

## Investment Outlook – February 2011

### Global Equities

The global equity markets continued its healthy recovery in February, following a positive January. Economic data in the US and Europe showed positive gains as unemployment dropped and monthly job gains were amongst the highest levels in over 2 years. In the US, net job gains approached 200,000 exceeding expectations. At the same time the Fed continued its program of QE2 (quantitative easing) – helping to suppress US interest rates and making US equities more appealing.

Encouraging corporate earnings report also helped fuel the gains in stock prices across both the US and most global markets. The US continued to record new post Lehman highs with the Dow exceeding 12,300 while the S&P pushed through the 1300 level.

Developed markets continue to outperform emerging and developing markets the past few months.

The Global Developed world index (MSCI World) gains 3.3% for the month, and is up 5.6% for the year to date and 19.3% over the past 12 months. This compares with the MSCI BRIC and MSCI Emerging Market Indexes – both posting far weaker returns as follows: 0.9% and -1.0% (respectively) in February and for year to date: -2.4% and -3.8% respectively.,

Non US developed markets showed encouraging gains too, with the MSCI EAFE recording a 3.1% monthly gain and is now up 5.5% during 2011 and 16.8% for the past year. The Eurozone as measured by the MSCI EMU gained 2.7% in February and 9.5% for the year to date (all US\$ measures.)

While much of 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.

A weaker US Dollar on the back of continued Fed QE, has assisted most large US exporters to post encouraging earnings. With the Euro recovering to 1.40 to the US\$, European exporters are less competitive than they would prefer to be, relative to US players. This will continue to feed into better US corporate earnings as overseas earnings are converted into US\$. This is particularly true of the S&P 500 constituents who earn more than 50% of their profits from outside the US.

The MSCI Pacific Index has also performed well – up 3.3% for February, 2.9% for the 2011 year and 16.0% for the past 12 months.

The lack of a full economic rebound and relatively weaker job growth at this point in the economic cycle than normal – has meant Central Banks continue to maintain the stimulus and keep interest rates at their low levels. No further rate hikes are imminent, although the ECB is likely to come out ahead of the Fed later this year with a rate rise – given its strong anti-inflationary mandate. By comparison the Fed has a mixed mandate to foster economic growth and jobs – while ensuring inflation is kept in check. In reality this means the US is likely to indulge in lower interest rates for considerably longer than the ECB or other leading Central Banks.

The fear of deflation in the US no longer exists and the Fed will continue with its QE2 (quantitative easing) program, allowing it to buy the remaining portion of the \$600bn US Treasuries over the next few months. This bond purchase is aimed at keeping rates low and stimulating the economy, will ultimately total a \$900bn infusion. Higher oil, food and commodity prices do threaten to hike

inflation rates across the globe. While food inflation has less impact on the US, global inflation is now affecting China and many developing countries are more sensitive to commodity and food imports. A further concern is the rising oil price exceeding \$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.

Given uncertainty in the Middle East, inflationary pressures remain the main obstacle to retaining lower interest rates. Emerging Markets saw a large outflow during the first week of February as a consequence of political maneuverings in Egypt and a possible flight to developed markets continues to be a real possibility.

The recent Obama administration policy shift to embrace big business and sign off on an attractive tax bill and more business friendly policies is also likely to encourage business leaders to begin hiring and consider larger M&A (acquisitions) transactions. In effect the new White House policies reducing tax levels have boosted business confidence in Corporate America.

The main weakness in the US remains in the lack of job creation and the slow real estate and construction recovery. Consequently, a relatively high unemployment rate exceeding 8% is expected to prevail for up to another 18-24 months. In fact it is expected to take 4-5 years to get back to a normal level of unemployment in the US (around 5%).

After an impressive rebound in the US REIT the past few months – it continues to power ahead of its Eurozone rival index. The US REIT index gained another 4.6% in February and is now up 8.3% for 2011 and 39.2% over the past 12 months.

Emerging market equities remain more fully priced than developed markets. US PE ratios on the S&P 500 are at levels of 15 for 2011 which remain 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

Despite inflationary threats due to higher oil prices and the unrest in the Middle East, the key Central Banks (ECB and Fed) maintained their low rate policy and have kept their rates on hold.

Nevertheless long term rates in the US continue their upward trend which is limiting any recovery in the mortgage market. Real Estate prices – both residential and commercial remain in a slump. Refinancings are well down from their highs seen in 2010.

Although the 10yr Treasury hit 3.75% by early February, by mid March it had fallen back to 3.25% following the Japanese earthquake. This may help boost the US property market if long term rates (30 year mortgage rates) also subside in March-April.

With no threat of deflation – Bernanke is expected to keep US rates lower for much longer than the ECB and other Central Banks. It is for this reason plus a weaker US dollar, that US equities and bonds remain more in demand – acting also as a safe haven.

Once QE2 is stopped, the Fed runs the risk that rates will rise in the US as the Fed no longer buys Treasuries. The consensus is that rates will rise later in 2011 as the Fed's buying spree disappears from the bond market – thus driving bond prices down and rates higher – due to less demand.

The concern remains that higher rates will dampen any real estate rebound, putting a further drag on construction employment and home sales.

The lack of any agreement over how to tackle the huge US budget deficit – remains as a sword of Damocles over the bond market. Higher US rates are likely required to offset concerns that the US administration is not keen to tackle the tough business of dramatically reducing the deficit to more sustainable levels. The new Obama budget released in February did not tackle any of the tough

questions – leading experts to predict that US bond rates will need to rise over time to satisfy foreign investors concerns that the US does not have a handle on controlling its growing budget deficit. It is expected that only after the 2012 Presidential election that tough choices over the budget will finally be made. The next 18 months leading to the election will likely see mostly minor tweaks to the budget process with no single political party willing to stick its neck out to demand specific budget cuts over medical care, social security or taxes.

Despite the rise in oil and inflation threat, the Fed is expected to keep rates at the lower levels for much of 2011, in order to try stimulating the economy as much as possible. An oil price reaching or exceeding \$100 on a sustained basis throughout this year, will dampen the economic growth outlook globally by as much as 1% and by at least 0.5% in the US.

Continued worries over municipal and state finances could lead to a further erosion of demand for US bonds, leading to higher rates. This would definitely 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.

The differential between short term US rates and long term rates is now at its widest level in many years – this seems unsustainable over the long term however. Consequently short term rates will begin to rise throughout 2011. Eventually the Fed will be forced to act too and raise rates.

Given record inflows into bond mutual funds in the US the past 2 years, many retail investors are now rushing for the bond exits (ahead of rate rises expected towards the end of 2011). 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 non existent, US consumers still laboring under way too much debt – it will likely take years for US consumers to repair their balance sheets.

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's Global Bond Index gaining 0.4% in February, following a flat January - while it remains up 5.2% 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 threat of inflation exceeding levels of 3% in Europe may compel the ECB to also act in the next few months to raise rates. For now the UK and ECB central banks are expected to remain on hold through the spring and possibly into summer.