Signature Global Roadmap: Second Quarter 2014

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Welcome to normal

Compared to the past several years, the broad macro roadmap is looking decidedly BORING! There is no obvious economic crisis looming, financial systems are not collapsing, funding channels remain wide open, valuations are reasonable, fear has subsided but greed has yet to seize the day. Yes, Putin is throwing up some interesting political challenges and regional economies such as Venezuela and Argentina are collapsing. But none of this offsets the fact that the global economy continues to gradually heal and return to a more normal setting. Perhaps the biggest challenge is that after the adrenalin-inducing swings from one crisis to the next and the dramatic policy and political drama of the past seven years, we have forgotten what normal looks like. However, understanding the global macroeconomic picture remains essential.

The biggest macro challenge that will continue to play out over the year is the normalization of U.S. monetary policy and rate structures, with varied implications for asset classes and regions. Furthermore, many longer-term issues such as economic rebalancing and structural reform in Europe, Japan and the emerging markets have not been resolved and may resurface. But that is normal. It means that when it comes to markets, the top-down macro issues no longer completely dominate the bottom-up micro fundamentals. It may be less exciting, offer lower expected returns and volatility, but it's more normal.

As we enter the second quarter, the view we outlined at the start of the year remains intact: A synchronized global recovery led by the U.S., with the stronger U.S. outlook allowing the Federal Reserve to stay on a path of winding down its unconventional monetary policies, which have dominated global markets for the past five years.

While very little has changed in our full-year outlook, there have been a few surprise twists and turns. Far and away the biggest twist was the long and harsh winter across much of North America. More importantly, a number of studies have concluded it was not just a cold or snowy winter, but it was a particularly disruptive winter for the economy. I recall being huddled around a fireplace in minus 20 degree weather with no electricity for three days around Christmas, trying to keep warm rather than go shopping. That was just the beginning, with the below-normal temperatures and above-average frequency of winter storms continuing into March. Thankfully, I spotted my first robin the other day and hope it may be a harbinger of better weather.

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The year had started with a strong consensus that the U.S. economy was in an accelerating recovery out of the 2013 fiscal cliff induced slowdown and the markets were expecting stronger data, rising interest rates and a stronger U.S. dollar. The harsh weather immediately put an end to any such visibility. Needless to say, the U.S. economic surprise index, having rallied into the year-end, immediately turned south In January and kept plunging right through the quarter. It is irrefutable that the weather has significantly affected the economy but what's uncertain is how much of the impact is temporary and how much is reflective of a broader underlying trend. This uncertainty will persist for several months.

As the weather improves, we expect – and are beginning to see – stronger economic data that will confirm the U.S. economy is snapping back from its first quarter lull. The challenge for the coming quarter is that the data may prove to be overly strong relative to the underlying growth trend as economic activity plays catch-up. In the same way that the data understated the true health of the economy in the first quarter, it may well overstate its strength in the second quarter.

This can matter to the markets. While longer-term expectations were not impacted by the economic slowdown, the U.S. bond market reacted. The U.S. 10-year bond yield declined to 2.6% from 3.0% during the quarter, even as the Fed made clear that it viewed the economic weakness as temporary and continued to wind down or taper its bond purchases at a rate of $10 billion at each meeting. In fact, the 10-year Treasury has traded in a sideways range since rates jumped last summer when the Fed first began its taper talk. While we do not expect a significant rise in rates, we are wary of a potential spike higher should we see a string of stronger-than-expected economic reports in coming months. In a healing economic environment, markets are likely to test the Fed's forward guidance to keep rates lower for longer if they suspect that the Fed is behind the curve. With the prospect of an economic bounceback in the coming months, we expect some minor fireworks as the showdown between the Fed and the bond market flares up.

Outside of that scenario, we expect U.S. rates to remain in the current range of 2.6% to 3.0% through mid-year until clear evidence of a sustainable pick-up in demand emerges, which is likely in the second half. We see the U.S. economy accelerating toward 3% growth in the second quarter, close to double that of the first quarter, which appears to be tracking close to 1.5%. The Fed should continue to taper its asset purchases at a rate of $10 billion a month to end quantitative easing in the fourth quarter. While we expect the Fed to tolerate a modest rise in the short end of the curve as markets begin to discount an eventual exit from zero rates, it will push back against any significant increase in rates at either the short or long end of the curve. With this backdrop in rates, we expect equities to continue to outperform, but at a more moderate pace than last year and with more of the volatility we saw in the first quarter. My base case for the year is that markets can be expected to grind out a return in line with earnings growth of 8% to 10%.

European outlook mixed

Cyclically, Europe continues to benefit from an improving global outlook and the continued financial stability engineered by the European Central Bank's commitment to protect the euro. That confidence has allowed for a significant contraction in sovereign bond spreads between peripheral and core European countries. Even Greece, Europe's poster child of fiscal irresponsibility, has been welcomed back to global bond markets! For now, we can comfortably declare that the Eurozone sovereign debt crisis is over. The ECB has restored the confidence of financial markets and bought time for Eurozone countries to continue to rebalance and reform their economies, though we do not expect all countries to successfully seize the opportunity.

Beyond Greece, 10-year borrowing rates in Italy and Spain have fallen to around record low levels of 3.2%, while Ireland can borrow below 3% – only marginally higher than U.S. rates! Cyclically, we expect the Eurozone economy to recover from a contraction of around 0.5% last year to post growth in 2014 of nearly 1%; however, we expect growth in the broad economy to level off at this range as the structural reforms necessary for stronger growth remain missing in action, particularly in the key economies of France and Italy. Some political shifts, particularly in Italy, offer faint rays of hope, with the new Italian Prime Minister Matteo Renzi grasping the need for significant reforms. Time will tell if he can overcome entrenched resistance, but even in a best-case scenario, we are only approaching the start of what needs to be a multi-year reform process.

The more immediate challenge for Europe is the persistently low inflation and the very real threat of outright deflation. Eurozone inflation fell to just 0.5% in March, and while most commentators, including the ECB, expect this to mark the low point for the cycle, it should be a cause for concern. For several years now, we have been highlighting the need for higher inflation in the Eurozone to ease the adjustment process required for peripheral countries to restore their relative competitiveness within the monetary union and to help manage or deflate the substantial debt burdens plaguing several countries. Outright deflation would make both of these adjustments next to impossible. With a strong euro and very high unemployment putting downward pressure on inflation right across Europe, it would be prudent for the ECB to take out a little "deflation insurance" in the form of further unconventional easing. While this has yet to be done, the ECB has certainly ratcheted up the rhetoric about what might be possible. Stay tuned....

Japan facing recession again

In Japan, the long-anticipated increase to its value-added tax from 5% to 8% kicked in on April 1 and should be sufficient to tip the economy back into recession in the coming quarter. The real test will be Japan's ability to recover from the hit. While many expect the country to bounce back quite strongly in the third quarter, I remain skeptical. Yes, there will be a bounce off the bottom, but I expect that it will disappoint the markets. There remains an overly optimistic consensus on the efficacy of Abenomics in driving a sustainable pickup in growth and inflation sufficient to address Japan's dire fiscal position.

Evidence that Japan is truly embarking on a stronger growth trajectory, particularly in nominal terms, would challenge its ultra-low interest rates. Ten-year Japanese government bonds are trading at only 0.6%. This is clearly a level more consistent with a stagnant economy than one approaching the government's target of 4% nominal growth. With government debt to GDP approaching 250%, Japan can clearly ill afford to see a significant backup in funding costs. This would likely require the Bank of Japan to escalate its extraordinary level of quantitative easing to continue to repress any tendency for rates to rise. As a result, either path for the economy would appear to result in more aggressive action from the Bank of Japan, ultimately weakening the yen over the longer term.

While the abysmal performance of Japan so far this year reflects a growing disappointment in the reality of Abenomics versus the hype of last year, it is also beginning to reveal some interesting investment opportunities, particularly among Japan's global multinational companies in the auto, industrial and electronics area, as these companies are driven more by global demand rather than domestic demand and will be significantly more competitive and profitable should the yen continue on its downward trend.

China's transition continues

Concerns have again been growing regarding a slowdown in China. This is getting tiresome! Yes, China is slowing. The outcome of the type of aggressive reform and restructuring being embraced by China is likely to be slower but more sustainable growth. In particular, the focus on financial market reform will tend to restrict and raise the cost of capital, as will the crackdown on polluting industries and the efforts to reduce over-capacity and stem non-viable but politically driven asset investment in many regions. However, China has no interest in allowing growth to slow to the point that it begins to significantly worsen unemployment and, hence, social stability. Crucially, Chinese officials have the resources to crank open the fiscal taps if and when they perceive that growth is slowing too much, and we have seen signs recently that they will use targeted infrastructure investment programs to offset the impact of their reform agenda.

On a recent visit to the country, I met with several policymakers and advisors and it was clear that they were adamant on the need for major reforms and were acutely aware of the challenges. The attitude was that it is going to take many years to achieve their objectives, so they had better get started! Unlike most of Europe and Japan, where policymakers do everything in their power to avoid difficult structural adjustments, China's leadership is driving a reform agenda that is far more aggressive than anyone expected. While the risks of errors and unanticipated complications are significant, the pragmatic approach being pursued in China leads us to believe that they can successfully manage the process.

Current outlook supports equities

Our overall outlook for the second quarter is quite benign and remains generally supportive of risk assets. Although equity valuations re-rated last year, making outsized returns unlikely, we expect overall equity markets to track earnings growth, which we anticipate to be roughly 8%, notwithstanding the impact of the severe winter weather in the first quarter. In this environment, we expect that the value added by our global sector portfolio managers through security selection will become increasingly important relative to the broad macro calls that have contributed to returns in recent years.

We expect rates to move back up to the 3% range during the second quarter, negating most of this year's gains in government bonds. By the same token, following a strong first quarter in credit markets, we are expecting them to trade sideways in the coming months. Not as exciting a backdrop as past years perhaps, but one in which the strength and depth of Signature's global team of stock and income specialists can add value to our portfolios.