BLUE HORIZON
Wealth Partner AG

Year-end rally despite the start of Fed tapering
Outlook 2014 – Ten predictions

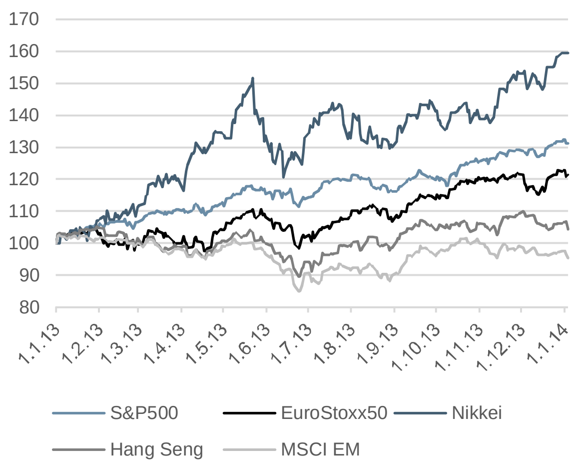
- US fiscal and monetary policy took center stage in December. On December 18 the Fed announced its long-awaited tapering measures and will reduce its monthly bond purchases from USD 85 bn to USD 75 bn as of January 2014. Ben Bernanke did an excellent communication job. For financial market participants the “bitter” tapering news was sweetened by Bernanke’s dovish rhetoric – including a strong commitment to keep the short-term interest rate target at zero – and the result was a year-end rally.
- Further relief for markets came from US fiscal policy. On December 10 the US Senate unveiled an agreement to ease automatic spending cuts of about USD 63 bn over two years, thereby avoiding another potential government shut-down on January 15.
- The US debt ceiling, however, remains a key political risk. In October, Congress and the administration suspended a USD 16.7 tn cap on borrowing until February 7. Failure to find an agreement on the debt ceiling would result in a by far more dangerous situation compared with the budget decision. Given that the Senate was able to reach an agreement on the budget, we do not expect a disruptive outcome in the first quarter of this year.
- Equity markets staged a remarkable year-end rally. The S&P500 gained 2.8% in December and ended the year with a healthy increase of 32%. The Japanese Nikkei index outperformed most other markets and gained almost 57% (!) in 2013, thanks to Abe’s aggressively reflationary policy. Even the crisis-prone EuroStoxx50 rose almost 23% in 2013, while the MSCI Emerging Markets fell 2.3%.
- As anticipated in last month’s Wealth Management Review, Gold dropped below USD 1,200, albeit only temporally. Overall, gold fell 27% in 2013. Other major losers in 2013 were US government bonds, with 10Y yields climbing 127 basis points and the JPY, which fell more than 20% vis-à-vis the USD.
- In the following we summarize our 10 major predictions for 2014. We expect equity markets to continue to perform well, although we think it will be a bumpier ride than 2013, and developed markets equity will probably experience only single-digit growth. While the consensus has become almost unanimously bullish, we incline rather to caution. For emerging equity markets, which have fallen out of favor, we expect an upside surprise, especially since valuations have become rather attractive. On the back of stronger US growth and more Fed tapering, US treasuries will climb above 4%. The USD will finally gain lost ground against the EUR. We expect the EUR-USD exchange rate to fall below 1.30. Gold will continue its decline and may break below USD 1,000.

Outlook 2014 – Ten predictions

1. The US economy will continue its recovery and is likely to grow at 3%, which is well above trend growth. In addition, the US unemployment rate is likely to drop below 6.5%. Corporate America is still supplied with a lot of cash, and consumer sentiment is improving on the back of lower private debt levels, the recovery of the housing as well as the equity market. The shale oil and gas boom has reduced energy costs and is boosting US manufacturing. Furthermore, head winds from fiscal policy will be much less important in 2014. While spending cuts and tax rises shaved off 1.75% of GDP growth in 2013, the new budget deal will incur only a modest negative growth impact of 0.5% in 2014. By contrast, the European economy has not yet worked off the overhang from the financial crisis, and households as well as banks are not as advanced in the deleveraging process as their US peers. As a result, European growth will stay sluggish, rising from -0.5% to around 1%. The emerging markets overall will continue to grow at about 4.5% - as in 2013, with China too maintaining its 7.5% growth pace.

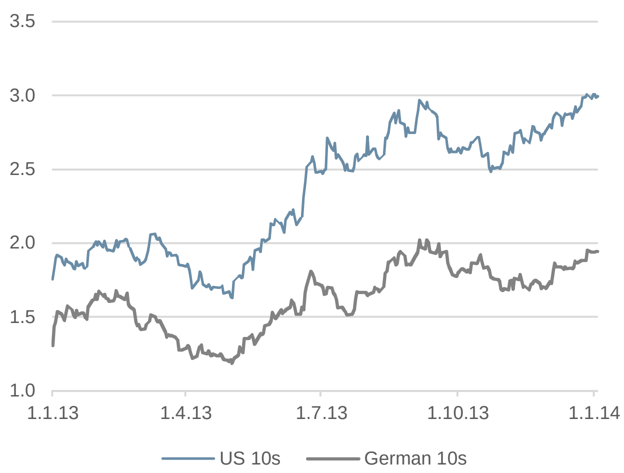
2. Inflation will remain well contained in 2014. Inflation expectations as priced by the markets remained firmly anchored in 2013. Europe and Japan will have their hands full to fight deflationary tendencies (Europe) and outright deflation (Japan). Even in the US, inflation has just dropped to an unwelcome low level of 1.5%, and despite the fact that 2014 growth may exceed trend growth, unemployment and overcapacity will limit inflation potential for the coming years.

Fig. 1: Major equity markets in 2013



Source: Datastream, Blue Horizon Wealth Partner AG

Fig 2: Benchmark yields in 2013

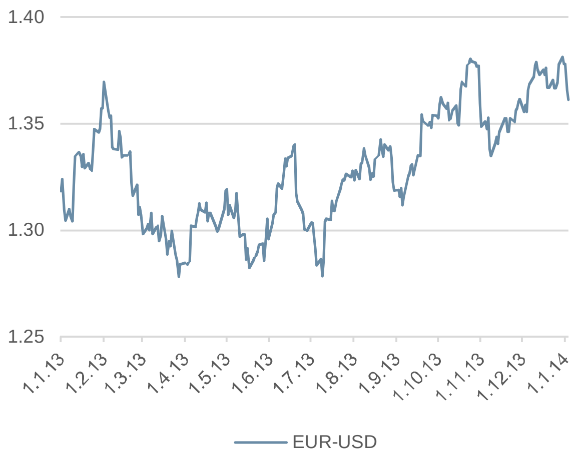


Source: Datastream, Blue Horizon Wealth Partner AG

3. Monetary policy will remain accommodative for the foreseeable future. The Fed reiterated its commitment to keep policy rates at zero "… well past the time …" when unemployment falls below 6.5%. We should also recall that Fed tapering does not imply hitting the brakes but rather reducing the pressure on the accelerator. The ECB lowered rates again in November and communicated its deflation fears. As a result, the zero interest rate policy is far from over, and ample liquidity will be providing the grounds for further asset price reflation.

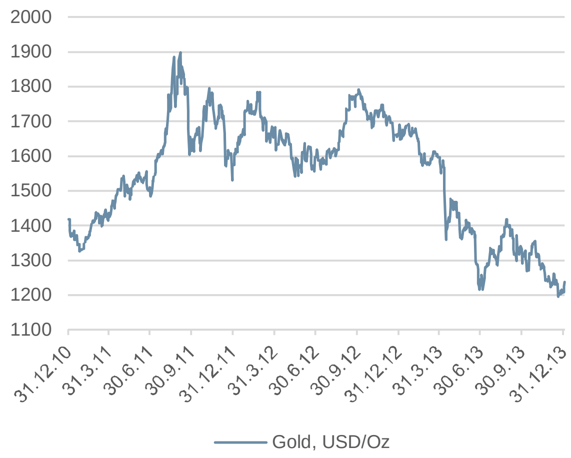
4. A major theme, in our view, will be the divergence between the major economic areas. So far, growth has been depressed across the developed economies and monetary policy has been ultra-loose across the board. The US Fed, if any institution, has set the pace when it comes to aggressive monetary accommodation. As a result, the USD has been weak. Going forward the growth gap between the US and Europe will widen further. At the same time, US monetary policy will start to become less accommodative, while Europe is far away from starting to taper and Japan has only just begun to take unconventional monetary measures. The diverging growth and monetary policy patterns are likely to drive relative performance of assets, with the USD likely to strengthen vis-à-vis the EUR and the JPY. Also, US treasuries are likely to continue to underperform. It will be very important to follow these developments, not least because higher US yields and a stronger USD could endanger the US recovery.

Fig. 3: EUR-USD exchange rate in 2013



Source: Datastream, Blue Horizon Wealth Partner AG

Fig 4: Gold price in USD/Oz.



Source: Datastream, Blue Horizon Wealth Partner AG

5. Equity markets will continue to perform well. Continued monetary stimulus, better growth and healthy corporate balance sheets will provide all the ingredients for positive returns. Moreover, valuations look rich but not overstretched and are certainly attractive vis-à-vis cash and the expected bond returns. However, we feel a little nervous about the almost unanimously bullish equity market outlook. The developed equity markets may end up with a bumpy ride in 2014 with "only" single digit returns.

6. In contrast, we expect emerging market equity to celebrate a comeback, outperforming developed equity markets. Valuations have become attractive and the consensus view, in our opinion, too negative. We recommend, however, building up exposure slowly in the first half of the year, and initially via multinationals.

7. We remain concerned about government bonds, i.e. interest rate risks. As already mentioned, we expect the yield gap between the US and Europe to widen further and US treasuries to underperform. Therefore, we recommend avoiding long-dated bonds or hedging the interest-rate risk. The 10-year Treasury bond will, in our view, break above 4% in 2014.

8. Investment-grade credit and high-yield markets should do well, at least when measured against benchmark yields. Credit spreads could well tighten even further, since corporate balance sheets look very healthy and so far there is no indication that corporates are moving into an aggressive growth strategy as a whole. Given more demanding valuations, we think that idiosyncratic risks have risen, which warrants a more selective investment approach. In addition, we see more upside potential for high yield as opposed to investment-grade credit, since the latter looks more expensive.

9. As far as commodities are concerned, Gold is heavily exposed and could well fall below USD 1,000. Given a more favorable economic environment, the need for safe-haven assets in general will decline, inflation will continue to be well contained and the opportunity costs of holding gold will rise steadily as equity markets rally and real interest rates rise. The additional US domestic oil supply is putting pressure on global oil prices and may even induce the OPEC to cut production to defend price levels. Copper prices are likely to rise in 2014 as the US and China continue to grow. Other industrial metals may suffer from unfavorable supply developments.

10. As already mentioned, we expect the USD to strengthen, especially against the EUR, and the EUR-USD exchange rate to fall towards or even below 1.30. The JPY will also probably remain under pressure to depreciate. Commodity currencies, like AUD, CAD and NOK, will probably weaken further. We do not expect large moves in EUR-CHF since the SNB continues to be willing and able to defend the 1.20 level, and upside is limited as the Swiss economy holds up well against a sluggish Europe.

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