Investment Outlook – December 2012

Global Equities

During December, global equity markets continued to rally as European worries receded and the fiscal cliff deal was finally signed off just after New Year.

Most leading global equity markets posted decent gains for the month. The Global equity benchmark (MSCI World) rallied 1.9% for December, helped by an impressive Japanese equity market rally that gained 10.4% in Yen terms. The re-election of Prime minister Abe who has called for higher inflation targets and a new stimulus plan for Japan helped send stocks high, while the Yen has depreciated by a similar amount against the US$ since early December (12%).

The US Equity market only posted a monthly gain of 0.9%, however this was due to uncertainty over the fiscal cliff which was settled days after month end. Markets have posted impressive gains for January 2013 – reaching five year highs in the US and Europe.

European markets have also had a significant recovery with the FTSE now trading at close to 6200. For December, the MSCI EMU was up 2.4%, while Emerging Markets based on the MSCI benchmark gained a significant 4.9%.

Over the past year, the most impressive of all has been the German DAX up over 31%, France's CAC 40 up over 20%, while the Hang Seng has gained approximately 25% and Singapore slightly more than 20%.

Clearly developments in the Eurozone have calmed markets, having also benefitted from the US fiscal cliff negotiations being resolved satisfactorily. The looming US debt ceiling cliff has also been averted for now so the 'risk on' trade has been rewarded. Volatility levels as measured by the VIX 'fear index' is sitting at 5 year lows below 14. Clearly if earnings disappoint globally we could see a pullback in the equity rally, but for now the bulls are dominating.

Europe remains in an overall recession, while the US economic prospects appear far brighter. US job hiring and unemployment figures are consistently pointing to a steady but slow recovery. Approximately 150,000 new jobs on average have been created during the past few months in the US which has also calmed the markets. Meanwhile the Fed remains committed to keeping interest rates at rock bottom levels for at least 2013 if not longer. Bernanke has stated that until such time as unemployment falls to the Fed's new targeted rate of 6.5% (currently 7.7%) rates will not be allowed to rise. For now, the Fed continues it massive bond buying spree and remains the main buyer of Treasuries – often taking up well over half of US Treasury debt offered at auction.

With a new central bank regulator mooted for Europe and tough austerity medicine being taken across the Eurozone, Europe is slowly getting its fiscal and regulatory house in order. However major structural weaknesses persist, particularly in the peripheral countries such as Spain and Greece. Spain remains reluctant to formally ask for a bailout, but massive Spanish unemployment may necessitate IMF/Eurozone assistance in 2013.

The reelection of President Obama and the fiscal cliff compromise ensures higher taxes on the upper middle class will kick in during 2013. While major spending cuts have been averted for the Pentagon and US federal budget, this may change later in the year as the Debt Ceiling debate is set to reappear. Congress has decided to kick the proverbial 'can down the road' for three months as the Obama administration enters its 2nd and final term. New appointees on economic matters show an emboldened White House eager to maintain all safety nets such as Medicare and Social security,

while increasing the taxes on the more successful members of society. Many Americans will see their effective income and capital gains tax rate go up between 5%-10%.

Despite Obama's victory, the Republicans still control the powerful House of Representatives, with the Senate in Democratic hands. The election did not change any of the controlling power in Washington, resulting in split control over the legislative and executive functions. Compromised government will be required to pass a Budget and to deal with the debt ceiling crisis.

US housing continues to show recovery off an admittedly very low base – the vast majority of states posted improved valuations in both November and December - the most in 3 years. While the worst is behind the property sector, there does exist worries of a hidden shadow inventory held on the books of US banks, still requiring major workouts and adjustments. Despite this, the best two sectors in the S&P 500 for 2012, has been financials and consumer discretionary – clear evidence that consumers are feeling more positive and thus beginning to spend.

In the property space both our Funds enjoyed impressive performance during 2012. For the 2012 year, the US Property Index (REIT) benchmark posted gains of 17.1%, while the European Citigroup BMI Property Index was up 27.7% for the year to date.

Global Bond outlook

With the risk-on trade back in a big way during December and into January, many expect the US bond rally to finally recede. Indeed the US 10 year Treasury yielded close to 1.9% by mid January – the highest in several months.

The Fed has indicated that it will maintain historic low levels of interest rates until unemployment drops to a rate of 6.5%. Most analysts expect this will take at least another 12-18 months, so continued Fed stimulus is expected. It remains the largest single buyer of Treasuries in the marketplace. This is an unprecedented move for the Fed to target a jobless rate, before changing course on monetary policy. His comments helped buoy the global market in mid December, although many suspect the bond rally may finally be coming to an end. The 10yr Treasury yield which was as low as 1.4% in October, before approaching 1.9% currently.

Similarly the ECB is not expected to raise rates nor the Bank of England. The strengthening of the UK Pound is likely to put a brake on UK recovery prospects in 2013. Consequently a weaker Pound policy is likely to be advocated by the UK's central bank.

Weak Eurozone economic numbers ensures that the Zone remained in a recession at the beginning of the year, despite Germany's favorable growth figures and optimism there.

Continued proactive comments by Draghi, the ECB president following his critically important summer statement of 'we will do whatever it takes', has definitely helped to dramatically lower sovereign yields in peripheral Europe. By January 2013 the sovereign yields for countries such as Spain and Italy continued to be well below their summer highs of approximately 7%.

Increasingly many feel that the deluge of money sitting in bonds will need to find a new home and begin to switch into equities. Evidence of such flows out of bonds were recorded in early January – with a weekly inflow into equity mutual funds the highest seen in some five years.

The successful fiscal cliff negotiations have also boosted hopes for an economic recovery and it is unlikely we will see bond yields dropping much from current levels.

Arguably it is only the pending debt ceiling negotiations (delayed for 3 months), that are holding back a wall of new money ready to enter the equity markets. Assuming the negotiations are fruitful, many analysts predict bond yield will easily rise over 2% on the 10 year Treasury Note and sounding the alarm for bond investors to begin bailing out of their fixed income investments.

Recent reports on the US housing market indicate that sentiment has bottomed and buying activity is at relatively high levels based on the past 5 years. Even construction activity, one of the largest drags on the US economy, appears to have finally begun to turn. Property prices are now rising in 40 out of 50 US states – the first time this has occurred in over 3 years.

But any gains in these areas are off an incredibly weak or low base that little positive impact is expected to filter through to the GDP growth numbers, anytime soon. The main positive is that they may no longer be pulling the economy down.

US banks remain very cautious and with lending standards still tightening, obtaining a mortgage is increasingly difficult. It is hard to see residential property prices recovering for a number of years – in many of the hardest hit communities.

With the recent positive jobs report in the US (almost 200,000 new jobs in November, and approximately 150,000 in December) - the US is poised to experience a far healthier recovery than Europe in 2013. The lack of severe austerity measures has in fact helped the US recover, while UK and Eurozone policymakers seem to be stuck in severe austerity mode, limiting economic growth.

China meanwhile has shown positive signs of recovery and staving off any real estate bubble for now. We predict China will surprise on the upside in 2013 economic growth terms, and manage to show healthy GDP figures.

The Global Government Bond index was largely flat for both November and December, but remained marginally up for the year, with a gain of 1.7%. By comparison the European Government Bond Index gained 0.8% for the month, and showed an impressive annual gain of 10.7% for 2012 (in Euros).