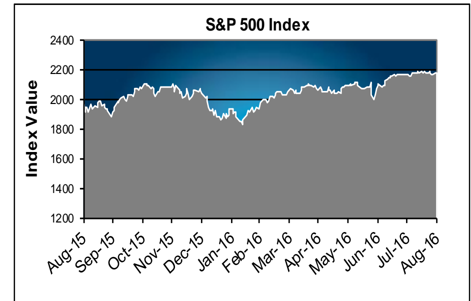
This Month in the Markets

August 2016

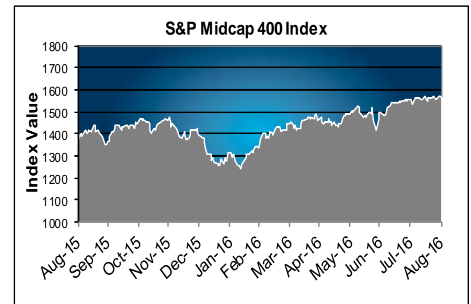
EQUITY COMMENTARY

Treading Water

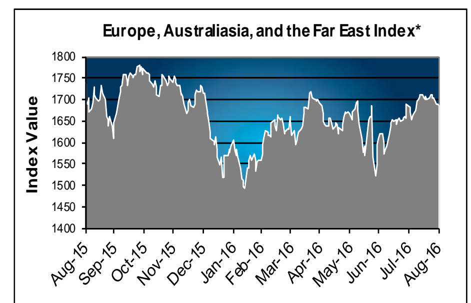
After a big bounce in July, global equities were flat in August. The Morgan Stanley Composite Index (MSCI) ended the month down 0.1%. Financials and technology companies were the strong performers up 2.9% and 1.7%, respectively. On the other side of the spectrum, utilities, heath care, and telecom companies were the laggards, falling 5.3%, 4.3% and 3.2%, respectively. On a geographic basis, U.S. stocks only marginally outperformed international stocks. Year-to-date, the MSCI has returned 2.6% led by the 5.2% gain in the U.S. benchmark index (S&P 500 Index), while international stocks (Europe, Asia, Far East Index) were down 2.4%.



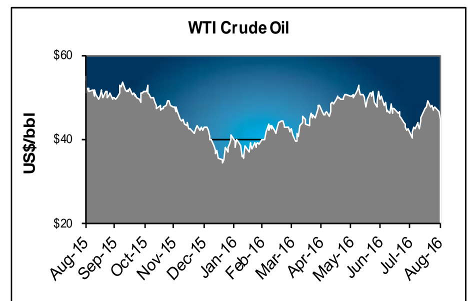
Over the past two years global markets have gone sideways. The MSCI is where it was in June of 2014; so what has happened? Although markets may not track earnings in the short term, over longer periods markets follow them. At the end of the second quarter of 2014, trailing 12 month earnings for the MSCI was $94.6. Two years later, MSCI earnings dropped 16.3% to $79.2. The two biggest drivers of this decrease have been the plunge in crude oil and the surge in the U.S. dollar. Thankfully for equity investors, the two major headwinds for earnings appear to have turned the corner.



On June 20, 2014 crude oil closed at $105.37. The massive selloff to under $30 per barrel in February of this year led to most oil producers reporting losses. Thankfully, since the February lows it looks as though crude oil has stabilized and has rebased near $45. While the price action has been choppy, fundamentals in the oil market have been slowly improving. The steep drop in price has led to a significant drop in investment. Although there is a lag, we are starting to see an impact on production, particularly in U.S. shale where the decline rates are seven times faster than non-shale producers. Surplus production looks to have peaked in the first quarter of this year and we expect the market to be in a slight deficit by the first half of next year. While we do not expect a huge spike in prices, we do see crude oil trading higher from current levels and thus providing less of a headwind to earnings growth.



Since earnings for the MSCI are calculated in dollar terms, a rise in the U.S. dollar means that any earnings made outside of dollars will be worth less. From June 30, 2014 to June 30, 2016, the dollar increased by over 20% on a trade weighted basis, which meant that earnings outside of the U.S. were worth 20% less when converted back into dollars. After a huge surge in 2014 and the first quarter of 2015, it looks as though the dollar is rebasing itself at current levels. In fact, after peaking at over 100 in March of 2015, the U.S. Dollar Index has been range bound between 93 and 101 ever since. Although we do not expect a selloff in the U.S. dollar, and a subsequent pop in global earnings denominated in dollars, we do expect that the dollar will no longer be a headwind to earnings growth.



After declining for seven consecutive quarters it looks as though earnings growth should turn positive in the third quarter. For 2016, earnings for the MSCI are expected to come in at $91.7, up 7.3% from $85.4 reported in 2015. As a result, we remain constructive on global equities. At current levels the MSCI trades at 18.75 times 2016 earnings, equivalent to an earnings yield of 5.33%. While global equities are not excessively cheap, we do find them attractive in an environment where the G10 10-year yield is just 0.92%.

*MSCI EAFE Index

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FIXED INCOME COMMENTARY

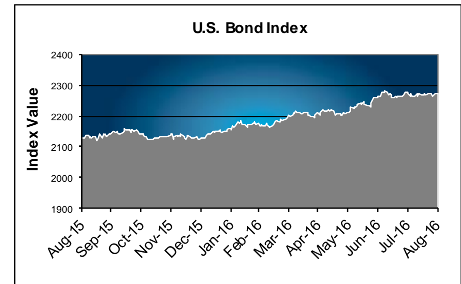
Quiet

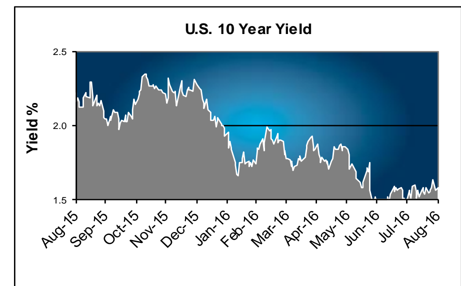
The fixed income and foreign exchange markets stayed fairly quiet in August. At the beginning of the month, the Bank of England responded to the Brexit vote with a widely expected rate cut and the expansion of its asset purchase program. Federal Reserve (Fed) Chairwoman Janet Yellen's speech at the Economic Policy Symposium at Jackson Hole did not bring any surprises and consequently did not move interest rate expectations by much. The monthly performance of the fixed income asset classes was similar to July, with the BofA Merrill Lynch US High Yield Index once again the star performer with a monthly return of 2.2%. Due to the lack of any major announcement or event, the foreign exchange market did not show many impulses either. At the end of the month the US Dollar Index was up 0.5%.

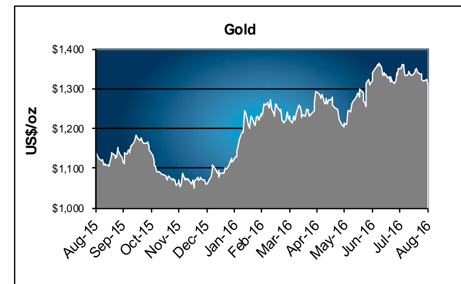
The few released data points in August did not bring any new conclusions regarding the U.S. or global interest rate outlook. The U.S. employment report was of highest interest and showed that 255,000 jobs were added. This is the second monthly reading of over 200,000 which indicates a healthy job market and the U.S. being close to full employment. It is also reassuring that the annual change of the weekly leading indicator from the Economic Cycle Research Institute (ECRI) has shown a steady improvement since the start of the year. On top of that, the U.S. housing market has remained strong and continues to support economic activity due to low interest rates, rising household formation and relatively attractive affordability.

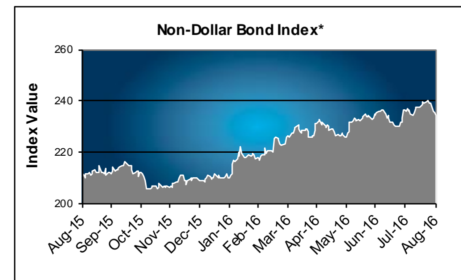
However, not all data points were encouraging and some bigger structural trends may provide headwinds. Business bankruptcies in the U.S. have increased by 25% in the second quarter over the same period last year. This trend has also been confirmed by a rise in credit rating downgrades versus upgrades and declining corporate income tax collections. It is also interesting to note that the Group of Seven (G7) governments have slowed their investment spending since 2000, according to Oxford Economics - the percentage rate of GDP has dropped from 4.3% in 2000 to 3.3% in the first quarter of 2016. Global monetary stimulus which has been intended to provide corporations with cheap funding in order to spur investment and consequently job creation has not played out as hoped. Some research papers even argue that zero and negative interest rates have provided incentives to raise savings due to lower return expectations and therefore have not led to higher spending and investment.

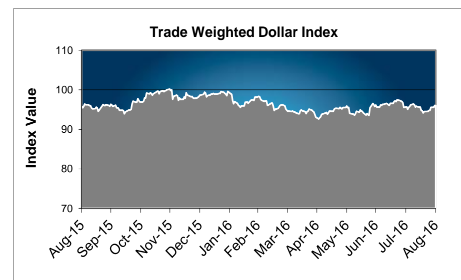
Europe and Japan's economies do not seem to be gaining any long-lasting traction. So far, any economic rebound seems to be just cyclical and has to be followed by even more monetary accommodation. The odds are quite high that both central banks (European Central Bank and Bank of Japan) will have to keep interest rates very low or negative for many years to come. Both economies lack the necessary structural reforms and the low growth and inflation environment is not sufficient to stimulate investment and reduce high debt levels. The economic picture in the U.S. is more promising although the weak global outlook will result in only small and cautious interest rate hikes by the Fed. A lot will depend on the August employment report and a number of 250,000 or higher may drive the central bank to hike rates by 25 basis points in September. Otherwise, the Fed would be wise to not change monetary policy before the U.S. elections in November in order to avoid any political backlash. December is probably the most likely date for an interest rate hike.











*Merrill Lynch Global Broad Market, Ex US Dollar Index

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