Investment Outlook – June 2012

Global Equities

Global equity markets enjoyed a rebound during June, following a Eurozone summit that purported to help Spanish banks and assist Italy too. The summit also gave clarity on a new Eurozone bank regulator to support the ECB, while also addressing ways to assist banks - without having to first loan monies to the sovereign governments themselves.

Many observers believe that Spain will likely require a much larger bailout for its banks. Spanish and Italian government yields are both at unsustainable levels approaching 7%. Recent positive comments from the ECB indicating it may be willing to play a more aggressive role mirroring more of the Federal Reserve activities, has boosted confidence. The cost of a Greek exit with its predictable negative fallout on other weak Eurozone members has led many to believe that Germany will do whatever it takes to keep the Eurozone together. Unfortunately the UK along with the Eurozone are both in recession; and the austerity policies being implemented are expected to do little to lift these countries out of their slumber. The UK is now suffering its worst double dip recession in over 60 years. Its economy is now smaller than when the Cameron government took over.

The weaker Euro currency which has lost more than 10% against the US$ over the past year, should help European exporters and make the Zone more competitive. Unfortunately structural labour problems with record high unemployment levels require fundamental policy reform along the lines of reforms implemented by Germany a decade ago.

Despite increasingly weak US and China economic data, low inflation in both countries will permit more aggressive monetary and possible fiscal stimulus. China's political transition which occurs later this year (every 10 years), means that the leadership will prime the pump and ensure banks lend sufficiently to keep the GDP numbers as close to 8% or better for the year. We remain more bullish on China than other economies.

While US housing seems to have finally bottomed out and recent construction figures have begun to turn slightly positive, it is sadly one of a very few bright spots. With the presidential elections just a few months away it highly unlikely that Obama will be able to implement any economic reforms such as tax changes. The pending fiscal cliff at year end – with the expiration of the Bush era tax cuts and a $1trillion hit to the defense budget could plunge the US back into recession. Most analysts predict Congress will extend the tax provisions at the last minute (in December), after the election in the so-called lame duck session. Meanwhile the uncertainty has led to fewer hirings than predicted earlier in the year. Job growth figures averaged less than 100,000 for each of the past three months, resulting in a terrible disappointing 2nd quarter jobs picture. Obama may have won the battle regarding health care reform, however it may be a pyrrhic victory with the acknowledgment that it increases taxes on businesses and the upper middle class.

The weak jobs picture and low level of economic activity – GDP is expected to come in at barely 2% for the remaining two quarters this year – points to possible further Fed activity in the fixed income markets. With the record low rates on the 10 year Treasury Bond at 1.39%, it is likely that the Fed will play a more active role in the non Treasury bond market such as mortgage backed securities.

With Washington in election mode it is effectively paralyzed until after the November elections.

The Dow Jones Index recovered to the 12,500 level during mid July having fallen below the 12,000 level earlier. The broader S&P 500 has also regained its footing and has hovered around the 1350 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 the pending Fed action and likely changes in Washington which could unleash more optimism.

All major global equity markets posted gains in June, with the broad US Equity market (MSCI USA) gaining 3.9% and remaining up 9.1% year to date. The MSCI World Index also rebounded up 5.1% for the month and remains up 5.9% for the year to date.

Both the European Equity and Emerging Market enjoyed positive returns, with the MSCI EMU gaining 6.3% in Euros while Emerging Markets rose 3.9% as measured by the MSCI Emerging Markets Index.

In the property space both our Property Funds enjoyed solid performance too. For the month, the US Property Index (REIT) gained an impressive 5.5% and is now up a whopping 14.9% for the year to date. By comparison, the European Citigroup BMI Property Index was up 4.6% for the month – and is now up 9.3% for the year.

Unfortunately continued uncertainty in the Eurozone and Washington translates into an uncertain summer for equity markets. Given the historically low volumes seen in August, markets can be more susceptible to wider swings. Hopefully policymakers in Europe will be able to finally get ahead of market dynamics and assist the weaker Eurozone members. Most investors are hoping for a quieter summer in 2012 than 2011 when markets had significant falls. The ECB had better act soon.

Global Bond outlook

Continued worries about the Eurozone have led to a flight to safety with the US$ and bond markets being the biggest beneficiaries. The Euro has been pushed to multi-year lows barely above $1.20 – a 15% fall from just a year ago. Meanwhile the 10yr Treasury Note is now yielding just 1.39% - a 200 year low. Although this is positive for US mortgage holders, it points to growing nervousness amongst global investors.

It is clear that US policymakers have no room to move between now and the November election so all eyes are focused on the Fed and whether Bernanke may take more aggressive QE3 action during the summer. Weak US jobs data is major concern and long term unemployment now exceeds six months. Under-employment now ranks around 14% while core unemployment is at 8.2% but set to rise later this year if GDP growth is anemic as many forecasters predict. A US GDP growth figure of less than 2% for the remaining year would feel much like a recession for a large swathe of the country. The one silver lining for US consumers is the petrol price which has retreated by close to 20%, which will put a few more dollars in their pockets. With inflation not a concern – the Fed definitely has room to intervene with another dose of QE3 stimulus.

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%.

The record high government bond yields in Spain, Portugal and Italy point to a splintering in the Eurozone – along with huge cash withdrawals out of banks based in Greece, Spain and other peripheral countries. By comparison a fight to safety has occurred in Europe benefiting Germany and the UK with record low borrowing rates. It is imperative Eurozone policymakers strengthen the core of Europe's monetary and fiscal institutions to ensure that a de facto regionalization and possible breakup are not allowed to endure.

A simple solution would be issuing Eurobonds to help weaker members – and backed by stronger EU members. The cost of a breakup of the Zone is significantly more expensive than a bailout of some of the weaker banks or regions.

Lastly, 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, together with a weaker Euro relative to the US$ and Pound.

Despite concerns in China and other emerging markets, we believe 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 – once in a generation. Given that Communist Party controls all the key economic levers such as bank lending it is fairly easy for them to prime the pump by reducing interest rates and reducing capital rations – thereby permitting more bank lending. State owned enterprises continue to dominate the Chinese economic landscape so managing its GDP growth remains within its control.

The Global Government Bond index was flat for June, but remains up 2.7% for the year. By comparison the European Government Bond Index lost 0.7% for the month but is up 7.2% over the past year (in Euros).