GinsGlobal Index Funds

Investment Outlook – October 2011

Global Equities

Global equity markets staged an impressive recovery in October, with the US stock market recording its highest one month gain in recent memory.

During October it appeared that Eurozone leaders had cobbled together a sufficiently all encompassing deal to fight off any remaining fears of Greek default and contagion spreading through Europe. However upon closer examination markets were not convinced – by early November sentiment had turned negative, resulting in the fall of two Eurozone governments, Greece and Italy. Italian bond yields spikes to over 7% leading to Berlusconi's resignation and the appointment of a technocratic interim government lead by Mario Monti. Similarly in Greece the new Prime Minister is a former Greek Central Bank governor with limited authority and a short interim period to pass more austerity measures to convince markets Greeks have got their house in order.

Eurozone fears of a regional recession were realized with weak economic data - leading to incoming ECB President Draghi lowering the ECB rate by 0.25%. The consensus is for a 2nd European wide recession during the 2nd half of 2011 or possibly into early 2012.

While Greece's GDP represents no more than 2% of Eurozone GDP, the virus spawned there is infiltrating mainstream Europe. With the ECB unwilling to buy up sufficient Italian government debt, concerns have been raised that France may be the next target of market wrath. Already the spread of German government bond yields is at a recent all time high for other Eurozone members.

Austerity measures across Europe and the UK definitely do not help matters with public sector jobs shrinking and further cutbacks in government expenditures.

By contrast, the US showed a 2.5% GDP growth rate for the 2nd quarter, above expectations; and new job growth is at least positive (between 80,000- 150,000) the past two months. While such job growth figures are still not adequate, they show the US economy is at least beginning to grow. Unfortunately negative sentiment emanating from Europe has helped put a dampener on new capital formation, as large corporations bide their time awaiting a resolution to the Euro crisis.

The US economy will also remain hobbled while its housing mess remains. Currently 25% of homeowners owe more on their mortgages than their homes are worth. The prospect of increasing foreclosure filings exists – and possibly a large deluge of repossessions by banks, if the government programs now in place do not adequately save many homeowners from default.

The hope exists that the US Congress will finally take some tough choices in cutting excessive government expenditures from 2012 onwards, thereby instilling more confidence in Washington's ability to function and reach a consensus on a prudent fiscal policy for the US going forward.

The likelihood of a double dip recession in the US has receded and is unlikely unless the Eurozone grows into a full blown crisis shortly. With US Presidential elections now less than a year away, it is unlikely that major legislation will pass in the final year of Obama's office.

With almost half of all unemployed Americans out of work for 6 months or longer – an unheard of statistic in the past 30-40 years, it is clear that it will take upwards of 5 years to reduce the huge spike in unemployment resulting from the 8 million lost jobs since the 2008 recession.

The Global Equity developed world index (MSCI World) gained 10.3% recovering from a loss of 8.6% in September and a 7.1% decline in August. Similarly the US market (MSCI USA) gained 10.9% for the month.

The Eurozone as measured by the MSCI EMU gained 8.6% after losing 5.8% for the prior month (Euros). The MSCI Emerging Markets Index which was down 15.6% for September also rebounded by 13.3%. It is now down 17.8% for 2011 and 9.1% over the past 12 months. The global Consumer Staples Index has held up best with a 6.4% year to date performance (US$) and 8.8% over the past year.

The US Fed stepped into the market with Operation Twist in September and continues to push down long term yields. After the 10 year Treasury yield sank to approximately 1.7% - its lowest level in some 50 years, it rebounded to 2.2% by early November. Unfortunately lower rates still are not able to assist many US homeowners who simply cannot qualify because of their weak credit standing.

Global Bond outlook

The initial comfort provided by Eurozone leaders during their October meeting, did not last as markets remained unconvinced that these leaders could easily finalize the details of their plan across 17 countries.

With record Italian government bond yields above 7%, the Berlusconi government fell in early November to be replaced by a technocrat interim government. Similarly in Greece the government has been replaced by a former Greek Central Bank governor as an interim emergency measure. Markets remain convinced that Greece has to default. Eurozone leaders and the private sector have already agreed on a 50% haircut on all Greek public sector debt. Unfortunately Greek austerity measures have led to much civil unrest there so further tough measures such as privatization and reform of various protected economic sectors remains on the drawing board with little implementation to date.

Contagion in the Eurozone is expected to continue until the ECB shows more willingness to intervene with a bazooka size bond buying program, thus reducing government bond yields. For now Italy is the key test as to whether the ECB will finally step in and stave off any further debt contagion. If Italian debt panic continues, many believe France will be the next big test. French banks remain vulnerable to Eurozone haircuts on debt, as they are amongst the largest holders of government debt in the region. With the French President Sarkozy facing an election in mid 2012 he seems willing to do all he can to stave off any further contamination to France and its banks. France's AAA credit rating is for now vulnerable, making his reelection prospects increasingly dependent on economic prospects. A possible loss of this AAA rating will be a metaphor for France's loss of prestige and power and likely to lead to the fall of Sarkozy.

US economic data performed better than many analysts predicted with 3rd quarter GDP rising 2.5% and employment numbers exceeding 100,000 in September and October's number above 80,000.

After the lowest Treasury yields on record in October, the 10 year yield has recovered from a low of 1.7% to over 2% by mid November. Yields are expected to remain low due to a flight to safety in 10 year Treasuries. Money remains in cash and bonds – essentially on the sidelines awaiting some more detailed resolution of a Eurozone bailout package and plan going forward.

We expect a weaker Euro relative to the currencies for now, while Emerging Market currencies and markets will continue to suffer due to capital flight until more certainty returns to global markets.

With US unemployment rate at 25 year highs, wage growth (wage inflation) is nonexistent and US consumers are still laboring under way too much debt – it will likely take 5 years for US consumers to repair their balance sheets. Consequently the lack of consumer demand will sadly continue to depress many sectors such as retail and housing, that have a disproportionate share of consumer wealth and drive many spending decisions (so-called 'wealth effect').

The Citibank Global Government Bond Index which was down 2.0% in September, gained 0.5%. The index remains up 7.1% for the year to date and returned almost 26% for the past 3 years.

The European Government Bond Index lost 1.8% for the month but remains up 2.0% for the year to date (in Euros). US REITs suffered a large reversal in September of 11.2% but staged a huge 14.7% recovery in October. REITS are now up 8.7% year to date. By comparison, Eurozone Property stocks gained 6% in October, but remain down 11.2% for the year to date (in Euros).

Give the weakness in the Eurozone and lack of confidence it was encouraging to see Mario Draghi the new ECB President, lower the rate by 0.25% at his first meeting. However it is likely this reflects just how poor the prospects are for Eurozone growth over the next 6 months. The ECB likely needs to lower rates another quarter point going forward.