Investment Outlook – May 2012

Global Equities

Global equity markets continued to suffer during May on the back of increased Eurozone uncertainty. Although Greek elections may have delayed a Greek exit the fallout has led to higher interest rates on Italian, Spanish and Portuguese debt and markets remained spooked. In all likelihood the Greeks will not abide by their commitments and will demand a renegotiation of their bailout provisions.

Germany may ultimately realize it is worth keeping the Greeks in the Eurozone so that other peripheral countries are not tested or punished. Ultimately it is time for the biggest beneficiary of the Euro to cough up with more cash and friendlier bailout terms. The contagion has spread to Spain with the Spanish government now requiring a bank bailout. Not only have sovereign bond rates spiked to unsustainable levels given the Eurozone recession, global banks have also suffered broad downgrades from the various rating agencies.

Ultimately the stop gap measures used for Europe are clearly not sufficient and a more lasting Eurozone wide bank regulator and deposit insurance scheme will be required. A combined Fund to support Eurozone banks is increasingly being mooted, which could also buy up Eurozone debt.

Beyond the growing uncertainty over Europe's fate, increasingly weak US and China economic data paint a negative picture for the next few months. With US elections looming in November, Obama appears increasingly vulnerable given the recent spate of weak jobs data. Not only were just 69,000 jobs created, but the prior two months of figures were revised downwards, while unemployment rose to 8.2%. However US youth unemployment is close to 20% and the number of Americans not working in true full time jobs – when combined with the regular unemployment rate, now approaches a similar 20% figure.

China has tried to stimulate growth again by reducing the amount the banks need to hold in reserves. UK growth is stalled with the Cameron government increasingly coming in for criticisms regarding its austerity programme in the face of a recessionary environment on its doorstep.

In aggregate the three most important world economies, being the US, China and Europe all seem to now be suffering from an economic slowdown, just at the moment when equity markets had priced in a global economic recovery earlier in the year. The optimistic sentiments earlier in the year have again fallen victim to a slowing global economy from the 2nd quarter. Most economists did not predict another slowdown in the middle of the year.

Uncertainty over how the Supreme Court will rule on US healthcare reform, plus the looming fiscal cliff at year end is holding back business spending. The year end tax rises and sequestered $1trillion of defense department cuts means that an effective fiscal cliff could knock between 2.5%-3% off the US GDP figure, if implemented unchanged. In all likelihood Congress will act after the election, but businesses remain nervous.

Despite record low long term rates in the US (1.5% on the 10Yr Treasury Bond) – this has not helped breathe new life into the housing or broader real estate market which remains in the doldrums. As many as 25% of US homeowners are underwater on their homes – owing more on their mortgages than their houses are worth.

With Washington in election mode, it is effectively paralyzed until after the November presidential and congressional elections.

The Dow Jones has fallen well below the 13,000 level briefly flirting with the under 12,000 level. The broader S&P 500 has also retraced most of its gains from earlier this year. By June the S&P had fallen below 1300, having passed the 1400 mark in March.

With US consumer and employment data showing glaring signs of weakness, the likelihood is growing that the Fed will continue with its Operation Twist, buying longer dated bonds thereby reducing rates on that end of the yield curve. The Fed may yet print additional money in the form of further quantitative easing if Eurozone shocks and weak US jobs data do not start to turn around.

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 losees again in May, with the broad US Equity market (MSCI USA) retreating 6.2% in April, while remaining up 5.0% year to date. The MSCI World Index suffered it's worst one month loss in years, down 8.6%, although it remains flat for the year to date.

Both the European Equity and Emerging Market indices posted losses again in May after already retreating in April. The MSCI EMU lost 7.0% in Euros while Emerging Markets fell a whopping 11.2% as measured by the MSCI Emerging Markets Index. For the month the US Property Index (REIT) lost 4.6% although it is up 8.9% year to date. By comparison, the European Citigroup BMI Property Index is down 2.4% for the month - although it remains up 4.5% for the year.

Despite there being some hope in mid June that equity markets may settle down following the Greek election results, continued weak global economic data has led to world markets losing some of the spark and momentum they enjoyed earlier in June.

Global Bond outlook

Despite record low interest rates in Germany, the UK and the US, all three economies are struggling to grow. US jobs data was revised downwards for both March and April while May data was a bitterly disappointing recording just 69,000 new jobs. The US unemployment rate rose to 8.2% while some states such as California have numbers as high as 11%. More distressing, are the growing number of long term unemployed – its now about 50% of the US unemployed which have not worked for at least 6 months. Youth unemployment is the worst it has been in decades, with fewer college graduates gaining valuable early career work experience.

Worries about the Eurozone have pushed up the US$ as a safe haven, making US exports less competitive.

The one silver lining for US consumers is the petrol price, which has retreated by close to 20% . This certainly will put a few more dollars in their pockets.

Lower workforce participation and continued weak housing markets across the US, paint a bleak picture. The California budget crisis which has ballooned from a projected $9bn deficit to over $15bn is symptomatic of the broader problems facing local and state governments across the US.

Most worrisome is that Bernanke's Fed despite the lowest mortgage rates on record, has been unable to help fuel economic growth. With such weak economic demand, most observers believe that 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 without resorting to QE3 .

The growing uncertainty over Greece's membership in the Eurozone, plus weak economic data globally, has led to a flood of cash into US Treasuries – pushing rates down to a record low level of 1.5% on the 10 year Note. US sovereign bond market bulls have scored significant returns the past two months as rates have come down from 2.2% on the 10 year Treasury to current levels. UK and

German sovereign yields are similarly low, while the weaker peripheral Eurozone member such as Greece, Spain, Portugal, Ireland and Italy continue to pay huge premiums on their debt.

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 most likely in a recession already due to all the austerity programs in place across the Continent. Unsustainably high government bond yields in peripheral Eurozone countries 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 weaker Euro relative to other key currencies is likely a positive sign, assisting European exporters to become more competitive. The Global Government Bond index lost 0.6% in May and is now flat for 2012. By comparison the European Government Bond Index gained 1.1% for the month and is now up 4.5% for the year. (in Euros).

This impressive European bond performance reflects the positive actions taken by the ECB with its new leader Mario Draghi. However the new Spanish bank bailout has heightened fears that other countries in the region will require similar bailouts for their banks. A firewall protecting Europe's banks through a federal deposit insurance programme is a start, but a stronger tighter fiscal union with broad oversight powers is ultimately required with the leading European players stepping up to the plate and helping the weaker countries out. Germany as the leading beneficiary of the Euro, needs to play a more encouraging and decisive role in stepping up assistance to its weaker European allies.

Fears of the unresolved fiscal crisis in Greece spreading, have already been witnessed in Spain with its huge unemployment crisis and bank bailout. Most Spanish banks have also suffered large downgrades pushing up their cost of capital.

Unfortunately, there remain massive structural inefficiencies and huge unemployment concerns across these Eurozone countries – particularly youth unemployment which exceeds 20% in many 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, together with 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%.