BLUE HORIZON
Wealth Partner AG

Solution for the US fiscal debate and dovish central banks spark rally of financial markets

- In a surprise decision on November 7 the ECB cut its benchmark refinancing rate to 0.25% from 0.5%. The board of the ECB acted unanimously and on the back of lower inflation rates. Eurozone inflation dropped from 1.1% in September to only 0.7% in October, raising the Central Bank's concern about deflationary tendencies. The initial market reaction was higher equity markets, lower European yields and a Euro sell-off.
- We already observed a rebound of equity and bond markets after October 16, when Congress managed to solve – at least temporarily – the budget and debt ceiling dispute. In addition, the markets were supported by a dovish Fed, which showed no signs of accelerating its tapering intentions.
- Other risk factors also look less worrying. China's economy stabilized and continues to grow at around 7.5% pa. Furthermore, the situation in the Middle East appears – at least for the time being – to be better contained and to have less international contagion potential.
- Developed equity markets were up by 3.9% and emerging markets equity even rose by 4.9%. The Japanese Nikkei index underperformed by a wide margin and lost 0.9%. Government bond yields fell across the board, with German Bunds outperforming US Treasuries. The EUR-USD exchange rate underwent big swings but remained more or less unchanged. In the first half of the month the USD weakened but rebounded afterwards.
- With very accommodative central banks and major risk factors looking a bit less worrying, we expect equity markets to stay on the strong side. In our view, emerging markets offer interesting opportunities since the market sold-off so strongly in recent months. With bond yields lower, we would stay away from government bonds. For investment grade credit we see poor risk reward, especially on the back of recent spread tightening. As an exception we regard emerging market bonds as a little more attractive, since this market segment has sold off significantly in 2013. The ECB rate cut should continue to be positive for the USD. As the US economy is continuing to strengthen, we expect Fed tapering announcements and actual Fed tapering to happen in the first half of 2014, which will most likely have a negative impact on markets. Therefore, we would caution against overexposure.

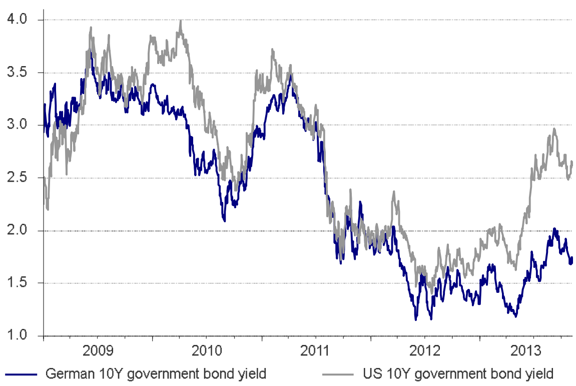
Macroeconomics and financial markets

The major concern at the end of September was whether the US fiscal debate could have a constructive outcome. We were of the opinion that more likely than not Congress would eventually find a compromise, since there was just too much at stake. In particular, if the US government had defaulted on its debt, the effect on global financial markets would have been catastrophic. Not only are US treasuries perceived as one of the most secure stores of value globally, they also serve as collateral for a myriad financial transactions. On October 16, after the US government had been shut down for 16 days, the Senate and the House agreed on a bill which effectively funds the government until January 15 and raises the debt ceiling sufficiently to provide a cushion until February 7. This agreement, however, only buys time. A Budget Committee is mandated to come up with a broad budget resolution by December 13. Given that Republicans and Democrats still have strongly opposing views, we have to expect another tug-of-war with negotiation tactics only allowing for a last-minute compromise. This would most likely dampen the upbeat mood of the financial market players.

Central banks turned out to be more dovish then we anticipated. The Fed delayed any tapering talks and instead expressed its concern about the state of the economy. On November 7 the ECB surprised many of us with a rate cut on the back of very low inflation data and highlighted its concern about deflationary tendencies. Risky markets in general have profited from accommodative central bank actions.

In addition, other risks, which we discussed in our last few Wealth Management Reviews, are now less worrying. The Chinese economy seems to have stabilized with an annual growth rate of about 7.5%. This is not stellar growth for Chinese circumstances but is strong enough to satisfy Chinese officialdom and disguise the country's serious structural problems of overcapacity, unhealthy bank balance sheets, and a rapidly ageing population. The situation in Syria and elsewhere in the Middle East appears to

Fig. 1: US treasuries and German Bunds



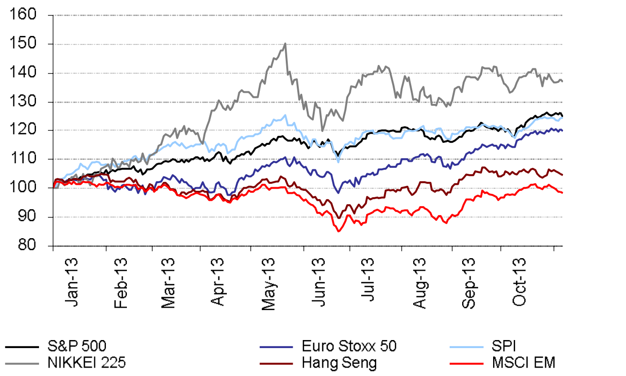
Source: Thomson Reuters Datastream / Blue Horizon Wealth Partner

Fig 2: EUR-USD exchange rate

Source: Thomson Reuters Datastream, Blue Horizon Wealth Partner be slightly better contained. To be precise, the risk of international escalation or contagion effects has diminished. This by no means implies that the circumstances for the local populations, especially in Syria itself, have improved in any meaningful way.

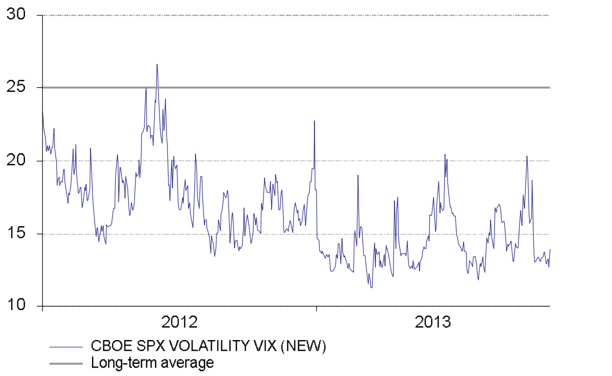
October proved to be a favorable month for financial markets. On the back of the US fiscal debate, equity markets fell during the first week of the month only to sharply rally afterwards. Emerging markets outperformed developed markets equity and rose 4.9% vs. 3.9%. The S&P500 index surged 4.6%, outpaced by the EuroStoxx50 with its rise of 6.1%. The Japanese Nikkei index did not benefit from the global equity rally and even dropped 0.9%. Bond markets also rallied, with German 10y benchmark yields falling 10 basis points and US treasuries falling 7 basis points. In October the EUR-USD exchange rate rose only slightly by 0.4%. However, we saw strong movements and EUR-USD rising to 1.38 and then falling back to 1.35 by the end of October, only to fall again to 1.34 after the ECB rate cut decision.

Fig. 3: Major equity markets in 2013



Source: Thomson Reuters Datastream, Blue Horizon Wealth Partner

Fig 4: VIX implied volatility index



Source: Thomson Reuters Datastream, Blue Horizon Wealth Partner

Outlook

Contained risk factors and accommodative central banks provide the ingredients for stronger equity markets. At present, staying in equity markets still looks to us like the best risk-return strategy. We urge caution about becoming overly excited, however, and we think that current market circumstances require close monitoring. Equity valuations do not look overstretched but do not look cheap either. There is a significant probability of another damaging US fiscal debate in December and January, when we once again approach budget constraints and the debt ceiling. If the US economy continues on its current growth path, the Fed will sooner or later start the tapering discussion again. We still see a likelihood of this happening in the first half of next year, with negative consequences for equity and bond markets, at least initially. Emerging market equity seems to us to be an interesting addition to the portfolio right now, since valuations look quite attractive and we expect economic dynamics to pick up.

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