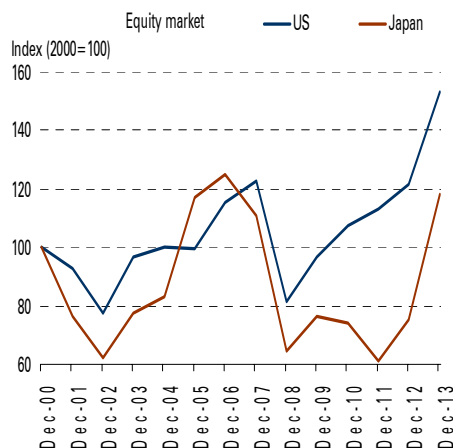


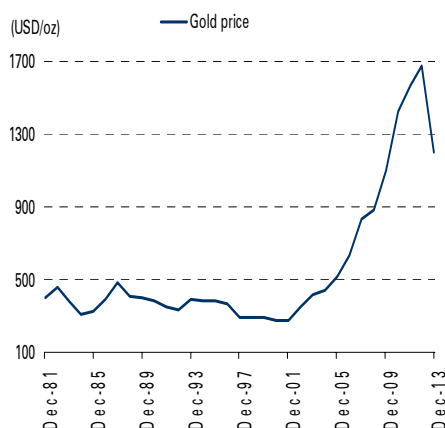
2013: a year of volatile returns

DM equities posted phenomenal gains...



Source: Bloomberg, ICICI Bank Research

...while Gold reversed more than decade-long rally



Source: Bloomberg, ICICI Bank Research

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- This year saw substantial market volatility and concerns over Fed QE tapering a key theme driving markets
- There was also a rotation of capital flows from Emerging markets (EMs) to Developed markets (DMs), amidst improving growth prospects in DMs led by the US
- While DM equities posted phenomenal gains, Gold turned out to be a major laggard with highest annual loss in 3 decades

The markets moves in 2013 were driven by 2 key themes: concerns over QE tapering by the US Fed and the sharp improvement in growth prospects in advanced economies led by the US.

Great rotation in equities

DM was the flavour of the season, with US and Japanese equities rising ~30% and 57% respectively. Meanwhile, EMs posted a relatively weak performance.

Broad based sell off in bonds

Fed QE tapering concerns triggered a global debt market selloff. The US 10Y yield spiked ~1.3%, while EMs like Indonesia with high FII debt holdings saw a more than 3% rise in benchmark yield.

Volatile trading in FX markets

Dollar performance against EMFX was in sharp divergence compared to DM counterparts. Euro was a major gainer, while Yen was pressured heavily by BoJ policies. EMFX sold off particularly in high current account deficit economies.

Gold loses sheen

The key theme within commodity space was the reversal of a more than decade-long rally in Gold. The bullion witnessed highest annual loss in ~32 years. Meanwhile, Brent crude prices remained largely stable, though periodic spikes were attributable to geopolitical tensions.

In conclusion, the markets have digested the Fed taper and are entering 2014 with a semblance of stability. The underlying fundamentals warrant a continued outperformance in DM equities. However, any shift toward aggressive taper remains a key risk to financial market outlook.

<p><i>Fed QE tapering expectation was a key market mover in 2013</i></p> <p><i>2013 witnessed a rotation of capital flows from DMs to EMs</i></p> <p><i>DMs growth prospects have improved sharply vis-à-vis the EM peers</i></p> <p><i>DM was the flavour of the season while EMs underperformed</i></p> <p><i>US 10-year yield spiked more than 1% triggering a broad based debt market sell off</i></p> <p><i>EM bond performance linked to FII debt holding</i></p>	<p>Introduction</p> <p>This year saw substantial volatility in the global financial markets. The major market mover was the concerns over reversal of the Fed's policy stance as Bernanke popped the taper word in May-2013. This triggered a broad selloff across asset classes, particularly in the liquidity-dependent emerging markets. The global markets slowly digested the fact that tapering was imminent. The recent US monetary policy decision to actually start the taper was thus the anticlimax of a market reaction that had started in May. The global markets took the Fed policy decision in their stride and have witnessed a semblance of stability.</p> <p>Interestingly, the year witnessed a rotation of capital flows from Emerging Markets (EMs) to Developed Markets (DMs). DM equities were the key performer, amidst improving growth outlook, led by US economy. However, gold was the biggest loser of 2013 with weakest performance in 3 decades.</p> <p>Great rotation in equities</p> <p>The year witnessed a Great Rotation of flows from bond to equities and EMs to DMs. This was driven by fundamental improvement being witnessed in the DM growth prospects, vis-à-vis EMs. As per the IMF estimates, global growth is likely to strengthen to 3.6% in 2014 from estimated 2.9% this year, amidst a rise in DM growth to 2% from 1.2% in 2013, primarily led by the US. Meanwhile, EM growth is likely to be subdued in 2014 at 5.1% as against long-term average of 6.1%.</p> <p>This translated into a rise in investor interest into DM equities, with US stock index hitting record highs. Dow Jones posted an annual gain of ~26%, the highest annual gains since 1998. Another notable outperformer was the Japanese Nikkei index, which witnessed the highest annual return since 1972. The spectacular performance is largely attributable to "Abenomics", the term coined to indicate the ultra accommodative policy stance adopted by Japanese premier.</p> <p>Meanwhile, the liquidity driven EM stock indices posted relatively weak performance vis-à-vis their DM counterparts, as the Fed initiated QE tapering. Within the key EM equity space, Brazilian Bovespa underperformed, registering a loss of 15%.</p> <p>Meanwhile Indian equities market gained 9% during the year. Interest in Indian equities continued to remain strong, as FII poured USD 20 bn in the Indian equity markets.</p> <p>Broad based sell off in bonds</p> <p>In anticipation of Fed reversing its easy monetary policy stance, the global fixed income markets remained under pressure in CY2013.</p> <p>The US 10 year yield jumped more than 1% to touch the psychological 3% mark. This also triggered a sell off in German and UK bond market.</p> <p>With US rates rising, the foreign investors sold their EM debt holdings, thereby leading to broad based selloff in EM bonds. The extent of sell off was also determined by the FII holding in specific EM markets.</p>
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<p><i>Indonesia underperformed all debt markets, given ~60% FII debt holding</i></p> <p><i>Dollar performance against EMFX was in sharp divergence compared to DM counterparts</i></p> <p><i>EMFX came under pressure on Fed QE tapering concerns, with BRL, INR, IDR, ZAR and TRY coming under severe stress</i></p> <p><i>Gold was the biggest loser amongst asset classes, with highest annual loss in 3 decades</i></p> <p><i>We are entering 2014 with a semblance of stability in global markets</i></p> <p><i>Shift toward aggressive taper key risk to financial market outlook</i></p>	<p>A case in point is Indonesia, where the benchmark bond yield, spiked by more than 300 bps, given that FII hold almost 60% of the debt holding.</p> <p>Meanwhile, India with a relatively lower foreign participation of 7.8% of debt holding, witnessed a rise in benchmark yield by ~80 bps, highest annual increase since 2009.</p> <p>Apart from implementing an interest rate defense for the currency, some EM central banks tightened policy rates to combat inflationary pressure, thereby keeping the debt markets under pressure.</p> <p>Volatile trading in FX markets</p> <p>Dollar index remained subdued through the year despite Fed tapering its asset purchase program. However, there was a stark divergence in its performance against EM currencies vis-à-vis their DM counterparts.</p> <p>EM currencies remained under pressure on account of capital outflows, specifically from the vulnerable economies with a high current account deficit, namely, Indonesia, India, Brazil, South Africa and Turkey. However, the selloff was concentrated in the May-September period. Since the currency markets witnessed a semblance of stability, with support from respective policymakers.</p> <p>Within the DM space, Euro was the biggest gainer on account of economic turnaround and Central Bank policy support. The major outlier was the Japanese Yen, which remained under pressure owing to Bank of Japan's liquidity measures. The Yen is currently trading at lowest level in 30 years versus Swiss franc and weakest in 5 years against Euro and Sterling.</p> <p>Gold loses sheen</p> <p>The key theme within commodity space was the reversal of a more than decade-long rally in Gold. The bullion witnessed highest annual loss in ~32 years. The concerns of QE tapering by the Fed coupled with loss of demand from India one of the largest consumers, amidst government curbs led to the sell off in Gold prices.</p> <p>On a broad basis, commodity prices remained subdued, amidst slowdown in Chinese economy, though losses were capped by improving growth prospects in US and Eurozone.</p> <p>Meanwhile, Brent crude prices remained largely stable, though periodic spikes were attributable to geopolitical tensions in Middle East.</p> <p>Conclusion</p> <p>While 2013 witnessed a very volatile trading, a semblance of stability is being witnessed in the markets as we enter the New Year as markets have digested the Fed taper. Further, the underlying fundamentals are likely to guide the outperformance of DM equities. From an EM perspective, the returns are likely to be guided by improvement in growth prospects (if any) towards the second half of the year. Any shift in policy stance toward aggressive tapering, in light of better than expected US growth, will be the key risk to the financial market outlook.</p>
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Snapshot of key market movements in 2013

Global Market roundup		
	Current level	1 Year Ago
Equities return (%)		
Dow Jones	16504	25.9
FTSE	6749	14.4
Nikkei	16291	56.7
Hong Kong	23306	2.9
Sensex	21171	9.0
Kospi	2011	0.7
Indonesia	4274	(1.0)
Brazil	51507	(15.5)
Russia	1442	(5.6)
10Y Bond yield (bps)		
US	3.00	123.9
UK	3.04	120.9
Japan	0.74	(5.0)
India	8.83	77.5
Brazil	10.88	85.0
Indonesia	8.45	326.3
Currencies return (%)		
DXY INDEX	80.12	0.4
EURUSD	1.38	4.4
GBPUSD	1.65	1.6
USDJPY	104.99	21.0
USDINR	61.80	12.4
USDBRL	2.36	15.1
USDIDR	12171	24.3
USDRUB	32.84	7.6
USDZAR	10.53	24.2
USDTRY	2.14	19.9
USDCNY	6.05	(2.8)
USDKRW	1050	(1.4)
Commodity return (%)		
WTI	99.0	7.8
Brent	111.1	(0.0)
CRB	282.6	(4.2)
Copper	7375.0	(6.5)
Gold	1203.8	(28.1)

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