



“ We contend that for a nation to try to tax itself into prosperity is like a man standing in a bucket and trying to lift himself up by the handle. ”

– *Winston Churchill*

The “fiscal cliff” deal does little to alleviate the uncertainty that remains about US fiscal policy this year and beyond; it is nonetheless positive for the US economy and the compromise made by both sides of the Congress is a significant first step. The political dogfight notwithstanding, investors should look beyond the headlines and not miss the wood for the trees. My base scenario is that there will be a long-term fiscal deal struck during the two year life of the 113th Congress that takes seat in Washington DC this month. In the US the manufacturing data is much stronger than forecast. Beyond the US, Europe is likely to stay stable not least because Germany has its elections in September this year; Italian elections in April look less of a destabilizing effect, the ECB’s OMT is in place and ready for use. Chinese growth is more robust than most expected. Despite the postponement of spending by consumers and corporate alike, it is also a fact that eventually the car breaks down and needs to be replaced, and so does the plant equipment. This is what drives the economic recovery. As the next round of jawboning in the US Congress starts and “debt ceiling” negotiations intensify, I expect the initial rally in equities to lose steam before the end of Q1 and endure a volatile Q2. My end of year target for the S&P 500 is 1554. A modest +7% upside from current levels but a +14-16% upside if you can pick the dip in Q1-Q2.

#### Down the Potomac; one ‘cliff’ at a time

Christmas is incomplete without ‘Home alone’ and ‘Dennis’ on TV. It is as if these movies are put in the deep freeze and thawed every year on Christmas Eve. Something else thawed this festive season – taxes on US high earners. They went up. On the eve of New Year, at the eleventh hour, the US Congress broke a cantankerous stalemate to pass the bill designed to avert the so-called “fiscal cliff” and raised taxes on higher earners for the first time since 1993.

The compromise bill blocked most impending tax increases (except for high earners) and postponed spending cuts i.e. they broke the fiscal cliff into a “tax cliff” and a “spending cliff”. They dealt with the first and set the second sailing down the river to handle at a later date. Also downstream comes the “debt ceiling” negotiations in February-March. A volatile first quarter is anticipated.

While the “fiscal cliff” deal does little to alleviate the uncertainty that remains about fiscal policy this year and beyond; it is nonetheless positive for the US economy and the compromise made by both sides of the Congress is a significant first step. The political dogfight notwithstanding, investors should look beyond the headlines and brinkmanship. The backing down on the claim - no tax hike - may well spell the end of their career for those Republic Congressmen who drank the “tea” but I am hopeful we will see more such gestures, including some from President Obama himself who has no re-election to fight and a

legacy to establish. Therefore, while it’s easy to be cynical and turn bearish, I don’t believe that politicians on either side of the debate can, or want, to abdicate their responsibilities. To trade on the back of bad tempered news in the short run is to miss the wood for the trees.

My base scenario is that there will be a long-term fiscal deal during the two year life of the 113th Congress that takes seat in Washington DC this month. Hardened leftist and right wing Congressmen alike will extract revenue and spending cuts from each other respectively to put the US budget deficit and thereby debt, on a sustainable path. With US growth notching +3.3% at its last reading, additional revenue from the “fiscal cliff” deal and an improving macro environment are likely to keep the US growth pegged to the 3% handle for this year.

#### 2012: the year that cried wolf

2012 promised fire and brimstone at the start but ended in a good cheer with positive performance across the asset class and markets. The S&P 500 ETF (SPY) finished the year at +13.10%. Greece’s equity Index (ASE) was up +35% for the year and up +90% from the lows of June. It was the best year for Greek equities since 1999, and this when Greek debt was restructured at least twice during the year. Germany’s DAX (EWG +28%), India’s MSCI India Index (INP, +27%), Hong Kong’s Hang Seng Index (EWH +26%) were other star performers with the DAX enjoying its best year since 2003.

However, the good cheer didn't quite extend to Apple (ticker: AAPL). AAPL found itself vying with the Mayan Calendars to be the most discounted item in the end of year Sale. Of course AAPL is still a quality stock and rose +32% for the year (down from +72% on September 19). The earnings announcement is due January 23 and this stock is a Buy for me. In the same period from September to the end of the year when AAPL was turning sour, Research in Motion (ticker: RIMM) had contrasting fortunes. RIMM more than doubled from lows of \$6 to \$14. Was this the switch the market was making? Some of the selloff in AAPL was clearly driven by end of year profit taking, and the anticipation of increased tax levels in the US in the New Year. The two stocks also make very valid investment learning.

AAPL - When there is no one left to buy the stock (since everyone has it already up to their eyeballs), sustained selling, once begun, can take the stock much lower than anticipated.

RIMM - When there is no one left to sell the stock (since almost no one would touch it with a barge pole); the starting of sustained buying can ratchet up quickly and send the stock skyrocketing.

In terms of the sector performance in 2012 - the S&P 500 Financials (XLF, +26%), Consumer Discretionary (XLY, +21%), Telecom (IYZ, +15%) Technology (XLK, +13.5% despite the sell-off in AAPL), Industrials (XLI, +12%), Materials (XLB, +12%) were the standout performers. The majority of these are cyclical sectors and regular readers on this column will of course recall my continued emphasis on being long cyclicals throughout last year.

When it came to sovereign bonds, Treasuries, Gilts and Bunds were up between +2-4% in 2012 compared with the handsome returns of over +10% in 2011. Brent Oil was down over -4% for the year and Natural Gas declined by more than -14%, the biggest decliner in commodities. Within the broader commodities mix, Gold (GLD, +7%) was up for the 12th consecutive year, a subdued performance relative to gains of +11% in 2011 and nearly +30% in 2010. Platinum, the best performing precious metal (+11%) and Silver (+9.0%) outpaced Gold in 2012.

A good performance all around means the year 2012 turned out to be - the year that cried wolf. However, let's not forget the outcome of the Aesop's fable, where the wolf did eventually come and destroy the shepherd's flock. We need to be ever so watchful of our portfolio even though things seem bullish going into 2013.

TIME magazine picked President Obama as 2012 Person of the Year. In my opinion. Mario Draghi's claim to the

accolade was just as good if not better. If it wasn't for Draghi's leadership at the ECB and the introduction of the LTRO (Long Term Refinancing Operation) at the start of the year as well as his famous words in July, "whatever it takes", which led to the setting up of OMT and had a calming effect on the world markets; we would be looking at a very different market scenario today and perhaps a very different Europe and world. The Euro would have failed had Italian bond yield stayed higher for longer. Mr. Draghi's leadership and actions at the ECB ensured this didn't happen and Mario Monti (Italian PM) provided the much needed political unity and stability required in such extraordinary times. Someone said - if Mario Monti is a Catholic then Mario Draghi is the Pope. Let's hope Monti stays on as political leader in Italy and helps the Pope, I mean Draghi, stabilize the Euro congregation further.

#### Where to invest?

The US economic recovery that started in the summer of 2009 is now more than three and a half years old. Yes, an anemic recovery, but one that didn't result in a double dip recession despite the repeated recession forecasts from esteemed economists. In the US, the manufacturing data is much stronger than was forecast. Beyond the US, Europe is likely to stay stable, not least because Germany has its elections in September this year; Italian elections in April look less of a destabilizing effect, the ECB's OMT is in place and ready for use. Chinese growth is more robust than most expected. Despite the postponement of spending by consumers and corporate alike, it is also a fact that eventually the car breaks down and needs to be replaced, and so does the plant equipment in the factories. This is what drives the economic recovery.

As I wrote in my December newsletter, I see Europe and Emerging Markets equities offering a better return on a relative basis not least because they trade at a discount to US equities and a catch up rally is due. We have already seen this rally start in Chinese stocks. The Shanghai composite index (SHCOMP) rallied over +12% in the month of December alone and finished the year up only +3.2% compared to the S&P 500 index, which rose more than +13% for the year. There is more upside to come in Chinese stocks, I would expect at least +15-20% rally for the full year 2013.

If we look at the US equities, the headwinds are the same - Washington policy stalemate and lack of household income growth. However the tailwinds are getting stronger - the ongoing recovery in the housing market, the shale energy revolution, and higher consumer confidence. My crystal ball is pretty cloudy from the New Year's Eve party but I do see another year where equities will return to

favor and investors will start to leave the safety of bonds come mid year. As the next round of jawboning in the US Congress starts and “debt ceiling” negotiations intensify, I expect the initial rally in equities to lose steam before the end of Q1 and endure a volatile Q2, but the refocus on economic fundamentals in the second half of the year. My end of year target for the S&P 500 is 1554. A modest +7% upside from current levels but a +14-16% upside if you can pick the dip in Q1-Q2.

**Elsewhere,**

- Be long the Nikkei (EWJ); I expect another +20% gain given Shinzo Abe’s determined policies to weaken the Yen. I recommend you hedge the currency risk or you may get only half the upside. A structured product denominated in USD is best way to play this.
- Gold still has upside and more so given its recent decline. Another rally back to 1900 levels by the end of the year as money printing starts in Europe and the US Fed continues its loose monetary policy through 2013
- The US Housing sector (XHB, SPG, PHM, LEN, and EMR) has and will continue to provide a boost to US economic growth this year.
- The US also has the potential to see an energy boom in the years ahead (SLB, XOM, OXY, HAL) driven by shale gas.
- US financials have done well and are likely to continue the good performance in 2013. XLF is my choice of ETF and JP Morgan (JPM), Bank of America (BAC), Wells Fargo (WFC) and Citibank (C) the choice of stocks. These four largest banks control in excess of 50% of all U.S. banking assets and 50 percent of all revenues.
- As mentioned previously, I am more positive on Emerging Market (EM) and European equities (SXXP, VGK, EWG, EWU, EWQ) due to higher upside potential compared to US equities.
- In the EM, my preference is for economies with GDP growth slowdown bottoming out, improving manufacturing and anticipated currency appreciation - i.e. India (INP), South Korea (EWY), China (FXI) and Russia (RSX)
- In Europe, Utilities (RWE), Auto (BMW), Pharma (Novartis, Roche), Insurance (Aviva, Prudential), Basic Materials (Rio Tinto, BHP Billiton), Industrials (Siemens) and Consumer discretionary (Anheuser-Busch, L’Oreal) are some of my preferable stock play.

In currencies, I expect continued JPY weakness vs USD and USD weakness vs the EUR and AUD. I would not sell EUR vs USD until the OMT is activated. Once the OMT is activated, that will be the time to short EUR since EUR will then have joined the USD and JPY in the camp of “money printers” and the basis of its strength will be gone.

The downside risk to GBP has increased as a number of recent developments call into question the credibility of the UK’s policy framework. The Chancellor will have no option but to tolerate fiscal slippage. An expectation of the UK conforming to a fiscal target was keeping GBP strong; this doesn’t seem to be the case now. I expect the UK to lose its AAA-credit rating this year. The next Bank of England (BoE) governor has kick-started a debate over the appropriateness or otherwise of the BoE’s inflation mandate. If under the new Governor, the UK is to follow an overly reflationary monetary policy, accompanied by loose fiscal policy, then as we have seen with JPY, a slide in GBP will ensue.

Best wishes,



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