



Global Markets : Outlook and Review

28 February 2014

Global equity markets represented by the MSCI World benchmark mostly powered ahead in February and through mid-March, recovering all losses experienced during January.

US economic data continues to improve with unemployment figures at multi-year lows of just 6.7%. The Fed is starting to believe there is less spare capacity left in the US economy and new Chairman Yellen has signaled possible rate rises by mid-2015. These more aggressive interest rate forecasts are backed up by economic forecasts indicating an earlier tightening of the US labor market. The Fed has cut its end of 2014 unemployment rate forecast from 6.5% down to 6.2%. The rate setting FOMC continued to taper its monthly asset purchases by another \$10bn in March – reducing the bond buying stimulus to \$55bn. Since the previously mentioned 6.5% unemployment threshold is likely to be breached prior to interest rate hikes, the Fed has moved away from this measure.

While US 10 year Treasury rates continue to hover around 2.7%, markets are expecting an increase. Mortgage rates have already risen on the 30 year to approximately 4.5%. Global bond markets and the European bond market both surprised investors year to date with returns of 2.8% (in US\$) and 2.9% respectively (in Euros).

US Equity markets are up 25% year on year to the end of February, slightly surpassing the Globally Developed market benchmark (MSCI World) which returned 21.7% over the same period.

Political drama in the US Congress has largely moved to the back burner with squabbles over relatively minor economic issues dominating the current agenda. With a mid-term election looming in November, it is likely that rhetoric will step up as the summer approaches.

Continued improvement amongst many of the weaker European countries GDP growth prospects has helped push equity markets in the region to recent new highs. The MSCI EMU Index gained 4.8% in February alone, pushing the index up 23.7% over the prior one year period.

European property markets have also shown encouraging growth, [posting a 6.7% gain in February. The Citigroup BMI Index is now up 10.9% over the past 12 months. By comparison the US REIT Index gained just 6.2% over the prior year, but has shown an impressive year to date return of 9.4% (end February).

Emerging markets largely show negative growth in US\$ terms over the past year. This is mostly due to the BRICS in particular being out of favor. Russia's incursion into Crimea along with negative economic data emanating from Brazil and China have not helped. The Fed tapering and the prospects of higher US interest rates has also led to a flight out of riskier emerging markets – the promise of higher Treasury yields has led to a severe outflow from emerging market bonds in particular. This has left many developing nations with not only depleted foreign reserves but also weakened currencies. The so-called Fragile Five countries that run large twin deficits (Turkey, Brazil, India, South Africa and Indonesia) have been most hurt. South Africa's currently has lost slightly more than 20% over the prior year, breaching the psychological 11:1 barrier against the US\$ earlier this year.

The out of favor emerging markets masks the progress made by many developing nations in liberalizing their economies including Colombia, Chile, Peru and others. Prospects in Mexico are far improved from just two years

ago with the new president showing a willingness to open up the economy to further foreign direct investment, including the oil and resources sector.

Likewise, China appears to be taking some tough decisions to ensure weak companies go out of business and default on their creditors. We still believe China will succeed in growing close to the 7.5% rate projected, based on positive data emerging on electricity and railway transportation usage. However muted Chinese demand for resources will hamper other emerging economies from benefiting from the prior boom conditions experienced they have enjoyed. The shadow banking system grew too rapidly in too short a time frame, resulting in the potential for misallocated funds and risk of future defaults. The Chinese government has increased regulation on the shadow banking system, which could moderate credit issuance, increase borrowing rates, and slow economic growth in 2014.

Unfortunately, the Eurozone's recovery is not yet self-sustaining. Lingering after affects of the recession are evident, with lending still contracting, and prices of goods and services moderating to levels that have brought about concerns of deflation, or a broad-based decline in prices.

Pressure is increasing for the European Central Bank (ECB) to act, given that its balance sheet continues to contract, which is an effective tightening of monetary policy. The complex picture for inflation resulted in the ECB postponing action at the February meeting, but there are also complexities in terms of options for the ECB.

Without more aggressive measures by the ECB, we believe lending could have difficulty thawing until bank regulation and capital standards are finalized. This isn't expected until the second half of 2014 at the earliest, which could keep economic growth subdued. We remain positive on European stocks, due to the prospects for economic and profit margin improvement.

Japan's economy will likely suffer somewhat later this year after a sales tax hike in April. There remain questions about the rise in inflation that the Bank of Japan (BoJ) is targeting and whether it will break the deflationary cycle or simply reduce consumers' purchasing power. Despite Prime Minister Abe's call to boost wages, they aren't keeping up with inflation.

US stocks have bounced and we think the market's still attractive and in the midst of a secular bull market. But there are likely to be bumps along the way; notably given that this is a midterm election year; which is known for first-half pullbacks. A diversified portfolio is important and both European and Chinese stocks appear to have upside, while Japan continues to frustrate with a two-steps forward, two-steps back sort of approach.

Globally, we believe Central Banks will remain accommodative and equities will perform well. We expect Europe and Japan to possibly outperform the US due to more favorable valuations there. While Emerging Markets remain out of favor, we believe it is a terrific buying opportunity currently given low valuations across the MSCI EM Index.

A final reminder is not to replace fixed income assets with equities in search of higher income without recognizing that the risk profile of a portfolio has changed in doing so.