

Investment Outlook – February 2012

Global Equities

Equity markets enjoyed an impressive rally in February on the heels of an already significant rally in January. Continued positive sentiment in the US with unemployment data moving lower, together with the ECB's LTRO lending facility to European banks - have had a significant calming effect on equity markets. The finalization of the Greek government debt bailout terms in early March helped extend the equity market rally into double digit percentages across many leading equity markets by mid March.

Not surprisingly, the Dow crossed the 13,000 level followed in quick succession by the Nasdaq powering beyond 3000 and the S&P 500 poised to exceed 1400.

Although the Eurozone crisis has been averted for now, yields remain unsustainably high amongst peripheral nations (Portugal, Ireland, Greece and Italy). Further action will be required to assist these countries. For now the ECB had done what it can to reduce anxiety by offering low cost 3yr money to Eurozone banks – once in December 2011 and again in late February via the LTRO mechanism. The ECB's printing of money has led to its balance sheet mushrooming well beyond the size of the US Federal Reserve, so it remains unclear what further action the ECB can deliver, despite the almost certain European wide recession expected this year.

Given Europe's travails it is not surprising to see weaker economic data emanating from China – with extremely weakest export data being reported. In fact China slipped into a trade deficit earlier this year and this has led to the Chinese currency reversing course and depreciating slightly for the first time in years. The Chinese Central Bank (PBOC) has indicated that it seems the RMB currency is closer to equilibrium with its main trading nations now – possibly pointing to much slower appreciation of the RMB than many had come to expect. The past few years it has averaged close to a 5% annual appreciation.

Although China has successfully navigated a fairly soft landing – worries persist that its residential real estate market needs to cool off further. With 2012 GDP growth now expected to be 7.5% - the lowest in living memory, China is entering a period of consolidation and maturity leading to slower growth. This may be the only way to prevent China from experiencing rabid inflation and an overheating economy prone to bubbles, such as its residential real estate market is currently experiencing.

US consumer and employment data for February continues to be very positive with over 225,000 new jobs created while the prior two months' employment data were revised upwards by over 60,000. The extension of credit in the US is at a post recession high, spurred on by continued low Fed interest rates mooted to last until possibly 2014. It seems increasingly unlikely that the Fed will print 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 rates for mortgage loans.

All major global equity markets posted impressive gains, with the broad US Equity market (MSCI USA) gaining 4.3% in February and now up 9.2% year to date.

Similarly the European Equity and Emerging Market stocks had a very healthy February – reporting a 4.2% and 6.0% increase, respectively. Overall the MSCI World Index measuring developed markets closed up 4.9% for February and is up 10.2% for the year to date.

The real estate sector is also up for the year with the US REIT Index up 5.2% in 2012 and the European Citigroup BMI Property Index up 5.1% over the same period.

Despite the positive sentiment and the global equity market rally of the past two months, it is clear that commodities remain an attractive store of wealth. With gold hitting \$1700 an ounce and oil well above \$100 a barrel – many investors believe this is a crucial asset class to have exposure to over the long term. Increased political tensions in the Middle East (i.e. Iran and Syria) – point to a sustained higher level of oil price than would otherwise be expected during such a weak global economy.

Global Bond outlook

Given the positive economic data emanating out of the US, the Federal Reserve is unlikely to do any further quantitative easing. So no QE3 is likely. Inflation remains fairly benign allowing the Fed to keep interest rates at record lows well into 2013 and possibly 2014.

The weakest part of the US economy – housing and construction, require all the stimulus on offer from low long term rates, so the Fed is expected to hold rates as low as it can for as long as possible. Hopefully this will begin to stimulate more housing demand.

Given the recent equity market mini-boom over the past few months, it is likely that monies will begin to flow out of bonds and into equities, helping to drive bond yields up. This has already partially occurred in the US where the 10 year Treasury Note hit 2.2% after hovering around 1.8%-2.0% for much of the past year.

As previously mentioned, the performance of US Treasuries in 2011 stumped even the most seasoned bond investors. Many predicted rates would rise towards the 3% level, whereas the 10yr Treasury closed out the year with rates hovering around 1.9% and touching 1.7% a few months ago.

The ECB remains very accommodative to banks and large lenders by massively expanding its balance sheet and lending capacity. 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 such as Greece, Portugal, Ireland and Italy 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 Global Government Bond index lost 1% in February, but remains up 6.5% over the past 12 months. By comparison the European Government Bond Index gained 1.6% for the month, and is now up 7.5% over the past year.

This impressive European bond performance reflects the positive actions taken by the ECB via its LTRO cheap long term financing facility. The new austerity measures adopted in Greece, Portugal, Ireland and Italy are also providing further comfort to the markets.

Unfortunately there remains massive structural inefficiencies and huge unemployment concerns across such countries as Spain, Italy and Greece – 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%. Unfortunately many US homeowners simply no longer have the credit necessary to qualify for these new low rate mortgages.

With US unemployment rate at 25 year highs, wage growth (wage inflation) is nonexistent, US consumers still laboring under way too much debt – it will likely take another 5 years for US consumers to fully repair their balance sheets. Unemployment levels are not expected to decline to pre 2008 levels for at least another 5 years.