INVESTMENT COMMENTARY

It has been a positive start to the year for equities, with talk of the 'great rotation' beginning to build momentum. This can be seen through the strong performance of the major bourses during January, supported by a strong inflow of capital.

Most risk assets started the year on a positive note with developed markets finishing the month – FTSE100 +6.5% / S&P500 +5.2% / DAX +2.1% . Some of the standout performers for January were based on the European periphery – Portugal +9.0% / Greece +8.7% / FTSE MIB +7.2%; all coming in with impressive positive performance.

United States – recent macro data have been a little surprising. The US ISM printed 50.7 in December, which was a bit stronger than the consensus (50.5) and above the November reading of 49.5. Smoothing through some of the volatility seen in recent months, the December reading stands basically in line with the six-month average reading of 50.5. There was a notable increase in the employment index, which rose to 52.7 (previous: 48.4), though this was offset by a decline in the production index to 52.6 (previous: 53.7). The latest trade data showed the nominal trade deficit deteriorated to $48.7bn from $42.1bn in November, a significantly wider deficit than the consensus ($41.3bn) had expected. Industrial production rose 0.3% m/m in December, in line with consensus forecasts - a significant upward revision to October (to -0.3% from -0.7%) meant that industrial production rose modestly in the quarter as a whole (when previously a decline had looked likely), the gain in December was led by a strong 0.8% increase in the core manufacturing output component. Strength within manufacturing was broad based, with gains across durable goods, such as vehicles (2.6%) and machinery (0.6%), and non-durables, such as apparel (1.9%) and chemicals (1.4%). Alongside upward revisions to November (by two-tenths, to 1.3%) and October (by one-tenth, to -0.9%), this left manufacturing up an annualised 0.2% on a q/q basis, up from -0.8% in Q3. The strong gain in December (following Hurricane Sandy distortions in October and November) is an encouraging sign that production has regained some ground following a soft patch during most of the second half, consistent with the rebound in the ISM in recent months back into expansionary territory. The consumer price index was unchanged in December - falling energy prices (-1.2% m/m) were offset by modest gains in food (+0.2% m/m) and core prices (+0.10% m/m, core prices exclude food and energy). Core retail sales rose 0.6% m/m in December which was largely offset by a small downward revision to October (now -0.1%, previously flat). Unemployment remains above 7.8%. Real GDP contracted at a 0.1% annual rate in the fourth quarter - a disconcerting headline number which masked better underlying performance of the economy. The weakness in Q4 output was primarily driven by two factors: a 22% annualised drop in defense spending, the most in forty years, and a pullback in the pace of inventory accumulation. Absent these two factors the rest of the economy expanded at a relatively decent 2.5% pace in Q4.

The US government agreed a bill to allow the government to extend the debt limit with the Senate passing the bill, 64-34. The legislation will put off, at least for a couple of months, the showdown over the debt limit between Republicans, who demand more spending cuts and Democrats, who favour reducing deficits with a combination of spending cuts and tax hikes. Officials are voicing increased concern that record-low interest rates are overheating markets for assets from farmland to non investment grade bonds, which could heighten risks when they reverse their unprecedented bond purchases. In this context, policy makers said they will probably end their $85 billion monthly bond purchases sometime in 2013, with members divided between a mid or end-of-year finish.

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Euro area – the January final PMI manufacturing release marked a step in the right direction. The total Euro area manufacturing PMI index was revised up 0.4pts to 47.9, which means that the survey increased 1.8pts since December. These revisions were largely driven by a 0.7pts upward revision of the output index to 48.7 (up 2.7pts since December) and a 0.9pts upward revision of the new orders survey to 46.9 (up 3.3pts since December). Although manufacturing output still remains in contraction territory, the survey reached an 11 month high. Euro area consumer confidence jumped 2.4pts to -23.9 in January - the rebound in consumer confidence already started in December, when the survey rose 0.6pts to -26.3 (including a two tenths upward revision made in January), but the level of the survey remained low when compared to business surveys such as the PMI. This gap was thus partly closed in January.

German exports and imports did a synchronised nose-dive in November - nominal exports and imports of goods slumped 3.4% m/m and 3.7% m/m respectively. Both were a lot worse than generally expected. In real terms, the outcomes were similarly bad, with exports falling 3.5% m/m and imports falling 4.2% m/m in November.

ECB President Draghi suggested the worst of the sovereign debt crisis may be over. “We can begin 2013 on a more confident note, precisely because significant progress was made during 2012. We are now back to a normal situation from a financial viewpoint.” While the ECB expects the euro-area economy to shrink 0.3 percent in 2013, the bank expects a “gradual recovery” to begin later in the year.

United Kingdom – the UK economy is contracting again. Although Q4’s drop in GDP was partly down to temporary factors, another contraction in Q1 is quite possible, meaning that the UK may now be in a “triple dip”. It may be likely that the underlying stagnation is likely to continue for most of this year. The 0.3% drop in GDP in Q4 was a bit worse than the consensus forecast and left GDP in 2012 as a whole flat. It is worth keeping in mind that the provisional estimate is prone to (sometimes quite large) revisions. But it looks plausible given that the business surveys were pointing to a small contraction. Industrial production fell by 2.4% q/q, while services output was flat and construction output rose by 0.3%. Admittedly, the drop in overall GDP primarily reflected the unwinding of the boost from the Olympic Games. Extended maintenance of the UK’s biggest North Sea oil field also contributed to the weakness of industrial production. Nonetheless, underlying output looks as though it is doing little better than stagnating. The big picture is still that the UK economy is going nowhere. The latest labour market data released by the ONS showed an unexpected improvement in unemployment figures, both for the ILO and claimant count measure, while earnings growth was weaker than expected. The ILO unemployment rate fell to 7.7% in the three months to November (consensus / last: 7.8%). Claimant count unemployment, a more timely measure, fell significantly by 12.1k (consensus 0.5k) in December.

Policy makers refrained from adding further stimulus following some signs of success for the funding for lending program. The target for QE was maintained at £375 bn. The minutes of the meeting show members voted 8 to 1 to leave the QE target unchanged. Members views differed on the risks to the economy, some argued there was scope for wages to pick up while others suggested the economy could grow faster without generating inflation. The minutes acknowledged that substantial headwinds to recovery remain, including the drag to activity from fiscal consolidation, a further squeeze in household real incomes and the deterioration in U.K. competitiveness over the past couple of years. Concern was also noted on the Sterling exchange rate, which members believed might be above the level compatible with the necessary rebalancing of the economy. In a recent speech King stated that further QE was not off the table and noted the central bank will continue to assess the benefits and costs of further reductions in overnight interest rates. King also urged the government to do more to support the UKs disappointingly slow recovery, stating that relying on monetary policy alone is not a panacea. In a dismissal of comments by Mark Carney who will take the helm of the BoE in June, King argued that a long run 2% inflation target should remain an essential part of the UK’s macroeconomic framework.

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On the whole, recent activity data have been encouraging of our view that the global economy is improving, albeit slowly. Of course, in Europe, fiscal consolidation remains at the top of the political agenda. Even though financial markets seem to consider that the worst is over, the situation remains fluid, with many sources of risk that could materialise in the course of the year ahead. World growth remains vulnerable despite the support of loose monetary and financial conditions. The slack in the economy at the end of 2012 was close to its record high and unemployment is declining only slowly in the US while still increasing in the euro area. Therefore, monetary conditions will have to be kept easy for an extended period of time to offset the drag coming from fiscal policies. Hence, we believe that recent fears of an early ending of monetary support by the main central banks are exaggerated. We expect the Fed to continue to purchase assets through year-end, while the ECB should strive to keep rates close to zero and maintain ample liquidity in the economy after the partial repayment of the 3-year LTRO.

And finally…

A tunnel in Norway was closed-off in January by a truck-load of burning cheese. The ill-fetad vehicle came a cropper while driving through Brattli Tunnel at Tysfjord, setting alight its 27-ton cow-made cargo. The accident brought traffic to a stand-stilton for five days. "We can't go in until it's safe," said one official, adding that the cheese could burn "almost like petrol if it gets hot enough". The driver is said to be taking a refresher course in motorway fondues and don'ts. That should hopefully help him drive more caerphilly. He may, of course, take some stick from his fellow rivers – but he'll just have to grin and camembert it.

Equities	1 Month Return	Last 3 Months	Last 12 Months
S&P 500 INDEX	3.16%	10.04%	13.10%
FTSE 100 INDEX	3.54%	9.90%	8.30%
MSCI WORLD	1.72%	10.31%	10.71%
MSCI EUROPE x UK	-0.59%	7.55%	10.47%
Commodities			
Gold Spot $/Oz	-0.98%	-4.32%	-4.45%
S&P GSCI Total Return Index	4.10%	6.27%	0.69%
Foreign Exchange			
DOLLAR INDEX SPOT	0.55%	-1.27%	1.12%

Source: Bloomberg 12.02.2013

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