Global Markets : Outlook and Review

31 Dec 2014

One of the biggest stories remains the weakness in commodity prices, particularly oil losing half its value in the final 6 months of 2014. This should be a net positive for many developed and emerging markets including the US, Europe, India, China and South Africa who are net oil importers. In the US it has been calculated that oil below $50 a barrel translates into an average annual tax cut per household of some $1500.

Global markets began experiencing considerably more volatility in the final few months of 2014. Uncertainty with economic growth levels in Europe and Japan has helped raise fears of disappointing global growth into 2015.

The new QE (quantitative easing) program announced by the ECB which will inject Euro 1.1 trillion into sovereign and other bonds – will lead to a weaker Euro, but will help boost inflation. Europe is arguably already experiencing deflation so the QE program at Euro 60bn per month until late 2016 will help prime the pump and boost prices.

Global growth will continue to diverge in 2015 with the US leading the pack. It is clear that the world remains in the throes of a two speed recovery. We therefore expect higher short term rates in the US with Eurozone and Japanese rates moving sideways. Negative borrowing rates already exist in the Eurozone and Switzerland.

Despite the US experiencing annual 2014 gains of approximately 13% in the broad-based MSCI US Index, the strong US dollar severely impacted global equity returns. The MSCI World gained a paltry 4.9% for 2014, while the MSCI EMU (Eurozone) Index rose 4.3% in Euros but posted a negative return in US$.

With 10 year US Treasury rates currently around 1.9% - well below last year's levels, it is expected the Fed will raise rates around mid-year. These continued record low rates indicate that the US remains a safe haven for global investors. Further it shows the weakness in Europe which is struggling to recover from another recession suffered in 2014. Threats of a triple dip recession in the Eurozone have led finally to the approval of QE across Europe in 2015.

The US economy is gathering momentum posting regular monthly gains exceeding 200,000 jobs (December approximated 250,000 and prior two months were revised upwards). Unemployment at just 5.6% is now almost at half the levels seen during the Great Recession. Almost 11 million new jobs have been created during the recovery from the Great Recession. Finding value in record US equity prices is clearly more difficult than its beaten down European counterparts. The case for US equities is premised largely on continued impressive earnings amongst large corporates. At 14X earnings, Europe trades at a discount to the US market PE ratio of 17. Despite a stronger US$ we believe lower energy prices and the GDP pickup will ensure positive US corporate earnings – leaving sufficient upside for US stocks to post healthy gains in 2015. However investors should expect more volatility given that valuations, by many measures, are not cheap by historical standards.

No doubt the weaker Euro which is moving towards parity to the US$ will help boost European exports – helping the Eurozone to finally escape the clutches of a recession. While Europe may appear to muddle along there are a number of tailwinds now helping it in 2015 with credit easing, ECB"s QE program and the declining Euro – off more than 12% against the US$ since early 2014.

Clearly the expected European recovery faltered in 2014, as did the much touted Abenomics plan in Japan. Japan went into reverse after its sales tax hike. The Eurozone and Japan are both expected to grow by little more than 1% in 2015, while the US is on course to hit 3% growth.

The UK outperformed its European neighbors in 2014, effectively decoupling from the weakest areas of the Eurozone.

Emerging markets failed to overcome the headwinds of weak commodity prices and the slowdown in China. China is now the world's 2nd largest economy representing 12% of global output – larger than the three other BRICS combined.

China's foreign exchange reserves continue to grow – now at almost $4 trillion. If the economy can grow by at least 7% in 2015, this will exceed growth predictions of 6% for India and 4.7% overall for Emerging Markets. Expectations are that Emerging Asia outside of China will surprise on the upside given the pick-up in US economic activity. Since the US accounts for one fifth of the ASEAN bloc's exports – this region is set to benefit from a stronger US growth rate in 2015 too.

Latin America is expected to be weighed down by a weak Brazilian economy that will struggle to achieve a 1% gain this year. Mexico despite also being reliant on oil - will by contrast grow at least 3% in 2015.
Meanwhile sanctions on Russia and the weak oil price has led to severe weakness in its economy.

US inflation prospects have subsided with the significant drop in oil prices. It is unlikely 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.