Global Markets : Outlook and Review

31 March 2014

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 it continues to reduce asset purchases (tapering), while discussing how to better communicate its monetary policy intentions.

Europe's growth has improved but more needs to be done, although there are some hopeful signs. Likewise, China appears to be making progress towards 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. 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. We don't believe rate hikes are in the cards for this year. The Federal Open Market Committee (FOMC) remains concerned about the long-term unemployed, as well as the low labour 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.

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 per cent in January, and Eurozone wholesale prices falling by 0.8 per cent 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. Despite the risks and the potential for volatility, we remain positive on European stocks, due to the prospects for economic and profit margin improvement.

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

Investors are uncertain about the trend for economic growth in China. Pessimism towards Chinese stocks reigns, with mutual funds experiencing outflows in 30 of the last 38 months. Meanwhile, we believe reforms to China's economy could result in higher quality and more sustainable growth in the future. As investors gain confidence about the reforms as the year progresses, the valuation discounts for Chinese stocks could decrease. We believe Chinese stocks could outperform the emerging market (EM) universe.

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 mid-term election year – these are 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. And a final reminder not to replace fixed income assets with equities in search of higher income without recognising the risk profile of a portfolio has changed.