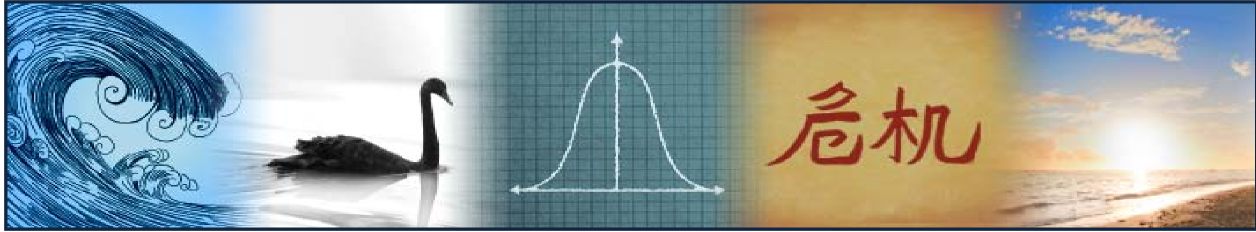


2013: The Year Ahead

MV Capital Management
Annual Market Outlook, January 2013

THE FUTURE OF GROWTH

Mater omnium bonarum artium sapientia est.

Knowledge is the mother of all good skills.

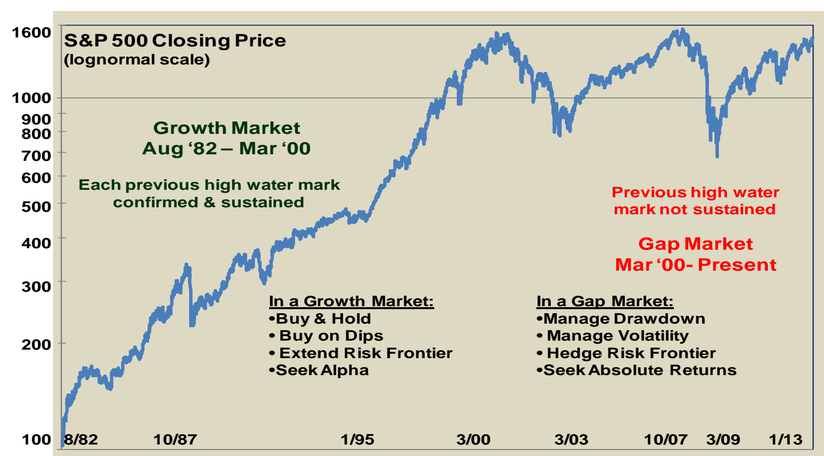
-Cicero

The world has changed considerably since 1982, the year when the last macro growth market in equities began (it ended in March 2000). The balance of global economic power has shifted. Vibrant middle classes have emerged in some parts of the world, and appear to be in decline in others. The Information Age that was in its ascendancy back in the early 1980s has matured and is now evolving into a more advanced Age of Big Data, where predictive analytics, robotics, machine learning and other innovations both tremendously empower and massively disrupt economies and the people who work in them. Growth may be at hand, but will we know when it arrives? Will we even recognize it? In this year's Annual Outlook we're going to focus quite a bit on growth, in its various meanings and guises.

A Refresher on Growth and Gaps

In analyzing equity markets we have a technical definition of growth, as illustrated in the chart below.

Table 1
S&P 500 Price Performance, 1982-2013



Source: Standard & Poor's; MVCM Research

We say that markets are in a growth trend when they confirm and sustain a previous high point, such as happened after every cyclical downtrend from '82 – '00. When they fall below and then fail to regain a

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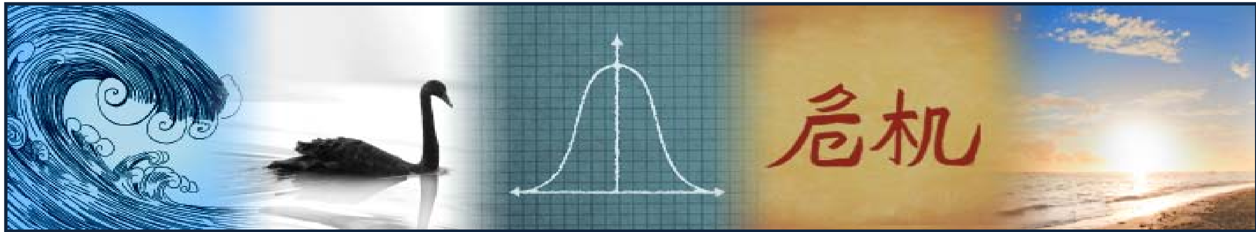


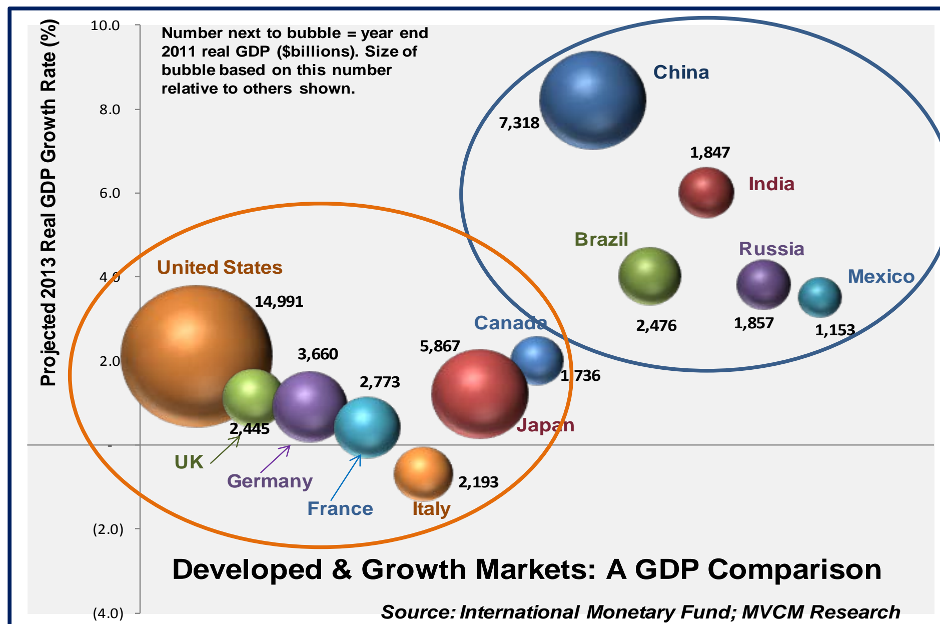
previous high we have a gap scenario, which is where we've been since near the beginning of the 21st century. It's an easy enough calculation – just look at the previous high points reached for the market index of your choice. We use the S&P 500 because it is a broad-based market benchmark (more so than the more concentrated Dow Jones Industrial Average or the technology-heavy Nasdaq Composite). The S&P 500 is currently about 2.5% away from its 2000 high of 1527 and is about 4.6% off the all-time high water mark reached in October 2007 (as of January 22). So it is within striking distance – but once it regains that lost ground it still will have to sustain the new highs without falling back into another slump.

Is any of this important or is it just a bunch of technical inside-baseball blather? Well, these long-term market trends – macro growth and gap markets – are useful for a couple reasons. The risk-return paradigm is vastly different in the two environments, and that influences portfolio choices. For example "buy on the dips" is a good strategy in a macro growth market, but it can be disastrous in a gap market when any dip has the potential to turn into a deep dark chasm. Knowing that you are in one environment or the other thus informs strategy and choices, and statistically speaking this knowledge gives you a greater likelihood of making the right choice.

Growth, Income and the Standard of Living

Most of the world's economic growth of the past 200 years or so has been to the benefit of what are now known as the developed markets, led by the US. That has been changing, as the next chart indicates.

Table 2
GDP Growth and Size Comparison



Two things are apparent from a quick glance at this chart. The first is that the bulk of the world's growth is taking place outside the mature economies of the US, Europe and Japan. That's not surprising – we know that the emerging markets of Asia and Latin America in particular have been growing at a fast clip for more than a decade now. But the second thing we see in this chart is the disproportionate amount of wealth that still exists in the mature markets as compared to the growth markets. China has indeed surpassed Japan as the world's second largest national economy, but it is still less than half the size of

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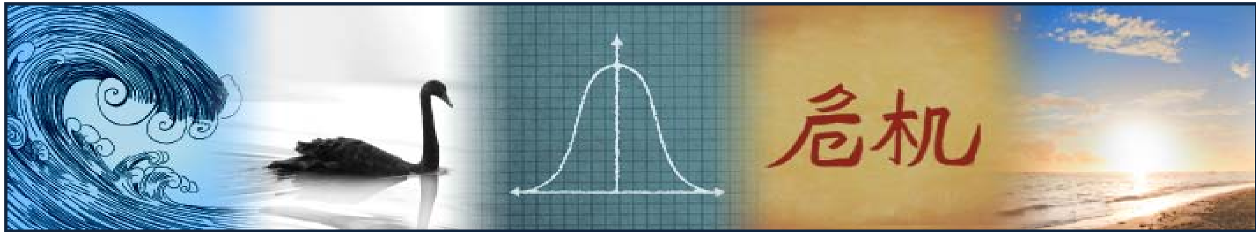

the US. Likewise Mexico is still half the size of Italy. A great amount of wealth remains in the developed world – wealth that is crucial to the global growth equation, even if that wealth has already passed its peak growth years.

Many observers believe that the billions of middle class *arrivistes* in the major urban centers of the growth markets, from Shanghai to Sao Paulo and St. Petersburg, will be the defining touchstone of the next growth era. We at MVCM made this case in a white paper we published way back in 2006 called "Emerged Markets". A major premise of that paper was that a trend of decoupling among world economic regions would accelerate; in other words, for example, more capital raised in Asia would be invested in businesses in Asia, which in turn would offer more goods and services to consumers in Asia, creating a virtuous cycle of organic regional growth. The export-led strategies of these countries would shift to a greater concentration on opportunities in their domestic markets.

Growth and the Golden Years

But that shift won't happen unless the world's developed economies in North America, Europe and Japan are able to mature gracefully and stably. Think of this in lifecycle terms: the rich developed countries need to enjoy a comfortable retirement. A protracted era of "golden years" for these nations is crucial because their collective wealth remains an indispensible part of the growth equation for the younger, more dynamic economies. Personal consumption expenditures in China account for just over 35% of GDP, while US consumers drive 70% of our national output. Chinese businesses desperately need our crazed Black Friday bargain-hunters to keep them profitable until such time as their own domestic market becomes sufficiently robust to sustain them. That time has not yet come and probably won't be at hand for some time yet.

We cannot just assume that the golden years will play out smoothly and harmoniously in the West. The slow pace of recovery in the job market is most likely structural, not cyclical. And job economics have changed dramatically just within the last five years or so. Nowhere is this more apparent than in the area of mid- to upper-end professional services, such as financial analysis, legal services and business writing/copyediting. Four to five years ago we came up with a shorthand for this – the "Boston-Bangalore Differential", meaning the difference between the compensation a professional in a major US urban hub would expect to receive for services rendered and what those same services would run for in a growth market hub like Bangalore in India.

The Boston-Bangalore Differential is still relevant. But there is another wrinkle in the equation now, which is the ability to do away with the human element altogether and have the work performed by machines. Machine learning is a facet of computer science that uses techniques like neural nets to "smarten" the technology to perform ever more advanced tasks. Think of a service like legal discovery. This has long been the realm of well-paid staff attorneys and paralegals whose job is to work through and analyze mountains of legal documents in preparation for a case. Now machines can do more than just crunch through the documents in fraction of the time; they can also handle the more cognitive complexities of doing the analysis. Good for businesses, but disruptive and alarming for employees.

There have been previous eras of growth where observers worried about the effect of disruptive technologies on the livelihoods of citizens, going all the way back to the Industrial Revolution. Somehow the growth equation has always managed to work out one way or another to increase the wealth and the standard of living of an increasing number of people. Now that equation is playing out on the world stage. As living standards improve dramatically in some places, the challenge will be to ensure that the golden years will proceed smoothly in others. How we respond to these challenges and how markets react to them will play a big part in determining what the future of growth looks like.

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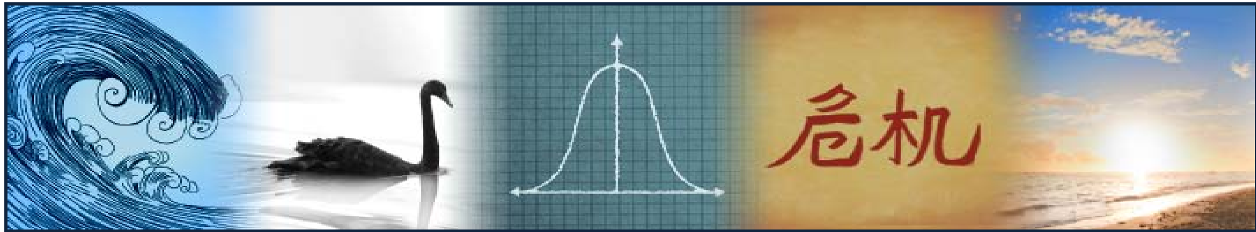

INVESTMENT THESIS

Last Twelve Months Recap and Outlook for 2013

- In other commentary pieces we have referred to 2012 as the year of living on the edge. So close to the edge of collapse for the Eurozone, so close to the edge of falling back into a double-dip recession, but always managing to move back from the edge and keep on going. As markets navigated the shoals in the shallow water **volatility fell sharply**, so that 2012 wound up being much less frothy than 2011, with fewer of the 2%+ gyrations in the course of a single trading day. Even the fiscal cliff drama at the end of the year failed to rouse the volatility bears from their dens.

- US equity markets led the way for most of the year, but as confidence shored up in Europe's near term prospects **foreign equity markets surged**. The MSCI EAFE index of developed non-US markets and the MSCI Emerging Markets index both finished the year ahead of the S&P 500. Stronger Eurozone nations (like Germany) and ex-Japan developed Australasian markets contributed much of the upside.

- It was something of a **wash for style investors**; they were neither rewarded much nor punished much for taking style bets. Among the main Russell style (growth/blend/value) and capitalization (large/mid/small) benchmarks there were only a few percentage points separating the best (midcap value, up 18.5%) from the worst (small cap growth, up 14.6%). But investors looking to reap continuing rewards from the high flying enhanced dividend stocks of 2011 were disappointed.

- Despite the general uptrend in equity markets, with most major indexes returning double digit gains for the year, **bond yields remained stubbornly low**. The 10-year Treasury yield stayed under 2% most of the time, and actually reached a new post-Second World War low at one point. This lent a bit of a "yes, but…" flavor to the rally in stocks – evidence that many investors were still concerned about drawdown and were keeping their bets hedged and powder dry.

- **Alternative assets were a mixed bag**. Hedge fund of funds kept up their recent streak of mediocre performance. The HFRI Fund of Funds Composite gained 5.25% for the year, providing yet another data point in the arsenal of the growing number of observers who see hedge funds as overpriced and underperforming on average. Commodities were also underachievers last year, with the Dow UBS Commodity index down -1.06%. Volatile oil prices hurt, and gold lost its luster as a safe haven in a year when risk was not as dominant a trend as it had been recently.

- The **low volatility trend is so far continuing** into 2013. The CBOE VIX index, a measure of investor volatility sentiment, is close to cyclical lows (a low VIX reading indicates subdued volatility fears). The S&P 500 has been above its 200 day moving average for all but 10 of the last 264 days. Investors seem to be assuming that: (a) any policy crises that surface will be dealt with, or just kicked down the road; (b) an improving (if slowly) job environment and housing market will give a boost to household budgets and thus to spending; and (c) subdued inflation will give the Fed plenty of latitude to negotiate the transition while keeping rates low. Those factors could all add up to a year of growth in equity market performance.

- Those same trends may be **more damaging to bonds**, especially at longer durations. We've been burned before by prematurely calling bond market malaise, but it's likely to happen sooner or later. The question is whether that is clear and present or a problem for a different day.

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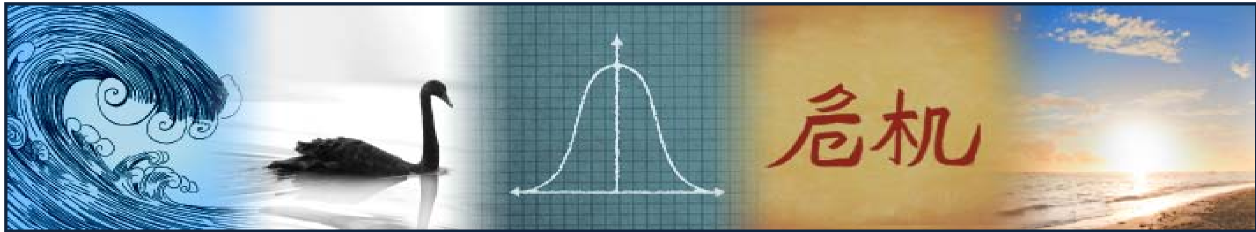

Market Drivers

In this section we identify some key themes we think will play a large role in driving market performance in 2013 and beyond.

The Safe Haven Challenge

At the beginning of 2012 one of our key assumptions was that a large dose of volatility was likely to be in store for risk assets over the course of the year. As it turned out, the big volatility story of the year was to be found not in stocks, but in bonds. Consider the following chart:

Table 3
S&P 500 versus 10-Year Treasury Yield

S&P 500 versus US 10-year Treasury Yield
January 1 2012 – December 31 2012

Source: Wall Street Journal Online

Two interesting things jump out from this chart. The first thing you can see from just a casual glance is that the 10-year Treasury yield was more volatile than the S&P 500 over the course of the year. The Treasury yield varied by more than 20% on the upside and more than 25% on the downside from where it started at the beginning of the year (remember that we are looking at yields here, and when yields go down prices go up). By contrast the S&P 500 varied by no more than 15% on the upside (bear in mind that this is a price-only graph not reflecting dividends) and was never in negative territory over the whole year. The picture tells the story: the normally staid Treasuries bounced all over with sharper and deeper price swings, while the equity trendline looks more like a vista of placid rolling hills.

The second interesting thing to note here is that bond yields stayed mostly lower while equities rallied strongly in the second half of the year. In fact the yield on the 10-year fell below 2% in late April and never rose back above that threshold level for the rest of the year. That trend continues; the S&P 500 was up over 3.6% year to date as of January 17, while the 10-year yield still languishes below 1.9%. What does that tell us? That there has been a significant dose of caution in this long stock rally – a “yes, but” caveat to the impressive gains equity portfolios have enjoyed. There are some signs that this cautiousness may be changing. Net equity mutual fund inflows had their second-strongest week ever in the first week of 2013, with about $22 billion flowing in globally (the previous high was $23 million in the third week of September 2007. Elsewhere in this report we will talk about what we think that means for equity markets

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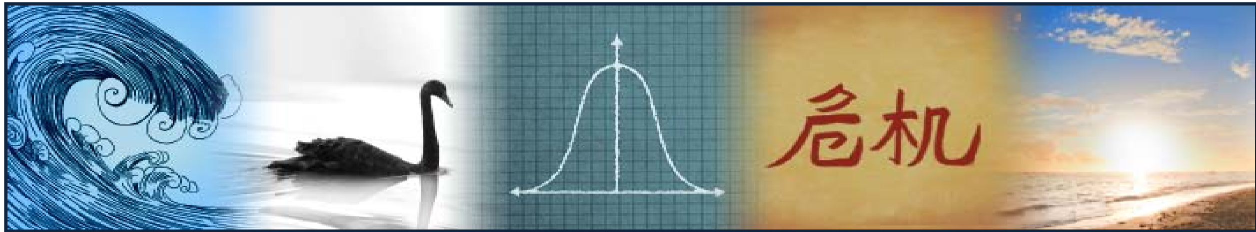


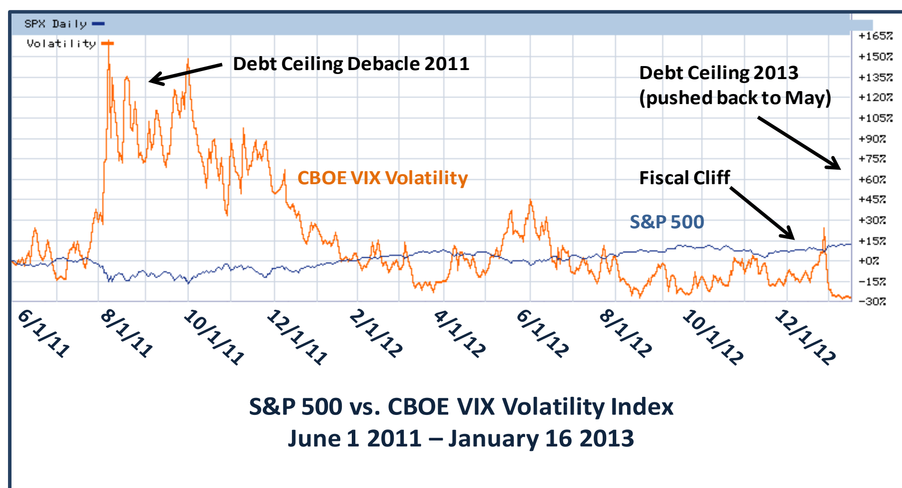
in 2013. Here the important point to note is that *bonds – and particularly the safe haven fixed income asset classes – are vulnerable as the year gets under way*. Readers of our 2011 Annual Outlook may recall that we were bearish on bonds then, and it turned out that we were early to the party as bonds rallied briskly that year. Back then the 10-year Treasury was over 3%. Historical norms are much higher. During the high growth market environment of 1995 – 2000 the 10-year yield was as high as 7.8% and never fell below 4%.

And that – to come back to the subheading of this section – is what makes for the safe haven challenge. We're not talking about the risk characteristics of bonds versus stocks over the long term – that's a different story for a different day. What we're talking about is the intermediate term where a trajectory back to anything approaching historically normal interest rate levels is going to wreak havoc on bond prices. It's interest rate risk, pure and simple, and in our view it is an elevated risk for 2013.

Markets to Washington: Yawn (For Now, Anyway)

The second market driver we have in our sights for the year ahead is the continuation of Washington's odd game of turning policymaking into a gruesome spectator sport every bit as cringeworthy as the worst of cable reality TV, but with real-life consequences. One and a half years ago it seemed incredible to most observers (not to mention the credit rating agencies) that government officials presumably elected to serve the people would be willing to deal the people a completely unnecessary black eye by allowing the US to default on its debt, potentially triggering an economic cataclysm. Sad to say, it is no longer incredible – not a bug but a feature of the system, it would seem. Having managed to run up to the edge of the so-called "fiscal cliff" at the end of 2012 and then back away with a kick-the-can deal that did absolutely nothing to address any long term structural issues, the players are limbering up for their next donnybrook. The latest maneuvering as of this writing would appear to have us kicking the debt ceiling can down the road until May, but it will be very unlikely to lie dormant. For as many challenges as the economy faces in reaching and sustaining a healthy level of growth, it is truly sad that this non-stop drivel of self-inflicted crises has to occupy people's attention and concern. But as we said – it's a feature of our dysfunctional political system, not a bug, and probably will be around for some time.

Table 4
S&P 500 Performance and Volatility



Source: Wall Street Journal Online

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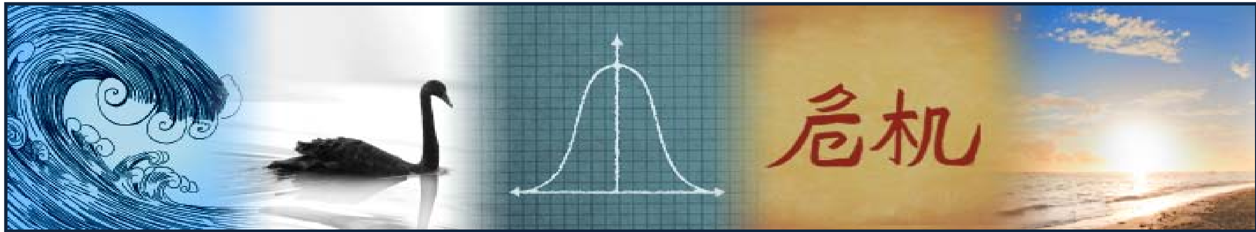
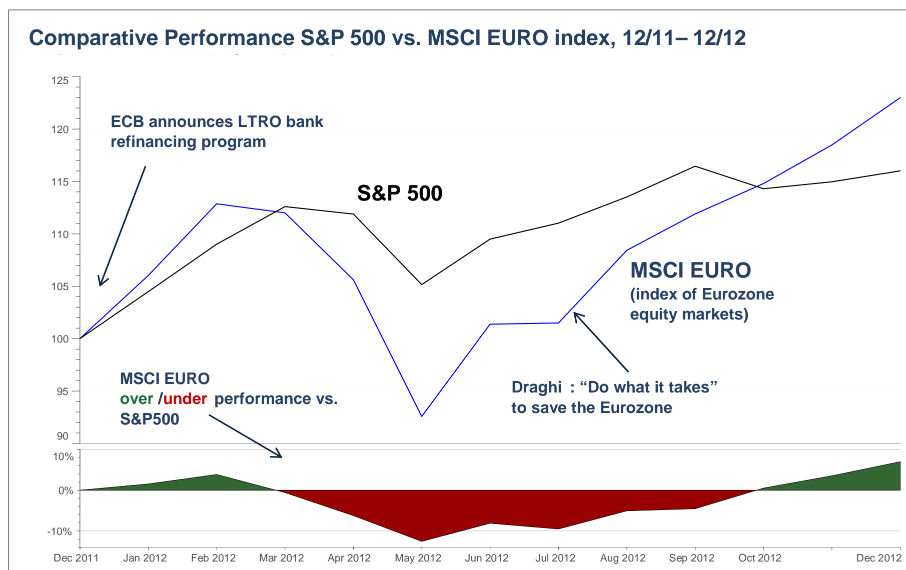


If it's a feature of the landscape, the chart shown above indicates that it may be a feature with which investment markets have learned (or at least are learning) to live. What the chart shows is the price performance of the S&P 500 from the summer of 2011 to the present, and also the CBOE Volatility Index (VIX) for the same period. Note how the VIX spikes up so dramatically in July '11 as negotiations are going nowhere and default day is approaching. That's typical – the VIX is popularly known as the "fear gauge" for this very reason. Now look at the relationship between the S&P 500 and the VIX during the fiscal cliff negotiations and into early 2013 as the next possible default outcome approaches. A giant, collective shrug of the shoulders it would seem. Now, that is not to say that the VIX may not spike up again if these talks break down closer to the date. But markets are Pavlovian, and the Pavlovian response learned from so many other crisis points – from Washington dysfunction to the Eurozone and back to pretty much everything post-Lehman Brothers – is that somehow a fix surfaces at the last minute to avert total disaster. The day we have to fear is the day when markets no longer believe these fixes will work – that the wound has progressed beyond the usefulness of another Band-Aid. But at least from what the S&P 500 and the VIX tell us today, that day is not yet at hand.

The Synthetic Growth Wizards

2012, a year in which the S&P 500 gained 16.0% in total return and other major market indicators were mostly in a pretty close range around that figure, was a year for synthetic growth. There were three important ingredients that manufactured this growth. The first happened at the beginning of the year – actually at the end of 2011. That was the Long-Term Refinancing Operations (LTRO) facility put together by the European Central Bank to extend the term European financial institutions had to make good on their outstanding obligations – essentially swapping near-term payment dates for ones further out and thus substantially reducing the likelihood of default. No major European banks defaulted in 2012, so it seems to have been a good idea. But a second act was to come.

Table 5
Relative US and European Equity Market Performance



Source: Zephyr & Associates LLC

That second feat of synthetic wizardry came courtesy of ECB Chairman Mario Draghi in the summer, at a point when concerns over the Eurozone were making a comeback. Draghi managed to accomplish what

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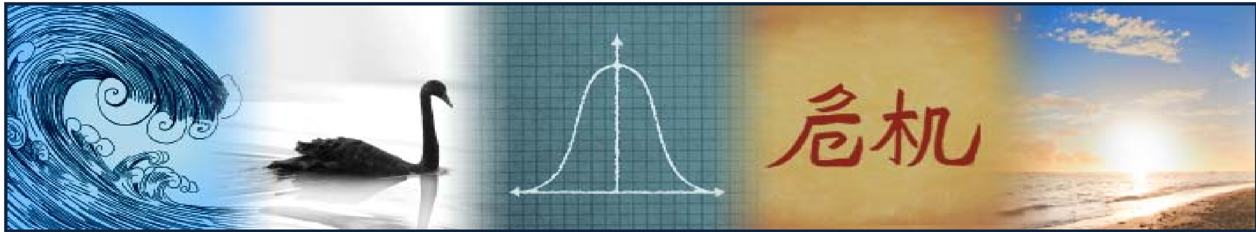


had eluded other European leaders to date; namely strong-arming Germany into agreeing to support Euro bond issuance facilities when and as needed to bail out troubled sovereigns. There's a bit more to it than that, but Draghi's tough talk made a huge impact on market sentiment. As with most of these inflection points the outcome did little to address the underlying economic problems plaguing the single currency zone, but it was enough to assure investors that the specter of a national default was much less likely.

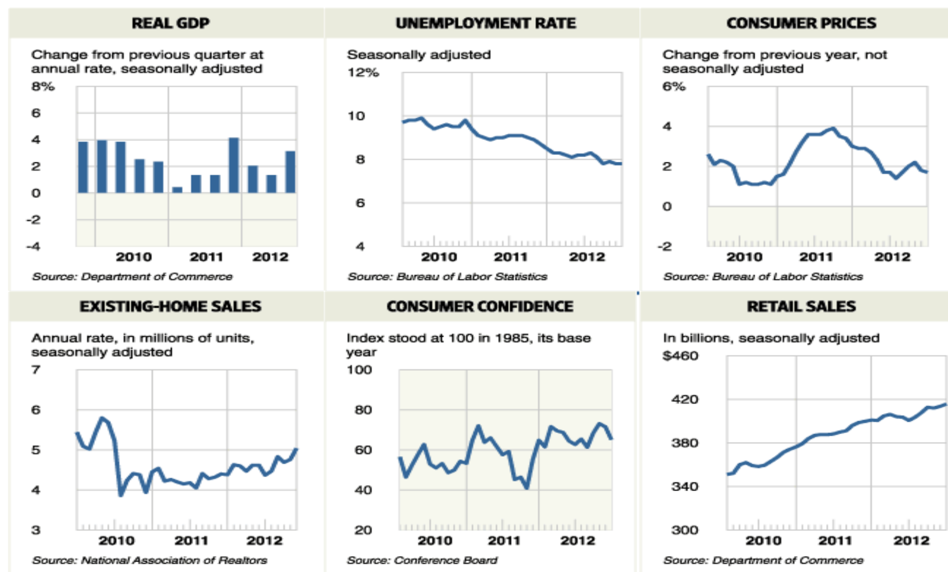
Finally, not to be outdone by his European colleagues, Fed Chairman Ben Bernanke kept the party going with an announcement in September of the Fed's intention to resume a new quantitative easing program – QE3 or QE4ever as you prefer. The new program would entail monthly purchases of $40 billion in mortgage backed securities until conditions were stable again, with very wide latitude as to what "stable" would mean. In a nutshell, easy money as far as the eye can see.

All these synthetic measures remain in place today, and for that reason they will continue to be market drivers in 2013. Even if we see continued evidence that real organic growth is taking place (we talk about this more in the next section below), we think it is unlikely that any of the synthetic devices will be turned off during the next twelve months. Inflation is tame (see chart below) and demand remains moderate enough that concerns about overheating the economy are not at the top of the concerns list at the Fed.

US Economy: The Case for Organic Growth

There is a reasonably good case to make that the US presidential election was decided on the basis of a handful of economic data points that surfaced in the fall of 2012 to confirm (if cautiously) a growth trend taking root. The charts below show a composite of some of the key indicators.

Table 6
Selected U.S. Economic Indicators



Source: Wall Street Journal Online

The chatter for much of the year was about how historically unprecedented it would be for a US president to be reelected with unemployment above 8%, real GDP below the level needed for sustainable job

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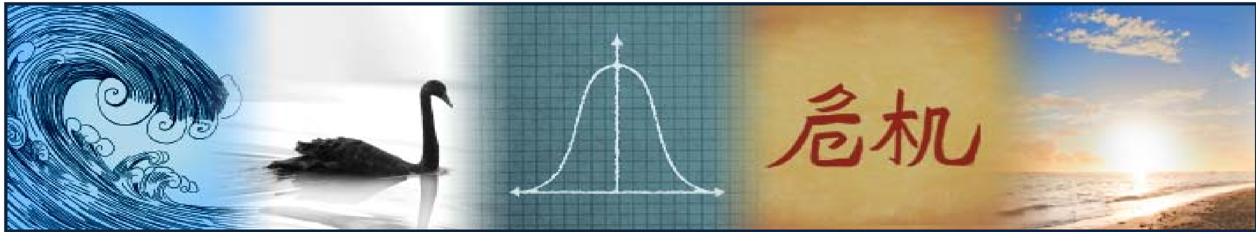


creation and so on. Notwithstanding the lack of statistical validity of most of these pronouncements (there simply aren't enough data points to make them meaningful) there is no question that the economy was front and center. As voters started to focus on the election after Labor Day what they noticed was that the trends were generally positive. Unemployment did dip below 8% and managed to stay there through subsequent readings. Consumer confidence hit a post-recession high. Retail sales were generally firm and the long-moribund housing market was starting to show signs of life. As the chart of selected indicators below shows, there is a case to make for growth carrying into 2013.

These are tenuous trendlines, to be sure. GDP growth was strong in the third quarter (last available reading) at 3.1% year on year. Continued growth around that level would support an environment of net job creation, but the next couple readings will be important before determining that the trend is in fact underway. Job growth remains painfully slow and people who lose their jobs are continuing to have a hard time finding new work at skill and income levels commensurate with what they enjoyed before. Wage erosion continues to be a fact of life for a variety of reasons that have been discussed in other sections of this document including the rapid advancement of smart technology and the continued effect the lower wage levels of growth hubs in emerging Asia and elsewhere are having on the rates US professionals are able to charge for the same services.

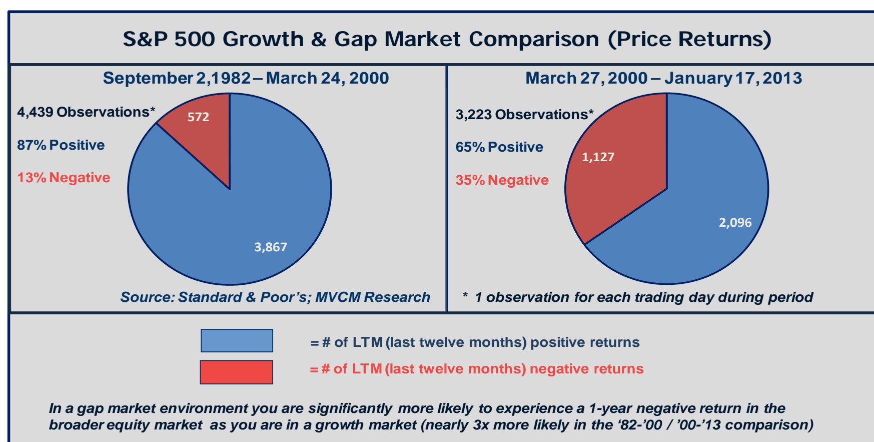
Still, the numbers we are looking at today tell us that some level of growth is more likely than not to be in the cards. If the recovery in the housing market continues to gather steam it will help households repair the damage done to their balance sheets in 2007-09. That along with incremental gains in employment trends may be enough to foster a demand-led growth environment.

Asset Class Review and Outlook

The Big Picture: A Return to Growth?

Investment strategies work differently in growth markets and gap markets. Consider the following chart:

Table 7
LTM Returns in Growth and Gap Environments



What is this chart telling us? We are looking at two different environments – the growth market of 1982 – 2000 and the gap market of 2000 to the present – and asking the following question for every trading day

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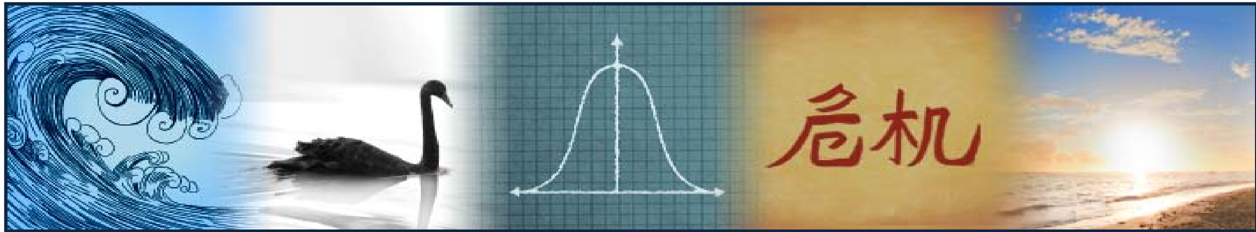
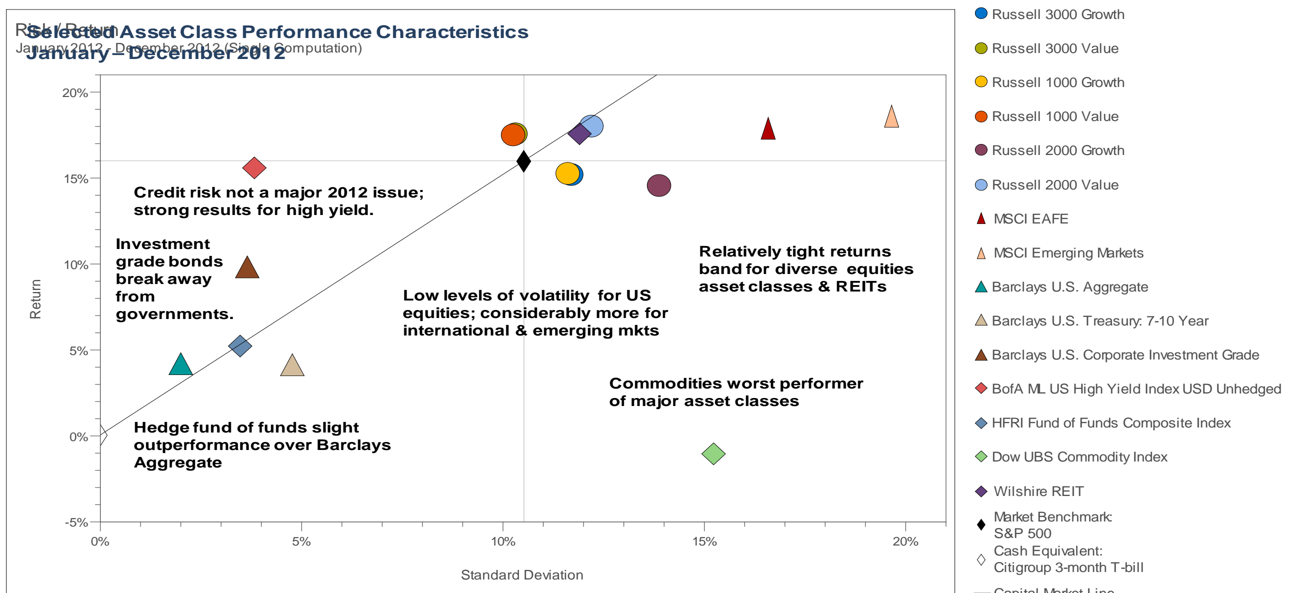


that took place during each period: If I had invested my money twelve months ago would my investment be positive or negative today? Doing this for every trading day gives us several thousand observations, which in turn makes the data more statistically significant. It turns out that during a growth market the odds of a positive outcome are nearly three times greater than they are for a gap market. The point of this is that if there is a reasonable case to make for a return to growth 2013, we need to consider strategies likely to benefit from that growth. At the same time if we are getting false signals now and find ourselves back in another year of the gap market, we need to consider the most efficient ways to stay nimble and move quickly into a hedge position if need be.

Table 8
LTM Risk/Return Performance of Selected Asset Classes



Source: Zephyr & Associates LLC

In our view portfolios for 2013 should take into account that there are elevated risks for poor performance in fixed income and a cautious-optimism case for growth in equities. That is, in considering the relative scale of potential risks we believe portfolios should be weighted towards the lower end of approved ranges in fixed income asset classes, with an orientation towards higher quality low duration where possible, and towards the upper end of the equities weighting spectrum. It may be opportune to re-weight asset classes such as developed and emerging market equities that have performed relatively poorly in the past couple years, and also possibly to increase positions in US small cap equities. Alternative asset classes can help provide diversification in relation to both debt and equity positions, but it's important to note that there are not all that many alternative classes that are performing well in the current environment. Hedge fund of funds and commodities have been particularly disappointing in this regard.

The Risk Decision: Equities versus Fixed Income

One of the ways we can see how growth or gap market conditions translate into investment performance is to consider how much better a bet it would have been to be invested in fixed income rather than equities during the period from March 2000 (when the gap market began) to the present. The chart below shows this. The green-shaded area at the bottom of the chart shows you how much better off you were over the period to be in a proxy for the Barclays Aggregate Bond index rather than one for the S&P 500.

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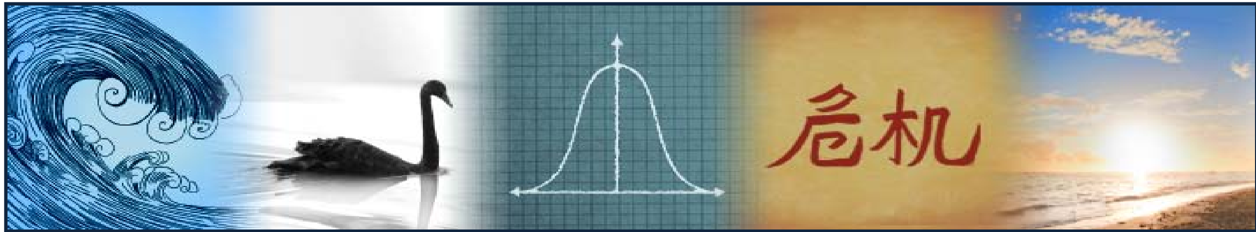
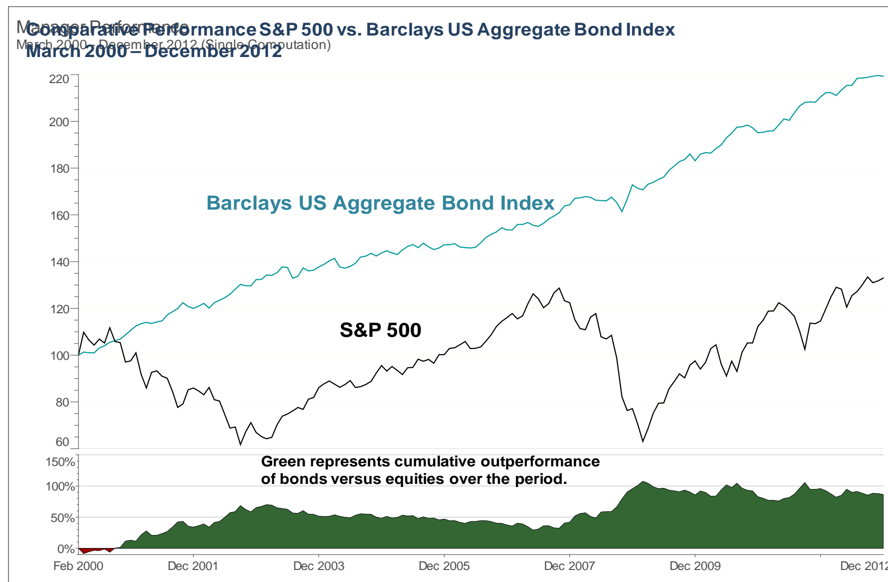


Table 9
US Equities Asset Class Dispersion Last Twelve Years to Dec 31 2012



Source: Zephyr & Associates LLC

So again, with yields on the 10-year Treasury still below 2% the question is how much more bond prices can realistically appreciate. The answer may be "still more", but our job is to evaluate the relative merits of the cases for (a) yields managing to reach new lows, sending safe haven bond prices to new highs, or (b) yields beginning a long and difficult journey back to historical norms. We think the evidence supports the decision of reducing fixed income allocations to the low end of the approved range in any given strategy. What fixed income exposure there is should, according to this strategy, be in low duration instruments or cash equivalents, and the cash equivalent component should be flexible enough to increase if market conditions merit a quick return to a more defensive posture.

The Style & Location Decision: Six of One, A Half Dozen of the Other

Sometimes style and geographic decisions matter more, sometimes they matter less. In 2012 there wasn't much to gain or lose by your choice of style or capitalization weights. There was a very narrow spectrum of returns between the top and bottom performer among the key Russell style and capitalization indexes. On the other hand 2012 saw a fairly decisive reversion away from the strong performance of the high dividend stocks that were strong in 2011. In that year just about any diversification away from high dividend large blue chip US stocks hurt portfolios.

Style and location decisions may become more important again in 2013 if the growth trend consolidates early in the year. The chart below shows the performance of large & small cap, growth & value and non-US benchmarks over the last three years. Growth and value largely have been a wash, while there has been a small returns-based (but not risk-adjusted returns) advantage to owning small caps and of course a severe penalty for holding non-US stocks.

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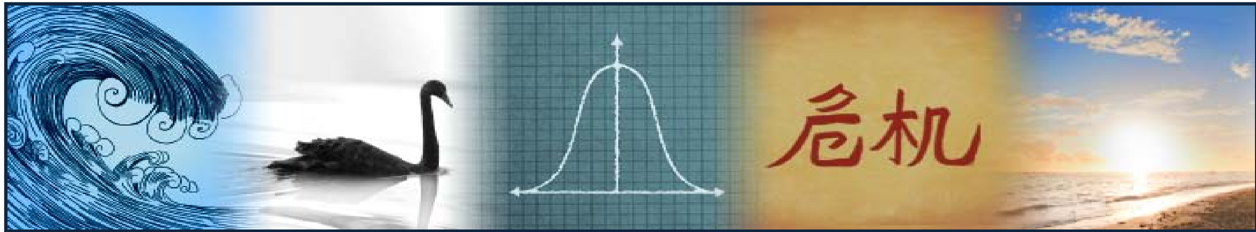
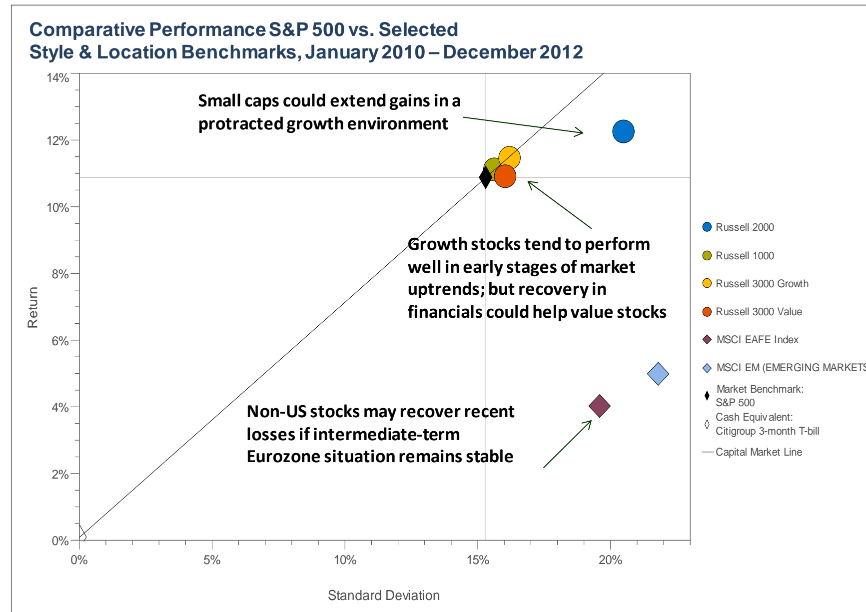


Table 10
Style & Location Performance Characteristics 2010-2012



Source: Zephyr & Associates LLC

That severe penalty started to reverse in mid-2012, as we have discussed elsewhere in this paper. Non-US equities had a strong finish in 2012 thanks mostly to Mario Draghi and his band of European policymakers for keeping the Eurozone from breaking up – at least for now. In 2012 strong Eurozone nations, developed Asia Pacific (ex Japan) and core emerging markets growth engines led the way. That trend could continue if Eurozone stability holds and global economic growth continues.

In terms of US style decisions a growth market environment could be kind to small caps, which tend to benefit when capital flows push out the risk frontier. As the chart above shows, small caps have gained some modest outperformance over large caps in the past three years, but there is potentially room for expansion of the differential. As for value and growth, this is a harder call to make. At different times over the past three years both growth and value have done well, driven on the one hand by technology leadership (much of which had to do with one single stock, Apple) and on the other hand by a recovery in large financial institutions (which tends to benefit large value indexes) as various financial crises diminished over 2012.

Overall our sense for 2013 is that style decisions should follow the risk frontier out into higher weightings for small caps and non-US equities, with the caveat that market conditions may change quickly if that scenario doesn't play out or is disrupted by lurking X-factors.

Using Alternatives: Ongoing Challenges

Alternative assets are supposed to play two roles in diversified portfolios. The first is to provide a hedge against fixed income and equity positions. This allows portfolios to stay within prudent risk/return guidelines while responding to opportunities and/or threats in stock and bond market environments. The second is to identify asset classes that can contribute strong returns themselves. Both these roles are challenging in the present environment.

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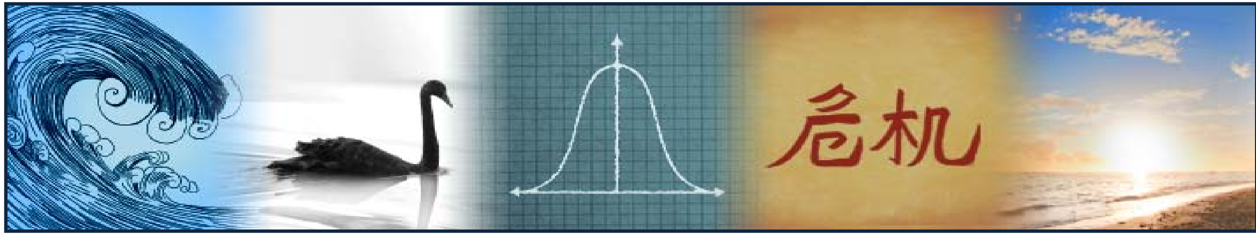
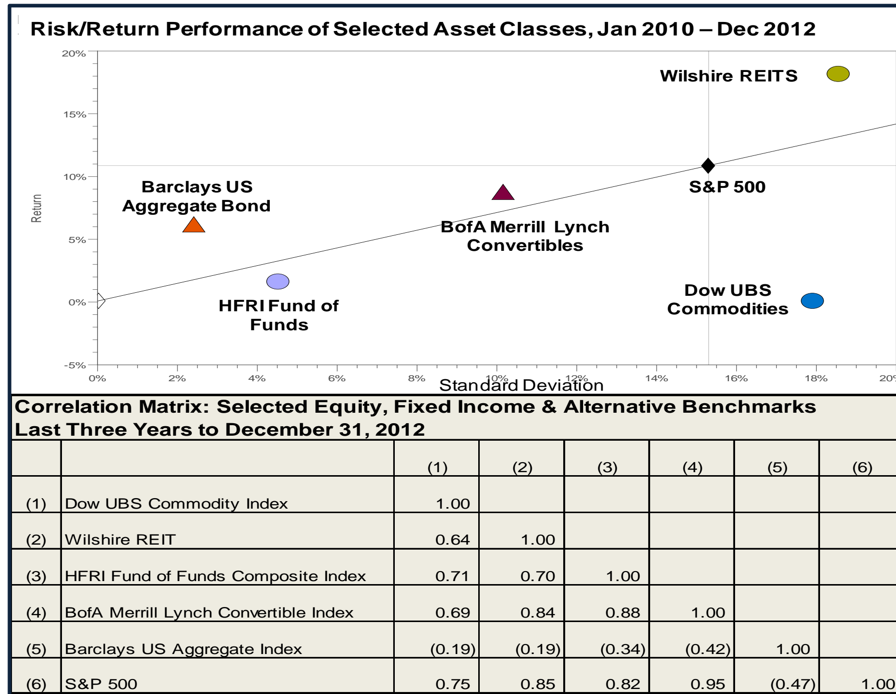


Table 11
Dispersion of Alternative Asset Classes 2010-2012



Correlation Matrix: Selected Equity, Fixed Income & Alternative Benchmarks
Last Three Years to December 31, 2012

		(1)	(2)	(3)	(4)	(5)	(6)
(1)	Dow UBS Commodity Index	1.00					
(2)	Wilshire REIT	0.64	1.00				
(3)	HFRI Fund of Funds Composite Index	0.71	0.70	1.00			
(4)	BofA Merrill Lynch Convertible Index	0.69	0.84	0.88	1.00		
(5)	Barclays US Aggregate Index	(0.19)	(0.19)	(0.34)	(0.42)	1.00	
(6)	S&P 500	0.75	0.85	0.82	0.95	(0.47)	1.00

Source: Zephyr & Associates LLC; MVCM Research

Let's consider the hedge role first. As the chart above shows, the correlation between several key alternative asset classes and equities is very high, indicating that they are not ideal as a hedge. In particular the relationship between equities and commodities, long a source of diversification value, has grown significantly more correlated in recent years. The correlation between these assets and fixed income is lower, however, so there is still a reasonable argument to make for their use as a way to diversify the fixed income portfolio. In the current environment we have been describing in this paper that is an important consideration.

With regard to the individual value contribution of any given asset class there are a couple developments we think may continue to impact performance going forward, and this concerns hedge fund of funds and commodities. Regarding fund of funds, we see the weak performance of this asset class in recent years as being in no small part attributable to the rapid growth of fund of fund managers during this time period. As the number of people fishing in a pond grows, the availability of suitable fish diminishes. It's much harder to add and sustain value when there is so much more competition. As for commodities, this asset class has in our opinion fractured into its subclasses, most importantly oil-related energy commodities and precious metals. It is potentially more prudent to selectively obtain exposures to the subclasses when opportunities permit, rather than maintaining a permanent strategic exposure to commodities.

We will continue to employ alternative assets as an important part of our investment strategy, but their ongoing roles will reflect our assessment of these changing conditions.

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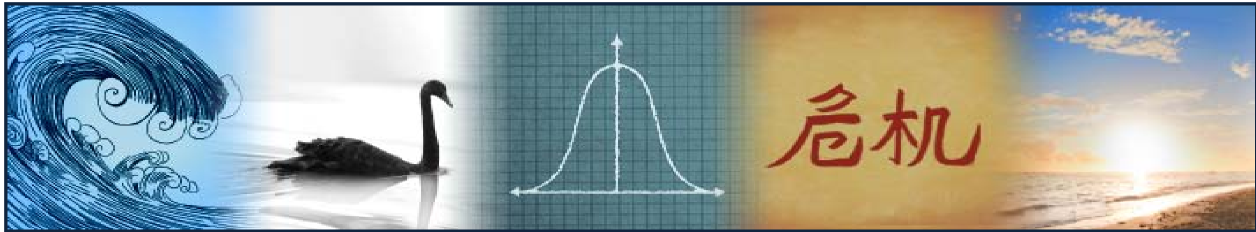

SUMMARY OF KEY POINTS

- 2012 saw a significant diminishing of the volatility that had characterized the second half of 2011. Risk asset markets for the most part returned healthy gains in the low double digits, with the S&P 500 gaining 16% after being virtually flat the previous year. Non-US assets recovered sharply as tensions in the Eurozone eased, and both developed and emerging markets benchmarks ended the year higher than their US counterparts.

- Performance in 2012 depended to a great extent on synthetic policy stimulus rather than genuine organic growth. The European Central Bank and the US Federal Reserve each did their part to keep cheap money flowing through the system in an effort to prevent further systemic collapses in financial institutions and to stimulate growth. Concerns about the potential long term effects of these measures are mitigated to some degree by a continued low inflation environment.

- With the US elections behind us there continue to be questions about Washington dysfunction and the effect such dysfunction could have on markets as issues like the debt ceiling, spending cuts and tax policy continue to come up for debate. Markets seem less inclined to worry about this than was the case in 2011. The CBOE VIX Volatility Index is close to all-time lows as 2013 gets underway. However volatility can spike up very quickly and Washington-related risk must remain on the table as a factor in play.

- The signs of organic growth that began to appear in the macroeconomic data releases in the second half of 2012 continue to offer hope of a sustained recovery. That in turn could be the driving force of a longer growth cycle in equity markets that sustains market benchmarks above the previous highs reached more than 12 years ago. However the growth environment is likely to be different from that of previous macro growth trends, with more dispersion of wealth among more parts of the world and standard-of-living tensions between growing and maturing markets.

- After an extended period where diversification into traditional style and location asset classes didn't pay, 2013 may be an environment where investors benefit by following the risk frontier out into traditional growth-oriented asset classes like small caps and non-US equities. We are recommending equities weightings at the higher end of approved ranges with a willingness to prudently take on more risk where the potential benefits may be merited.

- Fixed income is a potential cause for concern as the year gets under way. Despite the strong equities rally last year yields on the 10-year Treasury note remained below 2% for most of the year and are still below that level today. This is exceedingly low by historical standards, and a reversion to anything close to the mean is likely to cause significant pain in the bond market. We are recommending fixed income weightings at the lower end of approved ranges with an orientation to shorter duration instruments and cash equivalents. Cash equivalent positions should be flexible to allow for nimble deployment as needed if the risk situation changes to a more negative outlook for growth.

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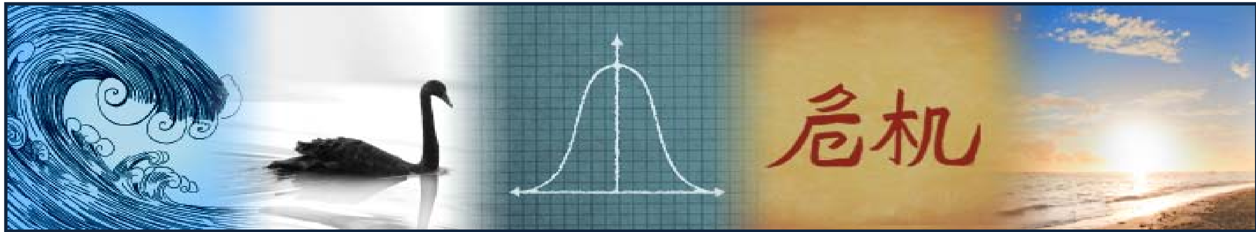

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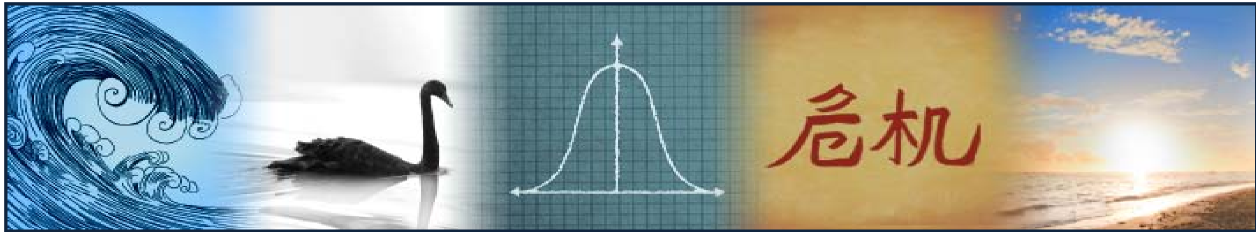

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