Weekly Perspectives

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A Weekly View of Global Economies

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We said at the beginning of the year that the risk of tighter monetary policy hurting the stock market was high, and so it has turned out to be. Equity markets have given back most of the gains made over the past six months. As of the date of writing (13th of June), most markets are already into negative territory, on a year-to-date basis. Over the past few weeks, they have made several feeble and failed attempts at recovery.

Some central banks have turned up the hawkish rhetoric. They had been perceived as being behind the curve in fighting inflationary pressures and their hand has been forced by economic trends. There was a need to show some resolve in making sure that expectations about higher inflation do not become entrenched, because once they do, the cost of reversing the trend is even higher than initiating a slowdown now.

Among the major central banks, the Bank of Canada is one that is unlikely to increase interest rates. It appears to have signalled its intentions to that effect. The reasons are not hard to determine. Canada has a very open economy (i.e. trade constitutes a large proportion of the GDP). And, of course, the United States is by far the largest market for Canadian exports. Normally, slower growth, down south, has a big impact on Canada's economy.

Therefore, in formulating policy, the BoC has to forecast what the Fed is likely to do and what will be the state of the American economy six to nine months from now. Putting all this into their models, smart policymakers at the Bank are unlikely to jack up interest rates any further. The lagged impact of tighter policy, now, will hit the economy just when the US will be entering a slowdown phase. There are additional reasons for foregoing higher rates. Commodity prices are retreating and the loonie continues to be strong.

As for the Bank of Japan, they are also likely to delay an end to the zero interest rate policy (ZIRP). The prospect of higher US interest rates and slower global growth is one reason to stay their hand. Meanwhile, the stock market is slumping as foreigners reduce their holdings for the same reason. So, asset inflation is hardly a problem. But slower earnings growth is indeed a concern.

Hawkish comments from the Fed have diminished hopes of a June pause. Previously, the markets thought that Ben Bernanke was a softie. Now, the Wall Street crowd are griping that he has changed the message too abruptly. Greenspan was always a favourite because he was ever ready to provide sloshes of liquidity. Well, poor old Ben, is facing a more challenging environment. For now, he has to look tougher on inflation.

The analysts have been wrong-footed. They expected a goldilocks scenario of moderate growth, low inflation and an end to policy tightening. Instead the markets are now pricing-in a possible hard landing. Risk appetite continues to be at a low level.

Riskier asset classes are being whacked hard. Emerging-market equities have plummeted, taking a hit because of weaker commodity prices and prospects of higher interest rates. Until quite recently, these markets were easily outperforming developed stock markets. Some of us noticed the dark clouds forming and warned of a correction.

But the theme of emerging-market out-performance was already well entrenched and the money kept pouring in. It has to be said that whenever such a theme takes hold there are a lot of vested interests in the investment industry that are willing to encourage inflows. They are not too keen to spell out the risks run by investors.

All stock markets are down, some more than others. Over the past month, the US market has declined less than the world index, on a local currency basis. This is partly the result of portfolio switches from even riskier markets. Among major European markets, Germany has been the worst performer, over the past month. Given its heavy concentration of exporters and capital goods producers, this isn't a surprising result.

In this environment defensives are, naturally, outperforming cyclicals. For example, the "consumer staples" sector (a defensive) that was being shunned earlier in the year is now preferred to the "industrials" sector (a cyclical). It is all relative, of course. The expectation is that a defensive sector is likely to fall less than a cyclical one.

Other lower-risk qualities that investors are looking for are: big capitalisation, relatively low beta and high credit quality. General Electric (GE) is an industrial conglomerate that had been underperforming its sector, as well as the market, until quite recently. Its valuation doesn't make it particularly attractive compared to other industrials. But it does have the qualities mentioned above, and that makes it relatively more attractive than other industrial stocks with a bigger cyclical exposure.

Risk aversion is helping to shore up government bonds. Prices are up, and the yield on the benchmark US treasury ten-year bond is down some twenty-five basis points since reaching a high on May 12. Meanwhile, expectations of further rate hikes have led to gains for the greenback against the euro.

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