The curate’s egg

May 2013 // Market commentary

» 12 month outlook positive, interest rates and share markets balancing complex mix of good and not-so-good signals
» Housing and share market recoveries underpinning the U.S., but fiscal tightening and profit outlook subdued growth
» Japanese policy stimulus and a cyclical rebound in China add to the bullish mood
» Weak growth continues in Europe, but politics is muddling through so far
» Risk of near term pull back in share markets after solid run
» Longer term, shares to outperform bonds, emerging markets offer the best value

The curate’s egg

Global economies and markets are to us like the proverbial curate’s egg—good in parts. The good parts are the U.S. housing recovery, Japanese policy moves, and the cyclical rebound in China. These factors are driving the current bullish investor mood. There are, however, some bad and not-so-good parts of the outlook that could trigger a short-term market reversal. We will highlight the key issues in each region in turn.

Asia-Pacific

The Asia-Pacific region is experiencing a reacceleration of growth in 2013. Firstly, China is currently benefiting from: a re-emergence of infrastructure strength, underwritten by Government commitment; housing, notwithstanding some regional curbs; export growth; and a continuing undercurrent of urbanisation together with an expanding consumption base. This firming of economic conditions is being controlled but not stifled by policy settings.

In Japan, policy settings are at full-steam ahead. Growth will be underpinned by the boost to competitiveness in general, and to export growth in particular, flowing from the associated 20% depreciation of the Yen, versus its 2011 – 2012 levels.

Australia, which last printed a negative real annual GDP number back in 1991, also continues to run its own race. Expected Australian real GDP growth of 2.5% for 2013 is still satisfactory, albeit down on the 2012 number of 3.5%, as some of the heat comes out of the resources boom. Fiscal policy is contractionary at the margin, and the strength in the Australian dollar remains a further dampening influence on the domestic economy.

Nonetheless, the residential property market continues to defy the sceptics, and the labour market also remains broadly healthy. We continue to expect that Australia’s polarised 2-speed economy (fast-paced resource-based states, recessed industrial states) will devolve into one, more pedestrian, growth outlook.

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Europe

First on the list of the ‘bad’ outlook is obviously Europe as leaders perfect the art of “extend and pretend”. They keep doing the same things while pretending to adopt new policies: the recently cobbled together bail-out program for tiny Cyprus shows that weak banks still threaten sovereign bond markets; Italy’s political outlook is fragile post-election; and a corruption scandal still threatens Prime Minister Rajoy in Spain.

Similarly, the European Central Bank (ECB) may have overcome last year’s liquidity problems, but ongoing austerity creates the risk of social and political instability. Weak economic growth will keep bank balance sheets under pressure with the risk that this spreads to sovereign bond markets. The crisis could easily flare up again.

U.S.

U.S. fiscal tightening and the sluggish outlook for U.S. corporate profits also come within the not-so-good category. The fiscal cliff may have been avoided, but our analysis shows that the combination of payroll tax increases and sequester spending cuts will deliver fiscal tightening equal to 2% of gross domestic product (GDP) — the second biggest fiscal contraction since World War 2. We believe fiscal tightening will offset the economic benefit of the housing recovery to leave the U.S. with real GDP growth of 2% in 2013.

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In our view, corporate profit margins have already peaked—a situation that will constrain earnings growth to less than 5% per annum. Equities should outperform fixed income investments, but the modest outlook for profit growth, in the U.S. market at least, means that we are in a low-return world. It also means that equity-market bulls are likely to be held in check by fairly lacklustre profit reports every quarter. Apparently reasonable U.S. profit results in the last few weeks have been driven by cost-cutting rather than by sustained sales growth.

Market outlook

The stellar start to 2013 in equity markets makes us cautious about the near-term outlook. Markets move in cycles of optimism and pessimism, and the risk is that investors have become over-optimistic about the outlook for the U.S. economy, and are underestimating the downside risks out of Europe. Thus, near-term, we think that a market pull-back is likely sometime over the next few months.

Our longer 12-month view is positive, and we expect that equities will outperform fixed income. The gains, however, are likely to be limited by a mature earnings cycle, reasonably full valuations, and moderate economic growth. In terms of asset markets, we think:

» Most global equity markets are now fully valued to expensive. Markets can rise in line with Earnings Per Share (EPS) growth, and there is the potential for fund flows (the so called “great rotation” from bonds into stocks) to make them more expensive. However, we believe emerging markets equities are the exception and still have valuation upside potential.

» Sovereign bonds are extremely expensive, given their very low yields. We continue to worry about the potential for a sharp sell-off but think sluggish global economic growth, low inflation, and ongoing quantitative easing will keep yields relatively low.

» Corporate credit spreads are becoming less attractive, with the overall yield of 5.9% at the lowest on record (since 1997).

In summary, our models point to some moderate equity market upside potential over the next 12 months. For now however, a lot of the upside risks have been priced in. Markets move in cycles and there are enough warning signs to suggest investors are becoming overly optimistic. Longer-term, we expect equities to outperform bonds, but we are cautious about chasing the current rally. We want to avoid the traps of buying and selling on market sentiment in what we still believe is an ongoing choppy, risk-on/risk-off environment.