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Uncertainty has been dictating the markets until September 6 with the two leading macro factors being the Euro crises and the state of global growth in particular in the U.S. and in China. Politics also remain a major issue with elections in the U.S. and the transition of power in China this November. Growth expectations across the developed world are expected to be sub-trend in the foreseeable future and consequently inflation is likely to remain benign around 1%. Central banks around the world are expanding their balance sheets at an unprecedented rate which could potentially lead to inflation if this policy is not reversed timely and appropriately. The market has become highly correlated in its risk-on or risk-off mode when one risk category does poorly all do and vice-versa. This market behavior has prevailed for the last three years and reflects the function of ongoing deleveraging. There is much less liquidity and risk capital in the market which magnifies the movements of asset prices. We are in a period of transition.

The S&P 500 rallied 12.9% in Q3 through September 11 since the bottom on June 1st as U.S. data surprised and Draghi's "whatever it takes" promise reduced euro stress. A large part of the rally was, however, driven by corporate share buy–backs as risk adverse investors increasingly preferred bond to equity investments.

Negative news about the U.S. and global economy are already well known and reflected in current prices. We expect Europe to remain center stage in the near future as only shorter term liquidity problems can be averted by the European central bank, but not the underlying structural and fiscal problems. With austerity measures that are being implemented across Europe, we expect a weak outlook for economic growth in Europe. U.S. exports to Europe are only 3% and to China only 1% of GDP respectively. It is, therefore, more likely that changes in the price of gasoline have a greater impact on U.S. GDP than developments in the Euro area and China. The U.S. equity market has outperformed global equity markets by 8% for the past two years fueled by corporate earnings, but only a modest increase in the U.S. valuation premium. We expect this trend to continue with slow growth expectations for Europe and a sustained period of below growth trend in emerging markets.

Fixed income markets

Fixed income markets have been factoring in market uncertainties and are fairly valued with high-yield bond yields (BB) are around 5,75% and spreads at 340 bps over 10 year Treasuries. The government bond markets of developed markets are overpriced, driven by the flight to quality. Supply and demand continue to support corporate bonds as investors seek yield and issuers take advantage of low interest rates, but a weakening global economy and systemic risk from sovereign issues are risk factors likely to limit upside potential.

Real Estate Market turning the corner

We believe we are in the early stages of a multi-year real estate recovery fueled by improving cash flows, rising demand, a scarcity of new development projects, improving credit availability, and generationally low interest rates. We believe the outlook is promising for both residential and commercial real estate. Though housing activity is improving, it remains at unsustainably low levels relative to population growth and household formation. Furthermore, Americans continued to pay down their debt during the second quarter by 0.5% to $ 11.38 trillion, a process that has weighed on the recovery with Q2 GDP growth at a meager 1.7%, but could fuel more robust growth in the future with consumers on a sounder financial footing.

Labor Market indicated slack recovery

Only 96K jobs were created in the U.S. in August, and in uly and June numbers were revised downward. The politically important unemployment rate fell to 8.1% from 8.3% which was largely due to more people dropping out of the workforce. By the end of July 2012, labor force in the U.S. was 155 million people. Population and labor force grow at approx. 1% per year in the U.S. which means that the U.S. economy should generate additional 1,55 million jobs per year or up to 129'000 jobs per month. In order to decrease the unemployment rate, the number of generated jobs needs to be significantly higher. Since the beginning of the year, nonfarm payrolls average monthly growth rate was 139'000. In order to obtain a 2% and more annual GDP growth, the productivity growth rate needs to compensate for the lack of labor force which has been the case so far in 2012. We expect the labor market to improve when Washington addresses this mainly political rather than structural issue after the election.

Central banks reassuring markets

The ECB unveiled a radically new program called "Outright Monetary Transactions" on Sept.6 to support the debt markets of ailing EU member states and ensure that their banks had enough access to its credit lines by an open-ended program to buy short term government bonds only of those states that have agreed to conditioned loan programs tapping EU bailout funds. The ECB will continue to avoid increasing monetary stimulus, by draining equal liquidity from circulation. This measure is aimed at securing finance at reasonable cost for ailing member states and to provide a fully effective bacstop against market volatility. Thus, the ECB is not only reassuring markets, but is gaining time, which is an important step towards strengthening stability and growth in the Euro area. In an unprecedented and controversial move, the Fed unveiled an aggressive program to spur the economy through open-ended commitments to buy mortgage bonds and promised to keep rates between 0 and 0.25% to mid-2015 in order to spur the economy and improve the job market.

Corporate Earnings recession?

In Q2 2012, earnings of the majority of the companies in the S&P index exceeded expectations. However, about 60% did not meet the revenue growth expectations and were highly conservative in their guidance for the next 3 quarters. The cost reduction effect has come to an end and the focus will be on revenue growth as the long term source of earnings. With the exception of the financials, materials and energy sectors, revenue growth in all other sectors although slower since 2011 has been at a steady 8% on average. We expect earnings to be mixed in Q3 with improved earnings in consumer discretionary, technology and healthcare.

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Outlook

As nervous investors are chasing short term returns the market for long term returns has become less efficient than the market for short term returns. Therefore, valuation has become a much stronger driver of equity returns than either corporate earnings or macroeconomic growth in our opinion. We continue to invest in companies with a lesser than the market price volatility, a competitive advantage in difficult times, an attractive dividend yield and a high potential to grow dividends over time. As the real estate market is in recovery we included REITs. We also find energy MLPs, as well as companies in the consumer discretionary space attractive. Good investment opportunities can also still be found in high yield and senior bank debt.

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