GinsGlobal Index Funds

Investment Outlook – August 2010

Global Equities

August experienced an equity market pull back with the Dow dropping briefly below 10,000 and most global markets suffering a drop of approximately 4% in local currency.

Although September to date has retraced these losses, the weak economic data continues – particularly in the US. Continued concerns about European recovery has helped drive government bond yields lower in August across all major markets. The US 10 year Treasury Bond dropped to a 30 year low of 2.6%.

The likelihood of a double dip recession in the US is extremely low, but growth is likely to be very weak for the duration of 2010 and 2011. Further quantitative easing by the leading Central Banks worldwide is still a strong possibility as everything possible is being done to prevent any further economic contraction.

The US jobless recovery will continue to put a damper on any housing or real estate recovery. With the upcoming US election, no major economic policy initiatives are expected until the next US Congress (beginning January 2011). The likely expiration of the Bush personal tax cuts means that most US middle class workers will face higher tax bills in the midst of a very weak economy. This sends the wrong message to the markets. A Republican victory in the Congressional election will likely see a renewed boost to the markets – particularly if the Republicans win both houses of Congress in November. Lower tax rates will then likely be maintained through at least 2011.

The unemployment rate is expected to remain around 9% for the next 6-12 months – a 25 year high. Few commentators expect the jobless rate to reach its pre recession rate of 5.5% until close to 2014. The risk of any inflation has completely receded and the risk is now deflation. The expectation is for the Fed to leave rates on hold for far longer than previously expected. We could be in this holding pattern on rates for another 18-24 months. Weak Eurozone growth will further constrain any Fed tightening that may have been predicted for late 2010. Despite emerging market growth, these developing countries (BRICs) in particular cannot alone help boost world economic growth, when burdened by slow developed country growth.

Despite this, we still believe valuations are cheap in the US (S&P 500 PEs are trading at 15) – and believe any further sustained slowdown or correction is unlikely. A weaker US$ will ultimately be a boost for the US economy. Sentiment has already begun to turn positive on the Euro which has touched 3 month highs against the US$ at levels of $1.30 – an almost 10% rebound off its recent lows. This is all bullish for the US stock market.

The MSCI World (All Country) Index lost 3.7% for the month and remains down 6.2% for the year. The MSCI US market by comparison lost 4.5% for the month and is down just 5.0% for the year. Outside the US as measured by the MSCI EAFE, the monthly return was similarly down by 3.3% and is down by a whopping 9.8%, for the 2010 year.

The impressive rebound in the US REIT Index in July (up 9.9%) was tempered with a retreat of 1.3% in August. It remains up 33.3% over the past 12 months.

US corporations are in remarkably good financial health (outside of the banks) – due to low leverage, weak labor markets and top line revenue growth. Extremely low interest rates have also helped ease any debt repayment burdens and spur refinancing, often savings companies a small fortune in their borrowing costs.

Emerging market equities are more fully priced than developed markets. The concern exists that the booming commodity market and exports will taper off as the developed world continues to deleverage and consumer demand remains weak, for a much longer period than previously expected.

We remain bullish on the Asia-Pacific region excluding Japan – China in particular as well as Taiwan, Brazil and India.

Global Bond outlook

Continued weak economic data in the US during August drove the 10 year Treasury Bond yield down to record lows of 2.6%. It is clear the US economy is not firing on all cylinders and is struggling to regain any sign of its old confidence. Jobless claims fortunately may have plateau, in a large part thanks to government stimulus plans and the Fed preventing rates from rising.

The Fed intervention in purchasing more US government bonds indicates that has changed course, and expects a far weaker recovery – with unemployment levels remaining dangerously high, well into 2012.

The risk of inflation has receded and deflation is now the new watchword. With wages static or moving backwards and consumer demand lethargic, this appears to be the far greatest threat faced by the US economy over the next 12 months. With US unemployment rates at 25 year highs, wage growth is nonexistent, US consumers are still laboring under way too much debt – thus it will likely take years for US consumers to repair their balance sheets.

The Fed will keep rates at these historical low levels as long as possible to assist the housing and broader real estate markets.

Given weak corporate lending, the Fed has no desire to raise rates – in fact Chairman Bernanke is actively encouraging banks to increase their lending books to small business so that these businesses can begin to add to their payrolls and production. 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. The two government owned entities, Freddie Mac and Fannie Mae, have now been subsidized (bailed out) to the tune of $150bn with at least another $30bn expected. They now insure over 90% of all US household mortgages as the private sector has largely left this business alone. Without Fannie and Freddie, the real estate market would be completely dead. Over 3 million additional foreclosures are expected in the residential property market, while commercial property remains in the doldrums for the foreseeable future. Retail vacancies are at a 25 year high too.

Both the ECB along with the 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 fully appeased markets. Given that bonds are a virtual safe haven from equities, it was not surprising to see the European Government Bond Index gaining 2.6% in August and is up 5.9% for the year.The Citibank Global Bond Index gained 2.0% for August given the expectation of low rates persisting. For the year to date it is up 4.6%. Over the past 3 months it has returned a total of 7.5%.

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

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 still expected to recover far quicker than most of the Eurozone laggards mentioned above. It is expected that Asia will outdo both these two old world economic regions.