Global Markets Outlook (Aug 27th 2015)

The US 2nd quarter GDP was revised upwards on Thursday from 2.3% originally to 3.7%. This helped power the stock market recovery - in the past two days almost 1,000 points have been added to the Dow Jones Industrial Index – an almost 6.25% recovery. The broader S&P 500 also gained and is now also out of its 10% correction territory - approaching the 2000 level (closing at 1,988).

A large portion of the US 2nd quarter GDP revision was led by increased corporate spending. Most positive was business investment growing by 3.2%. This compares with a far lower initial estimate of a 0.6% decline. Net exports also boosted GDP, as imports fell. This was backed up by increased government spending, especially at the state and local level.

Other pockets of good news, show last week's US weekly initial jobless claims declining by 6,000 to 271,000. This is well below the 274,000 Bloomberg estimate and continues to come down from prior levels of closer to 300K earlier in the year.

Developed word stocks remain attractively priced when considering their dividend yields outpace bond yields in the following comparison (respectively): UK 3.8% vs 3%, France 3.4% vs 1.8%, Germany 3.1% vs 1.6%, US 2.1% vs 2.2% and Japan 1.4% vs 0.7%.

Consequently we remain long term equity bulls in these developed markets, despite the recent falls over the past week. We expect volatility to remain relatively high as measured by the VIX for some time to come.

The US will continue to help pull the global economy along and will likely still record an annualized 3%-3.25% GDP growth for the rest of the year. These additional factors provide optimism:

- US and developed country inflation levels remain largely benign;
- US interest rates are low - and given the interest rates on both the 10 Year Treasury (2.1% currently) and the 30 Year Treasury (2.7%), we expect them to remain relatively low indefinitely. Ultimately interest rates are related to inflationary expectations;
- The US has an accommodative Fed and solid corporate profits – so at most a 25bps increase will be seen in 2015 and likely very slow rate hikes into 2016-17.
- The earnings yield on the S&P 500 is now 3 times the interest rate on the 10 Yr. Treasury – a ratio that is typically 1:1 over long periods of time. Owning equity in a group of superior businesses producing returns of 6% is attractive, within the context of alternative investment choices (i.e. bonds);
- The lower energy prices (oil around $40/barrel) are a reallocation of wealth from the oil and gas companies to consumers – and will eventually cause an increase in consumer spending;
- The USA is largely a self-sufficient economy and will not be materially affected by problems currently present in emerging market economies;
- The US "Insider Transactions Ratio" is at a "bullish" level. This means that those (directors) who are most knowledgeable about their companies are not sellers of stock and are in fact generally buying;
- US employment growth is expected to remain firm at more than 200,000 new jobs coming each month, though wage growth has been weak.

- Inflation is nonexistent, with last week's report on the Consumer Price Index (CPI) coming in at just 0.1% for July, and only 0.2% for the past twelve months. Core CPI – which excludes food and energy – also reported a gain of just 0.1% for July and 1.8% for the past year. The Fed's target rate for inflation is 2.0%.
- The Fed remains unique among central banks given its dual mandate of inflation and employment. With the unemployment rate falling to 5.3% and 215,000 jobs being added in July, the broader economy is strengthening. However wages, remain stagnant, with no move up in hourly earnings – so the US is well positioned for further growth without much inflation.
- US manufacturing shows renewed growth based on both the Institute for Supply Management (ISM) and Markit surveys in July.
- The large US services sector continues to outpace manufacturing growth – the ISM non-manufacturing index recently hit its best level since 2005.

China & Emerging Markets

While the health of the Chinese economy appears to be weakening and unable to post the high levels of growth previously seen – the recent market turmoil is likely an over-reaction to weakening Chinese PMI (manufacturing) data. Many analysts do not believe China is still growing at 7% GDP levels as officially reported recently. However China continues to grow – albeit far slower due to the emphasis away from infrastructure and investment linked growth to more domestic consumption based growth. Recent weak consumption data is less surprising given China's anti-corruption purge that is ongoing, which has likely reduced certain gift giving and consumer expenditure.

While China recently surprised investors by lowering its exchange rate to the US dollar by just under 2% - the decision is not the start of any currency war and in fact makes much sense:

1) China's policy to peg the Renminbi pegged to the dollar has caused it's currency to soar in relation to most of its trading partners and particularly the Euro and the Yen this year. China is simply seeking to stabilize its currency following strong gains of some 60% over the past seven years to the Euro.
2) In order for China to become a global reserve currency (part of IMF's special drawing rights) – its currency needs to be more market oriented and freely usable. Prior to the devaluation it was seen as a one way bet.
3) China faces deflationary risks as its rising currency pushed prices lower. Inflation is just over 1% by most estimates. A slightly weaker currency will alleviate the deflation risk by increasing the price of imported goods slightly.

Finally, a number of emerging markets remain fragile due to their dependency on commodity exports to China and running large current account deficits. Their local stock markets, debt markets and currencies will remain under pressure until certain structural reforms are put in place. We expect the weakest of these emerging markets to remain under pressure until such time as the commodity cycle begins to turn (i.e. higher prices) and confidence in Chinese GDP growth returns.

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