Brighter Days Ahead

OUTLOOK

2013

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Talking Points

- Fiscal resolution leading to revenue and spending adjustments
- Highly accommodative monetary conditions and continued ZIRP
- Positive but subpar growth that may accelerate in 2H
- The search for income yields an asset class rotation
- Overweight equities and increased exposure to non-US markets
- Underweight bonds and particularly interest-rate-sensitive debt
- Shift commodity exposure from liquidity to growth
- Adopt low-correlated investments to temper portfolio instability
ECONOMIC GROWTH WILL BE POSITIVE BUT BELOW TREND

GDP will initially grow by a lethargic 1.0–1.5% but accelerate to 2.0–2.5% in the second half

- Expect growth, averaging approximately 2% in 2012, to provide similar momentum leading into 2013
- Resolution to the fiscal cliff may present a haircut to economic activity in the year’s first half
  - Lost fiscal thrust of 1–1.5% due to tax adjustments and spending cuts compromised to solve the “cliff”
  - Uptick in growth resulting from a release in pent-up demand by businesses as “cliff” is rendered into a “slope”
- Building on improving housing, employment, and consumer demand, the economy strengthens through the year
- Exogenous risks relating to Europe and China recede, increasing global economic stability
- In-shoring will continue as wage arbitrage and low-cost energy feedstock work to benefit US-based manufacturing
  - US companies repatriate manufacturing
  - Non-US companies diversify currency exposure and avail input cost structure to cheap natural gas

U.S. GDP

GDP will initially grow by a lethargic 1.0–1.5% but accelerate to 2.0–2.5% in the second half
Business investment will recover, providing an economic boost

- Core capital goods orders have declined precipitously
  - Loss of confidence in the C-suite
  - Lack of visibility to demand
- Corporate profits are high and rising
  - Companies hold near $2 trillion in cash
  - Profits are healthy
  - Capital stock has been underinvested
- Businesses spending will increase as uncertainty clears
  - Resolution to the fiscal cliff
  - Global risks abate
- Capital goods orders will increase
  - Lift in activity will boost GDP
  - Hiring intentions will be converted to job growth
New and existing home sales are rising

- Household formation crossed over 1 million
  - Apartment vacancies are at decade lows
  - Home ownership rate stabilizes near trend of 65%

- Housing affordability is at a generational high
  - Prices declined 33% from the peak
  - Historically low mortgage rates

![U.S. New Homes Sold (Annual)](image-url)
THE HOUSING RECOVERY IS UNDERWAY. MAKING A POSITIVE ECONOMIC CONTRIBUTION

**Housing stock is declining**
- Inventories of homes for sale are at or below equilibrium
- Fewest new homes for sale since 1963 (NAR recordkeeping)

**Economic contributions are material**
- Residential investment will add +/- 0.5% to GDP
- Rising home prices induce the “wealth effect”

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**U.S. Existing Homes Sales (SAAR)**

![U.S. Existing Homes Sales (SAAR)](image1)

**Case Shiller Home Price Index**

![Case Shiller Home Price Index](image2)
Job creation will expand
- Currently averaging 150,000 new jobs per month but picking up
- Unemployment has slowly worked lower
- Hiring intentions in small business community will tick higher

Job Openings and Labor Turnover (JOLTS)
- More job openings remain unfulfilled
- Employee skill set needs to develop to match employer needs
EMPLOYMENT GROWTH WILL INCREASE CONFIDENCE AND SPENDING

Consumer confidence is rising
- Job stability has firmed
- Economic news is supportive

Wage growth remains weak, but is still positive
- Inflation-adjusted wages are growing, albeit marginally
- Incomes have outstripped spending enough to increase savings
Consumers are repairing their balance sheets

- **Debt is being destroyed**
  - Debt-to-household disposable income is moving to trend
  - The cost of debt service is at multi-decade lows
  - Low mortgage rates have created a refinancing bonanza

- **Household wealth is within 4% of the 2007 peak**
  - Financial assets have re-priced
  - Home prices have begun to lift, adding to home equity

- **The saving rate has stabilized near 3.5%**
  - Allows for further debt repayment
  - Room for spending to continue at 3% or better

![U.S. Household Debt Service Ratio](image)
The unwinding of credit excesses will last several more years

- **Current pace of deleveraging will achieve trend by 2016**
  - *Debt levels topped at 130% and today stand at 108%*

- **Reduced debt burden will increase consumer confidence**
  - *Personal balance sheet flexibility*

- **Improved consumer credit quality solidifies US economic foundation**
  - *Debt relief frees spending capacity and credit access*
EUROPE IS STRUGGLING ECONOMICALLY. BUT RISKS OF A FINANCIAL CRISIS HAVE ABATED

Eurozone GDP is contracting

- Recession conditions likely to persist in 1H
- Relatively short and shallow fall in output

Monetary Policy

- Mario Draghi at the ECB declared to do “whatever it takes”
  - Lender of last resort to troubled sovereigns
  - Likely to lower overnight rate
- Troika will utilize the European Stability Mechanism to fund troubled institutions and bailout recipients
EUROPE IS STRUGGLING ECONOMICALLY. BUT RISKS OF A FINANCIAL CRISIS HAVE ABATED

**Fiscal policy**
- Politics is coalescing around budgets and structural reform
- Banking union to be established and supervised by the ECB

**Eurozone PMI**
- Still indicative of contraction but hooking upward
- German Ifo index of business sentiment is improving
Japan’s economy has fallen into recession
- Consecutive quarters of economic contraction
- Yen strength is counterproductive to export activity

New Prime Minister Shinzo Abe vows structural change
- Japan is fighting massive government debt and an aging population
- Deflation has been endemic for fifteen years
- PM Abe is vocal in requesting central bank intervention

Bank of Japan
- PM Abe is spurring the central bank into more aggressive action
  - New stimulus measures being taken
    - Expanding asset purchase program will outpace US Federal Reserve as a percentage of GDP
    - Security purchases include an array of equity and fixed instruments
- Central Bank Governor Shirakawa may jeopardize his role if he fails to cooperate
  - His position is up for reappointment in April
China’s GDP slowed after running in double digits for years
- Q3 growth of 7.4% was below the 7.6% pace of Q2
- Export activity has been crimped by Europe’s recession (exports to Europe dropped from 20% to 14% of total)
- China is still growing quickly enough to create an economy the size of Greece every three months

Recent data suggest the economy has stabilized
- Manufacturing PMI readings indicative of expansion
  - *Industrial and electricity production is on the rise*
  - *Retail sales are growing*
- Inflation is well controlled and below the People’s Bank of China’s target of 4%
- Property sales have increased, and prices are nudging higher
The once-in-a-decade change in regime is settled

- Xi Jinping, leader of the ruling Communist Party, is joined by just six other members in the Politburo
  - Expect only incremental reform but an attack on corruption
  - Mr. Xi will work to transition China toward a consumption-based economy

- 7.5% GDP growth is targeted in 5-year plan
  - Lessening reliance on exports and internal investment
    - Ultimately a healthier proposition for China and its contribution to global activity
    - Rising per-capita incomes will lead to increased spending on consumer products
      » Consumer spending is less than 35% of Chinese GDP vs. 71% in US
      » Wage growth and installing a more robust social safety net will reduce the need for high savings rate
Fiscal Issues

- Congress has little appetite for underwriting a large fiscal stimulus
- Austerity measures underway to control budget deficit
- Tax reform and spending cuts will establish a path toward debt reduction
  - A directional positive, but years removed from the end of deficit spending
  - Credit downgrade will remain a threat if the political will wavers
- Federal deficit exceeds GDP, which may begin to retard economic growth
US debt issuance needs willing lenders to ensure smooth auctions

- China and others are diversifying away from US dollar-denominated assets
- Dollar debasement hurts investment values held by foreign hands
  - Central banks have been buying record levels of gold
  - The IMF has expanded its roster of reserve currencies to include Canadian and Australian dollars
- US retains its status as the world’s reserve currency, but that is a privilege, not an entitlement
- The Federal Reserve is indirectly underwriting debt accumulation with low interest rates and asset purchase programs
Interest rates are being carried at historic levels

- The Federal Reserve has begged interest rates at 0-0.25%
  - Held at these levels since 2008
  - Policy will likely remain intact for several more years

Asset Purchase Programs

- The Federal Reserve instituted “quantitative easing” to drive bond yields lower across the yield curve
- The program underway is directed at purchases of Treasury and mortgage-backed securities
  - $40 billion in MBS and $45 billion in Treasuries per month
  - If the purchases run through 2013, it would add $1 trillion to the Fed’s balance sheet
- The Fed’s balance sheet would expand to approximately $4 trillion from roughly $800 billion in 2008
- Rates have effectively been lowered across the curve as a result, but the issue is demand, not cost of capital
The Federal Reserve adopted a state-dependent policy regime

- Rather than a date-dependent policy – “the middle of 2015” – the Fed expressed its intent to keep its policy highly accommodative until unemployment reaches 6.5% as long as inflation 1-2 years forward stays below 2.5%
- Designed to allow market participants to better anticipate a Fed policy shift
  - *Defuses the chance an unexpected change might alarm bond investors*
  - *Stages a more “communicative” Fed, where markets can adapt without the Fed using traditional policy tools*
CASH AND EQUIVALENTS WILL OFFER ONLY MARGINAL YIELDS

Short-term fixed instruments (such as money market funds, savings and checking accounts, and CDs) will be relegated to yield the equivalent, or thereabout, of Fed’s overnight rate (near zero)

- Economic growth will not be strong enough to warrant a change in Fed policy for some time to come
- Even as the economy improves, the Fed will likely err on the side of caution and raise rates timidly

Cash is an important source of liquidity for near-term liabilities, and a place to store money being staged into longer-duration assets

- The opportunity cost of holding cash earmarked for risk assets is extraordinarily high given its yield
- With little change expected in the short near-term forecast for interest rates, the loss of purchasing power due to inflation makes holding cash an expensive decision
Bonds have benefitted from the lack of inflation and aggressive fed policy

- Bond yields have worked lower, providing total returns to investors that rival equities over the last several years
  - The pattern can continue only if the economy worsens or an event occurs driving a flight to safety
- The eventuality of interest rate normalization by the Fed suggests investors should prepare in advance
  - Consider the interest rate sensitivity of fixed income securities being bought or held
    - Credit versus guaranteed government securities
    - Test the duration of portfolio holdings

We expect bond yields to move slightly higher toward 2.25% for the 10-year Treasury

- Yields rise as the market begins to perceive the Fed’s outlook for improving conditions and full employment by 2016 is correct
- Corporate bond values will decline, but the improving environment for corporate health will temper the impact

Spread product is appealing against the option of government securities

- Taxable fixed income
  - Corporate securities are favored as a steady economy and strong corporate fundamentals compensate for the risk of a balance sheet as collateral versus a government guarantee
    - High-quality corporate bonds offer a spread of 1% or more over comparable Treasuries
    - High-yield (or junk) bonds offer a spread of as much as roughly 5%, but are most suitable for risk-based capital
- Tax-free fixed income
  - Municipal bonds are appealing as the revenues of state and municipal governments have improved
  - Tax-free status could be subject to prospective changes in tax policy expected to occur in 2013

Bonds of foreign sovereigns and corporations may be a means to diversity income sources

- Yields found in many emerging market countries are higher than US debt
  - Prefer sovereign over corporate debt as the fiscal conditions have improved markedly in developing markets
  - Inflation-protected securities are appealing as many central banks are attempting to reflate economic activity
- Currency diversification can be added or hedged predicated upon the issuer
US stocks have performed well since the lows of 2009

• While prices have risen, the move has been supported by a commensurate rise in profits
• Valuations are undemanding
  – *Based on earnings estimates for 2013 ($108 for the S&P 500) stocks trade at a reasonable P/E of 13.3*
  – *The Earnings Yield (EY = 1/13.3) of 7.5 is historically high and richer than the yield on speculative debt*
  – *The Equity Risk Premium (EY – risk-free rate) near 5.7% is unusually high*
• Equity prices are poised to advance approximately in line with earnings growth plus dividends
  – *Earnings growth of 5-7% y/y plus a 2% dividend yield on the S&P 500 results in a total return estimate of 7-9%*
Non-US equities offer greater appeal in 2013

Europe
- Equity valuations are some 20% cheaper than in US markets
- The earnings growth disparity compared to the US is near historic levels
- Market expectations are low, allowing for positive surprise to trigger a “catch-up” phase in performance

China
- Averting an economic hard landing will lead to a re-rating of valuations
- Equity valuations are more than 10% below the emerging market average and well below global equities

Japan
- The Japanese equity market has had many false dawns, but the change agent now in place may be a catalyst
- Stocks are very cheap compared to other world equity bourses
- Aggressive monetary intervention, which should lower the yen, reduces currency-induced friction to Japanese multinationals
US equity markets should produce near trend returns

Large, high-quality companies
- Shift emphasis back to those that are globally geared
- Sector sentiment is increasingly less defensive
  - Consumer facing – improving consumer condition bodes well for spending
    » Autos
    » Housing stocks and related companies
  - Energy – 55% of oil consumption comes from the near inelastic demand of emerging market countries
    » Major integrated
    » Oil services
  - Financials – balance sheet improvement and increased spending on financial services
    » Regional banks
    » Insurance companies
  - Health care – inexpensive valuations and growing health care expenditures in emerging markets
    » Medical device
  - Technology – benefactor of the coming capital spending revival
    » Software
    » Semiconductors
  - Special situation
    » Gold miners
    » Non-gold miners
    » Select industrials

Low-yield fatigue may force a rotation from bonds to stocks as an income-producing alternative
- Dividend payers will be rewarded as the search for income sources goes unabated
  - Seek payers that have an extended history of raising the dividend regularly
  - Conventional areas for dividends, such as Utilities and Telecom, sport rich valuations capping upside potential
    » Consider healthcare, energy and tech instead
These non-US equity markets may deliver performance that exceeds that of the US equity markets

- **Europe**
  - Germany – a diverse and relatively resilient economy
  - France – French companies often get unfairly penalized for their location
  - Italy and Spain – the sovereign crisis extracted a great toll on these economically important countries
    - The ECB will act to prevent insolvency, which has stabilized these markets
    - Generationally cheap valuations could rise as the fog of uncertainty lifts
  - UK – London market hosts many non-UK-based mining companies, hinging the exchange to the global economy

- **China**
  - Chinese equities should most often be purchased through a diversified investment vehicle
    - Chinese H-shares are listed and traded on the Hong Kong exchange
    - Chinese A-shares are listed and traded on the Shanghai exchange
      - Generally more utilized by Chinese retail investors
      - May not move in tandem with the H-shares

- **Japan**
  - Nikkei is inexpensive on a price-to-book value (below 1.0)
  - Japanese multinationals may pick up a tailwind through a lower currency
  - Hedge currency exposure as a US-based investor to be rewarded if the yen’s expected decline is realized
Look to transition from liquidity- to growth-driven commodities

- Hold gold for now
  - “Alternative currency” that is no country’s liability and cannot be debased through central bank money printing
  - No cost of carry in a world awash in negative real interest rates
  - Increasingly viewed as a hard currency that is still under-owned by institutions
THE COMMODITY COMPLEX MAY BE IN THE LATE INNINGS OF ITS DECADE-LONG SUPER CYCLE

• Moving precious metals exposure to palladium, then platinum
  - These two “white” metals benefit from an uptick in auto sales as they are used in catalytic converters
  - Palladium is used in more cars going to China while platinum is used by more cars sold in Europe

• Industrial metals are not likely to repeat the parabolic move of the last decade as the supply/demand imbalance has move closer to equilibrium
• Soft commodities are heavily influenced by weather patterns, but the secular theme is strong
Oil prices should remain elevated as supply constraints preclude an abundance of inventory hitting global markets.
Commercial real estate has improved as vacancy rates have declined

- The lack of overbuilding during the real estate boom has helped the commercial market recover
- Employment growth has drawn down available space and hardened pricing
- Yields have moved lower as a result of price appreciation, decreasing this sector’s appeal

Residential

- The housing market recovery should continue as inventories have been drawn down to equilibrium or below
- Housing starts are increasing but at a measured pace
- The “shadow” inventory of homes that are in foreclosure or bank-owned is less threatening, given the quickening pace of sales activity
- Prices have started to recover, with some markets (Nevada, Arizona, and Florida) showing steep gains year-over-year
  - Aggregate prices are still near 30% off of highs
  - Housing affordability will remain high given the Fed’s mortgage-bond buying program
- New IPOs of residential roll-ups are in the pipeline
  - Allows for a public mechanism to participate in the housing recovery via an exchange-listed security

International real estate is a diversified way to capture a resumption of global economic activity

- Emerging Asia, in particular, holds promise
- Canada and Australia have highly indebted consumers, which could be a negative for housing activity
Currencies are a zero sum game where one’s strength is based off another’s weakness

For US dollar-based investors, a foreign currency’s merit is evaluated by comparing the sovereign against the US.

Australian dollar (neutral) is benefitting from an economy that has not experienced a recession since 1991 and whose proximity to China gives way to a strong export market, given its resource-laden composition.
CURRENCY MARKETS ARE INCREASINGLY INVESTABLE

Canadian loonie (bullish) should gain on rising oil prices and a stable US economy, its most important trading partner.

Euro (neutral) will likely rise unless the ECB undertakes an aggressive form of money printing or the US economy firms.
Yen (bearish) strength will be tested against the will of the new Prime Minister and his influence over the Bank of Japan.

Yuan’s (neutral) peg to the US dollar has loosened, leaving it likely to trend higher, albeit slowly.
Traditional policy portfolios consist of stocks, bonds, and cash
- Stocks for growth, bonds for predictability and income, and cash as a vehicle to feed spending policies
- A 60% stock, 40% bond mix is a commonly constructed “foundation” portfolio
  - Optimal risk/return characteristics
  - Precedent for delivering a spending target while keeping up with inflation

Traditional portfolio architecture is challenged by today’s interest rate environment
- Quality bonds yield a third of their historical average
- Low yields increase the interest-rate-sensitivity of bonds
- Convention holds that bonds are the stable portion of a balanced portfolio

Augmenting portfolios with low-correlated investments may increase return predictability
- Seek investment strategies that produce return streams with a low correlation to stock and bond benchmarks
  - Real return, managed futures, merger arbitrage, distressed debt
- Strategies that can reduce swings in market value are useful to combat policy infidelity
- Conditions change, often unexpectedly, warranting increased use of alternative solutions
  - Helps to reduce drawdown potential on equity values
  - A portfolio stabilizer when long-only bond exposure limits flexibility
## SECULAR INVESTMENT THEMES

### Feed the World

Global population is expected to grow from 7 billion today to 9 billion by 2050. It is estimated that 70% more food will be needed, given rising per capita incomes and expanding dietary desires. In addition, available sources of drinking water are already being stressed by today’s needs.

*Agribusiness and desalinated water production are themes to consider via fertilizer companies, food enhancers, water facilities, and farm or earth-moving equipment makers. Related investments are soft commodities and the New Zealand Kiwi.*

### Energy

Global energy demands are rising. Increasingly, the highly populated and urbanized areas such as Asia, Latin America, and Africa are buying cars and need power to support infrastructure development. The IEA has forecast energy independence for the US by 2035 at current rates of technologically accessible reserve development and production.

*Energy companies, from major integrated multinationals to equipment makers and oil-service enterprises, will benefit.*

### Infrastructure

Developing markets are undergoing a massive transformation from rural to increasingly urban. China alone is expected to have as many as a half billion people shift from farmland to the cities. Roads, bridges, buildings, apartments, airports, are going to be built, wired, heated, and cooled. Electric and other energy sources will be needed.

*Consider equipment makers for power generation and non-precious metal miners for cooper, iron ore, and nickel. Also commodity currencies, such as the Australian dollar, and industrial metals.*
Optimistic Case – 30% Probability

- **Economy and Markets**
  The fiscal cliff is rendered a mere slope and sidelined demand is released. Hiring edges above 200,000 per month. Business and consumer confidence lifts. Europe posts positive growth in the third quarter latest and China’s GDP prints an 8-handle. Corporate profits push toward double-digit year-over-year gains, and the market’s risk premium compresses. Applying a mid-point 1-year trailing/forward multiple of 15 to earnings pushes the S&P 500 to new highs of 1680.

- **Investment Strategy**
  Risk assets produce double-digit gains with stronger returns from emerging market equities. An asset rotation from bonds to stocks begins, which is the kindling for equity prices but is counterproductive for bond returns. The market begins to think the Fed may pull in its QE program and rate target, jarring bond yields.

Base Case – 60% Probability

- **Economy and Markets**
  The US continues to grow at a below-trend rate, but the pace accelerates over the year as uncertainty over the fiscal cliff clears. Europe’s recession remains relatively shallow and brief, and China’s growth stabilizes. No new threat rises from the Middle East that could disrupt oil supplies, leaving WTI prices below $110. Corporate profits rise mid-upper single digits and little margin pressure is applied. Limited multiple expansion that moves the P/E up slightly to 14.3 takes the S&P 500 to 1545 by year end.

- **Investment Strategy**
  US stocks act reasonably well, outperforming bonds and cash. As evidence accumulates that macroeconomic risks are receding, global growth potential is upgraded. Investors should add to non-US equity exposure, where returns will likely be more favorable. Interest-rate-sensitive securities should be underweight.

Pessimistic Case – Probability 10%

- **Economy and Markets**
  The US does not avert the fiscal cliff, and no resolution is found for an extended period of time. Anxieties rise and worries over US growth impact global business activity. Europe’s recession worsens, and China cannot bail out the deterioration in world-wide economic conditions. Corporate profits succumb to lack of demand, and equity investors de-risk. Valuations compression leads the S&P 500 to correct 15% to 1250 before rebounding to finish the year at 1400.

- **Investment Strategy**
  US stocks do relatively better than non-US equities. High-quality, large-cap dividend payers gain sponsorship for predictability. Bonds produce better returns than stocks with Treasuries gaining most from the flight to safety. Cash and low-correlated investments serve to buffer portfolio volatility. Gold serves as a good hedge.

A weighted blend of these scenarios establishes a year-end price target for the S&P 500 of 1575.
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