Weekly Perspectives

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A Weekly View of Global Economies

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The US equity market has been moving broadly sideways and marking time in December, after the strong run-up since the October lows. Some technical indicators now suggest a pause and possibly a correction, though it is not out of the question that investors may muster enough conviction to push the market higher before the year closes.

If we measure risk appetite by an aggregate index, then in some formulations the indices are in the euphoria zone, which is often an indication of a high probability of near-term correction. At the same time, the OEX volatility index - - a measure of volatility expectations embedded in options prices - - continues to hover at a low level, and the equity put/call ratio is also giving a low reading. Both of these measures indicate a degree of investor complacency, which means that there is a greater degree of vulnerability to bad news

As for the 52-week indicator of those stocks making new highs minus those making new lows, it is still positive, though the near-term trend has flattened out. Meanwhile, optimism among retail investors appears to be mildly bullish and there are modest inflows into equity mutual funds.

Consensus estimates of forward S&P 500 earnings per share have been edging down. And the price-to-earnings multiple, using next year's profit forecasts in the denominator, is now roughly in line with, or slightly above, historical averages. So on this basis, the market may be considered to be fairly valued.

Calculating another measure, namely the earnings yield relative to the bond yield (using the ten-year Treasury bond or high-grade corporates), the stock market still looks attractively valued. However, this is partly the result of bonds being overvalued.

Liquidity is being slowly drained, as the Fed continues to tighten, and modest interest rate hikes are already discounted by the market. But if growth and inflation are stronger than expected and the central bankers have to squeeze harder, then a re-pricing of bonds could have negative effects on the stock market. In that case, we will have to deal with the problem of a compression of PE multiples.

Looking at the global picture, the general expectation is that there will be a re-balancing of growth away from American consumers towards capital spending, as well as other regions such as Europe and Japan. However, the risk is that US growth does not slow down as much as expected. The state of household finances isn't as dismal as commonly assumed and, barring a serious correction in the housing market, consumers may not rein in their consumption substantially.

In the recent past, growth in the United States has often surprised to the upside. We should be monitoring leading indicator for both the US and the global economy, in the first quarter, to gauge whether the expected growth-slowdown in the second half of next year is on track.

At any rate, at the present time, the broad expectation is that a growth-acceleration will not occur next year, which would force monetary authorities to press harder on the brakes. Rather, people are generally banking on a temporary soft spot that will dispel all inflation worries and allow faster growth again. As a result, investors expect that real yields on cash and bonds would remain low relative to real output growth. And this has a tendency to promote higher risk appetite and a revaluation of risky assets.

To some extent, investors are already discounting such an outcome, which is why a risky asset class such as emerging market securities continues to enjoy a re-rating. EMBI (Emerging market bond index) spreads over Treasuries are quite tight and emerging market equities have outperformed developed markets since stocks began to rebound, at the end of October.

A flattening Treasury yield curve used to be interpreted as a precursor of a significant weakening of the economy. But Alan Greenspan has denigrated it as a forecasting tool, and many people agree with him. Indeed, its signals haven't been accurate in recent times, though it worked very well in earlier periods.

The Fed is expected to stop sooner rather than later in the tightening cycle, and with inflation fears put to rest, this should favour a steepening of the yield curve. Of course, as mentioned above, there is a risk that the scenario does not unfold as expected.

Meanwhile, the Bank of Japan is maintaining its policy of quantitative easing, which has been a factor in fuelling global liquidity. Many assets, and not just US Treasury bonds, have benefited from this policy. A move by the BoJ, expected sometime in the second or third quarter of next year, could represent a tightening of liquidity conditions globally. The hope is that the government will lean on the Bank not to tighten too quickly. An appreciating yen and a stronger-than-expected revaluation of the Chinese renminbi would also be bearish for bonds.

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