Investment Outlook – July 2012

Global Equities

Global equity markets continued to recover throughout July and into August, enjoying a solid three month summer rally. Global equity markets have now recovered most of their losses from earlier this year and many developed and emerging markets are close to their 2012 highest levels.

Favourable comments from Mario Draghi the ECB president, reiterating that he would defend the Euro at all costs, helped spark a rally in July and into August. Markets such as Spain and Italy have experienced significant market recoveries, with the Eurozone gaining 2.9% for July (MSCI EMU). At the time of Draghi's comments, yields on Italian and Spanish debt had reached unsustainable levels of around 7% on 10yr sovereign debt. The German Chancellor Merkel has also shown extra commitment to saving the Euro and the risk-on trade has clearly helped push Euro and world markets higher the past month.

Given that the Spanish problem of bad real estate debts will take years for banks to sort out – no quick fix is seen for Spain. For now the ECB has bought additional time for the peripheral European countries simply by warning markets it is prepared to launch it's bazooka at any time. This could include various quantitative easing measures such as buying up sovereign bonds or providing additional direct assistance to banks at low interest rates. Draghi has shown a willingness with the past LTRO program to actively intervene to assist European capital markets. Despite worries in Germany – it seems he has a green light to provide further assistance.

For now markets remain on an upward trend with volatility levels at historic lows. The US so-called 'Fear' Index – the VIX which measure volatility on the S&P 500 is now trading at just 14, well below its normal range of closer to 20, and at less than half the fear gauge registered earlier this year, when it spiked around 30.

Meanwhile, the Fed has also shown a greater willingness to push for additional measures such as QE3 if the US jobs markets show no improvement. However a robust 160,000 new jobs (well above expectations), were created in July relieving some of this pressure and the Fed is now less likely to act.

With the US election less than three months away, any major moves from the Fed are unlikely at this stage. Unfortunately the looming fiscal cliff beginning in 2013 will begin to worry US markets as we approach the election. Unless policymakers in Washington strike a compromise between the election and year-end 2012 – tax rates are set to rise dramatically on dividends while $500bn is to be cut from defense budgets, further hurting the economy. Any preventative action against this fiscal cliff is unlikely until after the election. Major policy proposals are all on hold until the new Congress and President are elected in early November. Most experts predict further gridlock in Washington in 2013, with the elections resulting in split control over the legislative and executive functions in the US.

Sadly the US economic recovery has been the weakest in half a century. With GDP figures constantly being revised downwards into 2013, the best that can be said is that few expect a double dip recession to occur. For now, the US may seem the least ugly economy amongst the major developed countries. However only a 2%-2.5% GDP growth figure is predicted by most analysts over the next 12 months. Such an anemic recovery will likely result in higher unemployment unless more than 150,000 new jobs are created monthly over the next few months. For now the jury is still out on whether this is likely.

Most investors should be pleased that we have had a relatively benign summer of little bad news from either Washington or the Eurozone. This has indeed been a far quieter summer than the past two years, which experienced severe markets falls. For now, comforting words by the ECB and German Chancellor has taken the fear out of markets.

Consequently, the Dow Jones Index has powered through the 13,000 level and by August was sitting above 13,200. The broader S&P 500 has also regained its footing and has remained above the 1400 level. With PE ratios at 13 times earnings, the US equity market is not seen as overly cheap, but could still enjoy a boost given any positive economic reports, that could help unleash more optimism.

All major global equity markets posted gains in July, with the broad US Equity market (MSCI USA) gaining 1.3% and remaining up 10.5% year to date. The MSCI World Index also rebounded up 1.3% for the month and remains up 7.3% for the year to date.

Both the European Equity and Emerging Market enjoyed positive returns, with the MSCI EMU gaining 2.9% in Euros while Emerging Markets rose 2.0% as measured by the MSCI Emerging Markets Index. The German DAX passed the 7000 level in early August, and the FTSE 100 in the UK is now above 5800 – impressive levels considering the lows earlier this year. The Japanese Nikkei Index posted gains above the 9000 levels while the Hang Seng has recovered to the 20,100 range.

In the property arena, both our REIT Funds enjoyed solid performance too. For the month, the US Property Index (REIT) gained 1.9% and is now up a whopping 17.1% for the year to date. By comparison, the European Citigroup BMI Property Index was up 5.1% for the month – now up an impressive 15.0% for the year.

Global Bond outlook

With global equity markets positing impressive recoveries the past few months, it is clear the risk-on trade has gained followers. Despite weak growth in the US and a Eurozone recession, many believe the Fed and ECB are willing to use additional measures to help bail the economy out.

Proactive comments by Draghi, the ECB president stating he 'will do whatever it takes', has definitely helped to dramatically lower sovereign yields in peripheral Europe. By early August the unsustainable yields in the 7% range for Spain had come down. The same effect is true in Italy. Rates in the US have also risen – with the 10yr Treasury moving up from 1.39% to over 1.8% in just the past few weeks as the risk-on trade continues.

Increasingly, many feel that the deluge of money sitting in bonds will need to find a new home and will begin to switch into equities. Rates in the US may well move higher shortly as more confidence returns to global capital markets. In reality, the ECB and the Fed have done little over the summer – but the power of their words has helped settle markets.

Recent reports on the US housing market indicate that sentiment has bottomed and there is increased buying activity. Even construction activity, one of the largest drags on the US economy, appears to have finally begun to turn. But any gains in these areas are off such a 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 posting 160,000 new jobs in July, the fed is unlikely to make any major moves until after the election. No new policy initiatives are expected until 2013.

With the US unemployment rate officially at 8.3% it is clear the recovery has stalled. The broader U6 unemployment measure shows a rate close to 16.5%, accounting for those under-employed or only having temporary work. The expected US GDP growth figure of less than 2% for the remaining part of the year, will likely feel much like a recession for a large swathe of the country. The earlier silver lining for US consumers of a lower gas price has since reversed itself – with gas prices again rising throughout the country.

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 as possible to current levels in order to help spur refinancings and new affordable mortgages at 30yr rates hovering around 4%.

Regarding Europe, a simple solution to the weak peripheral units would be issuing Eurobonds to help weaker members – and backed by stronger EU members. The cost of a breakup of the Zone remains significantly more expensive that a bailout of some of the weaker banks or regions. Europe ultimately needs to grow its way out of its liquidity and solvency problems – an infusion by the ECB and/or IMF along with a global economic recovery will help do wonders, together with a weaker Euro relative to the US$ and Pound.

Despite concerns in China and other emerging markets, we continue to predict China will surprise on the upside and manage to show healthy growth figures over the next 6-12 months. Its leaders are highly motivated to ensure a peaceful transition – occurring once over decade. State owned enterprises continue to dominate the Chinese economic landscape so managing its GDP growth remains within the leadership's control.

The Global Government Bond index rose 1.0% in July, remaining up 1.4% for the year. By comparison the European Government Bond Index gained 1.6% for the month, and is up 8.8% over the past year (in Euros).