BLUE HORIZON
Wealth Partner AG

Positive surprise from the US Fed – negative surprise from the US congress

- Politics took center stage in September. The US Fed decision to delay tapering was surprising, and the US congress delivered its own surprise in the form of the budget impasse, which forced the federal government into a partial shutdown. In Italy Berlusconi surprised everyone when he asked five ministers belonging to his PDF party to resign – thus shutting down the government. In Germany Angela Merkel surprised the world with a landslide victory, which will somehow, surprisingly, make it anything but easy to form a new German government, since the former government's FDP coalition partner failed to win any seats in parliament. And Syria? Surprisingly, the Syrian government agreed at the last minute to destroy its chemical weapons, and the US and Russia agreed on an international oversight program to monitor the process.
- It was no surprise that markets, including government bonds, credit and equity, rallied on the news regarding the Fed decision and Syria in the first half of the month. It may have surprised many observers, however, that markets remained very calm after the US shutdown.
- Emerging markets celebrated a comeback in September with emerging markets bonds and equity rebounding sharply. This may be the beginning of a recovery when, after a phase of being been oversold, the emerging markets are starting to look attractive again in relative terms.
- While macro-economic indicators by and large continued to strengthen, confirming a moderate growth scenario, political uncertainties remain dominant. In our view the Fed tapering decision has only been delayed. We expect Fed tapering to start within the next 6 months. Moreover, the US shutdown will probably be resolved within the next couple of days and the economic impact will remain relatively small. The larger risk remains, however, because the same people in congress have to decide on the debt ceiling later in October as the US reaches its borrowing limit. The base case remains a last-minute compromise. If congress failed to find a compromise, however, the US would default on its debt, with strong and complex ripple- on effects in the financial system.
- Overall we continue to take a cautious stance, but remain positive on equity markets medium term. We reiterate our positive USD outlook and think that a EUR-USD rate of 1.36 is a good buying level for USD, but we would hesitate to implement this view until we receive clarification over whether effective budget and debt ceiling decisions have been taken.

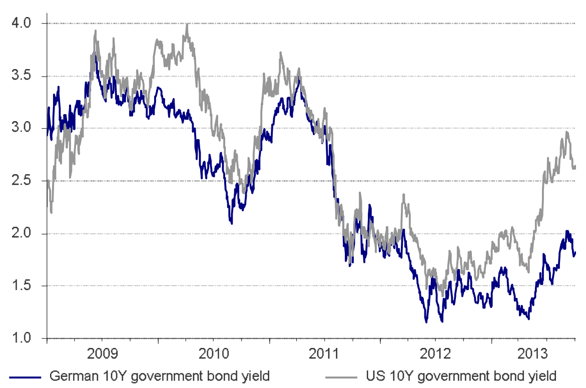
Macroeconomics and financial markets

While the biggest threat – US intervention in Syria – was diminished significantly when Syria agreed on a plan to destroy its chemical weapons under the supervision of the international community, other political developments took center stage in September. On 17 September — in contrast to the expectations of many Fed observers – the Fed decided not to start with tapering. Bond and equity markets reacted with a relief rally. In addition, gold was also able to benefit, but only temporarily. The USD fell against most major currencies and currently trades at about 1.36 vis-à-vis the EUR.

Since congress could not decide on an emergency budget before midnight on 30 September, the government is facing a partial shutdown. Many public services, excluding essential services like the security-related ones, will cease to operate. Market reaction was rather muted, equities stabilized very quickly and even US treasury yields fell somewhat. The last US government shutdown happened in 1996, when President Clinton's budget was not approved by congress, and it lasted 3 weeks. It is important to note that while shutdowns are of course disruptive in nature and have the potential to cause significant economic losses if they persist, the US has experienced 17 shutdowns since 1977, with the majority only lasting between one and three days. We expect that congress will find a solution sometime soon.

The by far more critical fiscal decision is to be expected later in October. The US will reach its debt ceiling by October 31, and the same people in congress have to find a compromise and raise the debt ceiling. Given the hardened fronts between Democrats and Republicans we expect a last-minute decision and would not exclude a delayed decision. If congress failed to find a compromise, the result would be the default of the US on its government bonds with unprecedented con-

Fig. 1: US treasuries and German Bunds



Quelle: Thomson Reuters Datastream / Blue Horizon Wealth Partner

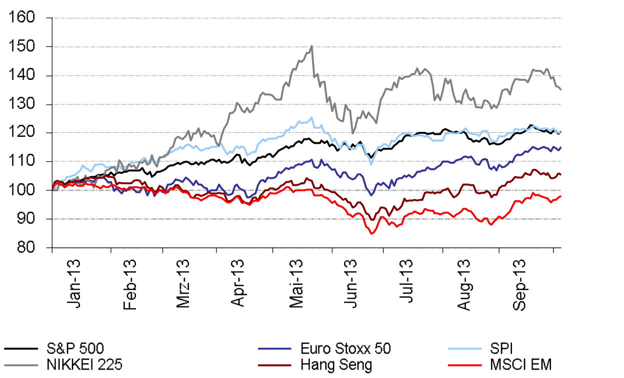
Fig 2: EUR-USD exchange rate

Quelle: Thomson Reuters Datastream, Blue Horizon Wealth Partner sequences for the international financial system. US treasuries are one of the most liquid markets globally and are the prime collateral for any kind of financial transaction.

In Italy the government broke up after five ministers belonging to Berlusconi's People of Freedom (PDF) party resigned. Italy is one of the core countries of the EMU and one of its largest debtors. In Germany the elections ended with a landslide victory for the CDU's Angela Merkel, who will nevertheless struggle to establish a new government. The CDU's former coalition partner, the liberal FDP, failed to clear the 5% hurdle and thus gained no seats in the federal parliament. As a result, the mostly likely outcome is a grand coalition of the two main German parties, the CDU and the SPD. Negotiations are expected to take months as the positions of the two parties differ widely, and the SPD is pushing hard for key cabinet posts and tax hikes for the rich.

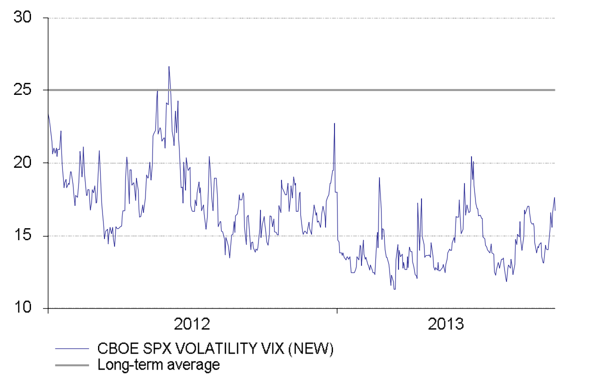
Overall, September was a very positive month for financial markets. Most equity markets rose, the S&P500 climbed 3.4% but underperformed the EuroStoxx50, which rose 6.5%. The Japanese Nikkei index rose 8.0% and the Chinese Hang Seng index 5.2%. The volatility index VIX (the cost of buying insurance against falling equity markets) fell clearly below 15, only to spike to almost 17 after the US shutdown (see figure 4). Bond markets also rallied, with German 10y benchmark yields falling 8 basis points and US treasuries by 13 basis points. In addition, credit spreads tightened. Emerging markets, following poor performance since the beginning of the year, recovered markedly. The MSCI emerging market equity index jumped 6.5% and emerging market bonds also rallied. The USD continued to weaken and currently trades at around 1.36 vis-à-vis the EUR.

Fig. 3: Major equity markets in 2013



Quelle: Thomson Reuters Datastream, Blue Horizon Wealth Partner

Fig 4: VIX implied volatility index



Quelle: Thomson Reuters Datastream, Blue Horizon Wealth Partner

Outlook

We expect the moderate growth path to continue and see this confirmed by leading economic indicators. The US fiscal situation caused by the ongoing power struggle between Republicans and Democrats will most likely be resolved. The recent shutdown leads us to believe that the upcoming debt-ceiling discussion has the potential to be disruptive. However, as everybody involved is aware just how disruptive a default would be, we believe that the worst outcome could be a technical temporary default on bills and bonds maturing around month-end. Based on the assumption that issues surrounding US budget and debt ceiling decisions will be only temporary, and given the continued robustness of the US economy, we expect Fed tapering to happen within the next 6 months.

With regard to financial markets we remain bearish on bonds and gold and constructive on equity markets in general. In the short term especially, fiscal risks will weigh on US equity and the USD, but for the medium term we remain positive and would see opportunities to buy into weakness. We would also consider starting buying emerging market equity, based on the probably oversold market conditions and attractive valuations.

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