The Weekly Letter

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CHALLENGES FACING EMERGING MARKETS: As the Federal Reserve continues to reduce its monthly purchases of Treasury and agency bonds, equity markets, and Emerging Markets in particular, are grappling with the reality of less support. At the same time, investors have been flooded with a number of concerns in Emerging Markets, but principally over the growth of the "shadow banking" system in China. Amid these crosscurrents, we believe volatility for both Emerging Market debt and equity markets are likely to rise.

MARKETS THIS WEEK: U.S. equities finished lower for the week, with the S&P 500 posting a 0.4% loss. The further reduction of quantitative easing by the Federal Reserve continued to weigh on markets this week, especially Emerging Markets. The yield on the 10-year U.S. Treasury fell to 2.7%. Our Bank of America Merril Lynch (BofAML) U.S. Economics team downgraded U.S. 1Q 2014 gross domestic product (GDP) to 2.0% from 2.3%, but upgraded 2Q 2014 GDP to 3.3% from 3.0%. The 2014 GDP growth rate of 3.0% remains unchanged, but the timing of the growth shifted.

LOOKING AHEAD: In the U.S., the ISM Manufacturing Index is expected to have slowed modestly in January and an increase in payroll data is likely to show ongoing improvement in the labor market. In Europe, both the European Central Bank and the Bank of England are forecast to keep policy rates at current levels.

Making Sense Out of Emerging Markets Turbulence

Over the past several years, risky assets—and equities in particular—have benefited from the abundant liquidity that the Federal Reserve (Fed) has provided through its quantitative easing program. In place since 2009, each new wave of easier monetary policy provided more support for upwardly trending equity markets. Emerging Markets in particular benefited from this liquidity, as investors used cheap U.S. dollars provided by the Fed to invest in Emerging Markets with higher expected returns.

However, with the Fed now reducing some of that support—this week the Fed elected to reduce further the monthly purchases of Treasury and agency bonds—equity markets, especially Emerging Markets, are grappling with the reality of less support. Like a bus with the U.S. at the wheel, as the Fed slowly takes its foot off the gas pedal, the Emerging Market passengers in the back seats are finding the slowdown feels more abrupt.

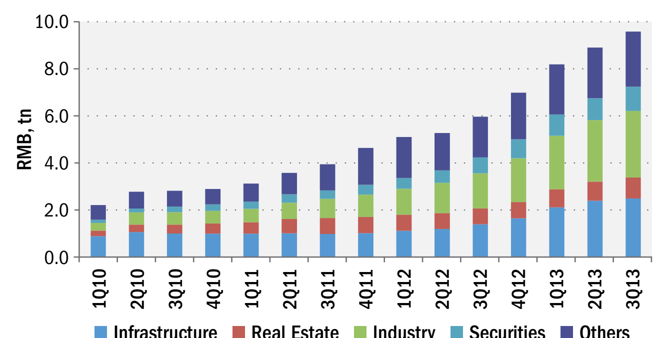
At the same time that concerns over monetary support are

Major Market Indicators

		Total Return (%)		
	Level	WTD	MTD	YTD
S&P 500	1,782.6	-0.4	-3.5	-3.5
MSCI World[1]	4,194.1	-0.7	-3.2	-3.2
MSCI EAFE[1]	4,913.7	-2.3	-4.0	-4.0
MSCI Emerging Mkts[1]	383.8	-1.4	-6.5	-6.5
Gold Spot[2]	1,244.2	-2.0	3.2	3.2
WTI Crude $/Barrel[2]	97.5	0.9	-1.0	-1.0
		Total Return (%)		
	Yield	WTD	MTD	YTD
ML U.S. Broad Market[1]	2.29	0.3	1.5	1.5
U.S. 10-Year Treasury[1]	2.70	0.7	2.9	2.9
ML Muni Master[1]	3.25	0.1	2.2	2.2

Source: Bloomberg. [1]As of previous day close. [2]Spot Price Returns. Data as of publication date unless previously indicated. **Past performance is no guarantee of future results.**

Exhibit 1: Composition of the trust sector's AUM



Source: BofA Merrill Lynch Global Research, CEIC.
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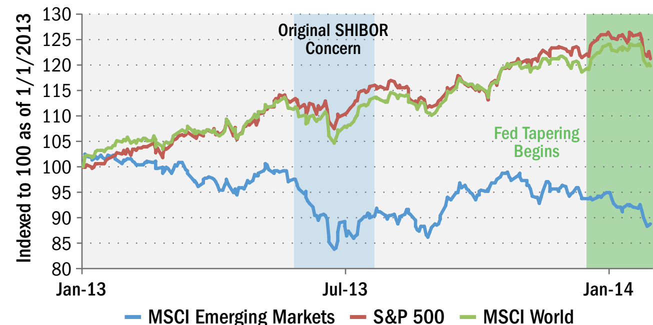
rising, investors have been flooded with a number of concerns in Emerging Markets, but principally over the growth of the "shadow banking" system in China.[1] News last week of a potential default in trusts reminded investors that it was a credit binge that fueled China's post-2009 economic recovery. While China takes center stage, volatility of Emerging Markets has also been heightened by political unrest in Turkey and the fragility of the currencies of many countries, including Argentina.

BEYOND THE HEADLINES

Our primary intermediate-term concern relates to the risk that a tightening of credit in China could have on both the Chinese and global economies. The backdrop for these concerns centers on the growth of the lightly-regulated "shadow banking" sector, in which the potential failure of structured products could expose investors and the Chinese financial system to significant losses. "Shadow banking" in China has grown from 8.3 trillion renminbi at the end of 2010 to 22.1 trillion renminbi in the third quarter of 2013.[2] Two areas of particular concern within the Chinese credit system are the growth of wealth management products and trusts (see Exhibit 1, on the previous page). The former are bank-generated investment products that are sold to both retail and institutional customers with the potential for high returns. Trusts resemble universal banks that can engage in most financial activities, including lending, equity investment, structured products and portfolio management; although they can't take deposits from the public, they offer much higher yields as compared to deposit rates. Trusts help move assets off bank balance sheets to free up on-balance-sheet capacity for additional bank lending. Yet with the asset quality of many of these trusts proving to be poorer than initially expected, the probability of default has risen. The fear is that in the opacity of the "shadow banking" system, a few defaults could lead to much larger losses across the Chinese financial system.

Although BofAML Chinese Economist Ting Lu believes trust defaults are likely to rise in 2014, his view is that they are likely to be constrained to the mining sector (which is believed to represent only a few percent of the trust market). Lu believes that the Chinese economy would likely be able to absorb the losses that would ensue. Several reasons are that China has large global foreign exchange (FX) reserves (over $3 trillion) and public debt remains low (central government debt is 21% of China's GDP). Still, with investors concerned about immediate credit issues in China, they will likely weigh on Chinese equities in the first half of 2014—and more broadly on Emerging Market equities, as was the case in 2013 (see Exhibit 2).

Exhibit 2: Emerging Markets haven't recovered since the original Chinese credit concerns



Source: Bloomberg and ML GWM Investment Management & Guidance.
Data as of January 29, 2014.
Past performance is no guarantee of future results.

With all of the turbulence in Emerging Markets, BofAML Global Research Global Emerging Market Equity Strategist Ajay Kapur emphasizes that the focus should be on preserving capital in the near term. In his view, this is accomplished by favoring countries with healthy current account balances and improving equity earnings ratios and companies with strong balance sheets—a view to which we adhere.

Portfolio Strategy: We believe that as the year progresses, many of the structural issues facing Emerging Markets are likely to be addressed through a combination of central bank intervention and fiscal policy. However, during this period we see a risk of greater volatility for both Emerging Market debt and equity markets until investors are comfortable with policymakers' actions. Our view on Emerging Markets remains neutral as we look for sustained improvement from both macroeconomic indicators and policy reform before reevaluating our positioning.

Amid these crosscurrents, we are not adding to broad Emerging Market equities. As we noted last July (see the *CIO Monthly Letter "Emerging Markets – Time for a CHANGE"*), where clients are allocated to Emerging Market equities, we advise moving away from index investments (which we find are unrepresentative of the future successes within Emerging Markets). Instead, we believe they should move toward active managers who can be selective and biased toward the smaller Emerging Markets, including Frontier Markets.

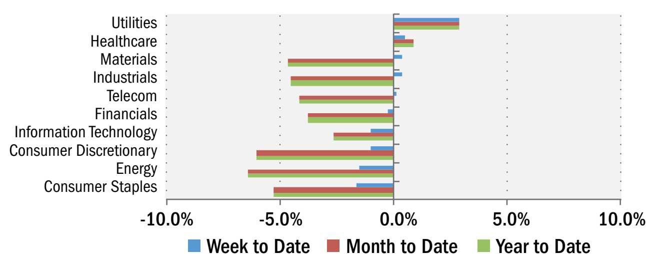
[1] We define shadow banking as the sum of trust loans, entrusted loans and corporate bond balances from the total social financing release.
[2] Data is from the Total Social Financing monthly tables that are non-seasonally adjusted from Haver Analytics & People's Bank of China.

Markets This Week

Trailing Economic Releases

- The Federal Open Market Committee (FOMC) continued its reduction of quantitative easing by $10bn, bringing the total monthly purchase pace down to $65bn. In addition, the FOMC made no changes to their forward guidance. While the pace of tapering will be a significant indicator as to how the Fed interprets incoming data, particularly related to the labor market, we believe that the Fed will continue to use a range of indicators in addition to the unemployment rate to evaluate the health of the economy.
- 4Q 2013 U.S. GDP showed the economy expanding at a 3.2% quarter-over-quarter seasonally adjusted annual rate (SAAR), following a 4.1% rate in 3Q. A significant portion of the 4Q 2013 GDP was from inventory build, which will likely reverse and weigh on 1Q 2014 GDP. BofAML Global Economics Research revised down their 1Q 2014 forecast from 2.3% to 2.0%.
- Durable goods orders in the U.S. dropped 4.3% month-over-month in December, well below expectations of a 1.8% increase. The November durable goods order was revised down to 2.6% from 1.6%. While the report disappointed relative to expectations, the report is inconsistent with other indicators of investment spending (e.g., ISM and Beige Book) and we look to additional data releases over the coming weeks to evaluate capital spending trends.

S&P 500 Sector Returns



Equities

		Total Return (%)		
	Level	WTD	MTD	YTD
DJIA	15,698.9	-1.1	-5.2	-5.2
Nasdaq	4,103.9	-0.6	-1.7	-1.7
S&P 500	1,782.6	-0.4	-3.5	-3.5
S&P 400 Mid Cap	1,313.1	-0.1	-2.1	-2.1
Russell 2000	1,130.9	-1.1	-2.8	-2.8
MSCI World[1]	4,194.1	-0.7	-3.2	-3.2
MSCI EAFE[1]	4,913.7	-2.3	-4.0	-4.0
MSCI Emerging Mkts[1]	383.8	-1.4	-6.5	-6.5

Fixed Income

		Total Return (%)		
	Yield	WTD	MTD	YTD
ML U.S. Broad Market[1]	2.29	0.3	1.5	1.5
U.S. 10-Year Treasury[1]	2.70	0.7	2.9	2.9
ML Muni Master[1]	3.25	0.1	2.2	2.2
ML U.S. Corp Master[1]	3.15	0.1	1.7	1.7
ML High Yield[1]	5.83	-0.3	0.8	0.8

Commodities & Currencies

		Total Return (%)		
	Level	WTD	MTD	YTD
DJ-UBS Total Return	253.9	-0.7	0.3	0.3
Gold Spot[2]	1,244.2	-2.0	3.2	3.2
WTI Crude $/Barrel[2]	97.5	0.9	-1.0	-1.0
Level	**Current**	**Prior Week**	**Prior Month End**	**2013 Year End**
EUR/USD[2]	1.35	1.37	1.37	1.37
USD/JPY[2]	102.1	102.3	105.3	105.3

Source: Bloomberg. [1]As of previous day close. [2]Spot Price Returns. Data as of publication date unless previously indicated. **Past performance is no guarantee of future results.**

Looking Ahead

In the U.S., the ISM Manufacturing Index is expected to have slowed modestly in January and an increase in payroll data is likely to show ongoing improvement in the labor market. In Europe, both the European Central Bank (ECB) and the Bank of England (BoE) are forecast to keep policy rates at current levels.

Upcoming Economic Releases

- Economists expect the U.S. ISM manufacturing PMI to edge slightly lower, from 56.5 in December to 56.0 in January, as cold weather likely weighed on manufacturing activity. Even at 56.0, the reading suggests a still healthy rate of expansion in U.S. economic activity.
- On Friday, U.S. non-farm payroll data is forecast to rise by 180,000 in January, reversing December's weak 74,000 increase. The unemployment rate is expected to remain at 6.7%. These data releases should confirm ongoing healing in the labor market.
- In Europe, both the ECB and the BoE are expected to maintain interest rates at current exceptionally low levels next Thursday (at 0.25% and 0.50%, respectively).

BofA Merrill Lynch Key Forecasts

S&P Outlook	2014 E
S&P 500 Target	2,000
EPS	$118
Real Gross Domestic Product	**2014 E**
Global	3.6
U.S.	3.0
Euro Area	1.0
Emerging Markets	5.0
U.S. Interest Rates	**2014 E**
Fed Funds	0-0.25
10-Year T-Note	3.75
Commodities	**2014 E**
Gold	1,150
WTI Crude Oil	$92

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Asset allocation and diversification do not assure a profit or protect against a loss during declining markets.

The investments discussed have varying degrees of risk. Some of the risks involved with equities include the possibility that the value of the stocks may fluctuate in response to events specific to the companies or markets, as well as economic, political or social events in the U.S. or abroad. Bonds are subject to interest rate, inflation and credit risks. Investments in high-yield bonds may be subject to greater market fluctuations and risk of loss of income and principal than securities in higher rated categories. Investments in foreign securities involve special risks, including foreign currency risk and the possibility of substantial volatility due to adverse political, economic or other developments. These risks are magnified for investments made in emerging markets. Investments in a certain industry or sector may pose additional risk due to lack of diversification and sector concentration. Investments in real estate securities can be subject to fluctuations in the value of the underlying properties, the effect of economic conditions on real estate values, changes in interest rates, and risk related to renting properties, such as rental defaults. There are special risks associated with an investment in commodities, including market price fluctuations, regulatory changes, interest rate changes, credit risk, economic changes and the impact of adverse political or financial factors.

Income from investing in municipal bonds is generally exempt from federal and state taxes for residents of the issuing state. While the interest income is tax exempt, any capital gains distributed are taxable to the investor. Income for some investors may be subject to the federal alternative minimum tax (AMT).

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