, suffering through daily share price movements of up to 20%.

It is hoped that Germany's reluctance to bail out its neighbors has helped ensure that this tough love makes Spain, Portugal and Italy take tough austerity measures. Greece, at less than 2% of Eurozone GDP, is still the biggest default risk and most analysts agree that they will need to go into some form of technical restructuring shortly.

Possible contagion is worrying most market observers, given the French and German bank exposure not only to Greece but other weaker Eurozone members. The lack of US dollars being made accessible to European banks is another worry – the Fed and other leading Central Banks have stepped in to provide additional liquidity. This is the first time since the 2008 crisis – indicating we are again in crisis mode re overnight liquidity funding levels. Siemens reportedly pulled out Euro5bn from some French banks in August, heightening the fear surrounding banks liquidity. The $2.3bn UBS trading loss due to a rogue trader, simply fuels the negative perception of banks. Further bank and country level downgrades are expected by S&P and Moody's.

The German DAX index is now down by more than 20% from its recent highs in early 2011. Global equity markets have endured a sizable correction between August and mid September.

Markets remain incredibly volatile with the VIX (so-called fear index) rising to levels well above 30, compared to its regular level in the high teens or low twenties.

The Global Equity developed world index (MSCI World) lost 7.1% in August after losing 1.8% in July and 1.6% in June. The index is now down 3.9% for the year to date, although it remains up 14.5% over the past 12 months. Similarly the US market (MSCI USA) lost 5.6% for August after suffering a 2.0% loss in July. It is now down 2.0% for the year to date and is more than 15% off its earlier highs.

The Eurozone as measured by the MSCI EMU lost 13.0% in August in Euros, following a loss of 5.7% for July. Year to date figures show a 14.5% loss, although it is off approximately 20% from its earlier highs.

The US Fed stepped into the market with Operation Twist in September to provide further liquidity to the market. We continue to maintain that the US Fed will likely be the last major central bank to seek to raise interest rates, given the ongoing weak state of the US consumer. The Fed also appears to be the least worried regarding any inflation threat.

Global Bond outlook

The growing sovereign debt crisis in Europe and poor US economic data have led to interest rates coming down to levels not seen in 60 years, A flight to safety in 10 year Treasuries has pushed the yield down from 3.6% earlier this year to below 2% by early September.

The flight to safe havens has led to gold spiking at over $1900 per ounce and the Swiss Franc hitting all time highs against the US$ and Euro. Swiss Bank intervention was required to cap the Franc's growth against the Euro.

The Fed has acknowledged its earlier economic growth assumptions were too optimistic, and to stem market turmoil announced that it will hold it Feds Fund rate at effectively zero for the next two years. This effectively confirmed that the US economic growth is anemic at best and may plunge into an official recession at any time.

With the Fed holding rates steady for another 2 years – it is clear that US economic growth has completely stalled and negative sentiment now pervades the corridors of US business. It is unlikely that any significant hiring will occur. Meanwhile US banks such as Bank of America and large global investment banks have been shedding thousands of jobs. Bank of America is laying off some 30,000 workers.

With US unemployment rate at 25 year highs, wage growth (wage inflation) is nonexistent and US consumers are still laboring under way too much debt – it will likely take years for US consumers to repair their balance sheets. Consequently the lack of consumer demand will depress many sectors such as retail and housing.

A massive overhang of foreclosed properties exists – some 5 million that are expected to come onto the market over the next 24 months as rates reset. Given the tenuous nature of the residential and commercial real estate markets in the US, the Fed has no desire to make mortgage finance more expensive for prospective borrowers.

The Citibank Global Government Bond Index was up 2.1% in August following a rise of 2.3% in July. The index is now up 8.6% for the year and 9.2% over 12 months. The European Government Bond Index was up 2.9% for August in Euros. However with the Euro losing close to 7% against the US$, returns have not been so appealing to global investors. US REITs were down 5.5% in August but do remain up 6.8% for the year to date and 19.8% up over 12 months. Bond prices will continue to rise as investors rush to safe havens.

Despite the S&P downgrading the US from AAA, US Treasuries now yield almost 1.5% less on the 10yr Note than before the downgrading. The latest yield is 1.9% following the Fed's latest $400bn buying action in Operation Twist. It remains unclear whether this Fed action will create any more confidence in the market. The day the move was announced, the US market fell almost 3%. Fed action is seen as proof of a stalled US economy and growing fears that a deep structural economic malaise has set in. Youth unemployment (under 30) is now at an all time high approaching 20%, while the housing market remains depressed. California, once seen as the driving economic force in the US, now records the second highest unemployment rate in the nation at 12%.

The sustained global economic recovery hoped for earlier in the year has evaporated, and a flight to safety has resulted in bond yields being pushed down to historic lows. The rush out of equities will continue to lead to volatile markets as investors reassess their views on corporate earnings in a weaker economic environment than previously thought. A stronger US dollar will reduce US corporate earnings which to date have enjoyed the tailwind of a weak currency relative to Europe and Asia. A stronger dollar may now be a slight drag on large cap index returns.