Middleburg Trust Company

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OUTLOOK

Evidence of the start of a global financial tightening cycle emerged earlier this month as Australia became the first G-20 central bank to raise its benchmark short rate, in this case from 3% to 3.25%. In the wake of this move, global equity markets rallied and the Australian dollar jumped 4%. Looking forward, what does the reaction of global markets to the Australian move tell us about the prospects for risk assets as we normalize policy globally? And just how important is a focus on central bank and governmental policy actions vs. the more traditional focus on the outlook for growth and inflation?

Because Australia was on sound financial footing going into the global crisis, including strong banking and housing sectors, its authorities have a freer hand in removing stimulus. In the United States, overreliance on securitization led to poor mortgage loan standards, which resulted in ballooning defaults and system wide losses. Contrast this with the experiences in Australia and Canada, where securitization is subordinate to the bank-based credit system and default rates that are less than 15% of those of the United States. This structure has led to Australia and Canada being home to seven of the 11 AA-rated banks in the world.

While Australia is clearly a developed market, the dynamics of its economy are most closely tied to emerging Asia. Due to both proximity and its natural resources, Australia has been a major beneficiary of Asian growth — and we expect this to continue. So think of Australia's move to start raising rates as one of the signs that the developing economies likely will be the first to normalize monetary policy, which contrasts with the European Central Bank and Bank of England actions earlier this month to leave current stimulative policy measures unchanged. This sequencing of the normalization process is in synch with our expectations for continued strength out of emerging markets, followed by the developed markets.

U.S. EQUITY

- September concluded a strong third quarter across all capitalization ranges.
- The continued positive performance was driven by increasing optimism about corporate earnings and the beginnings of an economic recovery.

Expectations of improving corporate earnings helped sustain the market rally that began in March. September returns were particularly strong for companies with high exposure to a global recovery and weaker dollar. September was notable, too, in that the low-quality rally began to diminish and high-quality stocks outperformed the market for the first time since mid-March. Analysts are becoming increasingly optimistic and raising expectations for improved earnings driven not only by cost cutting but by revenue growth as well. Increasing volume of deal activity and higher investor risk appetite may draw in some of the cash that has been on the sidelines, which could provide continued support for the equity markets.

EAFE AND EMERGING MARKETS

- European and Japanese industrial production growth underpins the recovery.
- The economies that entered the global downturn in the best financial shape likely will be the first to normalize policy.

The strength of the global inventory cycle is coming through in the production data being reported for the third quarter. European and Japanese exports and industrial production are showing robust growth, helping to offset soft consumer spending. Emerging market economic growth is cooling modestly from its blistering second-quarter pace, but we expect it to double the pace of developed market growth for some time to come.

The strength of the recovery in emerging market economies increases the likelihood of tightening monetary policy, as evidenced by China's recent move to moderate loan growth. Similarly, those developed economies with the strongest financial systems and leverage to emerging market growth likely will be early to normalize policy.

FIXED INCOME

- Record-low short rates continue to drive investors into bond investments.
- The return of traditional investor behaviors indicates that credit markets continue to normalize.

Flows into bond mutual funds continue unabated, despite strong performance results for equities and most other risk assets. Whether credit, municipal or high yield debt, investors have steadily moved large sums out of cash and into bond funds since the start of the year. It is unclear at this point whether the shift represents a permanently increased allocation to fixed income or an interim stopping point along the road of improving risk appetites. Other actions taken by bond investors, such as quarterly window dressing of portfolios to improve their appearance, are making a comeback. There was little interest in such action during the crisis period; its return is further evidence that the credit markets continue to normalize.

GLOBAL REAL ESTATE

- REITs outperformed the broader equity market in September, but lag year-to-date.
- Lodging was the top-performing property type in the United States during September, in line with the strong surge in cyclical areas of the market.

Global REITs returned more than 25% in the third quarter, despite the economic headwinds facing the sector, as investors bought risk assets broadly. For example, increasing unemployment continues to negatively impact demand for multifamily housing. Apartment vacancies in the United States rose to 7.8% in the third quarter, the highest level since 1986, and rents are down 2.7%.

Despite these negative fundamentals, residential REITs outperformed the benchmark in September. We do not think the groups' improved ability to access capital is enough to sustain returns, but that declining rents and occupancies, paired with rising delinquencies and defaults, likely will limit near-term performance.

COMMODITIES

- Commodity prices have continued to benefit from currency and reflation trades.
- Inventory levels are high and would normally suggest lower prices.

U.S. oil inventories remain above historical levels, which should be putting downward pressure on prices. But key market players are jawboning prices, with Saudi Arabia indicating that $75 per barrel is the "right" price, and Russia indicating a desired range of $80 to $90 per barrel. Financial hedging against currency depreciation and reflationary policies, combining with continued Middle East tensions, continues to support oil prices.

The metals complex is being supported by both financial transactions and historical stockpiling by the Chinese. Current data shows significant volatility in Chinese commodity imports — after falling this summer, recent copper and iron ore imports have surged again. Our commodities overweight rests on a thesis of emerging markets growth leading to increased demand — otherwise, current inventory levels could lead to a drop in commodity prices.

CONCLUSION

So what are the implications for the global markets and the positioning of portfolios as central banks contemplate their interest rate policies and the global economy seeks to transition from an inventory-led bounce to more sustainable growth? We think investors today need to focus more on policy actions than traditional growth and inflation metrics, as the growth and inflation picture today is unusually dependent on governmental policy.

We see the healthiest economies moving first to normalize monetary policy, as their economies are most able to handle higher interest rates. This likely will lead to continued strength in these currencies, probably at the expense of the U.S. dollar. This picture supports a focus in portfolios toward emerging markets and the commodities area as the likely beneficiaries of this stronger outlook. However, our focus on the important role of government policy in this recovery means we are keeping a sharp focus on the possibility of policy errors and the resulting implications for financial markets..

Commentary provided by Jim McDonald