Middleburg Trust Company

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OUTLOOK

Our investment policy deliberations currently center on the risks of the global tightening cycle, but the most recent communiqués from the Federal Reserve, the European Central Bank (ECB) and the Bank of England (BOE) indicated that higher interest rates in developed countries are coming later rather than sooner. The Fed continued to indicate that current conditions warrant "extraordinarily low levels of the Federal Funds rate for an extended period," while articulating the key factors they are monitoring. Unsurprisingly, the ECB struck a slightly more hawkish tone than the BOE, as the United Kingdom faces greater challenges in restoring growth. All in all, we view the continued central bank accommodation as a positive signal for risk taking.

We have seen some evidence of an improving outlook for economic growth. While U.S. third-quarter gross domestic product was modestly better than expectations at 3.5% annualized growth, the composition of the growth reminded investors that government stimulus measures are an important support to the economy. Strength in the October Purchasing Managers Index (PMI), and evidence of improved corporate capital spending, helped offset the negative news of October's unemployment rate reaching 10.2%. Outside the United States, Germany has seen industrial orders rise for the seventh straight month in September, and China also showed continued improvement in its manufacturing PMI.

Inflation currently is more evident in the financial markets than in the real economy, as investors worry about the eventual price of the current reflationary policies of global central banks. So far, inflation has been most apparent in real assets (think Asian real estate, oil and gold), and we expect inflationary pressures, and tighter monetary policy, to build first in the developing economies. The Fed has cited not just inflation trends, but inflation expectations, as being watch points for their current accommodative policies. With that in mind, the increase in the inflation breakeven rate of the 10-year Treasury Inflation Protected Securities has to be of concern.

U.S. EQUITY

- Equity prices pulled back in October, posting modest negative returns.
- Risk aversion increased as the low-quality rally began to fade.

Stock prices retreated in October amid concerns about the robustness and magnitude of the economic recovery. During the third-quarter earnings season, most companies beat consensus expectations. However, investor focus seemed to shift from bottom-line earnings growth to top-line revenue growth. Those companies that beat expectations on both earnings and revenue were rewarded the most. This reflects a view that future earnings improvements driven by cost cutting alone may be more limited. Overall, more defensive styles dominated stock market returns with performance reversing for inexpensive, high-volatility, high-leverage, low return-on-equity and smaller capitalization stocks. Acquisition and consolidation activity continues to emerge, which is likely to be supportive of equity markets going forward.

EAFE AND EMERGING MARKETS

- Economic momentum continued in developed economies.
- Emerging economies are seeing an earlier start to the tightening cycle.

The recovery in global industrial production, kicked off by the combination of low inventories and government stimulus, is leading to continued gains in forward-looking economic indicators. Germany, which benefits significantly from growth in exports, has experienced a 41% annualized sequential gain in industrial orders in the third quarter. As it's the largest economy in Europe, this helps underpin the view that Europe has solidly moved out of its recession.

There has been expectation of some moderation of the pace of emerging market growth toward year end, but China's recent fixed asset investment and retail sales figures for October don't indicate such a slowdown. Solid import data among emerging market economies indicates that domestic growth is helping to offset some of the reduced exports to developed economies.

FIXED INCOME

- The ever-rising U.S. fiscal deficit will require record Treasury issuance.
- The maturity mix of many new financings is being lengthened.

Prompted by the Fed's decision to maintain its funds rate near 0%, investors hungry for yield have exhibited strong and steady demand for all types of bonds. To date, the movement of assets out of money market funds and into longer dated paper has only modestly dented the huge pool of cash holdings. Going forward, expected shifts in the mix of buyers and investors' growing preference for lower risk assets are likely to keep demand firm for most fixed income securities. In fact, the U.S. Treasury is mimicking the actions of many corporate-type borrowers by shifting an increasing share of its new debt to longer maturities, especially the 10-year note. This reduces rollover financing risk and helps address the demand for longer paper.

GLOBAL REAL ESTATE

- In October, global real estate investment trusts (REITs) posted their first negative monthly return since February.
- Europe was the top-performing region and the only region in the black.

The fourth quarter began on a negative note for REITs. After seven consecutive months of strong returns, global REITs declined in October. This shift in the performance trend is not unexpected given the market's concerns regarding the sustainability of performance. Year-to-date, global REITs have returned almost 34% through October, despite challenging conditions in the credit, rental and sales markets. Although most data points in commercial real estate have been negative, there is some evidence that the market may be in the process of bottoming. According to the MIT Center for Real Estate, commercial property prices increased 4.4% in the third quarter, the largest increase since the market downturn began in mid-2007.

COMMODITIES

- Increasing commodity demand should address inventory concerns.
- Oil remains supported by dollar concerns and increasing global growth.

Coal is a useful economic indicator, as its primary uses are electricity generation and steel and cement production. We believe the 30% jump in October coal exports out of the Eastern ports was driven by increased demand from steel producers — a bullish sign for global industrial production. The uptick in commodity demand we have been looking for may be at hand.

Energy prices remain a story of two markets — constructive dynamics supporting oil prices, while domestic natural gas supply has been materially increased by new shale supplies. Global growth prospects should continue to support oil prices and help work down high domestic inventory levels. The most likely disruption to continued strength in the price of oil would come from a rally in the U.S. dollar.

CONCLUSION

So what are the takeaways from the most recent spate of economic data and central bank meetings? The growth picture, which we have been expecting to be strongest outside the United States, has been modestly better than expected — but not by a margin large enough to change our views. Inflation expectations appear to be increasing, which at some point could put the Fed in the uncomfortable position of having to raise interest rates before they are confident that the real economy is strong enough to withstand them.

As we assess the risk case surrounding the pace of the global central banks' exit strategies, we think there is a small chance that the Fed tightens more quickly than markets anticipate and that this could be disruptive to risk assets. Should developments over the next several months raise the probability of this outcome to a more likely scenario, we would assess portfolio changes to help reduce exposure to a market environment that we would expect to become more challenging.

Commentary provided by Jim McDonald