



## MARKET COMMENTARY • MAY 2010

### OUTLOOK

The environment for risk taking gained increased momentum during the last four weeks as many financial markets reached fresh cycle highs. U.S. small-cap stocks led the parade with gains of more than 6%, and emerging markets regained some momentum with a 5% gain. This performance was supported by relative calm in the currency and bond markets, with the dollar appreciating 1% while U.S. Treasury yields increased slightly. The continued strong performance of the equity markets, along with further reduction in the Chicago Board Options Exchange Volatility Index (VIX) to a cycle low, has finally jumpstarted equity market inflows — which increased to \$24 billion in March from \$7 billion in February.

March Purchasing Managers surveys indicate that the United States is seeing the third-highest level of business activity in the world (behind Sweden and Switzerland), and this is now showing up in first-quarter earnings reports. Consumer spending is on track to beat expectations as retailer results from the middle market (Kohl's and TJ Maxx) to the higher-end market (Nordstrom) trounced expectations. Corporate activity has also picked up noticeably, from the transportation sector (UPS) to technology (Intel). Because of the considerable slack in the economy, we do not expect this rebound to increase inflationary pressures over the near to intermediate term. We are still concerned, however, about the lack of credit creation, as reflected in the scarce 1.5% growth in M2 money supply last year.

The longer the economy can grow uninterrupted by tightening monetary policy, the greater the chance of a sustainable economic expansion. The recent survey of corporate confidence by the Business Roundtable indicates that CEOs are increasingly looking to boost hiring and capital spending. But the prospects for economic growth and financial markets do not always go hand in hand — at some point in the recovery economic growth that is too strong could actually become a negative for financial assets, as it would increase the likelihood of rising interest rates and possibly an eventual economic slowdown.

### U.S. EQUITY

- All segments of U.S. equity markets continued a steady and positive trend upward.
- Evidence supporting a sustainable economic recovery is a positive for stocks.

The overall U.S. equity markets rose during March, with the Russell 3000 gaining nearly 5%. The gains were led by small- and mid-cap stocks, which rose 7% and 5%, respectively. This is consistent with such stocks' higher sensitivity to economic recovery. Realized volatility continued to decline as investor confidence returned. In response, risky stocks, characterized by high beta and low profitability, performed the best. Steadily improving top line corporate results in the context of the current economic cycle suggest that stocks may gain further. With stocks

realizing a significant improvement in valuation during the last year, continued gains will be mostly dependent on strong earnings growth continuing into 2011.

## **EAFE & EMERGING MARKETS**

- After lagging the U.S. market, Europe, Australasia and the Far East (EAFE) and emerging markets are now more attractive.
- Euro weakness has helped bolster European industrial production.

Since mid-December 2009, U.S. stocks have outperformed most major international indices because of improving economic momentum and currency strength. In due course, this has led to some improvement in relative valuations and currency competitiveness. Therefore, we feel it may now be positioned to deliver better investment returns as industrial production starts to improve and export growth accelerates. We also find current valuations supportive.

Emerging market growth has continued to impress, most recently with a nearly incomprehensible 32% annualized growth in Singapore's gross domestic product. As a center of Asian trade and finance, Singapore is a leveraged reflection of the strength of economic activity in the region. We continue to expect Asian central banks to be incrementally tightening policy to reduce inflationary risks.

## **FIXED INCOME**

- Attractive mortgage-backed securities' valuations bring out the buyers.
- Historically low mortgage rates are supporting the economic recovery.

The Federal Reserve's \$1.25 trillion mortgage-backed securities purchase program expired on March 31, 2010. The program was instrumental in maintaining homebuyer financing and stabilizing the credit markets, a key factor behind the recovery in asset valuations during the past year and a half. Conventional wisdom called for mortgage rates to rise, perhaps significantly, after the Fed program ended. Instead, investors came to see the prices of mortgage securities as representing good value, especially in comparison to the more expensive nonmortgage sectors. In addition, the bonds are more attractive as their interest rate sensitivity has declined because of stricter underwriting standards. Despite the program's wind-down, conforming mortgage rates remain near historic lows and continue to support the economic recovery.

## **GLOBAL REAL ESTATE**

- The FTSE/EPRA NAREIT Global Real Estate Index posted a strong 6.8% return in March.
- U.S. real estate investment trusts (REITs) outperformed global REITs by 2.6%.

March marked the end of the Fed's legacy commercial mortgaged-backed securities (CMBS) lending program. The Fed settled \$12.3 billion in loan requests for legacy CMBS since last June. The slow return of the CMBS market is a positive, but there are still signs of negative

fundamentals in property markets. According to Reis, the U.S. office market recently hit a 16-year high in vacancies. As a result of the continued deterioration in fundamentals and the dilution effect of recent equity raises, U.S. REITs are expected to see a 10% decline in earnings in 2010. Although the United States is one of the weakest markets, the average earnings growth for REITs globally is -2.2%. For REITs to continue to generate strong performance, we need to see clearer improvement in fundamentals.

## COMMODITIES

- Financial investment is supporting copper prices.
- U.S. offshore drilling announcement was a snoozer.

Commodity prices are marching higher as North and South America are joining China at the buyers table. Western nations had been whittling down inventories, so this buying has added to demand pressures. Recent developments in the iron ore markets — 90% to 100% price increases and more frequent repricing — highlight the tightness of markets. The primary risk to commodities at this point is economic overheating, which may lead to a vigorous central bank response.

President Obama recently unveiled a program to expand offshore drilling. However, after studying the program, we conclude that the Obama administration remains enamored with clean energy and did not suddenly become a friend of Big Oil. We continue to expect higher oil prices during the intermediate to long term as supply challenges remain unanswered.

## CONCLUSION

Better than expected economic momentum, supportive valuations and accommodative global central banks lead us to continue to support risk taking in today's markets. Our view is that, in a constructive environment for risk taking, we likely will benefit more from broad market exposure than through a hedged approach.

Our risk-case discussions focus on weak credit creation in the United States, China's tightening cycle and Europe's handling of the Greek debt crisis. We think U.S. banks have adequate financial incentive to increase lending, and this should lead to improved money supply growth over time. We also think that, while appreciating the uncertainties involved, China and the European authorities will navigate their current challenges. Increasingly, our discussions will focus on the eventual Fed tightening cycle and whether it will be forced to move at a pace that is disruptive to financial markets.

*Commentary provided by Jim McDonald*