BIVIUM CAPITAL

Paths & Perspectives

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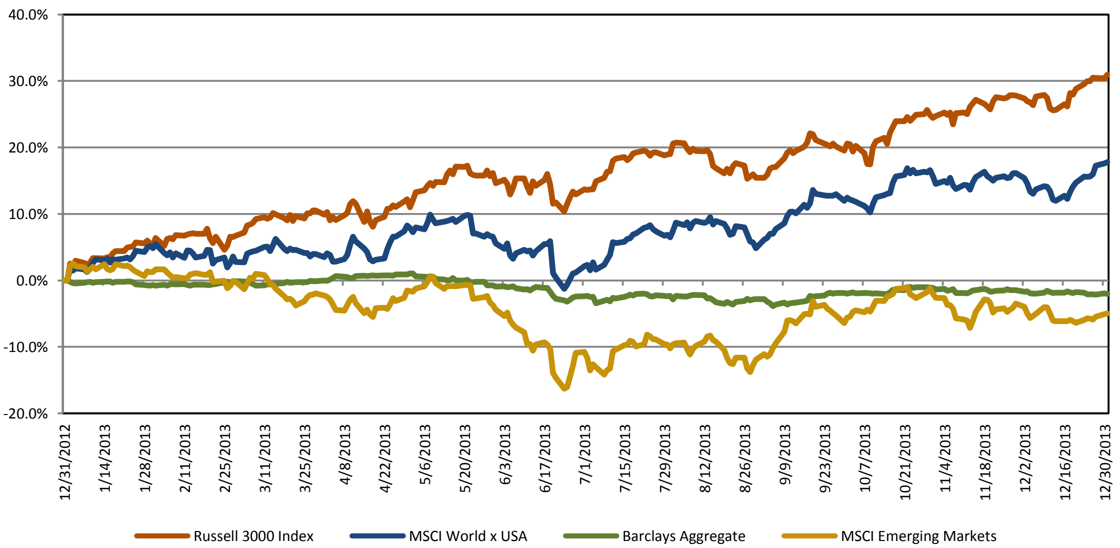
2013 Year in Review

Following the fourth year of recovery from the financial near-death experience that was 2008, investors were still in a somewhat cautious mood at the beginning of 2013. Despite three out of the four years showing solid double-digit returns in the equity markets (and a total return of greater than 100% since the bottom), one could still find as many doubters as believers among pundits and the broader populace. The most telling signal of this was the amount of uninvested cash on both corporate and personal balance sheets. Euphoria, this was not.

That said, as the year began macro concerns had become a sub-plot in the markets, and liquidity was certainly plentiful. Investor concern shifted from having too much equity to having too little, and the fear of missing out (relative returns) replaced the fear of losing out (absolute returns). The stage was set, and with the exception of a few blips, the markets did not disappoint (the fully-invested at least).

If 2012 could be described as "exceptional", 2013 was truly "astounding". However unlike the previous year, regional and asset class differences were stark. US equities as represented by the Russell 3000 Index finished with a +33.6% return, the developed market MSCI World ex US Index returned +21.0%, and the MSCI Emerging Markets Index returned -2.6%. Performance in the fixed income markets was weak with the Barclays US Aggregate Index returning -2.0%.

Figure 1. Index Performance in 2013



[Source: Bivium, Bloomberg]

Q1: Let the Good Times Roll

Aside from a modest swoon in late February – driven by wrangling in the US over the sequester, political paralysis in Italy, and the banking crisis in Cyprus – the quarter was testament to market optimism and the power of low interest rates and quantitative easing. In April, the Bank of Japan officially joined the ranks of the "aggressive", launching a massive money market operation aimed at halting deflation and driving inflation. A potential US government shutdown was avoided without the brinksmanship that had become characteristic of Congress. "Not bad" has become the new "good". Global equity markets turned in a mixed quarter with US equities outperforming Non-US developed markets and emerging market equities substantially. The Russell 3000 Index returned

+11.1% while the developed market MSCI World Ex US Index returned +4.7% and the MSCI Emerging Markets Index returned -1.6%. Fixed Income markets were flat with the Barclays US Aggregate Index returning -0.1% as long US Treasurys and credit each fell around 2%.

Q2: To Taper or Not To Taper

Following the generally upward slope of the markets in Q1, Q2 proved to be a bit more volatile. Concerns with macroeconomic growth, particularly in China, caused equity markets to swing between significant gains and losses in April until better budgetary numbers in the US and a re-commitment to stimulus from developed market powers reignited the rally. Sentiment was weakened in late May as market participants parsed Bernanke's comments to signal the impending tapering of the Fed's quantitative easing program. Only a concerted PR effort by various Fed governors was able to convince the market that the easy money punch bowl was still on the table. Global equity markets were much softer for the quarter, but US equities continued to outperform both Non-US developed markets and emerging market equities. The Russell 3000 Index returned +2.7% while the developed market MSCI World Ex US Index returned -1.6% and the MSCI Emerging Markets Index returned -8.1%. There was no shelter in fixed Income markets which also fell with the Barclays US Aggregate Index returning -2.3%.

Q3: Taper? What Taper?

The easy money rally that had resumed in late June on tapering the taper talk continued in July with strong performance in most equity markets (emerging markets being a notable laggard) pushing several indexes past the +20% mark for the year. At a macro level, concerns about the relative slowdown of growth in China and talk of potential military action in Syria were enough to drive a brief flight from risk in August. The rally recommenced in September on better than expected data from China and an end to an unusually public Fed chairman contest, but an impending (October 1) government shutdown in the US temporarily halted the upward march to all-time-highs. Global equity markets rebounded to turn positive once more for the quarter with Non-US developed markets leading US equities and emerging market equities. The Russell 3000 Index returned +6.4% while the developed market MSCI World Ex US Index returned +11.3% and the MSCI Emerging Markets Index returned +5.8%. Fixed Income markets continued their malaise with the Barclays US Aggregate Index returning +0.6%.

Q4: Politics as Usual, Again! (See Q4 2012)

The quarter started inauspiciously enough with the shutdown of the US government and wrangling over the debt ceiling. However, those concerns only served to lightly tap the brakes on the momentum in equity markets, and as the shutdown ended (October 17) and default was (once again) averted, markets were free to continue their exceptional upward run. With US markets hitting all-time highs, the question on many investors' minds at the end of the year was "what now?" Global equity markets ended the year fairly similarly to how they began it with US equities substantially outperforming Non-US developed markets and emerging market equities. The Russell 3000 Index returned +10.1% while the developed market MSCI World Ex US Index returned +5.6% and the MSCI Emerging Markets Index returned +1.8%. Fixed Income markets limped into the end of the year with the Barclays US Aggregate Index returning -0.1%.

In Sum

2013 could be seen as a year of macro consolidation. Nothing particularly new or dramatic happened, but gradually the range of outcomes seemed to narrow. In the US, moderate growth was accompanied by lackluster results in employment (even in light of the steady drop of the

unemployment rate to 6.7%) and political wrangling that did not achieve much of anything, good or bad. In Europe, the outlook for growth can be said to have improved the most given the low expectations that crisis governance had fostered, but the year will be remembered more for what did not happen than what did. In the emerging markets, 2013 may go down as the year that investors fell out of love with the story as growth rates fell, old weaknesses re-emerged, and better relative opportunities appeared (see Europe).

For those that had the foresight (or fortune) to be overweight equities and overweight the US, 2013 will be viewed with fondness – a nearly top decile return comparable with the heady days of the late-90s. The question for those investors will be whether to re-allocate the gains and if so where. For those who did not (and the significant amount of cash still held by corporations and individuals at the end of 2013 indicates that there were a lot of those folks), 2013 will be viewed with angst and regret. Assessment of valuation should be the same for either side, but the emotional baggage will weigh more heavily on the latter.

As 2014 starts, the markets have struggled for direction, and catalysts for further increases may be few and far between. Central bank liquidity is a given, corporate profitability may be hitting its limit, and overall valuations seem “fair” to “full”. In this environment, managing for risk (not just downside risk, but the risk of missing expectations) may be just as important as managing for return.

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