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Global stock markets: Break, correction or worse?

Peter Szopo

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The seemingly unrelenting climb of US equities has stopped in August. Market volatility spiked, the decline of the US dollar ended, bond spreads widened, and macro risk-indicators surged. While there has been no major correction (yet), the fresh breeze of optimism that characterized equity markets in the first half of the year gave space to the somewhat stale atmosphere that typically takes over when the majority of investors switch into risk-off mode.

We just passed the tenth anniversary of the 2007 great financial crisis (saying that it was celebrated would not be a correct description of most market participants' feelings) and it is summer again, thus investors' elevated jumpiness is somehow understandable. We are late in the cycle, valuations are on the pricey side, the end of quantitative easing is nigh, and most of the hopes pinned to the Trump-presidency have evaporated. Growing anxiety, therefore, about how markets will evolve going forward is not necessarily a sign of paranoid bearishness.

Reasons for moderate optimism

That said, there are a number of reasons to assume that global equity markets are just taking a breather rather than switching into a more worrisome mode:

1. Global growth is solid. The world economy is expected to grow by 3.5% and 3.6% in 2017 and 2018 respectively, according to the recent IMF update of its forecasts. It is also worth noting that for the first time in a decade, all 45 countries that are tracked by the OECD are expected to grow in 2017, with the majority of them expected to show higher growth next year (Wall Street Journal, Aug 23, 2017).
2. Monetary policy will remain supportive for some more time. Both the Fed and the ECB are not keen to surprise markets with monetary tightening shocks. Yes, rates in the US are set to increase further in 2018 and quantitative easing will likely be reversed in the US and stopped in Europe, but all steps are being reasonably well advertised by monetary authorities in an attempt to avoid market disruptions.
3. Earnings are on track. Consensus data suggest that in 2017 earnings will grow by 12.8% in Europe, by 10.7% In the US, and by 18.5% in Japan (IBES data from Deutsche Bank, Consensus Earnings Trends, August 24, 2017). In 2018, global earnings growth is expected to slow down but to stay in the high single-digit range. Interim results in the second quarter

were robust. In terms of positive surprises, in the US the recent quarter was the strongest in many years, and also in Japan earnings surprised strongly on the upside. In Europe, positive surprises outnumbered disappointments, but the earnings momentum has clearly slowed relative to the first quarter.

4. Finally, emerging markets, which often were the source of market disruptions in the past, are performing well as a group and seem better prepared to cope with further US monetary tightening than in recent years. Economic growth is accelerating faster than in the developed world, external balances have improved on average over the past 2-3 years, and a number of central banks has still room for further monetary easing. One reason for the improving macroeconomic backdrop has been the stabilization of commodity prices after their steep decline from 2011 to 2015. It is worth noting, that during the recent risk-off phase, the MSCI emerging market equity index has continued outperforming developed markets, which is unusual during period of higher risk-aversion.

Nothing of the above, however, is meant to suggest that equity markets are on the verge of entering a blue-sky scenario. While we believe that macroeconomic fundamentals stay supportive for equities, risks remain. They will probably even get bigger in the course of 2018, given the prospect of monetary tightening and the length of the US business cycle.

Earnings momentum will be key

One of the key risks – other than policy mistakes or unpredictable geo-political developments – are earnings disappointments. Similar to the difference in their macroeconomic backdrop, also with regard to earnings the US and Europe are in different stages of the cycle.

In the US, earnings and margins look toppy, and it is increasingly difficult to convince investors that earnings will grow fast enough going forward to justify current valuations. This could be seen clearly during the recent earnings season in the US, where the market reaction to strong results was more muted than in previous quarters. As the bar for third quarter interims has moved up, the riosk of disappointments is rising.

In Europe, to the contrary, margins are close to their longer-term average and well below historical peaks. However, with a strengthening Euro, it is difficult to see, how the corporate sector will manage to improve profitability. This was probably the reason, why European earnings failed to excite in in the second quarter and why consensus earnings in Europe have been downgraded as of late.

Bottom-line: The probability that there is another leg up for global equity markets is bigger than a significant correction in the near-term. However, there are no guarantees when it comes to investments in stocks in contrast to, as somebody said, the purchase of a vacuum cleaner. In case that the earnings momentum is cooling down or, for example, the macro-backdrop deteriorates, an extended period of equity markets going sideways or a correction cannot be excluded.

Legal note :

Prognoses are no reliable indicator for future performance.

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After his research work at WIFO (Austrian Institute of Economic Research) from 1978 to 1990, he worked as a securities specialist in various management functions at internationally renowned investment banks. During this time he held the position of Head of Research at such institutions as Creditanstalt Investmentbank, UniCredit Bank Austria, Robert Fleming Securities, and at Bank Sal. Oppenheim.

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