BLUE HORIZON
Wealth Partner AG

After the year-end party the January blues

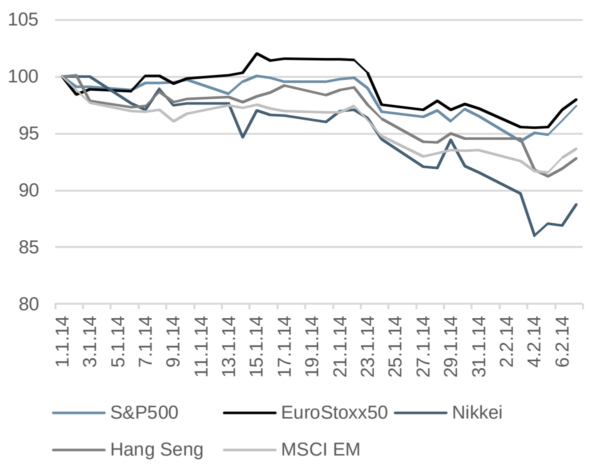
- A dovish Fed helped to make 2013 into a strong and almost euphoric year, but 2014 started in a mood of depression. Market participants seem to have shifted their attention to the issues and risks causing them concern. A main area of focus has been that of economic and political risks in emerging markets: the deleveraging in China, which comes along with slower growth and stress in the inter-banking market, political turmoil in Thailand, Turkey, Ukraine, and Egypt, as well as a strong devaluation in Argentina.
- This cocktail led to a significant sell-off of risky assets. In January the MSCI Emerging Markets Index fell 6.5%, the SA&P 500 index 3.5%, EuroStoxx 50 2.8%, and the Nikkei 225 even fell 8.5%. Since early February markets have bounced back somewhat. The VIX index, the price for insurance against equity market losses, rose 4.7 points to 18.4. At the same time, safe haven assets gained, gold rose 2.9% and 10Y Treasury as well as Bund yields fell 0.38 and 0.35 percentage points respectively. The USD rose against the EUR by 2.1% in January but weakened again after the ECB, at its last meeting on 6 February, left rates unchanged and was less dovish than anticipated.
- Overall we see no need to fundamentally change our view. We remain constructive on risky assets, especially equity markets, and would advocate seizing opportunities to take advantage of lower prices. With regard to Emerging Markets we do see that risks of further corrections are high. However, we think that China is less vulnerable than other Emerging Markets and less vulnerable than many market participants think.
- In addition, the volatility of markets has diminished significantly in recent years. We see one of the major reasons for this in massive monetary stimulus and central banks' commitment to stabilize the economy and financial markets. This commitment has essentially been insurance for investors against market losses. As a result, volatility fell and correlations within the asset classes rose. It was not that important to select the right stock as long as you invested in the overall market. We would make the case that Fed tapering is a first step towards normalization, i.e. less central bank insurance, which will lead to higher volatility and more idiosyncratic risks. In other words, we expect more volatile markets and a greater need for a selective investment approach.
- In February the US debt ceiling will be reached, which leaves Congress with only a few weeks before the money runs out. We expect that Congress will raise the debt ceiling in the next couple of days or weeks without too much controversial debate.

Macroeconomics and financial markets

The January economic figures were often disappointing. The US ISM manufacturing index, for example, fell to 51.2 in January from 56.5 in December. Also, US non-farm payrolls for January rose less than anticipated. The gain in hiring was only 113,000 compared to consensus expectations of 180,000. Weaker data in the US, however, may have been weather-related. Still, the unemployment rate fell to a five-year low of 6.6% from 6.7% in December. Some market participants have been especially concerned about this figure since the Fed has indicated that a 6.5% threshold in the unemployment rate might warrant a tighter monetary policy stance. However, inflation has stayed low and the unemployment rate has dropped, not least because a large number of discouraged workers gave up looking for a job. Despite the weakening US economic data, we still believe that US growth will continue to accelerate.

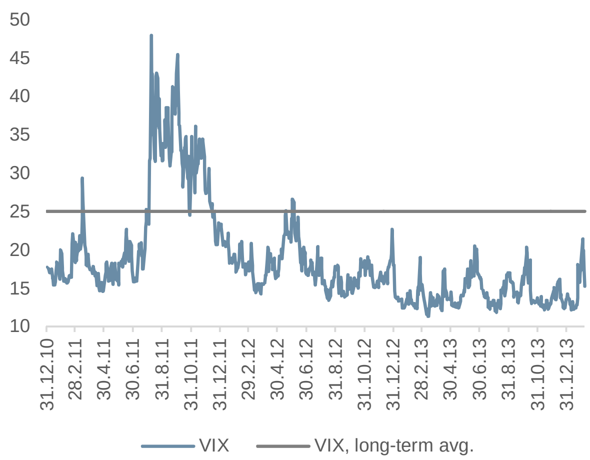
At its 6 February meeting the ECB left its benchmark refinancing rate unchanged at 0.25%. Draghi's comment that he is not particularly concerned about deflation in Europe disappointed markets regarding the prospect of further easing measures by the ECB. As a result, the EUR strengthened against the USD.

Fig. 1: Major equity markets



Source: Datastream, Blue Horizon Wealth Partner AG

Fig 2: VIX Index



Source: Datastream, Blue Horizon Wealth Partner AG

What about China?

China has become one of the largest economies in the world, the largest exporter of manufactured goods and the largest importer of commodities. In addition, China has had large trade account surpluses over the last few decades and the central bank has prevented the Yuan from appreciating by accumulating foreign reserves. China has become the biggest holder of foreign reserves, with USD 3.7 tn. All this emphasizes China's importance for the world economy and especially for emerging markets. Therefore, concerns about a hard landing for the Chinese economy are tantamount to concerns about the outlook for the rest of the emerging markets.

The Chinese economy is certainly slowing. The latest PMI index fell to a six-month low at 50.5. Chinese officials target a 7.5% GDP growth for 2014, which is below growth in recent years. Concerns are centered on over-capacity, the possible burst of a potential housing bubble, the soundness of the Chinese banking system (because banks are assumed to have a lot of bad debt on their balance sheets), and in recent weeks concern has also arisen about a fragile shadow banking system.

In our view, many of the concerns about China and, in turn, about emerging markets seem to be exaggerated. We would like to highlight a number of considerations supporting a more favorable outlook. For details we refer to a research paper by Jun Ma and Lin Li of Deutsche Bank: "China is not Turkey or Argentina," published on 7 February 2014.

Firstly, Chinese economic fundamentals remain very strong. In 2013 China's growth was at 7.7% in Q4, inflation was 2.5% in December, the current account exhibited a surplus of 2%, and external debt was 8.8% of GDP. In addition, the Chinese government has a strong track record of managing and keeping the economy on a stable growth path. Note, however, that national statistics are managed carefully by the Chinese leaders and have to be read with care.

Secondly, the political situation in China remains very stable. The change in leadership in 2013 went smoothly. The successful anti-corruption program is also worth mentioning.

Thirdly, China is implementing a number of structural reforms, with 60 such reforms announced last November. It seems that the leadership remains committed to the reform plans.

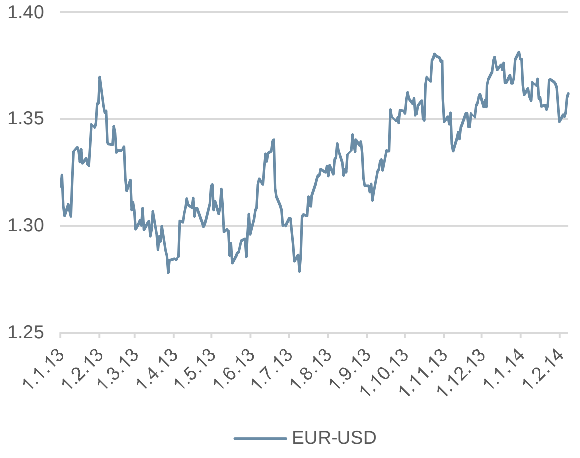
Fourthly, it is true that there are problems in the banking and shadow banking system and they are severe. But on the other hand, since the financial system is controlled by the state and the state possesses enormous financial reserves, the problems are certainly manageable. In addition, since the Chinese financial system is isolated from the rest of the world, there is little danger of strong contagion effects.

In summary we remain positive that China will manage to stay on a growth path, and though growth may slow down somewhat it will not grind to a halt. As a result, while there are a number of worrying developments in emerging markets, e.g. in Turkey, Thailand, and Argentina, we do not expect a major melt- down to occur in these markets generally.

Outlook

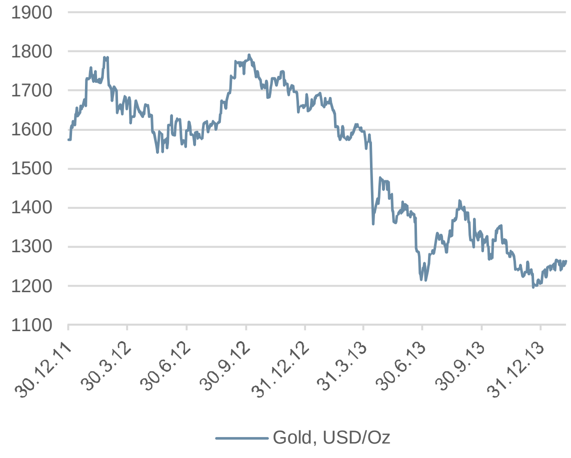
We remain constructive on equity markets and tend to see current weakness rather as a buying opportunity. Regarding emerging markets equity we would stay cautious for now, but in general we think that there is value and it is worth keeping an eye open for the right time to invest. At the same time, we would use the higher price levels of gold to sell. We also continue to believe in a further strengthening of the USD and we remain bearish on government bonds, especially US treasuries.

Fig. 3: EUR-USD exchange rate



Source: Datastream, Blue Horizon Wealth Partner AG

Fig 4: Gold price



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