



“ Was there ever a people whose leaders were as truly their enemies as this one?
– Ernest Hemingway, *For Whom the Bell Tolls* ”

As US GDP growth inches to the +3% level, China's official manufacturing index hits a 7-month high and a Greek exit from the Euro is off the table (for now), the outlook for equities has gotten better and is likely to keep improving. We will see more investors gradually leaving the safety of bonds and gold and moving into equities. The risk of not being in equities and missing out, is greater than holding equities and having temporary reverses. The case for US equities is still positive with a preference for cyclical sectors, however I am more positive on Emerging Market (EM) and European equities due to a higher upside potential. I forecast the S&P to finish 2013 at 1554, i.e. a +10% upside from Friday's close of 1416. Come Q1 2013, I forecast that Spain will ask for a bailout, that the ECB will activate the (Outright Monetary Transaction) OMT and will buy Spanish bonds aggressively and that Spanish 3 year bond yields will narrow from the current 3.4% to under 2%. A "risk on" accompanied with additional US monetary easing means Gold will see a slow grind up. Energy prices will continue to drop as US shale gas becomes a hot topic of discussion. Look out for overheating in the investment grade bond market by mid-year and mark your exit.

Fiscal Cliff ahead, (Congress) men at work

Last week, the US Q3 GDP growth was revised higher to +2.7% from an initial estimate of +2%. The first estimates of the Thanksgiving sales rush (i.e. when people start shopping barely hours after they have given thanks for what they already have), indicate a year-on-year increase in total spending of +12.8% in the period from the Thanksgiving Day to Sunday. The US Jobs picture is getting better and, most importantly, the US housing market is improving. However, before we really get too bullish on risk assets, the "fiscal cliff" issue needs resolving and the US Congressmen are hard(ly) at work on it.

The "fiscal cliff" (why not just call it responsible budgeting?) is an attempt to deal with the accumulation of over a decade of "temporary" tax cuts and budget deficits. If no agreement is reached, the automatic cuts that will be come into effect are expected to cause the US GDP to shrink by approximately 4% i.e. \$600bn over 2013. December 15 is the soft deadline for Washington to wrap up negotiations and December 21 the "last ditch" deadline.

Everyone is well aware of the market fallout from partisan gridlock over the "debt ceiling" in the summer of 2011, when the US lost its coveted AAA rating, \$12 trillion of wealth from global equity markets was wiped out and US GDP growth came in at paltry +1.8% for the year.

The US Presidential election is over and Mr. Obama has secured a clear win. One of the two key factors for the resolution of the fiscal cliff is raising taxes, the other is

spending cuts. If there was one clear message from the President throughout the campaign, it was that he wants to raise taxes on those he calls "the rich" (individuals with incomes over \$200,000 a year and couples with incomes over \$250,000). In voting him in, the majority of the American people endorsed that view. However, in re-electing a Republican House of Representatives, they didn't go all out and hand the President free reins. A compromise from both sides is the most likely way forward – some tax rises and some reforms to entitlement programs. Without faster growth there won't be sufficient tax revenues to reduce the deficit and any renewed recession would deprive the country from crucial quarters of growth. President Obama's first term saw a GDP growth of +0.8% (+2.1% if you leave out the negative quarters). The US needs at least +3-4% growth to get back to a satisfactory income and employment levels.

Will the "widowmaker" trade finally payoff?

Bond traders have been betting against Japanese government bond (JGB) for years — and losing spectacularly. The trade, shorting JGB has been nicknamed the "widowmaker" trade as investors have called the top in the bond market for years, only to get skewered. Since 1992, while the Japanese Debt to GDP ratio has risen from 71% to 211%, the yield on 10Y JGB has declined from 6% to the current 0.42%.

Last month, Mr. Yoshihiko Noda, Japan's sixth Prime Minister in as many years, called for fresh elections on December 16. Under Shinzo Abe's leadership, the

opposition Liberal Democratic Party (LDP) is likely to win back the reins of power it occupied for nearly all of the 55 years to 2009. Mr. Abe has proposed radical policies – bolder monetary policy from the Bank of Japan (BOJ) and more fiscal stimulus from the Ministry of Finance; and a higher inflation target of 2% (Japan has been in deflation for most part of last two decades). If Mr. Abe were to get what he wants (the likelihood is he may), the impact: Japanese Yen (down), JGB yield (up) and the Japanese equity market (up). Japan returning to positive growth would also be good for the rest of the world. It is possible that the BoJ's asset purchase program may involve foreign bond purchases in an effort to devalue the yen. This will generate upward pressure on long-term JGB yields.

The Spanish Patient

For weeks now the crisis talk in Europe has boiled down to two key questions – will Spain finally ask the ESM (European Stability Mechanism) for a bailout and activate the OMT (Outright Monetary Transaction); and will the Troika give Greece the next tranche of bailout money to prevent its hastened exit from the Euro.

The Spanish Patient has seen its 10yr bond yields rally in from over 7.6% to 5.3% since July 24 and is in a false pretense of good health. European policymakers and the ECB will know that there is no isolation ward possible in the financially integrated Eurozone. Therefore, if Spain were to relapse, it would infect other weaker Eurozone nations too. If Europe is out of the news and all seems quiet, it is because of the OMT and Spain's request for a bailout is the next stage in dealing with the European sovereign debt crisis.

Greece is set to receive €34.4 billion, the next tranche of bailout money. The three main concessions made to Greece are - lowering the margin on the loans from 1.5% to 0.5%, extending the maturity of these loans by 15 years and returning the profit from the ECB's SMP (Secondary Market Purchase) program of Greek bonds. This deal sends a strong signal as to the willingness of the core European countries to support the periphery. It underlines the message that it remains in everyone's interest (the IMF and its non-European stakeholders included) to avoid a systemic crisis so long as Greece and peripheral countries satisfy the bailout conditions.

In short, Greece is off the risk menu for a few months and any talk of a Greek exit from the Euro doesn't seem realistic until after the German national elections due September/October 2013.

Where to invest?

As US GDP growth inches to the +3% level; China's official manufacturing index hits a 7-month high, a Greek exit is off the table (for now), and the ECB's OMT is in place; the outlook for Equities has gotten better and is likely to keep improving. After a flat finish in 2011, this year the S&P 500 is up +12.6% with one month to go till the end of the year. Europe (SXXP) and Emerging Market (MXEF) equities, after taking a beating midyear, have recovered well to be up by +12.7% and +10% YTD respectively.

We will see more investors gradually leaving the safety of bonds and gold and moving into equities. Selling pressure on equities to rebalance large pension fund portfolios will ease too if the following two statistics from a recent report in the Financial Times are any indication.

- As of September this year, the UK's more than 6,000 defined benefit schemes on average hold 43 per cent of their assets in bonds and 38 per cent in equities. This reverses a trend set in motion in 1956 to switch into stocks and out of bonds. Allocation to equities by UK pension funds peaked in 1993 at 81 per cent.
- Allianz, the world's second biggest manager of money with about €1.7tn under management, has only 6 per cent of its insurance portfolio in equities while 91 per cent are in bonds. A decade ago, 20 per cent was in equities.

The bottom Line is: The risk of not being in equities and missing out is greater than holding the equities and having temporary reverses.

The case for US equities is still positive with a preference for cyclical sectors – Technology (XLK, AAPL, CRM) Industrials (XLI, UTX, CAT) Consumer Discretionary (XLY, AMZN, HD) Energy (XLE, SLB, HAL), Financials (XLF) and Home Building (XHB, PHM, LEN, EMR). However I am more positive on Emerging Market (EM) and European equities (VGG, EWG, EWU, EWQ) due to higher upside potential compared to US equities. Analysts at Société Générale report that the Eurozone equities are currently trading at a historical discount relative to US equities (50% on a price- to-book value ratio, compared to a 30 year average of 32%).

In the EM, my preference is for economies with GDP growth slowdown bottoming out, improving manufacturing and anticipated currency appreciation - i.e. India (INP), South Korea (EWY), China (FXI) and Turkey (TUR). Chinese equities on a relative basis have more upside than Indian equities. India is currently up +140% off its 2009 lows, while China is just half of that. In the

corresponding period the S&P 500 index is up +110%. With the leadership change in the past policy clarity is set to prevail in China, Financials and Autos in both markets are attractive. The names I like are (Axis Bank, ICICI Bank, ICBC and M&M).

Some other investment views for the year ahead

- Come Q1 2013, Spain will ask for a bailout, the ECB will activate the OMT and will buy Spanish bonds aggressively. The Spanish 3 year bond yield will narrow from the current 3.4% to under 2%
- OMT action will be positive for EUR and EURUSD to trade at high end of 1.25-1.35
- EM currencies will strengthen against the dollar. Long BRL/USD, Long INR/USD, Long MXN/USD but JPY to weaken against USD
- A "risk on" accompanied with additional US monetary easing means Gold will see a slow grind up
- Energy prices will continue to drop as US shale gas becomes a hot topic of discussion
- Look out for overheating in the investment grade bond market by mid-year and mark your exit
- US Treasury, German Bund and UK Gilt yields are all set to rise. Not a free fall in prices but a bungee jump

How well did my forecast for 2012 do?

In the January 2012 Market Viewpoints, I forecast the S&P 500 to finish the year at 1357 i.e. +8% upside to 1257 close on December 31, 2011. As of last week's close, with a month to go, the S&P 500 is at 1416 (i.e. + 4.3% higher than my forecast) but the "fiscal cliff" drama still looms so we will take the final reading in the next newsletter.

I also had listed few likely and unlikely outcomes. Let's have a look at how they did

2012 Likely outcome forecast:

- Sovereign default within the Eurozone [correct, Greece's 70%+ haircut is a default];
- France downgraded [correct] but Sarkozy ekes out re-election [incorrect we are stuck with Monsieur Hollande];
- EURUSD trades at 1.20 [correct it traded at 1.204 on July 24 after starting the year at 1.30];
- Gold correction proves to be overdone [correct, Gold is up +13% YTD from \$1545 at the beginning of the year to \$1725 today]
- Oil trades closer to \$100 than \$75 [correct, Brent is at \$110].

- Emerging Markets recover in the second half of the year [correct, H1 -3.5%, H2 +13.8%, +9.9% YTD],
- US GDP growth hits +3% [Q3 reading is at +2.7%, Q4 may easily come out at or over +3%],
- US unemployment falls below 8% [correct, it is now at 7.9%],
- Obama gets re-elected [correct, much to my disappointment], and
- The S&P 500 ends the year above 1350 [correct as of now]

2012 Unlikely outcomes forecast:

- Breakup of the Eurozone [correct, the Eurozone still exists and the most likely member to exit, Greece is still in it];
- Financials outperform [incorrect, Europe financials are up +20.47% YTD and have outperformed Stoxx 600 by +7.6%; US financials have done well too];
- EUR trades 1.40 [correct the EUR never got to 1.40, it reached a high of 1.35 in February];
- Facebook to trade above its IPO price at the end of the year [correct, at \$28, it is well below its IPO price of \$38];
- Spain to win Euro 2012 [incorrect, they did win it spectacularly]
- Great Britain to finish third in the medals tally surpassing Russia at the Olympics [incorrect, Team GB did finish 3rd with record 29 Gold medals ahead of Russia's 24 gold medals]

That is 9/10 on likely outcomes and 3/6 on unlikely outcomes for an overall score of 12/16. I will now put down my 2013-year end S&P target.

I forecast the S&P to finish 2013 at 1554, i.e. a +10% upside from Friday's close of 1416.

On that bullish note, I take this opportunity to wish you a Merry Christmas and a very Happy New Year.

Best wishes,



Manish Singh, CFA

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