Investment Outlook – January 2009

Global Equities

After a December rally, the market experienced a severe shock in January – with most industrialised countries suffering their worst January performance in decades.

Weakening economic data from the US and Europe – showing increased unemployment and precipitous declines in economic growth led to a major market correction in January.

US unemployment is now expected to reach between 9%-10% within the next 12 months – earlier expectations had been for perhaps a maximum 8% unemployment rate to be reached. The delayed US stimulus package that was passed in mid February will likely only stem the bleeding of government and state employment rolls. Private sector layoffs are expected to continue. January's US layoffs of almost 600,000, following a similar layoff number in December – means the US has now lost over 2 million jobs since the credit and financial crisis hit some 18 months ago.

Retail bankruptcies are beginning to gather pace in the US amongst well established electronics and clothing stores such as Circuit City and Linen 'n Things. Toy stores also are not immune.

A bank rescue package for the leading European and US banks will likely prove more important in the medium term than any government stimulus package. Until the banks are able to operate normally with regular lending practices and diminished foreclosures – but without the extension of credit, the economies will not recover for a much longer time than has been projected by analysts.

We believe it is vital to have a well diversified portfolio that is defensive in nature – with a larger exposure to non equities until the volatility in markets is reduced. Nevertheless this is bargain hunting time in the leading equity markets and for investors with a medium to long term outlook this is surely a tremendous buying opportunity over the next 5 years

Meanwhile the $350bn bailout of the US banking sector has not helped revive the property market and continued bailouts are expected of up to $1 trillion for US banks over the next year.

The MSCI World Index lost 8.8%, for January, while the Eurozone lost 15.0% (in US$ terms). The US lost 8.2% in January as measure by the broad MSCI US Index. Narrower measures such as the Dow, suffered worse recording losses of approximately 10%. The rest of the World (non US) - as measured by the MSCI EAFE Index lost 9.4 and is down 45.4% over 1 year. The MSCI World reported a decline of 41.4% for the year in US$ terms.

The Pacific region lost 7.5% for the month in $ terms. (MSCI Pacific Index). It was down 38.6% for the past 12 months.

Increasing worries over real estate write downs, lack of bank liquidity and esoteric financial instruments have created fear in the markets. The S&P 500 is now at levels last seen 10 years ago.

It is clear the US financial system will continue to see failed banks, and the real estate meltdown will persist for another 12-18 months – when prices are expected to bottom out. Housing prices have already fallen approximately 20-25% across most US markets – but further declines are expected.

Global Bond outlook

While safe havens such as government bonds have attracted sizable inflows there is a growing fear that a bubble is being created in the bond markets – particularly the US Treasury market where yields have been driven to historic lows.

Investors need to be careful of a yield rebound which will have a dramatically negative effect on returns possibly by year end.

Rates can only go up which could cause significant declines in US government bonds prices. As such, we suggest being underweight in the government bond sector.

The Fed has adopted a zero interest rate policy – with the ECB and UK central banks continue dramatically to reduce their rates. Recent data from the UK indicates the UK is in equally bad financial shape as the US - re its banking sector and property markets. Such large UK banks as Lloyds-HBOS are close to being nationalized following hard on the heels of RBS being taken over by the UK Government.

Additional cuts in ECB and UK central bank rates are still likely as the worldwide recession deepens during 2009.

Spreads on corporate, high yield and municipal bonds over governments are now also at historical highs. This spread is expected to contract as LIBOR and government yields recover to more normal levels in mid 2010.

The European Government Bond Index lost 1.2% for the month (euros) but is up 5.5% for the year. The World Government Bond after recorded an impressive 7.1% return for December, retreated 4.3% in January and is now up just 2.3% for the past 12 months.

Dollar strength has removed a concern the Fed may have had concerning lowering rates further and rates approaching zero on the Fed Funds rate are expected by the end of the year. Other key central banks will then feel free to follow the Fed's course down, to rate levels only seen in living memory in Japan.

Consumer spending across the globe is expected to dry up and unemployment across the world will rise to levels last seen since the early 1970s. There is a growing fear that government bailouts will not have a dramatic impact and it will take considerable time to work through the system – with mid 2010 now being the date where economies may show some relatively decent signs of growth.