Investment Outlook – March 2012

Global Equities

Equity markets in March continued their impressive rally from the start of 2012, building an impressive first quarter return that hit double digits for most developed and emerging markets.

Positive data emanating out of the US, particularly jobs data figures exceeding 200,000 jobs for both January and February, helped provide a sense of broad based recovery in the US economy. Following the ECB's LTRO quantitative easing program, worries of imminent debt defaults receded from the landscape, also pushing sovereign bond yields lower. However, forthcoming problems in Spain and Portugal may yet cause the Eurozone markets to show more volatility as we enter the Spring. Eurozone countries remain under pressure with severe austerity measures across all peripheral countries still to be implemented in a number of cases.

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 passing the 1400 mark. However such a strong rally means that the market is poised for a breather and it would not be a surprise were global equity markets to lose steam over the next few months and retreat from their first quarter gains.

The IMF will likely increase its firewall to assist countries in need of a bailout. The ECB will also play a more active role in assisting any Eurozone member in crisis by helping to lower their sovereign bond yields and possibly provide an additional level of easy cheap money to their banking community. Already two rounds of LTRO have been utilized with a third round a possibility should market volatility spike.

The ECB's quantitative easing program has led to a dramatic increase in the size of its balance sheet.

Chinese and other emerging markets economic data has been more muted the past quarter – however despite dire warnings on China, it appears a soft landing has been engineered with GDP growth close to 8%. Given Europe's likely 2012 zone-wide recession it is likely that Chinese exporters will suffer and China's trade surplus will shrink. The Chinese Central Bank (PBOC) has indicated that the RMB currency is closer to equilibrium with its main trading nations now – likely 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, while it has barely moved in 2012.

With US consumer and employment data continuing to show positive gains (March exceeded 120,000) - it is 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 rate mortgage loans.

All major global equity markets posted gains, with the broad US Equity market (MSCI USA) gaining 3.2% in March and now up 12.7% year to date.

However both the European Equity and Emerging Market posted losses in March, reporting a 0.1% and 3.3% losses. Overall the MSCI World Index measuring developed markets closed up 1.3% for March and is up 11.6% for the year to date.

The real estate sector is also up for the year with the US REIT Index up 5.2% in March and 10.8% for 2012, while the European Citigroup BMI Property Index grew 6.0% and 11.4% respectively, over the same period.

Global Bond outlook

The positive jobs data recorded in the US during the first quarter exceeded a total of 550,000 new jobs created. Compared with the Eurozone the US economy looks on an increasingly healthy trajectory. However lower workforce participation and continued weak housing markets across the US, paint a bleaker picture. Rising oil and gas prices may yet limit economic growth prospects for 2012. For now the US is projected to grow by at least 2% for the year while the Eurozone is likely to contract by at least 1%.

Bernanke's Fed is increasingly unlikely to resort to full quantitative easing given the improved picture. However such unknowns as continued record oil process and a growing stock of foreclosures could help dent the Fed's enthusiasm for a self sustaining recovery in 2012. Most observers believe the Fed will be true to its word and likely limit any rate increase well into 2014 – thus providing as much monetary stimulus as possible with resorting to QE3 .

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. However uncertainty in Europe could squelch such optimism bringing yields back down below the 2% level on the 10 year Treasury.

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 via the LTRO quantitative easing program. 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 March, but remains up 5.1% over the past 12 months. By comparison the European Government Bond Index gained 0.2% for the month and is now up 8.3% over the past year.

This impressive European bond performance reflects the positive actions taken by the ECB with its new leader Mario Draghi. The austerity measures adopted in Greece, Portugal, Ireland and Italy are also providing further comfort to the markets. However Spain has recently rattled financial markets by its delays and obfuscation, so negative sentiment in Spain with its huge unemployment crisis could yet create much uncertainty throughout the Eurozone.

Unfortunately, there remains massive structural inefficiencies and huge unemployment concerns across these Eurozone countries – 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%.

With the US unemployment rate at 25 year highs, wage growth (wage inflation) remains non-existent. US consumers still labor under way too much debt and it will likely take another 5 years for US consumers to fully repair their balance sheets. Further, unemployment levels are not expected to decline to pre 2008 levels for at least another 4-5 years.