# Investment Outlook – December 2010

## Global Equities

The global equity markets enjoyed a healthy recovery in December which has continued through mid January 2011. More positive economic data in the US specifically regarding job growth and positive corporate earnings report, point to a re-rating occurring for the stock market during 2011. Most analysts expect the market to enjoy healthy gains approaching 10% for the year.

While Europe continues to wrestle with sovereign debt issues affecting such peripheral countries as Portugal, Ireland and Greece, recent German and French economic data also point to an uptick in economic confidence and activity.

Nevertheless weaker than required economic growth means the Fed will continue with its QE2 (quantitative easing) program, allowing it to buy an additional $600bn US Treasuries over the next eight months. This bond purchase aimed at keeping rates low and stimulating the economy, will ultimately total a $900bn infusion. A weaker US$ is expected if the Euro overcomes its problems with an increased stability package and larger Eurozone lending facilities. ECB intervention in the European bond markets is also assisting the weaker sovereign countries. So Europe is expected to prevail this year given its active stance. One should also not discount the ECB President Trichet wishes to leave a decent legacy as his term winds down this year. More intervention can be expected if required.

During the first weeks of December a tax agreement between Obama and the Republicans also had a definite impact in boosting sentiment across US equity markets.

While US retail sales have held up well over the recent holiday season, the lack of job creation is a worrying trend with almost half the unemployed being out of work for 6 months or longer – this is an unprecedented phenomenon in the modern day US labour market. Consequently a structural unemployment level exceeding a high level of 8% is expected to prevail throughout the next 18-24 months.

For December the US market enjoyed gains of 6.6% (MSCI US Index), finishing the year up by 14.8%. Globally developed stock markets as measured by MSCI World enjoyed a 7.4% gain for the month and 11.8% for the year. Small and mid caps continues to outperform large caps over the past year.

Although continued concerns about the US economic recovery helped drive government bond yields to historic lows throughout 2010, by early December yields began to spike as a large bond sell off occurred. In less than 3 weeks, yields have risen more than 60 basis points on the 10yr Treasury Note to around 3.5%. Higher rates will limit economic growth and put a dampener on the US housing market recovery.

A further concern is the rising oil price to almost $100, as other commodity prices also hit near record highs. Oil at these current highs can put a drag of 0.50% on US GDP according to past experience.

Despite difficulties in the Eurozone, the Euro is expected to remain strong relative to the US$, despite recent levels below 1.30. The Fed seems happy to weaken the US$ as it seeks to maximize US economic growth. The broad Eurozone market index gained 5.3% in Euro terms for the month and returned a positive 2.4% for the year.

An impressive rebound in the US REIT and Eurozone real estate indexes occurred in December with both indexes gaining 4.7% (US$) and 8.9% (in Euros) respectively.

Emerging market equities remain more fully priced than developed markets. US PE ratios on the S&P 500 are at levels of 14 for 2010 and 12.5 for next year which are below long run averages for this market. PE ratios for large cap stocks in developed countries (US and Europe) remain cheaper in many cases than their Emerging Market counterparts – based on comparable risk profiles.

**Global Bond outlook**

Based on the significant uptick in US government yields the past few weeks, it is clear that the Fed's quantitative easing has not really worked as expected. Rates well below 3.5% on the 10 year Treasury Note were expected, however rates in fact exceeded this level in December. This was partly due to the new tax deal agreed in Washington DC that has led to growing worries of an unsustainable budget deficit – which has translated into far higher Treasury yields in early December.

The tax deal will likely have a decent stimulus effect on the economy, with upper income earners benefiting from continued low tax rates for another two years and the payroll tax being cut by 2%. The average American will save an additional $1,000 in taxes from the payroll tax alone.

While interest rates will remain relatively low well into 2011 – the recent increase in Treasury yields to 3.3% on the 10 year Note point to a larger sell off of US bonds during 2011. Continued worries over municipal and state finances will lead to a further erosion of demand for US bonds, leading to higher rates. This will have a detrimental effect on the already weak real estate market which many believe has entered into a double dip – particularly on residential properties.

A massive overhang of foreclosed properties exists – some 5 million that are expected to come onto the market over the next 24 months as rates reset.

It seems the US bond bubble may have finally been pricked in early December as rates head upwards albeit still at historically low levels.

Given record inflows into bond mutual funds in the US the past 2 years, many retail investors are now rushing for the bond exits and this will help fuel interest in the stock market, likely further pushing up equity prices.

Meanwhile the difficulties in the Eurozone have led to significantly higher government bond yields in Portugal, Ireland, Spain and Greece. Further bailouts in Europe are expected as peripheral problems spread to Spain and possibly Italy. The $100bn EU financing to assist Ireland with its bad bank problem is only a temporary measure according to many analysts.

With US unemployment rates at 25 year highs, wage growth is nonexistent, US consumers still laboring under way too much debt – it will likely take years for US consumers to repair their balance sheets.

The Fed will keep rates at these historical 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 – 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.

Higher rates in the US and Eurozone has led to Citibank Global Bond Index recording a 1.8% gain for December, and 5.2% for the year – well below earlier tends in 2010 when the index was up over 7%. The Euro Government Bond Index lost 0.3% in December and only gained 1% for the year.

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 Irish bailout of their banks and government deficit (reaching a massive 33% of GDP for 2010) – shows that the Eurozone laggards will continue to limit economic growth on the Continent.