

Investment Outlook – June 2009

Global Equities

Equity markets posted an incredibly strong 2nd quarter recovery. The market consensus is that a market meltdown was unlikely and the worst of the financial crises is behind us.

There remains skepticism that the green shoots are convincing. However better than reported earnings numbers in Europe and the US in early July do point to signs of economic stabilization that in some sectors such as technology, the worst is over.

Nevertheless a decidedly mixed picture is emerging regarding how sustained any economic recovery will be – with most experts predicting a very slow recovery. What can be said is that the pace of unemployment, layoffs and housing foreclosures is lessening across the developed world – as the most recent monthly figures indicate a slowing in all 3 categories over numbers reported earlier this year.

Emerging markets have shown the strongest recoveries amongst the equity markets to date particularly in Brazil, India and China. For the first half of June 2009 Shanghai posted a 62.5% gain, followed by Brazil with 37%, MSCI Emerging Markets with 32.2%, Hang Seng up 27.7%, Nikkei 12.0%, MSCI World 4.8% and S&P 500 up 2.0%. Over this period the German DAX remained flat at 0% while the FTSE 100 lost 3.1% and the Dow was down 3.7%.

By mid July, markets posted impressive gains wiping out the Dow's first half loss and moving it into positive territory for the year.

For the 2nd quarter, US financial stocks gained 35.7%, US small caps posted a 21.1% gain, US large caps were up 15.9%, followed by US Energy stocks at 10.7% and US Bonds up 1.8%. Technically speaking a new bull market began on March 10th this year with the S&P Posting a 40% gain through to June 12th.

Although talk of recovery and green shoots pervade the press – the reality is that the economic data for both Europe and US remain extremely mixed as overall unemployment numbers push new highs. The US is now expected to top out at a 11.5% unemployment level – not seen in over 25 years. This is more than double the 4.4% unemployment level at the beginning of the recession. Over 7 million American have now lost their jobs since the recession hit in 2007. Estimates are that unemployment, when factoring in under-employed and furloughed workers would reach 16% currently. Key US states are in particularly bad fiscal shape including Florida, Arizona, New York, Michigan and California. California's unemployment rate has now hit 11.5%. Layoffs continue across all sectors, except health care and government.

US housing is expected to still lose another 10-15% over the next 12 months when analysts predict it will then begin to bottom out. The US commercial property market is the latest shoe to drop with dramatic effect. Banks are expected to show massive write downs on their commercial mortgage loans over the next few quarters.

New tougher financial regulation is now the order of the day and it is expected that both the US Fed and Bank of England will be given wide powers to reign in large banking and financial groups who threaten the overall financial system.

It is clear the US financial system will continue to see failed banks and the real estate meltdown will persist for another 12-18 months – when prices are expected to bottom out. Any economic recovery will be anemic at best and throughout 2010 the recovery in the US is expected to be largely a so-called jobless recovery.

Global Bond outlook

The threat of inflation has spooked the bond markets with rates rising and falling based on every new set of data. The Fed has had to convince the market that it is not going to let inflation loose, despite every indication that this is the case. Any worries about deflation in the US have largely evaporated now. The Fed is expected to hold off raising interest rates through till 2010, although some observers believe we may see a rate increase before the year is out.

During late May and early June US Government bond yields began a pick up – especially the 10yr Treasury Note reflecting possible fears of inflation. The bad news is that the mini mortgage refinancing boom that was kicked off earlier in the year after the Fed's entry into the bond market drove rates downward - has since fizzled out with mortgage rates recently jumping as much as 1% on 30yr fixed loans. Larger mortgages above the \$417,000 threshold of Fannie Mae have moved up beyond 6.2% which is stifling activity at the top end of the market.

Meanwhile a 2nd wave of foreclosures is expected to hit as further layoffs effect the market. A number of banks had also observed a 90 day moratorium whereby they did not actively foreclose on their clients. This 90 day period is now over.

Fears still exist that the US Treasury market for bonds will be a bubble that is likely to implode once interest rates begin to rise. US rates on treasuries that were at historical lows have begun to spike upwards; negatively affecting bond fund performance. Rates can only go up; therefore can cause significant declines in US government bonds prices. As such, we suggest being underweight in the government bond sector.

Spreads on corporate, high yield and municipal bonds over governments are now also at historical highs. The European Government Bond Index gained 1.25% for the month of June and is now up 11.4% for the 12 month period. The World Government Bond was flat for the month, but it is up 4% over the past year.

Consumer spending particularly in the US has dried up and any economic growth out of the US will be delayed and be very anemic at best. The US structural deficit continues to plague the US bond market and may lead to higher rates to attract foreign investors. Meanwhile the recent stimulus plan (\$780bn) has received much criticism for its failure to halt the bloodletting in the employment ranks. Less than 15% of the money has been spent to date – almost 6 months since it was passed.