Equity Market Recap Third Quarter 2012

Market Environment

In a reversal of the general risk aversion seen in the prior quarter, global equity investors enjoyed solid gains across a majority of countries and economic sectors during the third quarter of 2012. Judging from the modest day-to-day volatility and very low trading volumes, one might surmise that it was a nice, quiet vacation season; however, it was anything but quiet in the monetary policy and political arenas. Proclamations of renewed central bank easing actions dominated the headlines with the Federal Reserve (Fed), the European Central Bank (ECB), and to a lesser extent, the Bank of Japan (BOJ) all delivering better-than-expected policy guidance. Furthermore, there has been movement to more accommodative monetary and fiscal policies in many emerging market countries. In contrast to the 2010 asset-purchase program (also known as quantitative easing, or QE) by the Fed, which was undertaken more or less in isolation to the frustration of many of its global counterparts, particularly in the fast-growing emerging markets, a global easing cycle now seems fully underway.

A few highlights to note, with apologies for the alphabet soup of acronyms:

- Under its dual mandate of price stability and full employment, the Fed has made clear that it sees the latter as much more imperative than the former, at present. The scope of "QE3" is broadly open-ended, and is specifically targeting big mortgage-backed security (MBS) purchases (to the tune of US$40 billion per month) to further stimulate housing, on top of its already sizable reinvestment and Operation Twist commitments. The Fed also provided guidance that the near-zero interest rate policy would be extended until mid-2015, if not longer.
- For the ECB, its newly unveiled Outright Monetary Transactions (OMT) program focuses on direct purchases of short-maturity distressed sovereign bonds in order to cap interest rates in the peripheral countries and redistribute monetary accommodation, signaling a move towards a unified banking structure. However, the program is still highly conditional and subject to many political and constitutional hurdles in the Netherlands, Finland, and especially Germany. Nonetheless, the ratification of the validity of the European Stability Mechanism (ESM) by the German Constitutional Court did avert chaos in the near term.
- Not to be outdone in the "race to debase," the BOJ indicated that it will expand its current asset-purchase program by ¥10 trillion ($127 billion) to ¥80 trillion with purchases extended through the end of 2013. The clear objective is to weaken the strong yen that is substantially impairing Japanese export competitiveness. Of the three major central banks, Japan seems to be playing the weakest hand since its currency devaluation efforts will likely prove temporary absent global coordination.

The market environment for equities was more valuation-driven than earnings-led. Leadership was primarily seen in higher-beta stocks, particularly those that had lagged significantly in the second quarter sell-off. Beyond that, it was not a typical pro-cyclical advance since it was not matched by rising earnings trends. A preponderance of economic reports during the period were consistent with slowing global growth and lower expectations for corporate revenue and earnings growth (although profits remain very high overall). As such, most economists and sell-side analysts were busy cutting forecasts during the quarter, a trend that has been prevalent since early spring. Our broadest global gauge of bottom-up earnings expectations for the year ahead registered a more than 6% median decline during the quarter. Profit outlooks were cut by even bigger margins for European and Chinese companies, while U.S. companies fared much better comparatively. Guidance from company management teams was also decidedly cautious during the latest earnings cycle. For instance, among S&P 500 companies that provide earnings guidance, the ratio of downward to upward signals was approximately three to one. Companies with a more global presence featured prominently among the downbeat, with few exceptions.

Against the cautious earnings backdrop, however, there were some elements of positive surprise, and even a few bright spots. Said another way, some of the economic news was less negative than anticipated. A slight majority of U.S. companies reported second-quarter earnings that came in ahead of the lower consensus expectations. Purchasing manager indices (PMIs) and other key leading indicators continued to signal slowing growth, but directionally bottomed and showed tentative signs of trending higher for Europe, and back into positive territory for the United States.

The United States is also now showing pretty clear signs of a housing recovery, albeit from a low base. Recent evidence includes higher home values, lower inventories of unsold homes, better existing home sales and even an uptick in building activity. Notwithstanding the general slowdown in global trade, the United States continues to fare comparatively well in export activity.

In Japan, meanwhile, the opposite has been the case since economic surprise was decidedly negative, especially from a global trade perspective. While this is in part due to the strong yen, it is also a reflection of deteriorating trade relations with China stoked by the territory dispute in the East China Sea.

China has also tended to disappoint both from a macro perspective and in terms of corporate earnings and balance sheet deterioration. One unfortunate similarity that both China and the United States face is trepidation regarding the political landscape. For the United States, the prospect of continuing gridlock around the looming “fiscal cliff,” as well as general regulatory and tax uncertainty will continue to limit business spending through the election season and beyond. For China, uncertainty regarding the leadership transition is keeping any major stimulus measures off the table pending the upcoming party congress slated for November. While the premiership and the presidency seem reasonably clear (Li Keqiang and Xi Jinping, respectively), there is still much uncertainty regarding the composition of the Politburo and the lower levels. .

The rise in equity values was also not matched with positive fund flows. Indeed, retail investors seem to remain very much disinterested with equity mutual funds continuing to see net outflows, offset somewhat by Exchange-Traded Fund (ETF) purchases. The ETF purchases seem to signal more tactical moves by advisors and asset allocators rather than long-term investment. Conversely, corporate treasurers continued to express their strong preference for buying stocks (share repurchases) and selling bonds (debt issuance), both of which continued at a rapid pace. It was also an environment where many hedge funds reduced short exposure, while pension funds and other active portfolios tended to rebalance in favor of the value seen in stocks relative to the ever- lower yields on most fixed income and yield-oriented asset classes.

For the quarter, the total return on the S&P 500 index was 6.4%, bringing its year to date advance to 16.4%. Developed markets, excluding North America, represented by the MSCI EAFE index, posted a 7.0% gain for the quarter and are up 10.6% for the year to date. Interestingly, this includes a 12.0% advance for Europe. The troubled markets of Italy, Spain, and Portugal all saw double-digit rallies, and even Greece posted a slight gain for the quarter. The MSCI Emerging Markets Index recouped some of its prior underperformance versus developed markets, with a 7.9% gain in the quarter, and is now up 12.3% for the year-to-date. China and Latin America were relative laggards in the period, but very strong results were seen in most Eastern Europe, Middle East, and Africa (EEMEA) markets as well as Asia ex-China.

A vast majority of currencies, both developed and emerging, appreciated versus the U.S. dollar. The euro, British pound, and yen advanced 1.4%, 3% and 2.6%, respectively. From a style perspective, value-oriented benchmarks fared slightly better than their growth counterparts during the quarter, thereby reversing some, but not all, of the growth leadership seen earlier in the year. In the United States, large-cap stocks fared better than small caps during the quarter and continue to lead year-to-date; however, outside the United States, small caps have outpaced large caps, particularly on a year-to-date basis. In aggregate, total global equity market capitalization, represented by the MSCI All Country World Index, expanded nearly US$1.6 trillion during the quarter.

The table below summarizes global equity results for the quarter and year to date by major region and sector in U.S. dollar terms.

	3 mo.	YTD
MSCI World Index	**6.8%**	**13.6%**
North America	6.7%	15.7%
Europe	8.8%	12.0%
Pacific	3.8%	8.2%
MSCI Emerging Markets Index	**7.9%**	**12.3%**
Latin America	4.7%	4.3%
EEMEA	8.5%	15.6%
Asia	8.9%	14.5%
MSCI All Country World Index	**7.0%**	**13.4%**
Consumer Discretionary	6.3%	16.8%
Consumer Staples	5.6%	13.7%
Energy	9.3%	4.8%
Materials	7.4%	6.0%
Industrials	4.8%	10.1%
Financials	8.8%	19.1%
Health Care	7.4%	17.5%
Technology	7.0%	18.2%
Telecommunications	6.8%	13.0%
Utilities	0.8%	3.7%

Looking Ahead

There is a spirited debate brewing among investors about the prudence as well as the potential growth and inflation impacts of quantitative easing and super-accommodative monetary policy. There is little debate about the consequence of making traditional fixed income assets unambiguously less attractive (and downright scary among certain varieties). The upside potential to downside risk is profoundly asymmetric, and not in a good way. While many investors continue to shun equities because of volatility concerns, there are virtually no "safe" assets that afford meaningfully positive real yields in the current environment. Indeed, the mere notion of "safe" assets has been fundamentally altered. In other words, savers in low-volatility fixed income products will continue to transfer wealth to borrowers, which should generally support the case for risk assets.

An interesting dichotomy that we noted early in the year was that bottom-up expectations and company guidance had already been trending down significantly despite the more optimistic macro conditions. Our instinct, as always, is to keep our focus primarily on the bottom-up indicators because we believe them to be the more reliable means of identifying opportunities and challenges. In general, that perspective has served our clients' portfolios well, especially our more cautious positioning on the situation in Europe, a more optimistic stance on the United States, and an eye for quality and value in emerging markets.

In the United States, we continue to see several favorable bottom-up themes. Specifically within the consumer discretionary sectors, we have invested in companies targeting high-end consumers with less economic and inflation sensitivity and in companies with exposure to the U.S. housing market. Within financials, we have been overweight banks with exposure to commercial loan growth and that are beneficiaries of refinance activity. We remain cautious with regard to money-center financials because of return-on-equity (ROE) deterioration and regulatory uncertainty. The balance sheets of both corporations and households have improved substantially and debt-service levels are now at their lowest in a decade. We also see opportunities among companies enjoying lower input costs because of the boom in shale gas. While the gas industry itself suffers from excess capacity, many industrial, chemical, and agriculture-related companies are benefitting from cost savings. Within energy, we prefer refinery companies because supply disruptions, wide crude differentials, and lower input costs provide support for ongoing earning growth.

The United States still faces a looming risk of the fiscal cliff, which, if not managed properly, could result in a sharp fiscal contraction of gross domestic product (GDP). And with the presidential election and a federal debt ceiling looming, these issues could easily spark renewed anxiety in markets. However, with any luck, and some cooperation across the aisles, clarity on the regulatory and tax environments should begin to emerge as we approach the new year. With any reduction in the current uncertainties, capital spending could be spurred back to life. In this context, we continue to see especially intriguing opportunities for technology companies with exposure to enterprise software and mobility solutions.

In Europe, we still see good reason to remain cautious around the epicenter of the crisis, particularly among financials. This remains an important area of concern, despite recent statements of positive intent from ECB. Too often in the past, European policymakers have taken a step forward just to take the next one back. While recent actions have led to a sharp decline in incremental funding costs and provide important support to the banking sector, the political environment will remain murky. Even with improved balance sheets, European banks still face very dilutive recapitalization potential and while recent budget announcements by Spain, Greece, and France indicate a welcome commitment to fiscal targets, austerity will continue to weigh heavily on growth. A bottom-up focus on credit conditions remains our best defense.

China market sentiment remains poor, but valuations are becoming increasingly compelling on a relative basis, even with a selective bias toward quality. Lack of action from the government remains the dominate theme as attention remains focused on the once-in-a-decade Chinese leadership transition. At the same time, social unrest and anti-Japanese protests in over 70 cities have taken place which undermines the desired smooth transition. It is not all bad news, though. After falling for three quarters, cement prices started to stabilize and pick up slightly over recent weeks. Several infrastructure projects are now receiving funding and real estate investment seems close to a trough. Inflation bears careful watching; although the consumer price index (CPI) remains low for now, international corn prices translate in to rising costs and reduced supply for hogs, a key bellwether for food prices. The asset quality of banks also remains a key focus. There is strong desire for the government to maintain stable growth and general stability given political transition year.

Apart from China, much of the Asian region continues to enjoy a relatively strong financial position with most countries running both current account and budget surpluses. With economic activity slowing and inflation low, both monetary and fiscal policy have moved towards an easing stance across much of the region and external contagion risk remains low for most countries.

The road to recovery remains a bumpy one. Our focus on bottom-up earnings trends (aka fundamental change) is well suited to the current environment, and further aided by our proprietary Style Risk Monitor (valuation dispersion analysis framework). Both are quite complementary means to identify pockets of opportunity and dislocations amid anxious investor sentiment. Regardless of the region, sector, or general market conditions, our bottom-up focus on sustainable earnings trends and valuations relative to expectations remains a constant across all portfolios, and helps rise above the fray of short-term “risk on/risk off” tendencies of many investors.

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