Global Market Commentary

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Taper: Trick or Treat?

Executive summary

The Federal Reserve's (Fed) decision not to taper the pace of its bond buying, known as quantitative easing (QE), was a positive surprise for global equity markets. The markets rallied again after the federal government's 11th-hour deal to end the shutdown and temporarily raise the debt ceiling. But risks remain. Investors should evaluate risk/reward opportunities on a region-by-region basis.

- **Overweight US.** I'm optimistic about the backdrop for the US equity market. A slowly improving economy, diminishing fiscal drag, seasonal trends and Fed liquidity bode well for stocks, especially small caps, growth stocks and cyclical sectors. However, a rotation in market leadership from growth stocks to value stocks is likely on the horizon.

- **Neutral weight Europe.** European valuations may appear overvalued on the whole, but the market is bifurcated between stocks that are deservedly cheap and those that are expensive and well known, in my view. Investors need to be more selective.

- **Overweight Japan.** Continued yen weakness may be supportive of Japanese equity prices, although the Fed's taper delay could be disruptive in the short term.

- **Underweight emerging markets.** Emerging market equities may be boosted by the continuation of QE, but I see more downside risks to emerging market economies, especially those that are commodity driven.

Beware policy uncertainty

Despite media noise about the potential impact of a US default if the debt ceiling weren't raised, the equity market was relatively sanguine during the federal government's budget and debt limit stalemate. In the past month, the S&P 500 Index stock price volatility — as measured by the Chicago Board Options Exchange Volatility Index, known as VIX — peaked on Oct. 8 at 20.34, below the five-year average and about half the level reached during the previous debt ceiling crisis in 2011.[1] The S&P 500 Index corrected no more than 4%, and on Oct. 17, the day after the debt deal, it closed at 1733, surpassing the previous high of 1725 set on Sept. 18.[2]

That said, the temporary resolution funds government spending only through Jan. 15 and suspends the debt limit through Feb. 7. As I pointed out in my Oct. 11 blog, "Move On, Markets, It's Only a Gaper's Delay," this temporary fix will likely keep political uncertainty elevated and hold the lid on equity appreciation. Furthermore, the Fed's taper timeline has likely been extended until after March 2014 as it awaits more convincing data that the US economy is on a sustainable growth trajectory.

This has a range of implications for global equity investors:

- Global equity markets may respond positively to the US government's budget deal if the equity risk premium — the excess return investors expect for investing in stocks — declines and the world economy accelerates.
- The Organisation for Economic Cooperation and Development (OECD) Composite Leading Indicator (CLI) — a proxy for future global growth — edged higher in August (the latest data available), to the highest level since March 2012.[3] It was the second monthly increase and the largest yearly gain since March 2011.[3]
- The increase in the breadth of individual country CLIs reached new highs as well, indicating broader-based global growth.[3]
- The Baltic Dry Index has broken out to the upside, which is further confirmation of a world on the rebound.[4]

Lack of change in the Fed's policy opens the door for a shift in regional asset class performance. Investors should consider the risk/reward opportunity for each region.

US: Overweight

I believe long-term investors have these reasons to be optimistic about US equities:

- The debt ceiling showdown is behind us for now, although it posed more risk to equity traders than equity investors. Historically, the equity market, as measured by the S&P 500 Index, traded 11% higher one year after previous government shutdowns since 1976.[5]
- The global and US economies should continue to slowly strengthen. US consumers' disposable income may increase as energy prices decline into the holiday season, and auto and housing sales are likely to continue to improve.
- Although third- and fourth-quarter corporate earnings could come in on the low side of expectations, the fiscal drag is expected to diminish next year, which could support corporate revenue and earnings growth in 2014.
- The Fed's expanding balance sheet is re-emerging as a key driver of stock prices. The S&P 500 Index is now 94% correlated to the Fed's balance sheet, as measured for the past five years.[6] Once again, I maintain liquidity may likely trump fundamentals until it doesn't - when the Fed begins tapering.
- Since 1942, seasonal trends have suggested higher stock prices going into year end.[7]
- Technically, a break above 1720 for the S&P 500 Index sets the stage for further upside in the market, in my opinion.

To be sure, there is a risk of temporarily disappointing economic data from the negative effect of the furlough on government workers' incomes and consumer confidence/spending. However, the potential negative impact on the economy will likely keep Fed tapering on hold until early after the first quarter of 2014, which bodes well for equity prices.

Liquidity-driven markets have tended to reward risk taking and momentum investing, in my experience. As a result, small-cap stocks may likely outperform large caps, growth stocks could outperform value and cyclical sectors may outperform noncyclical sectors. Growth stocks may benefit from a weakening dollar environment. The Russell 1000 Growth Index has the highest percentage of multinationals, which derive a considerable portion of their revenues from overseas. The Fed's delay in tapering its bond purchases has led to dollar weakness — down 4.35% in the third quarter.[8] That said, eventually Fed tapering is likely to lead to higher interest rates and dollar strength. During the past 10 years, a rising dollar environment has historically favored value stocks over growth.[9]

For now, interest rates are likely to remain range bound, gauging by the dramatic decline in mortgage refinancing and new mortgage applications when the 10-year Treasury yield reached 3%. The Invesco Fixed Income team estimates the 10-year Treasury could trade between 2.25% and 3% over the next three to six months.[10]

Furthermore, the Cleveland Fed's five-year forward breakeven inflation rate, historically a strong predictor of the 10-year Treasury note yield, is rising. The two have had a 99% historical correlation since 1985.[11] The current level of the breakeven rate is 1.75%, the highest level since July 2011, when the 10-year Treasury traded between 2.9% and 3.2%.[11]

Equity investors need to distinguish between before- and after-taper portfolios — those positioned for the next six to nine months before taper versus those positioned for the next one to three years after taper, when interest rates are higher and the dollar is stronger.

Europe: Neutral weight

My position on Europe hasn't changed since last month. The end of the European recession doesn't mean a return to growth. Without additional fiscal stimulus, too many banks with too much debt and a lack of credit growth will likely limit future economic growth. In my opinion, austerity measures instituted to improve competitiveness outside of Germany and the UK were insufficient.

The European Central Bank's (ECB) monetary policy is very different from those of the US and Japan in that the ECB's balance sheet is contracting, while the other two are expanding. The 25% decline in the ECB's balance sheet since the June 2012 peak is hardly stimulative and helps explain the continued strength in the euro/dollar exchange rate, which works for Germany but not for the other eurozone countries, in my opinion.[12]

Since the June 24 bottom, the MSCI Europe Index has appreciated 19.5% in local currency terms and 23% in US dollar terms as of Oct. 16, 2013, and European equities have experienced record capital inflows recently.[13] In hindsight, it seems I missed an opportunity to invest in a region where equity valuations were cheaper than in the US and economic data were getting "less bad."

However, I have concerns about European equities, including:

- Valuations look problematic. The market is bifurcated between very cheap stocks that deserve to trade at low multiples because they lack growth prospects and expensive stocks that tend to be well-known blue chips that everybody either already owns or wants.
- Investors have been paying a higher multiple for companies whose earnings are being downgraded. The MSCI Europe ex UK Index forward earnings composite fell 25.7% from the summer of 2011 through the summer of 2012 and has been flat since then.[14] Therefore, the jump in stock prices has been attributable to an increase in the forward price-earnings (PE) ratios from 10 to 13.[14]
- Despite a recent increase in the eurozone's manufacturing purchasing managers indexes (PMIs), the Net Earnings Revisions Index for the MSCI Europe ex UK Index remained in negative territory in August, meaning that more earnings were being revised downward than upward.[14]
- The MSCI Europe Index is dominated by financial stocks, which look unattractive to me right now.

To some observers the overall index may be undervalued relative to the US, but I believe it takes more selectivity to avoid a potential downward surprise. Investors may be better served by seeking managers with concentrated portfolios who are known to be stock pickers, not index huggers.

Japan: Overweight

The lack of Fed tapering could lead to temporary dollar weakness, which could negatively affect Japanese stock prices in the short run. I would use any weakness in Japanese equity prices to add to positions.

I still believe the Bank of Japan (BOJ) will be successful in weakening the yen/dollar exchange rate, and the Nikkei 225 Index remains 97% correlated to the direction of the yen/dollar exchange rate.[15]

My main concern is Japan's inflation rate, which has triggered every bear market over the past 20 years.[16] The BOJ wants some inflation but not too much. A weaker currency will increase the inflation rate at some point and become problematic. Investors should consider an investment vehicle that provides participation in the Nikkei 225 or Topix indexes but minimizes currency risk.

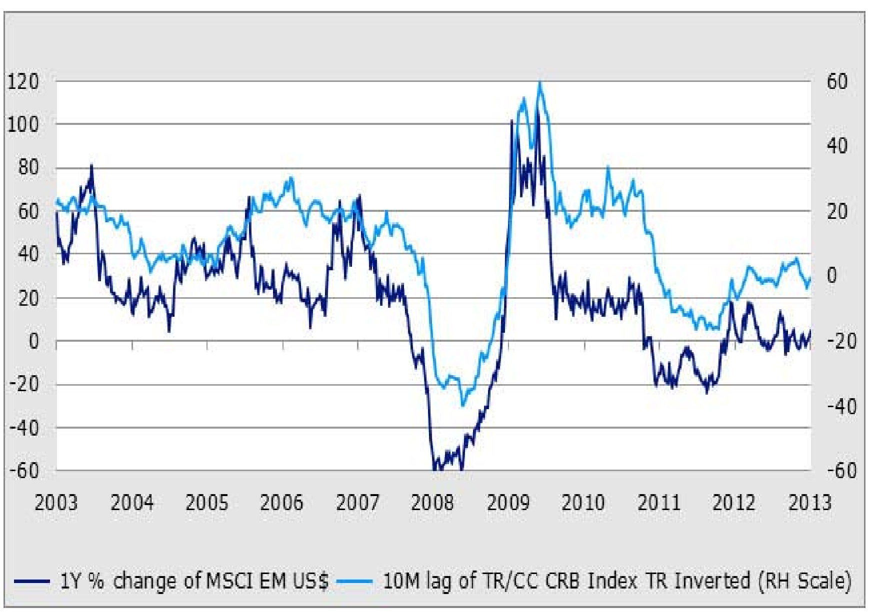
Emerging markets: Underweight

I haven't changed my recommended relative allocation in emerging markets, even though the seasonality of returns and the lack of tapering could benefit emerging market asset class performance.

The Fed's taper delay reduces pressure on US interest rates and tends to weaken the dollar, which are both positive for emerging market equity returns, in my view. The Fed's inaction brought risk taking back to the forefront, which could further benefit emerging market equity performance. However, I'm concerned by the disconnect in some key drivers of emerging market equity performance, including:

- Emerging market economic growth has been less responsive to the pickup in developed market economic growth. The MSCI Emerging Market Index has been 95% correlated to the CRB Raw Industrials Spot Price Index, a measure of raw materials commodity prices, over the past five years.[17] However, as shown in the chart below, the commodities index hasn't moved, despite the 13.8% rise in the MSCI Emerging Market Index since early July.[18] This suggests to me that emerging market export growth is less sensitive to developed market growth than in the past.

Emerging Market Exports Haven't Benefited From Recent Developed Market Demand



Source: Thomson Reuters Datastream, Oct. 21, 2013

- China, whose relatively large market capitalization tends to drive the performance of the MSCI Emerging Markets Index, is facing economic headwinds. The country's dependence on capital investment for future economic growth is likely to be limited, given the overinvestment that has taken place since 2008. China's unexpected decline in exports in September and the jump in its inflation rate due to rising food costs threaten its recovery, as financial conditions are likely to tighten.[19]

- Furthermore, capital outflows from emerging markets have led the International Monetary Fund to trim its global growth outlook last week.[20]

Equity investors should remain selective in adding positions in this region, as valuation levels have risen, and economic data could disappoint. Once tapering begins, the US dollar should strengthen, depressing commodity prices and leading to emerging market equity underperformance. Investors in this asset class may want to steer clear of commodity-exporting companies.

Final thoughts

The relative allocations are based on my risk/reward outlook for each region, not necessarily on which equity markets I believe may rise and fall. In summary:

- I would overweight the US equity market because of the likely continued economic recovery, the quality of corporate balance sheets and the continued accommodative monetary policy. Growth stocks may exhibit relative outperformance in the near term, but I believe investors should consider a value overweight as the prospect of Fed tapering gets closer to fruition.
- Outside the US, most European stocks look fully priced to me, but I like large-cap, high-dividend-paying companies. I expect the dollar to strengthen over the euro over the next few years, providing these European multinational companies a pricing advantage that could lead to an upward earnings surprise. European small-cap companies also look interesting to me because they tend to be highly levered and benefit from improving global growth.
- Japanese equities still look like they have more upside, in my opinion, as the currency continues to trade lower.
- Emerging market equities have been rebounding, but I'm afraid fundamentals could fall short and limit upside from current levels. Stock selection is critical to future success when investing in the emerging markets, in my opinion.

1 Source: Bloomberg L.P., Oct. 16, 2013
2 Source: Bloomberg L.P., Oct. 16, 2013; Bloomberg.com, "S&P 500 Surges to Record on Fed Bets After Debt Deal," Nick Taborek, Oct. 17, 2013
3 Source: Ned Davis Research, Inc., Oct. 10, 2013
4 Source: Bloomberg L.P., Oct. 8, 2013
5 Source: Bloomberg L.P., Oct. 1, 2013
6 Source: Thomson Reuters Datastream, Oct. 16, 2013
7 Source: Renaissance Macro Research, Oct. 15, 2013
8 Source: Bloomberg L.P., Sept.30, 2013
9 Source: Thomson Reuters Datastream, Oct. 18, 2013
10 Source: Invesco research, Oct. 16, 2013
11 Source: Gluskin Sheff, Oct. 3, 2013. Correlation measures the degree to which two variables move in tandem with one another.
12 Source: Bloomberg L.P., Oct. 11, 2013
13 Source: Bloomberg L.P., Oct. 16, 2013
14 Source: Yardeni Research, Inc., Sept. 27, 2013. Forward earnings are the estimated future earnings of a company forecasted by analysts or the company itself.
15 Source: Thomson Reuters Datastream, Oct. 4, 2013
16 Source: Wolfe Trahan & Co., Dec. 5, 2012
17 Source: Thomson Reuters Datastream, Oct.16, 2013
18 Source: Bloomberg L.P., Oct. 16, 2013
19 Source: Bloomberg L.P., Sept. 30, 2013
20 Source: Bloomberg News, "China Export Drop Limits Recovery as Food Stokes Inflation," Oct. 14, 2013

Important information

investment professionals. The comments should not be construed as recommendations, but as an illustration of broader themes. Past performance is no guarantee of future results.

All investing involves risk including the risk of loss. Diversification does not eliminate this risk.

Common stocks do not assure dividend payments. Dividends are paid only when declared by an issuer's board of directors and the amount of any dividend may vary over time based on the business prospects of the company. Securities that pay high dividends as a group can fall out of favor with the market, causing such companies to underperform companies that do not pay high dividends. Also changes in the dividend policies of the companies and the capital resources available for such companies' dividend payments may affect the Fund.

Commodities may subject an investor to greater volatility than traditional securities such as stocks and bonds and can fluctuate significantly based on weather, political, tax, and other regulatory and market developments.

Derivatives may be more volatile and less liquid than traditional investments and are subject to market, interest rate, credit, leverage, counterparty and management risks. An investment in a derivative could lose more than the cash amount invested.

In general, stock and other equity securities values fluctuate in response to activities specific to the company as well as general market, economic and political conditions.

To the extent the fund invests a greater amount in any one sector or industry, there is increased risk to the fund if conditions adversely affect that sector or industry.

The dollar value of foreign investments will be affected by changes in the exchange rates between the dollar and the currencies in which those investments are traded.

Fixed-income investments are subject to credit risk of the issuer and the effects of changing interest rates.

Interest rate risk refers to the risk that bond prices generally fall as interest rates rise and vice versa.

An issuer may be unable to meet interest and/or principal payments, thereby causing its instruments to decrease in value and lowering the issuer's credit rating.

The risks of investing in securities of foreign issuers, including emerging market issuers, can include fluctuations in foreign currencies, political and economic instability, and foreign taxation issues.

The performance of an investment concentrated in issuers of a certain region or country is expected to be closely tied to conditions within that region and to be more volatile than more geographically diversified funds. Many countries in the European Union are susceptible to high economic risks associated with high levels of debt, notably due to investments in sovereign debts of European countries such as Greece, Italy and Spain.

Growth stocks tend to be more sensitive to changes in their earnings and can be more volatile.

Treasury securities are backed by the full faith and credit of the US government as to the timely payment of principal and interest.

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Note: Not all products, materials or services available at all firms. Advisors, please contact your home office.

The **S&P 500® Index** is an unmanaged index considered representative of the US stock market. The **Chicago Board Options Exchange (CBOE) Volatility Index**, or VIX, shows the equity market's expectation of 30-day volatility. The VIX is a widely used measure of equity market risk and is often referred to as the "investor fear gauge." The **OECD Composite Leading Indicator** (CLI) is designed to provide early signals of turning points (peaks and troughs) between expansions and slowdowns of economic activity. The OECD compiles CLIs for 29 member countries, for six nonmember economies and seven country groupings such as the eurozone. Data are available from the beginning of 1960s for most countries. The **Baltic Dry Index** measures changes in the costs of shipping raw materials by sea and is considered a leading indicator of economic growth or contraction. The **Russell 1000® Growth Index** measures the performance of the large-cap growth segment of the U.S. equity universe. The **MSCI Europe Index** is a free-float-adjusted market-capitalization-weighted index designed to measure the equity market performance of the developed markets in Europe. The **MSCI Europe ex UK Index** is free-float-adjusted market-capitalization weighted index designed to measure the equity market performance of the developed markets in Europe, excluding the UK. The **Net Earnings Revisions Index**, calculated by Yardeni Research, Inc., is a three-month rolling average of the number of earnings revised upward minus the number revised downward, expressed as a percentage of the total number of estimates. A positive reading indicates more estimates are rising than falling. A negative reading means more estimates are falling than rising. **PMI** (formerly Purchasing Managers Index) is a commonly cited indicator of the manufacturing sector's economic health. The **Nikkei 225 Index** (or Nikkei Index) is a price-weighted index measuring the top 225 blue chip companies on the Tokyo Stock Exchange and is commonly considered representative of Japan's stock market. **TOPIX** (Tokyo Stock Price Index) is a free-float-adjusted market-capitalization-weighted index measuring the performance of large-cap stocks listed on the Tokyo Stock Exchange. The **MSCI Emerging Markets Index** is a free-float-adjusted market-capitalization index designed to measure equity market performance of emerging markets. **Commodity Research Bureau (CRB) Raw Industrials Spot Price Index** measures the commodity price movements of raw materials.

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