Global Markets : Outlook and Review

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Daniel Kahneman, a pioneer in behavioral finance who won the Nobel Prize for Economics - states that how frequently we react to market moves is a key factor in how our fortunes fare. “All of us would be better investors if we just made fewer decisions,” says Kahneman. In the case of today’s market, this is good advice in today’s markets.

US economic growth rebounded sharply in the second quarter, with GDP recording a 4.0% annualized growth rate. The disappointing first quarter reading was revised upwards by almost 1%. Growth continues, but not at such a rate as to push the Fed to accelerate their normalization process, leaving us with abundant liquidity. This is illustrated by robust merger activity and near-record low interest rates around the world as large cash piles have to find a home. This liquidity is working its way through the economy—particularly lending growth having picked up sharply—which should lead to the velocity of money, and economic growth, improving. Surprisingly the 10 year Treasury yield was below 2.4% in mid-August – a 14 month low.

Fed Chairwoman Yellen seems set on assuring the markets that the first hike won't likely occur until sometime in mid-2015. History has shown that stocks traditionally do quite well in the months leading up to and immediately following the first rate hike in a tightening cycle. The Federal Reserve maintained its tapering of quantitative easing, but with labor market conditions getting tighter, inflation could become a bigger concern if wage gains pick up.

Non-farm payrolls rose 209,000 in July, missing expectations of 230,000. However, employment has now increased by more than 200,000 for six straight months. The unemployment rate ticked up to 6.2 percent in July as the labor force participation rate rose slightly. Average hourly earnings were unchanged in July and remained at 2.0 percent higher than a year earlier. Average weekly hours were also flat. The second-quarter employment cost index showed a 0.7 percent quarterly gain, the largest since the recovery began and a possible sign of wage pressure.

The ISM manufacturing index showed strong gains in July, rising to 57.1 from 55.3, the highest level since April 2011. New orders and employment showed particularly large increases. Importantly, the ISM non-manufacturing index jumped to 58.7 in July, better than expected and the highest level since 2005. U.S. factory orders had a strong rebound in June, rising 1.1 percent after May’s 0.6 percent decline. Personal spending rose 0.4 percent in June, matching gains in personal income. The trade deficit continued to narrow in June, falling to $41.5 billion from $44.7 billion, mostly due to falling imports.

The likelihood US stocks will reach new highs by year end is high. The recent volatility in early August was healthy as consolidation was overdue - and should set us up for a nice recovery later this year.

While volatility is likely to increase in the near term, the fundamentals offer comfort; the equity risk premium now sits at 5.4 percent, above the long-term average of 2.8 percent, suggesting equities are offering a reasonable return for risk. And the S&P 500 Index’s price-earnings multiple of 17.3 times also seems fair given low inflation levels. If you are an investor, avoid the temptation to be short-term focused.

In contrast to the United States, the stagnation in the Eurozone is weighing on confidence and threatens to create a negatively self-fulfilling cycle. Declining German business confidence about future conditions, could restrain investment and hiring, diminish consumer spending and further weaken economic activity. Europe's leading economic indicators have started to stall, dragged down by what was assumed to be the strongman of Europe—Germany. At nearly 30% of Eurozone GDP—what happens in Germany, matters for the region. German GDP shrank an annualized 0.6% from the first quarter – possibly just a temporary hiccup given its low unemployment. Geopolitical risks have intensified the dour mood of businesses in the region. Over the past year, the euro zone's economy expanded just 0.7%—too slow to reinvigorate investment and job creation or to escape the legacy of heavy public and private debts in many countries.

The French economy, the bloc's second largest behind Germany, stagnated for a second straight quarter. Spain and the Netherlands posted some growth, but not enough to offset weakness in the economies of their neighbors. Italy fell back into recession in the second quarter, with GDP down 0.2 percent following a 0.1 percent decrease the previous quarter. U.K. manufacturing PMI was weaker than expected in July at 55.4, but that reading was still indicative of a strong expansion. U.K. industrial production rose less than expected in June, up 0.3 percent following May’s 0.6 percent drop.

Amid the negatives, there are areas of support. Lending may be bottoming, as Eurozone banks have been deleveraging; a slower rate of decline in credit could gradually reduce a hindrance to economic growth. Additionally, the euro has fallen; which could improve demand for exports, as well as corporate earnings, and diminish the drag on inflation. We believe the Eurozone is on the mend and remain positive on European equities longer term.

China’s official manufacturing PMI rose to 51.7 in July, the highest level since April 2012. China’s official non-manufacturing PMI declined for a second consecutive month in July, decreasing to 54.2. China’s HSBC services PMI fell to 50 in July from 53.1, a five-and-a-half year low. China's improved performance bolsters our view that Chinese equities remain quite attractive for a risk tolerant investor

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