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Markets in Review

Economic and Market Highlights in October 2013

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No Change

In the wake of the Fed's latest policy announcement on Wednesday October 30, both bonds and stocks dropped, suggesting that investors saw something more hawkish in the central bank's statement. We disagree. The Fed made no change to administered rates, its pace of asset purchases, or its forward guidance for either.

We also don't see any meaningful upgrade to the Fed's qualitative assessment of the economy relative to the last policy statement in September, when the Fed defied market expectations by holding off on tapering. Admittedly, the Fed did drop from its assessment "the tightening of financial conditions in recent months, if sustained, could slow the pace of improvement in the economy and in labor markets." However, we believe that the inclusion of this statement in September had the specific purpose of signaling that markets had gotten too far ahead of the Fed. Message received. In the past six weeks, markets have clearly reined in their expectations for tapering and tightening. And yes, financial conditions have loosened a bit with market rates down as much as a half point from the September peak (although they remain well up from the spring low). But in its recent assessment, the Fed also highlighted the fact that against the backdrop of the earlier jump in rates, the housing market recovery has slowed. Moreover, the Fed's assessment continues to highlight the restraint from fiscal policy, which is actually a bit of an understatement given the likely significant hit to growth in Q4 from the government shutdown and the persisting uncertainty about fiscal policy prospects over the next few months. So while it's fair to say that the Fed's assessment wasn't downbeat, it was hardly upbeat and indeed remained a bit guarded.

And in any case, the most important thing to remember is that the timing and speed of tapering is ultimately data dependent. At his press conference in September, Chairman Bernanke forcefully made this point to investors. The guidance was clearly reaffirmed in the latest policy statement. And our reading of the data is that the economy is weaker now than it was a few months ago. And we don't think there will be enough strong or clean data available over the next six weeks to convince the Fed that the economy has improved enough to warrant tapering in December. Even January may be a bit of a stretch, which means

"We may be nearly five months away from the first reduction in asset purchases."

Eleventh Hour Deal

An eleventh hour deal was reached to end the latest US fiscal crisis. The compromise legislation, which passed late Wednesday October 16, had four major components. First, the debt ceiling was essentially suspended through February 7, 2014. And importantly, limits were not placed on the Treasury Department's use of so-called "extraordinary measures," which buys breathing room beyond that. In short, February 7th is a "soft" deadline, with the ceiling not becoming binding until mid-March or perhaps a bit longer if we are lucky. Second, funding was provided to reopen the government and to keep it open through January 15, 2014. Third, the House and Senate budget committees will meet in conference and agree to a budget by December 13. While a grand compromise on fiscal reform appears unlikely, a budget agreement that eases some of the more negative effects of the sequester may be possible. Fourth, the deal included language strengthening the income verification process for subsidies under the Affordable Car Act. (This represents a small victory for Republicans seeking "Obamacare" changes—the central driving factor behind the recent impasse.)

Although potentially cataclysmic damage to the economy was avoided, **GDP will take a hit because of the loss of output associated with the 16-day partial government shutdown and the associated furlough of government workers**. We estimate the first order effects of that will reduce Q4 growth by roughly 0.25 point. Moreover, the second order effects on lost activity from government contractors, support businesses, and businesses otherwise relying on government services, along with multiplier effects, raise the hit to growth to as much 0.50 point. Consequently, we would now expect Q4 growth to remain lackluster at close to 2.0%, instead of picking up to near 3.0%. The good news is that this hit to growth should be temporary as long as there is no persistent damage to confidence.

Change

On a global note, the IMF downgraded its growth projections in its latest World Economic Outlook released in October. The IMF expects the global economy to expand a subdued 2.9% in 2013, down 0.3 point from 2012 and from July's projection for this year. Moreover, the IMF has downgraded its 2014 growth forecast to 3.6% from 3.8%. Advanced economies are forecasted to grow at 1.2% in 2013 and 2.0% in 2014, essentially unchanged from the July forecast, whereas developing economy growth forecasts have been cut to 4.5% in 2013 and 5.1% in 2014, down 0.5 and 0.4 point, respectively, from July.

THE MONTH IN REVIEW – MAJOR ECONOMIES

USA

The good

According to the latest Fed Beige Book, "national economic activity continued to expand at a modest to moderate pace" in September and early October. Consumer spending rose. Tourism expanded. Business spending and payrolls grew. Nonfinancial services and manufacturing increased moderately. Residential and nonresidential construction rose, the latter more modestly than the former. Residential and commercial real estate activity continued to improve. Financial conditions were little changed. Bank lending remained modest. Agriculture was mixed. Energy and mining activity was stable to higher. Price and wage pressures remained "limited."

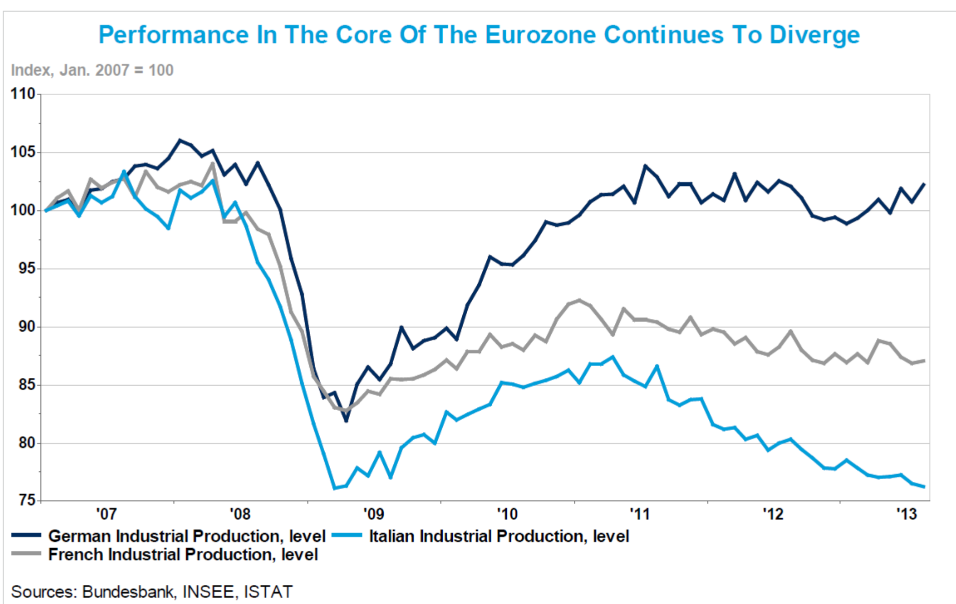
The not so good

Consumer confidence eroded severely in October against the backdrop of the government shutdown and the impasse over raising the debt ceiling. The Conference Boards' confidence index dropped 9.0 points to 71.2, the lowest reading since April. Moreover, this was the largest decline since August 2011, the month of the last major debt ceiling confrontation. In that episode, it took four months before confidence completely rebounded. In this latest report, expectations—which tend to be more volatile—eroded most severely, while the assessment of current conditions weakened more moderately. This said, the closely-watch labor market indicator posted its weakest reading since June.

Eurozone

The good

Inflation continues to slow and in fact has dropped to such a low level that the European Central Bank (ECB) may be getting a bit worried. Indeed, speculation that the ECB could cut administered rates again intensified following October's inflation report. The headline consumer price (CPI) inflation rate for the overall eurozone fell four ticks in October to just 0.7% y/y, its lowest since November 2009 and obviously well below the ECB's 2.0% target (technically, "below, but close to, 2.0%"). Moreover, this disinflation appears to be more than just an energy story because the core inflation rate (which excludes energy as well as food, alcohol and tobacco) fell two ticks to just 0.8%, its lowest since February 2010 and matching the record low for the history of the eurozone.



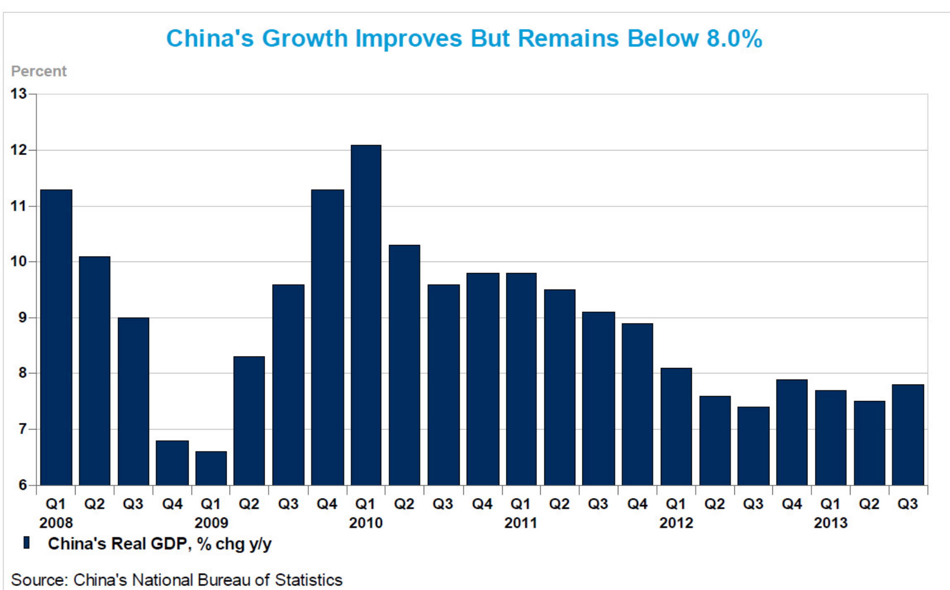
The not so good

The August industrial production data were decidedly mixed (see chart). In Germany, production rebounded 1.4% and continues to trend higher. The strength was concentrated in manufacturing, which jumped 2.1% on strength in capital goods. Utilities slipped 0.2%, and construction plunged 1.9%, although that follows robust back-to-back gains in June and July. Output rose just 0.1% y/y (or 0.3% on a workday-adjusted basis), highlighting the weakness of the sector in the second half of last year.

In France, production edged up 0.2% and continues to trend sideways. Manufacturing rose 1.1% largely on a 19.5% rebound in the highly volatile auto sector. Construction rose 1.1%, but water and utilities fell 1.2%, mining slipped 0.2% and electricity/gas was unchanged. Production fell 2.9% y/y, again on weakness in late 2012. In Italy, production fell 0.2% and continues to trend lower. Indeed, production has fallen in five of the last eight months, and is now back to the low hit during the Great Recession. Electricity and gas slipped 0.2% and mining 0.3% while manufacturing remained unchanged. Details within manufacturing were mixed, with food/tobacco, refining, basic metals and machinery falling, but transport vehicles, pharmaceuticals and electronics rising. Workday-adjusted production fell 4.6% y/y, highlighting the on-going weakness of the sector.

China

China's GDP rose 7.8% in Q3 from a year earlier, a pace up 0.3 point from the previous quarter to the fastest this year (see chart). The government has been targeting real growth around 7.5%, although this is well below the double digit growth rates typical over the last several years. Separately, the CPI inflation rate rose a half point in September to 3.1% y/y, the highest since February. Inflation has been drifting higher since spring but remains below the central bank's 3.5% target for the year.



Japan

Inflation continues to accelerate (see chart). Overall consumer prices (CPI) rose 0.3% (unadjusted) in September following a similar gain in August. Conventional core prices (excluding food and energy) were unchanged, and national core prices (which exclude only fresh food products) rose 0.1%. CPI inflation accelerated two ticks to 1.1% y/y, the fastest in five years. Conventional core CPI inflation accelerated a tick to zero percent, also the fastest in almost five years. But national core CPI inflation decelerated a tick to 0.7%, and although it remains close to a five-year high, it remains well below the Bank of Japan's 2.0% target.

UK

The recovery is gaining momentum (see chart). GDP rose a robust 0.8% in Q3, the third consecutive gain and the largest since Q2, 2010. Strength was widespread, with services rising 0.7%, manufacturing 0.9%, construction 2.5%, agriculture/forestry/ fisheries 1.4%, water/sewerage 3.8%, and mining 0.4%. The only decline was in energy utilities. No expenditure details are released with the preliminary estimate.

GDP rose a lackluster 1.5% y/y, held back by the 0.3% contraction in the final quarter of 2012.

The Month in Review – major asset classes

Equities

Equities rallied partly on relief that the crisis was over, but partly on delayed tapering.

Government Bonds

Bonds were generally bid on speculation that central banks could be easier for longer.

Commodities

Global growth concerns sent oil sharply lower, while gold caught a safe haven bid.

Currencies

EUR rose to its highest in two years, fueling fears of another unwanted headwind in an already tepid eurozone recovery.

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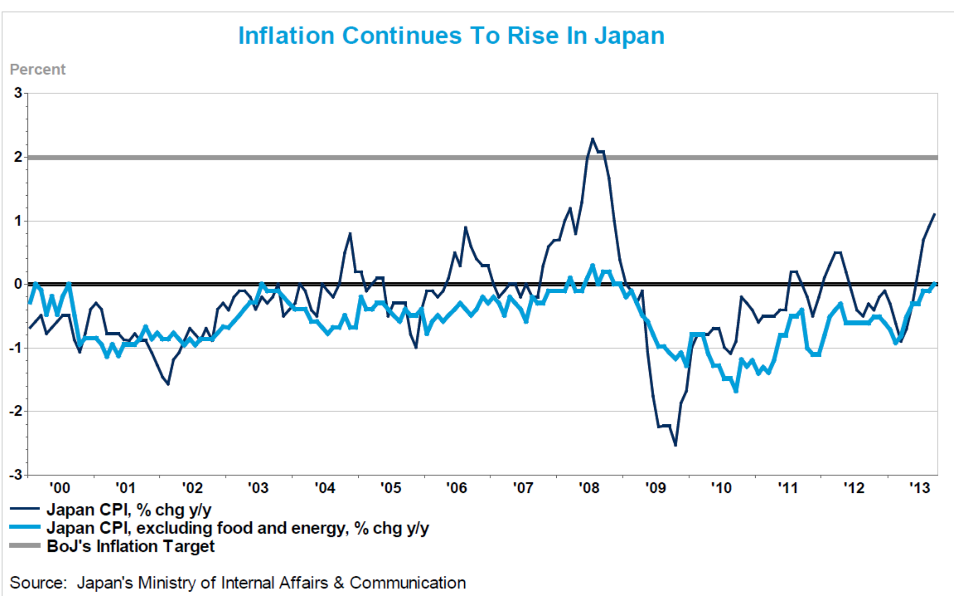

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Afonso Vieira has over nine years experience as a money manager producing strong risk-adjusted returns. He is TWM's Head of Investment Management, responsible for strategy, risk management and performance. He is licensed by the Financial Planning Association of Singapore and affiliated with the Markets Technicians Association of New York. In 2003 Afonso Vieira founded TWM, a personal financial planning firm with offices in Singapore, Saigon and Shanghai and Tokyo.

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Paul read Accounting and Finance at Leeds Metropolitan University in the UK. Between 1998 and 2006 he worked for Barclays Bank Plc within both the Private Clients and Corporate sectors in Manchester, UK. In 2007, Paul joined DVAinvest Moscow (Russia) as the Head of Sales and Wealth Management. He joined TWM in 2008 and writes financial columns for local publications in Saigon.

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Andrew is a Certified Financial Planner(TM) and completed the Certified Investment Management Analyst(R) program at Wharton University. He has been supporting clients in various capacities for the last 8 years. After graduating from Boston University, he joined UBS Wealth Management as an investment specialist, focused on investment analysis and financial planning. Andrew is currently supporting clients in China from Shanghai and Dalian.