Investment Outlook – May 2011

Global Equities

The global equity markets suffered a reversal of fortune this past month, on the back of very weak economic data from the US, China and ongoing Greek travails. US unemployment crept up to 9.1% in early June, with May payrolls only gaining 54,000 new jobs – far less than the expected 200,000 consensus expected.

Rising inflation rates across emerging markets and particularly in China has led to severe banking restrictions being imposed by Chinese authorities. They have effectively raised rates or reduced lending availability by a total of ten different times over the past year, with little impact on rising food prices in China. Currently depositors in China receive a negative 2-3% real interest rate on their deposits. The construction and small business sector in China is experiencing the most impact form these restrictions. However China is still expected to post an annual GDP growth rate of close to 8% - so fears of a massive China slowdown are overblown. Longer term China over reliance on construction and infrastructure spending to fuel its economic growth is a bigger worry. For now there remains a huge need to build adequate housing and fill out China's basic infrastructure needs for many years – which were neglected for many years.

This is not unlike developments seen in other emerging markets such as Brazil, India and South Africa – here years of neglect have finally been overcome with an aggressive focus on infrastructure improvements and housing improvements.

The ongoing debate over Greek debt has also unsettled the markets pushing the Dow Jones and S&P 500 to levels below 12,000 and 1,300 respectively. Markets globally have lost upwards of 6-8% since the beginning of May and into mid June. It is likely that an EU bailout will occur for Greece – although it will be termed a restructuring . This along with any positive data in June US employment figures will likely give the market a boost.

Extremely weak US housing, construction and related real estate markets has damped any hope of a significant consumer led recovery. Unlike most prior US recessions which saw a much faster housing and equity market recovery – this anemic recovery has resulted in GDP levels hovering at approximately half the level typically experienced in past US recoveries. With no property market recovering imminent in the residential housing arena, within the next year, another 5 million US homeowners are expected to owe more on their homes than their homes are worth.

The Global Developed world index (MSCI World) lost 2.1% in May and by mid June almost all its gains for the year had been erased. The US market lost 1.2% for the month and is also now flat for the year. Non-US developed markets suffered a 3.6% pull-back in May, but by mid June had also had all its year to date gains erased.

The Eurozone as measured by the MSCI EMU lost 2.3% in Euros for the month and has followed the other markets down. The MSCI BRIC and MSCI Emerging Market Indexes – both posted similar losses too – falling 3.2% and 3.0% respectively.

Significant inflationary pressures in emerging markets and the recent price reduction in commodities have put a dampener on emerging market returns during 2011. The Chinese slowdown and lack of US consumer demand has led to weaker orders across the board.

Policy makers in the US are under growing pressure to tackle the twin threats of inflation and continuing US deficits (trade deficits and budget deficits). However the sluggish housing market and continued high unemployment data (9% as of early May), indicate the Fed is likely keen to keep rates at their current levels - which is good for the equity market. Current rates on the 10yr Treasury Bond has slipped below 3% for the first time in almost a year. Rates have now fallen significantly from over 3.6% earlier in the year. Despite such a reduction in rates, no rebound is expected for years in the housing market.

The MSCI Pacific Index lost 2.6% in May. The after effects of the Japanese tsunami and nuclear reactor tragedy appear to be longer lasting than previously predicted – with energy supplies and exports from Japan all being hampered for many months. The strong Yen-Dollar exchange rate also has not helped Japanese exporters. The Yen at levels of 80 to the US$ are putting a strain on Japanese competitiveness.

By comparison one bright light has been the US REIT Index which gained another 1.6% in May and is up 14.8% year to date and a whopping 32.1% over the past year. Similarly the European listed property index (Citibank BMI) gained 2.0% in May and is up 7.6% in 2011 and 31.0% over the past 12 months.

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

Weaker than expected economic data form the US, Asia, Emerging Markets and parts of Europe – has led to a major selloff in equity markets during May-June. The loss of 7%-8% in global equities has led to lower interest rates in the US which should play a positive role over the next few months.

Although the Fed is not expected to launch into any additional quantitative easing policies (so-called QE3) – it is expected to keep rates on hold far longer than previously expected. The yield on the 10yr Treasury fell from around 3.6% down to 2.9% - despite the Fed's QE2 buying spree set to end in June. This points to the safe haven of Treasuries during this time of uncertainty across the globe.

Developing countries such as the BRICs are expected to exceed the 5% GDP growth projection, but uncertainty on the Greek bailout and ongoing delays amongst EU members in this regard has not helped markets.

With the US presidential election less than 18 months away, political posturing will likely prevent any real breakthrough in the fiscal policies to alleviate the debt burden or budget deficits. US states are also in dire shape particularly, Illinois, California, Pennsylvania and others.

A result of the weak economic results is an a continued reduction in commodity prices – which ultimately will give Central Banks more breathing room and rate rises may take longer to come to fruition. This is particularly true in industrialized countries. Unfortunately higher oil, food and commodity prices have already had a severe impact in developing countries. China's central bank and banking regulator has tightened the credit noose – effectively limiting the flow of credit to medium and large businesses. This is expected to reduce demand for raw materials in the short term and has helped reduce commodity prices around the world. Ultimately the Chinese economy is still on track for a 9% GDP gain, but the hope is to curtail inflationary pressures at the same time.

The growing US budget battle over the debt ceiling (due to be pierced in August) – could lead to a US government shutdown. Cooler heads will likely prevail at the eleventh hour – given the lack of popularity amongst the US populace. For now it is essentially a pox on both US political parties with neither particularly well liked by voters. President Obama is facing the real prospect of trying to be the first US president to ever be reelected with an unemployment rate higher than 7.5%. US business is increasingly blaming the White House administration for the massive amount of new regulations and costs being imposed on various sectors of the American economy. Although some of these policies may well be necessary they have often been implemented in a ham-fisted manner.

Few incentives have been created for business to reinvest in the US economy and much of their reinvestment is occurring abroad. This has led to the situation where the majority of unemployed Americans have now not worked for close to 7 months. This is a distressing phenomenon not seen in the US – where typically unemployed workers are rehired in about 3 months. Tough decisions are being pushed off in Washington, which continues to undermine sentiment towards the US$. A weaker US$ will help import inflation into the US over time.

The Fed is expected to curtail its QE2 purchasing program of US Treasuries by June which is expected to lead to an ultimate rise in US rates. However the Fed itself is in no mood to raise rates with the real estate market remaining vulnerable and posting very weak results for the first four months of the year. Home prices continue to fall across much of the US, as measured by the Case Shiller Price Index.

The ECB and UK Central Bank have missed their inflation targets the past few months and there is growing pressure for rate rises. This decision has fortunately been put off due to the weak equity markets and lower commodity prices seen in May. However ultimately higher ECB rates will be experienced and will negatively impact their economies and reduce export competitiveness as their currencies will gain in strength.

With little movement expected from the Fed on rates, a weaker US dollar will continue to subsidize US export and corporate earnings.

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

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 the need for a safe haven in May – significant bond inflows were seen pushing down yields.
The Citibank Global Government Bond Index was flat in May, but is up 3.8% for the year and 12.2% 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 up 1.1% in May, but is flat for the year (in Euros).

A sustained global economic recovery remains under threat due to huge structural deficit problems in certain Eurozone countries including the UK, Greece, Portugal, Spain and Ireland. A Greek bailout or restructuring in mid June will help calm the markets. However only sustained job creation in the US and lower commodity prices will provide the immediate shot in the arm and confidence investors are looking for.