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Despite continued uncertainty about the impasse of U.S. fiscal policy, weaker global growth and the eventual reversal of the Federal Reserve's loose monetary policy, the U.S. equity market regained its all-time-high in the third quarter before consolidating up until the partial government shutdown ended and a decision reached in congress to raise the debt ceiling on October 17th. Since then, the S&P 500 Total Return Index had a relief rally and was up 26.37% year-to-date.

## Federal Reserve postponed Tapering

The Fed decided on September 18th to postpone the tapering of its money easing program and to wait for more conclusive data on the economy and fiscal policy. Furthermore, the Fed was taken by surprise by the unexpected sharp increase in interest rates in response to their first indication of tapering in June. Higher mortgage interest led to a slow down in both the housing market and emerging markets with large deficits stifling growth. Currencies reached record lows, increasing energy import costs. Due to the ongoing debate about default simultaneously with a tight fiscal policy (sequester) aiming to reduce the fiscal deficit in only one year from $ 1.2 billion to $ 0.6 billion in 2014, and the lack of a sound fiscal policy, which is likely to weaken the economy and the labor market, we do not expect the Fed to taper until well into 2014. So far the Fed has been very successful with its monetary policy. The Fed's bond buying program has helped the economy to grow at a rate of 2% p.a. this year, despite the tight fiscal policy forecast by the Congressional Budget Office of a GDP reduction of 1% to 1.5% along with a negative impact on the job market. As long as inflation is held at bay, the Fed can fully open the monetary throttle to counteract Washington's tight fisted fiscal policy in order to achieve full employment.

## Fixed Income Markets

The yield curve, which historically signals a faster growing economy, is neither reflective of bullish expectations for growth, nor a great concern for inflation, but rather indicates that yields are near their peak, limited by an economy that is growing at half the average post WW II rate, with an inflation rate below the Fed's target rate of 2% and unemployment above the target of 6.5%. The Fed intends to keep interest rates for overnight loans between banks at zero to 0.25% into 2015, while reducing their bond-buying related economic stimulus once the trend of a stronger economy is sustainable. Against market expectations, the Fed shocked the markets in September by continuing their bond-purchase program. Consequently, the bond market, in particular the corporate bond market, recaptured a part of the loss incurred since April when interest rates started to rise abruptly. The Barclays US Agg Total Return Index recovered year-to-date from a low of -2.49% in 08/30 to -1.9% in 09/30. Until we get a clearer indication on the likely impact of fiscal policy on the economy and the markets, interest rates are likely to remain in a trading range in our opinion. If the economy continues to improve, albeit slowly, and credit spreads should tighten as demand for credit risk resumes.

## Economy – neither Boom nor Bust

The U.S. growth is not only directed by the Federal Reserve's loose monetary policy, but also by demographics, with aging baby boomers leaving the workforce, rising income inequality with a growing portion of discretionary money being held by a smaller number of people (1% owns 19% of household income –highest share since 1928), globalization leading to pressure on prices and a move of labor intensive jobs offshore, environmental regulations in the energy sector, the financial sector and lastly intense corporate, public and private sector deleveraging. In the U.S. the GDP growth has halved from an average of 3.2% since WW-II to 1.5%-2% in 2013. Weaker global growth, specifically in China, a more restrictive Fed policy and a tightening U.S. fiscal policy, will not only continue to put a lid on GDP growth medium term, but the long-term fundamentals are likely to lead to acceleration in growth momentum. We expect the economy to grow in a range of 2% to 2.5% this year and accelerate to 3% in 2014.

## Global Outlook

The size and consumer orientation of the U.S. economy (25% of world's economy) will likely be a big swing factor in the export growth trajectories of other countries. China on the other hand is much less of a swing factor today, as their economy is in the process of shifting from an entirely investment-driven, (49%) export-driven economy to a domestic consumption driven economy. In the process, their growth rate has been intentionally slowed from a peak of 10%-12% to 7.5% affecting all other emerging markets, in particular commodities based countries like Australia and Brazil. Furthermore, the Fed's money easing program had filtered through to the emerging markets as yields were more attractive than in the U.S. However, with the Fed indication of tapering, interest rates started to increase by over 1%, investments were withdrawn from these markets and their currencies depreciated making imports, in particular energy imports, more expensive, leading to higher inflation. Improvements in Germany and France have helped Europe, but fundamentals, such as the under capitalized finance industry and sovereign debt issues, still have to be addressed. Also, European economies are not as consumption orientated as is the U.S. economy and, therefore, less of a driver of global growth. Japan is in a similar situation. Credit availability and consumption have improved, but fundamentals causing the long lasting recession have not been sufficiently addressed yet. Therefore, the strong Euro due to a rising current account surplus, in combination with net long-term capital inflows, could potentially undermine the fragile social consensus to continue with the necessary structural and fiscal reforms in Japan.

## Corporate Earnings

Q3 earnings have topped Q2 earnings and were mainly driven by margin expansion rather than revenues. The lack of clear guidance on fiscal budget and taxation, reduced government spending, ever expanding regulation and the "mystery" of the affordable care act are likely to affect corporate cost structures making it increasingly challenging for corporate America to budget and make decisions on business strategies and capital investments. This is impacting top line growth, productivity and earnings. Given this scenario in addition to a GDP growth of barely 2%, we do not expect above earnings growth in Q4.

## Outlook

According to Bloomberg, during the last decade the S&P 500 Total Return Index has risen 11% on average during the 12 months following government shutdowns. Also, historically, bonds have been more stable than stocks. During the past 25 years, the worst calendar year for the bond market (as measured by the Barclays U.S. Aggregate Index) was 1994, with a 3.9% decline. By contrast, within the same period, U.S. stocks fell 38% in 2008. Even with 10-year U.S. Treasury yields having risen by 96 basis points from the start of the year through August 20, the bond market, as measured by the total return of the Barclays U.S. Aggregate Index, lost only 1.01%. At this point the bond market has, however, more downside than upside, and we recommend to continue to modestly shorten duration in strong market phases. The volatility in the bond market is likely to spill over to the equity market which will represent a challenge in the next quarters. Improving cash flow in cyclical sectors, valuation appreciation, and asset reallocation to equities will, however, benefit the market long term. We continue to take partial profits in cyclical industries, and to amply diversify portfolio risk within sectors and industries. Markets with increased volatility present opportunities to invest in great businesses at a discount. Portfolios need to be managed actively and in a timely fashion at this point in the market to take advantage of these opportunities. The equity market is close to fair value, and the most attractive valuations are in the energy and basic materials sectors.

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