

No *replay*

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Market Outlook | May 2012



While a strong first quarter followed by a choppy start to the second may appear reminiscent of 2010 and 2011, Wealth Management Research–Americas (WMR) believes concerns about a renewed broad-based correction are exaggerated. Nonetheless, WMR says risk assets are unlikely to experience further outsized gains given the existing structural challenges and potential tail risks.

Markets will remain largely range-bound...

Instead, WMR looks for markets to remain largely range-bound over the balance of the year—albeit with periodic surges and episodic setbacks likely along the way. In WMR's view, the following suggests a replay of these recent market meltdowns is increasingly unlikely:

- The recovery in the U.S. has become more durable amid better labor market conditions, improvements in bank lending activity, continued resiliency in manufacturing and a bottoming out in the housing sector.
- Economic activity in China is poised to reaccelerate following a temporary late-winter soft patch. Recently released PMI data improved somewhat, and the rise in new orders and bank lending suggests that growth is likely to rebound in the months ahead. Fears of a Chinese hard landing are therefore exaggerated.
- Monetary policy will remain broadly accommodative within each of the major developed economies as the Federal Reserve, European Central Bank (ECB), Bank of England and Bank of Japan appear willing to both keep rates low and expand balance sheets further.

- Even after a first-quarter surge that pushed the S&P 500 back above the 1400 mark, equity markets are still not trading at levels that would suggest stocks have become overly expensive.
- U.S. corporate earnings results continued to impress in the first quarter, although expectations were quite low, and forward-looking estimates are likely overly optimistic.

...but still eventful

But while an identical replay of the past two years is unlikely, challenges remain and risk assets will continue to be negatively impacted by a whole host of issues, ranging from regional economic weakness to sporadic escalation of geopolitical risks to the reflare of the eurozone sovereign debt crisis. Consider the following:

- The eurozone economy remains in recession and the sovereign debt crisis has been rekindled. While the actions of the ECB helped to ease stress within the financial system, ongoing deleveraging within the banking system and the impact from austerity measures now suggest a deeper recession.
- Tensions in the Middle East remain an important risk to the global outlook through the significant impact they could have on energy prices.
- Growth in China is reaccelerating following the winter soft patch, however, there is still a chance that the lagged impact from selective policy tightening, concerns over political leadership changes and the transition away from an export/infrastructure-led economy could push growth below estimates.
- Likely changes in the political landscape, including new leadership in such critical eurozone players as France and Greece, pose another near-term threat to markets.
- The U.S. also faces a potential fiscal cliff with both tax cuts and spending measures set to expire at the end of this year.

Remain selective and opportunistic

Against this backdrop WMR recommends investors continue to maintain a benchmark or neutral allocation across each of the major asset classes. Equity markets

appear mostly fairly valued at current levels, but a material rerating of stocks is unlikely amid continued balance sheet deleveraging and lingering geopolitical risks. While interest rates are apt to drift higher over the course of this year, still moderate growth prospects, a largely docile inflation outlook and continued accommodative monetary policy conditions serve to limit repricing risks for bonds as well. Commodity prices meanwhile, are also apt to remain largely range-bound—but with sharp divergences likely among the energy, precious metals, base metals and agricultural sectors over the next several months.

But while WMR advocates a largely neutral allocation across the major asset classes, it continues to recommend selective and opportunistic positioning with a modest pro-risk bias in both equity and fixed income markets. In WMR's view:

- While equity markets appear fairly valued, the profit picture is still something of a mixed bag. Emerging markets earnings have room to surprise to the upside, but U.S. companies will find comparisons more challenging in the second half of the year, and European companies are apt to disappoint amid still lofty earnings expectations.
 - WMR therefore continues to overweight emerging market equities, given still solid growth prospects, a positive earnings outlook, an absence of any material policy tightening and attractive valuations.
 - Despite the cheapest valuations across developed markets, WMR retains its underweight in eurozone equities, for reasons stated above.
 - WMR maintains a neutral allocation to U.S. equities amid only fair valuations and prospects for low- to mid-single-digit earnings gains this year and next year. However, WMR continues to recommend overweights in technology, consumer staples and healthcare.
 - WMR continues to underweight U.S. Treasury bonds. While rates are unlikely to rise very sharply amid still accommodative monetary policy, modest capital demand and limited inflation pressures, the return outlook remains underwhelming with coupon income at historical lows and the medium-term direction of yields biased upward. Treasuries should therefore be maintained largely as a hedge against any rise in geopolitical tensions and/or exogenous shocks to the economy.
- Despite the continued tightening of credit spreads, WMR retains its preference for credit-sensitive parts of the fixed income markets. Corporate balance sheets are in the best shape in half a century, as companies have been reluctant to over-commit on either capital spending or payroll expansions. This suggests that default rates will remain below historical averages, while default compensation through credit spreads is higher than average. Absent systemic financial shocks, further spread tightening is likely. WMR favors high yield over investment grade corporate paper but also shows a preference for dollar-denominated emerging market debt and preferred securities.

Despite the risk and challenges, investors need to remain committed to markets. In WMR's view, we need to engage selectively in those sectors and regions that not only offer the best return prospects, but are also priced at levels that fairly reflect the risks being taken. The economic recovery will progress—albeit at an uneven and moderate pace. Central bankers meanwhile appear willing to take the policy steps necessary to prevent either a sharp deceleration of growth or freezing up of financial markets. This should serve to limit the downside risks. So, while periodic setbacks are likely along the way, WMR does not look for a replay of the sort of steep and protracted selloffs that defined the past two years.

Let's talk about it

The above is based on WMR's May 2012 *Investment Strategy Guide*, "No replay." To obtain a copy of this report or discuss how its research insights might bear on your portfolio, please contact me.