Big risks fail to live up to their hype

After the volatility of the previous year, investors went into 2012 with some degree of optimism, whilst at the same time cognisant of the triumvirate of risks facing markets – a double dip recession in the US, the break-up of Europe, and a hard economic landing in China.

As the year wore on, views on the likelihood of each 'event' oscillated markedly, with overall levels of concern peaking towards the middle of year. However in the Year of the Dragon, none of the key risks delivered the fiery doomsday scenario that some were vociferous in promulgating.

Despite climbing a 'wall of worry' markets overall enjoyed a positive year.

We expressed our view at the start of 2012 that markets would deliver a return of 15-20% over the course of the year, and as the calendar draws to a close this is not too far off the mark. The ASX accumulation index is currently 14.6% ahead of where it began the year with the prospect of a Santa or fiscal-cliff-relief rally sending returns into this range.

The ASX has also been ahead of the game compared to many other global indices this year, which on the whole have also performed well. The S&P500 and DOW Jones as examples are up 15 and 9 percent year to date.

Given the risks facing the markets in 2012, and divergent views thereof, we sought to ramp up the activity with respect to portfolio management this year.

We initiated sell recommendations on 18 stocks in the portfolio, with a gain on all but one. On the other side we took advantage of periods of weakness to add 16 new stocks to the Fat Prophets Portfolio, 14 of which are ahead of their initial buy prices.

We also recognised that the noise in financial markets on key issues on almost a daily basis ushered the need, and created the opportunity, for us to communicate more regularly with Members.

As a result in 2012 we started producing a daily email to provide clarity on our views on macro and micro-economic developments, and the implication for stock markets. These daily emails were supplementary to our weekly audio which also remains popular.

We also introduced a weekly wrap to summarise the best ideas from across the Fat Prophets suite of research products.

Whilst somewhat of a challenging year (and nerve wracking at times!), the enhancements we have introduced looked to have proved worthwhile. More nimble portfolio management has lifted the out-performance of the Australian Equities portfolio this year, and has also enabled us to establish positions in a number of high quality companies at reasonable prices. Overwhelmingly **positive feedback from Members meanwhile suggests that our service enhancements, and in particular the daily email, have been well received**.

We are pleased to report that this has also been rewarded in the form of an overall 'A' grade from Members this year. We thank Members that replied for their feedback and we have also published a representative selection of comments from each category in this year-end issue.

Back to the markets it is certainly telling to reflect back on changing attitudes towards (and outcomes in) key market risks at the beginning, during, and at the end of the year. And indeed it may offer some clues as to how markets will react to developments on each and other 'event risks' in 2013.

The US economic recovery

Going into 2012 many in the bear camp were forecasting a high probability of the US going into a double dip recession, with the world's largest economy growing at a relatively anaemic 1.8 percent in 2011. Some such as Nouriel Roubini espoused that the cold winds from Europe did not bode well for the health and wealth of the world's largest economy.

In our outlook piece at the start of this year we acknowledged the headwinds to US growth, and in particular those bellowing across the Atlantic from Europe. However, we also pointed out that the Fed had made allowance for its policy settings for a worsening European situation. And this would mitigate the economic fallout on the American economy.

And indeed as the year has gone on the Fed has not disappointed. **Interest rates have been kept low and the hands have remained on the fiscal levers, peaking in last week's announcement of QE4.**

The Fed has opted to continue buying $45bn of Treasury securities per month next year. This is on top of the existing $40 billion per month in mortgage-backed bonds they started buying in September.

Unlike the previous Operation Twist, the Fed will have no more short-term securities to sell, so the long-term Treasury securities are being rolled into QE3 and going forward will increase the monetary base.

As we commented last week in our daily emails, **the inflationary consequences here are yet to be fully appreciated**. As these policies (QE4) are implemented it will underpin an increase in asset prices (stocks and commodities), and most notably gold.

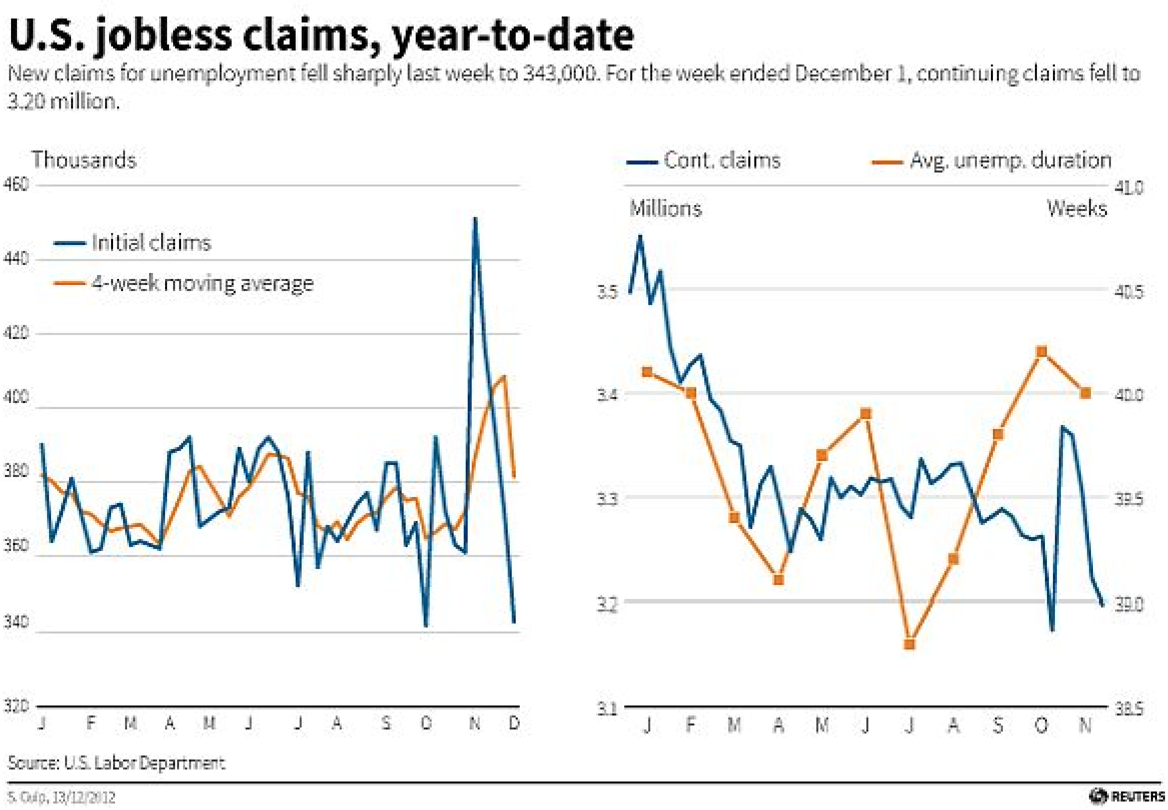
The Federal Reserve has also taken the unprecedented step to hold interest rates near zero until the US unemployment rate falls below 6.5 percent.

The FED has shown throughout 2012 that it remains committed to ensuring the US recovery remains on track, and this has placed a number of dents in the bear argument, as have meaningful improvements in a number of areas of the US economy.

A headline number that has been watched all year has been the jobs numbers and after remaining stubbornly high most of 2012, we have seen improvements coming through, particularly in the last quarter.

Most recently November's non-farm payrolls showed the number of jobs climbing by 146,000 in November. This was against a 'Sandy impacted' consensus of only 85,000 new jobs.

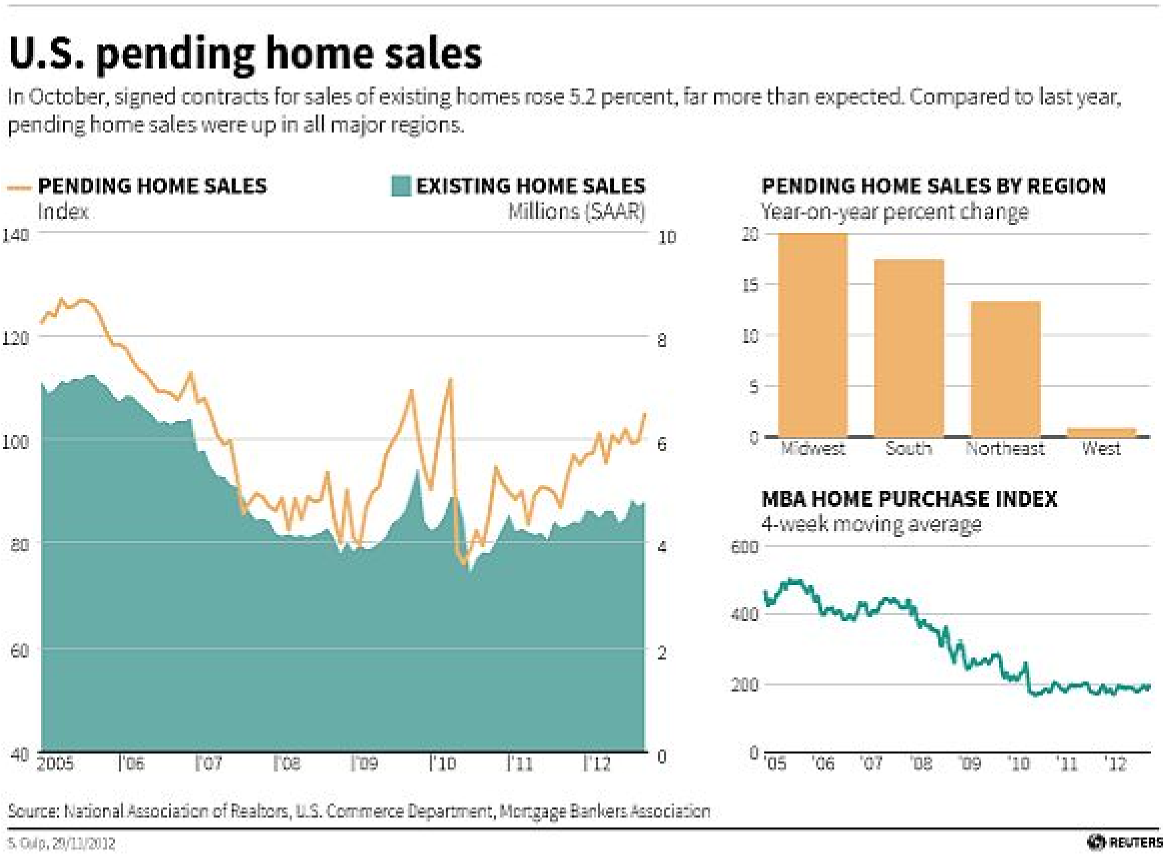
After popping above 8% earlier in the year, the US unemployment rate has also come down, recently falling from 7.8% to 7.7%, compared with expectations of a rise to 7.9%. The trend in the US is definitively down from levels post the GFC four years ago.



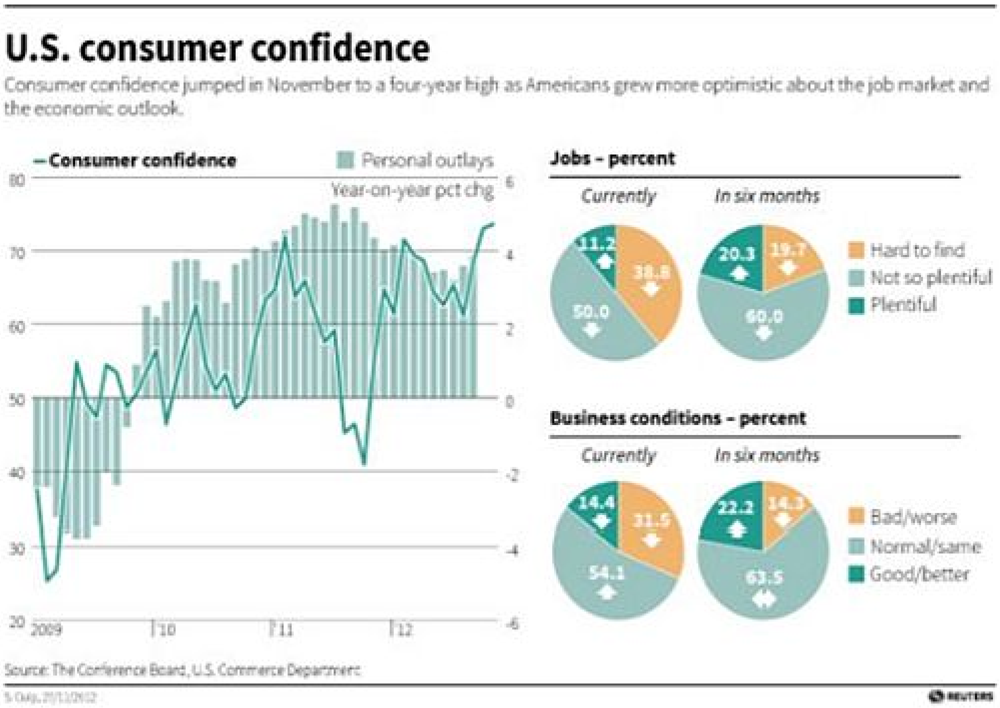
The health of the US housing market was also going to be key to an economic recovery in the US and the bearish case was aided at the start of the year by numbers showing that prices were continuing to fall.

However, signs started to come through in the early part of the year that the US real estate market was bottoming. We took the lead here, adding a number of US focussed building stocks to our portfolios. In Australia we recommended fibro cement maker James Hardie in July, with the upward move in the share price since, consistent with the housing recovery taking shape.

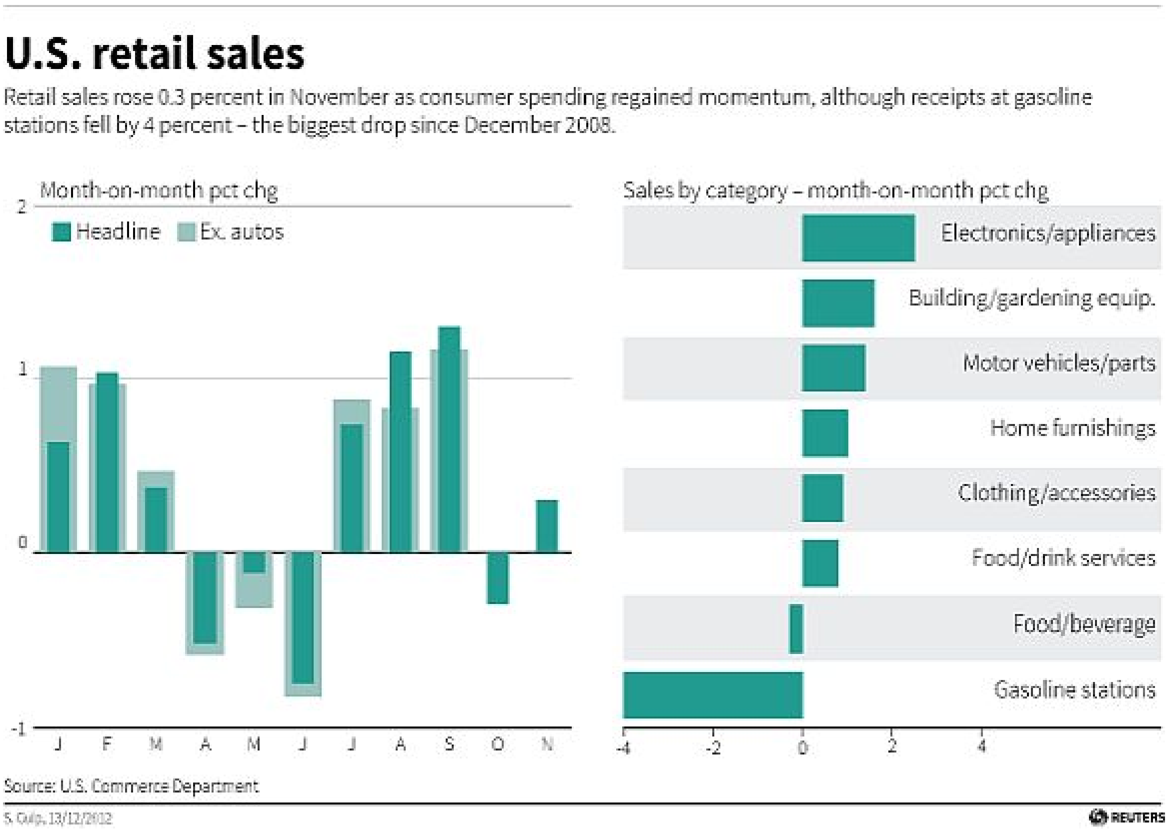
And certainly the US housing market continues to display positive signs**. An index of pending home resales recently climbed 5.2%, smashing the 1% consensus forecast, and exceeding even the most optimistic forecasts.**



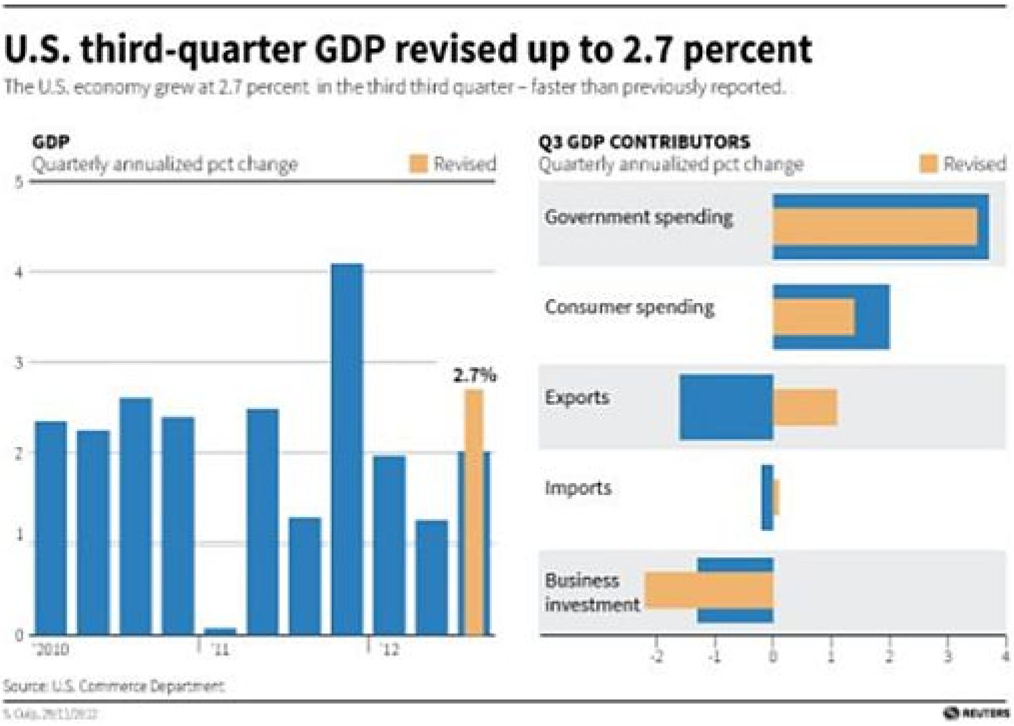
And with the jobs situation improving, and the housing market recovering, it is no surprise then that Americans are feeling more confident, and this is feeding through to consumer spending, a key engine of the US economy, accounting as it does for around 70 percent of the GDP.



Improving confidence has been increasingly showing in retail sales numbers as well as results from the big US retailers.



So overall the US economy has not imploded as many bears were suggesting at the start of, and regularly through, 2012. Third quarter GDP growth came in at 2.7 percent, and the US economy is still on track to clock a growth rate of about 2 percent this year.



US equity indices have also of course been aided by improving macro-economic data enticing cash back from the side-lines, and feeding through to earnings at the micro level. And whilst M&A activity has not scaled the heights anticipated, this has been made up for a trend of 'positive surprises' on the corporate earnings front.

Of course the big 'new event' risk heralded in recent weeks has been the fiscal cliff, with automatic stabilisers set to kick in the New Year. However as we have stated at length, the signs are there that parties on either side of Congress will find some middle ground, even if it does come at the eleventh hour. And it looks increasingly likely as if the fiscal cliff will prove another big non-event.

Europe

Another non-event this year was the break-up of the Eurozone.

The continent was very much in the cross hairs at the start of the year with lingering worries over sovereign debt risks in the 'peripheries' a key concern.

As the first half of the year trundled on, markets became increasingly concerned about the Eurozone, fuelled by doomsday predictions that the 'end of the zone' was nigh.

Things climaxed somewhat with an inconclusive Greek election in May which saw radical anti-bailout parties take charge, and predictions of a 'Grexit' followed. **Legendary trader George Soros upped the ante on officials, and caused some to panic, in forecasting that there were 'three months to save the Euro".**

Nouriel Roubini also chipped in, arguing to stay together the euro would need to hit parity against the dollar – this did not happen either – whilst down from the highs the euro is holding fairly stubbornly at 1.30.

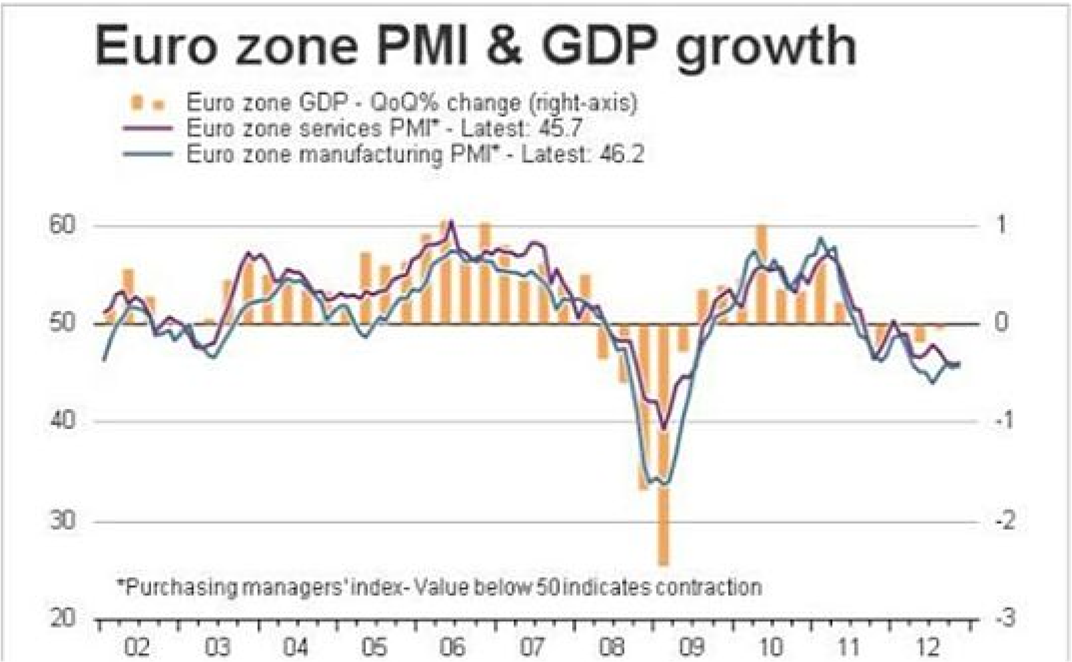
We took the view throughout the year (and still do) that the 'motivation' of self-preservation would see respective parties come together to ensure the Euro stayed together.

And so it proved with the climax of the EU rescue plan captured in the words of the ECB chief in June. **The self-preserving Super Mario stated they would do 'whatever it takes to preserve the Euro'**, emphasising that the ability of the central bank to achieve this end ought not be underestimated.

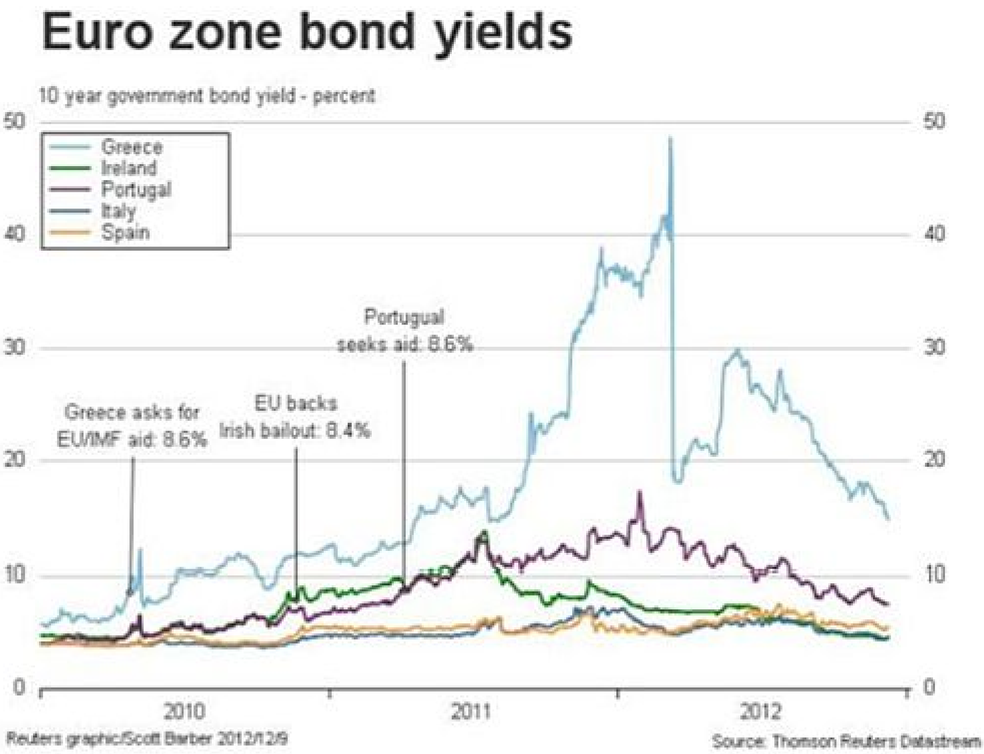
In the months since, cohesion between the respective parties in Europe has noticeably increase, and whilst the recovery is not done yet, fears over the breakup of the zone have greatly diminished. The recent agreement on a bailout deal for Greece not something that was in the reckoning a few months ago.

The air of co-operation in has been helped also of course by the commitment of Germany, the powerhouse of Europe and arguably the country having the most to lose from the demise of the Euro.

Certainly Europe has a long way to go before it is back to rude health, but the prospect of a breakup has all but gone.



Renewed investor confidence has also translated into a substantial decline in bond yields of the 'at risk' countries, thereby alleviating financing pressures in these countries, further reinforcing investor confidence.



And receding angst has also shown up in European equity markets, many of which have challenged eighteen month highs recently. The standout performer being the German Dax which has registered a gain year to date of 25 percent.

The Chinese landing

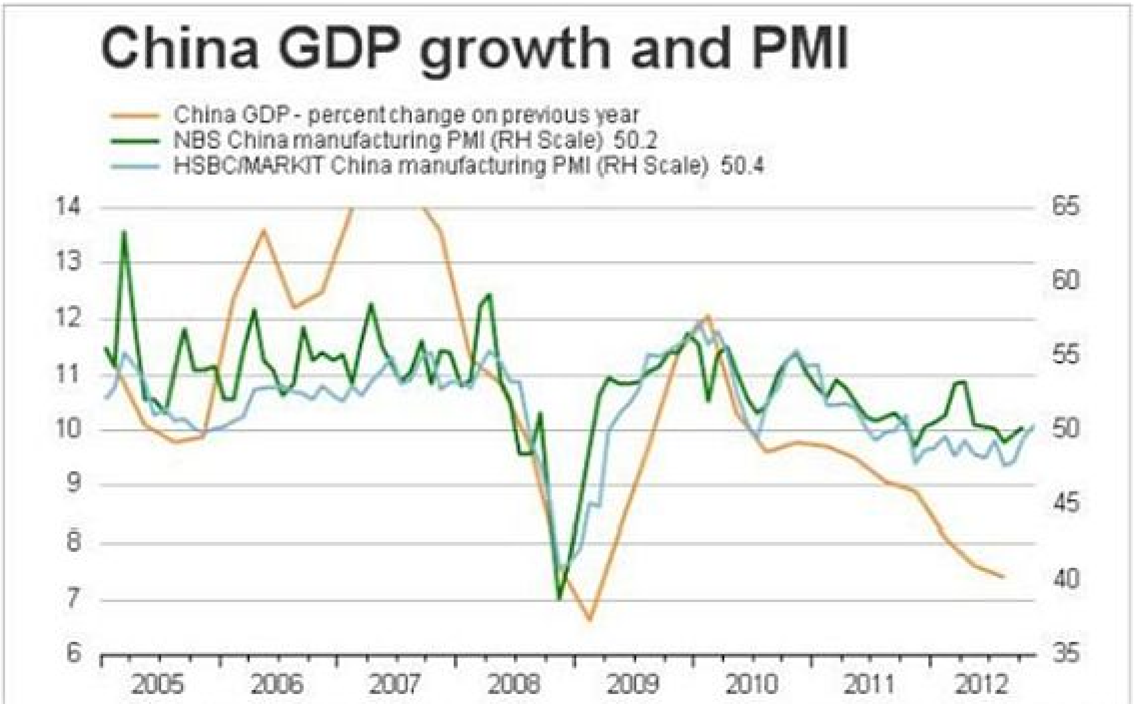
Another big risk heralded for the market in 2012 was a hard economic landing in China. Several months of growth deceleration in China, alongside a slump in the country's housing market, gave rise to speculation that the world's second-largest economy was headed for a hard thump in 2012.

At the start of year we commented that China's growth was certainly due to pull back from break neck speed, but this was not a bad thing. A slowdown to more sustainable levels of growth was in fact to be encouraged.

Throughout the dailies this year we have reiterated the view that the Chinese government with a few trillion in foreign exchange reserves had the means and willingness to ensure a soft landing. We also noted that the government's own annual growth target of 7.5% would be more than enough to facilitate an overall global economic recovery.

Such seems to have played out (particularly towards the latter end) this year, with China's growth rate slowing, but not collapsing. The country's growth rate slowed for seven consecutive quarters to 7.4 percent in the third quarter, but with overall annualised growth is still a fit 7.7 percent.

And the prospect of renewed momentum was seeded recently with the Chinese manufacturing sector expanding at the fastest pace in 14 months.



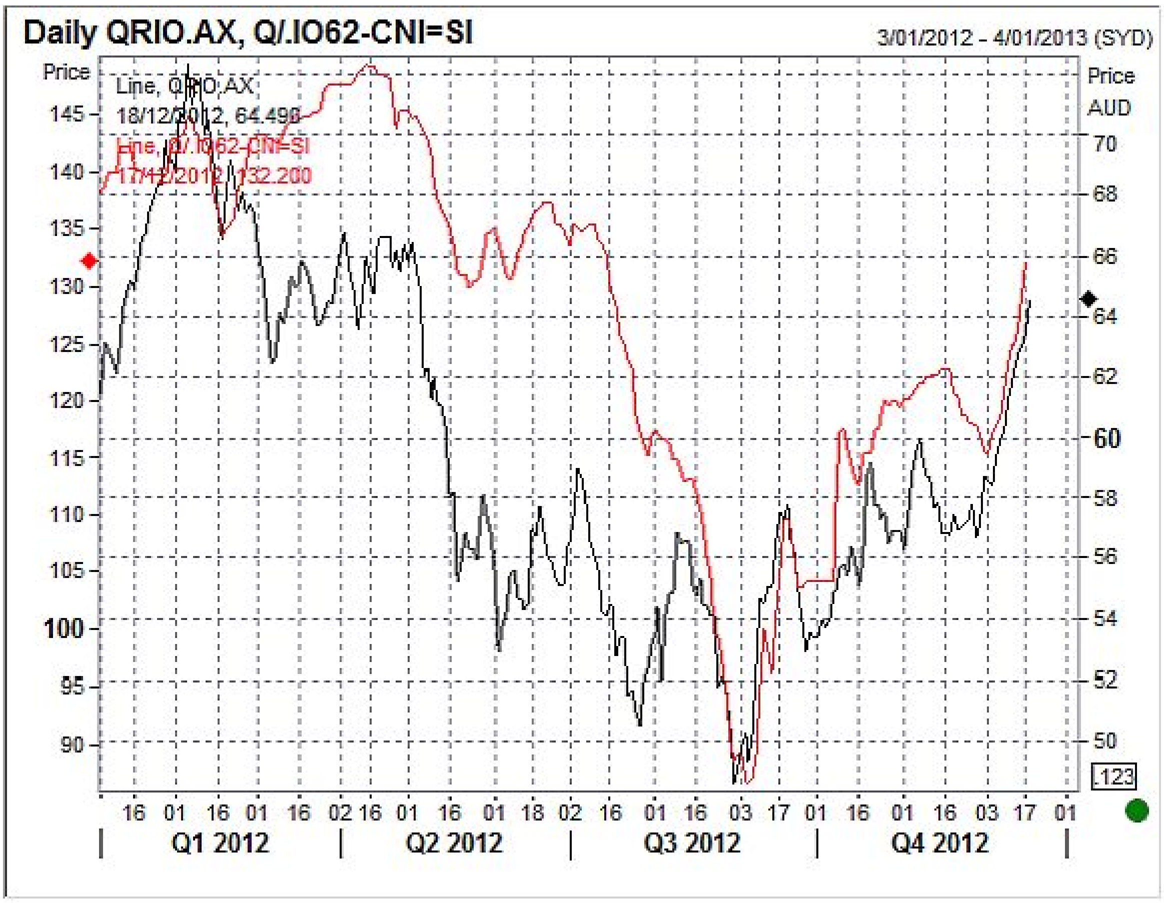
Other data (a recovery in exports and the housing market) also go to suggest that the hard landing scenario is less likely – and this is supporting investor sentiment globally. Certainly it is showing up in the Shanghai Composite Index which has broken up recently from a prolonged downturn.

The prospect of momentum returning to the China story also of course has important implications for the resource sector.

The resource space of course has not had the best year with the small end under significant pressure, and the larger end of the market struggling to eke out gains.

A look at the large diversified miners share prices however suggests that the tide may be turning, with the likes of BHP and RIO set to finish 2012 in positive territory.

These companies are heavily dependent on the fortunes of China (as the below graph plotting Rio versus the iron ore price shows) and a revival here should see a better year for both in 2013.



Gold

The gold market has also endured a challenging year with prices failing to push on to the previous year's highs in 2012, and not matching our expectation of prices going above $2000 an ounce. This was despite central banks applying the monetary and fiscal levers with some rigour throughout the year.

Underperformance in the gold price throughout the year seemed to lay in a lack of conviction that central banks would follow through on their promises of substantial stimulus. And arguably much of this did not come till later in the year. The perceived view of the greenback as the go-to safe haven currency no doubt also contributed during periods of volatility.

Softer than expected demand from the two largest consumers in the world, China and India, also failed to provide much support for the precious metal this year.

However recent central bank action could well up the pressure valve on the gold price in our view. The Fed has pushed the button on QE4, with the expansion in the total money supply inevitably proving to be inflationary, and a potential catalyst for a significant upward move in the gold price (and another downward leg in the US dollar). **A ramping up of exchange reserves diversification by China could be a key driver here.**

The performance of the gold miners this year meanwhile has been somewhat mixed with the sector lagging the gold price for long periods over the course of the year.

There have been some bright spots, such as Evolution Mining, but it has been somewhat disappointing to see the likes of Newcrest fail to finish the year in the black.

Our expectation of strength in the gold price next year however should see some catch up here, and restore investor faith. Particularly as many investors have already capitulated and given up on the sector.

The Australian economy and the RBA

Politicians further sullied their already poor reputations throughout the year with some disgraceful behaviour from all sides.

In the meantime, policy was cast adrift to bob around on the sea of indecision particularly with regard to illegal immigrants, gaming machine restrictions, tax reform, industrial relations and other important factors influencing the economy.

In tandem with the bickering and bile was the vaporising prospect of the Treasurer's promised budget surplus as commodity prices seemed to disappear down the plughole.

The nonsensical stubbornness of the Treasurer to stick with a political promise at the expense of economic reality could result in some distorted budget decisions that would otherwise have been unnecessary.

The government's fiscal tightness has contrasted with the Reserve Bank's increasingly relaxed monetary policy as the inflation threat has not materialised and weak international conditions have remained ominously present.

Recognising the risks to the economy, the RBA lowered interest rates by 1.25% this calendar year to 3.0%. This will no doubt be welcome respite to those industries suffering from strength of the Australian dollar and we believe there will be further relief in the offing in 2013.

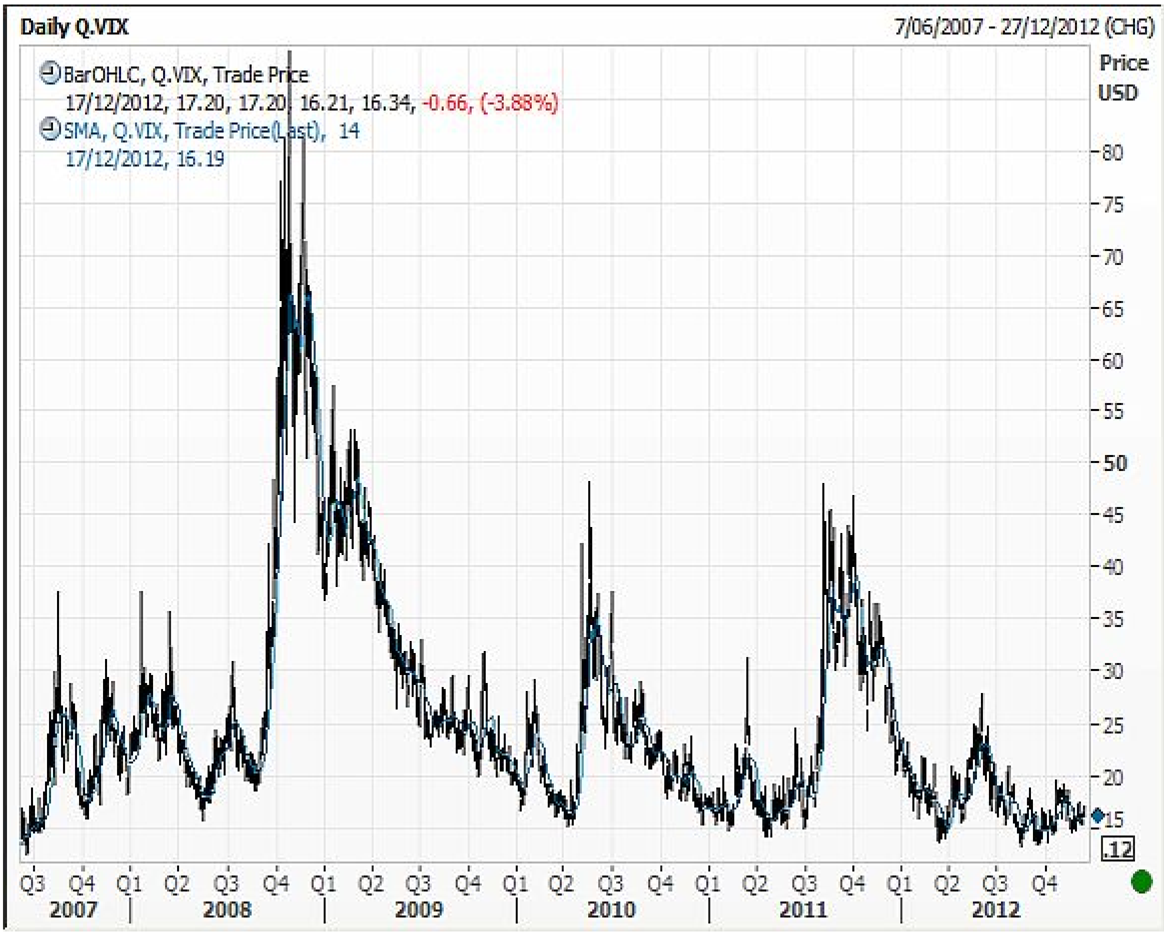
Low cash rates meanwhile have further increased the yield appeal of equities, with income-hungry investors lapping up the big dividends on offer across the banks, Telstra and other defensive stocks.

Where was the volatility?

Looking at the risks facing the markets this year, it is perhaps surprising to look back and see that levels of investor angst, whilst bumping up at certain times, at no point looked like reaching the heights seen in the GFC.

The VIX volatility index peaked in 2012 mid-year as concerns over Europe and the potential breakup there reached a crescendo.

However the market's realisation that many problems were 'fixable', given the wiliness and interests of preservation of various parties, saw the angst gauge fall back.



The story of the index, which has been pretty much range bound in the second half of the year, would seem to confirm the tale of 2012 as one of big risks that were somewhat navigated.

Stock selection

Nonetheless periods of market volatility created plenty of opportunity this year, both on the buy side and the sell side.

We took the opportunity to exit (or partially exit) a record 18 recommendations this year and these are outlined in a separate piece in this week's report.

On the buy side we seized various windows to add several high quality companies that we believe were being ignored by the market. Included in the list are the likes of Carsales.com, Magellan Financial, Graincorp, Onthehouse, IOOF Holdings, Silver Chef, Amcom Telecommunications, IMF and James Hardie,

The share price performance of the vast majority since, vindicates this strategy.

On reflection 2012 was indeed a year where many key market risks proved to be somewhat of a non-event, thereby rewarding investors who stayed the course amidst periods of volatility.

Whilst risks have certainly not dissipated we expect 2013 to again throw up opportunities, and we remain committed to seeking these out for Members again next year. We discuss the areas where these will potentially lie in our 2013 Outlook piece in our next report on the 8th January. We will also produce our views on the Top Themes for 2013, many of which might surprise some.

Signing off on 2012, we would like to thank all Members for their continued support, and wish all a happy and safe Christmas and a prosperous New Year.

Best wishes,

Fat Prophets
