



## Investment Outlook – January 2013

### Global Equities

Following the resolution of the fiscal cliff discussions over New Year, global equity markets enjoyed a significant rally throughout January. Concerns regarding Europe abated and were put on the back burner while investors focused on continued fed quantitative easing which helped push stocks higher across most leading markets.

The global equity benchmark (MSCI World) rallied 5.1% in January following a 1.9% return in December. For the past 12 months the benchmark is up 15.9% and an impressive 34.1% over three years.

Part of this growth was fuelled by changes in Japanese monetary policy following the election of Prime Minister Abe which has seen the Yen devalue by over 12% against the US\$ along with a rally in the Japanese stock market of 9.4% in January, after rallying 10.4% in December (in Yen).

The US Equity market posted a monthly gain of 5.3% with the S&P 500 and Dow Jones Industrial Index approaching new five year highs. With low interest rates on the cards for a number of years given the persistent high level of unemployment and lack of inflationary pressures, US investors appear to be rotating out of bonds and back in to equities. The so-called 'risk on' trade has taken hold as investor sentiment has improved. Despite weak 4<sup>th</sup> quarter GDP figures for the US showing a -0.1% retreat, it is clear that this was largely an anomaly due to a cut in government spending during the period. The private sector continues to expand and analysts expect a GDP growth rate of around 2.5-3% for 2013.

Bernanke has stated that until such time as unemployment falls to the Fed's new targeted rate of 6.5% (currently 7.7%) rates will not be allowed to rise. For now, the Fed continues its massive bond buying spree and remains the main buyer of Treasuries – often taking up two thirds or more of US Treasury debt offered at auction.

With a new central bank regulator mooted for Europe and tough austerity medicine being taken across the Eurozone, Europe is slowly getting its fiscal and regulatory house in order. However major structural weaknesses persist, particularly in the peripheral countries such as Spain and Greece. Spain remains reluctant to formally ask for a bailout, but massive Spanish unemployment may necessitate IMF/Eurozone assistance in 2013.

European markets have also had a significant recovery with the FTSE now trading at close to 6400. The benchmark MSCI EMU Index gained 3.0% for the month, after posting a 2.4% gain in December. The Eurozone stock market index is now up 16.6% for the past year. Despite a recession across much of Europe, the belief is that ECB President Draghi will backstop any problems with the Euro financial and banking system.

The MSCI Emerging Markets Index gained 1.4% in January following a significant 4.9% rally in December. Over the past year this benchmark is only up 7.6% and has been a relative under performer compared to developed equity markets. This masks the impressive rally seen in the Chinese equity markets which are up approximately 20%-25% since their summer lows.

Over the past year, most impressive of all has been the German DAX- up over 34%, France's CAC 40 up over 23%, while the Hang Seng has gained approximately 28% and Singapore slightly more than 22%.

While the US fiscal cliff negotiations were resolved satisfactorily, the markets face another test with the looming US debt ceiling negotiations which need to be resolved within the next two months. The market for now does not appear too concerned as the 'risk on' trade continues to be rewarded. Observers believe a debt ceiling deal will be negotiated shortly which will ensure the tough measures across the board budget cuts will not occur. It has been estimated that such cuts could cut 2% off the US GDP figure in 2013, were they to take effect through the sequestration procedure agreed to by Congress.

Volatility levels as measured by the VIX 'fear index' are now at five year lows below 15. Clearly if earnings disappoint globally we could see a pullback in the equity rally, but for now the bulls are dominating.

Europe remains in an overall recession, while the US economic prospects appear far brighter. US job hiring and unemployment figures are consistently pointing to a steady but slow recovery. Approximately 150,000 new jobs were again created in January and prior month's figures were revised upwards, adding tens of thousands of jobs to the employment data.

US housing continues to show recovery - the vast majority of states posted higher average and increased construction in January and in December. While the worst is behind the property sector, there do exist worries of a hidden shadow inventory held on the books of US banks, still requiring major workouts and adjustments. Despite this, the best two sectors in the S&P 500 for 2012, has been financials and consumer discretionary - clear evidence that consumers are feeling more positive and thus beginning to spend.

In the property space the US Property Index (REIT) benchmark posted gains of 3.4% in January - up 13.8% over the past year, while the European Citigroup BMI Property Index slid 1.2%, but remains up 21.3% over the year.

### Global Bond outlook

With the risk-on trade is back in a big way during December and January, many expect the US bond rally to finally recede. Currently the US 10 year Treasury yields 2.0% and has traded in a very tight range the past month.

The Global Government Bond Index fell marginally in January by 1.3% and is largely flat over the past year. By comparison the European Government Bond Index lost 0.5% for the month, but remains up 8.3% over the past 12 months (in Euros).

The Fed has indicated that it will maintain historic low levels of interest rates until unemployment drops to a rate of 6.5%. Most analysts expect this will take at least another 12-18 months, so continued Fed stimulus is expected. It remains the largest single buyer of Treasuries in the marketplace. This is an unprecedented move for the Fed to target a jobless rate, before changing course on monetary policy. His comments helped buoy the global market in mid December, although many suspect the bond rally may finally be coming to an end. The 10yr Treasury yield which was as low as 1.4% in October before approaching 1.9% currently.

Similarly the ECB is not expected to raise rates nor the Bank of England. In fact given England's weak growth prospects and fear of falling into another recession, higher inflation targeting is being rumoured which has helped to weaken the Pound. It now trades at its weakest level against the Euro in over 3 years.

Weak Eurozone economic numbers ensures that the Zone remained in a recession at the beginning of the year, despite Germany's favorable growth figures and optimism there. Political elections in Italy may yet lead to renewed uncertainty in that country if Berlusconi's party leads the formation of a new government in March. The Spanish economy continues to bleed jobs and shows record unemployment. A weakened Spanish Prime Minister due to recent scandals does not inspire immediate confidence that Spain will get its fiscal house in order.

Continued proactive comments by Draghi, the ECB president, following his critically important summer statement of 'we will do whatever it takes', has definitely helped to dramatically lower sovereign yields in peripheral Europe. By January 2013 the sovereign yields for countries such as Spain and Italy continued to be well below their summer highs of approximately 7%.

Increasingly many feel that the deluge of money sitting in bonds will need to find a new home and begin to switch into equities. Evidence of such flows out of bonds was recorded throughout January and into February particularly in the US. The weekly inflow into equity mutual funds has been the highest its seen in over five years.

The successful US fiscal cliff negotiations have also boosted hopes for an economic recovery and it is unlikely we will see bond yields dropping much from current levels. Many believe yields will slowly begin to rise at the long end of the curve as demand for bonds gradually decreases and economic recovery becomes more pervasive across the US. The hope is that demand in the US economy will help absorb renewed exports from Emerging Markets such as China and Brazil as well as the Eurozone.

China, meanwhile has shown positive signs of recovery and staving off any real estate bubble for now. We predict China will surprise on the upside in 2013 in economic growth terms, and manage to show healthy GDP figures.

Arguably it is only the pending debt ceiling negotiations (delayed for 3 months), that are holding back a wall of new money ready to enter the equity markets. Assuming the negotiations are fruitful, many analysts predict bond yield will easily rise over 2% on the 10 year Treasury Note and sounding the alarm for bond investors to begin bailing out of their fixed income investments.

Recent reports on the US housing market indicate that sentiment has bottomed and buying activity is at relatively high levels based on the past 5 years. Even construction activity, one of the largest drags on the US economy, appears to have finally begun to turn. Property prices are now rising in 40 out of 50 US states – the first time this has occurred in over 3 years.

With the recent positive jobs report in the US (over 150,000 new jobs in both January and December) - the US is poised to experience a far healthier recovery than Europe in 2013. The lack of severe austerity measures has in fact helped the US recover, while UK and Eurozone policymakers seem to be stuck in severe austerity mode limiting economic growth.