Global Markets : Outlook and Review

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Despite the early wobbles during January 2014, global equity markets largely recovered all lost ground by the end of February. We continue to believe that the year will end with the market higher, but that the possibility of another pullback in the near term is growing. US economic data continues to be skewed by the severe winter weather and equity investors seem willing to ignore weak data for January-February. The Federal Reserve also remains in that camp as they continue to reduce asset purchases (i.e. tapering), while discussing how to better communicate its monetary policy intentions. Congress has largely moved to the back burner with squabbles over relatively minor economic issues dominating the current agenda.

Europe's growth has improved but more needs to be done - there are some hopeful signs. Likewise, China appears to be making progress toward reform and could outperform other emerging markets in the near term. Japan, however, continues to send mixed messages, combining tax hikes with sluggish monetary action.

US sector action hasn't indicated that market participants are overly concerned about the economy, despite the weak start to the year. The traditionally defensive sectors, excluding utilities, did not fare better than the cyclicals during the selloff. The defensive areas of the market would traditionally perform better than the more economically sensitive groups if economic growth was the major concern. The utilities sector did outperform, however, likely as an interest rate play. Bond yields have again fallen, but haven't rebounded along with equities, sending investors into the traditionally high-yielding utilities sector in a search for income. Investors need to be aware that their portfolio risk profile will change if they replace fixed income positions with equity positions.

We continue to believe that the year will end up a positive one for equities, but the possibility of a correction in the near term can't be ruled out. At the latest Federal Reserve meeting - the FOMC discussed how to communicate to the market that rates will continue to be held near record lows, even if the official unemployment rate reaches the Fed's 6.5% threshold.

The bottom line is that we don't believe rate hikes are in the cards for this year. The FOMC remains concerned about the long-term unemployed, as well as the low labor participation rate; while inflation remains below its target, allowing it the flexibility to hold rates lower for longer. Finally, in testimony before Congress, Fed Chairwoman Janet Yellen sounded a decidedly dovish tone.

Fortunately, the drama in Congress has died down as the debt deal and budget agreement took the two largest near-term crises off the table. Overall, policy risk has ebbed as a market- moving force, but given it's a midterm election year, political volatility is likely to heat up again toward the fall. There is also increasing scrutiny around the Affordable Care Act (ACA) and its impact on the economy; especially in light of the recent somewhat-damning report from the Congressional Budget Office on the impact on jobs of the ACA.

Turning to the international picture, we believe the Eurozone's economic growth will continue to recover in 2014, as leading economic indicators, PMIs, and confidence continue to improve. Unlike 2013, the Eurozone could add to global growth rather than subtract from it. Unfortunately, the Eurozone's recovery is not yet self-sustaining. Lingering after effects 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. The drop in prices in countries such as Greece is a natural outcome of their "internal devaluation," where economic adjustment is accomplished through a drop in prices within the country, rather than by a weaker currency. However, subdued prices have extended to stronger countries, with German wages less inflation falling in 2013; French core inflation increasing at a very modest 0.1% in January; and Eurozone wholesale prices falling by 0.8% in December.

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. Additionally there is the risk that European parliamentary elections in May could reignite anti-euro sentiment. Despite the risks and the potential for volatility, we remain positive on European stocks, due to the prospects for economic and profit margin improvement.

Japanese stocks await clarity:

Japan's economy could likely see-saw near term, with a sales tax hike in April likely to pull forward demand into the March quarter, then subsequently drop. Looking past this volatility, there are 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. While some businesses are granting one-time bonuses, we believe Japan's businesses may delay making more lasting wage increases until they have better certainty on demand.

In the meantime, until the BoJ increases the size of its asset purchase program, the yen, and therefore Japanese stocks, could be range-bound.

Investors are uncertain about the trend for economic growth in China; with the shift in the timing of the Lunar New Year and the hand of government distorting normal market functioning. In January, exports and new credit were strong, yet the Purchasing Managers Index (PMI) fell into contraction territory, and the yuan dropped the most since 2010 in February. Meanwhile, the threat of several trusts defaulting increased the chatter to a feverish pitch about a potential burst of the credit bubble.

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.

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