TERRA NOVA
ASSET MANAGEMENT

U.S.Financial Markets
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Although the S&P 500 stock market index remains far off its all-time-high of 1565.15 on October 2007 it has had a cyclical bull market run of 24.25 percent since its lows in October 2011. More than a third of the 45 world-markets have done the same. As many investors have remained on the sidelines the true test of the cyclical bull market lies ahead. A steady flow of better-than-expected domestic economic data, a lessening of Europe-related fears and a positive corporate earnings picture were contributing factors, but they have already run their course, leaving little room for further near-term upside.

Credit Markets

The corporate bond rally started last fall and continues to grind along. Though spreads are now tighter than since last August, they remain well wide of the levels seen a year ago. We expect that developments in Europe will dictate whether credit markets head sharply higher or lower from here. With EUR 530 billion added to the banking system, near-term liquidity concerns among European banks have been put to rest at least for now. In the United States, solid economic data overall also continue to support the corporate credit market. With the threat of a downturn easing, weaker firms most susceptible to recession have seen spreads tighten the most recently. The spread gap between nonfinancial A- and BBB- rated issuers currently stands at about 140 basis points, down from nearly 220 basis points last fall and 180 basis points at the start of the year.

Headwinds continue from Europe

Some optimism may be warranted by the December EU agreement to opt for a greater fiscal integration but nothing tangible has materialized so far. The EZB has prevented the financial system from freezing but its role in the Euro zone monetary/financial framework has yet to be defined. The core of the problem remains and with the economy slowing and elections coming up in France and Greece in April political changes may add to the lack of progress. As long as the markets lack a roadmap about the creation of a fiscal infrastructure and an economic stimulus program the current quiet wait and see phase is nothing more than just that. The market seems to price in a far smoother and more stable process than is warranted. The near future, however, has a great potential to re-ignite a Europe-centric volatility in our opinion. The Euro area has entered a recession and all that turmoil will put pressure on the emerging markets and China. One way out will have to be a significant debasement of the Euro.

Economy

The Q4 of 2011 GDP was revised upward to an inflation-adjusted 3 percent. As the U.S. economy comprises of 70 percent consumption a noteworthy surprising factor of the revision was that real disposable personal income was also strongly revised upward, which explains the robust consumer spending during the holiday season. More importantly the savings rate increased from 3.7 percent to 4.5 percent which means the consumer did not tap into savings or increased borrowing to spend. As the Q4 is cyclical in nature with durable goods being shipped in December for tax credit purpose, we expect GDP growth to slow down in 1Q 2012 to 1.5-2 percent.

Labor market truly on the mend

The labor market continued to recover in February with 227,000 new private sector jobs. Every category in terms of small, medium-size, and large businesses grew robustly with 10 percent of the growth being manufacturing jobs. The percentage change in employment growth year-over-year on a three-month moving average is close to 2 percent up from 1 percent a year ago, which is in line with past recoveries. The unemployment rate remains at 8.3 percent.

Corporate Earnings

Corporate profitability was surprisingly strong during the early stages of the economic recovery mainly due to the bone cost-cutting, laying off workers, increasing productivity, buying profitable businesses at discounts, and thus generating substantial cash flow for shareholders. We do not think a high double-digit earnings growth rate is sustainable as companies will have to focus on investments to improve returns on invested capital, and we therefore expect more normalized growth in the quarters ahead. 60.4 percent of the companies in the S&P 500 beat earnings expectations in Q4 down from the historic average of 62 percent and well below 80 percent during the peak. Stocks are for the most part fairly valued and we expect that stock prices will reflect expectations of future growth and dividends rather than the kind of multiple expansion which is typical when going from undervalued to fairly valued.

Outlook

Given the threefold headwinds, the European debt crisis, a slowdown in the emerging markets, and a potential hard landing in China, we recommend to overweight U.S. investments, including equities, high yield bonds, real estate and other assets. The U.S. has entered a period of self-sustaining economic expansion, driven primarily by the aggressive monetary policy of the Fed which has now been reinforced by the EZB. The United States has become the economic locomotive of the global economy, and that is why the Fed is continuing to promote growth to support the economies in Europe and Asia. U.S. equities are at the cheapest level relative to bonds in more than 40 years, with the earnings yield of the S&P 500 Index at 7.2 percent compared with 1.99 percent for 10-year Treasuries. The forward 12-month estimate for earnings per share is 10.87 percent growth from the actual. Dividends per share are estimated to grow 9.3 percent. Although the market rallied about 100 percent from the market crisis low of March 2009 neither in length or strength has it been excessive in terms of historical comparisons as PEs on next 12 months earnings are 13 and not 17. We are relatively optimistic on the economy and as we enter the second stage recovery we recommend to focus on dividend paying cyclical rather than defensive stocks with the potential to increase dividends in the mid-cap technology, industrial and finance space. We also recommend to continue to invest in U.S. energy companies as the U.S. has turned into the lowest-cost provider of oil and natural gas in the world in 40 years as unconventional technologies such as fracking or pumping fluid into onshore oil reserves buried deep beneath the surface have successfully spurred production growth in the U.S. This robust development will be a game changer in the U.S.

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