



Investment Outlook – July 2011

Global Equities

Fears of a double-dip US recession pervaded the markets in early August. US economic data made the likelihood of another recession occurring far more likely. It is clear that the latest poor data will have a negative effect on US corporate earnings – being revised downward. In turn, this has led to a broad based sell-off in equity markets.

Growing concern that the sovereign debt problems in Greece, Portugal and Ireland would spread to Italy and Spain became increasingly acute when Italian and Spanish government debt saw yields rise to extreme levels. With European leaders and regulators continually one-step behind the sovereign debt crisis – markets remain nervous that Europe will not get to grips with the massive debt overhang suffered by some of its members. Calls for the issuance of Eurobonds and a new Euro-wide super-Finance Ministry are growing.

Spain and Italy have both finally taken budget cutting measures to show their serious intent to bring their debt levels down to more sustainable levels. Broad structural economic change is required in both countries where high unemployment and a labyrinth of business regulations stifle broad economic growth.

Political leaders continue to play catch up and have not shown a desire to get ahead of the lingering debt problems toiling Greece and other weak Eurozone members. Sovereign concerns persist in Europe primarily due to the twin problems of solvency and liquidity. It seems some form of debt restructuring for the Eurozone's weaker members is inevitable. Eurobonds issued by the ECB are the most likely course but this may take many months. Talk of imposing new taxes on financial transactions and banning short sales – will likely backfire. The German DAX index is now down almost 20% from its recent highs.

Similarly, the messy debate in Washington to reduce the US fiscal debt and raise the debt ceiling – has led to the Standard & Poors downgrading from AAA. This vote of no confidence in Washington of being able to clean up its fiscal mess is what set markets off on a downward spiral at the end of July and early August. It is unlikely that there will be any significant fiscal breakthroughs in the US until after the 2012 presidential election is concluded (15 months away).

For now Congress and the White House staved off a default with a last minute compromise that disappointed the markets – with no grand bargain agreement to cut US spending and reduce the deficit. The cuts announced amounted to less than 1% of the fiscal budget. A super committee of Congress now has to work out the details.

Continued weak US jobs and housing data point to a slow down – with many analysts believing the US may already be in a double-dip recession. President Obama is getting much of the blame for this, given the large number of new regulations and health care costs approved by his administration. He is expected to try revive his presidency by announcing a broad-based job creation plan in early September.

Divided US government is effectively leaving the country in a state of paralysis on any of the tough long term questions of how best to tackle the debt and bring the budget deficit under control.

Weak Eurozone economic data led by poor German 2nd quarter growth figures that barely registered positive – translates into volatile markets for some time to come.

The Global Equity developed world index (MSCI World) lost 1.8% in July after a 1.6% decline in June. By mid August the loss had extended another 14%, wiping out any earlier gains in the year. Similarly the US market lost 2.0% for the month after a 1.7% loss in June. It is also now in a severe correction, down 15% from earlier highs.

The Eurozone as measured by the MSCI EMU lost 5.7% in Euros for the month, but by mid August has lost another 13%.

We continue to maintain that the US Fed will likely be the last major central bank to seek to raise interest rates, given the ongoing weak state of the US consumer. The Fed also appears to be the least worried regarding an inflation threat.

Global Bond outlook

The growing sovereign debt crisis in Europe and poor US economic data have led to interest rates coming down to levels not seen in 60 years. A flight to safety in 10 year Treasuries has pushed the yield down from over 3.6% earlier this year to 2% by mid August. Such low rates have not been seen in 60 years.

The flight to safe havens has led to gold spiking at over \$1800 per ounce and the Swiss Franc hitting all time highs against the US\$ and Euro.

The Fed has acknowledged its earlier economic growth assumptions were too optimistic, and to stem market turmoil announced that it will hold its Fed's Fund rate at effectively zero for the next two years. This effectively confirmed that the US economic growth is anemic at best, and it may plunge into an official recession at any time.

With rates now mirroring what occurred in Japan the past 20 years – many are pointing to Japan as a possible disastrous road map that the US may be entering. This seems too negative. The US has far more economic diversification, resilience, flexibility and resources than Japan - so it is likely to stage a far faster recovery than Japan ever did.

Nevertheless it is true that the US consumer was massively overleveraged during the early 2000s. Far less consumer demand will exist once the economy resets. The economy can no longer be so depended on the US consumer to spend. Broad based capital investment and infrastructure needs are now also required to rebalance the US economy. A weaker US\$ certainly helps boost exports and make the US an increasingly attractive location to manufacture and assemble high-end goods.

With the Fed holding rate steady for another 22 years – it is clear that they are worried about a double-dip recession and want to do as much stimulation to keep the economy from slipping into recession again. Many believe a form of QE3 (additional quantitative easing may also follow) – but in a more informal process than before. So no official QE3 announcement is expected.

With US unemployment rate at 25 year highs, wage growth (wage inflation) nonexistent, and US consumers still laboring under way too much debt – it will likely take years for US consumers to repair their balance sheets. Consequently, the lack of consumer demand will depress many sectors such as retail and housing.

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. 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.

The Citibank Global Government Bond Index was up in July by 2.3% and 6.4% for the year. US REITs were also up 1.8% and 13.0% respectively during this time. Bond prices will continue to rise as investors rush to safe havens.

Despite the S&P downgrading from AAA, US Treasuries now yield almost 1% less on the 10yr than before the downgrading. So S&P's effect cannot be seen – instead of bond yields rising, the opposite has occurred, primarily due to increased economic weakness globally and growing uncertainty in solving the European debt crisis.

Not surprisingly, the European Government Bond Index was flat for July and has shown no growth for the year.

The sustained global economic recovery hoped for earlier in the year has evaporated, and a flight to safety has resulted in bond yields being pushed down to historic lows. The rush out of equities will continue to lead to volatile markets as investors reassess their views on corporate earnings in a weaker economic environment than previously thought.