Investment Outlook – December 2009

Global Equities

For the year 2009 equity markets posted an impressive recovery, considering the March lows experienced at the peak of the crisis.

The MSCI World Index returned 1.8% in December, recording a 30.0% total return for the year. By most measures including P/E ratios – the easy money has now been made on the recovery. However over a 3 year period the global equity index is down some 16.0% still.

December witnessed a stubborn increase of 85,000 further jobs losses in the US, with the unemployment rate remaining at 10%. However as job seekers re-enter the market looking for jobs in the recovery, the Fed does not expect unemployment to drop much below 10%. It is expected that it will take at least 4-5 years for unemployment levels to retreat back to the pre crisis levels.

The market has priced in a modest recovery now that the recession is officially over, with the posting of a 3.5% GDP growth rate for the 3rd quarter. Fourth quarter growth is expected to look similarly good given the benefit of the holiday season consumer spending binge.

Clearly the ongoing weaker US$ is also playing a major role in the US market's resurgence –given that more than half of the earnings from US companies in the S&P 500 originate from abroad. Thus a weaker dollar helps US exports and results in currency gains (boosting foreign earnings) - directly affecting the bottom line.

The broad US stock market index measure – MSCI US Index gained 2.0% for December and is up 26.3% for the year. Non US stocks as measured by the MSCI EAFE index gained 1.4% for the month and are up 27.8% for 2009.

The Pacific region saw a 1.2% gain for the month and returned 21.2% for the year in US$. The MSCI EMU (Eurozone) gained 0.9% for December and 27.0% for the year. Thus returns were very highly correlated amongst the industrialized markets in 2009.

Given the impressive gains over the past nine (9) months, many believe the market will need to pause and possibly retreat later in the year (midyear). This is increasingly likely in the event economic growth forecasts and jobless claims continue to disappoint as the year unfolds. Emerging markets which have posted the most gains on a relative basis – may be the first region to suffer from a change of sentiment, should economic recovery under-perform.

The US REIT (listed property) market posted an impressive gain of 7.0% for December following an equally impressive November return of 6.9%. The 2009 total return amounted to 28.5%, although it remains down 35.6% over three years.

The Japanese market gained 8.9% for the month and returned 9.1% in US$ for 2009.

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 – when prices are expected to bottom out. Approximately 140 smaller US banks were liquidated or taken over during 2009 – a record over the past 2 decades.

Global Bond outlook

All indications are that the Fed is uneasy to increase rates any time during 2010. In fact the reduction of the Fed's support – expected to begin in March may be delayed. The Fed is nevertheless expected to begin offloading large swathes of balance sheet purchases made the past 2 years to prop up the mortgage and corporate bond markets. At a minimum, the lack of Fed buying power will lead to increased US mortgage rates and rates at the long end of the yield curve.

The Federal Reserve remains hawkish on raising interest rates anytime soon – most recent Fed statements indicate that the risk of inflation is viewed as very minor considering that some 10 million jobs have been lost in the US over the past 2.5 years. (This figure includes the need to generate 100,000 new jobs a month simply to keep pace with the number of new job seekers.)

Currently the Fed Fund rate is 0.25% which has helped boost bank profits this year. Large banks are still hoarding much of their cash and have dramatically reduced commercial property lending. The lack of lending means that Main Street USA will not likely begin any significant job hiring until late 2010.

December proved a negative month for the bond market – with the global government bond benchmark losing 5.0% - posting a annual gain of just 2.6%, although over 3 years it has posted an impressive 26.2% (Citi World Government Bond Index). By comparison the European government bond market lost 0.71% in December but is up 4.4% over one year.

The Fed has to still convince the market that it is not going to let inflation loose, Bernanke is likely to simply remove the Fed's own spending and enlarged balance sheet purchases and related interventions beginning in early 2010. Removal of these quantitative easing measures will negatively impact the housing market, so any reduction is expected to be gradual.

A 2nd wave of US foreclosures is only now beginning to hit as further layoffs affect 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 the strong euro and huge 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 hoped that Asia will outdo both of the old world economic regions.