Market Tactics

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INVESTMENT RESEARCH
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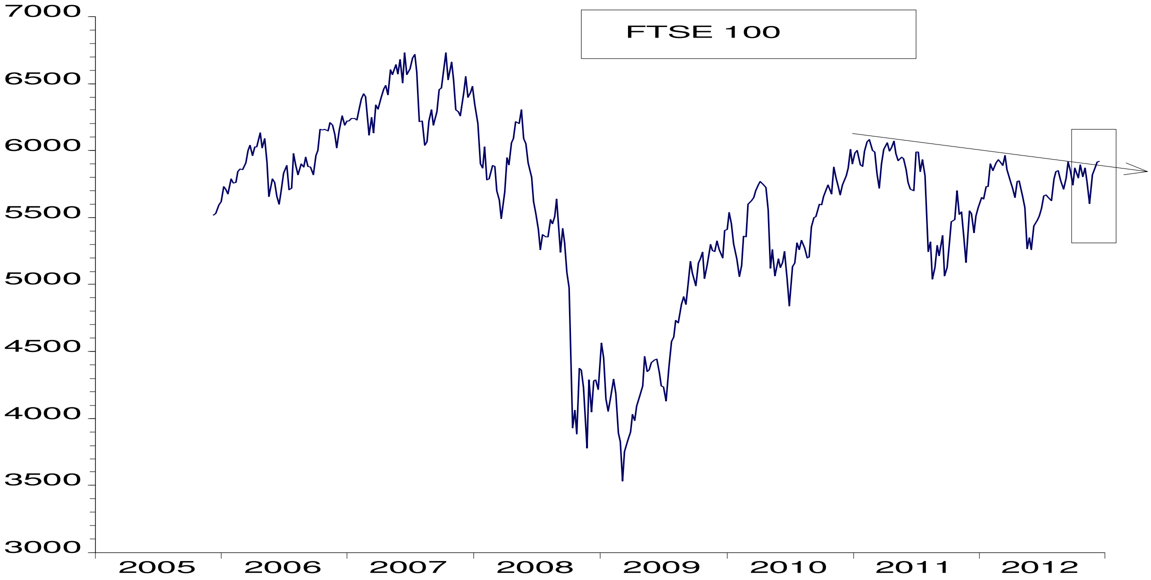
*2013 – a walk on the bright side**



Source: DATASTREAM

With one hugely important exception, the global economy looks set to enter 2013 on a better footing than it entered 2012. This should be positive for equity markets and maybe the FTSE 100 is getting a sense of it with what appears to be, as the chart shows, an attempt to overcome resistance heading into the New Year. So what's better?

Leaving the US for later and starting with China, the old guard is handing over to the new leaders an economy that has made the adjustment to slower growth and, in doing so, is neither heading for a hard landing nor heating up again. In setting their sights for growth in 2013, the new leaders are expected to target the 7.5 percent GDP growth that was targeted for 2012. The latest consensus expectation for GDP growth next year is 8.1 percent, no change on what it was last month and the month before.

In making the adjustment to slower growth, two points are relevant. One is that the de-rating of the Chinese equity market associated with the adjustment to slower growth has likely run its course and the other is that the drag on the global economy from China's own loss of momentum these past few years has likely run its course too. This, by itself, provides for a steadier outlook heading into 2013, but if growth in China rebounds even modestly, as is expected, this will be even better.

Better still will be the focus by China's new leaders on economic reform. To this end, policy is likely to remain geared to stabilising rather than stimulating the economy but also to nurturing the growth of domestic demand. This combined with a further strengthening of the renminbi, should boost import penetration and be supportive of the global economy.

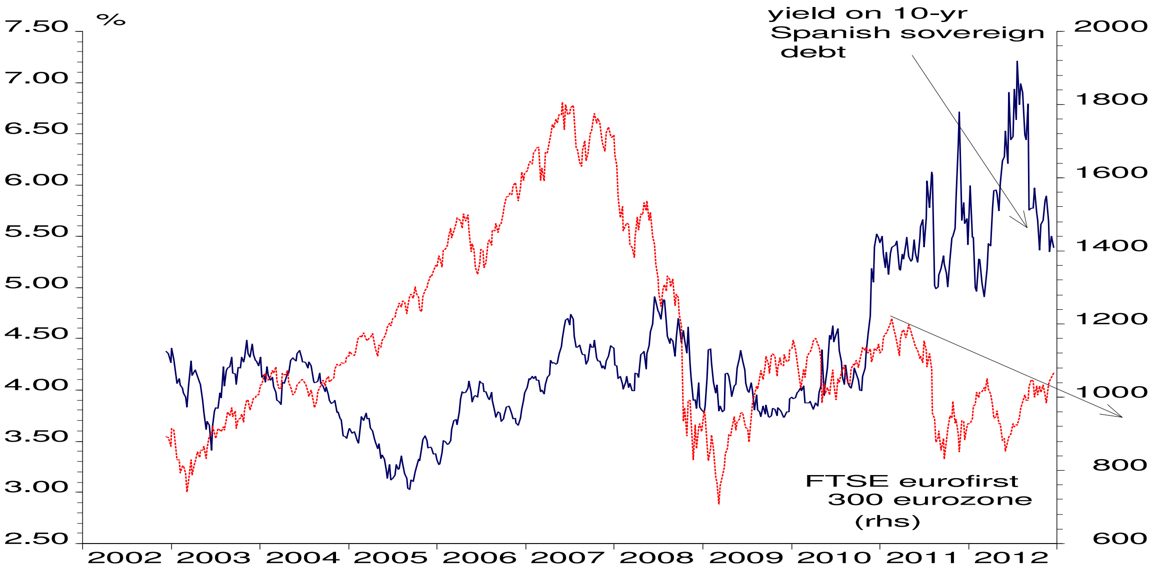
**** Much of this text is taken from the December 2012 Briefing Note for the Asset Allocation Committee.***

Europe's contribution to global growth in 2013 is expected to be minimal, indeed, marginally negative according to the consensus, but the key is the removal of what has been a destabilising influence on the global economy. With the European Central Bank (ECB) committed to ensuring, as best it can, the survival of the euro, the intention is that full integration and the long, hard adjustment to debt sustainability can be facilitated against a backdrop of financial stability. This puts the eurozone in a stronger position to confront the challenges.

Progress on banking supervision in the eurozone has just been announced. Some 150 to 200 of the eurozone's biggest banks are to come under the supervision of the ECB. Depending on the circumstances affecting individual banks, authority is to extend to smaller banks as well. ECB supervision is to become effective on 1 March 2014. Plenty of hurdles remain and there can be little doubt that the path to a banking union will be severely tested. But in looking back, the eurozone has been severely tested already. Contrary to expectations, the eurozone is surviving.

Mario Monti has said he will resign after a budget is passed this week. He will likely remain in charge of a caretaker government until the election, expected in February. The opinion polls indicate that the Democratic Party of Pier Luigi Bersani is likely to form the next government. That is, if Monti does not declare himself a candidate for prime minister.

Bersani has indicated a commitment to the reforms of Mario Monti's technocrat government. Too much has been achieved to throw away. If the polls are right and Bersani is to be believed, Italy would not likely be a source of contagion that Spain has feared. That would be good news for Mr Rajoy, the peripheral bond markets and the equity markets.



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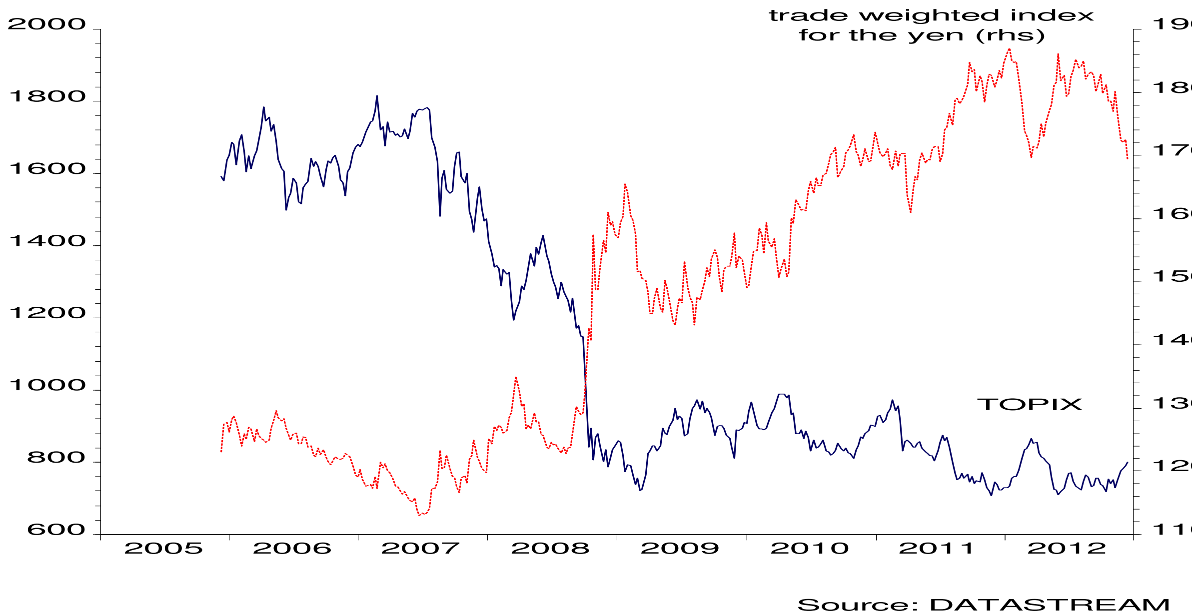
Shinzo Abe's big victory in Japan's weekend election was well flagged by the polls. The Liberal Democratic Party and its ally New Komeito won 68 percent of the lower house seats. That gives Abe a mandate to pursue his prescription for easy monetary and fiscal policy.

Markets will discover shortly how the new Prime Minister intends to proceed but his mandate will likely put more pressure than usual on the Bank of Japan (BoJ) to come forward with more easing. The BoJ meets Thursday and the expectation is that it will expand its asset purchase scheme, currently 91 trillion yen, by 5 to 10 trillion yen. Meanwhile, the equity market has continued to rebound and the yen has continued to weaken on the prospect of Abe's redefining of the BoJ's own mandate for 'unlimited easing' among other things.

After two lost decades, one cannot help thinking that ridding Japan of its entrenched deflation is a gargantuan undertaking requiring an end to the yen's secular appreciation at the very least, if not a sustained bout of depreciation to assist reflation.

The present governor of the BoJ has already indicated, in no uncertain terms, what he thinks of Abe's unlimited easing. Needles to say, his tenure will not be renewed in April next year – that is, if Abe is still Prime Minister. Nor for that matter is the BoJ likely to retain its independence, as Abe has indicated, unless it shares his conviction for unlimited easing, which it might if Abe can install sympathetic Board members.

Action speaks louder than words. Abe has been elected on his word and because of extreme disappointment in the failings of the Democratic Party of Japan. His parliamentary victory gives his new government the authority to purge deflation. If he is able to get his way it could be that 'this time is different' for Japan but the bond market will judge. If it spells the end to Japan's low yields, it could be positive for global equity markets.



Yet so much hinges on the US and a deal on budget policy that not only averts the fiscal cliff but does so in a manner that removes the uncertainty hanging over the corporate sector. Mr Boehner talks about how raising tax rates for top income earners would be bad for growth and jobs. The truth is that a deal would probably be the greatest stimulus of all in creating more growth and jobs than Boehner, the Tea Party and anyone else can imagine.

Last week the Fed's Open Market Committee (FOMC) reinforced its support for the economy with an open-ended extension of its QE programme with monthly purchases worth US$45 billion of US Treasuries, including TIPS, of varying maturities. This is on top of the US$40 billion monthly purchases of agency mortgage-backed securities. The FOMC also gave conditional guidance on interest rates like never before, saying:

... the Committee decided to keep the target range for the federal funds rate at 0 to 1/4 percent and currently anticipates that this exceptionally low range for the federal funds rate will be appropriate at least as long as the unemployment rate remains above 6-1/2 percent, inflation between one and two years ahead is projected to be no more than a half percentage point above the Committee's 2 percent longer-run goal, and longer-term inflation expectations continue to be well anchored.

But as the Chairman and other Fed officials have said, monetary policy can only achieve so much. Uncertainty over fiscal policy reduces the effectiveness of the Fed's easing initiatives but an economy less inhibited by uncertainty is likely to be more responsive to Fed policy.

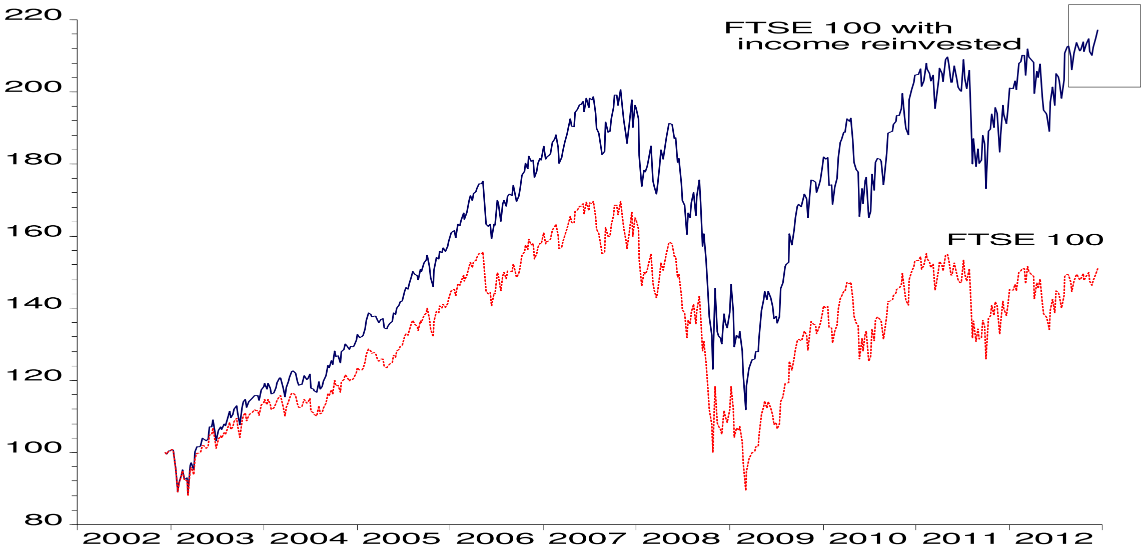
Mr Boehner gave some ground on tax policy over the weekend, proposing that the extension to tax cuts apply to all income earners except to the very top earners of US$1 million or more. Boehner's readiness to go part way on the raising of tax rates for the wealthy was not matched by any concession on entitlement reform even though Boehner has also increased what Republicans would endorse on tax revenue.

Reuters reported over the weekend that the White House had not accepted any of Boehner's proposals – and time is running out. However, higher tax rates even for top income earners is a big Republican concession and, while Boehner's proposal is still miles away from what Obama intends, it does suggest that the scope for negotiation is opening.

You wonder how a deal cannot be struck – but it may not! Moreover, a US recession may prove to be deeper and more protracted than the Congressional Budget Office has forecast. And plenty more can go wrong. China's new leaders may not be able to stabilise the economy; it may still hit the rocks. In Japan, Abe may not easily get his way since his government will be up against conservative forces that will resist what will be seen as his high risk policy. For the eurozone, all sorts of difficulties lie ahead along the road to full integration. Next year's federal election in Germany could re-introduce instability and renew the convertible risk which prompted the ECB to introduce its programme of outright monetary transactions.

But much can go right – and much has. Companies are not only paying dividends but still growing them and, because of this, the FTSE 100 with income reinvested is rising to a new all-time high. So against the backdrop described, Brewin Dolphin is setting its sights on a relatively modest 2013 year-end expectation for the FTSE 100 of 6350.

This may even prove conservative if reason prevails. A US budget deal would offer a more promising outlook for growth and corporate earnings and likely sustain the US equity market's upward trend with its pattern of rising highs and lows. A US budget deal would also mean that sentiment on the outlook for the global economy would improve and help push equity markets generally onwards and upwards.



Source: DATASTREAM

IMPORTANT NOTES

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