BLUE HORIZON
Wealth Partner AG

From depression to optimism (or to complacency?)

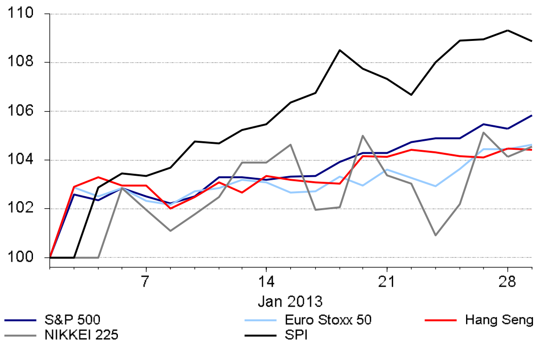
It looks like a different world. Since the turn of the year the sentiment has changed fundamentally. The fear of falling off the cliff – not only in US fiscal terms – turned into a thoroughly positive mindset, an upbeat mood confirmed in numerous comments by many of the global leaders at the WEF in Davos. As a result, the year-end rally extended into January. While, throughout 2012, we believed in improvements and stronger markets for risky assets, we are starting to ask ourselves whether we could end up in a phase of complacency and overheating. For now, however, we continue to be optimistic about the outlook for risky assets.

Not only did equity markets rise strongly in January (the S&P500 index climbed 5.7%, the EuroStoxx50 by 4.3% and the Nikkei by 4.5%), but also the VIX – the index for the cost of US equity options, a measure of investors' fear – fell to its lowest level since 2007 (compare figures 1 and 2). There were a number of reasons for the positive developments.

The US managed to avoid the fiscal cliff – although some fiscal braking tracks will be seen throughout the year – and the next big debate about the debt ceiling has been postponed. The Republicans rather surprisingly agreed to a 3-month deferral.

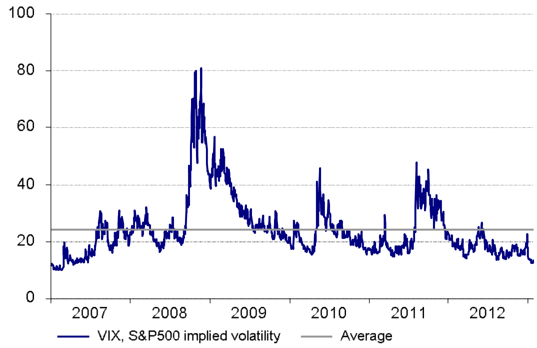
In Europe the possibility of a Eurozone break-up is much less of a concern, although fundamental problems have not been solved. In fact the growth outlook remains poor for Europe as a whole and very depressing for some of the peripheral countries.

Fig. 1: Major equity markets in 2012



Source: Thomson Reuters Datastream, Blue Horizon Wealth Partner

Fig 2: S&P500 implied volatility at multi-year low



Source: Thomson Reuters Datastream, Blue Horizon Wealth Partner

In Japan, the newly elected prime minister and leader of the Liberal Democratic Party (LDP), Shinzo Abe, committed his government to an expansionary and reflationary policy to fight deflation.

Central banks continue to pump liquidity into the markets, the ECB with unlimited bond-buying, and the Fed with its promise to keep interest rates very low until the unemployment rate drops below 6.5%, as well as with open-ended bond purchases. In addition, the Bank of Japan – urged by Mr Abe – doubled its inflation target to 2% in January and announced that it would buy assets on an open-ended basis from 2014.

European banks also seem to be gaining financial strength and confidence in their future. The ECB reported that 278 banks may already, by the end of January, utilize the possibility of making early repayments on their loans from ECB's EUR 1 bn longer-term refinancing operation (LTRO). The amount could reach EUR 137 bn, which would far exceed market estimates.

A number of macro indicators improved. This was most noticeable in China, where Q4 2012 GDP growth jumped to 7.9% from the 7.4% achieved in the previous quarter. The US housing market also seems to be improving (see figure 3). With its surprisingly high latest figure, the German IFO index has now risen for three months in a row (see figure 4).

The risk-on environment and the diminishing concerns about the stability of the Eurozone resulted in a stronger EUR against most major currencies. The EUR even strengthened against the CHF, which led to a relief rally on Swiss equity markets. JPY, however, weakened on the back of the announced expansionary fiscal and monetary policy measures. Bond and Treasury yields edged up and European peripheral country spreads continued to tighten.

Fig. 3: US housing market improved

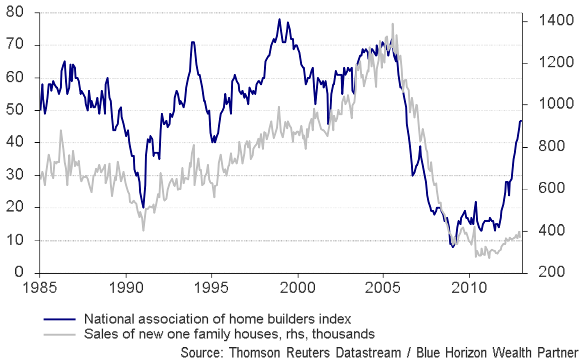


Fig 4: IFO advancing – ISM to follow?

While things have clearly improved, structural problems remain. Debt levels in many European countries as well as in the US remain unsustainably high, and muted economic activity makes it hard to see substantial improvements in public finances. In many cases there is no credible medium-to longer-term plan to cure the public debt disease. As much as expansionary monetary policy has helped to facilitate balance-sheet repair and has kept the economies going, we do not know how successful central banks will be in reducing the unprecedented monetary overhangs. We likewise do not know what form Europe will ultimately take. David Cameron's initiative to renegotiate the European-British relationship brings a complete new angle to the discussion – away from centralized decision making to a leaner and less bureaucratic union, based on the principles of subsidiarity. While David Cameron's tactics, including a British referendum in 2017, may be cumbersome, we welcome the direction of the discussion.

Outlook

Our view of the world has not fundamentally changed. We remain cautiously optimistic and continue to expect quite a long period of positive, albeit subdued, growth. Such an environment coupled with ultra-expansionary monetary policies can, in general, prove to be favorable to equity markets. Price inflation for goods will most likely remain low since unemployment continues to be high and production capacity underutilized. Monetary stimulus may instead translate into asset-price inflation. However, given deep structural problems and the existing macro risks, we feel that the stronger the current rally and the more upbeat the investor sentiment becomes, the greater will be the likelihood of setbacks and sell-offs during 2013.

Fig. 5: EUR-CHF exchange rate

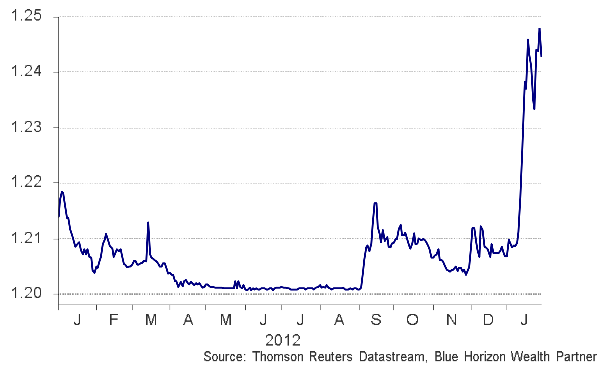


Fig 6: EUR-USD exchange rate

Despite those concerns we retain a positive attitude to equity markets and think that government bonds and gold could fall victim to the more constructive outlook of many investors. Gold especially is greatly overvalued in our view and could be vulnerable to a sharp sell-off. We consider high-grade credit to be priced to perfection, and we would take profits in this asset class. High-yield bonds provide better value and have a bigger cushion, i.e. higher spreads to compensate for a potential rise in government bond yields. In the course of the year we expect a rotation from fixed income to equity and are preparing to benefit from such a move.

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

Important Legal Notice