Market Outlook Review 4Q 2012 to 2Q 2013

Our methodology is simple. Its getting it right that's difficult. First of all, we observe, all the time, data, anecdotal evidence, trends, events and developments, everything. Then we postulate theses, what we think all the information evolving before us means. From these theses come predictions about the evolution of investable asset markets. This is the hard part. The next part is easy. We sit back and see if our predictions come true. If they do, we still ask ourselves if it is a coincidence or pure dumb luck, or if it was a consequence of our theses. If they don't, then we revisit our theses to see if they are still sound or valid. If they are not, then its back to the drawing board. We almost never rely entirely on the price evolution of the asset markets we are interested in. That's like forecasting the weather by looking out the window. We are not going to wait for a 20% drawdown in the market to inform us that we are in a bear market. That type of signal is ever so slightly late.

Since early October 2012 we have had an overweight on US (the S&P is up 13% from then till now (9 May 2013)), and UK equities (the Footsie is up 11.77%) and an underweight in German (DAX +6.12%) and China domestic listed equities (SHCOMP +5.23%). These were not based on drawing straight lines or smoothed lines through charts but our expectations for the performance of the respective economies, the psychology that transmits such fundamentals to markets and an analysis of the flows of capital to the underlying companies, most of which are global in nature and which thus confound traditional country delineated asset allocation techniques. Happily this view has worked and I have no reason to change the view so far.

The slowdown in the global economy is as expected. In China, it is the continuation of a longer trend, of an economy maturing and facing growing pains, and growing linearly without addressing speed limits and the instabilities that come with growth. In Europe, the EUR continues to sap the vitality of the region, and I expect more misallocation and under-employment of factors such as labour and capital, with associated impact on growth, profits and asset prices. The US remains a bright spot precisely because post 2008, its equilibrium growth rate has halved, so that the meager growth it managed last quarter was an overshoot (by my count) rather than an undershoot (by consensus' count.)

As the world becomes more mercantilist and less cooperative, the emerging markets will excel in some areas and lag in others. The developed markets hold the cards in technology, intellectual property and productivity and in the case of the US, cheap and domestic energy, and the emerging markets hold the cards in natural resources and cheap labour but could face energy inflation. Central banks will continue to try to engineer as much inflation as they can safely and covertly do so as to erode the debt pile of their sovereigns as well as improve their terms of trade. This can descend into hostilities if they are not careful.

Basically, the problems of 2008 have not been addressed, but global growth and progress has slowed to a rate that we are happy to coast at given the lack of visibility. Normally, this level of uncertainty over unresolved problems would trigger panic attacks but we have been under the Sword of Damocles so long that few even notice its presence any more.