Global Markets Outlook
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A BLIZZARD OF STIMULUS, GROWTH PROSPECTS STILL CLOUDY

IN BRIEF

- Events early in 2015 are consistent with our framework of unsynchronized growth, ongoing stimulus and commodity and currency volatility.
- Macro surprises can cause risk premiums and volatility to rise, with the potential to create opportunities in global equity markets.
- Bond markets have responded to policy action, political uncertainty and falling oil with lower sovereign yields and wider credit spreads.

Macroeconomic overview

Three themes to go on

In recent months we've talked about three themes that we believe characterize the current macroeconomic and investment landscape:

1. Modest and unsynchronized global growth
2. Ongoing need for global policy stimulus
3. Commodity and currency volatility

In our view, the global economy, led by the United States, remains in an unsynchronized expansion that is subpar by historical standards. At a pace of around 3% annually, global growth is below the long-run trend but in keeping with a world that continues to feel the lingering effects of the financial crisis — surplus capacity, deficient demand, excess debt and deflationary pressures.

The environment of extraordinarily accommodative monetary policies and record-low bond yields reflects this macro backdrop. A veritable blizzard of stimulus has been required just to deliver the modest growth we've experienced so far. In other words, monetary policy isn't making the situation significantly better, just preventing it from getting much worse.

Arguably the good news for 2015 is that the supply-driven declines in crude oil prices are likely to provide an additional layer of macro stimulus. And as actions taken by central banks change the dynamics of currency markets, they have the potential to alter the relative competitiveness of global trade — especially for European exporters who could benefit from a weaker euro.

Early 2015 events confirm our framework

Based on the news flow in the first month of 2015, we see no reason to change our macro framework.

Modest and unsynchronized global growth. The International Monetary Fund (IMF) just issued a forecast update that perfectly exemplifies this theme. Though up from last year, global growth estimates for 2015 were cut once again, this time from 3.7% to 3.4%. Of the major economies, only the US was upgraded meaningfully, while Europe, Japan and Canada were downgraded. Outside the developed world, China and emerging markets (EM) in general saw their forecasts lowered. In other words, it continues to be the US versus the rest of the world.

Sharp declines in oil and commodity prices are also redistributing growth from resource producers to consumers. The good news is that a bigger share of the global economy is a net importer of oil and other commodities, suggesting some upside to growth later this year — or at least holding out the hope that the recurring downward revisions to global growth estimates may come to an end.

Ongoing need for global policy stimulus. One statistic we saw just about says it all: According to Ned Davis Research, about 70% of global central banks are now in easing mode. In this brave new world of monetary accommodation, where negative interest rates are no longer shocking, the European Central Bank (ECB) has finally — perhaps belatedly — decided to engage in quantitative easing (QE) in an effort to end the slide toward deflationary expectations, weaken the euro, ease the flow of credit and boost growth.

Not only the ECB eased policy early in 2015 — so did central banks in India, Switzerland, Turkey, Canada, Denmark, Singapore, Peru, Russia, Australia and China. We also heard dovish talk from New Zealand, among others. By contrast, the US Federal Reserve is diverging, just like the country's economic trends. In its most recent statement, the Fed appears to remain on track for a rate increase sometime in 2015. Growth and labor market trends augur for a hike, though falling inflation and soft global developments are offsetting factors.

Commodity and currency volatility. As US growth and policy diverges from other economies, the US dollar remains the star on the world currency stage. The greenback is at a 12-year high against the euro and is up against all major currencies over the past six months.

A global environment of excess capacity, unsynchronized growth and a strong US dollar is typically inhospitable to commodities. This cycle is proving to be no different. Commodity prices as measured by the Commodity Research Bureau (CRB) index were down 3.5% in January. And commodity currencies like the Canadian and Australian dollars have plunged as their terms of trade have come under pressure — exposing underlying imbalances, such as current account deficits and credit booms.

Equity overview

Expect to be surprised

If there is one word common to most market news so far this year, it is *surprise*. During January, the decision of the Swiss National Bank (SNB) to de-peg its currency from the euro and the announcement of larger-than-expected QE by the ECB took equity investors by surprise. Other central banks have also tried to stimulate demand and inflation expectations by cutting interest rates.

On the political front, the election of the anti-austerity Syriza party provoked fresh debate on whether Greece will remain in the eurozone, while China's bans on opening margin lending accounts have taken steam out of that market. Against this background, it's not surprising that volatility has been rising faster in currency markets than in equity markets.

From experience, we know that the investment implications of macro surprises are difficult to quantify, as are the associated contagion risks. Rather than reacting from the top down, we try to discern from the bottom up whether the impact for individual businesses is cyclical or structural.

For instance, the oil price collapse warranted a reassessment of the energy positions in our portfolios, while the sharp surge in the Swiss franc prompted a similar review of our equity holdings domiciled in Switzerland. The basic idea is to determine if the underlying earnings drivers and financial positions of individual companies have fundamentally changed.

Macro headwinds, micro disappointments?

The breadth of policy support globally is aimed at improving economic growth, which should eventually translate into earnings growth for equity-issuing firms. Nevertheless, we are concerned that global earnings and inflation outlooks continue to be revised modestly lower.

There are examples of companies — mainly in the technology sector — beating consensus estimates. But from an earnings revision standpoint at the global level, all sectors are still experiencing earnings per share (EPS) downgrades, with the largest in the energy sector. And Japan is still the only region with positive EPS revisions.

Importantly for equity investors, though valuations have risen over the past several years, the trend of modest negative earnings revisions does not mean negative year-on-year earnings growth. The latest consensus forecasts for 2015 EPS growth across all major regions remain positive in the mid to high single digits, which seems reasonable on the surface.

Nevertheless, we expect current macro influences — in particular, currency markets and oil prices — to have a bearing on earnings this year. In the US, some companies are already flagging currency risk as a headwind, given that roughly one-third of S&P 500 Index earnings are generated from outside the US. Furthermore, there is a tradeoff between declining energy sector earnings and capital expenditures, on the one hand, and the tailwind of potential gains in consumer spending, on the other.

In Europe, the impact of lower oil prices and a weaker euro may help consumer cyclicals and exporters. By contrast, industrial sectors whose earnings drivers are based on commodity or EM cycles are now facing headwinds. Still, companies in the eurozone and the US with strong balance sheets and the ability to increase dividend payouts may do well in an environment of persistently low bond yields.

Japan's outlook is less clear. Other than yen depreciation, we see little evidence that economic prospects are improving. Among EM equities in Asia, however, there is increasing confidence in forecast earnings, thanks to signs of stabilization aided by recovering US demand, lower commodity and energy prices, and varying degrees of structural reform in select countries.

Looking for windows of opportunity

As bottom-up fundamental investors, we are used to maintaining a healthy degree of skepticism and focusing on the longer-term impact of any change. Though macro influences from lower oil and weaker currencies could continue to benefit earnings, what remains paramount is that underlying business models are unaffected by macro events, earnings visibility is high and valuations are supportive in an absolute sense. While we generally avoid taking rigid macro views in constructing equity portfolios, we are cognizant that adverse macro surprises can cause risk premiums and volatility to rise, thereby creating opportunities in the markets.

Fixed income overview

Policy, politics and oil

The bond markets have responded to the big macro stories with increased volatility. Policy actions, political uncertainty and oil price declines have pushed down sovereign yields and caused credit spreads to widen, most notably for oil-related issuers. How are we positioning fixed income portfolios in response to these events?

Direction of sovereign yields

Yields on US Treasuries appear too low, given a US economy poised to distinguish itself from global peers by generating above-trend growth in 2015. We expect the Fed to respond to reduced labor market slack by hiking the federal funds rate this year, even though there is little evidence of a level of wage growth that could presage higher inflation.

Fed action may not be entirely a function of domestic conditions, however, with the most recent policy statement citing the Fed's consideration of "international developments." As we discussed above, the ECB's QE announcement and the SNB's related currency decision are the most notable of these developments. If the ECB program succeeds, better growth and higher inflation could ultimately result in higher bond yields. But what QE seems more likely to achieve in the near term is lower bond yields.

The new QE program should push investors further out — and thus flatten — the German bund yield curve. It may also push investors out of core eurozone bonds and into the peripheral markets, which would exert downward pressure on sovereign yields in countries like Spain and Italy. We think the ECB's program is liable to do what QE has done best over the past six years — namely, raise investor interest in riskier assets, including EM debt, high-yield corporates and equities.

ECB easing also reinforces the secular strong US dollar story, with the potential to influence Fed action. Against this backdrop, we recognize the risk that currency movements could easily overwhelm bond returns in global fixed income portfolios.

As long as low growth, persistent disinflation and accommodative monetary policy are the prevailing trends in most parts of the world, "lower for longer" may remain the dominant theme for global rates, helping to hold long-term US Treasury yields in check. Though many sovereigns look expensive relative to historical valuation measures, the risk of mean reversion seems remote, and investors in sovereign debt may wait some time to get substantially more yield per unit of duration. So we remain relatively underweight US Treasuries, with selective overweights in sovereigns where monetary policy is easing.

Selective value in credit

The market has punished fundamentally vulnerable credits, and there has been some collateral damage as well. Amid rising volatility around policy, politics and oil, an element of indiscriminate derisking has created value. Among EM issuers, we've witnessed significant spread widening in the US dollar-denominated debt of oil exporters, such as Venezuela. Spreads have also widened — albeit to a lesser degree — in certain sovereigns that actually stand to benefit from cheaper oil prices, such as Indonesia.

Similarly, in the US high-yield sector, not only have oil services and exploration and production (E&P) companies been beaten up, but other lower-quality non-oil issues have also been pressured. With oil prices depressed, the likelihood of further headline risk from the European election cycle and the potential for vacillating sentiment on the efficacy of ECB QE, we think bond investors may have opportunities to use episodes of volatility as entry points to credits with sound fundamentals and relative resilience to macro developments. We've recently found good opportunities to selectively add credit risk to our portfolios.

Setting expectations

Lower sovereign yields and credit spreads that hardly seem generous — despite the recent widening — leave us with the expectation of modest returns in 2015 for most global bond markets. For US dollar-denominated debt, the prospect of higher US Treasury yields could partially offset income returns, resulting in "coupon clip minus." For many non-US dollar markets where monetary easing continues, "coupon clip plus" seems likely, with some scope for duration returns to add to income. In general, our view is that credit markets may deliver excess returns over sovereign debt. Accordingly, we've tilted our diversified portfolios toward credits with relatively strong fundamentals. ■

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