Investment Markets in December 2012

December saw equities continue to make gains as analysts began to look through the US budget negotiations believing agreement was likely at the last minute, so offering some US fiscal policy certainty for 2013 and avoiding the so called “fiscal cliff” of an immediate budget balancing spending cuts and tax increases. Further support for risk assets was provided by signs that the Chinese economy is to return to a positive growth trajectory next year after GDP growth stabilised at 7.5% in 2012. Japanese markets were boosted by an opposition election victory and consequential monetary policy easing which is expected to target economic stimulus and higher inflation.

Currency markets saw most foreign currencies weakening against the Euro on increasing market confidence that the risk of a splintering of the single currency is becoming less likely in the short term. Further Quantitative Easing by the US Federal Reserve also weakened the dollar. The strengthening of the Euro eroded a significant amount of the underlying investment gains in non-Euro markets in December.

Investment Market Performance

	Year to Date		Dec-12	
Index	**In local Currency (%)**	**In € %**	**In local Currency (%)**	**In € %**
ISEQ Index	17.1%	17.1%	3.2%	3.2%
FTSE 100	5.8%	8.9%	0.5%	0.3%
Eurostoxx 50 Index	13.8%	13.8%	2.4%	2.4%
S&P 500	13.4%	11.4%	0.7%	-0.8%
Nikkei 225	22.9%	7.8%	10.0%	3.7%
FTSE All-World	13.8%	11.8%	2.3%	0.7%
Oil	-7.1%	-8.8%	3.3%	1.7%
Eurozone Government Bonds		11.7%		0.9%
USD / Euro		-1.8%		-1.6%
GBP / Euro		2.7%		-0.2%

2012 Investment Market Summary

Equities

2012 was a strong year for stockmarkets with global equities gaining almost 12% in Euro terms as investor sentiment improved on reduced geopolitical and Sovereign and bank default risk. Improvements in US economic data into the second half of the year and Chinese data in the last quarter boosted markets into the year end. Relatively cheap fundamental valuations and historically low interest rates supported European stockmarkets despite the weakness in European economic data and European equities were the best performing market in 2012 rebounding somewhat from the significant underperformance of the last three years.

FTSE All-World Equity Performance for 2012 in Euro terms

Source: Bloomberg

Currencies

The US Dollar strengthened against the Euro in the first half of the year as concerns over Euro stability and the improvement in US economic data supported the greenback. This trend reversed markedly to year end as Euro risks reduced and the Euro finished 2012 marginally stronger. Expectations of aggressive monetary easing saw the Yen fall sharply against the Euro in the last weeks of the year, while the Aussie Dollar was flat against the Euro and Sterling gained.

Commodities

Metals were weak in 2012 given Chinese growth concerns in the first 9 months of the year but rebounded well in the fourth quarter as the Chinese growth outlook improved. Steel was down about 13% in the year while the Metals & Mining ETF which we use to gain exposure to this sector was down 12% in 2012.

Crude Oil fell almost 9% in 2012 as Shale Oil production saw the US become a net exporter of oil. Concerns over the strength of Chinese and European demand also weighed on energy prices, however, this reversed in the last quarter. Ongoing speculation of an Iranian sparked conflict in Middle East continues to provide support for oil prices into 2013.

Food prices saw a massive rally in summer 2012 gaining over 33% in two months as the worst drought in over 50 years hit the US corn and soya harvest and general grain inventory levels. We cut our exposure to food commodities in late summer after the sharp gains and since then food commodity prices have fallen back gradually to trend.

Wellesley Investments & Pensions

ETFS Agricultural Commodity ETF performance in 2012

Source: Bloomberg

Bonds

US bonds were stable in 2012 with 10 year Treasuries gaining over 1%. European bonds as a whole performed well, gaining over 11% but core sovereign bonds were broadly flat with the French 10 year bond up just over 1% and German 10 year paper flat. Yields on German Sovereign bonds remain close to record lows with the German 2 year Treasury paying 0.07% and the German 10 Year Bund paying 1.5%. Peripheral sovereign bonds (Italy, Greece, Spain and Portugal) did well as Euro risks appeared to recede over the second half of the year. Corporate bonds had a strong year as central banks committed to holding interest rates lower for longer and credit spreads narrowed.

Economic Data

Global Economic Data Heatmap

Category	Data	Release Date	latest reading	market forecast	prior reading	better than last reading	better than expected
US Economy	GDP QoQ Annualized	21-Dec	3.1%	2.8%	2.7%	√	√
	ISM (manufacturing)	02-Jan	50.7	50.5	49.5	√	√
US Employment	Initial Jobless Claims	03-Jan	372,000	360,000	350,000	X	X
	Change in Non Farm Payrolls	07-Dec	146,000	85,000	171,000	X	√
US Housing	Pending Home Sales (YoY) %	28-Dec	1.7%	1.0%	5.2%	X	√
	Case Shiller Home Price Index	26-Dec	146.08	145.93	146.22	X	√
	New Home sales	27-Dec	377,000	380,000	368,000	√	X
US Consumer	Advance Retail Sales (YoY)	13-Dec	0.3%	0.5%	-0.3%	√	X
	Conference Board Consumer Confidence	27-Dec	65.1	70.0	73.7	X	X
	University of Michigan Consumer Confidence	21-Nov	72.9	75.0	74.5	X	X
Europe	Eurozone Consumer Confidence	20-Dec	-26.6	-26.5	-26.9	√	X
	IFO (Business Climate)	19-Dec	102.4	102.0	101.4	√	√
	German Retail sales (YOY)	30-Nov	-0.8%	-0.3%	-0.8%	X	X
	German GDP (QoQ)	15-Nov	0.2%	0.1%	0.3%	X	√
UK	Nationwide House Price Index (YoY)	03-Jan	-1.0%	-0.9%	-1.2%	√	X
	GDP (QoQ)	21-Dec	0.0%	1.0%	1.0%	X	X
China	Consumer Price Index (YoY)	09-Dec	2.0%	2.1%	1.7%	X	√
	Chinese Real GDP (YoY)	18-Oct	7.4%	7.4%	7.4%	X	X
	HSBC PMI Manufacturing	31-Dec	51.5	50.9	50.5	√	√

Source: Wellesley I&P

US economic data continued to be strong with quarter on quarter GDP outperforming expectations, employment strong despite Hurricane Sandy and New Home Sales activity maintaining improvement. Chinese data was positive with manufacturing data again surprising positively and 2012 GDP is now expected to be between the 7.5 & 7.7% range. The European economy remains weak reflecting the ongoing commitment to austerity across most of the region and the residual risks faced by the Single Currency in Greece, Spain and Italy.

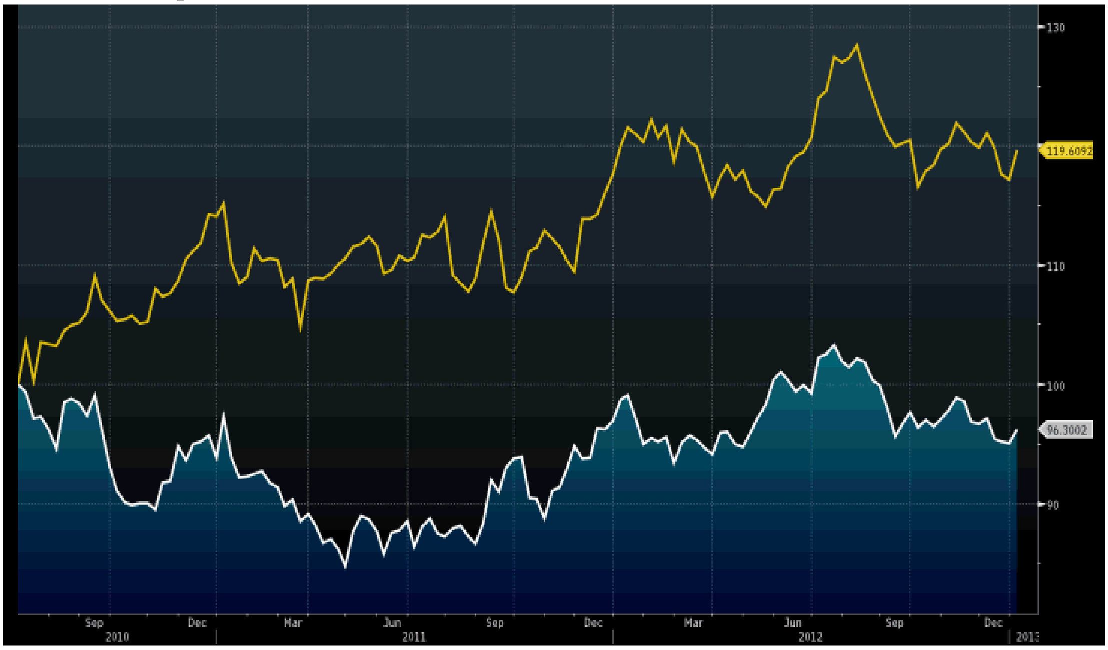
The Fiscal Cliff

US politicians finally agreed a deal to avoid the so called "fiscal cliff" which would have seen the immediate implementation of over $500bn of tax hikes and over $100bn of spending cuts equating to approximately 4% of US GDP and likely leading to recession. However, material challenges remain in terms of broking political agreement on how best to manage budget deficit reductions in a clear and sustainable way over time, that avoids destroying consumer and business confidence. If addressed now, debt to GDP is still quite manageable by European standards at c. 110% and unlike the European situation the US Central Bank is aggressively acting to reflate the US economy which will offset at least part of the impact of the fiscal retrenchment. An upcoming flashpoint is likely to occur in February as the debt ceiling of US$16.4tn needs to be raised by Congress to fund near term public sector activity that will likely lead to further political posturing and policy uncertainty.

Investment & Portfolio Outlook

Our main focus at present is on currency risk heading into 2013. In general we have been biased towards non-Euro currencies for the last three years reflecting our concerns regarding the future of the single currency and expectations of either sub-trend economic growth for a number of years in Europe, or alternatively very significant monetary easing by the ECB, both of which would be negative for the Euro. Developments over the last six months particularly around ECB policy towards the crisis lead us to reassess the logic of this strategy. The below graph shows the USD/Euro rate (White) and AUD/Euro rate (Yellow) over the last 2.5 years.

USD and AUD performance versus the Euro Since 2010

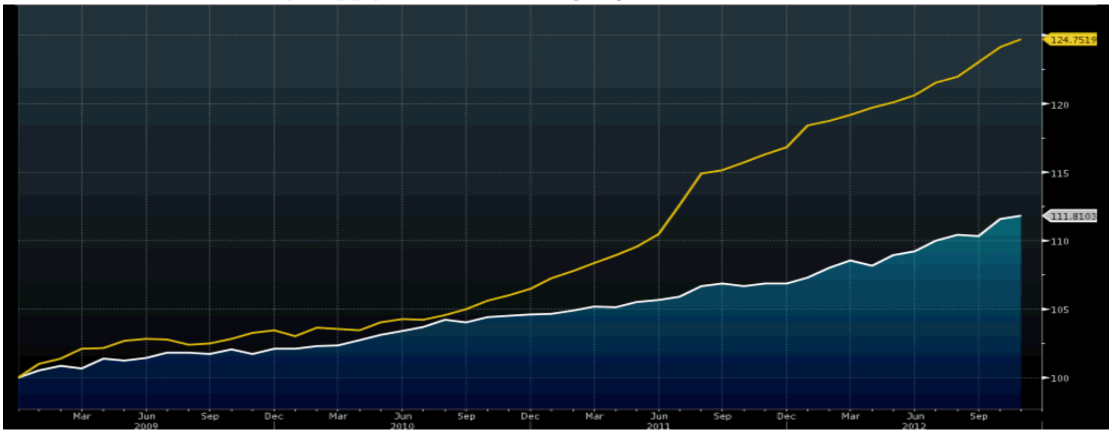


Source: Bloomberg

Further quantitative easing in the US supports negative sentiment towards the US Dollar as money markets reflect on its scale ($85bn monthly) and the US Federal Reserve's specific commitment to link its low interest rate tenure to inflation/unemployment targets. This coupled with the reduced Euro zone risk and relatively better balance of payments data has seen the Euro strengthen over the last number of months.

The below graph shows the difference in FED and ECB monetary policy over the last 4 years, as a reaction to the financial crisis. Since 2008 end, US M2 Money supply (Yellow) has increased by over 25% while the Euro equivalent (White) increased by just 12%. The reduction in the markets perception of an existential risk to the Euro over the second half of 2012 has seen the single currency strengthen and this may continue well into 2013 supported by the differential in money printing between the US and Eurozone. Caveats to this view are political/Euro risks increasing with the Italian Election on Feb 25th and German Election on Sept 1st of this year and the political situation domestically in Italy, Greece, Spain and Germany will require ongoing monitoring.

USD and Euro M2 Money Supply Since 2009 – Highlights Relative Scale of US QE



Source: Bloomberg

Equities remain cheap in terms of earnings but have had a very strong run on the back of a relatively weak economic recovery. Coupled with this, market expectations of volatility is at historic lows despite the real challenges being faced in the US and Europe in terms of stimulating growth, depressed consumer activity and high unemployment. Our recommendation is to hold current equity positions with a view to reducing ahead of key events (Italian elections and key US budgetary votes). Again we are satisfied to hold our current position in commodities but are reviewing with a view to increasing our metals and food exposure in the near term following significant recent corrections.

VIX Index of Volatility Expectations for the last 5yrs – currently below historical average

Source: Bloomberg