Global Markets : Outlook and Review

31 December 2013

With 2013 ending with ever rising stock markets, it was not surprising that early 2014 would likely see a selloff globally. The recovery in US real estate prices and wealth vis-a-vis the stock market allowed the Fed to begin tapering at a rate of $10bn a month. Low inflation and the need to reduce the safety net of an ever rising stock market created room for the tapering. By mid-January the Fed announced a second round of tapering – bringing the prior $85bn a month bond buying program down to a level of $65bn a month. We expect continued Fed tapering which will hamper portfolio investment flows into Emerging Markets, unless rates rise significantly in these nations. However rate increases are not likely in the best interests of local businesses. We expect a significant increase in inflation in emerging markets in 2014 along with rate increases to try to fend off panic selling of emerging market currencies.

Those emerging markets with large twin deficits are under severe pressure given the fickleness of hot portfolio flows. Emerging market bonds were one of the brighter spots in recent years for US and European investors to pick up significant yield. However these 'short term' flows have been reversed in earnest as of the past two months given the likelihood of higher rates in the US.

The recent pull back is in many way a healthy sign for global markets that require a breather after 2013 gains reached 29.6% for the S&P 500, 26.8% for the MSCI World Index, 54.5% for the MSCI Japan Index and 24.1% for the MSCI EMU (European) Index.

US markets have led the pack throughout 2012 and 2013 and it was not unexpected that this reflected the improving economic sentiment across the US. Hiring levels have averaged over 150,000 new hired per month over the past year and the expectation is that the average could rise closer to 200,000 per month later this year.

Interest rates remain low in the US despite the Fed tapering – with the current 10 year Treasury yielding less than 2.8%. Mortgage rates although higher than a year ago remain historically low at levels of around 4.5% on a 30 year fixed rate. This coupled with the US tax incentive to purchase property and deduct the mortgage interest against one's personal income tax – bodes well for an improving housing sector throughout much of 2014.

Despite the European Union being in a recession earlier this year, the indices have recovered much ground after lagging the US gains earlier in the year. European wide equities may however be held back by the strong Euro hitting 1.37 to the US$. The MSCI EMU Index gain for 2013 was an impressive 27.9% in US$ terms for 2013.

With Bernanke's departure at the end of January, we expect incoming Chair Janet Yellen to continue the tapering policy he has set in motion. It is likely that by year end 2014 no further Fed bond buying will occur and the taper will be complete. This will be the true test for the market as Fed stimulus and support will have effectively been withdrawn for equity market investors.

Under Yellin it is likely she will not increase rates for most of 2014 – given her sensitivity to unemployment and the housing market which represents the majority of American middle class wealth. Continued low rates will thus be the norm for the US well into 2015.

Despite elevated PE ratios in the US and European markets - the consensus remains that low rates will help support equity markets for some time to come, and no bursting of any bubble is imminent. Positive GDP growth figures in the US, EU (Spain, Germany, Ireland et al) and UK in recent weeks have helped reinforce the sense of a global recovery.

Most US bonds remain expensive given that interest rates are being held artificially low by the Fed's massive bond buying program. Fixed income investors will likely gain more confidence once the taper is completed.

The differentiation between huge equity inflows versus bond flows is significant with bond inflows at their lowest levels since 2008. US investors are also increasingly moving back into European equities. In particular, US fund managers are taking increasingly bullish bets on the Eurozone's sluggish recovery speeding up. An example of this is the disclosure that the value of shares in Europe's 10 largest listed banks held by US funds has increased by 40% since June this year.

The Fed will remain in easy money mode until such time that unemployment drops to 6.5% - it is currently at 7.0%. The accommodative European Central Bank under Draghi also seems to be in no rush to raise rates or worry about inflation which is almost non existent in the overall Eurozone. In fact deflation is a real concern for Draghi at present.

Household formation has revived, helping to boost demand for homes and spurning residential construction. Housing starts are now approaching 1 million starts a year – last seen prior to the 2008 financial crisis.

In sum, while global equity markets are likely to continue to show progress in 2014, we expect returns to be much more muted. Despite the negative sentiment currently surrounding various emerging markets, their weaker currencies provide their exporters with a significant competitive advantage. We expect emerging markets to rally within the next 12-18 months and believe the recent selloff has been overdone.

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