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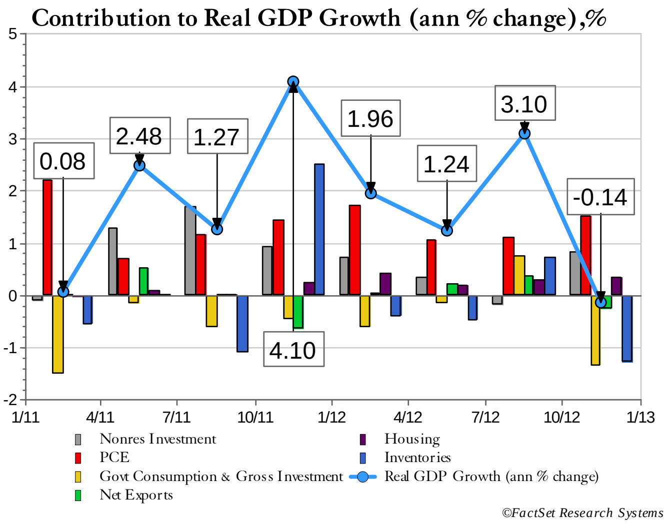
Market Review

January 2013

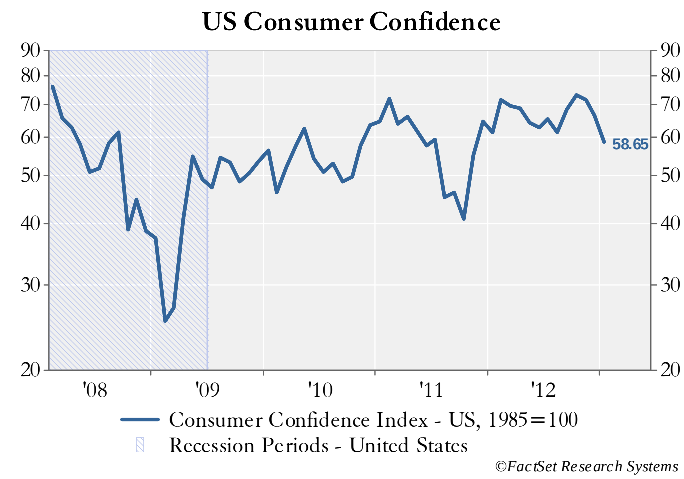
Economic Review

The U.S. economy contracted for the first time since the second quarter of 2009, surprising most market commentators who had forecasted a modest increase. According to the advance estimate, the fourth quarter real GDP was -0.1%, less than the consensus estimate of +1.6% and significantly lower than the third quarter growth of +3.1%. The decrease in fourth quarter real GDP primarily reflected negative contributions from government spending (-1.33%) - especially in defense, which reversed its prior quarter surge of private inventory investment (-1.27%) and net exports (-0.25%). These factors were offset by positive contributions from personal consumption expenditure, non-residential fixed investment and residential fixed investment.

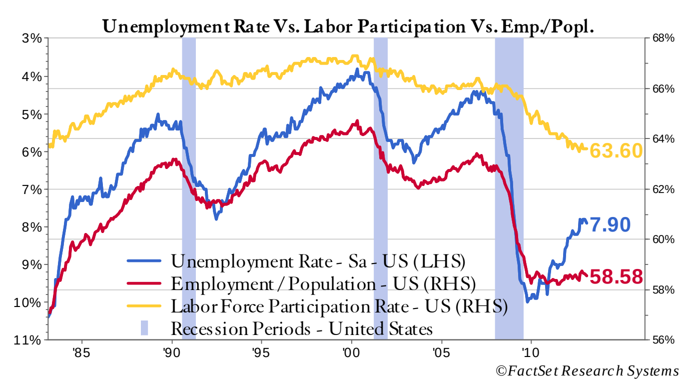


The Non-Manufacturing ISM indicated expansion in January coming in at 55.2, down from 55.7 in December. The January ISM Manufacturing rose to a nine-month high of 53.3, a 2.9% increase from December's 50.2, indicating expansion in manufacturing for the second consecutive month. All five PMI sub-components registered a reading above 50. A reading above 50 indicates expansion, below 50 indicates contraction. The headline CPI remained unchanged in December, as expected. Year-over-year, CPI increased 1.7%, which was less than expectations. The monthly Core CPI (i.e., excluding Food and Energy) rose 0.1%, while year-over-year Core CPI increased 1.9%. The 5 year/5 year forward breakeven inflation rate increased 15 bps (approx.) to 2.88%, indicating increased expectations of higher inflation in the future.

Existing and new home sales fell in December. New home sales were down 7.3% for the month, while existing home sales dropped 1%. Home prices in the 20 cities measured by S&P/Case-Shiller Index fell 0.1% in November. New home construction surged by over 12% in December. Consumer spending was reasonably robust, as retail sales rose 0.5% in December. U.S. personal incomes increased 2.6% in December, the biggest monthly increase since 2004, although accelerated payment of corporate dividends and bonuses ahead of the 2013 tax increases accounted for much of this increase in personal incomes. The personal saving rate increased from 4.1% of disposable income in November to 6.5% in December, as consumers saved the bulk of the income increases. Consumer confidence dropped to its lowest level since late 2011, indicating that Americans were very pessimistic about the economic outlook. The Index released by Conference Board fell to 58.6 in January from 66.7 in December, short of the 64 level expected by forecasters.



The U.S. unemployment rate increased to 7.9% in January from 7.8% in December while the economy added 157,000 jobs versus expectations of 185,000. The jobs data for November and December was revised up sharply. The change in payroll data for November was revised from 161,000 jobs to 247,000 jobs and the change for December was revised from 155,000 to 196,000. The employment-population ratio and the labor force participation rate held steady in January.



While speaking about the unemployment situation in a speech earlier this month, Fed Chairman Bernanke said, “There is still quite a ways to go”. In December, the Fed said that it would keep the short-term rates near zero until unemployment dips below 6.5%, if the inflation outlook remains mild. This month, Federal Open Market Committee maintained the overnight Federal Funds rate target and $85 billion per month securities purchase program. Congress passed an extension of the nation’s $16.4 trillion debt ceiling through May 19, ensuring the U.S. would not default and buying more time to negotiate a budget. President Obama nominated Jack Lew to replace Tim Geithner as Treasury Secretary.

The European Central Bank unanimously left the main refinancing rate unchanged at 0.75%, amid cautious optimism about Euro debt crisis. Later in the month, ECB President Mario Draghi suggested that the worst of the crisis is over, saying “the darkest clouds over the Euro have lifted”. European banks have started repaying a portion of over 1 trillion Euros granted by ECB as LTRO (long-term refinancing operation).

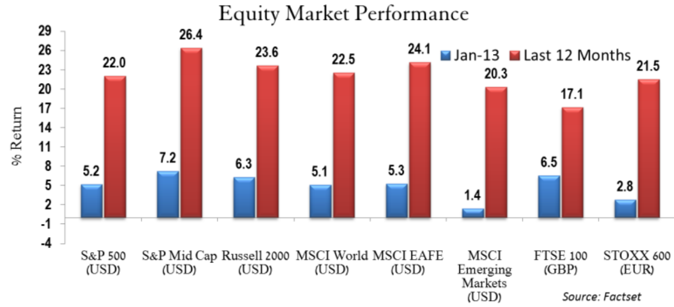
The Bank of England made no changes to interest rates or their quantitative easing program, although the BoE January 2013 meeting minutes showed that one member wanted more quantitative easing. UK Prime Minister Cameron wants to hold a referendum on Britain’s participation in the European Union.

The Japanese government, led by Prime Minister Shinzo Abe, unveiled a 10.3 trillion yen fiscal stimulus package to boost growth. The Bank of Japan yielded to government pressure, raising its inflation target to 2% and promising to enact an ambitious program of further monetary easing. The aggressive easing policies fuelled a rally in the Nikkei Index and pushed Yen to multi-year lows.

China’s export growth rebounded to a seven-month high in December. China’s manufacturing activity expanded in January as the official PMI came in at 50.4, slightly below 50.6 in the previous month. The Reserve Bank of India eased monetary policy for the first time in nine months, in an effort to rekindle economic growth, which has fallen to a three year low. The Reserve Bank lowered the key interest rate to 7.75% from 8% and lowered the amount of money that banks need to keep in reserve.

Equity Markets

Equity markets in the U.S. and developed world rallied strongly in January amidst increased risk appetite of investors following these events: the temporary end of U.S. fiscal cliff saga, accelerating growth in China and fiscal and monetary easing Except for Brazil, almost all major global indices posted strong gains. S&P 500 Total Return Index returned 5.2%, the best January since 1997.

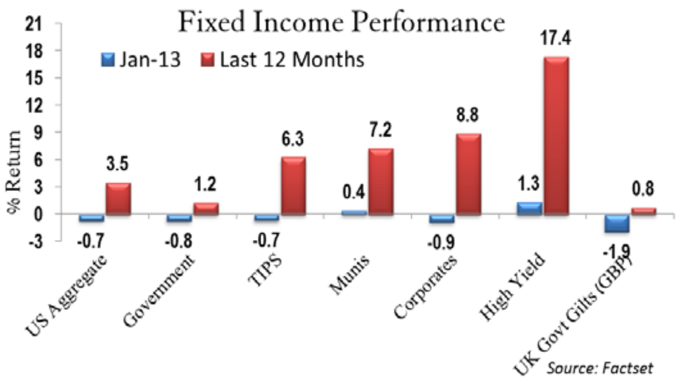


Equity markets started the year on a positive note as Congress struck a fiscal cliff deal at the last minute. Better than expected retail sales in U.S., positive manufacturing activity and strong export data from China further boosted sentiment. U.S. equity markets moved sideways for few days near the middle of the month, but strong housing starts reignited the rally. Positive earnings surprises further drove equity markets to multi-year highs. Low weekly jobless claims in the U.S. and better than expected economic data from China provided further tailwind to the rally. The equity markets brushed aside the fourth quarter contraction in U.S. real GDP, but pulled back a little towards the end of the month on Federal Reserve’s assessment of the U.S. economy.

Bond Markets

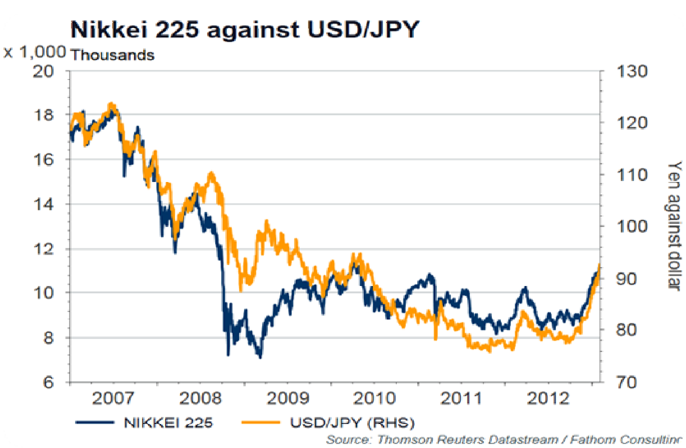
Barclays U.S. Aggregate Index finished January down 0.7%, as investor focus turned to equities and flight-to-safety investments struggled. High Yield bonds continued an impressive run by rising 1.3%, as global easing programs continued to support risk assets. Credit spreads, measured in the Bank of America Merrill Lynch US High Yield Master II Option-Adjusted Spread, tightened 38 bps in January, continuing a 10-month streak of spread tightening.

The 30-year Treasury rate climbed 22 bps in January to 3.17%, and the 10-year Treasury rose 23 bps to 1.99%. The 2/10 yield curve steepened 39 bps. The 10-year Euro bond composite yield rose 37 bps for the month, but is still down 20 bps over the previous 12 months. UK Government Gilts lost 1.9% in January and remain slightly positive, up 0.8% over the last year.



Currency

Major currencies returned mixed results in January, as global devaluation programs and whispers of a currency war circulated. The US Dollar Index, which tracks the currency against those of six major U.S. trading partners, declined 0.7% in January. The US Dollar appreciated strongly against the Yen, as aggressive Japanese stimulus programs drove down the Yen 5.25% against the USD. The Euro rallied 2.96% against the USD, extending a 6-month streak of outperformance, closing at 1.3574. The British Pound slumped 2.46%, to close at 1.58545 against the US Dollar as the British economy continues to falter. The South African Rand completely reversed its December gains against the US Dollar, falling over 5% in January.



Commodities

The S&P GSCI Total Return Index rose 4.36% in January, as all sub-indices rose for the month with the exception of Livestock and Precious Metals. The Petroleum and Energy sub-indices performed strongest in January, as both reported gains of over 5%.

Cotton was the top performing commodity in January with a price increase of over 10%. The rise in Cotton does not appear to have been driven by fundamentals, but instead by large inflows from hedge funds looking to speculate on a turnaround after two years of double-digit percentage losses in prices. Gasoline and Crude Oil also posted strong months, with gains of over 9% and 5.6%, respectively. The gain in Crude was the strongest January gain since 2006 and was driven largely by supply concerns from Algerian and Egyptian exporters. Cattle prices rallied into the month's close on news of a 61-year low in the size of the national herd, as drought has increased feed costs and damaged pastureland.

Global oversupply concerns pushed Sugar (down 3.7%) and Cocoa (down 1.4%) lower in January. Sugar prices, which fell 16% in 2012 and 27% in 2011, have been plagued by large harvests in India and Brazil, and global expectations for 2013 signal additional surpluses are likely. The Brazilian government has taken action to bolster sugar prices by diverting some cane crop into ethanol production. Though the Cocoa spot market fell in January, prices for mid-term dated futures remained steady, as Columbian crop conditions caused concern for future months. Gold also struggled in January, falling 0.95%, as investors shifted to risk-on mode.