Macro-economic environment

President Obama was re-elected by a wider margin than expected. Immediately after the election, however, risky assets sold off on the back of fiscal cliff concerns and softer data. After Barack Obama announced that a fiscal cliff solution would be within reach, equity markets recovered markedly and recouped most of their losses. The rebound of risky assets was further supported by a debt relief package for Greece and stronger macro data, most notably in the US and China.

November was a roller coaster with equity markets selling off after the US election and rallying back to about end-of-October levels in the second half of the month. The S&P 500 index underperformed major European indices, while the Japanese Nikkei index clearly outperformed most other equity markets (see fig. 1).

In our view, the turning point in the equity markets came when Barack Obama announced that a fiscal cliff compromise was within reach. This confirms our previous observation that fiscal and monetary policies are currently major market drivers. Markets were accordingly given a – short-lived – boost when Europe's finance ministers agreed on a relief package for Greece.

It is interesting that the EUR/USD exchange rate in November moved in parallel with equity indices, the USD sold off in the first half of November and then recovered strongly with diminishing fiscal cliff concerns. This suggests that currency markets are also trading in line with the fiscal cliff situation (see fig. 2).

Fig. 1: Major equity markets in 2012

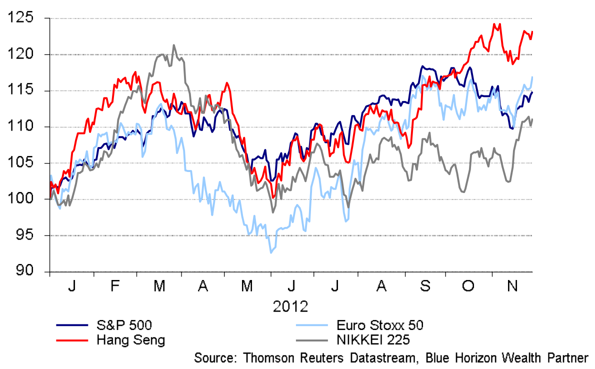
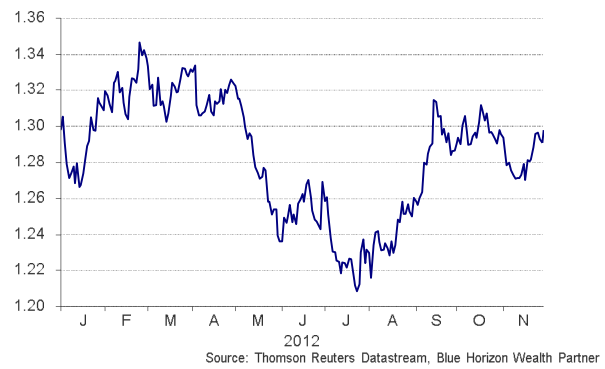


Fig 2: EUR-USD exchange rate



The Greek relief package

While action on the Greek debt situation is a matter of great urgency, the negotiations held both within Europe and between Europe and the IMF proved to be very difficult. The resulting relief package, announced on 26 November, by no means represents a definitive solution to the problem. Greek GDP has fallen massively since mid-2008 and Greek public debt will not be reduced to a sustainable level at any time soon. Europe therefore promised to do more if Greece continues its adjustment program. The new debt relief plan foresees the Greek debt-to-GDP ratio falling by 20 percentage points to 124% by 2020. The agreed bundle of measures includes lowering Greece's interest on bail-out loans by 100 basis points, doubling maturities from 15 to 30 years, deferring interest payments for 10 years, repaying Greece the profit the ECB makes on Greek debt buying, and beefing up funds for Greece through EU structural funds. Greek bonds have continued to rally as the market has anticipated that Greece will buy back outstanding bonds to lower its interest burden. While officials do not use the phrase "bail-out", this is of course what the relief package is about.

Diverging macro trends?

Macro-economic data seem to indicate that the situation in the US and China has been improving, while Europe continues its downhill slide (see figs. 3 and 4). US GDP in Q3 grew by an annualized 2.7% compared to Q2. Consumer sentiment in the US has improved markedly in the last few months, as strong

Fig. 3: Diverging consumer sentiment

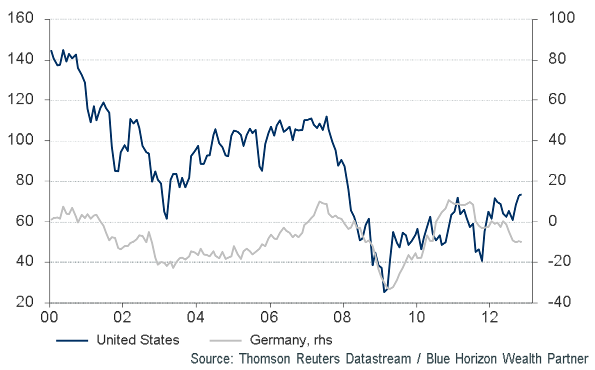
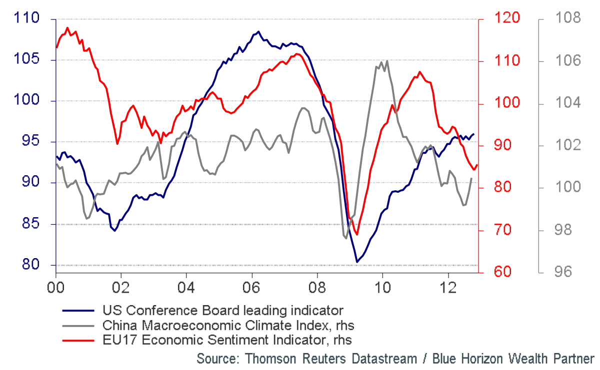


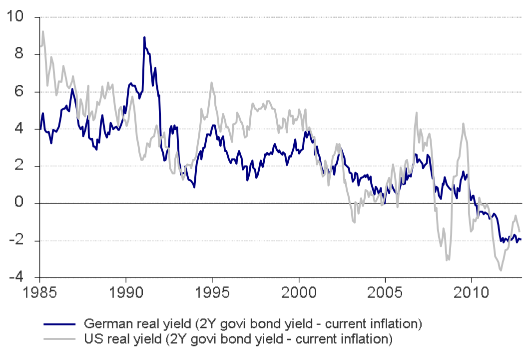
Fig 4: US, China stronger, EU still weak



black Friday sales confirmed. In addition, housing market data look better and leading indicators, like the conference board index and the purchasing managers' ISM index, have recovered somewhat. Leading Chinese indicators likewise strengthened. In Europe we have a huge divide between the southern countries, which are in deep recession, and stronger economies in the North. The German economy, however, which has acted as the European locomotive, has also started to weaken in recent months. We expect that for Northern Europe this will prove to be a short-lived soft patch followed by anemic growth in 2013. Consensus forecasts are in line with our view, with overall European growth at 0.1% in 2013, German growth at 1%, and US growth at about 2%. We believe that the diverging forces within Europe are strong and likely to stay. Peripheral countries have to undergo huge structural reforms and reduce public debt. The rest of Europe is likely to follow the US development, albeit with a time lag and a dampened upside potential.

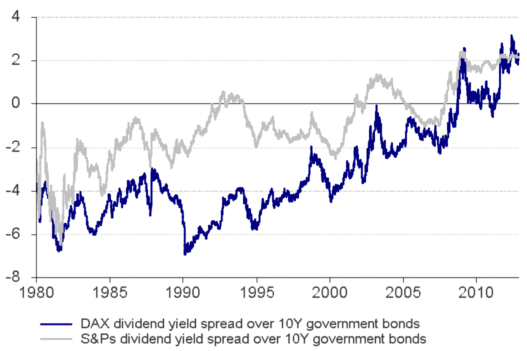
Given the above-mentioned macro picture, why did the US equity market underperform Europe? In our view, equity valuations in Europe may be a little more attractive compared to the US, but the single most important factor depressing the US equity market is the fiscal cliff. In our last Wealth Management Review we outlined the fiscal cliff situation, which has the potential to depress GDP growth by 5 percentage points. Common sense suggests that the political parties must strike a deal and avoid the worst outcome. It is, however, safe to assume that there will be some braking effect on the economy. As mentioned earlier, we believe that since the election campaigning is now over and the global economic environment looks so frightening, Democrats and Republicans will somehow manage to come up with a constructive compromise. However,

Fig. 5: Holding safe assets is expensive



Source: Thomson Reuters Datastream / Blue Horizon Wealth Partner

Fig 6: Stock valuations attractive vs. govi bonds



Source: Thomson Reuters Datastream / Blue Horizon Wealth Partner the way to this compromise will most likely be a bumpy road marked by fierce debate, face-saving maneuvers, and power struggles.

Outlook

Chinese and US growth is picking up and the European macro indicators are likely to bottom out soon. We can expect a rough ride towards the fiscal cliff but political common sense will no doubt be strong enough to turn the steering wheel before the vehicle goes over the edge.

Fiscal policy concerns will continue to limit upside potential for risky assets, while at the same time abundance of liquidity, coupled with negative real cash returns, and attractive valuations will limit downside risks considerably. Holding two-year US and German government bonds punishes the investor with a negative real return of 2% (see fig. 5), and dividend yields compared with ten-year government bond yields are at historic highs (see fig. 6).

Therefore, on balance, and despite worrying macro risks, we maintain a constructive view regarding risky assets, especially equity and high-yield bond markets. Markets will, however, remain very volatile and monitoring risks as well as potential shifts of market sentiment remains extremely important.

Blue Horizon Wealth Partner AG
Sihlhaldenstrasse 10
CH-8803 Rüschlikon / Zürich
info@bluehorizon-wp.com
www.bluehorizon-wp.com

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