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Reading the tea leaves

Fortunately, the December 21st end of the 5, 125-year Mayan calendar did not mark the end of the world as hyped by some pessimistic doomsayers. And much to the chagrin of financial market doomsayers, risk markets performed well as US and Australian equity markets gained 16% and 22%, respectively[1], while global bonds produced an impressive 9% return[2]. 2012 turned into a win-win for most investors, despite the calls of financial market pessimists.

While we remain somewhat bullish over prospects for 2013 financial markets, much of the 2012 tailwinds have faded. Investment grade corporate bond yields currently average 2.6%, or 1.35% more than government yields[3]. In contrast, at the beginning of 2012, corporate yields averaged almost 4.0%, or 2.6% more than government yields. Equity price-to-earnings ratios, or the value markets place on earnings, have already increased from 13 to 14.5 for US equity markets and from 13 to almost 18 for Australian equity markets[4].

But current, higher valuations appear reasonable as many of the early 2012 global risks have disappeared, justifying today's equity and bond market levels. Nonetheless, given today's low bond yields and higher equity valuations, investors need to be prepared for lower, but less volatile returns over 2013. While significant global risks remain and investors should remain vigilant, higher quality risk assets are fairly priced. We believe investors should avoid the lowest-quality instruments in an environment where corporate profitability and the consumer will remain tested. While today's global environment looks better than in 2012, significant risks remain.

Politics

Politics will continue to play a major part in both financial market returns as well as investor risk appetite. 2012 saw the re-election of US president Barack Obama. Of the last 5 US presidents, George Bush Sr. was the only president not re-elected for a second term. One could argue that the US has had a stable political system over the last 30+ years, with one large exception: the composition of the US congress. Democrats currently control the senate, while the republicans control the house of representatives. Congressional instability, leading to political gridlock will very much remain at the forefront of financial news over the first quarter. While the divided US congress finally approved a temporary budget, saving the US from going over a fiscal cliff, an artificial political issue, the raising of the debt ceiling, will add threats to financial markets over the first part of 2013.

The U.S. officially reached its congressionally-approved $16.4 trillion debt ceiling limit on the 31st of December 2012. This created another opportunity for congress to again re-hash tax and spending policies. As it has done in prior debt ceiling fights, the U.S. treasury undertook a series of accounting measures to avoid a technical breach of the debt ceiling limit. When these moves expire in mid-February, in theory, congress should become more motivated to compromise. Or the US will potentially be forced to selectively default on its obligations, including its debt service, payroll, social security, welfare, medicare and defence spending. We believe these short-term risks to US growth are substantial and a 'risk-off' environment will eventually take hold over the first quarter.

[1] Including dividends reinvested.

[2] Barclays Global Aggregated hedged into USD.

[3] BofA Merrill Global Corporate Index hedged into USD. In contrast, the BofA Merrill Australia Corporate Index currently yields 4.4%, down from 6.1% in December 2011.

[4] US S&P 500 and Australian ASX using 12 month trailing EPS before extraordinary items.

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In Europe, 2013 brings elections in Germany, Italy, and the United Kingdom. Slower growth stemming from greater fiscal austerity threatens current European leadership as voters look to new leaders supporting less painful short-term austerity solutions. The vicious circle of higher sovereign debt, weakening banking systems and excessive fiscal consolidation will lead to lower European growth prospects. In our view the Eurozone remains the single biggest downside risk facing the global economy. The perceived failure of current austerity measures has led to voter unrest, public demonstrations and workforce strikes.

Hollande's French election victory provides a hint of a move toward socialist solutions throughout more of Europe. While the European Central Bank (ECB) has provided temporary support which could last through 2013, longer-term European growth risks are substantial as political leaders fail to address the painful necessary economic harmonisation across Europe. We expect to slower growth, greater voter unrest and changes to European political systems, despite continued substantial ECB action. We do not believe European peripheral defaults will occur over 2013 given strong ECB action to 'do whatever it takes' to support the European monetary system.

The end of quantitative easing

The latest Fed minutes revealed concern over further increases to the central bank's $2.9trillion balance sheet. The minutes said, 'Several (officials) thought it would probably be appropriate to slow or to stop purchases well before the end of 2013, citing concerns about the financial stability or the size of the balance sheet.'

We believe talk of ending quantitative easing is premature. US unemployment remains stubbornly high at 7.8%, and with an average monthly gain of 150,000 jobs over the past 2 years, the US economy has barely recovered ½ the jobs it lost since the beginning of the financial crisis (8.4 million jobs lost vs. 4.5 million jobs gained since). At the current pace, we expect at least another 3 years before the US regains the lost jobs and the premature removal of monetary stimulus has the potential to derail the current short-term economic recovery. We expect quantitative easing to continue through 2013 and we expect central bank rates to remain near 0% through at least 2014.

Risks for Australia

Elections and the abandonment of the budget surplus

Australia is also scheduled to go to the polls in 2013. The economy has fared better than its global counterparts over the past few years, but the government recently abandoned its promise of a budget surplus due to a substantial fall in anticipated revenues. This was caused partly by a fall in mining revenues consistent with the unexpected Chinese slowdown. We believe this will put significant pressure on the government to achieve a surplus in 2013, although the risk to the domestic growth story is somewhat limited.

The high Australian dollar

The Australian dollar (AUD) remains stubbornly strong – as better relative economic growth, the continuing commodity boom and higher real rates have driven global capital to flow into the country. The higher AUD will force the central bank to leave rates lower for longer. However, the Reserve Bank of Australia (RBA) will maintain a keen eye on the impact of lower rates on the housing sector, which remains at elevated levels. Given our expectations for a continuing expansion in central bank balance sheets in much of the developed world (US, Europe and Japan), we find it hard to imagine a significantly weaker AUD. We believe the current level of 1.05 USD per AUD is the middle of our forecast range for 2013, with an upside of approximately 1.12 and a downside of 0.98.

A China/Asia slow-down

The direction of the Chinese economy will fundamentally impact the remainder of Asia. While policymakers are unlikely to endlessly stimulate the domestic economy and a slow -down in the commodity boom is inevitable, we

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believe concern over a hard landing in 2013 is overblown. While recognising some lack of dependability in current data, Chinese exports, credit growth and production appear to have weathered the current downturn fairly well and we believe growth will remain in the 7+ range over 2013. In our view, a relatively strong Chinese growth story limits the risk of a domestic Australian slowdown over the foreseeable future.

Investment implications

- We believe 2013 will be a much more challenging year for returns when compared to 2012, for both equity and bond markets.
- Bond yields are at historical lows in most developed economies and credit markets had an impressive run over 2012. It is hard to imagine further significant capital gains from corporate bonds at current levels. We expect coupon income from corporates over 2013. Overall corporate bond returns should be in the 4 to 6% range in Australian dollars.
- Equity markets have produced impressive returns from their lows of 2009 and now need the real economy and corporate earnings to grow in order for returns to continue. For this we need consumer confidence, a rising housing environment, especially in the US, a stable central bank and easy money, a rise in jobs and fall in unemployment.
- We will look for more opportunities in the BBB sector in order to increase portfolio return, but will also look to limit increased risk in order to maintain expected portfolio volatility in the 1% range.
- We continue to favour the debt of Australian/Asian & US financials. We prefer the debt of the big 4 banks, including lower Tier 1 and Tier 2 paper in addition to senior debt.
- We prefer floating rate assets to fixed rate assets as we expect sovereign rates in 2013 to rise as opposed to fall in most developed markets.
- We will limit our exposure to mortgage backed securities and asset backed securities to 15% of the portfolio – here we prefer to hold the highest quality AAA tranches.

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