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Investment Publications Highlights

CAMBRIDGE ASSOCIATES LLC

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"U.S. Equity Outlook 2013: Public Sector Deleveraging"

Barry C. Knapp et al., Barclays Capital, December 7, 2012

The fiscal cliff poses a serious risk to the U.S. consumer and equity markets in the near term. But the combination of earnings growth, reasonable valuations, and improving macro backdrop should see the S&P 500 return 10% in 2013. An increase in capital expenditure and the resulting rise in corporate earnings will create tailwinds heading into 2014.

The S&P 500 Index could return 10% in 2013 and rise to 1,525. There are many risks to this forecast including the low probability of a grand bargain on the fiscal cliff, lackluster growth, and the rising rate of mandatory federal government spending. Coupled with the fact that growth is weak and share prices have already overshot core fundamentals, the first significant market move of 2013 is likely to be downward. However, we would view a market downturn as a buying opportunity in the first half of the year and expect earnings growth to accelerate in the second half of 2013. This trend could potentially gain momentum in 2014 as a recovery in capital spending develops, the housing recovery broadens, and aggressive monetary policy leads to stronger growth in nominal GDP and, consequently, earnings.

In the near term, the market's focus will be on the fiscal cliff, and there are three likely scenarios that could play out. The first is a "bull case" scenario in which policymakers reach a palatable deal and avoid a cliff-related recession. The result would be an immediate improvement in business sentiment and increase in capital expenditure. While this would certainly bode well for corporate earnings, the potential upside could be limited by the actions of the Federal Reserve. If there is an increase in economic optimism, the Fed could choose to taper asset purchases at the end of the year, forcing a market correction. The second scenario is a "base case" in which we expect to see pullback at the beginning of the year, followed by an earnings trough at the end of the first or second quarter. Earnings growth would then accelerate into 2014 as a drop in policy uncertainty provides the necessary catalyst for capital expenditure. In the third "bear case" scenario, policymakers fail to reach a satisfactory solution to the fiscal cliff, resulting in significant economic drag. In this scenario, earnings may only see a light downward correction because consumers have already made significant headway in deleveraging and corporate balance sheets are healthy and flush with cash.

As attention shifts away from the fiscal cliff, investors will realize there are several favorable secular underpinnings for economic and earnings growth. The benefits from the U.S. energy boom are numerous. Cheap input costs are boosting industries like chemicals, and infrastructure spending to support energy transmission could be enormous. Domestic manufacturing is also benefitting as low wages and higher productivity make the United States more competitive (after adjusting for factors like shipping) with producers like China, which encourages onshoring and spurs economic activity. Finally, the United States enjoys more favorable demographics than much of the developed world, though this is accompanied by risks in the benefits that have been promised to the baby boomer generation.

There are several swing factors for the investment outlook. U.S. housing is rebounding, which has boosted consumer confidence and encouraged a lower savings rate. However, the spillover benefits have been partially offset by weakness in disposable incomes. If house prices

continue to rise and home starts increase, this could generate positive externalities like more construction jobs (where employment levels are currently two million below their 2006–07 peak). The pace of deleveraging is also important—any benefit from an improved housing market cannot be offset by consumers saving more. The household sector has already made some progress in reducing overall debt levels, though much remains to be done. However, 2013 could finally see consumer lending start to ease, which could provide further support for growth. State and local government cutbacks also could slow, easing a brake on growth. The wildcard is what is decided at the federal level. Higher taxes and increased austerity could serve to offset many of these positives. Hopefully, politicians will take note of events in Europe, and observe that too much austerity can greatly curb growth. Finally, business confidence and the outlook for capital expenditure are important. A reasonable resolution to the cliff could see businesses start to become more confident in making investments, setting the stage for earnings growth to accelerate into 2014.

The consensus estimate for 10% earnings per share (EPS) growth in 2013 appears inconsistent with macro data points such as global PMIs. In fact, this analyst optimism appears especially at odds with the recent spate of guidance revisions and earnings cuts. A 4% increase is more likely, but the good news is that downside risks are limited. The outlook for capital spending later in 2013 is improving, and imbalances are limited in the corporate sector, especially in economically cyclical sectors like autos, financials, and housing where many previous excesses have been washed out. Strong balance sheets will help many corporates weather any potential storm. The combination of 4% earnings growth, the 2%+ dividend yield, and a mild re-rating should generate a return of around 10% for the S&P 500 Index. Even in a bearish environment, where earnings dip 5% to 10%, the index may be able to eke out a small positive return.

Given the risk of a slowdown in 2013, a full-fledged rotation out of defensive stocks is not warranted, despite cyclical stocks appearing cheap on a relative basis. Barclays recommends cautious positioning with incremental exposure to capital-spending leveraged cyclical names. There is considerable downside risk to consumption given the tax implications of the fiscal cliff. Barclays is therefore underweight consumer discretionary and materials. The authors expect to see outperformance from enterprise tech, health care, and utilities and remain market weight consumer staples, energy, industrials, and telecommunications.

"Cross-Asset Strategy, 2013: Transition Path"

Gregory Peters et al., Morgan Stanley, December 12, 2012

Expect more of the same in 2013, with tailwinds carrying equity markets upward into 2014. Central banks have removed much of the tail risk in equity markets and will continue their quantitative-easing efforts. Despite expensive valuations, look for stocks to continue to trade higher, especially in Europe and emerging markets. The fixed income market remains overbought, but do not expect strong flows back into equities as investors will likely wait for stronger fundamentals.

The past year proved to be surprising for many investors and analysts that had forecasted low returns. Despite periods of significant volatility, most equity markets were in the black as central

banks forced investors into riskier assets, especially those that generate yield. The coming year is likely to bring more of the same, with several important differences. Tail risks have been lowered given European Central Bank action, so markets will not re-rate again without sufficient improvement in fundamentals. A related point is that more expensive valuations mean returns to risky assets will be lower in 2013. Finally, whereas previously macro risks seemed asymmetrically skewed downward, 2014 could be the first "normal" year since before the financial crisis. Markets could begin to price that in later in 2013.

The macro environment should improve in 2013. Global growth should come in at 3.1% (the same as 2012), with emerging markets expanding at a pace of 5.4% and developed markets, 0.7%. To be sure, the global economy still faces some of the same headwinds, which include deleveraging by western economies, the fiscal cliff in the United States, and the debate over austerity in Europe. However, the good news is that policymakers are taking more decisive actions to prevent a deepening global recession, and some structural reforms are beginning to bear fruit. The wildcard is probably the emerging markets, where economies are not as reliant on policy to resume cyclical growth, though some are transitioning from a "broken" export-led growth model toward a more sustainable domestic demand–led one. This transition might not be smooth. Growth in China and avoiding a "hard landing" will also be key to determining the upside potential of emerging markets.

Morgan Stanley is transitioning its equity recommendation from underweight to overweight, but remains cautious for two reasons. The high-yielding fixed income assets we preferred a year ago are now significantly more expensive and will generate lower returns, but the underlying conditions pushing investors into these assets (i.e., quantitative easing, zero interest rate policy) are not expected to change anytime soon. As well, though potential equity returns look a bit higher, their valuations have also risen and these potentially higher returns are accompanied by substantially more risk. Relative growth and earnings prospects will be critical for relative equity performance in 2013. Within equities we have a preference for emerging markets and Europe over the United States. The United States has outperformed in recent years based on superior earnings growth, but EPS may be poised to disappoint consensus expectations. In contrast, Europe outperformed in 2012 due to multiple expansion despite lackluster earnings growth. EPS growth in 2013 may also disappoint, but Europe still offers more upside from a valuations perspective. Asia ex Japan may offer the most upside, as prospects for macro improvement are relatively better, yet valuations and earnings expectations are muted. Overall, we believe there is little potential for broad-based upside surprise to earnings forecasts, though there is upside potential if multiples re-rate.

Fixed income markets offer limited opportunity in 2013 given that yields are at or near record lows and potential returns will be much lower. Still, there is no reason to believe that a sell-off is imminent. Technicals are supportive. Factoring in Fed asset purchases, the net pool of available fixed income products for private investors could shrink to only a couple hundred billion dollars. Second, credit returns may be lower but they have been much less volatile, which has driven a secular bid for the asset class that will not reverse quickly. The risk for fixed income at this point is that current yields offer little cushion against higher rates

(for example, it would only take a 25 basis point move higher on the ten-year Treasury to push the total return into negative territory). However, we do not expect a mass re-allocation from fixed income back into equities until the macro environment looks set to improve notably. Within fixed income, we prefer bunds to Treasuries given a better U.S. macro picture; we are long Italian and Spanish sovereign bonds given the eventual implementation of outright monetary transactions; we are long European credit vs U.S. credit; we are long U.S. dollars over yen; and we are buying gold on concerns over long-term inflation.

As noted, markets are likely to remain volatile in 2013, especially during the first half of the year. Investors are increasingly focused on the fiscal cliff in the United States, but other serious risk factors—such as uncertainty about the depth and length of current recessions in Europe and the United Kingdom, voter backlash against austerity in peripheral countries, material policy change in Japan, and the strength of the Chinese recovery—are still in play and will likely weigh on returns in the next six months. However, central banks have reduced systemic risks and should remain extremely supportive of markets in the near future. Growth should start to improve in several regions in 2013 as structural change takes hold in places such as peripheral Europe and emerging markets. These factors suggest a comparable outlook for 2013 to 2012 and an even better prospect for 2014. ■