



Global Markets : Outlook and Review

30 Jun 2014

Earnings growth in the US, continues to reinforce the US equity bull market. Approximately 80% of US 2nd quarter corporate earnings surprised on the upside beating analysts' estimates.

US economic growth continues to show healthy improvements – with the June labour report showing almost 290,000 new jobs and a drop in the unemployment rate to 6.1% - a 6yr low. Perhaps not surprisingly the S&P 500 is poised to hit 2,000 (a threefold increase from its lows less than 6 years ago. The Dow already broke through the 17,000 psychological barrier in mid-July..

Corporations are increasingly hiring staff again, despite some weaker than expected GDP numbers for the 1st quarter being posted.

The Producer Price Index which has been rising the past few months, for June only showed a small 1.8% year on year increase. Commodity prices have been sinking in recent weeks, with the CRB Index of 19 actively traded commodities falling by almost 6%, since its mid-June high and WTI oil reaching below \$100/barrel. Lower commodity prices clearly point towards a reduction in inflationary pressures. Gasoline prices are largely flat at around \$4/gallon – the same level for the past 4 years.

Consequently it is not surprising the Fed feels no compulsion to consider raising interest rates anytime soon. In fact Fed Chair Yellen suggests that only late in 2015 will the Fed have cause to begin raising rates.

While some analysts are worried that US valuations may become stretched, with positive 2nd quarter earnings, further stock gains are to be expected.

Fueling our confidence in the US market beyond the short-term is the pickup in the economy. Growth has picked up from the weather-hit first quarter, while job growth has accelerated. First, the Institute of Supply Management's (ISM) Manufacturing Index ticked only slightly lower in June to a still robust 55.3 and even more encouraging for the future outlook was that new orders gained two points to 58.9. A similar story is unfolding on the service side as the ISM Non-Manufacturing Index fell slightly, but remained at a healthy 56.0, while new orders jumped to 61.2. Additionally, despite the spike in automobile recalls, auto sales reached their highest annualized level since February of 2006.

A report that has been largely ignored over the past several years, the JOLTS (Job Openings and Labor Turnover Survey) release, shows job openings increased to the highest level since March 2007, while the "quits" rate also increased, indicating growing confidence in the labor market.

US small caps currently trade at almost twice the PE levels of US large caps and as such are relatively expensive. Similarly US retailers and consumer discretionary trade at a 25% premium to the broader market and should be under-weighted.

While US valuations are relatively high compared with the past two years, with PEs averaging around 19 on the S&P 500 - it is not seen as excessive for such a low interest rate environment. Meanwhile, exceedingly low 10 year US Treasury yields below 2.5% continue to surprise investors. This has helped fuel the US real estate recovery. By the end of June, the Dow Jones US REIT Index was up an impressive 18.2%.

Non-US markets

Recent geopolitical tensions have not led to much volatility in equity markets – despite Middle East tensions rising and the downing of the Malaysian plane over Ukraine. Volatility has been suppressed partly due to the Fed's unusually accommodative monetary policy and the very benign credit cycle in the US. Thirty year fixed mortgage rates still hover at historic lows between 4%-4.5%.

Emerging markets as an overall group remain out of favor, although India, South Africa and Mexico have posted recent highs too. The recent 7.5% 2nd quarter GDP growth figures reported for China and other improved economic data, has helped stimulate positive sentiment again for Emerging Markets.

The Eurozone's prolonged slow growth has some economists questioning whether the Eurozone recession actually ended. Sadly, recent economic data has disappointed, including declines in industrial production in Germany, France and Italy; as well as a decline in German factory orders and a fall in German and French business confidence. Spain's manufacturing PMI rose to the highest level since the global financial crisis, Spanish employment has gained nearly 2% from a year ago, and Spanish home prices appear to have stabilized in recent months. Within the composite PMI for the euro zone, new orders rose to the highest level in three years, and the fall in prices was the smallest in two years in July.

The Eurozone is on the mend and we remain bullish on European equities. Lending is bottoming out, while much-needed reforms are finally beginning in France and Italy, and the ECB has committed to doing "whatever it takes", including pursuing outright bond purchases, if economic growth slips too far. Profit margins in the Eurozone remain below the 2007 peak, and if the economy and corporate sales experience sustained improvement, earnings growth could outpace economic growth.