Illumination: Equity strategy and market outlook

September 2015

Published by Edison Investment Research

Global perspectives: Fed folds

Analyst

Alastair George
+44 (0)20 3077 5700
institutional@edisongroup.com

- **US Federal Reserve holds fire on a US rate increase.** Initially this was well received by global markets, but investors' increasing doubts over global growth are now coming to the fore. We believe equity markets will continue to be volatile and cannot exclude the possibility of further declines unless the US Fed drops a strong hint that further QE is a possibility for 2016.
- **The emerging market growth slowdown is spreading to the US.** A variety of US economic data are highlighting a loss of US economic momentum and investors should avoid the mistake of believing developed markets can 'decouple' within a highly interconnected global financial system. Recent earnings revisions indicate a loss of profits momentum across all major developed economic regions.
- **Conclusion.** Thus far, we have correctly anticipated that markets would remain volatile and would not make a quick return to the year's highs. We see little reason to change this view at this stage. For high-quality government bonds we have become less bearish and believe yields are now fairly discounting the possibility of further economic weakness or even in certain scenarios negative short-term US interest rates.

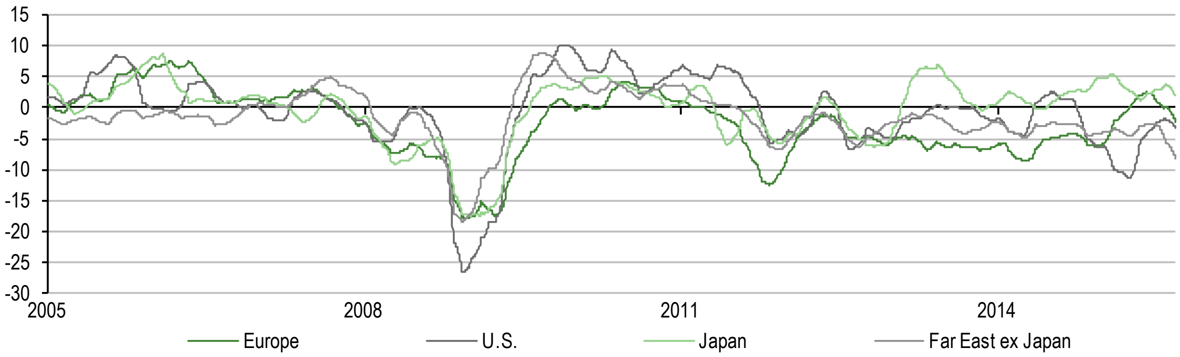
Fed folds

The second half of 2015 is proving to be a challenging combination of slowing growth and high equity valuations outside the resources and energy sectors. Now, question marks are being placed around the US Federal Reserve's ability and willingness to change course and add monetary stimulus should the global – and not just US – economic outlook weaken further.

For global equity markets, in our view the dominant central bank is the US Federal Reserve by some margin. The US Fed not only controls the cost of funding for onshore US money markets, but also, according to BIS data, approximately US$10tn (14% of world GDP) of US dollar-denominated loans to corporates offshore, primarily in emerging markets. During 2015's emerging market turbulence, the flow of foreign capital into emerging markets has slowed significantly, pressuring EM currencies and adding to debt service costs for EM corporates.

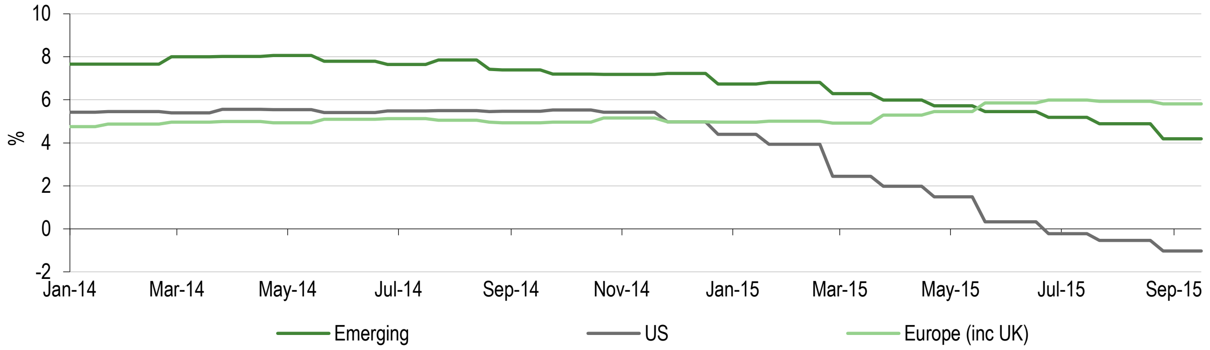
However, it is not just emerging markets that are of concern, as the economic slowdown may have already spread to developed markets. We note a substantial build-up in the US wholesale inventories/sales ratio, which suggests that US growth is likely to slow in coming quarters. The current Atlanta Fed "nowcast" for US Q3 GDP of 1.5% is well below the 3.7% recorded during Q2. With earnings revisions now turning lower in all major regions, Exhibit 1, this summer's declines in equity markets are becoming increasingly validated by the incoming data. We would also highlight that year-on-year consensus sales growth forecasts for 2015 may have stabilised in Europe due to the decline in the euro and the modest degree of economic recovery. However, sales growth forecasts have continued to decline in the US, and to a lesser degree in the emerging markets, Exhibit 2.

Exhibit 1: Global earnings revisions



Source: Thomson Reuters Datastream

Exhibit 2: Median forecast non-financial sales growth 2015/14

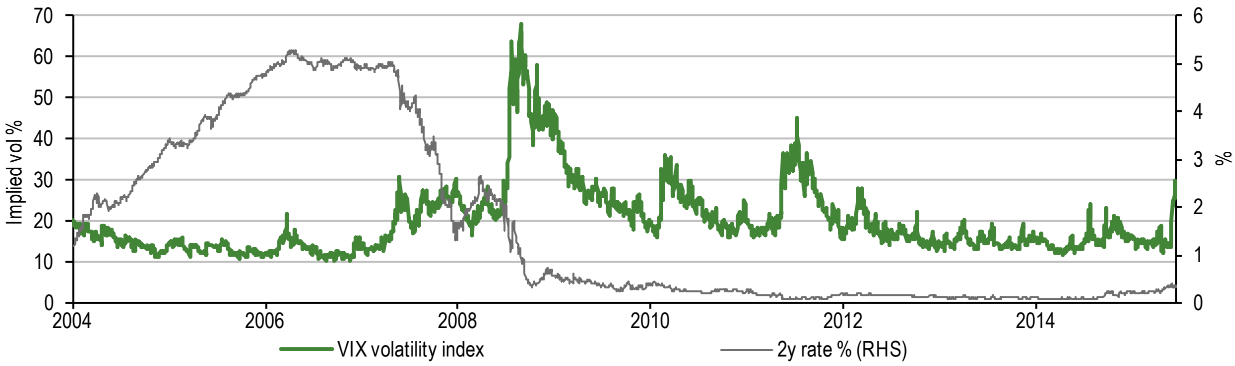


Source: Thomson Reuters Datastream, Edison calculations

The wrong kind of lift-off?

After carefully preparing markets for the first US interest rate increase in nearly a decade, at the September FOMC meeting Fed policymakers instead decided to keep interest rates on hold once again. Although a snapshot of US unemployment and inflation shows both parameters close to target, the FOMC chose to issue a statement that emphasised the increasing risk to growth from external factors, such as emerging markets. However, Fed policymakers are in an unenviable position. Having staked so much of their credibility and monetary policy firepower on delivering a sustainable recovery, they find themselves unable to lift rates from ultra-low levels, given the weakening economic data. Instead, we have the wrong kind of lift-off - namely that of market volatility, Exhibit 3.

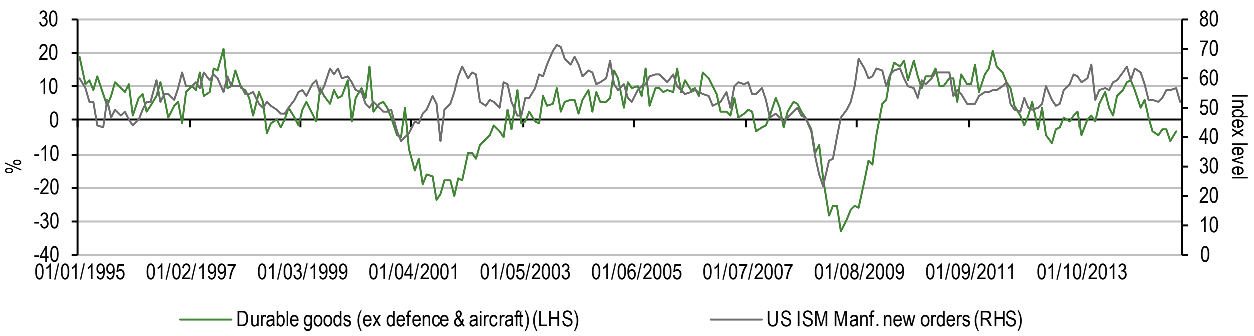
Exhibit 3: Lift-off in equity market volatility – rather than US rates



Source: Thomson Reuters Datastream

We are also unconvinced that the economic weakness is solely due to emerging markets as a variety of US data series are indicating a loss of momentum, if not an outright slowdown in recent months. Core durable goods orders are in negative territory year-on-year and the US ISM manufacturing index has fallen sharply, Exhibit 4. In addition, US exports have suffered from the rising dollar, Exhibit 5. Unsurprisingly in the circumstances, a mere deferral of US rate increases has not calmed markets.

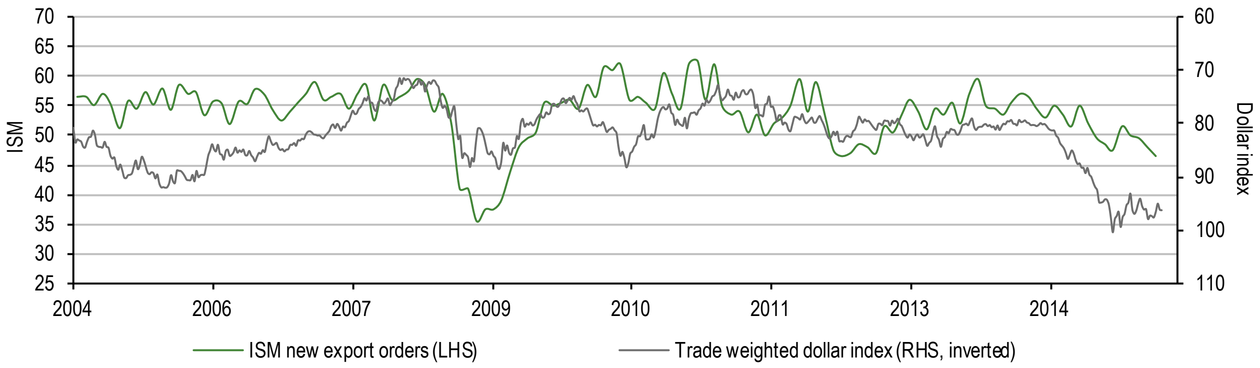
Exhibit 4: US core durable goods orders and ISM index



Source: Thomson Reuters Datastream

As we have argued previously, we believe it is too early to actively speculate on, for example, a reintroduction of US QE, which at the earliest would be a 2016 event, in our view. A significant policy U-turn such as this would run the risk of a loss of credibility and would have to be carefully signalled. However, absent a meaningful bounce in US economic activity, it is now entirely feasible that both October and December FOMC meetings pass by with no increase in US rates.

Exhibit 5: US exports and trade-weighted dollar



Source: Thomson Reuters Datastream

Conclusion

Incoming data during the month indicate that global economic and profits growth is slowing. We believe that by holding off raising rates the US Fed may have taken the first step towards a neutral or easing bias. The recent policy decision has proved insufficient to dampen market volatility or return global equity indices to levels seen earlier in the year. While any expansion of the Fed's balance sheet would be at the earliest a 2016 story, we would not be surprised to find a slowing US economy used as a justification for further delaying the lift-off in US rates during the FOMC meetings scheduled for this year.

In this regard, we have changed our view on highly rated government bonds and believe yields are unlikely to move significantly higher during this period of uncertainty over global growth and, additionally, such bonds are likely to find favour among investors seeking portfolio diversification. Investors should also be alert to the possibility in certain economic scenarios of negative short-term US interest rates.

We continue to believe equity markets in general remain very highly valued outside the basic industries and energy sectors. Although recent years have proved challenging for investors with a value discipline, recent market declines have shown how rapidly gains of the previous years can be lost if valuations are out of step with the outlook for profits growth. Thus far, for developed market equities the declines year to date represent in our view a correction closer to fair value rather than a value opportunity.