Investment Outlook – March 2010

Global Equities

March saw world markets gain substantially, boosting the February recovery figures. The MSCI World Index rose 6.2%, the MSCI EAFE (non US industrialized markets) gained 5.8% and the Eurozone itself rose 7.9% (in Euros) or 6.6% (US$). This positive trend has since continued into April with global indices reaching 18 month highs in the US, Japan, Hong Kong, UK, France and Germany.

As the US recovery gains steam, analysts expect further gains in the market throughout the year. Nevertheless unemployment levels are not expected to fall much this year as the massive 10 million unemployed workers seek to reenter the marketplace.

With the recent Fed meeting leaving rates unchanged for bank inter-borrowing, it is clear that the Fed is keen to provide as much stimulus as necessary to avoid any possibility of a double dip recession. US real estate remains very weak and mortgage rates are required to be extremely low to provide necessary assistance to this sector. Most Fed watchers do not expect any sizable rate rises this year – possibly only one 25 bps rate rise later in the year.

Despite Fed intervention in the economy through massive bond purchases and consequently keeping mortgage rates low – it is clear that the increased stimulus and money supply is not leading to much inflationary pressure at this stage. The velocity of money remains very slow and much of the stimulus from the Fed is not being recycled into economic expansion. Instead much of the fed's intervention is leading to banks parking their excess capital overnight with the Fed, as opposed to lending it out.

The ongoing saga of the Eurozone solution to Greece's fiscal imbalance and possible contagion to other Eurozone members – notably the PIIGS (Portugal, Italy, Irelands and Spain) – has put the Euro under continued pressure – trading at around 1.35 levels to the US – 15% down from levels seen 5 months ago. Uncertainty in the UK on the outcome of the forthcoming election and also record budget deficits there , has pushed the Sterling to levels of 1.50 to the US$ - also 15% below levels seen late last year.

Although these weaker currencies should help boost UK and Eurozone manufactured exports, no fast turnaround is imminent. In fact Eurozone economic growth is expected to be far slower now than any US or Asian recovery and structural unemployment is growing across Europe.

Although US companies on the S&P 500 have mostly beaten market expectations regarding their earnings, much of this is on the back of once off expenditure cuts. Top line growth remains anemic at best.

The Pacific region gained 5.1% for the month (US$) ; and when excluding Japan, the region in fact gained a full 6.8% for the period. The Hang Seng and Nikkei are both trading consistently above the 21,000 and 11,000 levels, respectively, which is very encouraging.

The US (listed REIT index) property market posted a positive 10.2% return for March and is now up 113.5% over the past year. The European property market is similarly up 6.6% and 68.3%, over the past month and year respectively. (in Euros).

It is clear the US financial system will continue to see failed banks, and the real estate meltdown (specifically commercial properties) will persist for another 12-18 months – when prices are expected to bottom out. Over 300 banks have failed since the crisis began. US government financial reform is shortly expected to be passed, adding further costs and pressure on large banks and financial institutions. Another looming concern is the refinancing of massive amounts of commercial real estate and private equity transactions over the next 24-36 months which will test the robustness of the recovery.

Global Bond outlook

No major moves by the Fed are expected throughout the year. Although the Fed raised the US discount rate earlier this year – the rate which it lends money to banks by 0.25% - as expected no further rate hikes were announced by mid March.

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

Mixed returns were experienced in global fixed income markets for March. The yield curves in both Europe and the US were largely unchanged. US bond indices largely fell back in March, while Europe gained. In Europe the government bond index benchmark gained 0.6% for the month and is up 2.2% for the year (Euros). By contrast the global bond index lost 1.7% for the month and is down 1.3% for the year so far – over the past 12 months however it has gained 6.3%.

While Australia, Israel and Canada are raising rates, the UK and US are more bearish on economic growth. The Bank of England kept rates steady at 0.5% in March. No policy change is likely in the UK until well after the election.

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 Fed holds large swathes of US bond market securities to prop up the mortgage and corporate bond markets. Given the weak economic recovery expected and problems in the real estate industry in particularly, the Fed will not likely unload its holdings as fast as some predict. Nevertheless at a minimum, the lack of Fed buying power will likely lead to increased US mortgage rates and rates at the long end of the yield curve.

The Federal Reserve remains hawkish on raising interest rates anytime soon – most recent Fed statements indicate that the risk of inflation is viewed as very minor considering that some 10 million Americans are now out of work. The US economy needs to generate 100,000 new jobs a month simply to keep pace with the number of new job seekers.

In the Eurozone, rate hikes are no longer seen as an option, given the fallout over sovereign debt risk. The ECB has continued to push back the target date of any likely hikes until well into the later half of the year.

A 2nd wave of US foreclosures is only now beginning to hit as further layoffs effect the market. Currently 1 in 5 US home owners are behind on their mortgage payments or are affected by negative home equity. Persistent high unemployment rates will continue to dampen any real estate recovery well into late 2010. Unemployment losses are expected to peak by mid 2010.

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 expected to recover far quicker then the Eurozone. It is hoped that Asia will outdo both these two old world economic regions.