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Contrarians look to rule roost in 2013

By Robin Wigglesworth

China's growth is still so strong, despite a slowdown, that it is effectively creating an economy the size of Greece's annual output every three months. But investors would have been much better off putting their money in the Athens stock market this year.

The past year has been a vintage one for contrarian investments. Portuguese bondholders have enjoyed much better returns than German Bund investors; banks have led stock market gains globally; and the euro has bested the US dollar. In fact, in dollar terms, European equities have outperformed the S&P 500.

The list of assets and markets that most investors and strategists favour for next year is a familiar one: corporate debt, emerging market bonds and blue-chip stocks in developed markets that pay robust dividends. In contrast, "haven" government bonds should be avoided.

But some have offered more unconventional choices for 2013, not all of which look particularly enticing. However, Peter Oppenheimer, chief global equity strategist at Goldman Sachs, points out that price matters more than growth.

"You can find lots of places with dismal fundamentals but valuations that overstate just how dismal they are," he says.

One of the most popular contrarian bets suggested by fund managers and strategists is one that has frustrated for more than two decades: Japanese equities.

The fundamentals appear gloomy. Japan has just entered its fifth recession in 15 years, the government is the most indebted in the world and the stock market has proven a perennial disappointment.

Yet Shinzo Abe, recently elected premier, has promised aggressive fiscal stimulus and called for "unlimited" monetary easing in an effort to fight deflation.

That has led many hedge funds to bet against the Japanese currency and bond market but has spurred some investors – including DoubleLine's Jeffrey Gundlach and BlackRock – to favour Japanese stocks, which would benefit from some inflation and a cheaper yen.

Although the Nikkei has already rallied 17 per cent since mid-November – making it close to a consensus rather than contrarian trade – the market remains a bargain, argues Russ Koesterich, BlackRock's chief investment strategist. "This is an asset class people have thrown in the towel on," he says.

There are other unloved equity markets for investors who like going against the flow. Brazil's Bovespa and Spain's Ibex indices have dipped in US dollar terms this year and stocks are on average trading close to their forecast book value next year.

But Brazil's bourse would benefit if China's economy regains its vim. The economic outlook for Spain is grimmer, but as Greece's stock market performance this year illustrates, investors can learn to shrug off recessions.

With the prospect of European Central Bank intervention, improving competitiveness and hopefully even some economic bright spots towards the end of next year, Spanish equities could prove to be an unlikely 2013 winner.

"Greece shows that growth is not everything," says Luca Paolini, chief strategist at Pictet Asset Management. "It's all about beating expectations."

For investors who like racier investments, Exotix, a brokerage, proffers some more unconventional bets for 2013, such as Ghanaian bonds, Ukrainian treasury bills and Argentine municipal debt.

Yet many fund managers argue the most appealing contrarian thesis for 2013 is that US economic growth surprises positively – causing Treasury yields to move significantly higher.

Although a rise in Treasury rates is widely predicted, few expect a sharp move upwards. The Federal Reserve has committed to keeping its benchmark rate at near zero until at least early 2016 and is manipulating longer-dated yields through bond buying.

But if economic growth accelerates, the Fed could soften its rhetoric, hold fire on more bond buying and let longer-dated Treasury yields rise.

A widely expected move out of bonds and into equities could then quickly become a stampede, hammering many fixed income markets in the process.

Fitch Ratings estimates that a typical US corporate bond could lose 15 per cent of its value if Treasury yields rise to just early-2011 levels.

Betting against the bond market has been a popular but unprofitable trade for several years now. Some investors think 2013 may be the year their luck changes.

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