Investment Outlook – September 2010

Global Equities

September enjoyed a record setting equity market rebound, with the US market up 9.0% (MSCI US Index) for the month. The Dow has remained above 11,000 by mid October. For the year to date the broad US market is now up 3.5%.

Although September US economic and employment data remained weak, the earnings season has shown large cap companies to be performing well and meeting expectations. The weaker US Dollar which has recently lost 10-20% of its value versus such currencies as the Euro, Yen and Pound – has helped to fuel US exports and bumped up US$ based earnings after converting for foreign based sales.

Continued concerns about the US economic recovery has helped drive government bond yields lower in August and September with the 10 year Treasury Bond yielding just 2.4%, a 30 year low. Likely further Federal Reserve quantitative easing is helping to fuel signs of a potential bond bubble in the US. With billions of dollars sitting in bond funds and on the equity sidelines, any consensus of anti- bonds and pro-equity could lead to a significant demand for equities and help fuel a further stock-market recovery. This is most likely after the mid-term elections set for early November. In particular if the Republicans regain at least the House of Representatives, business confidence is expected to rise, which will add fuel to the fire for a stock market rebound. The Obama administration is at present not well liked by leading business industrialists and Wall Street. A Republican success is seen as positive, as it will likely curtail any additional taxes or heavy handed regulations.

The likelihood of a double dip recession in the US is extremely low, but growth is likely to be very weak for the duration of 2010 and 2011. The expectation is for the Fed to leave rates on hold for far longer than previously expected. We could be in this holding pattern on low rates for another 18-24 months.

The US jobless recovery will continue to put a damper on any housing or real estate recovery. Despite record low mortgage rates, excess inventory build up remains high and credit financing is low. Currently US banks have a record amount of money parked at the Fed which they have not lent out.

A strong Euro and weak Eurozone GDP growth will further constrain any Fed tightening that may have been predicted. The broad Eurozone market index gained 5.27% in Euro terms in September and was down just 1.4% for the year. By mid October, the index was flat for year to date.

We remain more bullish relative to the US stock-market as compared to the Eurozone, given the US$ weakness and expectation of Fed assistance re quantitative easing – which will suppress any interest rate rises for the foreseeable future.

The MSCI World (All Country) Index gained 9.3% for the month and is up 2.6% for the year. Outside the US as measured by the MSCI EAFE the monthly return was similarly up 9.5% and is now down by just 1.3%, for the 2010 year.

The impressive rebound in the US REIT Index in July (up 9.9%) was followed by another positive showing in September - up 4.4%. It is now up 19.2% for the year and 30.1% over the past 12 months.

Emerging market equities remain more fully priced than developed markets. The concern exists that the booming commodity market and exports will taper off as the developed world continues to deleverage and consumer demand remains weak, for a much longer period than previously expected. PE ratios for large cap stocks in developed countries (US and Europe) remain cheaper in many cases than their

Emerging Market counterparts. So we believe there is good value in certain developed markets, particularly the US.

We remain bullish on the Asia-Pacific region excluding Japan – China in particular, as well as Taiwan, Brazil and India.

Global Bond outlook

September's weak jobs report showing a net loss of almost 100,000 jobs has dampened expectations for the US economic recovery. Talk of quantitative easing is pervasive and in all likelihood this will begin after the November Fed meeting. While interest rates will remain low well into 2011 – there is evidence of a bond bubble brewing – given record inflows into bond mutual funds in the US.

Continued weak economic data in the US during September drove the 10 year Treasury Bond yield down to record lows of 2.4%. It is clear the US economy is not firing on all cylinders and is struggling to regain any sign of its old confidence. Jobless claims fortunately may have plateaued, thanks in large part to the government stimulus plans and the Fed preventing rates from rising.

The Fed's likely intervention in purchasing additional US government bonds, indicates that the economy's outlook remains weak well into 2011, with unemployment levels remaining dangerously high, well into 2012.

While the risk of inflation has receded, deflation is the new watchword. With wages static or moving backwards and consumer demand lethargic, this appears to be the far greater immediate threat faced by the US economy over the next 12 months. A weaker US$ and the Fed priming the pump, will inevitably help create a measure of inflation – the Fed's historical unofficial target has been in the range of 2%-3%. With US unemployment rates at 25 year highs, wage growth nonexistent and US consumers still laboring under way too much debt – it will likely take years for US consumers to repair their balance sheets.

The Fed will keep rates at these historical low levels as long as possible to assist the housing and broader real estate markets.

Given weak corporate lending the Fed has no desire to raise rates – Bernanke is actively encouraging banks to increase their lending books to small business so that these businesses can begin to add to their payrolls and production. 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 two government owned entities Freddie Mac and Fannie Mae have now been subsidized (bailed out) to the tune of $150bn with at least another $30bn expected.

Both the ECB along with the Fed, are expected to keep rates on hold for far longer than earlier expected. The sovereign debt crisis playing itself out in the Eurozone is far from over – the recent Euro 750bn government bailout has still not fully appeased markets. Given that bonds are a virtual safe haven from equities, it was not surprising to see that the European Government Bond Index lost 1.2% in September and is up 4.6% for the year.

The Citibank Global Bond Index gained 2.4% for September given the expectation of low rates persisting. For the year to date, it is up 7.1%. Over the past 3 months it has returned a total of 8.2%.

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 still expected to recover far quicker than most of the Eurozone laggards mentioned above. It is expected that Asia will outdo both these two old world economic regions.