Annual expected return for US equities averaged over 10 years

GDP growth in the US could quicken to 3% in H2 2013 according to our core scenario

We are forecasting 7.6% GDP growth in China in 2013

The S&P 500 is up by 12% for the year to date, putting it ahead of the STOXX Europe 600 (+11%)

The price of crude oil looks set to hover between USD100 and USD115 a barrel in the early part of 2013

The Ifo’s Business Climate index for German industry advanced to 101.4 in November

The crux of the challenge in 2013 will be a rebooting of the credit cycle in the US

Average number of years the deleveraging cycle lasts in the private and public sectors

2013: a challenge offering some hope in an unsettled climate

December 2012
No return without volatility

Traumatised by the memory of two 50% drops in equity markets over less than a decade, investors have developed an in-built aversion to extreme volatility. Their frantic search for stability has resulted in massive flows to the bond markets and a steady weakening in the flow to equity markets. What are current prospects for returns from the major asset classes on a 10-year horizon?

Expected returns from asset classes (2013-2022)
(Nominal figures and total returns - assuming mean reversion)

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>Expected Return</th>
</tr>
</thead>
<tbody>
<tr>
<td>USD liquidity</td>
<td>2.6%</td>
</tr>
<tr>
<td>US Treasury bonds</td>
<td>1.0%</td>
</tr>
<tr>
<td>Corporate bonds (investment-grade)</td>
<td>2.8%</td>
</tr>
<tr>
<td>High-yield bonds</td>
<td>7.3%</td>
</tr>
<tr>
<td>US equities</td>
<td>6.5%</td>
</tr>
<tr>
<td>EU equities</td>
<td>7.4%</td>
</tr>
<tr>
<td>Asian equities</td>
<td>6.1%</td>
</tr>
<tr>
<td>Private equity real estate (IRR)</td>
<td>6.0%-8.0%</td>
</tr>
<tr>
<td>Private equity (IRR)</td>
<td>12.0%-15.0%</td>
</tr>
</tbody>
</table>

Source: Pictet Wealth Management, IA & MR

A cursory look at these expectations leads to the inevitable conclusion that those assets considered safe are now valued at levels that almost certainly imply negative returns after inflation over the next decade. Assets perceived as riskier, while not offering exceptional returns, will probably be able to maintain their purchasing power over this horizon. Obviously, there is no such thing as a free lunch. In a period of financial repression, the aim of governments is to transfer wealth from creditors to debtors. Inflation is one means to achieve that end. This is true in the United States, where inflation-linked Treasury bond yields are negative for all maturities up to 20 years. Peace of mind has never been more costly to achieve in living memory. The alternative choice of real assets, mainly equities, will certainly prove more attractive in the long term, but only at the cost of high volatility. Indeed, until the battle to reflate the Western economies has been decisively won, assets that benefit from this scenario, with equities foremost, are expected to remain highly volatile. In particular, new shocks with
drops of at least 30% in equity markets cannot be ruled out. The rebounds that follow these downturns will be even more spectacular.

Since the beginning of the year, our investment scenario has envisaged a rise in volatility. The opposite has occurred because of the activism of central banks. However, macroeconomic risks remain high and endogenous factors continue to point to an increase in volatility in 2013. Therefore, any relaxation in the political will in developed economies to manage the deleveraging cycle, or any problems in the transition of the Chinese economy towards consumption and services, is likely to lead to a brutal return of volatility. Our best advice in this context is to help our clients structure their assets so as to be ready to go through these periods of instability calmly. Such periods should be seen as opportunities, and it would be wrong to try to eliminate volatility risk at all costs, which would kill performance in the medium term.

I would like to thank all our clients and partners for their loyalty and support, and to express our very best wishes for the holiday season on behalf of the whole investment team at Pictet Wealth Management.

*Perspectives* is also available to download. Sign up to subscribe and keep up-to-date online with our views on markets, the economy and key underlying trends on the *Perspectives* website: http://perspectives.pictet.com
Global economy still in 3GD mode in 2013

The 3GDs – ‘Great Deleveraging’ in the US, ‘Great Divergence’ in Europe and ‘Great Dynamics’ in the emerging world – look set to continue shaping the economic landscape in 2013. The economic growth picture will be mixed in 2013, with economic policies lacking overarching coordination.

Christophe Donay*, Bernard Lambert, Jean-Pierre Durante and Laurent Godin – *With Wilhelm Sissener

The process of Great Deleveraging in the US is moving into its next phase. The private sector may well embark on a new round of the credit cycle as its financial surplus has recovered to historically high levels. Europe is on course to splutter along with anaemic growth as the Great Divergence continues to hold sway. The Great Dynamics in emerging nations should be confirmed during 2013 as economies are projected to generate growth of close to 4.5%.

The process of Great Deleveraging in the US is entering its next phase. The private sector, encompassing both businesses and households, is currently sitting on handsome financial surpluses and does appear prepared to embark on a fresh round of borrowing again. The Federal government will also increase debt further even though it is already running at high levels. It can now be reasonably assumed an uptrend in consumer credit and lending to businesses will become more firmly rooted. As housing prices are beginning to climb again, mortgages might also start to recover. This could generate more self-sustaining expansion in US GDP, helping the economy to regain momentum in the second half of 2013.

In the near term though, the US economy faces the challenge of two very specific systemic risk factors: (1) the so-called ‘fiscal cliff’ and (2) talks about raising the Federal debt ceiling again.

As for Europe, the Great Divergence, a term we have employed to describe the diverging trajectories of economic growth (slowing down) and government debt levels (climbing), which lies at the root of the debt-induced systemic crisis, should become even more entrenched in 2013 as GDP growth grinds virtually to a standstill and the economic competitive edge remains blunted. On the debt front, as two of the three major options available to cope with governments’ debt mountains – i.e. fund transfers, primarily via the European Stability Mechanism (ESM), and monetisation of the debt – i.e. fund transfers, primarily via the European Central Bank’s long-term refinancing operations (LTRO) and Outright Monetary Transactions (OMT) programme – have already been deployed, eurozone policymakers and the IMF will have to acknowledge the pressing need to wheel out the third ‘big gun’, i.e. restructuring of public debt for those countries struggling with persistent financing troubles.

The Great Dynamics in the emerging world could well accelerate to slightly above 3% by the second half of 2013. The economic outlook for the US remains shrouded in uncertainties. To start with, owing to all the disruption and upheavals caused by Hurricane Sandy in late October and early November, it is very hard to ascertain whether the gently accelerating growth registered in Q3 2012 will be carried over into Q4. Moreover, even though spokespersons from the Democrat and Republican camps have both waxed lyrical about constructive talks, with very few weeks remaining before politicians depart Capitol Hill for their Christmas holidays, little progress has admittedly so far been made in the whole debate over how to negotiate the looming ‘fiscal cliff’. We stick with our view that a deal will be struck, presumably not until the eleventh hour. Unfortunately, as last year, any compromise agreement might well do little more than delay the main hikes in taxes and proposed spending cuts for a few more months, and postpone the hard-graft bargaining to some later date.

Our economic scenario for 2013 resembles one for a game of two halves. The early part of the year will most likely be challenging. The need for the US Federal debt ceiling to be raised by early March 2013 at the latest seems very likely to result in political upheavals dragging on throughout most of the first quarter. Much the same can be said for any stopgap solution to the ‘fiscal cliff’ problem. Moreover, we are likely to witness the temporary blip of a slowdown in the economy even though we do believe Congress will push through measures to restrict negative knock-on effects from the ‘fiscal cliff’ to around one percentage point of growth. After that early bumpy ride, things should noticeably improve. The credit cycle seems likely to advance encouragingly, house prices should extend their rally and the recovery in housing construction gather momentum. Furthermore, monetary policy will remain supportive and the global economic climate should gradually improve. Given that overall outlook, we are projecting in our core scenario that US GDP could accelerate to slightly above 3% by the second half of 2013.

If Greece were going to return to the path of sustainable debt, a second round of debt restructuring had become practically unavoidable

Unmistakable signal about wanting Greece to stay in the euro

Eurozone policymakers at last managed to agree on a deal on Greece. If Greece were going to return to the path of sustainable debt, a second round of debt restructuring had
become practically unavoidable. Given the constraints inherent in the eurozone though, this option is, to all intents and purposes, a non-starter as Greece’s public debt is now two-thirds-owned by a range of public-sector bodies (member states, ECB, EFSF/ESM). Key clauses relating to financing of member states in those treaties in force strictly forbid any reduction in debt principal. In the end, several avenues were explored to avoid this particular stumbling-block and still lighten Greece’s debt burden: interest rates levied on bailout funds were lowered; profits earned from Greek debt owned by the ECB were returned to Greece; a 10-year moratorium was established on payments of interest on loans from the EFSF; debt held by private-sector creditors was repurchased.

The steps taken will probably still turn out to be inadequate, and many of the underlying assumptions made look too upbeat. Nevertheless, there is little doubt that, by eliminating debt in the hands of private-sector creditors and lowering debt-servicing rates to marginal levels, Greek debt is clearly being pared back closer to more manageable levels. With this deal, the eurozone has sent an unequivocal message that it wants Greece to stay in the euro, thereby dispelling many of the fears about the single European currency being torn apart. The markets’ attention may now well refocus on other peripheral member states that could lay claim to similar bailout terms and conditions. The danger of a referendum being called on Catalonia becoming independent makes any request for financial aid from the Spanish Prime Minister Mariano Rajoy even more problematic than before. Lastly, as even Germany is now suffering a slowdown, the debilitated state of the economy may well become a serious impediment to chances of exiting from the crisis in 2013. With the recession biting deeper, doubts over the real level of debt in member states already in difficulties are likely to remain in the forefront of financial markets’ collective mind.

China: overview of the outlook now the new Politburo has been appointed

China has embarked on a period of transition, with its two-stage changing of the political guard in Beijing. The first phase, the 18th National Congress of the ruling Communist Party of China, was completed on 15 November when the new Politburo was elected, to be headed by Xi Jinping, the party’s new General Secretary and Chinese President-in-waiting. The National People’s Congress will bring the interregnum to a close when it is convened in March 2013, the key event being Li Keqiang’s likely confirmation as China’s new Prime Minister.

The new Politburo is the fifth generation of leaders in the People’s Republic. They will be taking up the reins of office just as China’s economy reaches a key crossroads. After almost thirty years of exponential growth (per capita GDP as measured by purchasing power parity rose from USD525 in 1979 to USD8,400 in 2011), the Chinese economy is confronted today by a fresh array of challenges: slowing growth; widening inequalities; investment being disproportionately too weighty in GDP; a blunting of the economy’s manufacturing competitive edge relative to regional rivals. The major challenge remains to steer China towards becoming a member of the elite club of wealthy economic nations. We would not expect, however, to see much by way of radical reforms in the early days. The new leadership team will undoubtedly pursue a gradualist approach.

We would expect the authorities in Beijing to continue pursuing those supportive measures that have helped to stabilise economic growth since Q3 2012. Since October, the evidence has shown that infrastructure investment programmes, a more accommodating lending policy, an upturn in construction work and a rebound in exports have delivered gentle acceleration in growth. More recently, the Purchasing Managers’ Index for China as compiled by HSBC moved back above the key 50-point threshold for the first time since October 2011. Crucial components, such as industrial production, new orders and exports, have all been pointing towards an improving situation.

Nevertheless, we are sticking with our growth scenario for 2013. We expect China’s GDP to expand by 7.6% as the economic model gradually shifts to a healthier structural balance for expansion with greater reliance on domestic consumer spending.
STRATEGY

Dark economic skies should give way to clouds breaking up in 2013

The ‘fiscal cliff’ and the Federal debt ceiling in the US, along with systemic risk in Europe, may well exert a progressively diminishing impact on financial markets over the next few months, especially after the opening quarter of 2013.

Christophe Donay*, Chloé Koos Dunand, Jacques Henry, Laurent Godin, Yves Longchamp 
*With Wilhelm Sissener

Our approach to asset allocation based on risk factors had led us to conclude that, during the course of 2012, monetary policy and systemic risk have played the most influential roles in dictating movements in pricing of the various asset classes. A shift in the prevailing active risk factors seems most likely as we move through 2013.

According to our approach to asset allocation based on six risk factors, we arrived at the conviction that, during the course of 2012, monetary policy and eurozone-debt-related systemic risk have been the two active risk factors playing the most influential roles in dictating movements in pricing of the various asset classes. The prevailing macroeconomic climate liable to keep these two factors holding sway as crucial influences on how asset classes behave seems most likely to remain in place.

Nevertheless, our core scenario envisages that, firstly, the economic cycle and, secondly, the corporate earnings cycle may well re-emerge as the active risk factors as 2013 unfolds. If that does indeed happen, equities could well deliver superior returns for investors than either investment-grade corporate bonds or sovereign debt, both currently prized as the safest investment havens. Armoured-plated government bonds, like US Treasuries or German Bunds, have seen their yields sink to their lowest levels for decades. They now offer coupon rates on such securities are delivering returns below nominal rates of GDP growth for their respective economies. Furthermore, coupon rates on such securities are delivering returns below nominal rates of GDP growth for their respective economies. Some selected investment-grade corporate bonds issued by borrowers in those eurozone countries that have run into financial difficulties might, however, benefit from further spread tightening.

Equity markets in the developed world have not moved much since October amid pretty lacklustre trading. Average daily dealing volumes for companies in the EURO STOXX 50 have been running at EUR4.5bn, quite close to the lowest ebbs normally seen during the end-of-year festive season. So far in 2012, the S&P 500 has advanced by just under 12%, the Europe STOXX 600 by just over 11%. The main locomotive driving share prices higher in 2012 has been expanding valuation ratios: the P/E ratio on Wall Street has risen from 11.9X to 13.6X, the European multiple from 9.6X to 12.2X. It is worth noting, however, that the main thrust of multiple expansion in Europe has been eroded by downgrading of earnings estimates. We have basically been witnessing a clash of two opposing trends in 2012: on the one side, austerity trends have been squeezing margins and profits in Europe; on the other, measures pushed through by the ECB – its long-term refinancing operations (LTRO) to boost liquidity and its Outright Monetary Transactions (OMT) to help bail out those countries in difficulty – have served to diminish systemic risk associated with ballooning eurozone debt.

Equity markets look likely to remain fairly directionless over the next few weeks. From Q2 2013 on though, the economic cycle in the US can be expected to regain momentum. That would give a boost to the earnings cycle not just for US companies, but also for European groups as, historically, their cycles have run fairly parallel with each other. Given this outlook, equities on developed markets should be capable of delivering annual returns of 12%-15% for 2013.

Outlook for currencies in 2013
Investors’ aversion to risk is likely to remain high over the next few months on account of the talks in the US over the ‘fiscal cliff’ and the Federal debt ceiling, coupled with the ongoing crisis in Europe where the whole issue of solvency has not yet been satisfactorily dealt with in the

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### FINANCIAL MARKETS

Local-currency returns in % from financial markets. Data as at 30.11.2012

<table>
<thead>
<tr>
<th>Index</th>
<th>Since 30.12.2011</th>
<th>Previous month</th>
</tr>
</thead>
<tbody>
<tr>
<td>US equities*</td>
<td>USD S&amp;P 500</td>
<td>15.0%</td>
</tr>
<tr>
<td>European equities*</td>
<td>EUR STOXX Europe 600</td>
<td>16.5%</td>
</tr>
<tr>
<td>Emerging-market equities*</td>
<td>USD MSCI Emerging Markets</td>
<td>13.1%</td>
</tr>
<tr>
<td>US government bonds*</td>
<td>USD ML Treasury Master</td>
<td>2.1%</td>
</tr>
<tr>
<td>US investment grade*</td>
<td>USD ML Corp Master</td>
<td>10.4%</td>
</tr>
<tr>
<td>US high yield*</td>
<td>USD ML US High Yield Master II</td>
<td>13.8%</td>
</tr>
<tr>
<td>Hedge funds</td>
<td>USD Credit Suisse Tremont Index Global**</td>
<td>5.4%</td>
</tr>
<tr>
<td>Commodities</td>
<td>USD Reuters Commodities Index</td>
<td>-2.1%</td>
</tr>
<tr>
<td>Gold</td>
<td>USD Gold Troy Ounce</td>
<td>9.1%</td>
</tr>
</tbody>
</table>

* Reinvested dividends/coupons  ** End-October

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Perspectives | December 2012
circumstances, defensive currencies, such as the US dollar or yen, should gain ground against European currencies.

Looking ahead 6 to 12 months, we expect European systemic risk to subside, with two risk factors becoming the dominant forces: monetary policy and the economic cycle. Overall, economies should gradually pick up some speed again, which would support commodity currencies at the expense of defensive currencies.

The euro and the pound should be able to make up some ground during 2013 as the intensity of the crisis in Europe loses some of its heat and economic growth prospects improve. As for the franc, we expect it to hold steady against the euro in 2013.

Commodities closing 2012 in the black

With optimism tentatively resurfacing in the markets, prices of precious metals bounced upwards during November. Buoyed by some heartening economic data being released, chiefly for the US and China, prices rebounded and, at the time of writing, commodities’ performance for the year to date was back in the black after still being in the red in October.

The spike is, however, likely to be short-lived, principally on account of concerns about the US ‘fiscal cliff’ and the ongoing eurozone crisis, both factors that could trigger upheavals on the markets in the early part of 2013. Further into 2013 though, we would expect the manufacturing cycle to return to a more sustained tempo of growth, which would push commodity prices back up. The price of oil seems likely to hover between USD100 and USD115 a barrel early in 2013, putting on a further USD5 in the second half of the year.

Improving prospects likely for Asian equities

After a disappointing year for emerging equities in 2011, they enjoyed a change of fortunes in 2012 as their absolute and relative returns rebounded quite noticeably.

In the ‘Equities’ asset class, Asian markets (excluding Japan) have been the best performers: the MSCI Asia ex-Japan index is ahead by 16.7% for the year to date (up to 23 November), putting it ahead of the MSCI World (+13.4%) and the S&P 500 (+14.3%). The wavering by Asian markets in the earlier part of 2012, as the focus alternated between the negatives of macroeconomic risks (sluggish growth in Europe and America; eurozone debt crisis; slowing Chinese economy) and positives of earnings growth in Asia outside Japan, was followed by a more energetic rally from September, which would appear to suggest investors have turned more confident about economic dynamism in Asia.

We would highlight five key points likely to work to the advantage of risk-based assets, especially Asian shares: (1) a stabilising global economy, accompanied by a rebound in growth in Asia; (2) a halt to the contraction of Asian central banks’ balance sheets; (3) a recovery in corporate earnings forecasts; (4) a consistently attractive valuation for equities in both absolute and relative terms; (5) greater propensity towards taking risk on board.

Nevertheless, it would be misguided to ignore those threats still hanging over Asia’s equity markets. Corporate profitability is being undermined by the slower rates of growth after the years of hefty investment in production capacity and by anaemic exports. Moreover, levels of corporate debt, measured as

bank lending as a percentage of GDP, have risen quite steeply in Asia to reach 108%, the highest ratio since before the Asian financial crisis in 1997-1998.
Distinct upturn in indicators
The global economy appears to be stabilising, with pockets of improvement visible in some flagship economies. Switzerland registered GDP growth in Q3 2012 that beat expectations.

0.9%
The impact of Hurricane Sandy on the US economy is starting to become visible. Manufacturing output fell by 0.9% in October, well short of consensus expectations. The Federal Reserve Board is of the opinion, though, that, with the hurricane effect stripped out, manufacturing production would have been flat between September and October.

2%
GDP growth in Brazil is set to fall short of 2% in 2012, a marked slowdown from an annual rate of growth averaging 5% between 2004 and 2010.

Aa1
Moody’s cut its rating on France’s long-term sovereign debt from the top triple-A grade to Aa1, accompanied by a ‘Negative’ outlook tag. The agency believes that long-term growth prospects will be hampered by a loss of competitiveness and that France’s capability to withstand any future shocks in the eurozone is diminishing.
The Narodowy Bank Polski cut its reference interest rate by a quarter-point to 4.5% after downgrading its growth forecasts for Poland’s economy for 2013.

The Ifo’s Business Climate index for German industry advanced in November to 101.4, up from 100 in October, after six months of falling non-stop.

Switzerland recorded much more vigorous GDP growth in Q3 2012 (+2.3% annualised q-o-q rate) than had been expected. Employment also recorded a 1.9% rise y-o-y.

The yen fell 3.5% against the US dollar in November, making it the major currency loser over the month.

The Manufacturing PMI for China progressed from 49.5 in October to 50.4 in November, taking it to its highest level for 13 months and pointing towards an upturn in the economy.
Equities looking well placed for 2013

Shares could well move higher in 2013 although successful outcomes to talks in the US about the ‘fiscal cliff’ and raising of the debt ceiling, coupled with further progress being made towards resolving the eurozone debt crisis, will be needed for any such rally to materialise.

Equities

More upside to come in 2013

Markets are likely to remain in ‘wait-and-see’ mode in the run-up to the year-end. Renewed forward momentum in the economic cycle during 2013 should give a boost to the corporate earnings cycle, suggesting some interesting upside potential for equities.

The risk factors most influential for equities during 2012 have been European systemic risk and monetary policy. As we near the year-end, uncertainties over the ‘fiscal cliff’ are still weighing heavily on the markets so we would expect to see equities in the developed world remaining fairly tightly range-bound, as they have been since mid-September.

Once these fears have been dispelled, under our baseline scenario for 2013, risk factors influencing markets should switch to work in favour of the economic and corporate earnings cycles. We are looking for the following probable sequence of events: (1) economic growth in the US regains a modicum of stability from Q2 2013 before accelerating; (2) this upswing will feed through into an improving cycle for US company profits; (3) despite still anaemic growth in Europe, the earnings cycle for European groups should also show signs of picking up, as the evidence of the past 15 years reveals that earnings cycles on both sides of the Atlantic track each other quite closely; (4) at today’s levels, the potential for multiple expansion looks quite limited in Europe, but there does appear to be a little more scope for the US; (5) if this scenario does materialise, upside for equity markets should work out at around 12%-15% for 2013.

Bonds

An asset class looking at risk

The crisis upset the pre-existing supply/demand balance for savings. The new equilibrium may well be established at higher rates of interest.

As expected, uncertainties over what to do with Greek debt and worries over the US ‘fiscal cliff’ worked to the advantage of safe-haven instruments. Yields on benchmark 10-year US Treasury bonds fell back below 1.60% by mid-November. Subsequently, the prospect of a deal being secured to avoid the worst of the ‘fiscal cliff’ encouraged investors to turn away from safe havens. Yields on 10-year T-bonds duly moved back up some 10 or so basis points.

The outlook for this asset class will be permanently blighted by repercussions from the crisis. The supply/demand balance that existed pre-crisis is no longer valid. Firstly, governments’ and the private sector’s ballooning debt has fuelled increased demands for financing. Secondly, as the recession bit, households sought to maintain standards of living by drawing down their savings, causing the supply of financing to dry up. This squeeze could well result in the new supply/demand equilibrium being cemented at higher rates of interest.

The rebalancing may not, however, occur straightaway. As long as central banks are intervening to pull economies out of the crisis, rates on safe-haven bonds might well stay low for some time to come. Despite this, the threat of structurally higher interest rates does warrant erring on the side of caution with regard to this asset class.

Corporate bonds

Corporate bonds running out of steam

After four years of outstanding returns, further upside on credit-risk instruments looks to have considerably diminished. As the crisis has not yet been completely resolved, there are still some attractive possibilities in some areas, but investors would be best advised to be more discriminating.

For the fourth year in a row, corporate bonds look set to generate a decent annual return for investors. After +19.8% in 2009, +9.5% in 2010 and +7.5% in 2011, the annual return from investment-grade bonds for 2012 to date stands at +9.9%, a total gain of almost 55% since end-2008.

The cumulative gain over the last four years compares very favourably with that for US Treasuries (+14.5%), but is still some way short of equities, (S&P 500: +70%) and high-yield corporates (+114%).

The best sector performances this year have come from brokers (+14.3%), banks (+14.0%) and finance companies (+13.7%). The laggards have been technology groups (+4.2%).

After four such exceptional years, valuation has become an issue. Returns in recent years have been fuelled by factors whose influence is progressively fading as the crisis nears its end. Upside on ‘safer’ investment-grade bonds looks limited, especially compared to equities. In contrast, the riskier high-yield bonds do seem to offer some appeal still as the crisis, most notably in Europe, has not yet been consigned to the past.
Hedge funds

Back to fundamentals

The increased dispersion across risk assets created opportunities for fundamentally-orientated strategies.

The HFRI Weighted Composite Index was down 30 basis points, but estimates from mid-November suggest a partial recovery may be in the making. Although global stock markets succumbed to an aversion to risk assets in October, dispersion in equity markets increased – particularly in Europe – thanks to a reduction in systemic risk. The absence of unexpected shocks to global markets in November suggests another fundamentally-driven month for long/short equity managers. Hedge funds that employ deep fundamental research to select stocks and generate alpha were able to navigate Europe’s earnings season. Global macro managers generated mixed results as many had a ‘risk-on’ positioning going into October. Nonetheless, they remain constructive and want to remain ‘risk-on’ in the weeks ahead. Credit strategies again contributed strongly to returns for event-driven funds whereas merger arbitrage strategies detracted owing mainly to the collapse of two Canadian deals: Petronas/Progress Energy Resources and BCE/Astral Media.

Precious metals

Excellent returns from precious metals

With optimism being restored on the markets, prices of precious metals bounced upwards.

During November, we saw some degree of optimism return to the markets, buoyed by some encouraging economic numbers released in the US and China. Commodity prices were boosted by this, with the weakening dollar being an additional factor of support. During the month, the dollar price of palladium posted the steepest rise (up by just over 10%) whereas the bullion price moved 40 dollars higher from its low point at the outset of November, levelling off at around USD1,740 an ounce.

Rebounds in the prices of precious metals used in industry are, however, likely to prove a temporary spike as the US still has to cope with the looming ‘fiscal cliff’ and the Chinese upswing still needs to be further confirmed. The decent showing in November does point to some attractive rebound potential for the second half of 2013 when we would expect the industrial business cycle to have developed more sustainable momentum. Until then, gold looks likely to be the only metal capable of exhibiting a fairly stable price trend.

Currencies

Strong pressures pushing yen lower

Political uncertainties and the Bank of Japan’s quantitative easing exerted intense downward pressure on the yen.

The biggest loser on currency markets in November was the yen which lost 3.5% of its value against the US dollar. Its downtrend can be blamed on the latest quantitative-easing moves by the Bank of Japan (BoJ) and the unsettled political scene in the run-up to Japan’s early general election. The main opposition party leader, Shinzo Abe, is keen to restrict the BoJ’s independence and raise the inflation target from 1% to 3%, highlighting the risks to the economy posed by the strong yen.

The euro closed November at around USD1.30, the exchange rate barely changed compared to the start of the month. This stability on the surface masks the fact that the rate swung around during the month. The euro’s value fell as low as USD1.2662 in response to the Troika’s difficulties in securing the financing package for Greece. In the end, the reaching of a deal, coupled with some reassuring economic data coming out of China, helped the euro to rebound.

The Swiss franc stabilised at around CHF1.2040 to the euro, which would appear to be its new equilibrium rate.

As for forex-market strategies, carry trade delivered a positive return of 0.7% whereas the more defensive value approach recorded a loss of 0.6%.
We have described the US economy as being subject to the phenomenon of the ‘Great Deleveraging’. Europe is being influenced by quite different dynamics: the ‘Great Divergence’. As the US nears completion of the first stage of its deleveraging cycle, Europe is barely embarking on its odyssey. The gap of some three years between these two economic zones is fuelling hopes – once again – of growth regaining some momentum in the US. The recovery cannot, however, be taken for granted. A series of political hurdles need to be overcome before the US economy can successfully generate its much needed growth. Decisions to be made over the next four months on how to negotiate the ‘fiscal cliff’ and on raising the US Federal debt ceiling will be critical.

Two golden rules for economic growth

The economy is subject to operating rules. We have singled out two in particular that are essential for understanding how economic cycles are formed and how they can be forecast.

The first is as straightforward as rules can be: unless the credit cycle is strong, economic growth cannot either be long-lasting or match potential. Put differently, economic growth will only sustainably reach its potential if one of the economic agents – households, businesses or even the State – is prepared to shoulder the burden of debt to enable all to enjoy growth that is beneficial to all. If none of them wants or can cope with the buck being passed onto them, growth will grind to an abrupt halt and the economy will plunge into deep recession.

The second rule: sustainable economic growth in the developed world will only be feasible if the twin motors of investment/employment are generating solid forward momentum.

So, who’s going to shoulder the burden of debt? The challenge in the credit cycle

Since the sub-prime crisis exploded, credit mechanisms in the private sector, encompassing both households and businesses, have broken down in the US and Europe, and throughout developed nations. Looking back at the 2008-2012 period, we can pinpoint quite different dynamics relating to debt in the US for the three different categories of economic agent:

• households: busy running down their debts, matched by the Fed’s wholesale pumping-in of liquidity;
• the US Federal State: debt levels soaring to all-time highs;
• businesses: genuinely capable of taking on more debt, but refusing to borrow owing to the fog of invisibility clouding expected returns and payback on their investments – all the surplus cash is sitting idly on companies’ books, not being converted into either capital spending or jobs.

Mending these broken credit mechanisms will be vital to nurture any expectation of a return to healthy and sustainable growth. The full workings of credit mechanisms unfold over long economic cycles. Although the capability of one of the economic agents to take on debt is vital for growth, that alone is not enough. It must be accompanied by robust momentum in investment and employment. That brings us neatly back to the second inescapable rule of thumb for modern economies we cited earlier.

Four phases in the deleveraging/leveraging cycle

Modern economic history has turned up evidence of around thirty countries that have experienced leveraging/deleveraging cycles since World War II. The most recent examples in Sweden and Finland are most enlightening. Their experience points to the fact that the whole deleveraging cycle, involving both private and public sectors, takes on average eight years to run its full course. That implies the deleveraging/leveraging cycle together stretches over twelve to fifteen years, split into four distinct phases. The same rules apply to North American and European economies as a whole. Europe is only just moving into Phase III whereas the US is reaching the end of the whole process as the sequencing pattern below shows:

by 46 percentage points from 135% to 181%. By 2008, the ratio of household debt to disposable income rocketed to 128%.

- Phase II (2008-2009): financial shock. Households’ mountains of debt triggered a financial crisis. In 2008, just when households were on the verge of financially crippling themselves, the sub-prime crisis flared up. Households suddenly stopped borrowing. Many went bankrupt, leaving banks saddled with huge volumes of bad debt they had to clean up from their books. Credit mechanisms in the private sector went into deep-freeze. A harsh recession immediately ensued. GDP shrank by 5% as the economy contracted on a scale not seen since the Great Depression of the 1930s.

- Phase III (2009-2012): deleveraging in the private sector. Households pressed ahead with running down their debts – the private debt/GDP ratio for the US fell by 20 percentage points and the household debt/disposable income ratio retreated to 107%. At the same time, businesses’ finances were in fine shape, but companies were unwilling to take their turn at shouldering the burden of debt. The recession bit deeper and the economy teetered perilously on the brink of a real depression. The government, whose debt level was not particularly high at that point in the cycle, did step up to the plate to shoulder the debt. During this third phase, the public-sector debt/GDP ratio for the US rose by 20 percentage points.

- Phase IV (2013-?): in this fourth and final phase, lending to the private sector should resume and the State eventually begin to scale back its borrowings. Tentative signs of consumer credit picking up again have surfaced in recent months, but it may be too early to infer from this that a fresh credit cycle is taking hold in the US.

As we now stand at the end of 2012, the US economy is halfway through the eight years of the full deleveraging cycle typically experienced by economies that have gone through the whole sequence of leveraging ==> overindebtedness ==> deleveraging.

2012: a lynchpin year; 2013: the year of challenge
Looking at those phases, we can see 2012 is ending on a more upbeat note: US households have deleveraged and are no longer overstretched. The ball of private-sector excess debt was volleyed into the public sector’s court as the government deficit has been deepening at a rate of 10% a year. In turn, the State is now moving towards the end of its four-year phase of being overindebted. The public debt/GDP ratio has climbed to 100%, just short of a new record high. There is unfortunately still quite a way to go on the US government debt front before we can see a sustainable upswing in the economy.

As a result, 2013 opens with a daunting challenge. Will the private sector embark on a new credit cycle? Meeting this challenge successfully will only happen if economic-policy decisions taken over the next four months are advantageous. These key decisions in the US relate to two major issues. To start with, the looming ‘fiscal cliff’. Talks between
TOPIC OF THE MONTH: THE CREDIT CYCLE

Republicans and Democrats about extending tax breaks and social-welfare benefits should come up with a deal by March. If these tax breaks, most of which date back to the Presidency of George W Bush, are not rolled over to some degree, growth will be badly damaged in 2013: the economy would plunge back into recession from the very outset of the year.

Secondly, as American households have mopped up their excess debt and might consider embarking on a fresh wave of borrowing, the government will still need to increase its debt. Only once private-sector debt mechanisms have become firmly rooted again will the State be able to launch into its deleveraging process. So, in 2013, we will not be witnessing the onset of deleveraging by the government, but more likely ongoing expansion in public debt. For that to happen, the obstacle of the statutorily imposed ceiling on Federal debt will have to be raised. America’s politicians will vote on whether to approve this in March.

If the obstacles of the ‘fiscal cliff’ and the debt ceiling are not negotiated skilfully, both are capable of stalling any resumption in the credit cycle. So, we are not only facing a serious challenge in 2013, but also an ocean of political uncertainties. The US is fast approaching a crossroads: one route heading towards self-sustaining credit growth, the other towards a lifeless economy. We should all know where things stand by the time we move into the second quarter of next year. Although hopes are high that more favourable economic mechanisms will kick in to operation in 2013, we do have trust that policy decisions do not cause the wheels and cogs of the economic machine to seize up again. On the plus side, when national interests are at stake, Republicans and Democrats have, in the past, cobbled together a compromise deal – albeit all too often at the eleventh hour.

For now, Europe is still struggling to find its way with precious little hope of any economic upturn round the corner. The deleveraging process in Europe is running around three years behind the US. Next year will not pose the same challenge for Europe whose still crisis-wracked economies desperately need to be consolidated. However, Europe’s political leaders will have to agree swiftly on how to cope with the debt troubles of distressed eurozone member states, otherwise Europe’s flagging economies will be unable to benefit fully from any positive knock-on effects flowing from the right decisions being taken in the US.

ECONOMIC HISTORY SHOWS THE DELEVERAGING CYCLE LASTS FOR 8 YEARS


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Glimmers of hope for the economic cycle

Economic numbers released in recent weeks in the US, China and Germany have pointed towards a gently improving situation. If that does prove the case, financial markets are likely gradually to focus more on dynamics in the economy as 2013 unfolds.

Data in charts and tables dated as of 30 November 2012

### Key Figures

#### Main Economic Indicators

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<tr>
<th>GDP Growth Rates</th>
<th>2010</th>
<th>2011</th>
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<th>2013E</th>
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<tr>
<td>US</td>
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<td>4.3%</td>
<td>3.7%</td>
<td>3.5%</td>
</tr>
</tbody>
</table>

#### Inflation (IPC)

Annual average, except year-end for Brazil

| US               | 1.6% | 3.2% | 1.9%  | 1.9%  |
| Eurozone         | 1.6% | 2.7% | 2.5%  | 2.0%  |
| Switzerland      | 0.7% | 0.2% | (2.6%)| 0.4%  |
| UK               | 3.1% | 4.0% | 2.7%  | 2.0%  |
| Japan            | (0.3%)| 0.5% | 0.7%  | 0.1%  |
| China            | 3.3% | 5.4% | 3.0%  | 3.5%  |
| Brazil           | 5.8% | 6.5% | 5.4%  | 5.6%  |
| Russia           | 0.6% | 0.1% | 0.7%  | 0.5%  |

#### Exchange-Rate Movements (Since 30.12.2011)

#### Commodity Returns

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