Investment Outlook – March 2011

Global Equities

The global equity markets retreated in March after a strong February showing. The weakness of March was partly due to the twin stresses of the Japanese tsunami and nuclear fallout, plus the growing Libyan crisis. The Japanese market retreated approximately 10% in just one day following the devastation suffered. By the end of March Japanese equities were still down 8.1% for the month. Year to date its market is 2.8% down. Over one year it is lower by 10.0% - in Yen terms.

The Libyan crisis has pushed oil prices to 3 year highs approaching $115 a barrel. This is feeding inflationary fears worldwide and also creating negative sentiment in the US and other industrialized countries. President Obama's latest job approval ratings are at recent lows, partly due to the record rise in US petrol prices, averaging $4 or more a gallon in many parts of the US.

Despite the twin threats of inflation and continuing US deficits (trade deficits and budget deficits) – the market by early April had shrugged off the losses in March. By mid April the Dow had again risen to over 12,400 touching 3 year highs. This is largely due to continuing positive US earnings reports form leading S&P 500 companies. Most of these companies have benefited from a weakening US dollar that has retreated to 1.44 versus the Euro and 1.65 versus the Pound.

Monthly economic data in the US and Europe showed positive gains on the jobs front with the US adding over 200,000 new jobs in March and unemployment levels dropping below 9%. Such monthly job gains are the highest recorded levels in over 2 years. The Fed is expected to curtail its program of QE2 (quantitative easing) in June, which may lead to a run-up in US yields and a decrease in bond prices – particularly higher grade Treasuries. Leading analysts are expecting higher Treasury rates to result once the Fed's buying spree disappears – which has definitely helped put a lid on bond yields since QE2 was announced.

Developed markets which outperformed emerging and developing markets the past few months were superseded by emerging markets in March. The Mideast unrest and uncertainty did not halt emerging market equities in March as they enjoyed a considerable increase in US$ terms. This is partly due to a weaker US$ and the belief the commodity cycle has not yet run its course.

The Global Developed world index (MSCI World) lost 1.0% in March following gains of 3.3% in February. It is up 4.8% for the year to date and 13.5% over the past 12 months. This compares with the MSCI BRIC and MSCI Emerging Market Indexes – both posting far better returns as follows (respectively): 5.5% and 5.7% for the month and for the year to date: 3.0% and 1.7% respectively. Overt the past 12 months these two markets have rebounded 9.6% and 15.9% respectively.

Non US developed markets posted lower returns with the MSCI EAFE recording a 2.7% monthly loss – it is now up just 2.7% during 2011 and 7.5% for the past year (US$). The Eurozone as measured by the MSCI EMU lost 2.6% in Euros in March and is up only 3.8% for the year to date.

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. With the falloff, the Portuguese government and signs of Greek unrest continuing, a final solution to the Eurozone periphery is still required. Ongoing bank stress tests have not provided the certainty many investors were hoping for.

The MSCI Pacific Index lost 5.7% in March (US$) largely due to the Japanese crisis. It is now down 3.0% for the year. However a strong Japanese market rebound by mid April – saw the Nikkei back at almost the 10,000 level, which should provide confidence that equity markets are relatively healthy throughout the region.

The US REIT Index lost 1.5% in March but remains up 6.7% in 2011 and up 24.4% over 12 months. By comparison the European Listed Property Index gained 1.2% for the month, 4.3% for 2011 to date and 13.0% for the past year.

Despite the lack of a full economic rebound and relatively weaker job growth at this point in the economic cycle than normal – a number of leading Central Banks are seeking to hike interest rates. The Fed according to most expectations will continue to maintain the stimulus and keep interest rates at their low levels for as long as possible. It appears to be the least worried regarding an inflation threat. No US rate hikes are imminent as the Fed will likely be the last of the major Central Banks to raise rates.

The main weakness in the US remains in the lack of massive or sustained job creation (over 300,000 jobs created monthly is required) - 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%).

Global Bond outlook

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 $115, as other commodity prices also hit near record highs. Oil at these current highs can put a drag of up to 1.0% on US GDP according to past experience.

The growing US budget battle and the threat of a rating downgrade in the future on US Treasuries, will hopefully lead to some action on Capitol Hill this year, as 2012 is an election year and little progress is expected closer to the election. The threat of a government shutdown continues to loom although a last minute agreement was reached in early April.

The Fed is expected to curtail its QE2 purchasing program of US Treasuries by June which is expected to lead to a rise in US rates. However the Fed itself is in no mood to raise rates with the real estate market remaining very weak. New home sales are at 30 year lows despite the population almost growing by 25% during that time. Home prices continue to fall across much of the US, as measured by the Case Shiller Price Index.

Despite inflationary threats due to higher oil prices and the unrest in the Middle East, the Fed is expected to maintained its low rate policy and have kept their rates on hold. This, despite other leading Central Banks in the UK, ECB and elsewhere showing signs of raising their rates. The US Fed does not use inflation targeting as a public policy tool, nor is its mandate as strictly circumscribed as the ECB-s which solely focused on maintaining inflation at acceptable levels. The Fed is empowered to seek economic growth policies which is one of the reasons many expect it to be the last of the leading Central Banks to raise rates – possibly in late 2011.

This has led to a weaker US dollar relative to most global currencies, particularly the Euro and Pound – with the dollar retreating to 1.45 and 1.65 respectively by April. With little movement from the Fed on rates, a weaker US dollar will continue. Coupled with ongoing Budget battles in Washington that are unlikely to do any deep fiscal deficit cutting in 2011-2012 – worldwide investor sentiment may remain weary of the US government's commitment to getting it's house in order. The recent White house response to the Republican (Ryan) proposal – was too general and did not specify significant enough cuts in the US budget going forward. Sceptism reigns that no significant Budget cutting agreement will ensue prior to the 2012 Presidential elections.

Long term rates in the US are expected to continue their slow 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 April that had fallen back to 3.50% levels. However it has not led too much boost in the USD mortgage or refinancing market the past month.

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.

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. With the US unemployment rate at 25 year highs, wage growth (wage inflation) is nonexistent, US consumers still laboring under way too much debt – it will likely take years for US consumers to repair their balance sheets.

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. 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.

Given record inflows into bond mutual funds in the US the past 3 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.

The Citibank Global Government Bond Index gained 0.3% in March and is now up 7.3% over the past 12 months. This is in large measure due to the measurement being in US dollars. By comparison the European Government Bond Index was down 0.7% in March and has lost 2.4% over the past year (Euros).

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 will compel the ECB to also act in the next few months to raise rates.