Investment Outlook – May 2009

Global Equities

Equity markets continue to build on their good April recovery with further impressive gains in May. This was on the back of hopeful signs that so-called 'green shoots' were beginning to appear in the economies of the leading industrialized nations. 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 Brazil, India and China.

Although talk of recovery and green shoots pervade the press – the reality is that the fundamental economic data for Europe and US remained extremely mixed as overall unemployment numbers push new highs. The US is still expected to exceed a 10% unemployment level – not seen in over 25 years. 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%. Layoffs continue across all sectors, except health care and government.

US housing is expected to still lose another 10% over the next 12 months when analysts predict it will 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 rein in large banking and financial groups who threaten the overall financial system.

The MSCI World Index gained 9.1% following 21% gains over the past two months. The Eurozone gained 4.6% in May (euro terms) and is now up almost 5% for the year. The US gained 5.4% and is now up 3.2% for the year.

Japan gained 7.0% in Yen terms – and is now up 6.2% for 2009, despite its economy sputtering to its worst export figures in decades.

Obama's plans to regulate derivatives, raise income and capital gains taxes, health care and other aspects of financial reform – have created fear in the markets as government's role becomes larger in the economy. Many, however, feel its financial regulations unveiled recently, do not go far enough. A new consumer protection agency to monitor mortgages credit card and other banking products is a step no doubt in the right direction.

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. Housing prices have already fallen approximately 20-25% across most US markets – but further declines of around 10% are expected.

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Global Bond outlook

Spreads on corporate bonds remain high by historical standards although have reduced over recent weeks. Corporate bond issuance has begun to improve and with yields possibly dropping - remains an attractive investment from a capital gains perspective.

During late May and early June US Government bond yields began to 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.

Higher US energy costs (petrol has jumped 20% over the past few months) – has caused inflationary fears and has led economists to predict that any economic recovery will be anemic at best – beginning in late 2009.

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; which has begun to 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 lost 1.3% for May and is now flat for the year. The World Government Bond gained 3.3% in May and is down 1.6% for the year to date and up 4.4% over the past year.

Consumer spending across the globe is expected to dry up and unemployment across the world will rise to levels last seen since the early 1970s. There is a growing fear that government bailouts will not have the desired dramatic impact and it will take considerable time to work through the system – with mid 2010 now being the date where economies may show some relatively decent signs of growth.