Global Markets : Outlook and Review

31 Oct 2014

While global economies remain weak, it is encouraging to see central banks outside the US becoming more actively engaged. While the US has benefited from aggressive monetary stimulus, the Fed has now ended Quantitative Easing. The Chinese central bank recently announced it cut its one-year deposit rate by 25 basis points to 2.75%, and the one-year lending rate by 40 basis points to 5.6%. This is the first such cut in almost two years and comes in the midst of weaker than expected manufacturing numbers from China. China may still struggle to achieve the 7.5% GDP growth rate it has set itself. So this rate cut is welcome news to consumers and investors in China. In fact, most emerging markets have rallied on this news.

This follows all-time high equity markets in the US where the Dow is fast approaching the 18,000 mark, following the mid-October selloff that took it well below 17,000. Similarly with the S&P 500 recovering to levels of 2063, the FTSE at 6750, DAX at 930 and Nikkei at 17,357 – most developed markets have shown impressive gains throughout November. The further stimulus announced by the Japanese central bank has helped power its stock market to further heights and weakened the Yen which is now approaching a low of 120 to the US dollar.

Europe continues to show almost no economic growth and recent comments by ECB President Draghi appear to indicate he will provide further stimulus shortly. He has already penalized banks by providing negative interest rates on deposits they park at the ECB window. This will likely help boost equity markets in the Eurozone shortly. Currently Eurozone and Emerging Market stocks lag US stocks by double digits over the past 18 months and have significant ground to still make up. We expect 2015 to be the year when these markets step up and narrow the gap between themselves and the impressive US equity market gains.

Expectations in the US are for the Fed to make a rate increase around mid-2015, thus increasing short term rates most. Analysts see the two year rate being the most affected – perhaps rising from its current low level of 0.50% to end at around 2% within the next 18 months. The likelihood is that US bond markets will overreact at the very front-end of the yield curve. It is clear that global long term interest rates will remain low for an extended period of time. Putting this into context the 10 year US Treasury has a long term average of closer to 6%. So even is US Treasury Bond rise to 3%-3.5% over the next few years we will remain well below typical interest rates.

However the sizable foreign money flowing into the US seeking higher yields, in the face of collapsing Japanese and German 10yr rates – means the 2.3% US 10 year Treasury yield will remain under pressure for the foreseeable future. So 18 months out we could see a strange phenomenon that short and long term US interest rates are not that dissimilar!

Optimism in the US is reflected in continued monthly job gains well above the 200,000 mark, while oil has now almost halved over the past four years with Brent Crude trading at just $76 in mid-November. This is effectively a tax cut for the US consumer and those in developed countries too.

Increasing concerns about European deflation, revised IMF data showing a global slowdown and a possible rise in US and UK interest rates – resulted in volatile capital markets during October. It seems the past few years of low volatility in the equity markets is finally over.

Against the backdrop of disappointing growth in China, Europe and many emerging markets – the US data is encouraging. However weak German manufacturing and export data show that even Europe’s powerhouse cannot avoid the problems of the sick continent.

The strength in the dollar while a slight drag on US corporate earnings, will be a net positive for European exporters. 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 are unlikely to provide sufficient stimulus. Full blown quantitative easing is still expected, as parts of Europe are clearly entering deflation e.g. Italy).

Ultimately an aging European population and slowing population growth leads to a deceleration in the work force, downward pressure on inflation and such trends remain a big drag on economic growth.

Despite the recent volatility in financial markets, we believe equities particularly those in Europe and Emerging Markets remain cheap relative to the US. WE remain positive on the US equity market outlook although there may be further volatility as the Fed begin raising rates in mid to late 2015.