Global Markets : Outlook and Review

31 August 2013

Global equity and bond markets retreated slightly in August, but by mid September had fully recovered – with US equity markets recently hitting all time highs. The US economy continues to lead the rest of the developed world out of its deep malaise since the 2008 crisis. Over the past month, Emerging Markets have staged a healthy rally off their earlier year lows. Similarly, European equities have also enjoyed a robust rally.

Increased talk of Fed tapering (i.e. reducing its monthly $85bn bond buying binge) - clearly unsettled markets during August. We expect only moderate Fed tapering to begin within the next 2 months. This will likely ensure the weak Emerging Market currencies remain under pressure.

Given that year to date returns for the US, Europe and many sector funds show significant double digits – the August retreat was not wildly unexpected and helped the market consolidate impressive gains over the past few months. Over the past year, the broad MSCI World, MSCI US and MSCI EMU indices are now each up approximately 20%.

Weak US economic data persists – with job growth figures averaging well below the required 200,000 monthly level – which is seen as a benchmark for a faster recovery. Unemployment remains stubbornly at 7.3% - well above Bernanke's 6.5% target level for no further Fed bond buying stimulus (QE3). The number of labour market participants as a percentage of the US population continues to slip, leading many to predict that a permanent set of citizens have lost any interest in reentering the workforce.

Despite the anemic US economic growth now predicted to be around 2.2% GDP growth for 2013 – down from the Fed's earlier 2.5% prediction, the US is still leading the rest of the world out of its deep malaise since the 2008 crisis. US real estate prices particularly in the residential markets remain up across the board - on average 12% year on year.

Recent European economic data shows the recession ending in the UK, Spain and other parts of the Continent. The recent German election result will empower Merkel,(it is hoped,) to play a more activist role in Europe;specifically helping policymakers come to agreements on a centralized banking supervisory system and deposit insurance regime.

With the Fed delaying its tapering – sentiment briefly turned positive on emerging markets with developing currencies receiving a boost by the Fed's decision. Despite weak currencies persisting, by mid September it was clear that Emerging Markets had enjoyed a rally – gaining 10% off their earlier year lows (MSCI Emerging Markets index).

The global equity market rally that recovered in July stalled in August. The MSCI World Index lost 2.1% in August, but by mid September had retraced and improved on such losses. The benchmark is up a total of 17.6% over the past year and 11.7% year to date. The global Consumer Staples sector gave back 3.5% in August after gaining 4.0% in July. It remains up 10.9% in 2013, and 12.8% over the past 12 months.

The US markets measured by the broader MSCI US Index lost 2.8% in August, but had hit all time highs following the Fed's tapering non-decision in mid September. By the end of August, US equities are up 15.9% year to date and 18.3% over the past year.

By comparison, Europe lost 1.1% (MSCI EMU in Euros), but remains up 8.1% for the year and 17.1% over the past 12 months. Europe is trading at just 12 times earnings, while the US trades at close to 16 times earnings - as measured by the broader MSCI US Index. We continue to be bullish on European equities given the beginning of a recovery on the Continent. We see more valuation upside for the region (including a rerating of large cap stocks), as compared with many of their US counterparts that have already enjoyed significant gains this year. The MSCI World Index minus US stocks has a dividend yield of 3.1%. That's almost 50% higher than the 2.1% dividend yield of the S&P 500. Amongst the highest yields can be found in Australia (average of 4.5%), France (3.7%), and the UK (3.6%).

The Japanese rally stalled again in August – with the MSCI Japan losing 2.4%. Nevertheless for 2013 the Japan market remains up an impressive 30.2% in Yen terms. The market is up 55.6% over the past year (MSCI Japan) as stimulus measures in Japan are exerted to generate at least 2% inflation, so-called Abenomics. Further structural reforms including a long overdue consumption tax are expected with Abe's recent victory in a parliamentary election in July.

The MSCI Emerging Markets Index fell 1.7% in August, but since then has powered up almost 9% during September as sentiment improved. By mid September the Index was expected to erase most of its earlier losses for the year. By the end of August the Index was showing a 10.2% loss for the year to date and almost a zero return over the prior 12 months. With PE ratios trading at low levels of just 10 times earnings and a price to book ratio of 1.5X - Emerging Markets arguably have suffered from excessive investor pessimism and overshot on the downside based on slowdown fears in China and India. Making matters worse has been the weakening of many emerging market currencies including the Brazilian Real, South African rand and Indian Rupee, now at an all time low of almost 64 to the US$.

Recent new economic growth figures in China and Latin America point to a steady rebound in activity which should boost prospects for large cap stocks comprising the MSCI Emerging Markets Index. We expect this index to outperform a good deal of the developed world over the next 2-3 years.

The 10 year Treasury began in August inching its way back to 3% which caused the 30 year fixed mortgage rates to spike to their highest levels in years. The lack of any Fed tapering saw rates retreating down to 2.6% on the 10 year Treasury, by mid September. Higher rates in August helped push the Global Government Bond Index down by 0.5%, recording a year to date loss of 4.8%. European Government bonds lost 0.5% for the month and are flat for the year.

In the property space, the US Property Index (REIT) benchmark suffered a sizable loss of 6.9%, effectively wiping out all it's prior year to date gains. The index is now down 0.5% over 12 months. Similarly, the European Citigroup BMI Property Index lost 3.9% in August and is down 1.8% for the year (in Euros).

Rates across the UK, Europe and Emerging Markets are unlikely to rise due to weak economic growth. While lower rates would be helpful, many Central Banks are caught in the vice between possible inflation issues should their currencies weaken further due to lower rates. We are looking for Emerging Markets to begin to retrace their previous highs later this year as it becomes clear there are no great catastrophes affecting China, India, Brazil or Russia.

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