October 2018

Global Equity Outlook for Q4 2018

The U.S. market continued its strong performance for the third quarter. The S&P 500 was up 7.2%, while non-U.S. developed markets (as measured by the MSCI EAFE Index) were up 1.4% and Emerging Markets (as measured by MSCI Emerging Market Index) were down 1.1%. Year to date the S&P was up 9.0% while MSCI EAFE Index was down 1.4% and the MSCI Emerging Market Index was down 7.7%.

The strength of the U.S. market this year through the end of September can be attributed to growth, both in terms of GDP and earnings growth. For 2018, U.S. GDP has been forecasted at 2.9% and earnings growth at 22% while GDP growth and earnings growth has not been forecasted to be as strong in Europe or Japan. In addition, GDP forecasts have been revised downward in a number of European markets and a number of emerging markets over the last 6 months.

A strengthening U.S. dollar has raised concerns, especially in emerging markets. This concern arises from several sources, including the ability for emerging markets to pay off dollar-denominated debt, money flowing out of emerging markets due to competition from rising U.S. yields, and the vicious cycle of poor U.S. dollar return performance for investments in markets in which currencies are depreciating. This year, large depreciations have occurred in Turkey, Brazil, India, South Africa, Pakistan, and Argentina.

Nonetheless, there are differences in the sell-off in emerging markets this year from the emerging market crises in the 1990's. For example, before the Asian crisis in 1997, the Thai baht was pegged to the U.S. dollar, and many of the emerging Asian markets were running large current account deficits (imports were higher than exports which had to be financed). Thailand and Malaysia had current account deficits of 9.5% and 5.3% of GDP, respectively. Currency reserves were running low and declining. These countries could not finance their U.S. dollar denominated debt and imports. Today, few emerging market currencies are tied to the U.S. dollar and few emerging markets are running large current account deficits like those in the past. Currency reserves are much larger. Currently the most vunerable currencies are in markets, such as Turkey, which have large current account deficits and large debt which must be paid back in US dollars.

Going into the fourth quarter, investors are starting to grapple with a range of uncertainties. As mentioned above, although U.S. earnings growth has been strong so far this year, investors are grappling with rising interest rates and have concerns that U.S. earnings might have peaked. In addition, trade tensions might have started to weaken Chinese and global growth. In terms of valuation, the U.S. is an expensive market. The price-to-earnings of the U.S. is 23x while the price-to-earnings of other developed markets is 15x and for emerging markets it is 13x. This represents a large differential. The U.S. has been in a bull market since 2009. With this backdrop of uncertainty, we feel it is important for investors to stay diversified.

In terms of our equity positioning, we are modestly underweight in Continental Europe since GDP forecasts are being revised downward for many of the markets, higher oil and commodity prices are a headwind, beta risk (combination of volatility and correlation with the world markets) is high for many countries, and sovereign spreads have widened for some of the markets, especially Italy.

However, we are overweight select European markets such as Norway which is a major beneficiary of higher oil prices over the last 18 months. While valuations are not cheap, its GDP growth has been revised upward over the last 6 months, earnings revisions have been upward, and price momentum has been strong.

In Developed Asia, Japan remains an overweight. Japan looks attractive on valuation, risk, monetary policy, and price momentum. The forecasted 2019 price-to-earnings of the market is 13x, GDP forecasts are not being revised downward as in the case of European markets, it has a low beta risk (combination of low volatility and correlation with the world markets), and the yen is undervalued.

We have somewhat a contrarian position favoring some Emerging Markets, especially those that are cheap and have undervalued currencies. In Latin America, Colombia has attractive valuation ratios, strong export prices, and an undervalued real exchange rate. Brazil has moved higher in the emerging market rankings with inexpensive valuations and stronger price momentum. We are underweight emerging Asia due to our underweight in China and India. We find both India and China expensive and the Chinese economy is highly indebted. (One of our risk measures is change of ratio of domestic credit growth to GDP growth over the last 5 years.) Within emerging Asia, however, we are overweight Taiwan. Valuations are attractive, both relative to other markets (forecasted 2018 PE under 14x) and relative to its history.

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