From Prudential, Prudent Forecasts for 2013

By Editor Test *Thu, Jan 17, 2013*

"We're overweight stocks across the world. We're also overweight high-yield bonds even though the rally there has been going on a long time," said Edward F. Keon of Quantitative Management Associates, a unit of Prudential Financial.

Dangerous though it is to make predictions, football pundits, *Farmer's Almanac* publishers and financial professionals continue to make them, especially at this time of year. They can't seem to help it. It goes with the territory.

So, at the Millennium Hotel in chilly midtown Manhattan last week, a panel of five Prudential executives delivered their economic forecasts for 2013 to the assembled media representatives—though not in terms that could be construed as promissory or exceeding the legal safe harbor for forward-looking statements.

Sometimes it's good to be overweight

Prudential has a "bullish tilt" for 2013, said Edward F. Keon, managing director and portfolio manager, Quantitative Management Associates (seated at far right, with Quincy Crosby and John Praveen), a research unit of Prudential Financial. "We're overweight stocks across the world. We're also overweight high-yield bonds even though the rally there has been going on a long time."

Keon called 2012 "relatively calm" in terms of volatility and pointed to the S&P 500's 16% return as evidence. "It's been a pretty good year despite all the uncertainty," he said. "A lot of the bad stuff that we feared didn't happen."

In contrast to the 20% drop in equities that followed the battle over the debt ceiling in 2011, the market took the tumultuous Presidential contest and the fiscal cliff in stride, he said. The market had apparently decided to "ignore the rhetoric" and assume that politicians can generally be relied on to "do what they think is right" for the country.

Keon expects U.S. GDP to grow by (2% GDP growth?) and corporate earnings to grow by 10% in 2013. The drag from a higher payroll tax and higher taxes on the wealthy could be "offset by a drop in gasoline prices."

Asked why equities prices rose in 2012 despite huge outflows from equity funds, Keon said that some of the money has simply moved into equity ETFs but that the biggest factor has been corporate buybacks of their own shares. "There's no evidence of that slowing down," he said.

A 'dichotomy' explained

Reflecting on 2012, John Praveen, managing director and chief investment strategist, Prudential International Investment Advisors, observed a "dichotomy" between weak economies and strong financial markets around the world. Expansive monetary policies rescued the financial sector and eased pressures that might have split the Eurozone.

"Central bank liquidity explains this dichotomy," Praveen said, attributing actions by Ben Bernanke at the Fed and to Mario Draghi at the European Central Bank with calming the markets and keeping Greece from abandoning the euro.

The ECB, the Bank of England and the Bank of India have all cut interest rates, he said, and the Bank of Japan announced that it would do more in terms of providing liquidity. Praveen noted that a second quarter correction hurt the markets but a fourth quarter uptick in China's growth rate gave it a second wind.

Moving at 'muddle speed'

Quincy Crosby, chief market strategist, Prudential Annuities, extended the discussion of the macro-economy. "The markets have been driven by policy announcements," she said. "Draghi is responsible for the European rally. Credit has eased, there's less volatility and risky assets have been moving higher."

Crosby continued, "There have been 326 separate easing actions by central banks around the world, and the stimulus has underpinned markets. The lower rates are helping companies with their debt loads and giving households more disposable income, enabling the economy to move at 'muddle speed.'

"The truth is, markets don't need much growth to do well," she added, predicting industrial stocks and the industrial metals business will pick up in the U.S. in 2013. "Money will be moving to U.S. companies that have strong overseas markets."

In terms of bonds, she said, "the barbell strategy of 2012 should still be in play"—meaning that investors will put money in short- and long-term bonds but not in intermediate bonds.

"There will a scavenger hunt for yield by consumers," she added. "Pensions will be taking more risk. The worry is that you could see a buildup of tremors around the world. Inflationary pressures may be rising in emerging markets and the question is, will emerging market central banks 'tighten' in response. That's how the cycle works."

When emerging markets tighten, she explained, overseas sales of U.S. companies fall.

Crosby expanded on her comment about “tremors.” “I’m a devotee of Hyman Minsky,” she said. “Complacency leads to trouble. Ben Bernanke is forcing people into riskier assets. Risk begets risk until, when fear hits, it gets out of control.” She interprets the flow of money into high-yield bonds and rising levels of margin debt as signs of complacency about risk.

The Fed, she said, may be setting up the markets for a fall. “Bernanke made it clear that he’ll work out an exit strategy when we get to 6.5% unemployment. So now everybody is focused on the labor reports. But there will be dislocations associated with that. What if they all try to sell at the same time?” She would like to see a bit of inflation. “We hope we’re on the cusp of seeing some inflation and rise in yields. That would confirm that growth is picking up in the U.S.”

‘We like high-yield’

“Rates will stay low in 2013,” said Michael K. Lillard, managing director and chief investment officer, Prudential Fixed Income—a prediction that echoes the Fed’s own statements. In Washington, D.C., “budget battles will continue,” he added. Congressional action will be characterized by “small deals, little fixes and lots of brinkmanship.”

Otherwise, he thinks most of the economic indicators are reading positive for the year ahead. Lillard expects 2% growth in the U.S. this year, 5% growth in emerging markets and 3% average growth worldwide.

“The Fed is in a data dependent mode. Depending on the unemployment rate, the Fed will keep buying securities. There’s value in fixed income overall, but not in U.S. Treasury issues or U.S. agency debt. Government debt might be downgraded again. Two thousand twelve was a good environment for credit products,” Lillard said.

“We like high-yield. Companies are holding steady, with cash on hand,” he added. “The high-yield sector doesn’t show any precursors of defaults. We see a 2% default rate.” He likes “double B” bonds paying a 5% coupon and “single B” bonds paying 6% a year. “We like U.S. money center banks. Banks are more liquid and they’ve got fewer bad assets on their books” than had been the case, Lillard said. “Tighter regulations will keep the banks from taking too much risk.”

Lillard also likes AAA-rated floating rate CLOs (collateralized loan obligations) with subordination levels of 35%, which he said currently offer 140 basis points over LIBOR. “We’re also positive about emerging market foreign exchange, which is biased to outperform the dollar,” he said.

Social Security ‘not going away’

George Castineiras, senior vice president, Prudential’s Total Retirement Solutions, said, “The outlook is very positive for retirement income,” pointing to the fundamentals represented by $18.5 trillion in retirement-oriented savings, the inevitable retirement of the Baby Boom generation over the next 20 years and their need for retirement income.

Regarding Social Security, he said, “The average person thinks that it will go away. It won’t go away. Americans depend on Social Security for between 30% and 70% of their income in retirement. You can’t vaporize that.” He called the status of Social Security “grossly misunderstood” and feared that this misunderstanding might motivate too many retirees to start their benefit at age 62 and lock in a minimum payout for life.

Prudential Retirement is of course a big player in the defined contribution plan business, serving some 3.6 million participants and annuitants in more than 4,200 plans with accounts worth about $240 billion.

The big trend in DC plan is automation, he said, referring to automatic enrollment, automatic investment selection, automatic escalation of contributions and automatic income planning (default into a lifetime withdrawal benefit wrapper around target-date fund assets).

To succeed in the DC business, he said, a service provider has to be good at administration, risk management and employee engagement. “Right now, engagement models are bad,” Castineiras said—a reference to the still-evolving regulations intended to govern communication between 401(k) service providers and participants and ensure that participants get unbiased advice about their savings.