Investment Outlook – July 2010

Global Equities

July experienced an equity market rebound with global markets all generally higher. However weaker US data in August has led to fears of another major slowdown in economic growth. Only German, France and UK economic recovery looks on track with other Eurozone laggards such as Spain, Portugal and Greece pulling the region down.

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. The Fed has stepped in and continues to buy US government debt helping to drive yields down to historic lows – the 10 year Treasury yield hit 2.6% in mid August – reflecting growing nervousness and a flight to safety.

The US jobless recovery will continue to put a damper on any housing or real estate recovery. 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. The risk is now deflation. The expectation is for the Fed to put 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 this, we 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. Favoured areas are the US and emerging markets, as Europe seeks to get its house back in order. The austerity measures being introduced across the Continent means that European growth will be hampered for at least the next 12-24 months. Spanish unemployment has hit 20% levels and a Greek default or massive restructuring of its debt is still predicted by many.

Remarkably, 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. A stronger British Pound is also likely to assist US exporters – all bullish for the US stock market.

The MSCI World (All Country) Index gained an impressive 8.1% for the month but remains down 2.5% for the year. The MSCI US market by comparison gained 7.0% for the month and is down just 0.6% for the year. Outside the US as measured by the MSCI EAFE the monthly return was a whopping 9.4%, although it remains down 6.7% for the 2010 year.

The impressive rebound in the US REIT Index up 9.9% for the month and 55.0% over the past 12 months, is almost matched by the European Real Estate Index which gained 9.2% for the month – over 12 months it is up a more conservative 26.0% (in Euros).

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 saving 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 (down just 0.5% in June) - has announced a more flexible exchange rate policy, while no significant tightening has occurred. Other key emerging markets such as Brazil (up 6.8% in June) and Taiwan (up 5.0% for the month) are expected to power the region and emerging market growth.

Global Bond outlook

Weak economic data emanating from the US in July and early August foretells an economy struggling to regain any sign of its old confidence. Jobless claims continue to rise, while the Fed continues to do all in its power to keep a lid on interest rates rising and boost economic activity.

The Fed intervention in purchasing more US government bonds, indicates that it 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 the new watchword. With wages static or moving backwards and consumer demand lethargic, this appears to be the far greater threat faced by the US economy over the next 12 months. 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.

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.

In Europe the market is now expecting the Eurozone to inflate its way out of the debt crisis, by pumping in more money from the ECB to buy up government bonds and effectively devalue the currency relative to the US$, Yen and other leading industrialized currencies such as the Swiss Franc. Consequently, both the ECB along with the Fed, is also 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 0.9% in July although it is up 3.2% for the year.

The Citibank Global Bond Index gained 3.6% for July, given the expectation of low rates persisting. For the year to date it is up 2.6%.

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

The ECB has stepped in with promises to effectively buy hundreds of billions of Euros worth of southern European debt – this has led to borrowing rates amongst some of the weaker members dropping by half on the day of the ECB's intervention being announced. This quantitative easing and propping up the Euro Bond market – will cause inflationary pressures over the next 18 months. This is especially true give the recent impressive economic GDP growth figures reported for Germany and France over the 2nd quarter.

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.