New Albany Investment Management

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Market Insight: Conflicting Forces Around the Globe

It has been another choppy month in the global markets. Conflicting economic forces are causing various market sectors to move in opposite directions, leaving investors frustrated and questioning the sustainability of current stock prices levels. Recent news headlines such as: bond guru "*Bill Gross predicts the End is Near*" and "*Warren Buffet Predicting Upcoming Stock Crash*" are nothing short of sensational headlines with an unsupportive story. But rather than getting caught up on what one person says, or on one sector of the economy or market, it is important to step back and look at the whole picture because when it comes to investing, the markets are truly global. Below is a snapshot of some key positive and negative market drivers around the world.

Euro Zone Fastest Growth Since 2011: Several factors have contributed to Europe's rebound: Banks' asset quality ratios are in the clear such that they are now in a better position to lend; the ECB has initiated quantitative easing; and lower oil prices are a boost to the local economies. Combined, these forces have all contributed to positive first quarter GDP (+ 1.5%) and pulled inflation back into the plus zone. The European equity markets have also responded strongly, up +8% to +10% year-to-date.

Surging Global Bond Yields/Falling Prices: As expectations about growth in Europe have risen, so have interest rates. The rate on the 10yr German Bund, a benchmark for the Euro zone, has climbed dramatically over the last month from near zero to 0.65%. And because of the interconnectedness of the global markets, this rise has pressured global bond rates higher, prices lower. Also, the expected rate rise by the US Federal Reserve has also been a negative to global bonds. In sum, performance so far this year in many sectors of the bond market has been flat to negative around the globe.

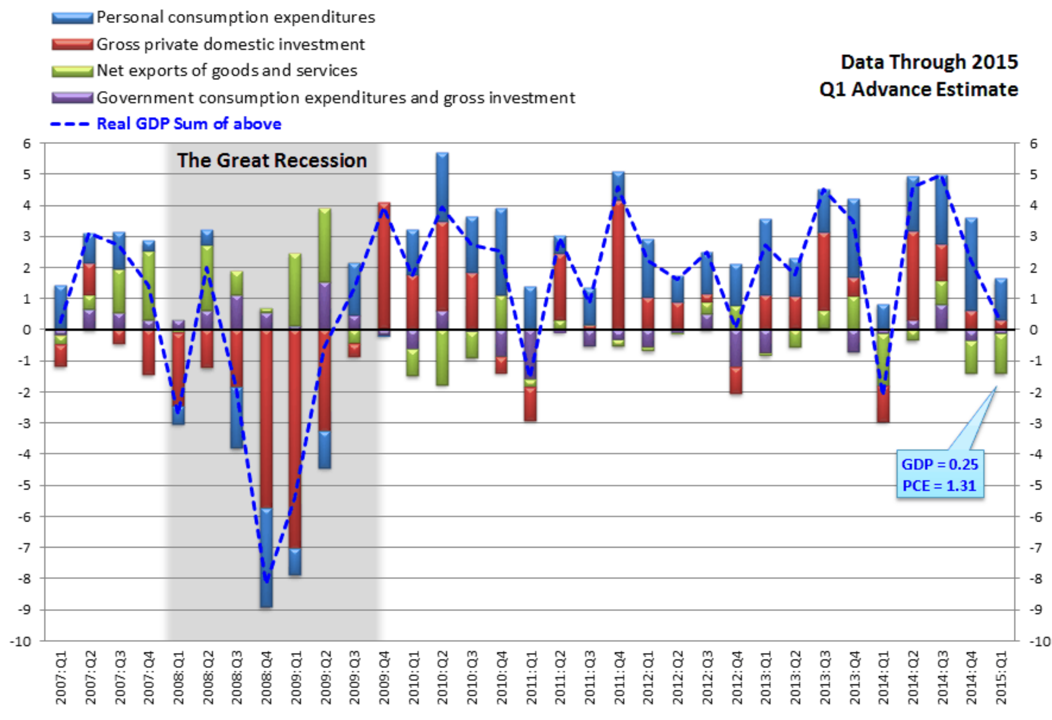
China's Growth Slowing/Stock Market Surging? A significant decline of investment in the industrial and property sector has finally taken hold in China and thus their need to import commodities and machinery continues to decline. Reported GDP is currently at 7% but expected to fall towards 3-4% over the next 5 years. Because China is the second largest contributor to global growth, their slow down puts downward pressure on commodity prices and global growth. Despite slowing growth, the Chinese stock market has surged to a new seven year high amid expectations for the coming 'China-Hong Kong' mutual fund recognition program and for the coming 'Shenzhen-Hong Kong' stock connection. Both initiatives have caused enormous demand for stocks and pushed valuations to bubble status. Investors beware!

US Dollar Rising/ Oil falling/US Economy Sputtering/ Stocks Grinding: The US Dollar has risen over 18% since last June which has caused US manufactured goods to be more expensive abroad, hurting sales and prompting reduction in industrial production. At the same time, lingering low oil prices have continued to cut into spending plans and profitability of the energy sector. The impact of a strong dollar and low oil have rippled through much of the economy. Though the consumer has benefited, the net effect has been a decline in economic growth and earnings growth. First quarter GDP was only +0.2% and the S&P 500 earnings growth was only +0.3% year-over-year.

However, there are a few bright spots in the US economy. The labor market continues to improve and the housing market is strong. Both of these indicators indicate the consumer is confident and able to spend. With consumption nearly 70% of the GDP, a happy consumer is essential to growth.

The two charts below give a picture of the progress in unemployment and the significance of consumption to GDP. The first chart shows the unemployment rate, which is now at 5.7%, the same level it was at in 2002-2004 when the economy was expanding and stock market rising.

The second chart shows the components of GDP by quarter since 2007. Personal Consumption Expenditures (PCE) is the blue portion of each bar and is almost always the largest contributor to GDP. Also, notice how Exports (green) have pulled growth down over the last two quarters, again a function of a stronger dollar.



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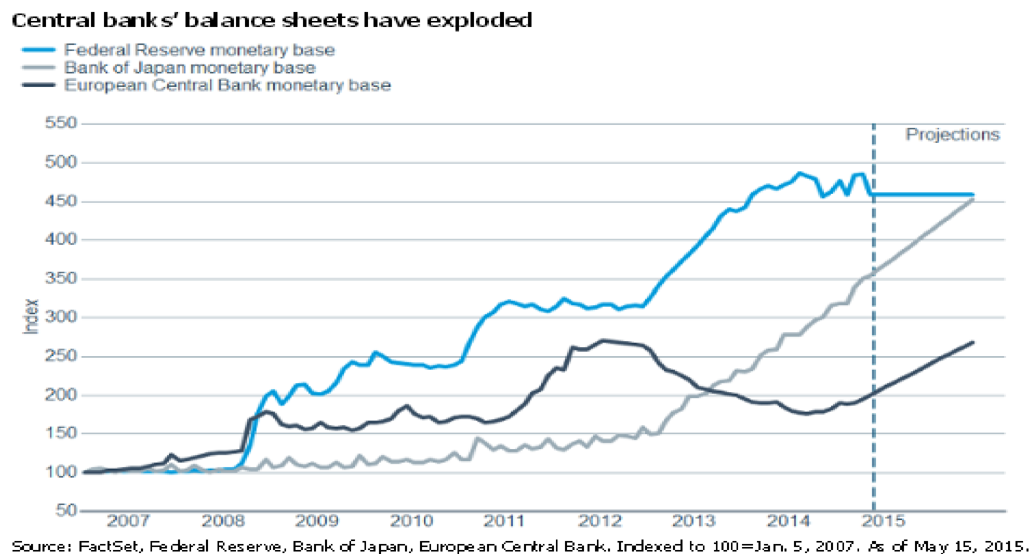
The GDP chart also depicts how different parts of the economy can be going in opposite directions. When this occurs, financial markets typically churn until all components start heading in the same direction. This explains why the US markets have been volatile and performance muted.

Central Banks' Huge Stimulus Programs: Make no mistake, the biggest factor contributing to global growth has been and will continue to be the ultra- easy monetary policies of the Central banks around the globe. Lots of cheap money continues to flood the markets and support asset prices. In dollar terms, the Fed has added $4.4 trillion; ECB $1.16Trillion, and Japan $29Billon. The chart below shows the relative amount of stimulus as compared to the monetary base, by each Central Bank.



Even though the Fed will probably start to raise rates later this year, rates are still very low and there is plenty of stimulus in the system. But with inflation near zero and growth still below target, <u>expect Central Banks around the globe to remain very accommodative for a long time</u>. This is good news to any investor!

Outlook through Year End Looks Choppy but Positive: Yes, there are many, many forces swirling around the global markets and causing some unpleasant gyrations. But this is typical and not alarming. Each economy must wrestle with local currency and political issues as well as adapt to constantly changing global conditions. But the significance of accommodative policy cannot be ignored and will continue to be a floor for asset prices. With this backdrop, the markets are likely to continue to slowly grind higher as the year progresses.

As always, please contact me with any questions or concerns.

Kind Regards,
Barbara

Barbara HS Huff
CEO & President
New Albany Investment Management
614-216-6139
www.newalbanyinvestment.com