



**Artemis**  
FINANCIAL ADVISORS LLC

# Market Outlook & Strategy

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### ***Executive Summary***

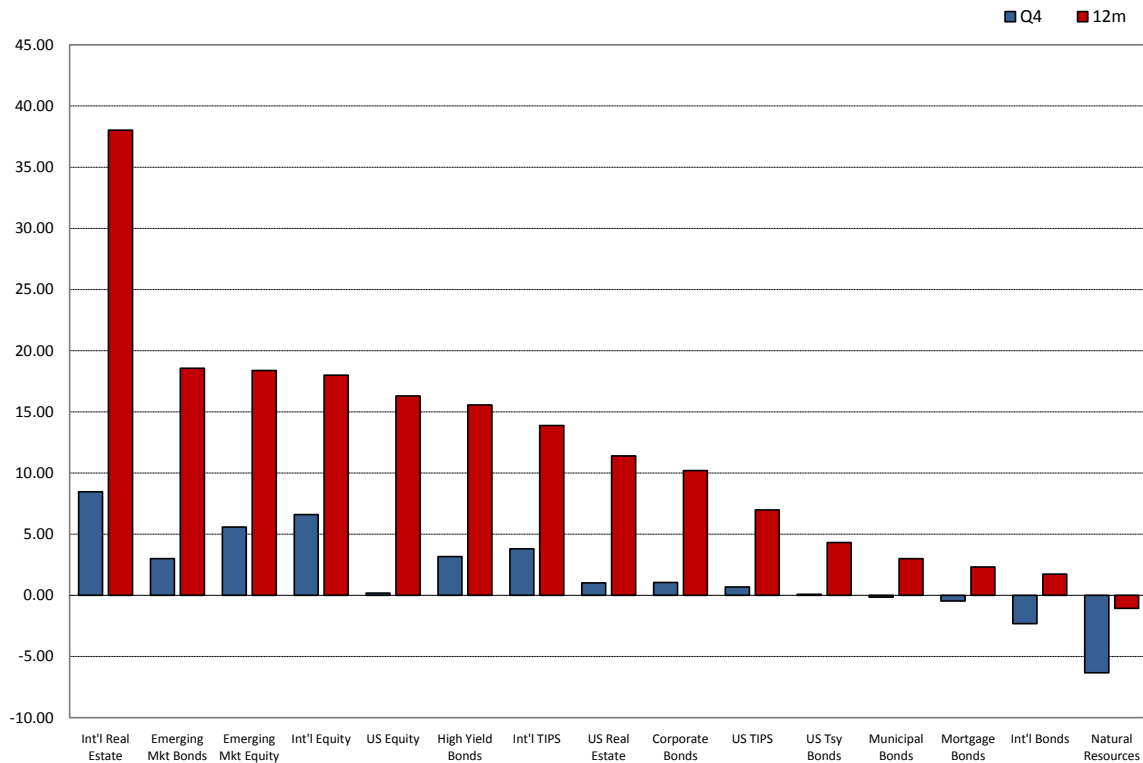
- **Financial markets experienced a surprisingly robust 2012**, with U.S. equity increasing by 16.3% and emerging markets rising 18.4%. The European stock market also had a decent year, with the Stoxx European 600 index rising 14% overall. But it was an extremely bumpy ride: First, the Stoxx rose by 10%, then fell back to a 5% loss, before rising again.
- Higher-yielding categories of the fixed-income market marched straight upward during the year, led by emerging-market bonds (+18.6%) and U.S. high yield (+15.6). This same demand benefited U.S. and international real estate, both of which posted stellar returns. **Overall, the results for the year reminded us that anemic growth does not necessarily make for a bad investment climate.**
- **In our view, the world looks less scary as we enter 2013**, as the risk of a hard landing in China has moderated, the European Central Bank has dramatically reduced the risk of a systemic financial crisis in Europe, and deflationary headwinds in the U.S. are diminishing. **Our expectations are that economic growth in the U.S. will be a tad stronger in 2013**, assuming Congress and the White House successfully manage the upcoming debt ceiling and spending cut negotiations. This is the key risk to our outlook.
- In terms of portfolio strategy, **we remain committed to five key themes: equity overweight, emerging markets, real estate, credit-sensitive debt, and municipal bonds**. We are increasing exposure to equity on the margin, moving to an emerging-market overweight position, and dipping our toes back into international developed markets because relative valuations in both markets are compelling.
- **We also favor using a credit “barbell” of municipal bonds and domestic high-yield bonds as a core fixed-income position, and supplementing this with emerging-market debt**. Municipal bonds are extremely cheap relative to similar credit-quality corporate bonds and exhibit lower default rates. We are also less concerned at the moment that Congress will limit the tax benefit of municipals.



**Markets in Review**

In spite of the lack of any substantive and long-term resolution to the fiscal problems plaguing the developed world and sluggish growth just about everywhere, the financial markets experienced a surprisingly robust 2012, with U.S. equity increasing by 16.3% (see Figure 1). Emerging markets clocked in similar returns, rising 18.4% overall, helped in large part by surprisingly strong performance in Turkey (up 52%), Thailand, and the Philippines. Even the Chinese stock market eked out a 3.2% gain on the year, bolstered by an eye-popping 15% increase in December. The European stock market also had a decent year, with the Stoxx European 600 index rising 14% overall. But it was an extremely bumpy ride: First, the index first rose by 10% and then fell back to a 5% loss, before rising again. Overall, the international index rose a respectable 18.0%.

Figure 1: Asset Class Performance in Q4 2012 (percentage points)



The year also ended with a bit of a surprise from the Fed, which, for the first time, said it would tie its monetary policy to specific economic indicators instead of to a time period.



The central bank said that it would continue its extraordinarily easy monetary policy until the unemployment rate hit 6.5% (the current level is 7.7%). The commitment is not binding — the Fed said it would act if inflation began to become a problem or if the unemployment rate fell only because of a reduction in the workforce. Still, the statement was another clear sign that the Fed plans on keeping rates incredibly low for some time.

In Europe, a new deal was reached with Greece that allowed another tranche of bailout funds to flow into the country and provided for a private-sector buyback that enabled the country to stay in Europe's common currency. In China, the Chinese Communist Party completed its power transition in November, and the economy continued to show clear signs of reacceleration.

In contrast to the swings in the equity markets during the year, higher-yielding categories of the fixed-income market marched straight upward, led by emerging-market bonds (+18.6%) and U.S. high yield (+15.6%). This same demand for yield benefited U.S. and international real estate, both of which posted stellar returns. Overall, the results for the year reminded us that anemic growth does not necessarily make for a bad investment climate.

In our view, several factors are responsible for the broad-based gains. First, Europe did not implode (as many had feared) due to the actions taken by the European Central Bank (ECB). Second, the Fed engaged in several new rounds of quantitative easing and explicitly stated that its commitment would be open-ended. Third, improvements in the U.S. housing market, coupled with declining energy prices, helped to restore consumer confidence and spending. In addition, China and several other developing countries engaged in various efforts to stimulate their economies as they detected signs of slowing growth. Finally, investors seemed complacent about risk by the end of 2012 (perhaps foolishly), as market volatility hit new lows.

### ***2012 Retrospective***

Before looking forward to next year, it is always useful – and often humbling – to take a look back at how we thought the prior year would evolve. Coming into 2012, we predicted sluggish, but positive growth in the U.S., poor near-term prospects in Europe, concern that that growth in China was slowing, and a belief that the U.S. dollar would remain strong and that inflation would remain low.

Our 2012 outlook called for continued outperformance of the U.S. market relative to Europe and emerging markets, and so we favored an overweight position to U.S. equities relative to all other markets. We believed that some combination of stronger global



economic growth and more pro-growth policies with the euro region would be required before we would become more positive about the relative outlook for euro-area equities. While we were more sanguine about emerging markets, we weren't ready to reduce our underweight position.

On fixed-income, we emphasized our preference for so-called spread product (i.e., fixed income that is more sensitive to default risk than to interest rate risk). In particular, we favored U.S. high-yield and investment-grade corporate debt, as well as emerging-market debt. In contrast, we were concerned that Treasuries and inflation-protected bonds were overvalued.

On balance, we were mostly right in 2012 (this doesn't always happen!). The U.S. was clearly the growth leader in the developed world, Europe spent the year mired in recession, and emerging markets suffered the effects of slowing global trade. One silver lining of slow growth was the near-complete absence of inflation. For developed countries as a whole, inflation fell from 2% at the start of the year to approximately 1.6% by the end of the year. The same pattern held in both the U.S. and even in many emerging markets.

In terms of the markets, U.S. equity outperformed both international and emerging markets until the last few months of the year, when fiscal cliff concerns weighed heavily (see Figure 1). Some research we did in the early spring on real estate markets (see our Q1 Market Strategy and Outlook report) led us to increase our allocations to both U.S. and international real estate, which paid off handsomely. Finally, our focus on credit-sensitive fixed income was a real winner, with U.S. high-yield and emerging-market debt posting equity-like returns.

There were a few things we didn't get right. Our volatility hedge implemented in August did not work as hoped (i.e., it stopped trading water and started losing value). Basically, our timing on the hedge was poor, as both the ECB and the Fed made open-ended commitments in September to stabilize markets, removing much of the "tail risk" the hedge was insuring against. Hence, we traded out of the position in late November. Finally, we underestimated the impact the ECB's move would have on European equity markets and missed the rally.



### ***Outlook for 2013***

The world looks decidedly less scary as we enter 2013, as the risk of a hard landing in China has moderated, the ECB has dramatically reduced the risk of a systemic financial crisis in Europe, and deflationary headwinds in the U.S. are diminishing. Our expectations are that economic growth in the U.S. will be a tad stronger in 2013, assuming that Congress and the White House successfully manage the upcoming debt ceiling and spending cut negotiations.

For several reasons, we are less concerned than many that the fiscal drag associated with reasonable tax and spending reform will derail the U.S. economy. Recent trends in retail sales and household net worth suggest that private consumption could strengthen to 4% annual growth rate next year. If so, this alone will generate about 2.8% GDP growth (because consumer spending is about 70% of U.S. economic activity). We also expect the economy to be supported by continued housing market recovery, relatively low energy prices, and employment growth.

Indeed, there may even be a positive surprise of increased corporate capital spending. The slow recovery in capital expenditures over the last three years has barely made up for capital depreciation. This aging capital stock may have reached a stage where new investment must be made or profitability will suffer, and the recent deal to avoid the fiscal cliff left intact some tax incentives for capital expenditures that were due to expire at the end of 2012.

In contrast, we expect the euro zone will continue to be mired in recession during the first half of the year, although the pace of decline will moderate. We think the ECB will continue to improvise effectively, however, in order to backstop the single currency and, therefore, we expect the euro to remain intact.

Finally, we think emerging-market growth will accelerate, especially in the Asian emerging economies, as they benefit from renewed growth in China. There is a widespread consensus that China has finally turned the corner and that China's new leader will not let up on the government's reflationary efforts.

From an investment perspective, we expect the cyclical bull market to continue in the U.S. With zero short-term interest rates and a forward P/E ratio of roughly 13, we believe U.S. equities will continue their march higher, although unlikely at last year's pace. Historically, investors have been rewarded with purchasing equities at current values (Figure 2 next page).



We do believe, however, that both European and emerging market returns have a fighting chance of outpacing U.S. returns in 2013. Emerging-market stocks are trading at a significant discount — more than 20% — to U.S. equities, which historically has been a good entry point (Figure 3). Emerging-market valuations look particularly compelling when adjusted for falling inflation.

Valuations are also compelling in Europe. In addition, while earnings growth in the U.S. will continue to decelerate until it converges to nominal GDP growth, which is about 4% to 5%, profit growth will likely accelerate in the euro zone, especially if the ECB continues to suppress borrowing costs. This desynchronized profit cycle looks bullish for euro zone investments (Figure 4).

Figure 2: S&P 500 Forward P/E and Future Returns

S&P 500 P/E ENTRY LEVEL	Subsequent Average Annualized S&P 500 Price Returns (%)				
	1 YR	2 YR	3 YR	5 YR	10 YR
<8	13.6	10.6	8.5	10.2	11.1
8-10	8.3	10.9	12.3	12	9
10-12	12.3	12.9	11.5	8	8.3
(Present) 12-14	8.9	8.8	6.7	6.2	7.4
14-16	11.4	7.3	6.5	6.8	6.5
16-18	3.3	1.8	2.3	3.1	2.6
18-20	3.5	3.4	3.5	4	3.1
20-22	2.4	5.8	7.4	8.2	6.2
22-24	-4.8	4.2	7.2	2.4	2
(Tech Bubble) 24>	-3.3	-2.5	-2.9	-0.7	-1.2

Source: Fidelity. Data from 1913 to September 2011.

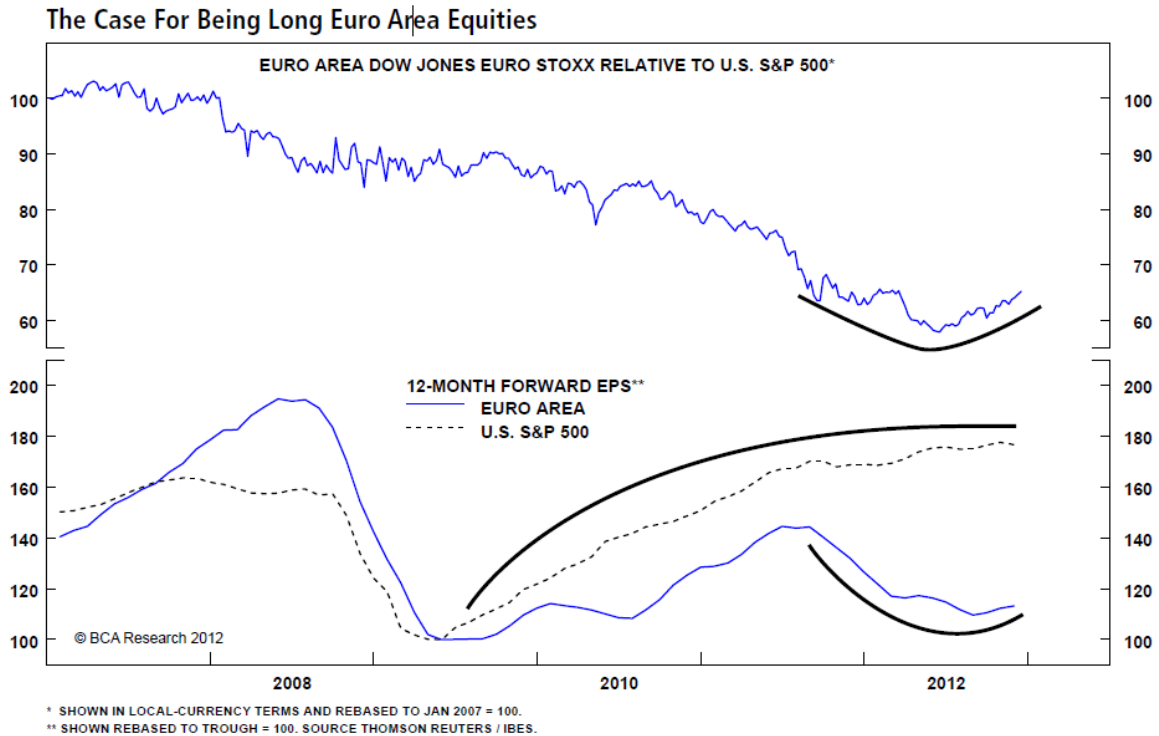
Figure 3: Equity Valuation Matrix

	Price/Book (P/B) Ratio	Forward P/E Ratio
Japan	1.09	12.82
Euro Area	1.25	11.04
Emerging Markets	1.65	10.55
China	1.70	9.92
U.S.	2.17	13.00

Source: BCA Research January 11, 2013



Figure 4:



Source: BCA Research

As for fixed income, the key point to remember is that Fed policy has sent out unambiguous signals: Rates will stay at zero at least through 2013. With unemployment projected to still be 7% or so until the end of 2014, the search for yield will intensify, and market signals for credit risk will still stay muted. Prices for any asset with a yield could get inflated. Indeed, the U.S. high-yield rally is already looking long in the tooth; high yield is at an all-time low in terms of yield and all-time high in terms of price.

### ***Artemis Portfolio Strategy***

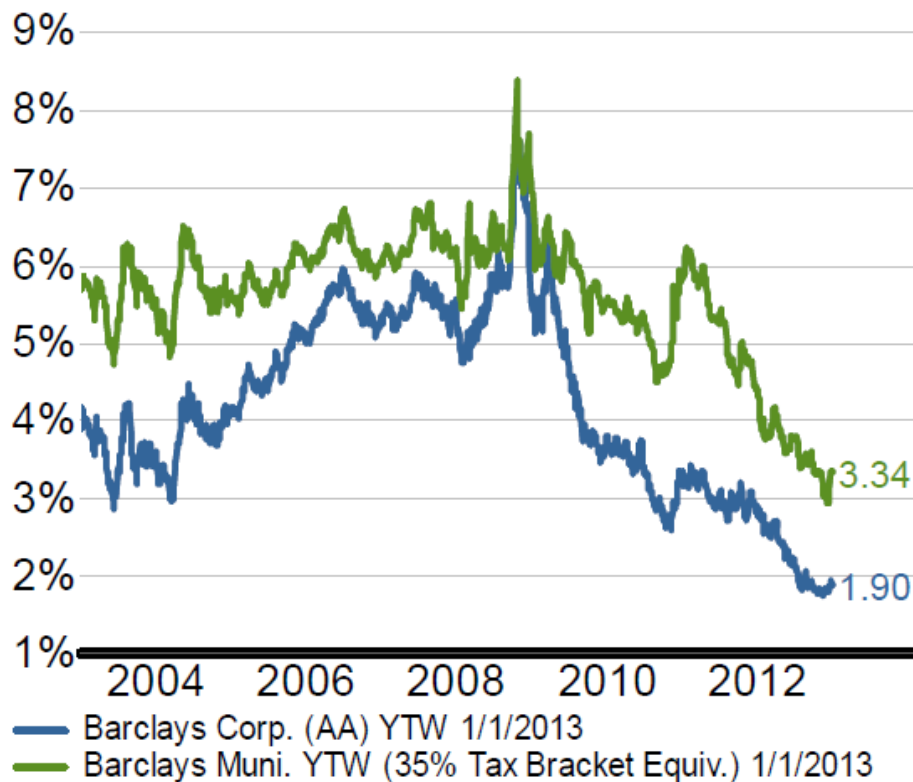
Overall, we like how our portfolios are currently positioned and are not planning major changes as we head into 2013. We remain committed to five key themes: equity overweight, emerging markets, real estate, credit-sensitive debt, and municipal bonds. We are increasing exposure to equity on the margin, moving to an emerging-market overweight position, and dipping our toes back into international developed markets.





In terms of fixed income, we favor using a credit barbell of municipal bonds and domestic high yield bonds as a core fixed-income position, and supplementing this with emerging-market debt. Municipal bonds are extremely cheap relative to similar credit-quality corporate bonds and exhibit lower default rates (Figure 5). We are also currently evaluating floating-rate bank loans because they appear particularly well-suited to addressing the risk associated with rising interest rates. At some point, the economy will be healthy enough for the Fed to begin normalizing monetary policy. Plentiful global savings and captive bond buyers will, perhaps, moderate the resulting bear market for bonds, but they will unlikely be able prevent a downturn.

Figure 5: Corporate Bond Yields vs. Municipal Bond Yields



Source: Fidelity