



# FIRSTRAND

Private Wealth Management

## Global Investment Review

Second Quarter 2009

### Introduction

The performance of most asset classes over the June quarter has been consistent with increased levels of optimism amongst investors, most evident in the strong rally experienced by global equities over this period. The MSCI Global Equity \$ index rose a fairly startling 20% for the three months under review, albeit from very depressed levels in March and led by emerging markets and Asia in particular.

Commodity prices rose sharply, with oil prices doubling from their lows. On the other hand, inflation fears resurfaced, leading to US dollar weakness and a sharp sell-off in government bonds, providing equity-like volatility on the downside.

Whilst the financial sector remains a net hoarder of cash, credit markets have seen a continued improvement, as reflected in a narrowing of spreads and gradually improving liquidity. Concerns over the solvency of the US financial system have been allayed by the stress tests carried out on the major banks, although there is less confidence in the European banking industry.

## Key Global Market Indicators

Asset Class Performance	YTD
USD 3m LIBOR cash returns	0.60%
MSCI World Equity (local currency terms)	3.21%
Citigroup World Global Bond Index (local currency terms)	-0.77%
CRB Commodity Index	8.90%
GBP/USD	12.78%
EUR/USD	0.44%
USD/JPY	6.31%

As June drew to a close, however, the first meaningful correction in markets has been seen, perhaps highlighting investor concerns that too much good news has been priced in too quickly. Are the bears correct to be sitting on the sidelines with enormous cash piles? Could the “green shoots” of (the northern hemisphere) spring soon wilt given high unemployment, rising private sector savings rates and significantly increased government debt levels?

### Global Economic Outlook

The savage contraction in global economic activity seen in the first quarter was possibly overdone and is now easing. Global industrial production is turning up and trade has rebounded.

Although the signals are mixed, consumer and business confidence seems to be improving and early indications of a stabilisation in housing markets in the US and UK have been seen.

The sharp drawdown in global inventories seen towards the end of 2008 and first quarter of 2009 is likely to reverse, providing the foundation for a recovery in economic growth in the second half of the year. Thereafter, consensus holds that the recovery will remain fairly muted for an extended period.

- It is expected that unemployment data will get worse before it gets better, probably exceeding a 10% rate in the US. But it should be noted that this is typically a lagging indicator of economic performance. Savings rates in the US are already back up to 6.9% of disposable income as households repay debt, a level last seen in 1992, and while this trend will continue to detract from consumer spending, this adjustment is well under way.

- Rising government debt levels represent a growing but necessary replacement of private sector activity in the economy. The funding of this and attendant inflationary concerns are a problem for the bond market only in the long term. A sustained level of muted economic activity (taking into account the amount of demand destruction and creation of spare capacity that has taken place) is likely to keep both short and long-term interest rates at low levels for an extended period.
- Strong trade interdependencies and the sheer size of the developed economic bloc make it unlikely that emerging markets can revitalize world growth on their own but there is growing evidence that China and other large emerging markets can generate high levels of internal growth even if driven initially by government stimulus. This is positive for commodities, especially noting the latent fundamental demand that will be generated as these economies industrialize in time.
- Fiscal, monetary and financial sector conditions are generally more favourable in emerging markets, supporting a higher allocation of investor funds towards these areas.

### Global Equity Market Outlook

Set against this backdrop, equity markets appear capable of extending their gains and are likely to be higher by year-end, although the risks of short-term setbacks remain high. Given the extent of the rally since March, investors are likely to be sensitive to the release of economic indicators either confirming or questioning the status of world growth.

- There is strong conviction that this is not a buy and hold market and investors will benefit from an active approach to managing equity exposure.
- It is noted that US money market assets are reported to have represented more than 40% of total US mutual fund assets at the beginning of June,



double that experienced at the bottom of previous corrections. The sheer weight of funds on the sidelines could therefore limit any downside movements.

- The Panel has maintained equity exposures although it is agreed that there may be scope to take risk off the table. An interesting variant on this theme is to increase higher yielding and better priced credit exposure and reduce possibly overpriced equity.
- There is consensus that emerging markets remain the preferred area of investment and portfolio

weightings reflect this. Japan is generally unloved and underinvested by global investors and is also preferred for its cheap valuations and operational gearing to world and Asian growth.

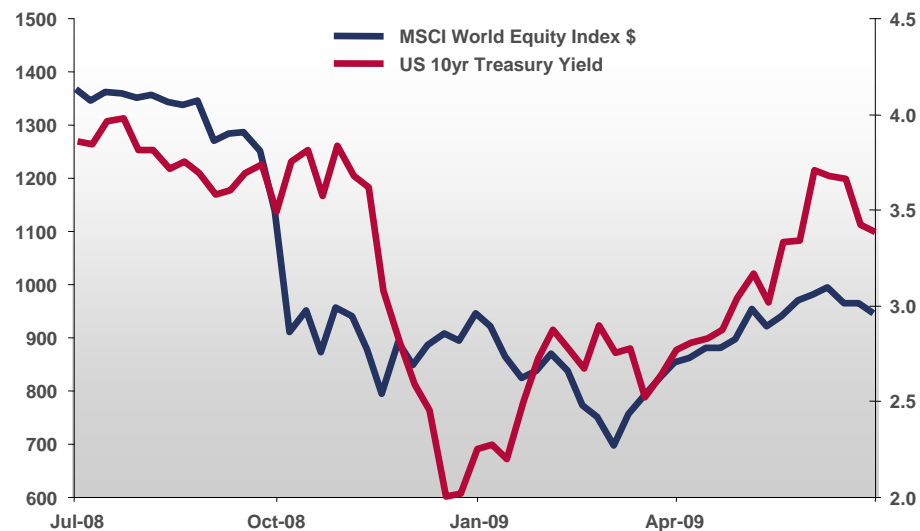
- The US and UK economies are likely to emerge fastest from the economic slump amongst developing nations. Other than its fairly high export exposure to China, Europe continues to display very poor fundamentals and is underweighted in portfolios.

### **Fixed Interest Outlook**

Bond markets sold off aggressively during the June quarter but have subsequently retraced a portion of these losses in recent weeks as economic data and central bank statements have confirmed that the low interest rate and muted growth environment is here to stay. Inflation is not imminent and in fact it could be questioned whether the deflation threat might yet resurface at some time in the future.

- At their higher levels, longer-dated yields (US 10 years around 4%) offer a highly attractive entry point for more risk-averse investors.
- Investors should also consider European bond exposure where weaker economic fundamentals do not appear to be effectively priced into fixed interest markets.
- Corporate credit, despite having rallied strongly, still offers an interesting option in the fixed income space. Attractive yields relative to government paper, the easing of credit conditions and some improvement in economic activity will stand this sector in good stead. However, credit risk remains relatively high and which issues to invest in must be selected carefully.

## Global Equities and US 10 Year Bond Performance – 12 months to June 2009



### Currency Outlook

Consensus holds that there is no clear favourite amongst the currency majors. Accordingly portfolio currency exposures are generally held close to benchmark:

- If there must be a favourite, however, then sterling draws the most votes. This is largely due to its retracement from what was a deeply undervalued position and excessive pessimism on the UK economy.
- By the same token, the Euro is most unloved based on fundamentals, although it should be stressed that this is a marginal view.
- The dollar continues to attract adverse comment from its major holders in the East although this is largely rhetoric at this stage. It remains, along with the yen, a strong currency when equities fall.

- Emerging market currencies have done particularly well, obviously assisted by stronger commodity prices. Portfolios have benefited from exposure via underlying asset classes to these areas. However, it is not evident that this momentum can be sustained without further upside in commodity markets.

### **Alternative Assets**

Hedge funds remain useful in a multi-asset portfolio as a diversifier and could limit downside if markets correct sharply. There may be opportunities in the plain vanilla strategies and consequently there may be opportunity to increase weightings at the margin. However, there are lingering concerns over the liquidity issues highlighted in the recent crisis and exit capacity must be carefully assessed.

- There is consensus that a return to investing in property should be delayed. While prices may have retraced, debt structures, valuations and yield sustainability issues still create a high level of uncertainty.
  - The positive longer-term view on commodities remains intact, driven by China and in the short-term by a rebound in industrial production. Given the extent of the price rises already sustained, increased volatility is to be expected.
  - Gold is seen as a potential hedge against higher inflation and as an alternative to equities. However, this is a low conviction call and would not necessarily warrant inclusion in portfolios.
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