Q2 2014 Market Spotlight

Morningstar Investment Management Asia Limited

The Global Picture

The global economy wobbled into—but improved during—the second quarter. Still, we don't have high hopes for near-term global growth levels as we don't see any economies that have the firepower to take over from a slowing China. Our overall outlook for global growth is lukewarm.

Renewed growth in U.S. gross domestic product buttressed claims that first quarter weakness was primarily a weather-related anomaly lacking further supporting evidence. Capital goods shipments, core retail sales, car sales, initial unemployment claims, purchasing manager indexes: none of these points to a slump. Significantly, payrolls rose during Q1 and grew even faster during Q2.

Across the Atlantic in the U.K., it would seem a neutral fiscal stance after the severe austerity and a renewed willingness to borrow are stoking domestic demand, while inflation has been kept in check. Part of the U.K.'s success is catch-up growth after falling more than other G7 economies during the Great Recession. Forecasters expect somewhat more growth (2.8%) in all of 2014 than in the final quarter of 2013 (2.7%).

However, the picture is different in the eurozone, where the pace of the recovery has disappointed. Europe's GDP growth dipped 10 basis points to 0.2% in Q1. Among laggards France, Italy, and the Netherlands, austerity and structural reforms outweigh the cyclical tailwind.

Opinion surveys through June and hard data through May suggest a sluggish Q2 for the eurozone as well. Tellingly, May marked the third month of industrial production decline in Germany, Europe's growth locomotive whose strength is industry.

Globally, a lackluster first half of 2014 has led to lower forecasts for the year. In June, economists lowered expected global growth to 2.8% from 3.1% in March. The Americas are mostly to blame (see **Figure 1**).

The U.S., where employment has picked up, will lead the world economy during the second half of 2014.

Figure 1

Consensus forecasts

Annual percent change

	GDP					
	2014			2015		
	Jun	Mar		Jun	Mar	
World	2.8	3.0	▼	3.2	3.3	▼
United States	2.2	2.8	▼	3.1	3.1	▬
Canada	2.2	2.2	▬	2.5	2.5	▬
Eurozone	1.1	1.1	▬	1.5	1.4	▲
Germany	2.0	1.8	▲	2.0	2.0	▬
Netherlands	0.6	0.8	▼	1.4	1.2	▲
France	0.8	0.8	▬	1.3	1.2	▲
Italy	0.4	0.5	▼	1.2	1.0	▲
Spain	1.1	0.9	▲	1.6	1.5	▲
United Kingdom	3.0	2.7	▲	2.6	2.5	▲
Japan	1.5	1.4	▲	1.2	1.3	▼
South Korea	3.6	3.5	▲	3.7	3.7	▬
Australia	3.1	2.8	▲	3.0	2.9	▲
China	7.3	7.4	▼	7.1	7.3	▼
India	5.4	5.4	▬	6.2	6.8	▼
Eastern Europe	1.5	2.5	▼	2.7	3.1	▼
Latin America	2.1	2.5	▼	2.8	3.0	▼

Sources: Consensus Economics.

The U.K. may continue on a firm footing, but the eurozone will lag because of low trend growth and lack of policy stimulus. Japan is meeting expectations, although lately it has lost momentum.

Emerging markets don't show much promise for much improvement, in our view. China's slowdown is weighing heavily on Asian manufacturers and commodity exporters. Beijing has managed to stimulate growth, lifting—slightly—short-term prospects. India may have recovered from a year ago, but there are few signs of faster growth in the other five major emerging economies (Brazil, Russia, Indonesia, Mexico, and Turkey).

The combination of tepid growth at best across developed economies and the lack of a new growth engine in the developing world leads us to expect cooling global growth in the near term (i.e., the next five years or so).

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SPOTLIGHT ON INFLATION

Monetary policy has diverged since early 2009. At first, most central banks were cutting policy rates to prop growth. Later, as momentum built, inflation rose, external imbalances widened, and currencies moved, some central banks changed course.

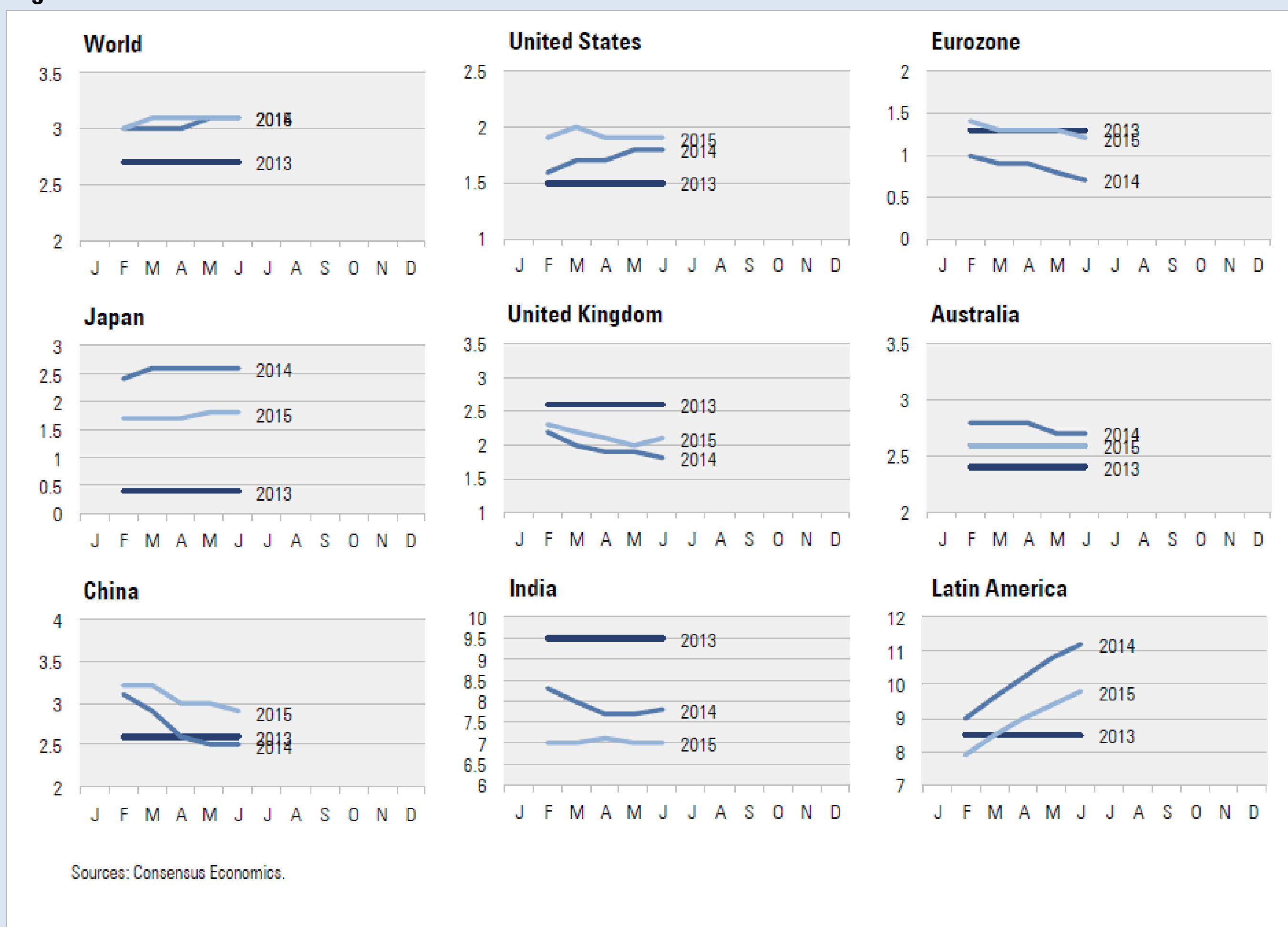
That divergence is seen among the largest economies as well as emerging markets. For example, the Federal Reserve and Bank of England have signalled ends to quantitative easing while the Bank of Japan and European Central Bank will continue to ease.

Monetary authorities in Russia, Brazil, Turkey, India, Indonesia, and South Africa have all raised policy rates to curb inflation, support their currencies, or both. Meanwhile, Mexico, Argentina, Chile, China, Thailand, Poland and Hungary haven't touched rates in a while. Turkey began lowering rates in May.

Forecasters now expect slightly faster price increases, mostly coming from the U.S. and Latin America. Inflation prospects declined for the eurozone, the U.K., and China, and barely changed elsewhere (see **Figure 2**).

Inflation remains low in advanced economies. Surveys suggest prices will increase in coming months less than the 2% targeted by many central banks. The picture in developing economies is mixed, as exchange rates have diverged. Food prices could spike if forecasts of an El Niño year prove correct. The consensus forecast for global inflation in 2014-15 was 3.1% in June, a notch higher than in March.

Figure 2: Inflation consensus forecasts



Sources: Consensus Economics.

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A Look at Local Markets

Clear winners and losers emerged in Asia-Pacific during the first half of 2014, as the shift to risk-on lifted markets in India and Taiwan while leaving others like Japan and China in the dust.

In India, the Bharatiya Janata Party-led National Democratic Alliance swept Narendra Modi into power after May elections. After a weak start to the quarter before the results of the Lok Sabha (lower parliamentary house) elections, equity markets cheered the election of Mr. Modi and his slogan “good times ahead,” jumping 13.52% in the quarter (see **Figure 3**). That follows a respectable rise in Q1, for a first-half increase of more than 20%. Small-cap stocks in India climbed a dizzying 55.75% in the first half of 2014.

Figure 3: Selection of equity benchmark performance

Country/Region	Index Name	Q2	Q1	YTD	1-Year
Japan	Nikkei 225 Average TR JPY	2.39	-8.26	-6.07	12.70
China	MSCI China A GR CNY	1.93	-6.81	-5.01	3.43
Korea	MSCI Korea GR KRW	1.13	-1.12	-0.01	10.46
Taiwan	MSCI Taiwan GR TWD	8.21	3.30	11.78	20.35
India	S&P BSE SENSEX India INR	13.52	5.74	20.04	31.03
Malaysia	FTSE Bursa Malaysia KLCI TR MYR	2.75	-0.35	2.39	9.38
Hong Kong	Hang Seng HSI TR HKD	6.86	-4.55	1.99	15.39
Singapore	FTSE/SGX STI TR SGD	3.40	0.99	4.43	6.65
Asia-Pacific	MSCI AC Asia Pacific GR USD	6.34	-1.64	4.59	14.64
Asia-Pacific	DJ Asia/Pacific TR USD	6.56	-1.37	5.10	15.40

Source: Morningstar Direct. All periods end June 30, 2014, except Q1 (Jan. 1 to March 30, 2014)

There’s likely some irrational exuberance at play here. Mr. Modi, after his impressive election win, now has to govern. His first budget, presented in July, disappointed. Tax revenues are projected to grow by 20%. That’s an incredible number because nominal GDP growth will likely come in under 14% (5% to 6% real growth plus 8% inflation) and because India reached 45% of the annual deficit in the first quarter of the fiscal year. The government also needs to demonstrate it can also bring greater discipline to expenditures.

Taiwan, meanwhile, looks steadier (if also more subdued). Stocks there rose 8.21% in Q2 as foreign investors crowded into the market, in part to tap Apple’s shift to using Taiwan Semiconductor Manufacturing Co. to produce its chips, a blow to Korea’s Samsung. Taiwan’s export orders grew 10.6% in June, well past forecasts, driven by electronics export annual growth of 17%, according to the Wall Street Journal. Stocks rose 11.78% in the six months ended June 30.

On the other end of the spectrum, Japanese stocks lost 6.07% as of midyear, despite a modest improvement of 2.39% in the second quarter. Economic data continued to be mixed, with bright spots in Q1 clouded over by the fact that capital and consumer spending were boosted by an impending tax hike. So far the data bear out a contraction. Retail sales fell in April and May, as did real household spending. In line with those numbers, the PMI composite output index fell to a quarterly average of 48.5, below the 50 mark, from a robust 53 in Q1.

China A shares also lost ground in the first half of the year, down 5.01%, after a 1.93% increase in Q2. We expect China’s economy to slow over the next five years to annual growth of 4% to 5%. Investment as a share of GDP is still high versus history, and credit is still rising relative to nominal output. Both trends are unsustainable, and an adjustment will bring about lower growth.

Korean stocks essentially broke even in the first half of the year and rose 1.13% in Q2. The Korean market is particularly susceptible to global growth trends because of the concentration of exporters in the KOSPI index, so the sluggish growth of global trade volume has weighed down stocks in 2014. Also, a growing surplus current account balance and inflows from investors have pushed the won to appreciate, dragging down returns.

The End of Contagion?

On July 17, Malaysian Airlines Flight 17 crashed in a separatist-controlled corner of Ukraine, apparently shot down by a surface-to-air missile. Later that day, the S&P 500 index closed down 1.2%, the first time the index had a one-day loss or gain of 1% or more since April 16, or 62 days earlier. That marked the longest such stretch of smooth sailing since 1995.

But the next day, the S&P bounced right back 1%, erasing most of the losses from the day before. The MSCI Emerging Markets Index followed a similar pattern on those days, falling 1.9% on July 17 and making nearly all of it back the next day. Volatile as the markets were these two days, nothing really changed.

Markets are increasingly unfazed by events that a few years earlier would likely have become contagion.

The fall of Portugal’s Banco Espirito Santo, territorial disputes in the South China Seas and the Middle East, and the wider dispute in Ukraine have all left investors—including those in emerging markets—unmoved, even as many market observers say stocks are overpriced (see **Figure 4**).

The Federal Reserve’s announced plans to begin tapering its quantitative easing program in May 2013 sent markets into a

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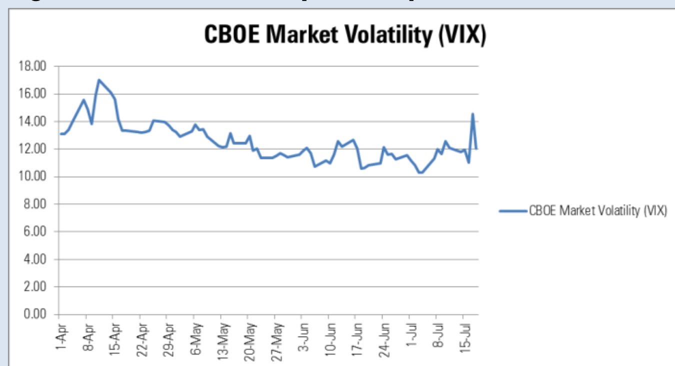
Figure 4: Market volatility since April



Source: Morningstar Direct

tizzy at the time. But in a recent update, Capital Economics said that the possible contagion of rising rates in the U.S. won't necessarily bring down emerging markets debt and equities. In the year following two of three previous tightening cycles (in June 1999 and June 2004), these asset classes delivered "very healthy" performance; in the third (February 1994), political instability in Mexico triggered a crisis there, not tighter monetary policy from the Federal Reserve.

But this does not mean equity markets are immune to contagion. The latest geopolitical incidents have been localized, and investors have weighed possible escalation with probable outcomes and have so far bet correctly against contagion, instead buying when markets dip. But a skirmish with wider effects would bring wider and more lasting jitters. For example, a South China Seas standoff involving multiple local countries, Japan, and the U.S. and others that have shipping-channel interests there, could bring contagion back to the fore. M

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