



Global Markets : Outlook and Review

31 October 2013

Global equity and bond markets continued their upward trajectory in October. A number of global developed equity markets hit all time highs during the month and into November. In particular the S&P 500 hit levels of 1800 by mid November, with the Dow surpassing 16,000 and the FTSE hit the 6700 range. Global equities as measured by the MSCI World index gained 3.9% for the month, following an impressive 5.0% gain in September. For 2013 this global benchmark is now up 21.9%.

US markets have led the pack gaining 24.9% year to date (MSCI US), after gaining 4.4% for the month. European equities are also up an impressive 20.8% for the year in Euro terms (MSCI EMU).

World equity markets look increasingly relaxed about the idea of a Fed under new prospective Chairman Yellen. Arguably the next Fed moves regarding tapering have 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. The Fed's continual emphasis that 'tapering did not equal tightening' helps ensure that bond investors don't panic either. All asset classes for now are being buoyed by the same central bank sponsored liquidity tide and the current global equity and bond flows highlight this.

This year continues to see record equity inflows - with total US flows into equity funds on course to equal all inflows experienced over the past four years combined. The consensus remains that low rates will help support equity markets for some time to come, despite valuations being much fuller than in prior years. With US equities trading at PE ratios of around 16, the market is particularly overpriced and the bull run is likely to continue for some time.

Arguably all bonds are expensive since 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. Consequently bonds in general are richly priced. By contrast a fuller priced equity market does not mean it is overpriced necessarily. The differentiation between huge equity inflows versus bond flows 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.

Recent OECD reports indicate that Europe's two largest economies are diverging - with growth in Germany's private sector hitting a 10-month high, while private sector activity in France contracted. Liquidity seems to have become the dominant force in determining valuations across various asset classes. Central banks liquidity provisions through sustained low rates, asset purchases and cheap loans, are arguably more important to many investors than economic fundamentals.

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.

Equity investors see these benign trends as positive for equity markets well into 2014 and possibly beyond. Good news for global equity and bond markets is that global inflation trends remain largely benign due to mostly a sideways trend in oil prices predicted through 2014.

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 spurring residential construction. Housing starts are now approaching 1 million starts a year – last seen prior to the 2008 financial crisis. With the US\$ clearly the world's reserve currency, this has allowed the US consumer to continue to borrow at record low rates.

The economic outlook for developed markets has been slightly downgraded by the IMF to around 2.5% for 2013, but is expected to accelerate in 2014 to above 3%.

Over the past month, Emerging Markets have staged a healthy rally off their earlier year lows. At close to just 10 times estimated 12-month earnings (PE ratio), valuations across emerging markets are relatively low, although earnings revisions have been negative. 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.

New economic growth figures in China and Latin America point to a steady rebound in activity which should boost prospects for large cap stocks comprising the MSCI Emerging Markets Index. We expect this index to outperform a good deal of the developed world over the next 2-3 years.

Emerging Market indices enjoyed a robust gain of 4.9% for October following an impressive rise of 6.5% in September (MSCI EM) –but it is now flat for 2013. Particularly impressive has been gains in such sector indices as Consumer Staples globally (MSCI Consumer Staples) – posting a gain of 19.7% year to date with a 4.6% jump for the month.

The Japanese rally took a breather in October and remains up 41.1% for the year in Yen terms – (MSCI Japan). So-called Abenomics has been well received globally, but such structural changes will take time to feed through into the Japanese economy and benefit the wider population. Fear that a recent consumption/sales tax may hurt the economy is not of much concern to the market. For 2013 the Japan market is now up an impressive 41.1% in Yen terms or 23.3% in US\$. If Abenomics can deliver a boosted inflation at around the 2% level, this will certainly help the Japanese economy recover and improve Japan's GDP growth prospects. The implementation of a long overdue consumption tax will also boost Japan's fiscal standing.

Lower rates in October helped push the Global Government Bond Index up by 1.0% following a 2.0% gain in September. Year to date the index is down by 2.0%. By comparison the stronger Euro helped boost returns in US\$ for those investing in the European Government Bond Index – which reported a 1.4% gain in Euros. This translated into an impressive US\$ gain of almost 2.8% for the month and 6.3% for the year.

In the property space, the US Property Index (REIT) benchmark gained another 4.1% and is now up 6.5% for 2013. Similarly, the European Citigroup BMI Property Index gained 4.0% for the month in Euros – and is now up 7.5% for the year and 10.7% over the past 12 months. (in Euros).

In summary, rates across the US, UK, Europe and Emerging Markets are unlikely to rise due to weak economic growth. The British Pound has shown considerable strength which is a worrying sign for the Bank of England. With little sign of inflation, low interest rates will remain with the leading world economies for much, if not all of 2014. Emerging markets central banks are caught in the vice between possible inflation issues should their currencies weaken further due to lower rates. We are looking at Emerging Markets to begin to retrace their previous highs over the next twelve months as it becomes clear there are no great catastrophes affecting China, India, Brazil or Russia.