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Uncertainty has been dictating the markets until the end of May with the two leading macro factors being the Euro crises and the state of global growth in particular in the U.S. and in China. Since the bottom on June 1st, the S&P 500 rallied 15% through December 20th as U.S. data surprised and the ECB helped to relax the market stress over the Euro-crisis. A large part of the rally was, however, driven by corporate share buy–backs, as risk adverse investors increasingly preferred bond to equity investments, shifting $ 100 billion into bond funds up until the end of November.

We expect Europe to remain a factor of uncertainty for the markets in 2013 although to a lesser degree. With austerity measures in place across Europe, the economic outlook is expected to be relatively weak. The biggest threat to the U.S. economy is the looming U.S. fiscal cliff. We expect that the fiscal challenges, which are a combination of expiring benefits and spending cuts of $ 607 billion to become effective in January 2013, will be avoided in a multi-step process. If not the consequences would likely lead to economic instability, a likely worldwide recession and a further investment grade downgrade for the U.S. Until the fiscal uncertainty is lifted, markets will remain volatile in our opinion, followed by a strong surge in investment and private spending.

Fixed Income Markets

2008 was the first systemic crisis in the U.S. since the 1930s, so the consequences have been much more significant than after a normal recession. Public sector debt has risen exponentially in the past five years and the most important question for investors concerns how these levels will ultimately be reduced. Restructuring debt is painful, structural reform meaning greater austerity and keeping interest rates artificially low will lead to more inflation. All three solutions will slow GDP growth. The long-term downside of mounting inflationary pressure is likely to ultimately lead to negative real returns in treasury and agency bonds. This explains why investors already started to shift from treasury bonds into riskier assets with higher yields in 2012. Emerging-markets bonds were up 16% followed by high yield (BB and lower) and credit markets have consequently returned 13% and 9%, respectively, year to date. Bond issuance increased to a record level of $580 billion through the end of November fueled by investors' demand for yield. Default levels have declined to below 2% in the past few years, a rock bottom low level. Demand will remain strong in 2013, facilitated by the Fed continuing to buy bonds as part of the Operation Twist program. Investors have to be aware, however, that once interest rates start to rise in 2015 as the Fed anticipates they need to transition into shorter duration credit and floating-rate products like bank loans and asset-backed securities for preservation of capital.

Outlook

The U.S. equity markets have outperformed global markets in the past two years fueled by corporate earnings. We expect this trend to continue with slow growth expectations for Europe and a sustained period of below average growth trend in emerging markets. In the U.S., we expect the housing market in particular to be supported by the Federal Reserve Bank, which has forecasted to hold overnight interbank rates near zero until inflation increases to over 2.5% or the unemployment rate drops to 6.5% which is not likely to happen before the middle of 2015. The expected U.S. Housing recovery will drive job creation and contribute significantly to GDP growth in 2013. The economy in Asia is improving, systemic risk has been reduced in Europe, and the U.S. economy is relatively robust. We expect the U.S. economy to grow at 2.5% to 3% on average in 2013, improving during the year as the fiscal cliff is being resolved.

Market Drivers in 2013

Given the current market valuations, equities continue to offer the best risk-adjusted return compared to other asset classes in our opinion. The companies in the S&P 500 Index generate $500 billion of annual surplus free cash flow (FCF) and have over $1 trillion in unused debt capacity to fund acquisitions and share buybacks. Net share buybacks in 2012 were $ 320 billion or 2.8% of market cap. As the U.S. corporate tax rate is the highest globally the expected corporate tax reform will likely further accelerate share buybacks and increases in dividends. About 35%-45% of corporate FCF is generated abroad, but only domestic FCF can be used to fund dividends and share repurchases. A lower corporate tax rate and/or move to a territorial system would significantly increase FCF available for buybacks and dividends. Furthermore, U.S. companies reduced investment between 4% and 20% during 2009 to 2011 in a move to boost cash reserves and provide for a cushion during the financial crisis which resulted in cash balances of $ 1.26 trillion. At some point in the near future companies need to invest again to remain competitive on the global stage. Furthermore, recent data indicates that the U.S. is becoming the largest energy producer in the world. This development was not expected in such a short time frame and, as a result, oil prices are likely to decrease by $10 to $15 in 2013 thus adding 1% to GDP and improving consumption. Lastly private investors are likely to return to the equity markets as soon as the cloud over the fiscal cliff is lifted. These are all very strong drivers for the market and investors should benefit from these developments in 2013.

Master Limited Partnerships (MLPs): U.S. exports of Natural Gas and rapid growth in petrochemical industry consumption of natural gas liquids may not occur simultaneously or at the pace that is currently projected, but the combination of these developments represents an unprecedented opportunity for the industry to spend capital under contractual commitments that secure favorable returns. We, therefore, see especially attractive investment opportunities in the Natural Gas and Master Limited Partnership (MLPs) sectors benefiting from the need for pipelines, processing, gathering, storage and terminals to be built, expanded or simply to improve utilization rates as increasing volumes of oil, natural gas and Natural Gas Liquids (NGLs) are produced. We expect oil production to grow over 10% p.a. in the next 5 years, 8% in NGLs and 2% in North American natural gas. This translates into well over $20 billion annually of growth capital expenditures in the Natural Gas & MLP sectors to move the production to markets in each of the next 3-5 years. It also benefits infrastructure builders as new facilities will be built or expanded. The outlook on future growth in dividends and distributions in these sectors are very attractive.

A conservative outlook on investment return for 2013 is 8%, 2.6% dividend yield and 5% earnings growth. From a valuation standpoint, cyclical companies are attractive. We favor large-cap industrial, con-

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sumer discretionary and technology companies. We recommend to also focus on energy MLPs and equity REITs (real estate investment trusts) both for income, capital growth and portfolio diversification.

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