GinsGlobal Investment Outlook – October 2012

Global Equity

Immediately following the re-election of President Obama in the US, US markets promptly gave up 5% of their earlier gains. This reflects the uncertainty of a resolution to the pending US fiscal cliff deadline at year end. Congress and the White House need to strike a compromise on various fiscal matters before year end otherwise the Bush era tax cuts expire which will hurt all American taxpayers, particularly the middle class. Taxes are expected to rise on everything from capital gains to estate tax, dividends, payroll and income tax.

Furthermore, huge government spending cuts have been imposed (called sequestration) which will have the effect of over $600bn being pulled out of the US economy. By all accounts the US economy could suffer a 3% GDP contraction were all the pending changes to be implemented without any resolution between Democrats and Republicans.

The Dow Jones index lost almost 1000 points within a week of the election outcome, although it has since begun to recover slightly. Markets remain on edge globally until the US fiscal negotiations are concluded. Many analysts believe a grand compromise will be fashioned before year end but there remain many doubters. Ultimately the markets will dictate to the politicians and ensure that a deal is reached - hopefully before New Year. Sadly many normal business capital expenditure, investment and related hiring decisions have been put on hold pending the outcome of negotiations.

While global equity markets have suffered, bond prices have risen in the US, the 10 year Treasury again swooning to near record lows of 1.60% - levels last seen almost four months ago. The bond bull run continues in the US for now, but we predict rates will head higher as soon as a compromise is fashioned.

Given the recent market volatility, investors are expected to remain on the sidelines. During October, the MSCI US Index lost 1.9% although it remains up 13.7% year to date. The MSCI World Index lost 0.7% for the month but also remains up by 12.3%. Not surprisingly most observers do not expect any further gains for the year, unless an agreement is reached in Washington over the fiscal cliff. The recent equity market losses show most of the uncertainty is now priced in.

By comparison emerging markets have gained 12% for 2012 (MSCI Emerging Markets Index), constrained somewhat by China's falling stock market – now at its lowest point since the crisis of 2008.

The developed world outside the US as measured by the MSCI EAFE Index gained 0.8% and is up 7.8% for the year. The Asia-Pacific region retreated by 0.4% but has gained 4.8% during 2012. However when excluding Japan from the Index the region has posted impressive gains of 15.5% year to date – double the MSCI EAFE one year growth rate.

Uncertainty has also returned to the Eurozone where Greece's bailout financing was held up at last minute despite the Greek parliament approving the country's next austerity budget. While the ECB has been pragmatic in buying record amounts of Eurozone bonds and attempting to help out the weaker sovereign debt markets, the focus has now shifted to the political decision makers who have the final say on when bailout funds are transferred to Greece.

At the same time France lost its AAA rating and concerns are growing that the entire Eurozone will remain in a recession for much of 2013. The continued set of austerity budgets across the region continue to hamper any prospects for renewed economic growth.

The ECB actions while offering unlimited bailout funds for such peripheral Euro nations as Greece, Spain and Portugal – has helped to reduce long term yields on sovereign debt and effectively bought the Zone more time by putting a temporary band aid on the festering wound. However the governments of these nations have to formally request bailout funds so further delays are expected in Europe since requesting funds from the ECB is seen as unpalatable by many electorates in the peripheral parts of the Eurozone. Spain in particular is seen as the next key dyke in the wall of the Eurozone. How much longer can Spain hold out before requesting a full bailout? The MSCI EMU shows a 1.7% gain for October, and a year to date gain of 13.4% - however with the weaker Euro when measured in US$ these returns are considerably weaker.

Weak Chinese growth figures plus the change in leadership there have kept Asia's largest economy under pressure and its stock markets at 5 year lows. For now the commodity boom cycle seems to have peaked, although gold is benefiting from all the Eurozone and US fiscal uncertainty, staying above $1700 an ounce.

Outside of equities – the US property markets continues to stabilize with most key housing markets beginning to show signs of month on month gains. The US REIT index is up 13.4% during 2012, while the European Property Index also remains up an impressive 24% for the year (Citigroup BMI Property Eurozone Index).

Global Bond

The late summer dramatic Central Bank moves led by the ECB and Fed temporarily helped reduce long term sovereign and corporate rates in addition to mortgage rates across the developed world. However these actions have not helped resolve the Eurozone's bailout of Greece and possibly Spain.

The looming year end fiscal cliff in the US has helped boost bond prices and push the 10 year Treasury to record lows of close to 1.6%. The bullish bond market has not helped confidence, with gold pricing at over $1700 an ounce.

Until the Congress and White House resolve the fiscal issues, uncertainty will dampen any chances of economic growth in the US. Businesses fear the uncertainty in Washington and have vocally come out in favour of a grand bargain between Republicans and Democrats. For now most CEOs of large companies in the US are holding back on large scale expenditure. According to Fed Chairman Bernanke, another problem is weak availability of credit amongst the banking industry, where he feels the pendulum has swung too far on the side of caution

since the housing meltdown in 2008. Despite some positive news on housing, it is unlikely the overall US housing market will show a strong healthy recovery for years.

With weak hiring the likelihood is that unemployment could rise above 8% again, in the event no agreement is found in Washington before the New Year.

Since any inflationary fears remain muted, central bankers have felt empowered to make dramatic gestures to ensure the world's leading economies do not fall back into a recession. With a growing number of Eurozone members already in recession and austerity programs set to continue in a wide variety of Zone countries, the fear exists that Europe could remain in recession for much of 2013.

Spain may well require a bailout along with Greece and government moves by both these countries could yet disrupt equity market confidence as we head into the final closing months of the year. Given the impending fiscal cliff in the US budgetary negotiations it is likely that we may have seen the top of the equity rally as of September. By mid October developed markets have already retreated by 3%-4% off their September highs.

A weaker Euro would be helpful for exports from the region, but with the US itself in a fiscal mess, a weak US$ policy will likely remain - thanks to the Fed increasingly priming the printing presses. US policy makers are happy to see a Euro appreciate almost 10% against the US$ during the past month.

It seems likely that the US economy is most likely to emerge stronger than Europe for some time to come – benefiting from growing exports and manufacturing due to the weaker US$ and real wages in the US continuing to fall for the middle class. The divide between rich and poor in the US has arguably never been greater as the middle class sees its standard of living fall further. However with high unemployment, US corporates are able to rehire workers at lower wages and with far less benefits – making the US far leaner and meaner to take on the global economy than it was prior to the Great Recession of 2008-2009.

The Citigroup World Government Bond Index is up just 2.8% for 2012, while the European Government Bond Index is up 8.2% over the same period (in Euros).