

Global Markets Commentary

January 2012

OVERVIEW AND OUTLOOK

After a lazy and uninspired finish to a challenging 2011, financial markets crept tentatively higher in the early days of 2012, trusting that the turn of the calendar might produce the renewal of risk appetites that often characterize January. While worries over capital needs for European banks initially kept buying enthusiasm muted amid still nervous sovereign bond trading, the massive injection of three-year liquidity from the European Central Bank in late December seemed to be providing meaningful support to security prices. Moreover, G-7 manufacturing surveys from December looked reasonably solid, and US payroll data delivered clear upside surprises. Volatility measures soon resumed their December declines, interbank conditions began to thaw, and credit spreads started retreating in earnest. Although ongoing negotiations on restructuring terms for Greek bonds appeared thorny, and ratings agencies hit several eurozone banks and sovereigns with additional downgrades as January progressed, Italian debt embarked on a ferocious rally, powered by the efficacy of the ECB repo operations. For its part, the US Federal Reserve intimated that short-term rates would remain minimal until 2014, leading investors to expect that any adverse developments in the near term would soon lead to expanded asset purchases. With central bank balance sheets showing no inclination to shrink, stocks, bonds, and commodities all flourished during January, providing investors with a more than welcome kickoff to a year that will later mark the much mooted end of the Mayan calendar.

As risks of a credit cataclysm in Europe receded, share valuations saw steady improvement. Stock markets showing signs of weakness at the start of 2012 were few and far between, and most averages easily surpassed their December highs well before the end of January, allowing broad equity benchmarks to produce generous gains in the opening month of the new year. Declines in US Libor gathered pace after the first week, removing appreciation pressure from the US dollar, and when on January 16 China reported solid GDP growth figures that eased concerns of a sharper slowdown, non-US equities proceeded to demonstrate sustained leadership for the rest of the month. Gains in emerging market currencies were particularly impressive, reversing an ample portion of the drubbing they had endured during the second half of 2011, and the MSCI Emerging Markets Index rebounded by a bountiful 11.3% in the first month of 2012. This result more than doubled the welcome but less prodigious 5.0% January gain achieved by the MSCI World Index of developed market equities.

For a month in which equities enjoyed ubiquitous upside, fixed income markets produced a remarkably solid performance. Because the January stock market rallies reflected relief that a crisis in financing was less likely, and thus arose more from improving liquidity and less from any material upgrade to the global growth outlook, government yields did not face much upward pressure. Indeed, with the ECB providing three-year financing at 1% and the US Federal Reserve indicating a similarly distant horizon before removal of its own aggressive accommodation, bond traders were happy to push intermediate yields down the most. Longer yields edged slightly higher among the major borrowers, reflecting incremental inflation risk, but the moves seemed outright docile relative to the outsized gains in equity markets. While government bond averages ended the month mildly positive in local terms, unhedged currency exposure boosted results further for dollar-based investors. For those invested in corporate bonds, credit tightening provided even bigger rewards. Ebbing volatility and easier financing costs provided an ideal environment for corporate yield spreads to retreat steadily from the more troubled levels that held sway through much of the final quarter of 2011.

The palpable improvement in liquidity conditions during January made defensive investment postures increasingly difficult to maintain. Since cash positions still pay next to nothing, they began to appear starkly unattractive as riskier assets enjoyed a reprieve from imminent financial disarray. Cash can provide wonderful access to opportunities when markets convulse wildly as they did in the summer of 2011, but with volatility eroding relentlessly through the winter of 2012, short-term holdings started to look increasingly onerous. An underlying bid for equities and corporate bonds therefore seems likely to persist through the first quarter, even with the historical tendency of February to bring somewhat choppier conditions. Exogenous disruptions can certainly arrive at any time, and a near-term cutoff of crude oil supplies from the Middle East would represent an unfortunate echo of the Libyan turmoil a year ago. But even the tragic tsunami in Japan last March brought only a temporary setback to the confidence of global investors. Sticky negotiations in Greece could still result in a disorderly dénouement, but a more dangerous setup may not arrive until and unless equity buyers succumb to undue exuberance. The good news is that the formal public offering of shares in social media juggernaut Facebook may still be a few months away, leaving plenty of time for equities to work their way higher in giddy anticipation of a scintillating debut.

US Equities

Amid a steadily firmer undertone for US economic indicators, including the lowest weekly print for new unemployment claims in more than three-and-a-half years and a sizeable jump in the University of Michigan measure of consumer confidence, US equities enjoyed a buoyant uptrend during the initial weeks of 2012. The S&P 500® gained ground in 12 out of the first 14 trading sessions in January. Even though the widely followed benchmark slipped lower in each of the last four days of the month, its worst daily result was a loss of less than 0.6% on January 26, in the wake of the US Federal Reserve's stated intention to keep rates exceptionally low into late 2014. With share prices exhibiting firm underlying support, and the latest batch of earnings reports showing that US corporate profits have continued to hold in well, implied volatility approached its lowest levels in six months. One of the few quibbles regarding the solid start to 2012 was the modest trading volume accompanying the rally. While one could interpret the lighter activity levels as reflecting limited buyer conviction, they may merely arise as a benign consequence of less emotional trading that can frustrate transactions with shorter-term objectives. Even after a lackluster chop into the end of January, the S&P 500 retained a generous 4.5% gain for the month. The US dollar retreated in the second half of January as news in Asia looked better and disdain for the euro may have run too far, but non-US equities as represented by the MSCI World ex-US Index only outpaced the S&P by 90 basis points, returning 5.4% for the month.

Perhaps even more than supportive calendar effects, waning volatility and tighter credit spreads enhanced the attraction of the broader spectrum of equities beyond the S&P 500. Smaller stocks shone in the beginning of 2012, building further on the tentative recovery that they started to sketch out during the fourth quarter. The Russell 2000® Index climbed 7.1% in January, easily recouping the territory it conceded during 2011, and then some. Ditto the S&P Midcap 400 Index™, which advanced 6.6% for the opening month of 2012. Cyclical themes figured prominently in the strong performance of both of these secondary benchmarks.

Growth-oriented portfolios had looked a bit tired late in 2011, when a number of trendier issues faltered badly and value biases started to regain modest favor after a difficult summer. But growth quickly retook the leadership mantle in early 2012, helped by big rebounds in several former market darlings, while a rotation away from utility shares limited gains for value styles. In a hopeful sign for value-oriented portfolios, however, the financial sector did not lag during January; the underperformance of value styles had more to do with lower exposure to winning groups like technology and consumer discretionary. The Russell 1000® Value Index gained 3.8% for January, but the Russell 1000® Growth Index jumped 6.0%. On the small cap side, the competition was a touch closer. The Russell 2000® Value Index climbed 6.7%, lagging the 7.5% return for the Russell 2000® Growth Index by less than a percent.

In a hopeful sign for active investors, sector performance was far from uniform at the outset of 2012. As the caution and uncertainty of late 2011 began shifting to more constructive sentiment, economically sensitive themes outpaced the S&P 500 average, while the more defensive issues that had held in well during the final months of 2011 lagged conspicuously. Indeed, despite the impressive S&P rally that held sway through January, the utilities and telecommunications sectors declined more than 3% each, and the consumer staples sector shed more than a percent. All three of these January decliners outperformed the S&P 500 over the course of 2011, and the utilities and staples had gained by double digits, making it even easier for investors to favor a shift into downtrodden cyclical issues. The materials sector led the way, surging 11.1% during January and recovering all its losses from a difficult 2011. Chemical names did particularly well, benefiting from signs of healthy demand and further declines in natural gas costs. The financial sector, the biggest loser of 2011, gained more than 8% during January. As liquidity improved and crisis worries receded, bargain hunters drove the KBW Bank Index to its best levels since August. Taking third place for January was the information technology sector, which climbed 7.6%. Device powerhouse Apple produced huge quarterly earnings, overwhelming analyst profit estimates by well over \$3 billion, but software giant Google reported disappointing results. Broader support for technology issues came among the semiconductor names, which rallied by double digits in aggregate and offered cogent corroboration of the more salutary tone in US economic figures.

EAFE Equities

Most stock markets outside the US hesitated in early January, not quite sure if a better tone to economic figures would be able to overcome the ongoing burdens of elevated yields in peripheral Europe and daunting capital needs at many banks. While troubled sovereign debt continued to trade cautiously, however, Euribor levels began to sink even more quickly than they had in November and December. Italian 10-year bonds soon took their cue from the budding improvement in liquidity, enjoying a quick 50-basis-point plunge in yield, and when the International Monetary Fund proposed in mid-January a \$500 million expansion of its lending capacity, equity traders grew confident enough to push share prices into meaningfully higher territory. Relief that the eurozone was no longer on the brink of a credit implosion flattered the euro and many other currencies, enabling unhedged holders of non-US equities to finish January with generous gains. Dollar-based investors in the MSCI EAFE® Index of developed market equities chalked up a 5.3% monthly return to begin 2012, outpacing the S&P 500® by more than 80 basis points. It was the first time in six months that EAFE managed to beat the S&P.

As refreshing as the rebound in Europe was for investors traumatized by the events of 2011, its vigor was limited by tempered rallies in UK and Swiss equity markets, each of which saw muted January gains after their solid outperformance amid the challenges of the past year. For the opening month of 2012, the MSCI Europe benchmark added 4.7%, topping the S&P 500 only marginally. But the Pacific region, notwithstanding continued relative languor in Japan, responded smartly to prospects of a less dangerous Europe and indications that Chinese economic activity still had plenty of fight. MSCI Singapore led the region, surging 14.5% on the month, as industrial and financial shares rallied and the Singapore dollar snapped back. MSCI Australia benefited from even stronger currency gains, as well as from strength in industrial and materials names.

The Hong Kong dollar moved little, retaining its peg, but resurgent property shares boosted MSCI Hong Kong to a 9.5% return on the month. As for Japan, a revisit by the yen towards its October highs against the US dollar benefited unhedged investors. The currency move did little to dent auto stocks, which still climbed briskly on a promising sales outlook, and financial shares also had a solid January, but pullbacks in telecom names limited MSCI Japan to a 4.5% gain for the month. MSCI Pacific as a whole still advanced by 6.5%, outpacing MSCI Europe by 180 basis points to start the year.

Only one European market managed to top the January performance of MSCI Singapore. After a horrific showing in 2011, MSCI Greece surged 24.7%, as several battered banking names more than doubled during the month. Even though negotiations on the next tranche of support payments to Greece remain fraught, banks benefited mightily from allowance of an extra year to meet increased capital requirements. Only two other EAFE markets made it into double digits during January. MSCI Germany rallied 10.6%, benefiting like MSCI Japan from strong gains in shares of car makers. German business confidence continued with its modest rebound, rising for a third consecutive month. MSCI Austria was close behind with a 10.3% jump. Many Austrian banking and materials names produced huge January gains after a harrowing second half of 2011. Other notable winners in EAFE included MSCI Israel, which climbed 9.1%, and MSCI Finland, with a 7.2% advance. Both had lagged badly during 2011, but sentiment in Israel improved with a fresh cut in interest rates, and shares of drug maker Teva climbed on optimism that sales of a key multiple sclerosis treatment would hold up longer than expected. In Finland, leading steel and forest product shares enjoyed double-digit rallies to start the year. MSCI Italy turned in a solid January as well, rising 6.4%, as government bond yields tumbled in response to ECB liquidity measures and signs of political resolve in dealing with challenging national finances. Equities took particular comfort in plunging shorter-term yields, which plummeted by more than 150 basis points in the one-year to three-year sector.

Other European markets opened the year with more modest monthly gains, but two unfortunate stragglers remained in negative territory during January. MSCI Ireland, the largely unheralded standout during 2011, pulled back by 0.8%. Even though shares of Ryanair rallied by double digits, defensive Irish stocks saw a mild retreat from their previous resilience. The notable January loser was MSCI Portugal, which faltered by another 3.5% after an already difficult 2011. With the budget outlook still difficult, Portuguese sovereign debt saw little relief from greater liquidity in the eurozone, and yields on intermediate issues climbed past 20%. Shares of Portugal Telecom had a difficult January, falling for a ninth consecutive month to complete a 50% slide since last April, as investors feared that the company's ample dividend might face a substantial cut.

With economically sensitive groups showing strength, sector performance in EAFE during January tended to reflect reversal of themes that worked well during the troubling second half of 2011. Materials did best, gaining 10.7% for the month as firm commodity prices boosted metals and mining names. Financials scored a 9.9% advance, responding well to a global improvement in credit conditions. Big advances in auto stocks led the consumer discretionary sector to a 9.0% January return, while solid moves in machinery and engineering names contributed to a 7.8% rally in the EAFE industrials sector. After these four outperformers, however, the other six sectors in EAFE were January laggards. Defensive groups were clearly the weakest. Even after a rough 2011, the utilities could only manage a 0.8% January bounce. Consumer staples slipped 0.7% for the month, hurt by declines in food and tobacco names, but at least they had strong 2011 results to excuse their lackluster start to 2012. The weakest EAFE sector in January was telecommunication services, which declined 2.0% for the month. Tepid revenue prospects helped make UK-based carrier Vodafone a contributor to the pullback.

Global Fixed Income

Given January's broader retreat from the brink of eurozone disaster, as well as its backdrop of incrementally sunnier economic releases, one might have expected the traditionally safer haven of fixed income securities to lose considerable appeal during early 2012, when global equity trading reflected a clear switch from defensive postures to more aggressive plays. Despite vigorous rallies of government bond issues during 2011, however, a most likely legacy of the treacherous year just completed is the potential lack of safety that could afflict holders of government obligations. Since ratings agencies have been focusing closely on political will and economic resources, profligate governments could face much greater chances of losing access to the public debt markets. With sovereign bonds seen in this light, the steady performance of fixed income during January appears more sensible. The combination of a friendlier attitude to credit and a more hospitable growth outlook, which would normally make government issues less appealing on principle, eased the risk that such paper would eventually encounter payment difficulties. Struggling eurozone borrowers benefited most from the dual catalysts of improved liquidity and steadier activity prospects, but even the biggest 2011 performers like German bunds and US Treasury bonds exhibited remarkable poise for a month that brought such generous gains to equities.

While January brought no interest rate adjustments from the G-7 central banks, their posture remained palpably dovish. The Bank of England maintained its existing target for asset purchases, and the European Central Bank indicated that accommodation would persist against a soft economic backdrop. As for the US Federal Reserve, it extended its plans for minimal fed funds into late 2014. With no actual interest rate adjustments, though, yields on short-term maturities were confined to a narrow range. Further out the curve, yields in the developed world saw a bias to modest declines during January, although 30-year issues were marginally weaker on the month after finishing December on a strong note. More substantive bond moves were confined to the eurozone periphery. Ireland, Spain, and Italy all enjoyed curve steepening rallies, as the undercurrent of cheap three-year ECB liquidity made the generous carry on short-term maturities seem irresistible. In Portugal though, only the very shortest paper held in. Portugal does not have as daunting a maturity schedule as Greece, but its longer-term solvency looks increasingly uncertain, and intermediate yields climbed well north of 20%. As for Greece itself, bond fluctuations remained tied to expectations for the coupon and structure that should result from negotiation between the nation, its creditors, and its European benefactors.

Fortunately for investors in global bond markets, the January rallies in Italy and Spain had a far greater impact on broad portfolios than did the continued deterioration in Portugal and Greece. Away from these issuers, investors in global government paper tended to earn close to their local-currency coupon during January. For unhedged dollar-based investors, solid rebounds in the euro, the Swiss franc, and the British pound produced additional value on the month. The Citigroup World Government Bond Index (WGBI) gained 1.5% for January, marking its best monthly result since August. The Barclays Capital US Treasury Index, with no extra benefit from foreign exchange, was a mild underperformer in January, showing a 0.4% advance.

While action in most government bond markets stayed tame through January, investors hungry for incremental yield fostered resilient demand for spread product, particularly in the corporate arena. Yields on corporate issues eroded steadily through the month, responding not only to improving equity valuations, but also to thawing interbank conditions and rapidly eroding volatility measures. The Barclays Capital US Corporate Index gained 2.2% in January to notch a second consecutive month of robust gains. The action in mortgages was much quieter, with their lighter duration limiting the upside, but the Barclays Capital US MBS Index still tacked on another 0.4% during the month. Commercial mortgages and other asset-backed sectors enjoyed results closer to corporate obligations. Overall, the Barclays Capital US Aggregate Index tacked on a solid 0.9% gain to start 2012, leaving the broad fixed income benchmark with its 29th monthly gain since equities bottomed 35 months ago in March 2009.

Results were even stronger outside the investment-grade realm, as high-yield issues enjoyed a most auspicious combination of rising equities, narrowing credit spreads, improving liquidity, and a placid government yield curve. The only quibble in January might have been the low-yielding starting point, since high-yield issues had already rallied nicely through the fourth quarter of 2011. Nonetheless, spreads on the Barclays Capital US High Yield Index narrowed by more than 50 basis points additional during January, and the Index kicked off 2012 with a handsome 3.0% gain that couldn't quite keep up with equity returns, but still outpaced other choices in the fixed income arena.

Alternative Assets

Unlike many other leadership categories from 2011, US real estate investment trusts (REITs) continued to power ahead in the opening month of 2012. Their latest strength began slowly, as a choppy bond market and profit-taking in income-oriented sectors kept REITs relatively quiet during the first two weeks of January. But improving economic sentiment and growing confidence that European credit concerns were stabilizing soon sparked renewed interest in property themes. Boosted most notably by a broad combination of lodging, office, and retail names, the Dow Jones US Select REIT IndexSM began 2012 with a robust January return of 6.4%. Many of the top 2011 performers, including apartment and self-storage issues that had benefited from the turmoil in the housing market, lagged the Index during early 2012 trading. But outside the US, where property themes had found progress difficult amid the financial disruptions of 2011, REITs got off to an impressive start on the year, helped by a lift in the growth outlook and solid currency gains in the second half of January.

As demand prospects brightened with the economic undertone, commodity prices rallied nicely to greet the new year, but unlike equities, commodities did little more than mark time after a big jump on the first trading session in January. Limiting progress for the asset class were energy prices, as natural gas continued to falter amid burgeoning supplies and a mild US winter. Crude oil prices held up better amid the nagging threat of supply disruptions from the Middle East, but a building contango in West Texas Intermediate chipped away at returns. Agricultural goods also had a lackluster month, with corn and coffee prices both faltering on signs of an improved production outlook. Industrial and precious metals were the clear leaders during January, with plenty of gains in the double digits. Copper, nickel, and aluminum all jumped in expectations that firming worldwide growth would buoy demand, while gold and silver surged on expansion of the ECB balance sheet and the US Fed's elongated preference for minimal interest rates. These rallies were not however enough to lift broader commodity indexes past equity performance benchmarks during January. The S&P GSCI[®] Commodity Index added 2.2% for the month, while the Dow Jones-UBS Commodity IndexSM appreciated by 2.5%.

Gains in metals prices gave additional confidence to buyers of inflation-protected debt issues, even though recent inflation figures have not been high enough to add much to their returns, especially in the US. Nevertheless, with nominal yields in a narrow range during January, rising inflation expectations forced real yields lower, and even deeper into negative territory in many cases. At the end of the month, the real yield on US 10-year Treasury inflation-protected securities (TIPS) sank to the unprecedented level of negative 30 basis points, and its five-year counterpart was indicating another 100 basis points lower than that. These trends redounded firmly to the benefit of the Barclays Capital US TIPS Index, which jumped another 2.3% in January after scoring double-digit gains for 2011, a year that saw the TIPS Index advance in 11 out of 12 months. Linkers outside the US did even better in early 2012, as Japan saw an especially ample lift in inflation expectations. With unhedged dollar-based investors in non-US linkers getting an additional boost from late January currency gains, international inflation-protected issues roughly doubled the returns of their US counterparts in the first month of 2012.

Sources: Bloomberg, FactSet, Morgan Stanley, JPMorgan, RBS, Credit Suisse, Citigroup, SSgA Performance Group, MSCI



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² Bloomberg, as of 31 December 2011.

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