# Investment Outlook – August 2012

## Global Equity

Global equity markets are approaching four year highs across many developed markets. The rally which began in late June has been sustained by aggressive actions undertaken by both the European central Bank (ECB) and most recently the US Fed.

Despite the looming US presidential elections the Fed boldly decided to embark on a third round of Quantitative Easing (QE3). This follows on the heels of QE1 in November 2008 and QE2 in August 2010 and more recently Operation Twist. The announcement of a new $40bn a month purchasing program of US mortgage backed securities is clearly sought to boost the tentatively rebounding housing market, which might gin up job creation in the US. A total of $85bn of long term securities is now being bought by the Fed until year end 2012, when adding Operation twist to the mix. Pumping this level of new money into the economy has not surprisingly led to a boost in real assets (gold) and a devaluation of paper money. The US dollar has already lost almost 10% of its value against the Euro in the past month (moving from 1.21 to 1.31).

By mid September the S&P 500 had posted a 17% gain for the year, followed by a 13.5% gain in the global developed markets equity index, the MSCI World. By comparison emerging markets have gained just over half the MSCI's return, constrained by China's falling stock market – now at its lowest point since the crisis of 2008.

The ECB actions while offering unlimited bailout funds for such peripheral Euro nations as Greece, Spain and Portugal – has helped to reduce long term yields on sovereign debt and effectively bought the Zone more time by putting a temporary band aid on the festering wound. However the governments of these nations has to formally request bailout funds so further delays are expected in Europe since requesting funds from the ECB is seen an unpalatable by many electorates in the peripheral parts of the Eurozone.

Bernanke and his Central Bank colleagues in Europe have already succeeded in creating a positive wealth effect following their actions. For now inflation remains muted and the governments themselves have in large part been unable to pass fiscally appropriate reforms to assist in the global recovery.

With the US poised for a fiscal cliff at the end of 2012, due to $1 trillion of public spending cuts taking effect and various looming tax increases – the Fed felt compelled to act now despite the intense political season the country finds itself in. The fiscal cliff could knock off approximately 2.5% of US GDP growth next year, so any Fed stimulus program will help. Most experts believe that an 11$^{th}$ hour compromise will be fashioned by the Republicans and Democrats but not before the US credit rating is again put in the line of fire and sentiment grows negative as the deadline grows ever closer.

With the end of the 3$^{rd}$ quarter looming it is unlikely that equity markets will slump anytime soon. But we may have seen the back of the 2012 rally and move mostly sideways for the remainder of 2012. Impressive year to date movements across the Eurozone (Eurostoxx 50 up 12.5% in

Euros) and such markets as Germany (Dax up 25% in local terms) and France's CAC 40 up 13%, lead many to believe that the rally will run out of steam shortly. With all the recent Central Bank moves now fully priced in, it is hard to see where another leg to the impressive equity rally may come from – especially with corporate profits remaining unimpressive in the latest rounds of 3rd guidance estimates. For now investors should remain cautious and feel content with riding the equity market gains, but should be willing to take some money off the table and pocket certain gains.

**Global Bond**

The dramatic Central Bank moves led by the ECB and Fed have helped reduce long term sovereign and corporate rates in addition to mortgages across the developed world. Since any inflationary fears have remained muted, central bankers have felt empowered to make dramatic gestures to ensure the world's leading economies do not fall back into a recession. With a growing number of Eurozone members already in recession and austerity programs set to continue in a wide variety of Zone countries, the ECB's move seems particularly well timed to assist its peripheral members with little hope of solving their immediate problems.

Solving non-performing Spanish bank assets is a long term structural issue, along with a bloated public sector in many peripheral European countries and rampant tax evasion too in places such as Greece and Italy. Fully restructuring government finances in countries such as Greece and Spain will take the better part of a decade to achieve – so structural changes need patience.

The ECB with the help of the IMF is best placed for now in cutting through Brussels political quagmire, requiring the sign off of 17 separate sovereign nations for deepening the political and economic relationships of the Eurozone. It is hoped that the ECB's strong defense of the Euro will buy the region enough time to begin to heal the weakest of its economies as economies begin to restructure on a firmer fiscal footing going forward.

Debt to GDP ratio need not be zero – a level of around 3-5% is sustainable and will help poorer Eurozone members begin to grow. Much of the draconian austerity measures being announced will not help the Zone rebound due to massive layoffs and salary cuts.

A weaker Euro would be helpful for exports from the region, but with the US itself in a fiscal mess, a weak US$ policy will likely remain - thanks to the Fed increasingly pumping the printing presses. US policy makers are happy to see a Euro appreciate almost 10% against the US$ during the past month.

If anything, it seems likely that the US economy is most likely to emerge stronger than Europe for some time to come – benefiting from growing exports and manufacturing due to the weaker US$ and real wages in the US continuing to fall for the middle class. The divide between rich and poor in the US has arguably never been greater as the middle class sees its standard of living fall further. However with high unemployment, US corporates are able to rehire workers at lower wages and with far less benefits – making the US far more leaner and meaner to take on the global economy than it was prior to the Great Recession of 2008-2009.