Three scenarios for 2013

Russ Koesterich | BlackRock | January 2013

Economies and markets ended 2012 having narrowly sidestepped a number of potential stumbling blocks, including a European banking crisis, a Greek exit from the euro, a Chinese hard landing and an indecisive US election. While Europe spent much of the year teetering on the brink of another crisis, aggressive action by the European Central Bank (ECB) and some tentative progress toward a banking union obviated the worst-case scenarios. Economic growth remained weak, but the lack of a crisis coupled with unprecedented monetary stimulus was enough to produce a good year for most asset classes. Ironically, as the year came to a close investors were most worried about the United States, where the prospect of premature and aggressive fiscal tightening risks sending the economy back into recession.

Summary

We expect slow growth but, coupled with low inflation and reasonable valuations, that should be enough to produce respectable returns for global equities.

Fixed income, particularly sovereign debt, continues to look expensive. Within fixed income portfolios, we would emphasise municipals, investment grade debt and emerging market bonds.

Inflation is unlikely to be a threat, but an increasing reliance on unconventional monetary policy and lack of a clear path to sustainable fiscal policy raise the long-term risk. Along with the fact that an environment of negative real rates removes the opportunity cost, we would continue to maintain a strategic allocation to commodities, with gold likely the biggest beneficiary of today's extraordinary monetary conditions.

In short, from an investment standpoint, we continue to have a preference

for equities, credit and a strategic allocation to commodities.

A quick review of our 2012 predictions

> "The less we deserve good fortune, the more we hope for it." Seneca.

There is no way around it - we got very lucky in 2012. At the year's mid-point, Europe appeared to be on the brink of an existential crisis, with only a razor-thin vote keeping Greece away from a showdown with the European Union. Outside of Europe, things also went better than they otherwise might. While the Middle East continues to simmer, some of the more dire scenarios, such as a conflict between Israel and Iran, were avoided. As such, the simple lack of a severe crisis plus open-ended commitments from the Federal Reserve (Fed) and the European Central Bank was enough to propel most risky assets forward.

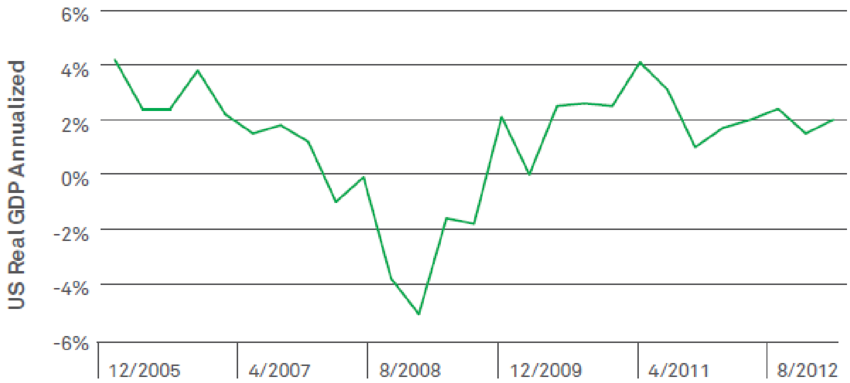
While growth was uninspiring, it was consistent with what you'd expect in the aftermath of a credit bubble. If there was one game changer in 2012, it was the aggressive actions by both the Fed and the ECB. Not only did they extend their asset purchase programs but, in both cases, they made their commitment open-ended. This provided the necessary fuel to lift sentiment and animal spirits, supporting markets in the third quarter.

Before looking forward to 2013, it is always useful - and often humbling - to take a look at how our 2012 predictions fared. Coming into the year, we envisioned three potential scenarios:

Great Idle, Crisis and Recession, and Growth Accelerates. Our baseline scenario, to which we assigned a 60% probability, was the Great Idle – basically, a continuation of the last several years of sluggish but positive growth. The second most likely scenario was another crisis, or at the very least a garden-variety recession. We gave this scenario a 35% probability. In the interest of not appearing too pessimistic, we gave a token 5% probability to acceleration in growth.

Calendar 2012 played largely to our baseline scenario. We viewed the most likely scenario for 2012 would be growth in the United States of 1.75% to 2.50%, a modest contraction in Europe, a rebound in emerging markets and little risk of inflation. During the first three quarters of 2012, the United States expanded at a pace of approximately 2.0%, with similar growth expected for the fourth quarter (Figure 1).

Figure 1: US gross domestic product (2005 to present)



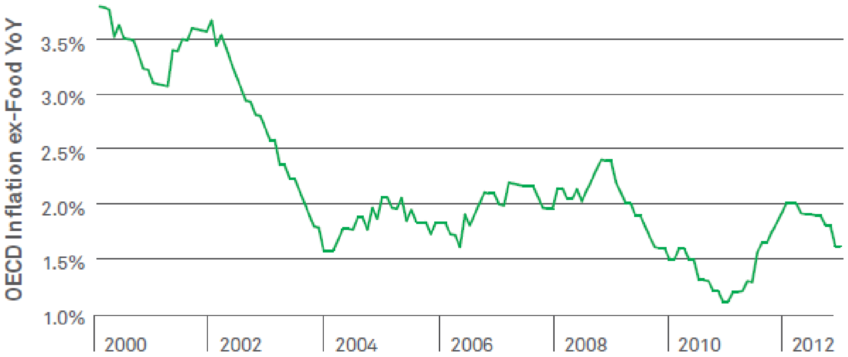
Source: Bloomberg, as of 31/10/12

The weak link in the US economy continues to be the consumer, still struggling with too much debt and little real income growth. During the first three quarters of 2012, personal consumption growth averaged around 1.75%, lower than 2011 and down significantly from 2010. More importantly, this pace is only about half the long-term average of roughly 3.5%. Consumption remained weak in the third quarter and, given the uncertainty surrounding the fiscal cliff and weather-related disruptions in the Northeast, fourth quarter is likely to be little better.

Most other developed countries struggled. One place where we were overly optimistic was Japan. We envisioned stronger growth out of Japan, but once again the country managed to disappoint. While the economy got off to a strong start, growing at an annualised pace of more than 5%, the tailwind of reconstruction-led growth quickly abated. By third quarter, Japan was once again contracting. We were more accurate regarding Europe. Our expectation was for a modest contraction in 2012. Some of the core countries – notably Germany – were able to eke out a bit of growth, but the overall euro area has been in a modest recession since second quarter. Current estimates suggest that euro-area GDP will contract by roughly 0.50% in 2012.

One silver lining of the slow growth regime was the near complete absence of inflation. For developed countries, inflation fell from 2% at the start of the year to approximately 1.60% by the end of September (Figure 2). The same pattern held for the United States. Over the course of the year, inflation moderated, from 3% to 2.2% at the time of writing. Even in emerging markets, inflation generally slowed, particularly in China.

Figure 2: Global inflation (2000 to present)



Source: Bloomberg, as of 31/10/12

Turning from economics to markets, our 2012 Outlook emphasized several themes. First, we advocated an overweight to equities, emphasising mega capitalization stocks (mega caps), smaller developed markets and emerging markets. On the fixed income side, we favored US corporate bonds, particularly investment grade.

With the exception of the emerging market theme, this was generally a good mix to hold. Stocks outperformed bonds by a wide margin. As of late November, global equities were up roughly 12%, versus a gain of approximately 4% for bonds. On the equity side, larger was better with US mega caps outperforming large caps, which in turn outperformed small caps. Finally, an equally-weighted basket of smaller developed countries - our CASSH theme, which includes Canada, Australia, Switzerland, Singapore and Hong Kong - outperformed global equities by roughly 5% in dollar terms.

The emerging market theme was less successful, although by no means a bad trade. Through late November, emerging markets gained roughly 11% in Dollar terms, narrowly trailing a benchmark of developed markets, which was up approximately 13%. While we were correct in our view that emerging market inflation would moderate, we were overly optimistic in our expectations for growth. As a result, investor fears of a hard landing trumped a steady drop in inflation and emerging market stocks modestly underperformed.

On the bond side, our central theme - credit over duration - was correct. US Treasuries gained around 5% while high yield advanced 9% and our preferred play, investment grade, gained more than 11%.

Finally, we advocated that investors maintain a strategic allocation to commodities, with an emphasis on gold. A broad commodity exposure - the Goldman Sachs Commodities Index -

was flat for the year, but gold managed to continue to advance, up around 10% through late November. As we outlined last year, we continue to believe gold will be supported as long as central banks maintain their fetish for negative real interest rates.

More of the same in 2013?

Looking ahead, the largest, and most immediate, unknown continues to be the United States. At the time of writing, it was still unclear as to whether or not the United States would succumb to politics, and go over the fiscal cliff, or if Congress and the White House can eke out a last-minute compromise. And, as has been the case for the last several years, there are still lingering questions on whether Europe can muster enough political will to address the significant structural issues that continue to plague the single currency.

Given these uncertainties, and keeping with our tradition, we'll frame our 2013 outlook in terms of scenarios and associated probabilities.

Compared to 2012, our outlook is marginally more optimistic, in that we see a smaller chance of a crisis and a marginally higher probability of a return to a more normal environment. That said, our baseline probability for 2013 is for more of the same - slow but positive growth in the United States, softness in Europe and better performance from emerging markets. We would put a 65% probability on this outcome - basically a continuation of the Great Idle.

The next most likely scenario would be a further weakening of global growth, characterised by

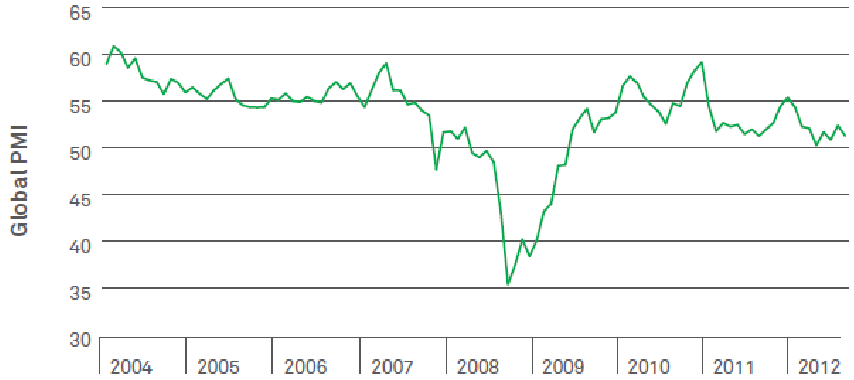
The next most likely scenario would be a further weakening of global growth, characterised by recession in the large, developed countries, including the United States. The most likely catalysts include premature fiscal tightening in the United States, a banking crisis in Europe, or an escalation of tensions in the Middle East with an accompanying oil spike. We put the odds at around 20%, although we would lower the odds significantly if the United States can avoid the fiscal cliff.

Finally, given the improvements in the US housing market and the likelihood of some modest acceleration in emerging markets, we would put a 15% chance that growth surprises to the upside, with the caveat that this would likely be accompanied by higher rates and some modest acceleration in inflation.

Slow but stable: 65% probability

Going into 2013, we see some evidence of stabilisation in global indicators, particularly in the United States, China and other emerging markets, suggesting that in the absence of an exogenous shock, the global economy should continue to expand in 2013 (Figure 3).

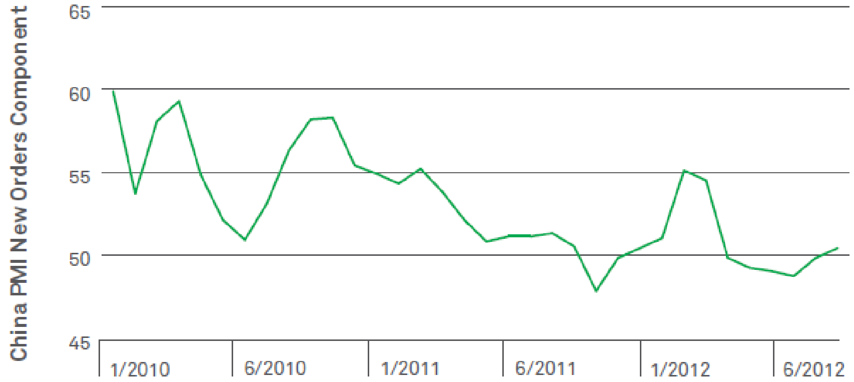
Figure 3: Global purchasing managers index (2004 to present)



Source: Bloomberg, as of 15/11/12

In particular, there are signs of an inflection point in China. In recent months, there is growing evidence that suggests China is finally emerging from its year-long slump. In October, the main manufacturing gauge crossed back above the 50 threshold (Figure 4). While we are realistic in what a Chinese expansion will look like – not 10% growth – it appears that the economy has finally bottomed. Assuming some modest additional fiscal and monetary stimulus, which looks realistic given the recent drop in inflation, we believe China can grow at around an 8% rate in 2013. That will not only be good news for China, but for a global economy that is in desperate need of growth engines.

Figure 4: China purchasing managers index (2010 to present)



Source: Bloomberg, as of 15/11/12

Outside China, we would expect a similar rebound in other emerging markets, particularly Brazil. Recent estimates from the International Monetary Fund (IMF) suggest that at least three of the four BRICs – Russia is the notable exception – should experience accelerating growth in 2013.

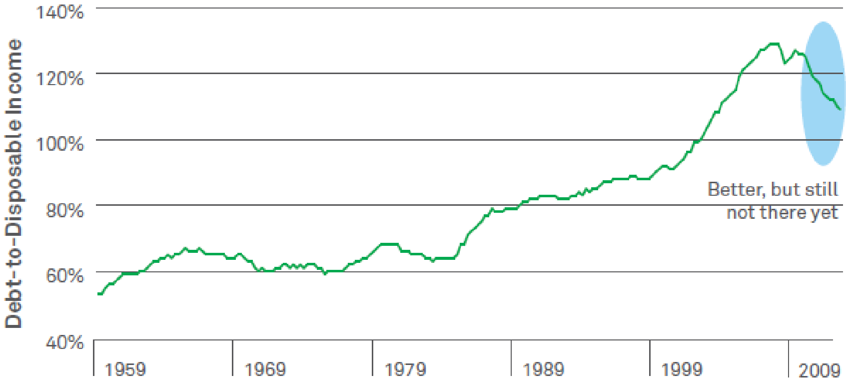
What about the outlook for the United States? Here our view is cautiously positive, with an emphasis on caution. If the tax increases and spending cuts are allowed to hit, then all bets are off and the United States is facing a likely recession. Assuming that most of these are avoided or postponed, we would expect more slow growth, but not another recession. On the plus side, the economy is likely to get some support from a strengthening housing market, upward earnings revisions and a robust US energy sector. But investors should avoid getting too optimistic. Three headwinds are likely to keep growth restrained.

1. A continuation of consumer deleveraging

Consumer balance sheets have been improving thanks to a deleveraging process that is now more than four years old. As a result, for the first time in years, we are starting to see the first green shoots of credit expansion in the household sector. Household debt rose by 1.2% in the second quarter, the fastest pace since first quarter 2008.

Still, 2013 is unlikely to be the year when this process reaches a conclusion. Consumer debt still stands at 108% of disposable income, compared to a long-term average of around 80% (Figure 5). Even by the less-than-frugal standards of the late 1990s, today's debt levels appear unsustainable and need to come down further.

Figure 5: US household debt relative to income (1959 to present)



Source: Bloomberg, as of 15/11/12. Shaded area highlights trend over last couple of years.

Not only does debt look elevated relative to income, but also compared to household assets. Household net worth has rebounded to $62.5 trillion, up $11 trillion from its 2009 low, but it is still $5 trillion below the 2007 peak. More importantly, household wealth relative to debt is relatively low. The current ratio is 4.8, well below the average of other developed countries as well as the long-term average in the United States.

2. Slow income growth

In September, disposable income grew by 3.6% from a year earlier. Growth at this rate is roughly half of the long-term average and a significant deceleration from early 2011, before the economy softened again. The one development that would make us much more bullish on the US expansion would be a meaningful pick-up in wages.

Part of the reason for the deceleration in income growth is that government transfer payments are slowing. In early 2010, transfer payments were growing at around 4% year-over-year. More recently, transfer payments have been rising by only about 1%. This is important. Surging transfer payments were key to supporting income growth in the aftermath of the crisis. Between the start of 2008 and third quarter 2012, disposable income grew by $1.3 trillion. Of that amount, roughly half came from increasing transfer payments. As the stimulus expires, this will exert some additional drag on income growth.

3. The likelihood of some fiscal tightening

Even under an optimistic scenario, US fiscal policy is likely to exert at least some modest drag on growth. Assuming that all the Bush tax cuts are extended and the budget sequesters are postponed, that still suggests fiscal drag of approximately 1% of GDP as the payroll tax holiday and extended unemployment benefits expire. Under normal circumstances, 1% fiscal drag would not represent a major obstacle. However, in an environment in which the economy is constantly flirting with stall "speed" this is significant. With the US consumer struggling under the twin burdens of too much debt and too little income, tighter fiscal policy is unlikely to help.

Stumbling over the cliff: probability 20%

While the environment in Europe and the outlook for emerging markets appear more stable than a year ago, we still see about a one-in-five chance of another global slowdown. The risk is that the global economy - still adapting to the aftermath of the credit bubble and a secular change in China's growth rate - is not strong enough to withstand a substantial shock.

Starting with the most obvious, we remain concerned about the United States having its own Thelma and Louise moment and driving over the fiscal cliff. As of this writing, there has been little meaningful progress in reconciling the two parties' competing visions on taxes or the size of government. In the absence of some compromise, the United States will, at least temporarily, be forced to suffer through fiscal tightening equivalent to about 4% of GDP. To make matters worse, if the negotiations yield no immediate solution, very soon in 2013 the debate will become intertwined with the debt ceiling. Should Washington stumble on the latter, the additional fiscal tightening coupled with an almost certain downgrade of US debt will usher in another recession.

Europe remains a lingering big risk, despite exceptionally aggressive behavior from the ECB. We remain particularly concerned about Greece, not because of its size, but due to the potential for a bank run should Greece, suffering from fatigue over austerity, default and leave the euro. Should Greece leave the euro in 2014, hopefully after a comprehensive banking union is in place, this would probably not engender a crisis. But, given that a full banking union is unlikely to occur until after the German federal elections, Europe's banks remain vulnerable to a disorderly exit by Greece. To be sure, risks of a bank run are substantially lower now, but investor fears may still impact the markets.

Another potential trouble spot is the Middle East. As 2012 comes to an end, energy prices are mixed on the year - Brent is up, West Texas Intermediate (WTI) down - but the region is certainly no more stable. The conflict in Syria has degenerated into a full-scale civil war, a fragile ceasefire holds in Gaza, a constitutional crisis looms in Egypt and the Iranians remain committed to obtaining a nuclear device. Should any of these scenarios unleash a new wave of violence, oil is likely to at least temporarily spike, which will further hamper consumption in most developed countries.

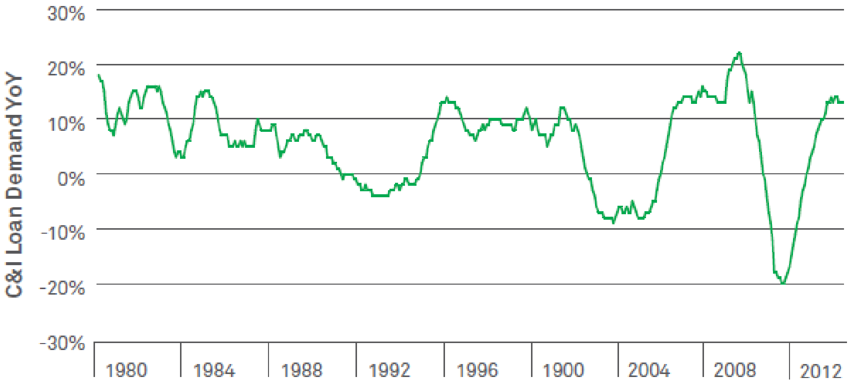
Life in the fast lane: probability 15%

Although unlikely, there is some chance that we will see a more substantial recovery in 2013. Potential catalysts include structural reform in emerging markets, banking and fiscal reform in Europe - although we view this as highly unlikely ahead of the German federal elections in the fall - or a grand budget bargain in the United States that leads to a surge in corporate spending.

The latter is arguably the most realistic. One bright spot in the US economy remains the corporate sector, where several years of record margins and conservative spending have left corporate America flush with cash. A "Grand Bargain" that not only clarified the fiscal outlook but introduced some rationality into the Kafkaesque phenomenon known as the US tax code could bring some of that cash off the sidelines and into the real economy.

However, under that scenario, investors may be trading one set of problems – too slow growth – for another, inflation. While we're skeptical that inflation will prove an issue in 2013, one necessary ingredient – credit growth – is starting to emerge. Banks are starting to lend again, particularly to corporations. 2012 witnessed a significant expansion in commercial and industrial loans. If that trend accelerates, with more aggressive corporate spending and hiring, wages are likely to stabilise and we may finally begin to see an inflection point in inflation. While not the most likely scenario, a spike in corporate spending, particularly if directed at hiring, could start to lead to modestly higher inflation by 2014.

Figure 6: US commerical & industrial loan demand (1800 to present)

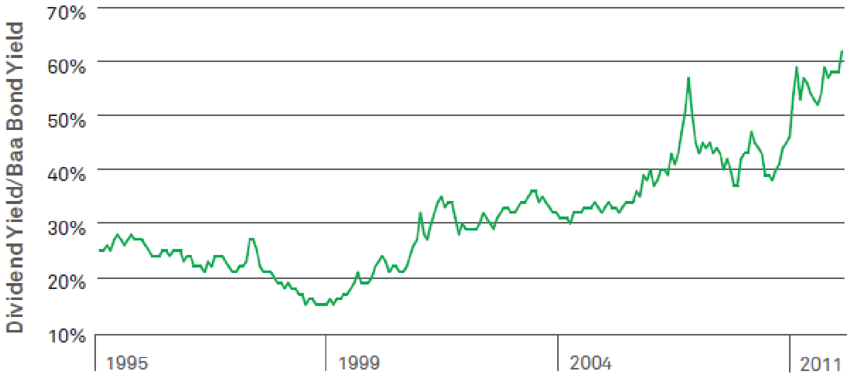


Positioning portfolios

Given these probabilities and scenarios, how should investors think about their portfolios going into 2013? We remain committed to four key themes: equity investment income; mega caps; emerging markets; and, municipal bonds.

Starting with equity income, while multiples have risen from their lows in late 2011, by most metrics, global equity markets look cheap. Furthermore, to the extent that bonds have become even more expensive, we would maintain our overweight to equities, even for investors with an income orientation. If anything, with yields collapsing in the second quarter, equities look even more compelling compared to bonds as an income source. As of the end of October, investors could replicate a record 62% of the income available on an index of investment grade bonds simply by owning the MSCI World Index (Figure 7).

Figure 7: MSCI world dividend yield vs. Moody's baa bond yield (1995 to present)

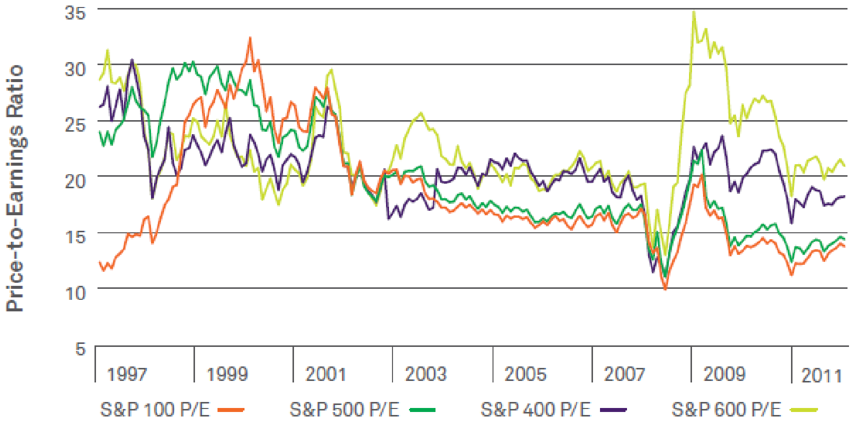


Source: Bloomberg as of 15/11/12. Past performance is no guarantee of future results.

However, this view comes with an important caveat: investors should emphasise income globally, not just domestically. Valuations and yields are less compelling in the United States, and investors may obtain higher yields at significantly lower valuations outside the United States. In particular, we see good opportunities in northern Europe, southeastern Asia and even select emerging markets like Brazil.

A related theme is mega caps. Mega caps in the United States outperformed other styles in 2012, yet still appear cheap by most metrics (Figure 8). In addition, they are still the most profitable segment of the market, with a return-on-equity in excess of other styles. Moreover, mega caps actually offer an interesting defensive play. Given their exposure to faster growing international markets, this style has historically been much less sensitive to changes in domestic growth. For investors worried about the fiscal cliff or any other shock-induced slowdown, mega caps look less vulnerable than other styles, particularly mid and small cap.

Figure 8: Valuations by market cap (1997 to present)



Source: Bloomberg, as of 15/11/12

Outside of the United States, we still favor smaller developed countries and select opportunities in northern Europe. But our favorite long-term theme is emerging markets. Despite trailing in 2012, investors should consider sticking with the emerging market theme for four reasons - faster growth, cheap valuations, lower inflation and lower relative volatility.

Starting with growth, as discussed above, we don't expect emerging market countries to return to their 2010 pace anytime soon or, in the case of China, ever. That said, while we expect slower growth, the ratio between emerging market and developed market growth is likely to remain firmly in favor of emerging markets. Developed countries continue to struggle with the three Ds of deleveraging, debt and demographics. In comparison, emerging market economies are less encumbered by debt, enjoy more sustainable fiscal policies and for the most part -

China being a notable exception – have much more favorable demographics.

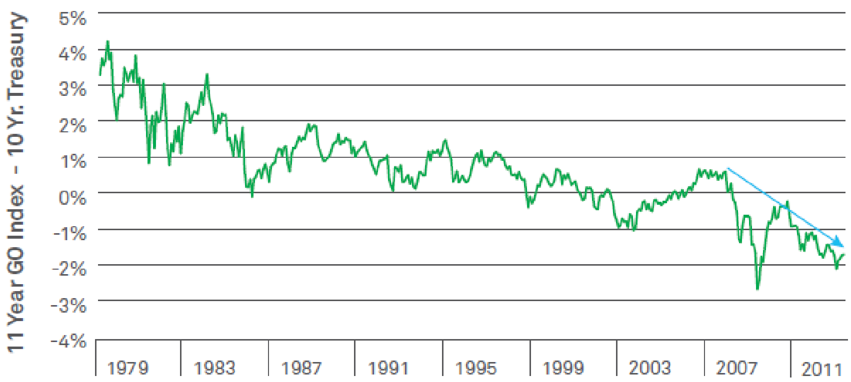
Despite this advantage, emerging market stocks are trading at a significant discount – more than 20% – to developed market equities, historically a good entry point. Valuations look particularly compelling when you adjust for falling inflation. At least historically, lower inflation has been associated with multiple expansions in many of the emerging market countries.

Finally, while most discussions on emerging markets focus on the prospects for growth and returns, the risk side of the equation also favors a higher weight. The ongoing deleveraging in developed markets has raised the overall level of economic volatility. In other words, growth and inflation are much less stable than they were during the Great Moderation. This spike in macro volatility has, not surprisingly, translated into higher volatility for financial assets. At the same time, while substantial issues remain, by most measures, emerging market economies have become more stable. This newfound stability has translated into a drop in volatility. As a result, while emerging markets are still more volatile in an absolute sense, the relative volatility between emerging market and developed market assets is converging. We expect this trend to continue and, to the extent that the relative risk of emerging market assets is dropping, the allocation should rise.

Although we maintain a preference for equities, within fixed income portfolios, we like corporate credit and tax-exempt bonds, with the latter looking particularly cheap on a relative basis. Despite the ongoing deterioration of the US federal balance sheet and the lingering threat of another downgrade, the yield spread between US municipal and US Treasury debt continues to widen. While the catalyst is no mystery – a determined Fed – for taxable investors, this still creates an opportunity. Today, investors can obtain a significantly higher yield from an index of general obligation municipal bonds than from a long-dated Treasury (Figure 9).

During the 20-year period between 1986 and 2005 when the relationship was relatively stable, Treasuries traded at an average spread of 50 basis points over an index of general obligation (GO) municipal bonds. Today, the spread is 170 basis points in favor of municipals and this is before accounting for the tax-exemption. With the US Fed continuing to suppress long-term yields, high-quality, general obligation munis look increasingly compelling compared to many taxable alternatives, particularly Treasuries.

Figure 9: Yield spread GO munis vs. 10yr treasury (1979 to present)



Source: Bloomberg as of 11/15/12. Past performance is no guarantee of future results.

Fire and ice portfolios

While we are comfortable with the above positions over the long term and, in particular, if our baseline theory plays out, investors will obviously want to re-allocate should either of the alternative scenarios start to look more likely.

In the event of a trip over the fiscal cliff or a European banking crisis, we are still comfortable with many of our themes – particularly munis and mega caps – but would lighten up on our emerging market exposure. Under that scenario, investors will want to increase their allocation to defensive themes. We would also expect gold to do relatively well under that scenario, as the Fed would probably be inclined to add even more liquidity to offset the impact of fiscal tightening.

We would suggest a much larger adjustment to portfolios should we see evidence of a real acceleration in growth. Under that scenario, our current positioning is arguably too conservative. Should growth start to pick up, and as a consequence the Fed began to raise rates causing investors to move out of Treasuries and into equities, we would raise our allocation to risky assets. Some of our preferred plays would include global technology stocks, high yield and cyclical commodities such as industrial metals. At the same time, we would reduce our allocation to municipals, investment grade debt and US mega caps.

Conclusion

While most of us warn our children about the dangers of procrastination, we all know it works sometimes - and 2012 was arguably one of those instances. Despite multiple governments kicking the proverbial can down multiple roads, the year turned out relatively well. In fact, the world looks marginally better than it did a year ago. The most significant change is that, while still facing an uncertain future, Europe is no longer teetering on the abyss. Other areas of progress include an apparent inflection point in the Chinese economy, modest structural reforms in Brazil and India, sparks of life from the US housing market, and the beginnings of a revolution in US energy production.

Despite the good news, many of the major risks that characterised the world a year ago remain. Premature fiscal tightening is now a clear and present danger to the United States, and no progress has been made when it comes to the longer term fiscal outlook. In Europe, while the ECB has bought politicians time, there has been only modest progress on banking reform and structural reforms. Finally, the Middle East remains as volatile as ever.

For better or worse, we believe 2013 is likely to continue to be a year when the market's fate will rest largely in the hands of politicians and policy makers. Avoiding the fiscal cliff, real progress on the long-term US fiscal outlook and structural reforms in Europe could unleash corporate spending, risk taking and animal spirits. Conversely, failure to address these lingering policy issues - particularly the US fiscal position - will lead to at least a modest recession, and potentially worse. For now, we remain cautiously optimistic, but are cognisant that the real hard work needed to restructure the global economy remains; the commitment of politicians is still an open question.

Figure 10: Three scenarios for 2013

Scenario	Probability	Strategy
Slow but stable	65%	Overweight: high-dividend global stocks, mega-caps, smaller developed markets, emerging market equities. Within fixed income portfolios, overweight municipal, corporate and emerging market bonds. Maintain strategic allocation to commodities, including gold.
Stumbling over the cliff	20%	Overweight: Treasuries, gold, and mega-caps.
Life in the fast lane	15%	Overweight risky assets

Russ Koesterich is Chief Investment Strategist for BlackRock. He is a regular presenter at PortfolioConstruction Forum programs and will be presenting at the upcoming PortfolioConstruction Forum Markets Summit 2013.

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