GinsGlobal Index Funds

Investment Outlook – February 2013

Global Equities

Despite fears that the failure to agree on a US budget and the resulting Sequester could unsettle markets – global equity markets led by the US enjoyed a further rally in February. The Dow Jones by early March had reached an all time high with the S&P 500 expected to shortly surpass its prior high in 2007. Both indices were up around 10% for the year to date. Over the past 3 years the MSCI USA broad index is up 43.8%.

The Sequester despite the likelihood of cutting $1 trillion of government spending over the next few years – has not led to fears of another US recession. In fact, Republicans and the private sector believe this is a positive development as it ensures that the bloated government is trimmed through these tough and indiscriminate cuts. Arguably there should be a more efficient surgical approach to reducing wasteful government spending, but for now the sequester cuts is the only game in town – as these cuts were the only spending cuts that could be approved by a fractured Congress over the past 12 months.

By comparison, Emerging Markets and the Eurozone have lagged dramatically. The MSCI EMU Index is up just 2.2% for the year (end of February in Euros), while the MSCI Emerging Markets Index is flat for 2013 and for the past 12 months has only gained 0.3%.

Positive economic news from the US include US jobs data for February showing almost 230,000 new jobs created with widespread improvement in housing prices and exports. Housing and real estate activity across most US states has shown a positive pick up despite being off a low base. Mortgage lending also seems to be increasing with construction job encouragingly being added in sizable numbers – the first such evidence in over 4 years. Give the Fed's continued policy of purchasing $85bn per month of US government bonds ($1 trillion a year) – the US stock market rally is expected to continue during 2013 given the low cost of money and the increasing outflow of bond and money market holdings into equities. US investors are growing more nervous that when the Fed turns off the low interest rate spigot that rates will shoot up, hurting bond holders. Inflation is expected to follow the dramatic growth in US money supply (i.e. $1 trillion Fed infusion this year alone) – translating into higher interest rates over the next few years. On a 10 year government bond, a capital loss of upwards of 25% could be realized if the 10 year Treasury were to go from 2% to 4%.

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 two thirds or more of US Treasury debt offered at auction.

Positive US data relative to Eurozone fears, has lead to a strengthening in the US$ relative to both developed and emerging markets. The British Pound sunk to a 4 year low of 1.49 to the US$, with the Euro below $1.30 and the Yen fast approaching 100 versus the US$ (after hovering around 80 less than a year ago). Emerging markets such as South Africa have seen a dramatic weakening against the US$ too, with the Rand hitting a four year low of R9.35 to US$1.

Concerns regarding Europe resurfaced with the problems in Cyprus with the imminent default of Cypriot banks likely, unless a Eurozone bailout occurs. It now appears that bank depositors in Cyprus will bear much of the brunt for the required bailout.

The global equity benchmark (MSCI World) grew just 0.2% in February, but is up 5.3% since the start of the year and is up 7.2% since the beginning of December. For the past 12 months the benchmark is up 10.7% and an impressive 32.4% over three years.

The Japanese market continues to rally on the back of the new Japanese monetary policy following the election of Prime Minister Abe - which has seen the Yen devalue by over 15% against the US$ in 3 months. In Yen terms the Japanese stock market rallied another 3.8% in February, following gains of 9.4% in January and 10.4% growth in December.

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.

Volatility levels as measured by the VIX 'fear index' remain near record lows over the past five year – touching 13 recently. Clearly if earnings disappoint globally, we could see a pullback in the equity rally, but for now the bulls are dominating.

Given ongoing Euro-wide austerity measure in the UK and Germany, expectations remain muted for positive job data and GDP growth over the next 12-18 months. The world is depending on the US to lead the economic recovery which may result in a US GDP growth rate of between 2.5%-3% for 2013.

In the property space, the US Property Index (REIT) benchmark posted gains of 0.8% in February following gains of 3.4% in January. The REIT Index is now up an impressive 16.0% over the past year. By comparison the European Citigroup BMI Property Index gained 1.3%, but remains flat for the year, although up an impressive 21.7% over the year.

Global Bond outlook

Given the continued positive economic news emanating from the US, and the Fed on track to buy $1 trillion of US government debt this year – it is not surprising that the so-called risk-on has led to a substantial equity rally leaving the bond markets in their wake.

Arguably US yields remain artificially low given this stage of the economic and inflation cycle. Many analysts expect the US bond rally to finally recede with investors likely to take a beating on their bond holdings in the next few years as rates rise substantially. Currently the US 10 year Treasury yields 2.0% and has traded in a very tight range the past year. An increase in yields to 3.5%-4% could cause capital losses of the order of 20%-25%.

The Global Government Bond Index fell again in February by 1.2% and is down 2.5% so far in 2013. Over the past year the Index is down 1.4%. By comparison, the European Government Bond Index gained 0.2% for the month, but is marginally down for the year. Over the past 12 months the index is up 6.8% (in Euros).

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 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.

It is unlikely US bond yields will drop from current levels. Once the Fed pulls back it giant bond buying program – US rates are expected to head considerably higher. Many believe yields will slowly begin to rise at the long end of the curve as demand for bonds gradually decreases and economic recovery becomes more pervasive across the US.

As expected, neither the ECB nor the Bank of England changed their rates in early March. In fact given England's weak growth prospects and the continued severe austerity measures, higher inflation targeting is effectively helping to weaken the Pound. It now trades at its weakest levels against the US$ in over 4 years and the Euro in over 3 years.

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. Upcoming German elections has led to a balanced budget being announced there with very little stimulus. Germany is in no mood to help bailout Cyprus which has close to one third of its depositors originating from Russia. Meanwhile the inconclusive political elections recently in Italy may yet lead to renewed uncertainty in that country – given the lack of a coalition government being formed almost one month after the results.

A weaker Euro relative to the US$ will assist the Eurozone over the next year to generate more exports. However continued problems with Spanish banks means the Zone is not out of the woods yet.

The rotation out of bonds is underway according to many analysts, which will help fuel the equity rally. The weekly inflow into equity mutual funds in the US has been the highest it has seen in over five years and has dwarfed any bond inflows.

The successful US fiscal cliff in January and lack of negative fallout form the sequestration in early March - has boosted hopes for an economic recovery. Further proof is that of a pickup in construction and lending activity, which has fueled the housing market resurgence particularly in Florida, the Northeast and California/Southwest.

With the recent positive jobs report in the US (almost 230,000 new jobs were created in February) - the US is poised to experience a far healthier recovery than Europe in 2013. The lack of severe austerity measures coupled with easy Fed money has boosted the US recovery. By comparison UK and Eurozone policymakers seem to be stuck in severe austerity policy mode – significantly limiting economic growth.

The hope is that demand in the US economy will help absorb renewed exports from Emerging Markets such as China, Brazil as well as the Eurozone.

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