Investment Outlook – September 2011

Global Equities

Following a volatile August which saw equity markets in full retreat, the uncertainty continued throughout September. Markets continued to worry about the negative economic data appearing in the US, Eurozone and from China. Fears of a global slowdown took hold, as the new consensus set in. Forecasters became increasingly convinced that the US if not heading for a 2nd recession, it was likely to bump along at an almost zero GDP growth rate for much of the next 3-6 months.

While no new jobs were created in the US during August, September showed slightly better numbers of approximately 100,000 new jobs. Along with some better hiring data released in early October – it has seen an almost 11% rebound in broad based US stock indices since the September lows. By mid October the S&P 500 was approaching 1250; while the Dow headed closer to the 12,000 level.

Part of the possible year end rally that has set in, may be due to optimism that Eurozone leaders have shown an increased level of focus and seriousness in tackling the Eurozone crisis from a number of different positions – including recapitalizing the banks, bailing out Greece and ensuring that new Eurozone entities such as the EFSF fund will ensure that the contagion is limited to the peripheral Euro countries.

With Obama's job bill (plan) making no headway through the US Congress and politicians here focused on their re-election campaigns, most analysts are growing increasingly happy with a do-nothing Congress that can do no further harm to the economy – and that it will exist for the next 12 months until the November 2012 presidential elections. The status quo with no major new legislation, is seen as a good thing by Wall Street as no new regulations or red tape are expected to impede economic growth or capital formation over the next year. It seems tough decisions on tax reform and banking reform will be pushed off to after the election.

The likelihood of a double dip recession in the US may be has a 50-50 likelihood, although it is more likely that the US will record anaemic growth and not fall into another recession. Particular sector such as housing, construction and finance remain very weak, with record levels of long term unemployment being recorded. Almost half of all unemployed Americans have been out of work for 6 months or longer – an unheard of statistic in the past 30-40 years. In some places such as California, official unemployment of 12% masks the extent of the economic downturn – with more than one in five white males now out of work. Job seekers who have been rehired typically receive 30% less pay than before they were laid off.

Despite the 4th quarter rally to date, there is unease whether the Eurozone leaders can sufficiently get ahead of the curve and come to grips with all the Eurozone problems.

It is hoped that Germany's reluctance to bail out its neighbors has helped ensure that this tough love makes Spain, Portugal and Italy take tough austerity measures. Greece at less than 2% of Eurozone GDP is still the biggest default risk and most analysts agree that they will need to go into some form of technical restructuring shortly. Talk of a 50% haircut or loss provision is being discussed – French banks more so than German banks will be most severely impacted and will require recapitalization should such a write down of 50% occur on Greek sovereign debt.

The Global Equity developed world index (MSCI World) lost 8.6% in September following a loss of 7.1% in August. Similarly the US market (MSCI USA) lost 7.3% for the month, after a 5.6%

retreat in August. By late September both indices had hit a full 20% correction from their previous highs reached earlier in the year. The October bounce had retraced half of this loss.

The Eurozone as measured by the MSCI EMU lost 5.8% for the month following a 13.0% decline in August (Euros). It suffered the steepest loss in the past three months along with their MSCI Emerging Markets Index which was down 15.6% for the month and 27.5% for the year to date. The global Consumer Staples Index has held up best with a 0.8% year to date performance (US$) and a small 4.7% loss for September.

The US Fed stepped into the market with Operation Twist in September to provide further liquidity to the bond and mortgage markets. With the growing uncertainty over Europe the 10 year yield sank to approximately 1.75% - its lowest level in some 50 years.

Global Bond outlook

The growing uncertainty over Europe's sovereign debt crisis plus poor US economic data led to the lowest Treasury yields on record. A flight to safety in 10 year Treasuries has pushed the yield down from 3.6% earlier this year to below 1.8% by September.

The flight to safe havens has also led to gold briefly exceeding $1900 per ounce and the Swiss Franc hitting all time highs, although gold has since retreated to the $1600 level.

By the end of September, the lack of a full scale Eurozone plan to solve its ongoing debt problems led to a weaker Euro and stronger US$. But due to ongoing Eurozone summits to resolve the crisis - in recent weeks the Euro has seen a rebound in the currency from as low as 1.31 back up to almost 1.40. It appears that by late October a more detailed solution proposal will be tabled by the leaders of the Eurozone. This has helped calm markets and led the Treasury yield higher from 1.75% to 2.20 on the 10 year Note.

The Fed has acknowledged its earlier economic growth assumptions were too optimistic, and in an effort to stem market turmoil is likely to stick to its earlier announcement, that it will hold it Feds Fund rate at effectively zero for the next two years. This effectively has confirmed that the US economic growth is anemic at best and could still fall into a technical recession again – however it would not be nearly as severe as the 2008-2009 period.

Fewer US banks are having funding difficulties and the crisis this time around is largely led by uncertainty emanating form the Eurozone. Given the lack of political leadership in Washington to respond to such weak economic growth and failure to pass any broad- based deficit cutting legislation in Congress, it is not surprising to come across much negative sentiment pervading the corridors of US business. US companies are just not hiring at the rate one would expect at this time in the business cycle – in fact large US banks such as Bank of America are shedding thousands of jobs. Bank of America is laying off some 30,000 workers, while Wall Street is expected to match with similar numbers by year end.

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. Consequently, the lack of consumer demand will sadly continue to depress many sectors such as retail and housing.

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.

The Citibank Global Government Bond Index was down 2.0% in September, following a gain of 2.1% in August. The index remains up 6.5% for the year to date and over 14% for the past 12 months. The European Government Bond Index was up 0.8% for the month and up 3.9% for the year to date (in Euros). US REITs suffered a large reversal in September of 11.2% down, and are now down by 5.2% year to date. They will likely recover quickly in line with any market rebound based on positive sentiment emanating from the Eurozone.

Despite the S&P downgrading the US from AAA, US Treasuries now yield almost 1.5% less on the 10yr Note than before the downgrading. The latest yield is approximately 2% following the Fed's latest $400bn buying action in Operation Twist. It remains unclear whether this Fed action will create any more confidence in the market. Fed action is seen as proof of a stalled US economy and growing fears of a deep structural economic malaise that has set in. Youth unemployment (under 30) is now at an all time high approaching 20%, while the housing market remains depressed. California, once seen as the driving economic force in the US, now records the second highest unemployment rate in the nation at 12%.

The sustained global economic recovery hoped for earlier in the year, has evaporated and a flight to safety has resulted in bond yields being pushed down to historic lows. The rush out of equities will continue to lead to volatile markets as investors reassess their views on corporate earnings in a weaker economic environment than previously thought. A stronger US dollar will reduce US corporate earnings which to date have enjoyed the tailwind of a weak currency relative to Europe and Asia. A stronger dollar may now be a slight drag on large cap index returns.

Give the weakness in the Eurozone and lack of confidence this gives the new incoming president of the European Central Bank, an immediate opportunity to lower interest rates is present. A new era begins, with Mario Draghi the incoming ECB president in November.