GinsGlobal Index Funds

Investment Outlook – January 2012

Global Equities

Equity markets continued their rally throughout January and into February. This is largely on the back of positive sentiment in the US and a consensus that the Greek bailout will proceed despite last minute demands by the European Union governments. It is likely that further assistance will need to be provided to Greece but the February agreement buys time and has helped reduce bond yields throughout the Eurozone. This is particularly true amongst the peripheral nations (Portugal, Ireland and Italy) where bond yields have fallen dramatically since the ECB also offered cheap three year money to Eurozone banks back in December via the LTRO mechanism.

It remains a virtual certainty that Europe will have a recession in 2012 due to the austerity budgets in place across most EU member countries. Increasingly there is a case for divergence amongst the developing and emerging economies and Europe. It seems China has successfully navigated a fairly soft landing – despite an overheated property market, but GDP growth remains robust in China topping 8%. The other BRIC countries are expected to post positive GDP numbers in 2012, while the US is expected to pick up growth as the year progresses. US unemployment levels may drop below 8% by year end and jobless claims are now at four year lows. While the US housing markets remains depressed, signs of manufacturing and export led growth have both been encouraging. Many experts believe a third round of US quantitative easing is likely, if the US economy runs out of steam mid-way through the year. Little sign of any inflation is imminent which will give the Fed more of an opening to buy up more bonds and keep rates low.

Most major global equity markets are up over 10% since early December 2011. The Dow Jones Index hit the 13,000 mark on February 20th and is expected to continue an upward trajectory during the first quarter. The broader MSCI US Index gained 4.7% for January, while the broad MSCI World Index showed a 5.0% increase over the same period. By mid February the MSCI World Index was flat over the prior one year period, recovering almost all its earlier losses in 2011.

Similarly the European Equity and Emerging Market stocks have had a very healthy January – reporting a 4.1% and 11.34% increase, respectively. Overall the MSCI World Index measuring developed markets closed down 5.5% for the year and was flat for December.

Despite the Greek bailout being approved, most analysts believe Greece will be unable to repay its debts and will require a further bailout later in 2012. For now Europe remains the number one concern due to the likelihood of recession. The big question is whether it will be a deep and prolonged recession in the Eurozone or a reasonably shallow one. Eurozone banks will be required to recapitalize their balance sheets such as Commerzbank and a number of Spanish lenders too. The issue of dramatic spikes in youth unemployment and a possible 'lost' generation points to wider structural problems in Europe which will takes years to fix. For now it is hoped that the ECB's second round of LTRO lending will help stimulate bank lending and place the financial sector on a firmer footing with cheap funding for the next three years. Arguably the ECB's moves since December have replicated the successful Fed stimulus actions that have helped move the US away from a double dip recession.

The other big unknown is how long will the Fed keep rates low and continue its stimulus policies. Since inflation is tepid at this point, there is no significant concern that it will rise much beyond 2% in the US. The Fed is likely to keep rates as low as possible through 2013 and into early 2014 – with possibly no increases, unless higher inflation begins to show up.

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 again above $1700 an ounce and oil above $100 a barrel – this points to many investors remaining unconvinced that the world economy is yet out of the woods. 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.

One gauge of trepidation is the Baltic Dry Goods Index which records the cost of shipping commodities (mostly coal, iron, grain etc). Recent data indicate the shrinkage in world trade and equates to the global economic slowdown. The Index stands at the same level it was at in 2009 with no pick up.

While China's property bubble has already burst at the high residential end – the rest of the economy remains on a firm footing. Given the political leadership transition in China this year, the authorities will do everything they can to keep the economy humming along and credit flowing. In the US, listed property markets gained 6.4% in January following an almost 10% gain in December. The US REIT Index is now up 12.4% for the past 12 months and up a whopping 133.8% over just the past three years. By contrast the Eurozone listed property sector gained 4.1% for the month of January, but it remains 12.9% down over the past year.

While the outlook remains uncertain for Europe in 2012, with a definite recession already taking hold in the region, the US has moved further away from its worst economic slump since the Great Depression. Over the past quarter, an average of 150,000 new jobs were created monthly with December peaking at over 200,000. More than 2.5 million new jobs have been created over the past 18 months pointing to a definite upward hiring trend which is expected to continue.

Global Bond outlook

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 ten year Treasury closed out the year with rates hovering around 1.9% and touching 1.7% a few months ago.

The Global Government Bond index gained 1.5% for January following a similarly positive result in December. It is now up an impressive 7.9% over the past 12 months. By comparison the European Government Bond Index gained 1.7% for the month and closed up 5.7% over the past year. This impressive European bond performance reflects the positive actions taken by the ECB, the government of Italy as well as good response for sovereign debt auctions held in the past few weeks.

The ECB's LTRO Euro 500mn lending facility for Eurozone banks has been largely taken up by Italian banks and Commerzbank, the weakest of the German banks. In effect the ECB has also become the lender of last resort, pumping in hundreds of millions of Euros into the sovereign bond market sustaining demand for the recent auctions.

With German economic performance showing robust health and maintaining its AAA rating – observers increasingly believe the Eurozone crisis can muddle along well into 2012 and there is no imminent danger of a Lehman like event occurring that could freeze up capital markets. The recent approval of the Greek bailout plan by the Eurozone also points to more confidence returning to the markets. Rates of sovereign debt across the peripheral European countries has come down dramatically as a result of the above actions – reducing the budgetary strain on a number of European countries.

Nevertheless there remains massive structural inefficiency and huge unemployment concerns across such countries as Spain, Italy and Greece – particularly youth unemployment which exceeds 20% in these countries.

Despite the imminent danger in Europe being averted for now, it is clear that simple austerity measures will not allow Greece or the other peripheral countries to grow their way out of their

solvency problems. Greece will require their bondholders to take an increasingly large haircut (i.e. a default) in order to write down its level of debt. Ultimately a 60-70% write down on such bonds is expected. Continued social unrest in Greece is expected for some time as it remains far from clear whether the initial Euro 130bn bailout approved in February will solve Greece's budget and financial woes. Many believe a second bailout will be required in late 2012 or early 2013.

Clearly 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) nonexistent, US consumers still laboring under way too much debt – it will likely take another 4-5 years for US consumers to repair their balance sheets. Unemployment levels are not expected to decline to pre 2008 levels for at least four years from now.