THE BERMUDIAN BUSINESS

OUTLOOK **2011**

Argus Financial Ltd forecasts the economic and investment scene for 2011

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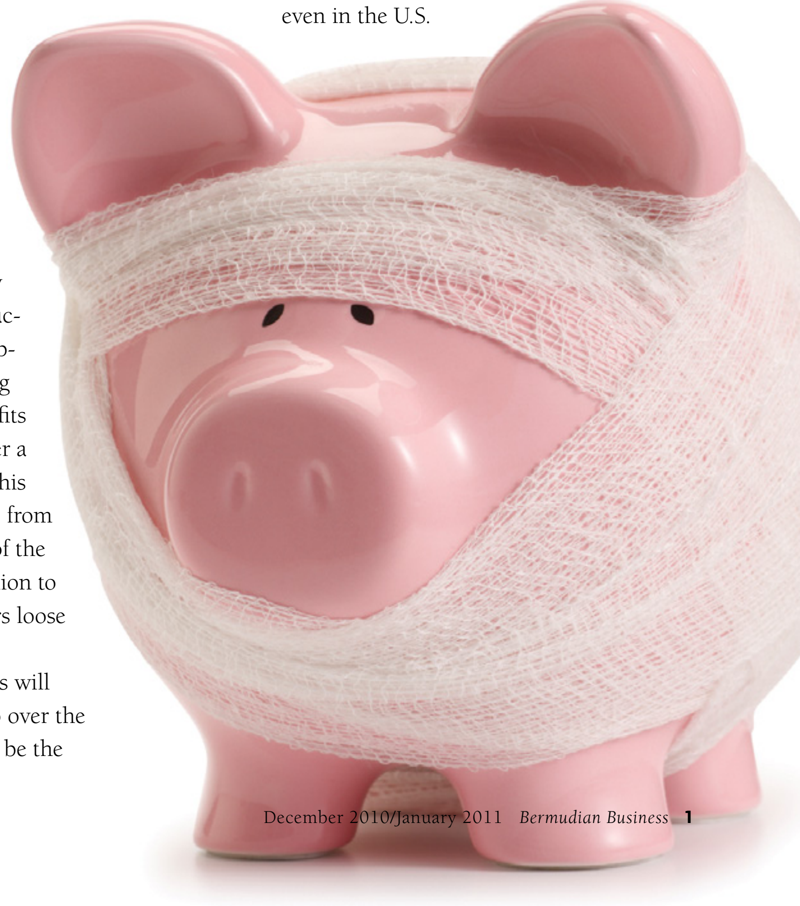
In the major developed economies conditions continue to be relatively weak, albeit vastly better than 18 months ago. GDP growth in the U.S. remains slightly positive and recently the National Bureau of Economic Research declared the recession that began in December 2007 officially ended in June 2009. The duration of 18 months made it the longest of any recession since World War II. Any future downturn of the economy would now be considered a new recession and not a continuation of the previous one.

In Europe, economic conditions have varied tremendously by region. While in Germany conditions have been reasonably good, the weaker countries have faced difficulties this year. The experience in Greece earlier this year, where the deficit problems turned out to be much bigger than markets initially realised, caused equity markets to sell off sharply in late April through to June. The European Central Bank led bailout package brought confidence to the markets that Greece would not default on their debt. However, while this has bought some time it may simply be delaying the inevitable fact that Greece may eventually need to restructure their debt.

There are several other issues coming from the debt crisis in the Euro region. One is a concern over the stability of the monetary union itself. Some of the conditions of the European Central Bank rescue package involved Greece implementing austerity measures such as cutting spending and raising the retirement rate. These conditions led to strikes and riots in Greece. With Greece effectively being subsidised by the larger, stronger European economies, which have less generous retirement and compensation schemes, taxpayers of a country like Germany are understandably reluctant to provide such subsidy without demanding a reduction in the benefits received in Greece. Over a longer period of time, this could result in pressure from the stronger members of the European Monetary Union to cut the weaker members loose and kick them out.

Other issues investors will need to pay attention to over the course of next year will be the impact of austerity measures on the underlying economies. In the case of Greece for instance, cutting spending so drastically could lead to such a weak and shrinking economy that the country could end up with an even worse deficit than they started with. Greece may be an extreme example but even in the U.S.



there is more of an appetite to cut government spending.

Moving on to Bermuda, we believe Bermuda's economy is facing a slow recovery as indicated by the sluggish GDP growth, reduction in the numbers of consumers in Bermuda and the generally high consumer uncertainty for the Bermuda economy in the next 12 months.

In Bermuda, the latest unemployment statistics show that the island reached 4.5 per cent in 2009. Total positions filled in the labour market fell by 693 jobs between 2008 and 2009, 493 of which were held by non-Bermudians. The non-Bermudian number is critical to Bermuda's economic health because these guest workers rent homes and buy goods such as groceries, cars and gas in addition to services.

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The decrease in demand for local purchases, caused by the rising unemployment for Bermudians and by having fewer guest workers, is going to make it more challenging for local businesses to recover from the economic downturn. Unfortunately, this trend appears to have continued into 2010 as anecdotally indicated by the number of lives covered by local insurance companies continue to decline and the steady news of guest workers, friends, or neighbours leaving the island. In addition, large forward looking projects, such as the City of Hamilton's waterfront development, have also been put on hold due to lack of revenues.

Inflation has been steadily increasing over the last year which, coupled with low salary increases, will encourage consumers to increase savings, putting less money back into the economy. This trend can already be seen in the Q2 2010 Quarterly Bulletin of Statistics, where overseas spending by residents dropped by $1 million and local retail sales dropped by 3 per cent when compared to the same quarter a year ago. This trend is not likely to change rapidly as there is a great deal of consumer uncertainty about the economic future of Bermuda with 72 per cent of the Q3 2010 Omnibus respondents indicating that the economy will either remain flat or worsen within the next 12 months.

On the positive side for the future, the Throne Speech promised disciplined and effective financial management across all Government ministries, which is a positive move in managing the Government debt. In addition, Standard and Poor's upgraded Bermuda to stable from negative and there appears to be a concerted effort by the Government to reduce divisive language, which may have negatively impacted international business. Meanwhile, the Government signed its 23rd TIEA and most importantly the Government extended the exemption for local corporate taxes for international business until 2035.

As investors look ahead to 2011, we believe there are several important factors that will drive economic conditions (and investment returns). An important one that markets have focused on recently is how accommodative monetary policy is. In the U.S. money market rates have been effectively zero for almost two years now. Policymakers will argue that this helped prevent a recession turning into a depression, and this may or may not be true. However, this cheap money has not led to a sharp positive recovery in the economy. Now the U.S. Central Bank is embarking on another round of quantitative easing (dubbed QE2), buying U.S. treasury bonds in an attempt to lower interest rates further out the yield curve and encourage borrowing.

The Central Bank hopes to encourage a 'wealth effect' to emerge and spur on economic growth over the course of the next year. The belief is that as investors' wealth increases through appreciation of their equity holdings, commodity holdings, etc., this will begin to ignite the 'animal spirits' in the economy and encourage consumer spending, business investment and so on. There was a definite wealth effect in the 2000 to 2007 period, when home prices increased dramatically in most major economies and this did have a major effect on consumer spending. People were effectively using their homes as ATMs and taking out equity to finance spending.

One problem with this thesis is that investors have now experienced two large bear markets in the last decade, where equity markets dropped by more than half. Consequently, investors may not view an increase in equity markets as a permanent increase in their wealth and so may not increase their spending much, if at all. While the increase in housing prices in the last decade did result in a wealth effect, prior to 2007 home prices had generally only gone up and people viewed such increases in their wealth as much more permanent and so were more comfortable spending more. It is probably more likely from these levels to see a sharp, sudden decline in equity markets than a sharp sudden increase in real estate prices.

Other major factors will be the state of the U.S. housing market and the unemployment rate. Although the recession ended over a year ago, the unemployment rate remains close to 10 per cent and the housing market remains very weak. At a fundamental level the reason QE2 is seen to be necessary is because growth and the economy are weak.

With economic conditions looking fragile as we enter 2011, we encourage investors to take the time to properly evaluate how much risk they are comfortable taking and how their portfolios are positioned. While corporations have spent the last few years cutting costs and building cash and are generally in quite a healthy state, share prices can decline fairly quickly if investors' risk aversion increases (as happened this spring). It is more important than ever for investors to work with a wealth manager to create a long-term financial plan that is designed to meet your future goals and objectives. BB

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