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OUTLOOK

The saga of the European sovereign debt crisis dominated markets during the last month, with unease over the financing abilities of Southern European countries blossoming into a €750 billion rescue package from the European Union, the International Monetary Fund and the European Central Bank. While we think this has improved the short-term liquidity position of the most indebted European countries, it is just a swap of one type of debt (backed by a single country such as Greece) for debt backed by the European Union. The price for this backstop is increasing fiscal consolidation, with significant budget cuts becoming a headwind to European growth during the next several years. One positive outcome of this process is the devaluation of the euro, which should benefit European growth through increased competitiveness.

Signs of cyclical strength in the global economy continue to appear, with emerging markets and the United States leading the pace. With residential real estate prices increasing in China at a 12.8% pace, and consumer inflation now at 2.8%, the pace of growth there will likely lead to continued monetary tightening actions — somewhat increasing the risk of a hard landing. U.S. growth has benefited substantially from a drop in the consumer savings rate, while corporate activity is now showing broad signs of strength. Continued improvement in corporate confidence is necessary, supported by strong balance sheets and profitability, to help sustain the U.S. recovery through continued gains in hiring, increasing capital expenditures, and merger and acquisition (M&A) activity.

The financial markets forced Europe to face its fiscal problems earlier than expected, which could lead to both lower growth and interest rates than we had expected. It also serves as a preview of how the “bond vigilantes” will force action when confidence wanes in a country’s outlook. The U.S. benefits from the dollar’s status as the world’s reserve currency, while Japan continues to lean on its own citizenry to fund its gargantuan debt levels. Those advantages, while considerable, do not inoculate these countries from the eventual need to address their building fiscal problems.

U.S. EQUITY

- Risk levels rose during the last month after a long period of decline.
- We see U.S. stocks as attractive relative to developed market counterparts.

U.S. stocks followed global markets lower during the recent market sell-off, but some cyclical aspects of the market did outperform. Small cap stocks, for example, gained about 1% compared with the 2% decline in large caps. Also, the cyclically sensitive transportation sector gained 2%, undoubtedly helped by a 13% drop in oil prices, and the industrial sector realized a modest gain. The underlying fundamentals for stocks remain positive, with steadily improving corporate earnings and sales, continued low interest rates, and reasonable valuations. However, the increase in market volatility suggests an increasing sensitivity to macro-economic risks. We think U.S. stocks are better positioned than developed markets outside the United States to handle this increased uncertainty due to better economic momentum and policy clarity.

EAFE & EMERGING MARKETS

- Accelerated fiscal consolidation is expected to moderate growth in Europe.
- Higher risk premiums temper the emerging market outlook.

Global bond markets have accelerated the timetable of the fiscal adjustment in Europe's weaker economies. Limits of the European Union structure, where the strength of the monetary union isn't matched by the political, cultural or fiscal union, are being tested by the fixed income and currency markets. The resulting weakness in the euro should help cushion the European growth outlook.

Emerging market growth remains impressive, but there is continuing worry about the pace of inflation in certain markets (particularly China) and the resulting effect of monetary policy. We reduced our recommended exposure to both Europe, Australasia and the Far East (EAFE) and emerging market equities this month to reflect our view that increased investor uncertainty about the global fiscal outlook would affect these markets more than the United States.

FIXED INCOME

- U.S. bank debt experienced pressure amid recent sovereign contagion worries.
- We don't expect these spreads to return to pre-crisis levels anytime soon.

The 2008 financial crisis upended valuations on most financial assets, many of which have since rebounded. Although banks' fundamental operating performance has been strong over the last several quarters, spreads on bank debt have not recovered to pre-crisis levels. Mostly, this reflects uncertainty about how proposed regulatory reforms will affect core earnings power after the Federal Reserve normalizes its policy rate. Investors also remain alert to the ongoing possibility that governments may meddle more deeply in the credit markets and banking industry. This was evident in the widening spreads on banking debt, relative to industrial debt, which occurred during the flare-up of sovereign contagion fears. We continue to think high yield corporate and municipal debt look more attractive than investment-grade bonds because of their current higher yield.

GLOBAL REAL ESTATE

- Global real estate investment trusts (REITs) posted gains for the third month in a row.
- U.S. REITs outperformed equities substantially in April.

In most markets, real estate securities have outperformed equities in 2010. Year-to-date, the global index has returned almost 6%, while U.S. real estate has outperformed the S&P 500 by 9%. The strength in the market is resulting in numerous initial public offerings and secondary equity offerings. In April, Macerich, a U.S. retail REIT, raised more than \$1.2 billion, the largest secondary offering of all time in the real estate market. According to CoStar Group, there have been more than 90 filings by REITs since March 1 seeking to raise more than \$50 billion. Although REITs currently have the benefit of access to capital, we still have concerns regarding real estate fundamentals and the effect of debt maturities on real estate valuations — hence our continued cautious stance.

COMMODITIES

- Gold has been a standout beneficiary of increased investor anxiety.
- Broader commodity indexes are suffering from demand concerns.

One of the most notable developments in the commodities markets this year has been the performance of gold, which is up nearly 12% compared with the broad Dow Jones/UBS Commodities Index decline of 7%. This reflects increased worries about sovereign debt levels and the resulting central bank response, compared with concerns about the near-term outlook for commodities coming from China.

Our research indicates increasing concerns about a potential slowdown in commodities demand from China, because inventories have been built up and infrastructure demand may slow. Also, oil prices have declined this year from \$82 to \$73 per barrel, primarily due to worries about slowing global growth. We think a reduction in investor risk appetite will dent the appeal of commodities, and recommend some reallocation to gold as a portfolio hedge.

CONCLUSION

During the last year, we have described our near-term outlook as partly sunny (cyclical economic rebound supported by massive liquidity) while our longer-term view was partly cloudy (growth in developed economies retarded by high debt levels). The cyclical global rebound has been holding up its end of the bargain, while the European debt crisis will likely mean more liquidity for longer. However, the markets have forced the issue on sovereign debt levels sooner than expected, moving some clouds into view.

The European bailout plan is far from complete, and there remains significant national discord, raising risks to a smooth recovery in markets. In this environment, we think it is prudent to reduce the risk in portfolios back toward strategic levels. Accordingly, we have reduced our recommended tactical allocation to EAFE and emerging market equities and commodities, with the proceeds moving to cash and gold. Cash can be deployed as market conditions warrant, while gold remains a hedge against the increasing risk of sovereign creditworthiness.

Commentary provided by Jim McDonald