Top Non-Predictions for 2014

- The business cycle is dead
- Bonds for the long-run
- QE causes inflation
- The government shutdown will destroy growth
- Rob Ford is a family man
- Dennis Rodman will build a bridge to North Korea through basketball
- Bonds will deliver stable returns

Like in most years, markets got a lot of things wrong in 2013 and it is likely that 2014 will bring us more surprises. Since we view our job as striving to deliver low volatility returns regardless of the financial market environment, we feel comfortable in making forecasts we can somewhat afford to get slightly wrong. We are currently buying tickets for the 2014 North Korean basketball league and are planning a juice cleanse with Rob Ford.

As we kick of 2014 with the US recovery gaining traction while the Fed begins its tapering programme, we continue to believe that 2014 is poised for risk assets to continue to their ascent. In the last five years the Fed has turned on the monetary spouts each and every time there the US recovery was in danger. While many naysayers still doubt the effectiveness of Quantitative Easing, the proof is in the pudding. US consumer confidence has continued to climb, led by job growth, stable commodity prices and less risk of political gridlock. But the main US story is employment, where job gains have been substantial with the year-end unemployment rate 7%, a 5-year low. The US economy has now gained 7.4 million jobs since the beginning of 2010, now more closely offsetting the 8.7 million jobs lost over 2008-2009.[1]

The power of QE proved to be substantial, and as a result investors became less enthralled with maintaining a more defensive stance. Eventual tapering talk led to a marked sell-off in the bond market in mid-2013, something we believe will continue (albeit at a more gradual pace) over the course of 2014. As we have been saying for numerous years, 'the Fed is borrowing at teaser rates', and with investors taking the unwinding of stimulus in stride, we can now get back to the 'normal' investor psyche where positive economic data is good for risk assets and detrimental to safe haven securities (i.e. Treasuries).

A trip down memory lane (2013)

The US S&P 500 ended the year up almost 30%, while the Australian ASX and UK FTSE 100 returned 15%, the German Dax returned 25%, and the Nikkei delivered a whopping 56%. Investment-grade corporate credits also rallied, in the US the 5-year investment grade credit default premium rallied from almost 1% in June to 0.63% by year-end. High-yield bonds performed even better, the 5-year US investment grade premium rallied from 4.8% in June to 3.1% by year end.

Unsurprisingly, 'safe' assets such as government securities delivered both volatility and poor returns as bond yields rose amidst optimism over future growth, higher inflation prospects and the eventual end of the Quantitative

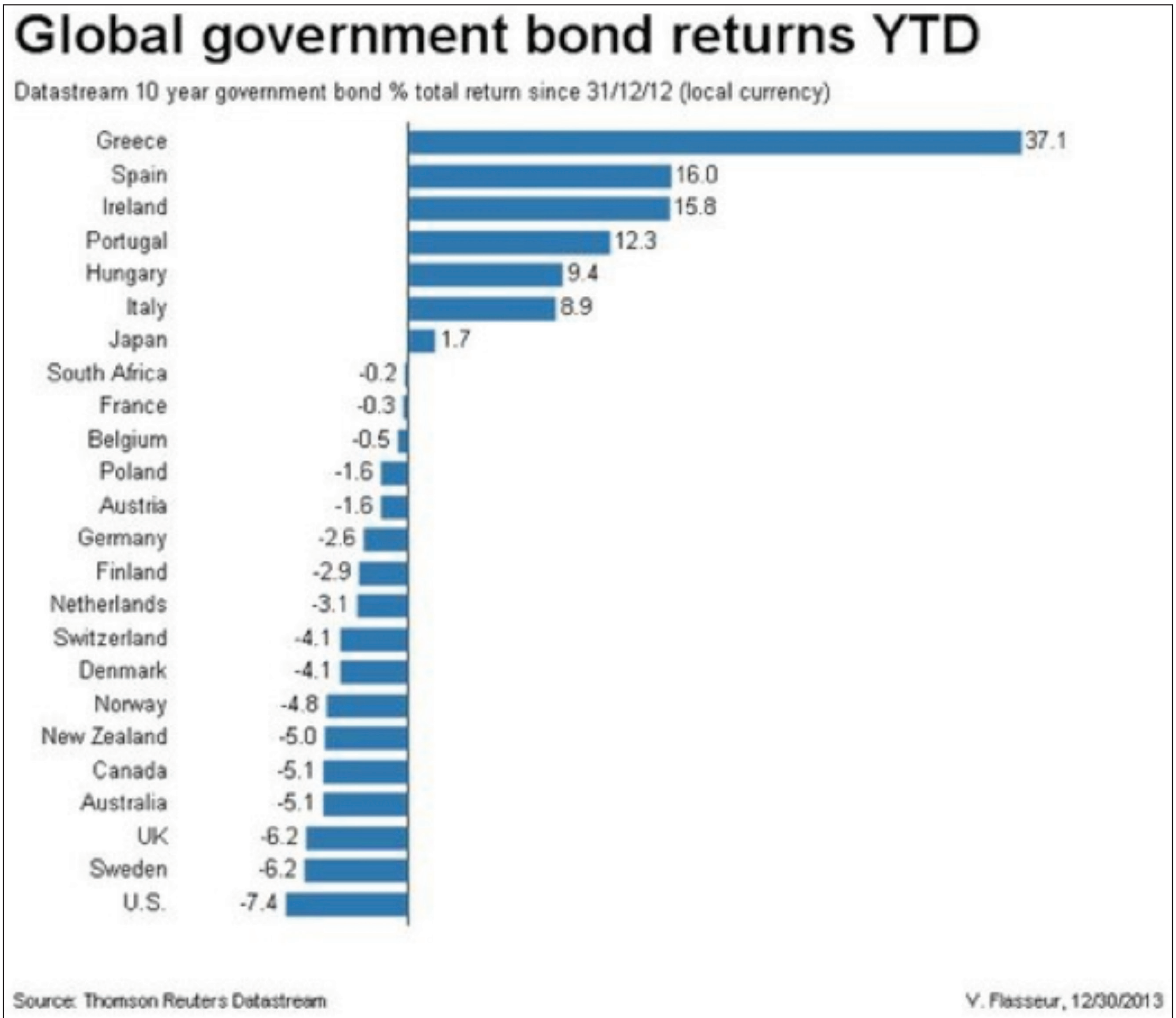
[1] While the jobs number released January 10 2014 was well below expectations, it does not change our view on the US economy. Job growth will be steady but will not grow at 200,000+ per month. There will be bouts of volatility and this is one example of that. This report only endorses our view that a slow and steady taper is the way forward. The Fed (especially when led by mega-dove Janet Yellen) will not risk unwinding QE at the expense of decelerating US growth.

Easing. As the chart below depicts, US 10 year government bonds were the worst performers in the government space, resulting in a lost –7.4% over 2013 as 10-year US Treasury bond yields rose 1.25%, reaching 3.01% by year-end, their highest level since July 2011. The periphery debt of Europe was the best performed in the government sector, which makes sense given their 'risk-on' characteristics.

Now what? A blue print for 2014

With the global recovery taking shape we forecast the following macro themes over 2014:

- Growth continues to recover in the US (housing, jobs, and consumer confidence)
- The likelihood of a hard landing or debt spiral in China dissipates
- The market prices in a monetary policy 'exit'
- Real yields normalise from alarmingly low levels



Rate hikes remain years away, in our view. However, we don't believe taking large interest-rate positions are warranted in this environment as the information ratio is low and interest-rate volatility will remain high. 10-year US Treasury yields in the 3% range appear fairly priced, balancing moderate growth and minimal inflation risks versus the imminent end of US Federal Reserve support for the Treasury market amidst a more stable jobs environment.

While US growth is improving, the pace will remain fairly muted. US 3rd quarter GDP grew at 2.8%, however, excluding the increase in inventories, growth was about 2.0%, near the 2.25% average growth rate over the past 3 years and well below the 3.4% average pace for the period following WWII through 2007. Despite an improving consumer, private sector deleveraging will continue and put pressure on the recovery in 2014. And business spending will only improve marginally – business sentiment has fallen in recent months. Nonetheless, the private sector will continue with moderate gains over 2014. We expect modest acceleration in personal and business spending as housing and equity markets continue to support wealth, despite increases in mortgage rates which will slow the housing recovery. Employment gains will continue, which could bring the unemployment rate down to the 6% range by year-end 2014. However, inflation will remain under control, still below the Fed's 2% target given the enduring slack in the labour market.

While a continuing US recovery provides our bias for eventual rises in interest rates, we foresee a cap in government yields as other global deflationary risks still remain, particularly in Europe. The ECB may continue to play lip service to easy money and quantitative easing, even in the face of growing fundamental structural issues, but they will eventually reach their limit. Despite recent (temporary) success in Greece and continuing rallies in Italian and Spanish sovereign bonds, Peripheral economies will not reach their fiscal targets and austerity will prove to be even more difficult to implement over the long term. The rationale the ECB has used to continue supporting Peripheral countries, i.e., promises of fiscal austerity, is quickly deteriorating. We foresee significant European financial shocks over the course of the next 12 months, leading to more volatility for global markets.

In Australia, the Reserve Bank of Australia (RBA) will remain on hold although the currency isn't doing as much of the RBA's work as it had hoped. The transition from mining investment to manufacturing/export sectors will take time and require an even lower AUD. The economy is still functioning at below trend in terms of jobs and sentiment. However, the housing market has improved, the labour market isn't doing too poorly and we've seen a boost in consumer and business confidence following the elections. While equity markets reached new record levels, we do not believe current levels reflect strong growth and earnings potential, but rather cost cutting and downward wage pressures which will put more pressure on the labour market and non-mining domestic growth. The downward pressure on wages has kept disposable income levels extremely low. While we foresee further AUD weakness, the currency is more likely to be driven more by US Fed action and the speed of QE3 unwind rather than by anything in Australia. We expect QE3 will conclude toward the end of 2014 and provide some further relief for the AUD, although it's hard to see a dramatic fall, particularly as the interest-rate differential between the US and Australia will continue to support financial flows into Australia. With moderately attractive real yields, we like Australian interest-rates relative to the US and the rest of the developed world. We expect USD weakness to continue its reversal in 2014 as the ending of the Fed's Quantitative Easing programme combined with stabilising growth support the USD over the year.

Markets will continue to worry about China, but as the 2013 headline stories of the risks of a Chinese hard-landing dissipate, the 2014 story will center over the growth of Chinese local debt, another red herring in our view. This burgeoning debt of Chinese municipal localities, used to finance infrastructure projects, is unlikely to bring about a major debt crisis in 2014. This growing debt may represent China's largest economic

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problem, however, defaults are unlikely and ultimately the central government will allow more tax revenues to flow to localities to pay construction debts. While a recent report showed this debt alarmingly increasing over the past 2-1/2 years, reaching $3 trillion, China's overall total debt at 56% of GDP still compares favourably to most developed countries. We expect Chinese growth will remain in the 7-1/2% range over 2014, allowing China to continue to support the global growth story.

While Asian fundamentals appear fairly solid in both the corporate and sovereign world, a rising rate environment will prove challenging for inflows, similar to the 2nd half of 2013. From a fundamental perspective, sovereign downgrades/negative outlooks appear to be closer to the end of the cycle, unlike much of the remainder of the world, particularly Europe. We will remain more cautious in Asian sovereigns with weaker fiscal fundamentals, i.e., those with deteriorating budgets, current accounts and reserves. India will remain a top Asian story as weaker fundamentals will provide a challenge to maintaining its investment-grade rating. We will continue to favour investment grade corporates in lower-beta (less volatile) countries such as Korea, China, Hong Kong and Singapore. We expect to hold 10 to 15% of the portfolio in this region over the course of 2014.

Overall, the theme of extremely low global central bank rates will continue in 2014, compelling investors to persist in holding risk assets, but it will be tough to again see the gains of 2013 amidst a steady but moderate growth environment. While we expect volatility to be a mainstay in 2014, we believe risk markets will continue delivering solid returns, particularly investment-grade credit. You still get paid to take the default risk inherent in investment-grade corporate bonds. While corporate fundamentals still look attractive, the technicals surrounding the unwinding of quantitative easing will continue to put pressure on corporate spreads. We favour corporate assets to sovereign assets (specifically in Australia and Asia), with a preference for floating rate assets, as floating rate assets will outperform in a secular environment of increasing rates. We particularly like short-maturity, defensive securities (less than 5-year maturities, high-rated banks, conglomerates and quasi-sovereigns) which are both held in more solid hands and less sensitive to moves in interest-rates.

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