



Market Viewpoints

Manish Singh

December 2013

“What the New Year brings to you will depend a great deal on what you bring to the New Year” - Vern McLellan

The twinkling lights on the streets and cold morning air tell us it's almost time for Christmas. It is time to bid a year farewell and welcome another one. As for the markets this year, the global economy has returned to trend-like growth, following a very weak start. Less fiscal tightening both in Europe and the US have played a major role in this economic recovery. This year, there was no US fiscal crisis; no hard landing in China; and the European Union managed to keep both the Euro and Eurozone intact. As a result, equities soared, gold collapsed and the bond market bull was dragged back and tethered. If the S&P ends near 1800 and the 10 year US treasury yield ends at 3%, equities will have outperformed bonds by +40% in total return terms – the highest ever. The year 2014 will be a year for cautious optimism. I am optimistic about the US but cautious about Europe. US equities continue to be a good long trade and Japanese equities are also a buy. Emerging Market (EM) equities had a great Q4 as a tactical long, however, I am wary to be long EM equities beyond January when ‘tapering’ talk will likely gain momentum. USD will strengthen more against EM currencies than the developed currencies.

2013 - The year that was...

So it's December! A month of fun, generosity, and good will. The twinkling lights on the streets and cold morning air tell us it's almost time for Christmas. It's time to bid a year farewell and welcome another one.

This time last year, a looming ‘fiscal cliff’ in the US (government spending cuts of \$600bn during 2013) was the talk of the markets. A year later, the plunging feeling of a ‘fiscal cliff’ has been replaced by a feeling of ‘vertigo’ as the S&P 500 Index (SPX) reaches a record high of 1808.

Looking back at 2013, it had some historic moments. Pope Benedict's resignation (the first pope to resign since 1415); the passing away of two great leaders - Margaret Thatcher and Nelson Mandela; a thaw in US-Iran relations; a US Government shutdown (first one in 17 years); and Andy Murray's victory at Wimbledon (first British men's singles title in 77 years) to name but a few. This year, Pope Francis was the most searched item on the web, and so popular is the new Pontiff that even an atheist was quoted as saying - “I may be an atheist, but there's something about Pope Francis that makes me want to be Catholic. He's so inspiring.”

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It has been a great year for risk assets despite the slow start. At the beginning of the year, my own prediction for the SPX was to finish at 1554, which I revised higher in August to 1744, as both data and sentiment improved. Here we are now with the SPX near 1800, and a YTD gain of +27%. The SPX is now up +167% since the lows of March 2009 (an annualised return of +23%). Stellar returns by any measure!

The last US Federal Reserve meeting of the year takes place Tuesday and Wednesday of next week. The committee does seem somewhat closer to giving the green light for ‘tapering’ to commence and last week's strong unemployment report increased this likelihood. The two most important considerations for the Fed are the outlook for the US economy and the reaction in the financial markets. A third consideration perhaps for Ben Bernanke (in his last meeting as Federal Reserve Chair) will be, does he ‘taper’ and be remembered as the Grinch who stole Christmas? I am of the opinion that



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Bernanke will leave things as they are, leaving it to incoming Chair Janet Yellen to decide on the timing of the tapering. The first meeting of the New Year with Yellen as Chair is scheduled for January 28-29, 2014.

2014 - A year of cautious optimism

The global economy has returned to trend-like growth following a very weak start to the year. The second half of this year has been particularly good and leading indicators suggest the growth momentum will persist in 2014. According to IMF projections, global growth is expected to increase from +2.9% in 2013 to +3.6% in 2014, driven largely by the developed economies.

2014 brings out the cautious optimism in me. Less fiscal tightening both in Europe and the US have played a major role in this economic recovery. As a regular reader of this newsletter, you will recall my protestation to mindless austerity all through my writings in 2012. The reduction in the pace of fiscal consolidation, both in the US and in Europe, has boosted household income and spending budgets.

The Eurozone region is out of recession. However, the pace of recovery in the Eurozone will probably disappoint, although the resolve of the European Central Bank (ECB) is strong. The banking union discussion is on track and the ECB's Asset Quality Review (AQR) of Eurozone banks could be the tipping point for a recovery. A major point of concern will be the rise in anti-Euro sentiment as the right wing parties are projected to score major gains in the European parliamentary elections to be held in May next year. IMF forecasts the Eurozone economy to grow +1% in 2014. The growth for 2013 is projected to be -0.4%.

The UK meanwhile, is doing better than anticipated, powered by – loose adherence to austerity targets, loose monetary policy, a resurgence in manufacturing (car exports), a recovery in the housing sector, and a weak GBP. The IMF forecasts the UK economy to grow +1.9% in 2014. The growth this year is projected to be +1.4%.

Among the developed world, Japan has had the best GDP growth this year (+2%) and the stranglehold of deflation has finally loosened. Last December, Shinzo Abe won a landslide victory in the Japanese elections. The optimism it brought has led to the Japanese equity market surging +75% since then, accompanied by a -30% fall of the currency on a trade-weighted basis. Japan will be an important market again next year, with more reforms and therefore more equity gains (and currency weakness) to come.

The Emerging Markets (EM), I suspect, will continue to face challenges as they struggle with changes of government, high inflation and the dire need for structural reforms. As the IMF has noted, a new round of structural reforms is a must for many EMs economies, including investment in infrastructure to reignite potential growth. China needs to rebalance growth away from investment toward consumption, to make way for more balanced and sustainable domestic and global growth.

Portfolio mix for 2014

US equities continue to be a good long trade although there are chances of a mini sell-off on account of profit taking as the year comes to a close. Next year, another +27% gain on the SPX is unlikely. A +12-15% gain from my 2013 target of 1744 is what I would expect. P/E expansion no doubt will play a smaller role in 2014 than we have seen this year. I expect the earnings to increase by +8-9% and the SPX to finish 2014 somewhere in the range of 1956-2000. I strongly believe that the developed economies will do better than the EMs in 2014 and this will be reflected in the high P/E multiples sustaining themselves throughout the year.

Japanese equities are also a buy. Japanese government policies are pushing investors to go into risk assets and the deflation trade is still on. So far, it has largely been the foreign investor who has driven the rally in Japanese equity markets. Next year, it could be the turn of the local investor.



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In Q1 2014, Eurozone equities could come under pressure as AQR banking union challenges and deflation fears abound. However, on a full year basis, Eurozone equities should record +10-12% growth. Stock picking will be more rewarding than indexing.

EM equities had a great Q4 this year and in my [Bloomberg interview](#) at the end of August, I suggested a tactical long trade in EM. However, I am wary to be long EM equities beyond January when 'tapering' talk will likely gain momentum. Next year is a key test for EMs, like I have mentioned before, EMs are now faced with reforming to deliver the returns international portfolio flows expect. The ones that reform will be lauded and rewarded and the others shunned, as developed markets improve and therefore offer less and less incentive for cash to be deployed in search of return. As for Bonds, given the imminent tapering, buy short duration bonds (2-5 years maximum) only if you have to. EM bonds are a good play, but be wary of a sell-off in Q1 2014. EM bonds will be a better bet once the effect of 'tapering' and its impact on EM are known. Euro area bonds are preferred over US bonds, and within the Euro area, peripheral Europe (Spain, Italy, Greece, and Portugal) bonds offer better yield.

Currencies and Commodities

A strong US jobs report last week reinforced the 'tapering' view and therefore a strong USD. However, the magnitude of this and the Fed communications going forward will be the determinants of how soon and how far USD strengthens. The Federal Reserve under new Chair Yellen will no doubt remain dovish and not threaten the recovery. Therefore, any gains in USD versus EUR and GBP will be slow. However, USD gains versus EM currencies will be stronger.

I expect EUR/USD to trade at the 1.30 level or below by mid 2014 but look for GBP/USD to hold the 1.60 level through the first half of the year. USD/JPY on the other hand, should strengthen, as monetary policy diverges more between Japan and the US. USD should also strengthen against the AUD.

The trend in commodities is still down, with Brent likely to slide and find a bottom at the \$100 level. Gold is going to struggle to break to the upside, but in the \$1,100-1,200 levels it is worth accumulating.

In brief...

As we all prepare for the festive season, I take this opportunity to wish you Happy Holidays and a New Year filled with good health and continued investment success.

See you in January!

Best wishes,

Manish Singh, CFA