Global Markets : Outlook and Review

30 Jun 2013

Global equity markets retreated during June, due to fears of the Fed 'tapering' – the US Central Bank's stimulus possibly being withdrawn sooner than previously expected. By mid July such fears were put to rest and equity markets in the US were again at new all time highs. For now it appears that the Fed's Bernanke is trying his best to ensure a soft landing in 2014 as the Fed withdraws from its massive $85bn monthly bond buying program.

Key benchmark interest rates such as the 10 year Treasury and 30 year mortgage rates have already bounced up almost 100 basis points from their lows of earlier this year. The US property market has certainly enjoyed a robust past 12 months, with prices up across the country – on average 12% in residential properties. However there are fears that a big spike in mortgage rates could dramatically reduce housing activity and reduce economic growth prospects. With GDP figures still tepid at best - expected around 2.5% for 2013 and stubborn levels of unemployment - Bernanke is not expected to stop the stimulus program until well into 2014. A dramatic cut back in the monthly $85bn bond purchases will likely see rates rise another 75-150 basis points in short order.

The consensus appears that until monthly jobs data consistently hits over 200,000 jobs the Fed will continue with its stimulus program in various ways. Were it not for the government Sequester earlier in 2013, US growth would be at least 0.50% higher according to most analysts. The private sector is beginning to hire steadily, but the public sector is now a drag on the economy and the employment numbers, due to the sequestration cut backs.

Although volatility levels such as the VIX (the so-called fear index) rose from levels around 12-13 to close to 20, by mid July the VIX had retreated back to its previous low levels.

The global equity market rally stalled in June across the board. The MSCI World Index lost 2.5% in June while remaining up 8.4% for the year. The benchmark is up a total of 18.6% over the past year. The global consumer staples sector retreated 1.5% in June, but remains up 10.5% in 2013, and 16.9% over the past 12 months.

The US markets measured by the broader MSCI US Index lost 1.4%, while European losses were more dramatic. The MSCI EMU Index lost 5.5% in June (Euros) wiping out most of its gains made earlier in the year.

The Japanese rally ended in May and remained stalled in June with the MSCI Japan flat for the month. Nevertheless for 2013, the Japan market remains up an impressive 33.9% in Yen terms. Measures in Japan to generate 2% inflation, so-called Abenomics, has seen the Japanese equity market rise 52.2% over the past 12 months. Further structural reforms are expected with Abe's recent victory in a parliamentary election in July.

The MSCI Emerging Markets Index gave back 6.4% in June and is now down 9.6% for the year to date. Over the past 12 months the index achieved just a 2.9% growth rate. With PE ratios trading at low levels of just 10 times earnings and a price to book ratio of 1.5 - Emerging Markets contain numerous bargains and are seriously under priced by the standards of the past decade. Unless one expects the Middle East to fragment or China to enter a significant long term downturn or malaise, the pessimism apparent in the Emerging Market Index prices appears to have been considerably overdone.

By comparison Europe is trading at 12 times earnings, while the US trades at close to 15 times earnings - as measured by the broader MSCI US Index.

Clearly the slower growth being experienced in emerging and developed markets is due in part to a European recession and lower demand in China. The recent lending curbs and tightening up of credit in China are designed to reduce the dependence on state finance and shadow banking. China is moving to a more consumption based model as it weans itself off further massive capital infrastructure projects to fuel its growth. Recent GDP figures in June indicate China is making the transition fairly smoothly with growth of 7.5% being reported.

We are not concerned about the perceived credit crunch in China as it remains one of the world's largest savers and richest economies. China is trying to change the composition of its GDP growth – less state intervention in the form of loans and infrastructure investments, and more organic growth.

On the backs of Bernanke's comments in June, global bond markets also faltered in June with the Citigroup World Government Bond index losing 0.6% in US$ terms and the European Government bond market down 1.5%. Nevertheless the fear of inflation has not reared its head in the US or Europe for now. This permits the Fed to 'taper off' its bond buying, perhaps more slowly then markets may expect. Continued bond buying by the Fed may extend well into 2014 but at a far slower pace than $85bn monthly.

In the property space, the US Property Index (REIT) benchmark retreated by another 1.8% following a sizable loss of 6.0% in May. The index remains up 5.7% for 2013 and 7.7% over the past year. This is similar to the reported increase in housing values in the US over the past year which have averaged an 11%-12% gain according to recent data tracked by the National Association of Realtors. By comparison, the European Citigroup BMI Property Index lost 7.5% for the month, and is down 1.6% in 2013 and 14.9% over the past year.

On a 10 year government bond, a capital loss of upwards of 25% could be realized if the 10 year Treasury were to go from 2% to 4%. Currently, rates on the 10yr bond have bottomed out around 1.7% by mid April. The Bond bull run seems over with the 10yr Treasury approaching 2.6% in May.

Until employment data is consistently above 200,000 jobs monthly there is little hope that the unemployment rate with fall sharply to the noted 6.5% level required by Bernanke.

Due to their commodity dependent exports, many emerging market currencies remain under significant pressure with the South African rand amongst the worst currency performers in 2013. All the large Emerging Markets including Brazil, Russia, Turkey and India have seen their currencies lose significant value against the US$.

With European austerity and weak growth in emerging markets continued, inflows of portfolio investment into the US will likely underpin a modestly bullish equity market and relatively low Treasury rates. It is unlikely we will see a weak US$ given the inflows into the US and its economy being the least ugly of all the industrialized regions.

Rates across Europe and Emerging Markets are unlikely to rise due to weak economic growth. In fact lower rates would be helpful, but 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 that there are no great catastrophes affecting China, India, Brazil or Russia.