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BUILDING BETTER INSIGHTS®

GETTING IN FRONT OF THE FOURTH-QUARTER BACKDROP

IN BRIEF

- We see reasons for the bull market in the US dollar to persist, with further gains against other currencies.
- In our view, central bank liquidity may no longer be a sufficient condition for equity outperformance.
- The potential for additional monetary policy easing outside the US could act as a partial brake on Treasury yields.

Macroeconomic overview

Considering the stronger dollar

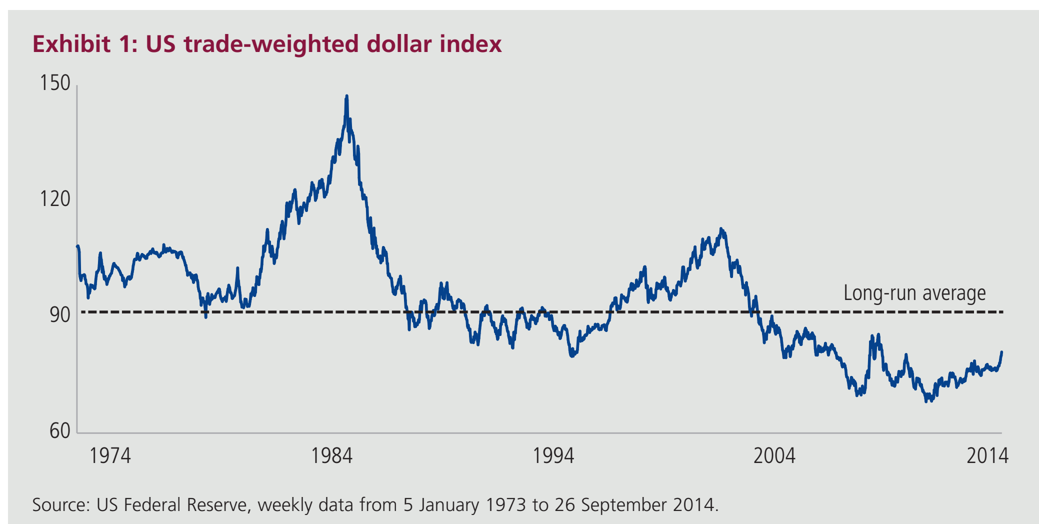
As growth in the United States diverges from other major developed and emerging economies, the US dollar has risen to the top of the foreign exchange (FX) performance table so far this year. In trade-weighted terms through the end of September, the greenback has reached its highest level since 2009, the outperformer among the 10 major currencies.[1]

The many drivers of the FX markets are often conflicting, and currencies rarely move in a straight line. At the moment, however, most of the factors we monitor are positive for the US dollar. There are several reasons to believe that this may be a full-fledged bull market, and further medium-term gains for the dollar may lie ahead.

First, the US dollar is undervalued. For a simple valuation metric, we look at the US Federal Reserve's real broad trade-weighted measure, which was 14% below its long-run average at the end of September (see Exhibit 1). Furthermore, large up and down moves in the US dollar are typically 6 – 10 year cycles. The current upswing began in 2011, suggesting this cycle has not yet reached a mature stage.

[1] Australian dollar, Canadian dollar, Eurozone euro, Japanese yen, New Zealand dollar, Norwegian krone, Swedish krona, Swiss franc, UK pound, US dollar.

Exhibit 1: US trade-weighted dollar index



Source: US Federal Reserve, weekly data from 5 January 1973 to 26 September 2014.

Trade and capital flows can help us identify longer-term structural FX trends, and these are also dollar-positive. Thanks to the US energy boom, domestic production has surged and import volumes have declined 30% since the mid-2000s. Consequently, the US current account deficit as a share of GDP has narrowed from 6.3% at the end of 2005 to a more sustainable 3.1% in early 2011 — around the time the US dollar rally began — to 2.3% by the second quarter of this year. As non-US demand for US assets including Treasuries has held steady, talk of a dollar collapse triggered by balance-of-payments issues has faded.

Implications for the US economy

Over the longer term, a rising US dollar tends to crimp net exports and the offshore earnings of US companies, while boosting trade and corporate earnings among US trading partners. The effect on growth depends on the economy's sensitivity to trade and will probably be seen first in the momentum of negative earnings revisions.

In the short term, a stronger dollar can put downward pressure on underlying inflation, with a real-time impact on commodity prices. Since midyear, for example, the US dollar's 8% appreciation against the euro has been associated with a nearly 5% decline in commodity prices, as measured by the Commodity Research Bureau's index including food and energy. US and global inflation has been falling in recent months, and this trend is expected to continue — a headwind for the widely anticipated rise in bond yields.

Divergence continues

We expect the US economy to remain a growth leader. Though slowing from the second quarter's revised 4.6% annual pace, the run rate on US GDP looks to be around 3%, with many key leading indicators trending upward. By contrast, growth in Europe has stalled, and the forward-looking business surveys we follow have yet to point to a positive reversal in momentum. In Japan, the rebound in activity after April's consumption tax hike has been tepid at best. And China's growth has sputtered, as recent stimulus measures have failed to boost the economy for more than a few months — a likely sign that the true underlying growth rate is well below the official target.

This growth divergence has implications for monetary policy. With the third round of the Fed's quantitative easing (QE3) winding down later this month, the days of the central bank's aggressive balance-sheet expansion are behind us. To be sure, the Fed is unlikely to tighten any time soon — the consensus remains clumped around an initial rate hike in mid-2015 — and the rising US dollar is unlikely to have any immediate impact on the path of Fed policy. Further appreciation could limit the prospects for US growth and inflation, leading to an additional bout of market volatility when the Fed is ready for liftoff.

While the Bank of England may follow a similar trajectory, other major central banks are either adding stimulus[2] or staying firmly in neutral.[3] Historically, US dollar strength has led to tightening financial conditions in emerging markets (EM). How individual EM central banks respond to more limited US dollar liquidity may depend on inflation trends in their respective economies.

Equity overview

Setting the stage for stocks

The Fed's latest announcement maintained that there would be a "considerable time" between the last QE3 asset purchase and the first federal funds rate hike, which can be taken as supportive of equities. The flip side, however, is that monetary policymakers' forward guidance may reflect their view that US unemployment and inflation have yet to reach their desired targets — a caution against owning stocks based on the liquidity argument alone. As growth normalizes and rates rise over the medium term, we expect equity volatility to increase.

From an equity market perspective, higher yields generally signify an improving US economy, which should be positive for cyclicals and growth stocks — for example, more domestically focused industrial goods and services, financials, technology and consumer discretionary such as autos. On the other hand, dividend-paying stocks in utilities and telecommunications are likely to suffer as higher bond yields become a more attractive alternative. Yet in the near term, still-depressed yields and the search for bond proxies reflect the market's ongoing worries about global growth and geopolitical risks posed by Islamic State militants and the Russia – Ukraine conflict, among others.

Europe

Elsewhere, we are seeing renewed monetary easing as economic momentum has faltered. The ECB has launched a targeted long-term refinancing operation (TLTRO) to provide low-cost funding to banks that is intended to stimulate credit generation. Nevertheless, we remain cautious around European markets in the short term, given the still-weak earnings outlook and the rapid rise in valuations as multiples price in a recovery that has yet to take shape. And we suspect that the market has not truly begun to think about the implications of the upcoming European bank stress tests.

China

Our cautious view on China's growth prospects was reaffirmed by the lowest industrial production reading since the global financial crisis. The PBOC has launched another mini-stimulus, injecting US$81 billion across the five largest banks, while the government has reduced money market rates and established five new asset management firms to help clean up balance-sheet problems.

[2] European Central Bank (ECB), Bank of Japan, People's Bank of China (PBOC).

[3] Bank of Canada, Reserve Bank of Australia.

Along with other reforms, these measures have been viewed as positive, and the equity market has recently shown some life. The question is whether these reforms are sustainable, especially if the pro-democracy protests in Hong Kong become a distraction.

Emerging markets

We do not expect rising rates and the strengthening US dollar to have as much negative impact on EM equities as we saw during the 1994 tightening cycle or last summer's "taper tantrum." Then again, the recent retracement suggests that not all country-specific EM challenges have been put behind us. The long-term prognosis largely depends on each country's willingness to undergo real structural reform. In the near term, slower credit growth could have a negative impact on corporate earnings, especially for less competitive state-owned enterprises. In particular, Latin American markets could face headwinds in an environment of higher US Treasury yields, weaker commodity prices and a stronger dollar; Brazil will be an important test case during the current election cycle.

In general, we feel increasingly cautious as global equity markets have moved higher. Valuations look relatively full, so there could be an initial market retracement when rates rise, though the deliberate nature of the Fed's tightening may limit such a downturn. We have noted that quality large-cap stocks have underperformed year to date, creating a long-term investment opportunity among those out-of-favor names that can generate earnings growth throughout the cycle. As always, we continue to monitor monetary policy and earnings, which are critical in determining the direction of equity markets.

Fixed income overview

Keeping a finger on the scales

We view the fixed income markets as having at least three sets of asymmetrically skewed risks, with a central bank finger on the scales that could distort the outcomes. In other words, the extent and speed of monetary policy shifts will have a bearing on which way and how far each balance swings.

Weighing the risks

First, the balance of risks to US Treasury yields appears to be skewed toward higher rather than lower yields — a view that we and many others have been wrong about so far this year. While positive trends in the US macro data should allow the Fed to proceed with policy tightening, we do see a range of factors in play that could limit how high Treasury yields rise. For example, easier monetary policy outside the United States signals weak regional macro conditions that could ultimately ripple through the global economy. This would have the potential to act as a partial brake on Treasury yields.

Second, we see asymmetry in the balance of risks to credit spreads. Given that spreads are already relatively narrow, we think the probability of further widening from here is greater than the probability of spreads grinding tighter. Extraordinarily loose monetary policy has held sway over bond valuations, leaving investors with often meager compensation for the risks they are underwriting. Compounding our valuation concerns is the weak secondary market liquidity, which could magnify the downside of any bond selloff.

Third, the balance of risks to the market environment is probably tilted toward a further increase in volatility, rather than a return to the recent quiet. Historically, the correlation between volatility changes and spread movements has been fairly strong — that is, upticks in equity or rate volatility have been associated with wider credit spreads. Yet there have also been prolonged periods in which volatility stays low and spreads remain tight. Lower volatility could still prevail as long as major central banks generally remain dovish and supply sufficient liquidity to encourage investors to buy riskier assets.

Positioning the portfolios

With the asymmetry of risks in mind, we have become incrementally more defensive. We still see interest rate risk as a greater threat than credit risk, given that the underlying fundamentals of many credit markets remain relatively solid. The low cost of capital engineered by monetary policymakers is keeping interest expense under control even as leverage rises, suggesting that the finger on the scales may be artificially extending the credit cycle. By overweighting credit risk, we seek to use the excess yield to help cushion total return against price declines as rates rise.

We favor US investment-grade and high-yield corporate bonds and hard currency EM debt. We still think BBB- and BB-rated US corporates — the highest tier of high yield and the lowest rung of investment grade — offer the most attractive balance of risk and reward, and we see good value in selected EM corporates. But we remain wary of diving deep into the lowest-quality credit tiers, as the high yields found there may not fairly compensate investors for the risk. In short, as we wait for the finger to be lifted off the scales, we continue to overweight credit, with a bias toward taking risk off the table by moving up in quality and down in beta. ■

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