Investment Outlook – April 2012

Global Equities

Equity markets in April suffered from growing uncertainty over Europe's fate, coupled with weak US job data and weaker than expected Chinese economic data. In aggregate the three most important world economies all seem to now be suffering from an economic slowdown, just at the moment when equity markets had priced in a global economic recovery.

Given the impressive equity rally of the 1st quarter, an April pullback in itself was not surprising. However the April losses became more acute following the effective hung Parliament in Greece as of early May. Equity markets suffered their worst week of 2012 in mid May, given the growing uncertainty of how the Eurozone would handle a Greek exit and possible contagion spreading to other weak members of the Eurozone.

The election of a socialist President in France, the first in 17 years also rattled markets although this appears to be overdone. President Hollande and Chancellor Merkel will likely agree on a growth compact that will acknowledge that Eurozone members cannot successfully reboot their economies simply through austerity measures. This may provide the necessary encouragement to other members and telegraph to markets that new leadership in Europe is being more pragmatic.

Although a flight to safety (risk-off trade) has occurred in the past few weeks driving up the US$ and weakening most other currencies, particularly the Euro and emerging market currencies – most observers believe that when staring into the abyss Germany will ensure that Greece remains part of the Euro. Unfortunately with a new Greek election set for June, little certainty will return to markets until the election results show a greater willingness by Greeks to remain in the Eurozone. Ultimately the cost of contagion that could result from Greece exiting the Euro is likely to spread globally and be hard to contain, with dire predictions being made. As such, a German and ECB backed rescue plan for Greece, may be considered a bargain in the long-term.

Following the ECB's LTRO quantitative easing program late in 2011, worries of imminent debt defaults receded from the landscape, also pushing sovereign bond yields lower. However, the recent Spanish government bailout of Bankia, the 2nd largest Spanish lender , has unnerved markets, helping to send sovereign yields back to unsustainably high yields – touching 6% for both Spain and Portugal, with Italy not far behind.

Weak US jobless data for April, of approximately 120,000 disappointed equity markets and has led many to consider the US economy far weaker than predicted earlier in the year.

Not surprisingly, the Dow Jones has fallen well below the 13,000 level followed by the broader S&P 500 retracing much of its gains from earlier this year. By mid May the S&P had fallen below 1300, having passed the 1400 mark in March.

Chinese and other emerging markets economic data has been disappointing the past two months. However despite dire warnings on China, it appears a soft landing has been engineered with GDP growth expected to remain close to 8%. Nevertheless, given Europe's likely 2012 zone-wide recession it is likely that Chinese exporters will suffer and China's trade surplus will shrink. The Chinese Central Bank (PBOC) has indicated that the RMB currency is closer to equilibrium with its main trading nations now – likely pointing to much slower appreciation of the RMB than many had come to expect. The RMB has experienced its weakest performance relative to the US$ in many years – over the past few months. While over the past few years the RMB has averaged close to a 5% annual appreciation against the Dollar, it has barely moved in 2012.

With US consumer and employment data showing glaring signs of weakness, the likelihood is growing that the Fed will consider printing additional money in the form of further quantitative easing. With little sign of any inflation on the horizon, the Fed appears willing to do everything it can to energize the housing sector through very low 30 year rate mortgage loans. The US real estate sector has for now weathered the storm, posting gains of 3.0% for April and an impressive year to date gain of 14.1% (DJ US REIT Index).

All major global equity markets posted losses in April and into May, with the broad US Equity market (MSCI USA) retreating 0.6% in April, while remaining up 11.9% year to date. The MSCI World Index lost 1.1% for the month but was up 10.3% for the year.

Both the European Equity and Emerging Market posted losses in April, reporting respective losses of 5.1% and 1.2% for the month. The European Citigroup BMI Property Index is down 3.9% for the month although it remains up 7.1% for the year. All the above indices have lost an additional 3%-5% by mid May driven by the Eurozone uncertainty.

Global Bond outlook

Following the 1st quarter and very positive jobs data recorded in the US with a total of 550,000 new jobs created – April proved to be a bitter disappointment with only 120,000 new jobs being created. Most disappointing was the shrinking US workforce which points to many jobseekers simply giving up actively looking for work.

Consequently lower workforce participation and continued weak housing markets across the US, paint a bleak picture. The California budget crisis which has ballooned from a projected $9bn deficit to over $15bn is symptomatic of the broader problems facing local and state governments across the US.

Concerns about rising oil and gas prices may still limit economic growth prospects for 2012. For now the US is projected to grow by at least 2% for the year while the Eurozone is likely to contract by at least 1%.

Most worrisome is that Bernanke's Fed despite the lowest mortgage rates on record, has been unable to help fuel economic growth. With such weak economic demand, most observers believe the Fed will be true to its word and likely limit any rate increase well into 2014 – thus providing as much monetary stimulus as possible without resorting to QE3 .

The growing uncertainty over Greece's membership in the Eurozone, plus weak economic data globally, has led to a flood of cash into US Treasuries – pushing rates down to record a low level of 1.7% on the 10 year Note. Bond market bulls have scored significant returns the past two months as rates have come down from 2.2% to current levels. UK and German sovereign yields are similarly low, while the weaker peripheral Eurozone member such as Greece, Spain, Portugal, Ireland and Italy continue to pay huge premiums on their debt.

The ECB remains very accommodative to banks and large lenders by massively expanding its balance sheet and lending capacity via the LTRO quantitative easing program. By offering extremely low cost credit to banks (approximately $1bn in all) – this will help stimulate European lending. However Europe is likely to enter a recession in 2012 due to all the austerity programs in place across the Continent. Unsustainably high government bond yields in peripheral Eurozone countries are the next major hurdle to tackle. Only lower sustained rates on such government bonds, will help ensure the debt crisis fully subsides and economies in the region begin to post positive growth.

The weaker Euro relative to other key currencies is likely a positive sign, assisting European exporters to become more competitive.

The Global Government Bond index gained 1.5% in April and remains up 1.0% for 2012. By comparison the European Government Bond Index lost 0.2% for the month and is now up 3.3% over the past year (in Euros).

This impressive European bond performance reflects the positive actions taken by the ECB with its new leader Mario Draghi. The austerity measures adopted in Greece, Portugal, Ireland and Italy are also providing further comfort to the markets. However Spain has recently rattled financial markets by its delays and obfuscation, so negative sentiment in Spain with its huge unemployment crisis could yet create much uncertainty throughout the Eurozone.

Unfortunately, there remain massive structural inefficiencies and huge unemployment concerns across these Eurozone countries – particularly youth unemployment which exceeds 20% in these countries. It is clear that such economies cannot grow their way out of the crisis through purely austerity measures being implemented. As with Greece, other large bondholders of Eurozone sovereign debt will likely need to take ever increasing losses or partial haircuts (i.e. a default) – to provide breathing space for governments as they cope with a recessionary environment.

Europe ultimately needs to grow its way out of its liquidity and solvency problems – an infusion by the ECB and IMF along with a global economic recovery will help do wonders, helped by a weaker Euro relative to the US$ and Pound.

In the US with housing remaining under pressure no interest rate increases are expected for another year – as already indicated by the Fed. The implied aim is to keep long rates as close to current levels as possible to help spur refinancings and new affordable mortgages at 30yr rates hovering around 4%.

With the US unemployment rate at 25 year highs, wage growth (wage inflation) remains non-existent. US consumers still labor under way too much debt and it will likely take another 5 years for US consumers to fully repair their balance sheets. Further, unemployment levels are not expected to decline to pre 2008 levels for at least another 4-5 years.