Global Markets : Outlook and Review

31 Aug 2014

The US stock market continues to exhibit great resiliency, with bouts of selling this year stopping short of a correction, and reversing quickly. Stocks are likely to continue their upward momentum, although volatility could increase with Federal Reserve interest rate uncertainty, combined with midterm elections and geopolitics. An improving economy, decent valuations and a still-accommodative Fed leave us confident that dips should be viewed as buying opportunities. The main reasons for our continued optimism are the improving economy, higher earnings growth and still-reasonable valuations. Stocks typically haven't suffered bear markets unless a recession was imminent, and we see no indications of that—in fact, quite the opposite.

The labor market continues to improve with initial jobless claims remaining around 300,000 on a 4-week moving average basis and continuing claims moving to their lowest levels since June 2007. In addition, the Job Openings and Labor Turnover Survey (JOLTS) continues to show the "quit rate" (people voluntarily leaving their jobs) is increasing, indicating growing confidence in the labor market's improvement.

US housing has rebounded, while the labor market continues to improve. Disagreements appear to be growing within the Fed; while politicians are fixated on the upcoming mid-term elections (November 2014).
In August, the U.S. economy created 142,000 net new jobs, well below what economists and analysts expected and the weakest number this year. However, we believe the modest report was mostly a reflection of seasonal weakness and is likely to be revised higher. Average monthly non-farm payroll gains are above the 200,000 level, consistent with a decent economic expansion, even as structural headwinds remain.
Indeed, outside of the jobs report, other economic releases painted a consistently positive picture. An important economic indicator, the Institute for Supply Management's manufacturing survey, showed that new orders reached their highest level since 2004, while the service component of that survey hit a nine-year high.

The economic landscape is consistent with our view that shorter-term interest rates are most vulnerable to rising rates. Long-term rates have remained relatively stable. This lack of volatility in longer-term Treasuries is partly a function of the collapse in yields in Europe and much of the developed world outside the U.S. Although Treasury yields are low, they still appear attractive versus even lower rates in Europe and Japan, which increases demand for U.S. Treasuries, driving down yields. Meanwhile, short-term rates have been steadily grinding higher.

The strength in the dollar is not simply a function of an accelerating U.S. economy; it also reflects weakness in other regions. For example, European economic data continue to disappoint, which has forced the European Central Bank to further lower interest rates and initiate a new program to buy asset-backed securities. The effect, as expected, was to push the euro down against other currencies, especially the dollar.

Europe's economy continues to struggle and we are skeptical about the European Central Bank's ability to aggressively fight deflationary pressures. Draghi's recent moves to drop the ECB's rates further and to increase the penalty charged to banks parking monies with the ECB is unlikely to provide sufficient stimulus. Full blown quantitative easing is still expected as parts of Europe are clearly entering deflation e.g. Italy).

Much bigger problems exist across the Atlantic as Europe's economy has failed to gain traction due to the Eurozone debt crisis, a hobbled banking system, and a lack of flexibility. Regulations that stifle innovation and competitiveness have kept the region from reinventing itself and growing on par with the United States. While these negative factors are gradually being addressed, it has been a slow slog, and reforms have been notably absent in France and Italy.

Meanwhile, Japan's economy is showing some near-term signs of improvement; while China has stabilized, providing opportunities (although substantial longer-term challenges still remain).

The worse the economic and deflation outlook becomes, the better the chance of QE and a bounce in European stocks. However, we currently have a neutral view on Europe and believe it is prudent to hold off on aggressively buying European stocks.

China's economy has returned to its gradual slowing trend in the third quarter—the "new normal" in China, in our view. The slowdown highlights the balancing act Chinese policymakers are trying to perform; pursing reforms that will likely slow growth, yet not allowing growth to slip too much. This could result in quarterly bumps up and down in the economic data along the way as the government experiments with market-based mechanisms for driving the economy.

The biggest risk to China's economy, in our opinion, is a sharper downturn in the property market, as the sector influences 23% of China's GDP according to Moody's Analytics. The longer the slowdown, the bigger the risk that property developers slash prices, reinforcing a buying freeze, and risk loan defaults.

Although Chinese stocks probably need to take a breather after the recent run up, we believe there is more upside and that Chinese stocks will outperform the broad emerging market (EM) universe. Chinese stocks could benefit from further stimulus, attractive valuations, and continued reform moves; such as privatizing state-owned enterprises (SOEs) and increasing the availability of yuan-denominated investment opportunities through the upcoming cross-exchange Shanghai - Hong Kong Stock Connect (SHKSC), or "through train."

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