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Global Markets : Outlook and Review

30 November 2013

With no real risk of inflation in the US economy and tapering put off until at least December, not surprisingly global equity markets continued their upward trajectory in November and into December. The strong global bull run includes most industrialized countries, with only emerging markets failing to respond to the continued US Fed's monetary stimulus.

A number of global developed equity markets hit all time highs during November, with the US Nasdaq index hitting a 13 year high. By mid December the S&P 500 hit levels approaching 1850, while the Dow easily surpassed 16,000 and was fast approaching the 16,500 mark. The UK's FTSE is now hovering around the 6700 range, while the Nikkei has powered through the 15,000 level given the Abenomics stimulus.

Global equities as measured by the MSCI World index gained 1.8% for the month, following an impressive September and October combined gain of almost 9.0%. For 2013, this global benchmark is now up 24.1% and over the past twelve months up 26.4%. The annualized five year return is an impressive 15.3%.

US markets have been leading the pack most of the year and did not fail to inspire once again this month – with a gain of 2.8%- bringing it's year to date performance to 28.4% (MSCI US). Despite the European Union being in a recession earlier this year, the indices have recovered much ground after lagging the US gains earlier in the year. European equities rose 1.3% for the month, but are up 22.4% for the year. With the Euro hitting 1.37 to the US$ - the MSCI EMU Index gain is approximately 30% in US$ terms for 2013.

While the talk of a Fed taper continues to unsettle some, global equity markets seem increasingly relaxed about the idea. With Bernanke departing the Fed at the end of January some expect he will begin the taper under his watch. This will help ensure confidence that there is no difference in policy between the old guard under Bernanke and the incoming Fed chairman, Janet Yellin. Most market analysts believe the next Fed moves regarding a small tapering off of the $85bn monthly bond buying has already been built into equities – regardless of whether it takes place next month or closer to the end of the 1st quarter 2014. The markets believe that US rates will remain exceedingly low based on the Fed's easy money policy. Under Yellin it is likely she will not increase rates for most of 2014 – given her sensitivity to unemployment and the housing market which represents the majority of American middle class wealth.

The Fed's continual emphasis that 'tapering did not equal tightening' does help ensure a somewhat relaxed bond market. However the great bond bull market is likely almost over – after some 20 years where rates have consistently declined from high teens – seen during the Reagan/Volcker days of taming inflation in the early 1980s. As US rates begin to rise it is likely to reduce mortgage lending and lead to a stronger dollar. Currently no such trends are apparent – for now the US$ continues to weaken relative to both the Euro and British Pound.

Despite higher PE ratios in the US and European markets - the consensus remains that low rates will help support equity markets for some time to come, and no bursting of any bubble is imminent. Positive GDP growth figures in the US, EU and UK in recent weeks have helped reinforce the sense of a global recovery.

Corporate earnings continue to be healthy – not always due to top line growth but following 5 years of the Great Recession it is clear corporations have become far more efficient and increasingly dedicated to cost savings. Sadly for new hires this means in the industrialized world a mostly jobless recovery is on the cards.

Most US bonds are expensive given that interest rates are being held artificially low by the Fed's massive $85bn a month bond buying program. When the Fed tapering begins we expect to see the 10 year Treasury yield move higher – from 2.7% to around 3.5%-4%, but not much higher. By contrast a fuller priced equity market does not mean it is over-priced necessarily. The differentiation between huge equity inflows versus bond inflows is significant, with bond inflows at its lowest levels since 2008.

Value remains in US stocks as corporations continue to squeeze out more profits due to cost cutting measures taken over the past few years as a result of the Great Recession. Investors are also increasingly moving back into European equities. In particular, US fund managers are taking increasingly bullish bets on the Eurozone's sluggish recovery speeding up. An example of this is the disclosure that the value of shares in Europe's 10 largest listed banks held by US funds, has increased by 40% since June this year.

The Fed will remain in easy money mode until such time that unemployment drops to 6.5% - it is currently at 7.3%. The accommodative European Central Bank under Draghi also seems to be in no rush to raise rates or worry about inflation which is almost non existent in the overall Eurozone. In fact deflation is a real concern for Draghi at present.

US real estate prices continue to show double digit growth as compared with 2012 prices - across most states. Household formation has revived, helping to boost demand for homes and spurning residential construction. Housing starts are now approaching 1 million a year – last seen prior to the 2008 financial crisis.

Although Emerging Markets have recovered somewhat form their earlier losses this year, it remains a huge laggard to the global equity bull market. An eventual rise in US yields due to the tapering by the Fed will likely put further pressure on depreciating emerging market currencies that harbor both a large current account deficit and fiscal deficits. But export oriented players based in emerging markets will likely see a boost to their bottom line due to the currency effect.

Emerging Market indices such as India enjoyed a robust gain in October and November. However Brazil, Russia and China have failed to impress. For November the benchmark (MSCI EM) retreated by 1.5% and is now down slightly for 2013, by 1.2%. For the past year the index has only gained 3.7%. With the major emerging economies currently out of favour and under-priced, we expect them to outperform a good deal of the developed world over the next 2-3 years.

The Japanese rally after taking a breather in October, powered up another 5.9% in Yen terms for November. The MSCI Japan Index is now up an impressive 49.4% for 2013 and a whopping 64.9% over the past year. The first year of so-called Abenomics has been well received globally, but analysts fear that a recent consumption/sales tax may hurt the economy and slow growth.

Higher rates in November helped push the Global Government Bond Index down by 1.1%. Year to date the index is down by 3.1%. The US Barclays Aggregate Bond Index which includes treasuries, mortgages and corporate bonds is likely to also have its first losing year in more than a decade. By comparison the stronger Euro helped boost returns in US$ for those investing in the European Government Bond Index – which reported a 0.3% gain in Euros. The index is up 2.8% for the year and 3.6% over the past twelve months.

In the property space, the US Property Index (REIT) benchmark retreated by 5.5%, losing all its prior month's gains of 4.1%. It remains in positive territory for the year – up 4.5%. We believe the US REIT market still continues to have significant upside as it remains somewhat undervalued compared to other US stock market sectors. By contrast the European Citigroup BMI Property Index gained a marginal 0.3% for the month in Euros – and is now up 2.8% for the year.

In summary, while global equity markets are likely to continue to show progress in 2014, we expect returns to be more muted and for Emerging Markets to outshine the more developed markets going forward. We expect Emerging Markets to begin retracing their previous highs during 2014-2015, as it becomes clear there are no great catastrophes effecting China, India, Brazil or Russia.

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