Investment Outlook – May 2010

Global Equities

World markets suffered a severe pull back during May on the heels of increased worries over Eurozone sovereign debt and in particular the Club Med countries led by Greece's huge fiscal indebtedness and imbalances.

Despite Euro leaders belated interventions with a Euro 750bn rescue package, markets remain unsettled and new austerity plans introduced across Europe provide little cause for any consumer led recovery. Europe is now belatedly taking these pain measures and this will lead to slower world economic growth over the next 12 months than previously expected. New UK austerity measures are expected to be announced by the new Cameron led government in its late June budget.

The fully fledged crisis in Europe has led to a steep sell off in the Euro with some calls for parity with the dollar. Only a year ago there were calls for the Euro to replace the US$ - how quickly times change. On balance a weaker Euro will provide a subsidy and much needed boost for Eurozone exporters. Unfortunately severe austerity measures introduced by Germany will restrict any Eurozone economic recovery until well into 2011. Asia and the emerging markets are leading the world out of the global recession and it is hoped US economic recovery will grow stronger through the end of 2010. Unfortunately the US seems likely to experience a mostly jobless economic recovery with persistent high unemployment prevailing over the next 24 months.

Despite the Euro led recovery package, equity markets remain unconvinced that sovereigns piling on more debt to rescue weaker Eurozone members such as Portugal, Spain, Ireland and Greece - is going to solve the immediate crisis. These countries all have double digit fiscal deficits and a weakening Euro seems to be their only viable solution to create a more competitive environment for their manufactures and exporters.

The markets remain very uncertain with volatility levels spiking to previous highs not seen since 2008. The MSCI World Index lost 9.6% for May and is now down 6.6% for the year to date. The Eurozone lost 5.9% for the month (in Euros) – the weaker Euro has also compounded these equity losses for investors seeking US$ returns. The US$ has reasserted it safe haven status and the UK's Sterling currency has also retreated to its weakest levels since the 2008 crisis at levels around 1.45-1.47 to the US$. The dramatic belt tightening required by the Eurozone and UK public sector indicates that the US economy will likely power ahead of most industrialized regions, except for Asia.

The MSCI Asia Pacific Index reported losses of 10.3% for May and is now down 5.7% for the year.

The growing crisis in Europe has reduced the likelihood of the Fed or ECB increasing rates any time during 2010. In fact the Fed is assisting the Eurozone by opening up swap and lines of credit facilities to Eurozone countries and their treasuries.

Although US companies on the S&P 500 have mostly beaten market expectations regarding their earnings, much of this is on the back of once off expenditure cuts. Top line growth remains anemic at best. The US market as measured by the MSCI US 750 top companies lost 8.1% for the month and is down 1.8% for the year.

The US (listed REIT index) property market retreated by 5.4% but remains up by 11.2% for 2010. The European property market lost 8.4% for May and is now down by this same amount for the year in Euros.

It is clear the US financial system will continue to see failed banks and the real estate meltdown (specifically commercial properties) will persist for another 12-18 months as foreclosures work their way through the system. Banks have been slow to clean house and foreclose on delinquent borrowers. US government financial reform is shortly expected to be passed adding further costs and pressure on large banks and financial institutions.

Global Bond outlook

The massive spike in volatility during May and across the board losses in the equity markets globally, has sparked fears of a double dip recession possibly for the Eurozone. Although this is unlikely for the region as a whole, certain member countries will indeed suffer through new austerity measures introduced. Further belt tightening will hamper any economic recovery in the Eurozone.

The market is now expecting the Eurozone to inflate its way out of the debt crisis, by pumping in more money form the ECB to buy up government bonds and effectively devalue the currency relative to the US$, Yen and other leading industrialize currencies such as the Swiss Franc. By mid June the Euro was trading at a 4 year low to the US$.

Consequently, both the ECB and Fed are expected to keep rates on hold for far longer than earlier expected. The sovereign debt crisis playing itself out in the Eurozone is far from over – the recent Euro 750bn government bailout has still not appeased markets. Given that bonds are a virtual safe haven from equities, it was not surprising to see the European Government Bond Index gain 1.5% for the month – it is up 3.1% for the year.

Despite improved job outlook figures and recent monthly gains in employment – the recovery is anemic on the jobs front. Real estate in both residential and commercial arenas is also lacking any significant turnaround. The weak US economic recovery plus concerns in the Eurozone indicate the Fed will be in no rush to raise rates during 2010. Any action on this front is now likely to be delayed given the spiraling sovereign debt crisis in Europe and worries regarding the UK economy.

The lack of inflationary pressure and lack of bank lending seems to have put the threat of inflation to one side for now.

By comparison the European Central Bank has been under tremendous political pressure to play a more activist role in helping to reboot the Eurozone and indeed save the weaker members from defaulting on their government debts. The ECB has stepped in with promises to effectively buy hundreds of billions of Euros worth of southern European debt – this led to borrowing rates amongst some of the weaker members dropping by half on the day of the ECB's intervention being announced. This quantitative easing and propping up the Euro Bond market – will cause inflationary pressures over the next 18 months.

The ECB has effectively brought the Eurozone into a closer political union in conjunction with the IMF stepping in with a bailout package worth more than Euro 200bn.

The World Government Bond Index lost 1.0% in US$ terms for May and is now down 3.0% year to date. This partly reflects the stronger US$ which has offset any gains in Eurozone bond prices.

Given the tenuous nature of the residential and commercial real estate markets in the US, the Fed has no desire to make mortgage finance more expensive for prospective borrowers – thus the Fed's support of the mortgage markets through the purchase of mortgage securities while being dramatically reduced will not evaporate as some analysts suggest.

A 2nd wave of US foreclosures is only now beginning to hit as further layoffs effect the market. Currently 1 in 5 US home owners are behind on their mortgage payments or are affected by negative home equity. Persistent high unemployment rates will continue to dampen any real estate recovery well into late 2010. Unemployment losses are expected to peak by mid 2010.

A sustained global economic recovery remains under threat due to huge structural deficit problems in certain Eurozone countries including the UK, Greece, Spain and Ireland. The US is expected to recover far quicker then the Eurozone. It is expected that Asia will outdo both these two old world economic regions.