Weekly Perspectives

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A Weekly View of Global Economies

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Fourth-quarter GDP growth in the United States was weaker than consensus forecasts, but this outcome didn't reverse upbeat expectations of future output. The quarterly slowdown was attributed largely to temporary factors such as a drop in car sales and the timing of government defence expenditures. It is likely that growth will rebound in the current quarter.

The stock market looked right past the weak data and moved higher. It appears that investors are in an optimistic mood, and the rise in risk aversion in mid-January was a temporary phase. The earnings reports are somewhat more positive now, after some disappointing results from biggies such as GE, Intel and Citigroup, earlier in the season. Results and guidance from Caterpillar, Microsoft and Exxon have lifted the gloom

Roughly fifty percent of the S&P 500 companies have reported so far, and in terms of hits and misses, the picture isn't all that bad. Still, the season isn't over and we shouldn't count all the chickens before they are hatched.

Looking forward, there are a number of worrying factors. Analysts are lowering their estimates for financials, which constitutes the biggest sector in the S&P 500 index. As such, this could weigh down the aggregate earnings per share for the index. Also, energy companies are leaders in the earnings-growth tables, and if oil prices fall this will remove one of the pillars of the market's profit performance.

The stock market sell-off in mid-January appears to have been a temporary correction. Emerging market equities, as represented by the Morgan Stanley index, have risen sharply since then, while the EMBI (Emerging Market Bond Index) spread has tightened, even as other credit spreads for riskier assets remain tight. As for the Japanese equity market, it has staged quite a rebound after the Livedoor incident was digested. And looking at commodities, metal prices are hovering around their highs.

So risk appetite is quite hearty and, currently, somewhat extended, rendering it vulnerable to surprises. The two main sources of nasty shocks are interest rates and oil prices. Global growth is sufficiently strong to keep energy prices at an elevated level. What is worrying, in this context, is that geopolitical risk has risen in the ever-strategic Middle East. It is quite possible that miscalculations will be made in the current dispute over Iran's nuclear programme. A significant spike in oil prices, if sustained, will seriously compromise global growth.

As for interest rates, most of the attention is focussed on the United States, which has experienced the greatest measure of monetary policy tightening among major economies. The premise is that the Fed has done just about enough to de-bubble the housing market and that the economy will go through a growth pause before reaccelerating. This base-case scenario seems to be too optimistically scripted to be taken as a realistic balancing of the risks. Chances are that the economy will either accelerate or decelerate at a greater pace than currently expected.

The Fed's policy response, at this stage of the game, is likely to be even more data driven than previously. Ben Bernanke is taking over as chairman, and is likely to proceed cautiously during the settling-in period. At the same time, the markets may try to test the new man at the helm. There was a certain comfort level that the markets had reached regarding Greenspan, the retiring chairman, even though his pronouncements were often as vague as those of the Delphic oracle. Bernanke has yet to establish his presence in words and deeds. What's more, he has to do it in a challenging environment.

The VIX index has again descended to a low level, after having risen to 14.56 on January 20th. So the average for January is well below the level registered last October, when there was a significant stock market sell-off. What's important about the VIX is that it is a measure of implied volatility, incorporating expectations.

The volatility is backed out of the Black-Scholes option pricing model, for a number of options contracts on the S&P 500 index, by setting the model price equal to the market price. As such, it reflects investors' expectations about the volatility of the underlying on which the options contracts are written.

This sort of volatility measure is obviously different from statistical volatility, which is estimated in its sophisticated form by various GARCH models. Options traders commonly take account of the discrepancy between statistical and implied volatility to trade options. GARCH models are superior in taking account of the time-varying nature and clustering of volatility. But they don't measure expectations, which implied volatility does.

Anyway, the current level of the VIX is signalling that there is a degree of complacency out there. Also, as noted above, risk appetite has risen again. So there is a potential for risk factors to spring a surprise and upset calculations of smooth sailing.

There is encouraging economic data coming out of Japan. The job market is firmer and real wages are increasing. So it comes as no surprise that household spending is on the rise, and domestic demand appears to have found a more solid footing. As a result, the Bank of Japan is expected to move towards ending its policy of quantitative easing, at a gradual pace.

As consumer price inflation moves into positive territory and real interest rates turn negative, households will have an incentive to move out of cash and into assets that generate better returns. This could be positive for the stock market. Currently, valuations are a little rich, but earnings are robust and buying momentum has not waned significantly.

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