January 2013

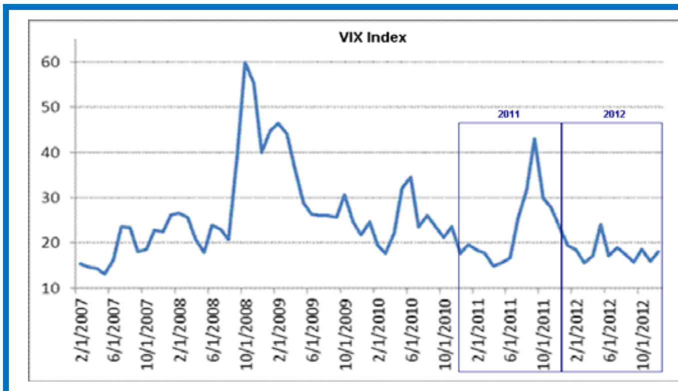
Market Commentary

Progress in 2012; what's next in 2013?

The month of January gets its name from Janus, the Roman god of beginnings and transitions. Janus is often depicted with two faces since he looks to the future and to the past. The ability to look both ways also comes in handy when navigating the paths that matter most to investors: Wall Street and Bay Street. The arrival of a new year is the perfect time to review the events of 2012 and scout the big issues that will dominate 2013.

It would be easy to characterize 2012 as a somewhat difficult year for markets and economies. Yet that would discount the many key accomplishments of policy makers who faced very significant challenges at the outset of the year. It would also ignore the gains made across the capital markets compared to the previous year and the overall reduction in volatility in most equity markets. Remaining fully invested in risk assets was clearly the right strategy.

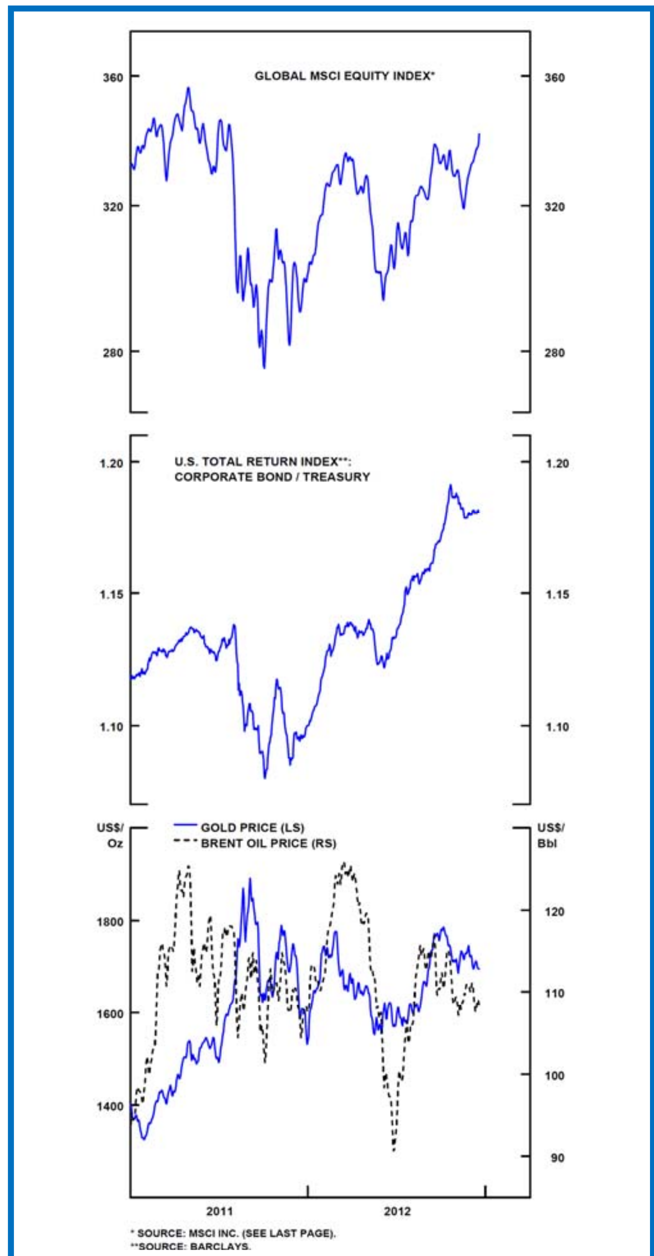
Chart 1: Throughout 2012 expectations for equity market volatility were generally lower than in 2011. The VIX index gauges expectations for U.S. equity volatility.



Source: Bloomberg

In our view, 2012 was a year of progress in resolving some major problems that were obstructing the capital markets. Does that mean that the structural roadblocks in the eurozone, the U.S. and elsewhere are behind us? Absolutely not. The message is simply that the world is in better shape now versus 12 months ago.

Chart 2: A decent year for risk assets (across equity and energy markets)



Source: BCA Research

BMO Harris Private Banking

Improvements in Europe

Europe began 2012 entangled in a sovereign-debt crisis and closed the year with a clearer path forward. Twelve months ago, catastrophe seemed not only probable but also imminent. After all, the plan in the early days of 2012 was simply to come up with a plan. Several peripheral European economies needed a three-pronged approach to restore fiscal health and investor confidence:

1. better integration of banking oversight;
2. strong coordination of fiscal policy and better congruence with EU guidelines; and
3. mutualization of debt (combining the sovereign debt of all EU countries in a common mechanism to help decrease borrowing costs).

It was apparent that austerity programs, while necessary, were not enough. In fact, austerity on its own (without a simultaneous effort to grow the respective economies and address punishing unemployment levels) was backfiring. Investors and the general public were skeptical. Citizens bearing the brunt of the austerity programs were angry – violent street protests and riot police were constant fixtures on the nightly news. Against this challenging backdrop, European policy makers made more progress in 2012 than anyone could have reasonably anticipated back on December 31, 2011.

The successes are many. Europeans now have an agreement on banking supervision. Mario Draghi, the president of the European Central Bank, stated in July, "Within our mandate, the ECB is ready to do whatever it takes to preserve the euro, and believe me, it will be enough." He made it clear that the debt of EU members would be backstopped – which is not quite debt mutualization, but has a similar outcome in that no default would be allowed. Communication among all constituents improved vastly; that clarity has gone a long way to restoring confidence. Considerable progress toward stability was made. Despite the good news, however, Europe has not fully recovered. The economies of two core countries, Germany and France, have shown some worrisome signs of slowing, and both recession and unemployment are persistent in many smaller EU economies. Even though more work is required before the markets regain confidence and the region begins to grow again, we are encouraged that there is now a framework in place.

Progress in the U.S.

The U.S. Federal Reserve effectively set the tone for policy clarity in 2012. First off, Federal Reserve Chairman Ben Bernanke firmly indicated that interest-rate policy would remain accommodative, even going so far as to tie monetary policy to the unemployment rate. The target of 6.5% unemployment means that rates will remain low for at least another year.

Next, the fiscal cliff (the tax hikes and spending cuts that were due to take effect January 1) was the ideal catalyst to showcase political posturing and brinkmanship at its finest. Stakes were high. The minimum standard for resolving the fiscal cliff was straightforward: don't interfere with the momentum of the economic recovery that had gradually built up in the last half of 2012, but do address in a meaningful way the growing ratio of U.S. debt to GDP. Despite all the noise from Republicans, Democrats and pundits, politicians made substantial progress in the important area of tax reform. Here are a few highlights of that last-minute legislation:

1. There is now a permanent extension of the lower and middle income-tax brackets at current levels, preserving the tax cuts in the Economic Growth and Tax Relief Reconciliation Act of 2001 and the Jobs and Growth Tax Relief Reconciliation Act of 2003. This is good news for middle-class wage earners.
2. Individuals earning more than US$400k and joint filers earning above US$450k will see their marginal tax rate rise from 35.0% to 39.6%. Limits on itemized deductions and personal exemptions for upper-income earners will also return to levels predating the Bush tax cuts of 2001. The Personal Exemption Phase out will be set at US$250k and the itemized deductions will begin at US$300k. Prior levels were US$175k and US$265k.
3. There is also a change to the capital gains tax rate, dividend tax rate and estate tax. For those in the US$400k/US$450k upper-income bracket, the tax rate on capital gains and dividends will rise from 15% to 20%. Estate tax will rise from 35% to 40% on estates valued above US$5 million, with that threshold indexed to inflation.
4. The payroll tax will revert from its current level of 4.2% to its previous 6.2% level for employees and the self-employed. This adversely impacts all taxpayers and is roughly equivalent to the cost of a tank of gas every two weeks.

Markets rallied in reaction to the passage of the bill. Legislators gave up on the notion of a “grand bargain” that linked spending cuts to tax reform and postponed for another two months the deadline for those cuts to automatically kick in. It was a wise move given the complexity of getting such an all-encompassing deal done. Anticipate more political theatre in the weeks ahead.

A soft landing for China

Would China land softly or with a thump? That was the question in January 2012. It wasn’t clear that the Chinese authorities could orchestrate a soft landing. It was clear, however, that China wanted growth to fall back to the region of 7.0% to 7.5%. Analysts view economic data from China somewhat skeptically; they frequently voiced concerns that the economy was doing far worse than the reported numbers indicated. Thanks to policy makers, money and credit growth have stabilized and many measures of economic activity have moved higher.

China still has lots of room for growth. To put this in perspective, it is projected that 300 million people in China will migrate from rural to urban communities by 2025. That’s roughly the equivalent of building every town and city in the U.S. It’s a staggering challenge that will likely continue to have a significant impact on demand for, and the prices of, commodities. It also exposes China to the potential for social unrest.

Canada: steady as she goes

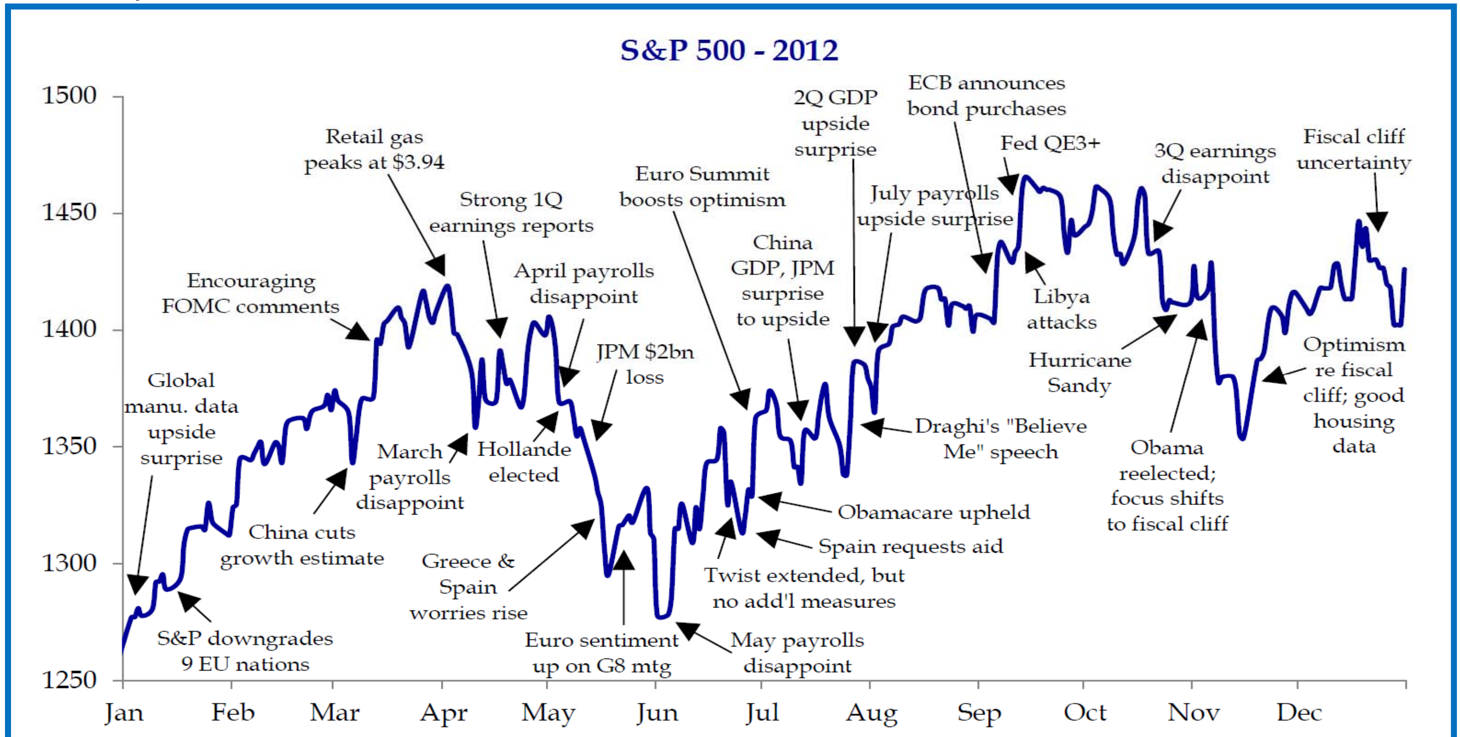
While public policy issues were not as dramatic in Canada, two events are worth noting. First, the Bank of Canada maintained a steady course of low interest rates, which provided further incentive for business development.

Bank of Canada Governor Mark Carney will be a welcome addition when he takes the helm at the Bank of England later this year, helping the Brits deal with an ill-conceived austerity program. Second, the Canadian government introduced tighter rules for longer-term mortgages that have somewhat cooled a hot housing market.

Investment Strategy

At the outset of 2012, our tactical asset allocation was neutral. Early in the second quarter, we increased exposure to Canadian equities based on improvements in many of the areas that had concerned us in 2011. We were a bit premature. In the spring, markets pulled back, nervous about short-term weaker economic indicators. By the end of the year, however, that overweight in equities added value to most client portfolios. Returns for individual asset classes were generally in line with our expectations, while U.S. stock returns provided some pleasant surprises.

Chart 3 - Key events in 2012



Source: Strategas

In 2013, our focus across the investment strategies is to generate yield, primarily from the fixed income allocation within our clients' portfolios. Central bankers have been clear that short-term interest rates will not rise this year, and likely not in 2014. In this environment, wringing out every drop of return is vital. We have recently added an allocation to high-yield bonds to most of our clients' portfolios. Despite somewhat narrower spreads, U.S. corporate bonds should continue to deliver superior returns compared to lower-risk assets such as government bonds which provide diversification and protection against downside risk.

When assessing the three major investable asset classes of cash, bonds and equities, from a valuation standpoint, equities are the clear winner, although they are only slightly undervalued compared to historical price-to-earnings levels. Up against bonds, the undervaluation is much more pronounced. That makes sense though: investor uncertainty about the macroeconomic environment has driven the overvaluation of bonds. The eurozone debt crisis, the slowdown in China, and the fiscal cliff in the U.S. are three good reasons that investors have demanded the perceived relative safety of bonds, even if they must sacrifice real returns. As the macroeconomic environment stabilizes, investor risk aversion will subside and fund flows will return to equities.

Worries over the pace of the slowdown of the Chinese economy had a strong impact on Canadian Energy and Materials stocks in 2012. Both of these sectors, along with the Information Technology group, prevented the Canadian equity markets from making any significant advances in 2012. Decreased Chinese demand for industrial metals, oil and other energy commodities weighed heavily on the two main resource-based components of the Canadian market, which combined make up nearly 45% of our market. As 2013 progresses, the economic recovery in China will likely strengthen. Coupled with a stronger U.S. economy, it is expected that energy and commodity prices will increase, which will positively impact Canadian equity markets.

U.S. equities are also expected to have a strong year as monetary policy continues to be supportive, the housing recovery continues to strengthen and consumer and corporate sentiment improves. The strength and robustness of the U.S. economy will hinge on the outcome of the next phase of the fiscal cliff debate, which we will be watching closely in the coming months.

European equities enjoyed a strong 2012, despite the turmoil surrounding the peripheral nations. Although current valuations remain generally compelling, economic data in Europe remains weak. It is still our view that the uncertainty remains too high to compensate for potential attractive returns. That said, we do continue to look for opportunities.

Finally, it is important to note that our investment strategy continues to be shaped by two major global themes – the headwind of further unwinding of the debt super cycle and the tailwind of the on-going industrialization of emerging markets. With that in mind, we look forward to 2013.

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