Global Markets : Outlook and Review

30 Nov 2014

Volatility in global markets has increased, given the recent selloffs in October and again in December. In both cases equity markets recovered their lost ground. Nervousness has increased given the dramatic fall in the oil price and its knock on effect on developing countries, in particular Russia.

The strong US dollar is up 8% on a trade weighted basis since June 2014. Clearly with the US acting as a safe haven – this has helped attract further inflows into the US equity market, pushing up valuations. At current levels these valuations assume the stock market will likely record strong earnings again in 2015. Corporate earnings growth in this bull market has been approximately 20% above average levels of growth for all previous bull markets since 1957. This has not been fueled largely by top line revenue growth, but rather by increases in productivity and stock buybacks which push up earnings per share levels. Although we continue to be optimistic on US equity prospects over the next 18 months, it is clear there is more likelihood of volatility along the way as valuations rise.

The stronger US economy has also helped ensure its stock market is priced at a significant premium to Europe, Asia and Emerging Markets. The new US Congress will be more business friendly under the Republicans which may lead to more tax and regulatory reform assisting business and households too.

Given the recent recovery in equities, 2014 remains on track for a solid year of gains. Impressive US November job data recorded 321,000 job gains capped off an unemployment rate that has dropped from 6.7% in January to 5.8% in early December. The US economy is clearly in its healthiest state since the Great Recession with the number of jobless claims at a multi-year low and the number of work week hours hitting their highest level since 2009.

Equity market divergence in 2014 is partly due to the ever rising US$ - translating into slight loses in dollar terms for the Nikkei, MSCI EMU and the UK's FTSE. The recent election in Japan is expected to unleash further Abenomics which will continue to see a weak Yen and a rising stock market on the back of an inflationary push by policymakers.

Given the relatively low valuations across Emerging Markets, 2015 could well be the year for lift-off and a turning point in these developing stock markets. The MSCI EM Index is trading at a Price to Earnings Ratio of 10. By comparison, the S&P 500 trades at a PE of more than 15. Other developed countries as measured by the MSCI EAFE trades around 14. It is worth noting that emerging market stocks can perform well despite a strengthening dollar. Over the prior 10 years when global exports exceed a 2.5% growth rate in a quarter, returns from emerging markets have posted gains double those of developed country stock markets.

The stronger dollar is holding down interest rates, making the equity market more attractive for the time being. The 10 year Treasury Note offers a yield of just 2.2% and will likely continue in this low range for some time to come. A flatter yield curve is expected in 2015 assuming the Fed raises short term rates.

With the Fed planning to raise interest rates (0.25% is likely), between the 2nd and 3rd quarters in 2015, emerging market currencies have begun to suffer in late 2015. The Russian ruble, South African rand, Turkish lira and Brazilian real have all shown significant losses. The effect was compounded as US Treasuries increasingly became a safe haven during the recent collapse in oil prices (from $105/barrel in June to around $55/barrel in December). The lower oil price acts as a tax break or stimulant in the US as price drops are felt almost immediately at the gas station. It should also have the effect of bolstering global economic growth, although this will take longer to play out outside the US.

Since US consumer spending accounts for more than half of the US economy (68% of GDP), lower energy prices are a huge boost. It is noteworthy that the deleveraging period since 2008 is largely over. Consumer spending is already picking up significantly. Meanwhile the continuing low interest rates have helped boost capital expenditure.

US inflation prospects have subsided with the significant drop in oil prices. It is unlikely that the Fed will raise rates much, without evidence of renewed inflation. Consequently we are not expecting much Fed tightening in 2015, despite the historically record low interest rates currently experienced.

Talk of the ECB doing full blown Quantitative easing continues. With the prospect of deflation in the Eurozone if oil remains around $60/barrel for an extended period – Draghi may decide to significantly expand the ECB's balance sheet and unleash some elements of QE as seen in the US until it was recently ended.