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BUILDING BETTER INSIGHTS®

WATCHING AND WAITING

IN BRIEF

- Despite an uncertain start to 2014, we are sticking with our story of an improving macro environment and its implications for the markets.
- We continue to focus on a cyclical earnings rebound in Europe and Japan, while looking for value to re-rate as global GDP growth picks up.
- Recognizing that this positive outlook has risks, we are keeping close watch on economic data releases and evolving geopolitical tensions.

Macroeconomic overview

The waiting game

Late last year, we opined that the market was giving a clear message for the 2014 macro outlook: The strong advance in equities combined with a steady rise in bond yields signaled more robust global economic growth. One-third of the way into this year, however, that message has been muddied.

Admittedly, the MSCI All Country World Index has generated a year-to-date total return of 2.2% through 30 April, which still amounts to a high-single-digit gain when annualized. Moreover, in fixed income, credit continues to outperform. At first glance, such results seem to suggest that all remains well with the global growth picture. But wait… the real star has been the 30-year US Treasury. An investment in this bond at the start of 2014 would have generated a gain of 11% so far this year, or more than 30% annualized. And this is where the message gets murky, since strong gains in US Treasuries are typically associated with *deflationary* pressures and a *slower* pace of expansion.

We remain of the view that global growth is likely to improve and that the policy backdrop should remain supportive of risk assets, such as credit and equities, and put upward pressure on bond yields. But this outlook is not without risks, giving us the feeling that we ought to be looking for clarity on some significant issues. Here are five areas in particular that we are watching:

US economic rebound

We are waiting to see if the recent improvement in US macro data can be sustained. First-quarter growth was basically flat, well below consensus expectations, with some but not all of the slowdown attributable to the weather. Economic reports for March and April have been

more solid, perhaps best illustrated by the latest report of 288,000 jobs gained in April while the unemployment rate fell to a new cycle low of 6.3%.

Neither the slump in the first quarter nor the evidence of a tighter labor market is likely to shake the US Federal Reserve, and the quantitative easing taper will probably continue at the present pace. With few signs that job gains are causing inflation or wages to accelerate, the Fed's current guidance is unlikely to be altered. Financial markets appear to take that guidance at face value, generally accepting that there will be no tightening until well after QE ends and anticipating the first Fed rate hikes in mid-2015. When rates eventually do rise, the increases are expected to be slower and to a lower level than in the past. However, if the labor market and the rest of the economy exhibit broad-based strength and inflation moves higher, the markets could test the Fed's resolve by pricing in an earlier hike.

European inflation

We also await the next move from the European Central Bank, which presides over an economy that has demonstrated real signs of progress on the growth front but is still struggling with excess leverage and exceptionally low inflation. Up just 0.7% year over year through 30 April, consumer prices are near their cycle lows, and credit growth remains negative, suggesting that eurozone monetary policy is still tight. Although the ECB has hinted at cutting rates further and initiating some version of QE that would support the economy and also help to weaken the euro, we are concerned that the hurdle for fresh stimulus may be high.

Japan' consumption tax

We are watching how the Japanese economy responds to the value-added tax hike that came into effect last month, with the likelihood that inflation may initially spike higher and put downward pressure on real wages. Many expect the Bank of Japan to respond to post-VAT weakness in growth by stepping in with more QE, which could potentially weaken the yen and boost stock prices. But if the BOJ is in no hurry to provide more liquidity — perhaps taking its own wait-and-see approach — then the financial markets may be disappointed.

China's way forward

We are closely monitoring China, where GDP growth has slowed to less than 7.5% on the back of softer exports and the lagged impact of past tightening. Policymakers seem to be caught in a jam, since aggressive stimulus could boost the very sectors where structural reforms are trying to address excesses, and recent measures to support growth can be described as cautious. While even weaker growth numbers would not be welcome, the mild stimulus policies attempted thus far may have helped growth find a bottom, which has supported commodity prices. But we wonder about China's next steps, should growth fizzle.

Russia and Ukraine

Finally, we are keeping vigilant watch on the situation between Russia and Ukraine, which took a turn for the worse even before the ink was dry on the Geneva agreement to de-escalate. Russia's ambition for a stealth takeover of Ukraine appears to be evolving, while US and EU sanctions have not been set for maximum impact. The interaction between what happens on the ground and in world capitals is where the source of instability may lie. As we observed last month, the road to war is not impossible — even though both sides stand to lose.

Equity overview

Just wondering

Market participants have been wondering how to digest a variety of events, ranging from the Fed's apparent flip-flop on the pace of rate hikes and the US economy's weaker-than-expected growth in the first quarter to Japan's consumption tax, Indonesia's disappointing elections, Ukraine's escalating crisis and the eurozone's troubling signs of disinflation. We hope to help simplify the outlook.

Global monetary policies and equity markets

In the United States, the recent messaging from the Fed may have sent mixed signals and caused some confusion. Yet it is widely expected that interest rates will rise at a slower pace than had been feared when QE tapering was first announced in May 2013. A year later, the 10-year US Treasury yield is about 100 basis points higher, as the initial shock of that announcement has been replaced by a more rational response to the actual reductions in asset purchases. Now the expectation seems to be that improving growth will justify a measured pace of rate increases, which would be supportive for US equity markets.

As for Europe, though there is increasing talk that the central bank may use unconventional monetary policy to raise inflation expectations, we would not count on QE to drive the equity markets. Given the ECB's track record of complex and relatively slow decision-making — and with bond spreads in the periphery near pre-crisis levels after Greece's recent successful bond auction — the urgency to act seems somewhat tempered. After all, the ECB balance sheet has actually shrunk by nearly 30% since President Mario Draghi famously pledged to do "whatever it takes" to save the European Union in July 2012.

Instead, we would continue to focus on the strength of a cyclical recovery and its impact on profit margins, and to look for increases in private sector lending to support growth. At the same time, we would be cautious on peripheral Europe given the relatively stretched valuations and extremely tight credit spreads.

We have been quite skeptical of Japan's structural reform — the third arrow of Prime Minister Shinzo Abe's economic program that also includes fiscal stimulus and monetary easing. Thus far, few policy actions that would alter our view have come to the fore. We do believe, however, that the BOJ is committed to meeting a 2% inflation target. Given the anticipated weakness from the sales tax, the central bank will likely monitor economic activity to determine whether its QE experiment should be amplified. Japan is the only major market with an earnings upgrade, and if there is a further devaluation of the currency, we see continued upside in Japanese equities.

Valuation and earnings

We are not in the camp that sees valuations as excessive. Yes, there are clearly pockets that appear to be overvalued, including social networking apps and electric vehicles, but these have already started to see a correction. Our belief is that the outperformance from such new and emerging technologies will likely cease as the focus on value increases.

In terms of valuations, the United States and Europe are at long-run averages, while emerging markets are about one standard deviation below. Globally, the dispersion between the highest and lowest deciles ranked by price-to-earnings ratio is the widest it has been in about five years, reflecting the premium investors have been willing to pay for earnings certainty.

We reiterate that in such an environment, multiples cannot continue to expand significantly without further earnings growth. It is noteworthy, then, that across various markets including Japan, Europe and even the United States, one-year forward consensus forecasts for earnings per share growth remain below their 10-year averages — indicating that there appears to be room for earnings to grow.

Furthermore, we expect continued use of share buybacks and dividend payments as a way to reward shareholders as long as monetary policy stays relatively loose. According to Bloomberg, USD 1.64 trillion was sitting as cash on the balance sheets of nonfinancial US corporations at the end of 2013. Capital expenditures may be starting to pick up in the United States, but only very tentatively.

Given our view on measured rate increases and ongoing opportunities for earnings growth, combined with reasonably fairly valued markets, we think there may be a change in sector leadership. Typically in this kind of environment, cyclicals — energy, technology and industrials — outperform defensives — utilities, telecommunications and consumer stocks. We have considered reducing exposure to small caps after their massive rally last year and focusing more on value and quality stocks, which have historically tended to limit the downside when equity markets hit a pothole.

Fixed income overview

In a holding pattern

Watching US Treasuries

Like many other market observers, we have been waiting for US Treasury yields to rise. We entered 2014 anticipating that above-trend US growth and continued Fed tapering would drive yields higher, creating challenging headwinds for bond performance. We have been expecting that additional curve steepening would eventually give way to a bear flattener — that is, short rates rising faster than long rates — as the markets begin to price in the commencement of Fed tightening in mid-2015.

Instead, US Treasuries rallied on weak data in January and have since traded within an exceptionally narrow range. Equity volatility has remained low along with rate volatility, lending solid support to credit spreads. The result has been bond returns so far this year that have exceeded those we had expected by this point at the beginning of 2014.

Nevertheless, we are sticking with the improving growth story and its consequences for rates, though we have ever-so-slightly moderated our expectations for how high the longer end of the curve may rise. And we are closely watching measures of US economic activity for signs of acceleration, especially among labor market indicators. Should the data released during the next few months suggest that the first quarter's pause was more than just a temporary weather-induced interruption of the growth trend, we could see capitulation — and subsequent short covering — by bond market participants who have been positioned for high rates.

Searching for value in global bonds

Looking beyond US rates, we are waiting to see if inflation differentials and divergent central bank biases will cause further decoupling across developed market sovereigns, potentially pushing yields on US Treasuries and UK Gilts higher even as those on German Bunds and Japanese Government Bonds perhaps head lower. Global business cycles are comparatively unsynchronized at present, with growth in late-cycle emerging economies continuing to disappoint.

We are also waiting to see how the geopolitical crisis in Ukraine may impact the capital markets. Thus far, the credit markets have largely shrugged off the tail risk of negative economic consequences from a possible escalation, though perhaps that tail risk is one factor holding perceived safe-haven yields in check.

Our search for value continues among bond markets characterized by varying degrees of richness. We believe investors still need bonds for all the usual reasons, including income and the potential for capital preservation and diversification against equity risk. Staying away from fixed income until bond valuations become universally cheap is probably not a viable option for most investors. Therefore, we have focused on identifying the best relative value available.

Finding opportunity in emerging market debt

As is often the case, relative value may be found in markets that have lagged. While emerging market debt returns have led the way so far this year, underperformance in 2013 left spreads at levels that still provide attractive carry. This could allow the asset class to absorb much of any upward move in US Treasury yields — provided that the move follows the typical cyclical bear flattener pattern rather than resembling the rate spike in 2013. Though a repeat of last year's positive correlation between US Treasury yields and emerging market spreads is not out of the question, it seems unlikely. A fair amount of the heavy lifting of rate normalization is now behind us, and further progress toward higher rates also seems to be widely anticipated. This should allow dollar-denominated EM spreads to compress.

When considering the opportunity in EM debt, we believe it is important to recognize that the asset class is not a monolith but rather a diverse mix of credits with widely varying risk and reward prospects. Thus it makes sense to think in terms of owning specific EM countries that offer good fundamentals at attractive prices, not about owning the asset class as a whole.

In our view, investing in EM debt is about steering around the hazards of lower-spread sovereign bonds that could be vulnerable to widening US Treasury yields and higher-yielding countries that are characterized by deteriorating credit fundamentals, such as Venezuela. Selectivity among sovereigns is critical, and recognizing when fundamentals and valuation diverge is crucial to effective selection. For example, several of last year's pariahs — including Indonesia, one of the "Fragile Five" — are becoming more attractive as the process of adjusting external imbalances continues.

Moreover, we see value in casting a broad net when attempting to capture value in the asset class, as a number of EM corporate issuers are supported by solid credit metrics and offer the benefit of less rate sensitivity than sovereigns. With the prospect of Fed tightening in the not-too-distant future, we would stay strategically cautious on local currency, while ready to capitalize on tactical opportunities in the currencies of economies with strong or improving capital and current account balances. ■

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