Investment Outlook – January 2010

Global Equities

The global equity markets continued its healthy recovery in January. More positive economic data in the US regarding economic GDP growth, new job growth and positive corporate earnings, continue to power the stock market to new post Lehman highs. The Dow is now approaching 12,300 while the S&P has exceeded the 1300 level.

Although January's jobs report in the US did disappoint, relative to other developed economies such as Europe, the US appears to be climbing out of the recession far quicker.

While much of Europe continues to wrestle with sovereign debt issues affecting such peripheral countries as Portugal, Ireland and Greece, recent German and French economic data also point to an uptick in economic confidence and activity.

Nevertheless weaker than required economic growth in the US and Europe has meant Central Banks have wanted to maintain the stimulus and keep interest rates at their low levels. No further rate hikes are imminent, as the economic growth, while positive, remains sluggish by normal post recessionary standard. At this point in the economic cycle GDP and job growth are significantly higher – often double the current levels seen in both the US and Europe.

The fear of deflation in the US has receded and the Fed will continue with its QE2 (quantitative easing) program, allowing it to buy the remaining portion of the $600bn US Treasuries over the next few months. This bond purchase aimed at keeping rates low and stimulating the economy, will ultimately total a $900bn infusion. Higher oil, food and commodity prices do threaten to hike inflation rates across the globe. While food inflation has less impact on the US, global inflation is now affecting China and many developing countries are more sensitive to commodity and food imports. A further concern is the rising oil price to almost $100, as other commodity prices have also hit near record highs. Oil at these current highs can put a drag of 0.50% on US GDP according to past experience.

Given uncertainty in the Middle East following the democratic movements in Egypt and Tunisia which has seen the ousting of two Arab leaders, the US$ has again been seen as a safe haven. Emerging Markets saw a large outflow during the first week of February, as a consequence of political maneuverings in Egypt.

The Eurozone leaders appear to be close to an agreement on increasing their Stabilization Fund. The ECB also continues to assist with its unusually large lending and liquidity facilities. ECB intervention in the European bond markets is also assisting the weaker sovereign countries. Germany and France will not let the euro fail and this has shored up support for the currency – rising to 3 month highs approaching $1.40.

The recent Obama administration policy shift to embrace big business and sign off on an attractive tax bill effectively keeping tax rates at their current levels has boosted business confidence in the US.

While US retail sales have held up well over the recent holiday season, the lack of job creation is a worrying trend, with almost half the unemployed being out of work for 6 months or longer – this is an unprecedented phenomenon in the modern day US labour market. Consequently a structural unemployment level exceeding a high level of 8% is expected to prevail throughout the next 18-24

months. In fact it is expected to take 4-5 years to get back to a normal level of unemployment in the US.

For January the US market enjoyed gains of 2.4% after December gains of 6.6% (MSCI US Index) – almost 10% up in just two months and 21.8% up for the past 12 months. Globally developed stock markets as measured by MSCI World enjoyed a 2.3% gain for the month and 19.2% for the year. Small and mid caps continues to outperform large caps over the past year; however this is expected to change – with a shift back to large caps in 2011.

Despite difficulties in the Eurozone, the Euro is expected to remain strong relative to the US$. The Fed seems happy to weaken the US$ as it seeks to maximize US economic growth through continued low rates. The broad Eurozone market index gained 4.5% in January after a 5.3% December gain (Euros). For the past 12 months it is up 12.3%.

After an impressive rebound in the US REIT and Eurozone real estate indexes during December, the Eurozone index took a slight breather retreating 0.6%. By contrast the US REIT index spurred onwards with a gain of 3.6% - for the past 12 months it us up 40.7%.

Emerging market equities remain more fully priced than developed markets. US PE ratios on the S&P 500 are at levels of 15 for 2011 which remain below long run averages for this market. PE ratios for large cap stocks in developed countries (US and Europe) remain cheaper in many cases than their Emerging Market counterparts – based on comparable risk profiles.

Global Bond outlook

Long term rates in the US continue their upward trend reaching 3.75% on the 10yr Treasury by early February. This is a significant uptick in US government yields in just the past 6 weeks. It is clear that the Fed's quantitative easing has not really worked as expected as mortgage rates have also spiked to levels above 5% recently.

The concern remains that higher rates will dampen any real estate rebound, putting a further drag on construction employment and home sales.

The lack of any agreement over how to tackle the huge US budget deficit – remains as a sword of Damocles over the bond market. Higher US rates are likely required to offset concerns that the US administration is not keen to tackle the tough business of dramatically reducing the deficit to more sustainable levels. The new Obama budget to be released in February may point the way. Regardless, with inflation rearing its head, expectations are for rates to continue to rise.

Despite the inflation threat, the Fed is expected to keep rates at the lower levels for much of 2011, in order to try stimulate the economy as much as possible.

Continued worries over municipal and state finances will lead to a further erosion of demand for US bonds, leading to higher rates. This will have a detrimental effect on the already weak real estate market which many believe has entered into a double dip – particularly on residential properties.

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.

The differential between short term US rates and long term rates is now at its widest level in many years – this seems unsustainable over the long term however. Consequently short term rates will begin to rise throughout 2011. Eventually the Fed will be forced to act too and raise rates.

Given record inflows into bond mutual funds in the US the past 2 years, many retail investors are now rushing for the bond exits and this will help fuel interest in the stock market, likely then to further push up equity prices.

Meanwhile the difficulties in the Eurozone have led to significantly higher government bond yields in Portugal, Ireland, Spain and Greece. Further bailouts in Europe are expected as peripheral problems spread to Spain and possibly Italy. The $100bn EU financing to assist Ireland with its bad bank problem is only a temporary measure according to many analysts.

With US unemployment rates at 25 year highs, wage growth being nonexistent and US consumers still laboring under way too much debt – it will likely take years for US consumers to repair their balance sheets.

Given weak corporate lending the Fed has no desire to raise rates – Bernanke is actively encouraging banks to increase their lending books to small business so that these businesses can begin to add to their payrolls and production. 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.

Higher rates in the US and Eurozone has led to Citibank's Global Bond Index recording a flat January while it remains up by 5.0% for the year. The Euro Government Bond Index lost 0.5% in January and is flat over the past year.

A sustained global economic recovery remains under threat due to huge structural deficit problems in certain Eurozone countries including the UK, Greece, Spain and Ireland. The Irish bailout of their banks and government deficit (reaching a massive 33% of GDP for 2010) – shows that the Eurozone laggards will continue to limit economic growth on the Continent. The threat of inflation exceeding levels of 3% in Europe may compel the ECB to also act in the next few months to raise rates. For now, the UK and ECB central banks rates are expected to remain on hold through the spring.