TRANSAMERICA®

TRANSAMERICA
Market Trends

2013 AUGUST EDITION

ECONOMIC & MARKET RECAP

In July, U.S. corporate bond markets had positive returns thanks to Federal Reserve chairman Ben Bernanke's reassurance that rates will not be raised in the near future. In addition, second quarter earnings to date were mostly in line with expectations, helping U.S. equities rally in sympathy with their corporate bond cousins.

European equities followed suit in July on similarly dovish comments from the European Central bank while Asian equities managed more muted gains held back by continued signs of slowing growth in China. Most global bond indexes held their ground, with neither significant gains nor losses. However, country divergences were significant due to rising rates in key emerging markets.

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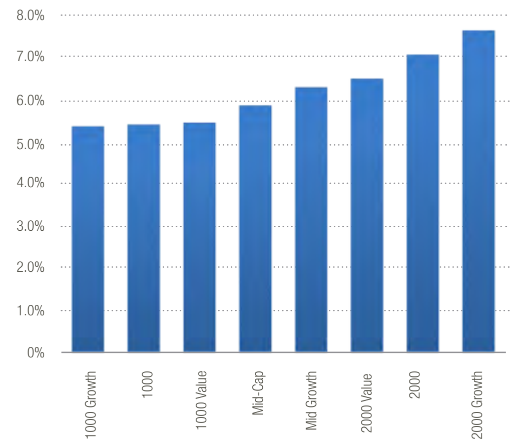
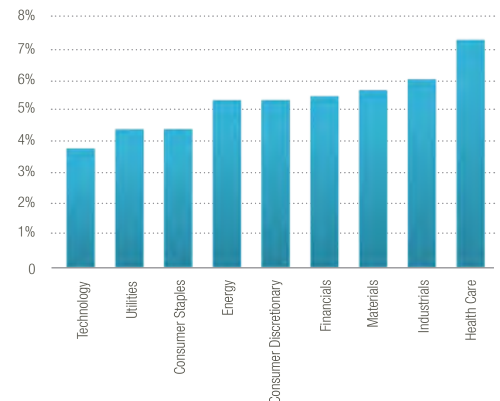
Driving the U.S. economy was consumer credit which expanded by the most in a year ($19 billion in May). This helped boost retail sales which grew by 0.4% in June. Retail sales were likely also boosted by the 195,000 new non-farm jobs added in June. In addition, industrial production grew by 0.3% in the same month. Rising rates had a mixed impact on housing as starts and existing home sales slowed in June while new home sales grew 8% in the same period. Finally, business investment in capital goods also continued to strengthen along with the private economy in the U.S. Meanwhile, the government sector continues to right-size as Detroit filed for the largest municipal bankruptcy in U.S. history.

CHART 1:
Russell Style Indexes July 2013 Returns



Source: Bloomberg, as of 7/31/2013

CHART 2:
S&P Global Sector Indexes July 2013 Returns



Source: Bloomberg, as of 7/31/2013

CHINA: PRESENT CHALLENGES & FUTURE OPPORTUNITIES

China faces several economic challenges and appears to have reached the limits of its past growth strategy. Chinese leaders hope to solve these challenges by navigating the economy through the next stage of development. The success or failure of these efforts may well determine the next chapter of China's economic future.

The migration of the rural poor into urban areas has been a source of cheap labor for two decades. However, this migration has, for the most part, run its

course. In fact, some estimates indicate that significant rural migration will only last another two to three years (Sharma, 2012). This trend has reduced the supply of new labor and pushed labor costs up by 12% per year over the last decade, accelerating to 18% in the most recent year. In addition, China's currency, the yuan, has strengthened 25% versus the dollar during that same period, making Chinese exports more expensive (LeBeau, 2013). These trends plus increasing freight costs have led manufacturers to begin moving production to locations that either offer lower labor costs or are closer to key consumer markets such as the U.S. and Europe. Countries with these attributes and a strong manufacturing base, such as Mexico and the U.S., could benefit. In fact, one consulting firm estimates that if current trends continue, the U.S. could achieve cost parity with China in two years (AlixPartners, 2013).

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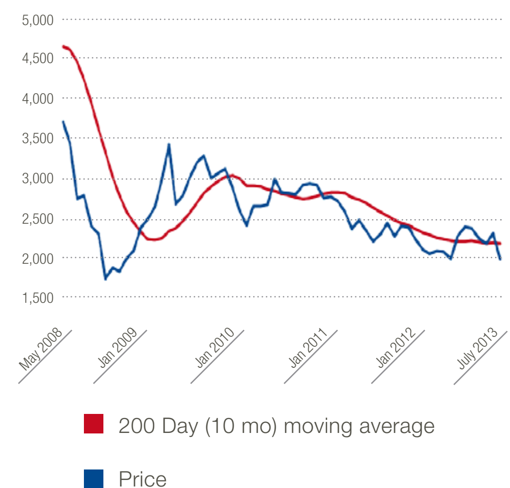
In addition, government-planned growth that focused on investments in infrastructure and manufacturing capacity compounded these issues. Rather than letting demand determine capacity, government-planned growth resulted in significant overcapacity in a number of industries (including steel, textiles and solar). This overcapacity, concentrated in state-owned enterprises, combined with reduced export competitiveness resulted in industrial losses in 2012. In July 2013, the government ordered 1,400 companies to reduce capacity and also announced plans to work with banks to wind down firms in industries with overcapacity (Reuters, 2013).

This indicates that the Chinese government realizes that continuing to grow the economy primarily through planned capital investment is not the way to move forward. In fact, the government's most recent five-year plan outlines the key elements of moving the economy through the next stage of development. These elements include: opening up its financial markets, moving up the manufacturing value chain and rebalancing its economy toward more services and consumption.

Regarding consumption, the government is attempting to leverage rising wages to increase consumption as a share of its economy from the current 30% of gross domestic product (GDP) to closer to the 55-65% range seen in most developed economies. The Chinese are well known for their high savings rate. However, the government plans to encourage increased consumption and lower saving by strengthening their social security and healthcare programs and extending the number of citizens covered. A recent McKinsey & Company report appears to believe that these program changes could work. According to the report, the upper middle class, those making $16,000 to $34,000 a year, currently represents only 14% of households. However, McKinsey estimates that this group may grow to be 54% of households in less than 10 years (Dominic Barton, 2013). It is these consumers that have much more "disposable income" to spend on higher-end goods beyond basic necessities such as consumer electronics and services. If these projections pan out, the shift to consumption could be a viable long-term plan.

CHART 3:
China's Shanghai Composite Index



Source: Bloomberg, as of 7/1/2013

That is the long-term plan. In the short term, Chinese regulators are trying to prevent credit growth from getting out of control. Bank loans in China have grown by $5.8 Trillion since 2007 and by 10% of GDP (roughly $1.1 Trillion) in 2012 alone, now totaling 145% of GDP (World Bank, 2013). This compares to the developed economy average of 123%. About 85% of Chinese lending has been to corporations while households account for the rest (Richard Dobbs, 2013). In addition, Chinese banks are reported to be loaded with potentially bad debt loaned to local governments based on land sales, which have since tailed off. These sales fell as regulators try to slow the rapid property price appreciation, which has made housing unaffordable. The regulators have been attempting to short-circuit the potential bubble by tightening lending standards, raising interest rates and pushing banks to raise capital.

China appears to be moving in the right direction to structurally remake its economy, but equity prices and valuations do not reflect this due to the current concerns about a potential banking or credit crisis. Until this situation is resolved, Chinese regulators and central bankers will be more focused on preventing a crisis than on achieving the growth that markets expect.

THE BOTTOM LINE

Equity valuations are attractive but risk remains to the downside until Chinese central bankers give the "all clear" signal by easing monetary and/or fiscal policy.

WHAT'S WRONG WITH EMERGING MARKETS (E.M.)?

Implications for E.M. investing

China is not alone in tightening monetary policy. Although the reasons are not the same, several other E.M. countries are also tightening. We explore the reasons why, what happens next and the implications for investing in E.M. debt and equities.

In Brazil, a lack of infrastructure investment and productivity improvements caused inflation to heat up with just moderate growth. As a result, the Brazilian central bank has increased rates three times in 2013 in order to cool off inflation. In addition, three key central banks (India, Indonesia and Turkey) have recently raised interest rates in hopes of attracting foreign capital in order to prop up their falling currencies.

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Regardless of the country or the reason, rising interest rates and tighter credit will likely slow both economic and earnings growth. Anticipating this, investors have sold E.M. equities and corporate bonds. In addition, rising U.S. Treasury rates have reduced the additional yield that investors gain from investing abroad. Combined, these effects have precipitated significant capital flows out of E.M. markets and countries, which have weakened the currencies. This is the situation that faces E.M. investors today. The key for understanding investment implications is to understand how this situation potentially develops from here.

As we have seen, either too much outflow or too much currency weakness can cause a central bank to intervene to support their currency. Intervention is typically done by central banks in one of two ways. First, they can buy back their own currency in the open markets. However, these purchases are limited by the "reserves" of foreign currencies that a central bank holds. Once these reserves are depleted, the central bank is usually compelled to defend their currency by raising rates even further to attract capital inflows. Initially, more rate increases slows growth even further which negatively impacts bonds and equities and causes further outflows and currency weakness in a negative feedback cycle. This negative feedback cycle typically ends when growth and inflation slows enough that the central banks are able to begin lowering rates. In addition, once outflows from short-term foreign investors have been exhausted, further rate increases begin to attract inflows from yield-seeking investors.

These new flows would strengthen those currencies. On the other hand, a stronger currency could make their exports more expensive, further slowing growth and earnings. At the same time, a strong local currency will also cause foreign earnings to convert into more dollars which boosts foreign interest in E.M. equities. So which effect wins out? Research confirms that positive E.M. equity returns are most highly correlated with a combination of both strong local economic growth and either a stable or strong local currency. Therefore, the stronger currency appears to more positively affect earnings than it negatively impacts export competitiveness.

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CHART 4:
MSCI® Emerging Markets Index
Cyclically Adjusted P/E

Source: Bloomberg, U.S. Census Bureau, Transamerica calculations, as of 7/1/2013

Valuations in E.M. equities have become attractive (see chart) thanks to growing earnings without significant price appreciation. So when is it time to buy on valuation? We believe the opportune time to increase E.M. holdings will likely be when rates are high enough to begin to attract inflows and, at the same time, the central banks reverse direction and begin loosening monetary policy. However, that likely won't happened until currencies stabilize in India and Brazil and the credit and banking stress is resolved in China. Until then, we believe the risk/reward balance remains to the downside in E.M. equities.

Sovereign debt should be less impacted given most E.M. governments have low debt levels, low deficits (or in some cases surpluses) and large foreign currency reserves. We believe security selection and active management is therefore critical to E.M. bond selection.

THE BOTTOM LINE

Despite compelling valuations, E.M. equity risk is still to the downside. When rates rise high enough to stabilize currencies and monetary policy begins to loosen, then E.M. equity rewards will outweigh the risks.

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SELECT MARKET PERFORMANCE (as of 7/31/2013)

Equities - Global	Closing Price	TOTAL RETURN 1 Month	Year-to-Date
MSCI ACWI	$373.28	5.0%	9.87%
MSCI EAFE	$1,729.84	5.6%	7.85%
MSCI EM	$953.65	1.7%	-9.62%
Equities - The Americas			
Brazil - Bovespa	$48,234.49	-1.6%	-20.9%
Canada - S&P/TSX Composite	$12,486.64	5.6%	0.43%
Mexico - IPC	$40,837.88	2.0%	-6.56%
US - Russell 2000	$1,045.26	7.0%	23.07%
US - S&P 500	$1,685.73	5.1%	18.20%
US - NASDAQ Comp	$3,626.37	6.6%	20.10%
US - DJIA	$15,499.54	4.1%	18.28%
Equities - Europe			
France - CAC 40	$3,992.69	9.1%	9.66%
Germany - DAX	$8,275.97	6.1%	8.72%
UK - FTSE 100	$6,621.06	6.6%	12.26%
Spain - IBEX	$8,433.40	12.4%	3.26%
Italy - FTSE MIB	$16,482.35	10.4%	1.28%
Equities - Asia Pacific			
Australia - S&P ASX 200	$5,051.98	3.4%	8.67%
China - Shenzhen A Index	$1,993.80	1.6%	-12.13%
India - SENSEX	$19,345.70	-2.2%	-0.42%
Japan - Nikkei 225	$13,668.32	1.0%	31.49%
South Korea - KOSPI	$1,914.03	4.3%	-4.16%
Singapore - FTSE Str Times	$3,221.93	1.9%	1.73%
Commodities			
DJ UBS Commodity Index	$126.16	1.4%	-9.29%
WTI Crude ($/bl)	$105.15	8.9%	14.52%
Natural Gas ($/mcf)	$3.44	-3.4%	2.75%
Copper ($/lb)	$311.95	2.3%	-14.58%
Silver ($/oz)	$19.80	1.8%	-34.39%
Gold ($/oz)	$1,323.30	8.1%	-21.03%

Barclays Global Bond Indexes	Yield	TOTAL RETURN 1 Month	Year-to-Date
AsiaPac ex-Japan Corporate Index	5.63%	-1.16%	3.98%
AsiaPac ex-Japan Sovereign Index	4.04%	-0.98%	6.00%
Pan-European HY Corporate Index	6.64%	1.69%	3.31%
Pan-European IG Corporate Index	3.87%	0.85%	0.93%
Pan-European Sovereign	3.42%	0.74%	0.82%
US HY Corporate	7.28%	1.90%	3.34%
US IG Corporate	4.40%	0.83%	-2.60%
US Treasury Aggregate	2.08%	-0.11%	-2.21%

Source: Bloomberg, Barclays Capital Global Family of Indices. Copyright © 2013.

Key

bl	barrel
mcf	metric cubic feet
lb	pound
oz	ounce
IG	Investment Grade
HY	High Yield

SELECT ECONOMIC RESULTS

Country	Indicator	Period	Value	As of Date
Brazil	Retail Sales	May 2013	4.50%	7/11/2013
Canada	Retail Sales	May 2013	1.90%	7/23/2013
China	Industrial Prod.	June 2013	8.90%	7/15/2013
China	PMI-Mfg	July 2013	47.7	7/24/2013
China	Retail Sales	June 2013	13.3%	7/15/2013
European Union	Industrial Prod.	May 2013	-1.30%	7/12/2013
European Union	PMI-Mfg	July 2013	50.1	7/24/2013
European Union	PMI-Services	July 2013	49.6	7/24/2013
France	Industrial Prod.	May 2013	-0.4%	7/10/2013
France	PMI-Mfg	July 2013	49.8	7/24/2013
France	PMI-Services	July 2013	48.3	7/24/2013
Germany	Factory Orders	May 2013	-2.30%	7/5/2013
Germany	Industrial Prod.	May 2013	-1.00%	7/8/2013
Germany	PMI-Mfg	July 2013	50.3	7/24/2013
Germany	PMI-Services	July 2013	52.5	7/24/2013
Germany	Retail Sales	June 2013	-1.50%	7/31/2013
India	Industrial Prod.	May 2013	-1.60%	7/12/2013
Italy	Factory Orders	May 2013	-1.1%	7/19/2013
Italy	Industrial Prod.	May 2013	0.1%	7/10/2013
Italy	Retail Sales	May 2013	0.10%	7/24/2013
Japan	Industrial Prod.	June 2013	-3.30%	7/30/2013
Japan	Personal Spending	June 2013	-0.40%	7/30/2013
Japan	PMI-Mfg	July 2013	50.7	7/31/2013
Japan	Retail Sales	June 2013	1.60%	7/29/2013
Mexico	Industrial Prod.	May 2013	0.5%	7/12/2013
Mexico	Retail Sales	May 2013	0.10%	7/22/2013
Russia	Industrial Prod.	June 2013	0.10%	7/15/2013
Russia	Retail Sales	June 2013	3.50%	7/17/2013
South Korea	GDP	2Q 2013	2.30%	7/25/2013
South Korea	Industrial Prod.	June 2013	-2.60%	7/30/2013
Spain	Factory Orders	May 2013	-1.30%	7/17/2013
Spain	GDP	2Q 2013	-0.40%	7/30/2013
Spain	Industrial Prod.	May 2013	-1.30%	7/5/2013
Switzerland	Industrial Prod.	1Q 2013	3.00%	7/9/2013
Switzerland	Retail Sales	May 2013	1.80%	7/9/2013
United Kingdom	GDP	2Q 2013	0.60%	7/25/2013
United Kingdom	Industrial Prod.	May 2013	-2.30%	7/9/2013
United Kingdom	Retail Sales	June 2013	0.20%	7/18/2013
United States	Construction Spending	May 2013	0.50%	7/1/2013
United States	Consumer Prices (CPI)	June 2013	0.50%	7/16/2013
United States	Factory Orders	May 2013	2.10%	7/1/2013
United States	GDP	2Q 2013	1.70%	7/31/2013
United States	Industrial Prod.	June 2013	0.30%	7/16/2013
United States	Personal Income	May 2013	0.50%	7/1/2013
United States	Personal Spending	May 2013	0.30%	7/1/2013
United States	PMI-Mfg	June 2013	50.9	7/5/2013
United States	PMI-Services	June 2013	52.2	7/5/2013
United States	Producer Prices (PPI)	June 2013	0.80%	7/16/2013
United States	Retail Sales	June 2013	0.40%	7/16/2013

Source: Respective National Statistics Agencies, Markit, HSBC Markit

Comments Key

ar	annualized rate
M/M	month-over-month
Q/Q	quarter-over-quarter
Y/Y	year-over-year
real	adjusted for inflation
sa	seasonally adjusted
saar	seasonally adjusted and annualized rate

TERMS AND DEFINITIONS

Capital Goods: Machinery and equipment used by businesses to produce other goods and services.

Cyclically-adjusted price to earnings ratio (CAPE): Price-to-earnings ratio based on average inflation-adjusted earnings for the previous 10 years.

Emerging markets: Countries undergoing rapid growth and industrialization, often with financial markets which are still in development.

Gross domestic product (GDP): The output of goods and services produced in a nation or region. GDP is expressed in real terms (adjusted for changes in prices) and thus represents the volume of economic activity.

Industrial production: A measure of the output from the manufacturing, mining, electric and gas industries.

MSCI Emerging Market Index: An index of equity market indexes from 21 emerging economies which are market-cap weighted and float-adjusted.

Monetary policy: Those policies set by a central bank which affects the amount of money in an economy as well as the cost of borrowing money (interest rates).

Price-to-earnings ratio (P/E): Measurement of a stock's price divided by its earnings-per-share (EPS).

Shanghai Composite Index: This is a capitalization weighted index of all A-shares and B-shares listed on the Shanghai Stock Exchange. This index is also known as the Shanghai Stock Exchange Composite index.

Valuation: The price paid for a company or stock of a company. This is often expressed using a ratio of price to a financial measure such as price to earnings or price to book value.

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