Global Markets : Outlook and Review

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Global equity markets finally hit some bumps in May, following a significant bull run since the start of 2013. Repeated warnings by the Fed's Bernanke that he may begin to 'taper off' the $85bn monthly bond buying programme sent shivers through the markets.

The US remains the poster child for economic recovery and is experiencing a far healthier recovery than Europe. The lack of severe austerity measures coupled with easy Fed money has boosted the US recovery. By comparison, UK and Eurozone policymakers seem to be stuck in severe austerity policy mode – significantly limiting economic growth.

The hope is that demand in the US economy will help absorb renewed exports from Emerging Markets such as China, Brazil as well as the Eurozone. Continued positive US economic data on real estate, manufacturing and employment helped push the US Equity indices higher in May with the MSCI US index now up 14.9% for the year.

The rally has likely come to an end given the imminent Fed stimulus progamme being withdrawn. This will lead to high Treasury and related interest rates in the US causing a reset of both the equity and bond markets. Towards the end of May increased volatility had already reached these markets. The 10 year Treasury jumped from 1.6% to 2.6% in less than 30 days, a clear signal that the Fed's moves are tough to fight. Despite the inevitability of quantitative easing being withdrawn by mid 2014 and being well telegraphed by the Fed, when such announcements are made, markets will be unsettled.

The global equity market rally continued in May for European equities with the MSCI EMU gaining 3.2% in Euros and now up 8.7% for the year. By comparison the Japanese rally ended in May with the MSCI Japan retreating 2.2%, although it is still up an impressive 33.8% in Yen terms for 2013. Measures in Japan to generate 2% inflation, so-called Abenomics, has seen the Japanese equity market rise 62.7% over the past 12 months. For the month, the MSCI Japan gained 12.7% and for the year to date the index is up 36.8%.

The overall global equity benchmark (MSCI World) was flat for the month. The benchmark is up a total of 11.1% for the year to date.

The MSCI Emerging Markets Index lost 2.6% in May and is down 3.4% for the year to date. 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 primarily to reduce the dependence on state finance and shadow banking. While it is now questionable if China will be able to produce GDP growth of close to 7.5%-8% for the year, it is a positive development for authorities to focus on more long term sustainable and diversified GDP growth fueled by consumer spending rather than huge government infrastructure projects and spending.

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 – from the ground up type of growth based more on consumer spending and small and medium size enterprises and entrepreneurs.

Global bond markets also faltered in May with the Citigroup World Government Bond index losing 3.4% in US$ terms and the European Government bond market down 1.3%. 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 than markets may expect. Continued bond buying by the Fed may extend into early 2014 but at a far slower pace than $85bn monthly.

US unemployment remains at a historical high level of 7.5% - although well down from almost 10% at the height of the financial crisis. With US job gains of approximately 170,000 being reported for May, real estate sentiment has remained positive. Many analysts are looking for a construction and housing led recovery to carry the US GDP figures to a level approaching 2.5% for the year.

The earlier fears of a failed US budget agreement, have not led to any major concerns amongst investors. Many private sector executives are in fact pleased that government spending has been reigned in. Earlier this year the US market has taken the Sequester and the threat of any Debt limit fallout in its stride. It is clear the Obama administration is somewhat weakened by recent IRS, Libya and related scandals, so it is in no mood to force a government shutdown.

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.

By comparison, Emerging Markets and the Eurozone continue to lag US equities. This is not too surprising given economic weakness in such commodity laden countries as Brazil, Russia and South Africa. Emerging market currencies remain under significant pressure with the South African rand amongst the worst currency performers in 2013. India's economic growth also continues to disappoint while a new reality is setting in for China – no longer can the world expect double digit annual GDP gains.

Concerns regarding European banking and austerity measures in Europe continue to worry the markets. Until such time as a more centralized Eurozone regulator and deposit insurance mechanism is instituted; there remains arguably a two speed Europe in financial services too.

Given ongoing Euro-wide austerity measure in the UK and Germany, expectations remain muted for positive job data and GDP growth over the next 12-18 months. The world is depending on the US to lead the economic recovery which may result in a US GDP growth rate of between 2.5%-3% for 2013. Until the German elections are behind us later this year, it is unlikely Chancellor Merkel will make any significant moves to assist fellow European countries.

Until the end of May, US economic news remained positive as it is was seen as not 'hot' enough to stop Fed meddling in the bond markets. This has helped, in large part, to fuel a real estate resurgence given 30 year fixed mortgage rates still sitting below 4%. Massive bond issuance by the likes of Apple and other corporates are also expected to continue given the cheap cost of capital.
But the Fed's recent announcement of scaling back (tapering) bond purchases has sent shock waves through the markets.

This is due in part to lower rates, as they are seen as a huge stimulus and boon to more capital projects occurring in 2013 and significant construction spending and a more vibrant real estate sector. Higher rates will now lead to more subdued capital spending.
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 sustained Treasury rates.

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. Such concerns exist across a number of Emerging Markets countries, including South Africa and Brazil. Weak Chinese demand has softened commodity prices, reducing export earnings for many Emerging Markets.

The rotation out of bonds continues, which will help fuel the equity rally. The weekly inflow into equity mutual funds in the US during April and May was the highest it has seen in over five years and has dwarfed any bond inflows.