Centre for Asset Management Research & Investments
NUS Business School

CAMRI Global Perspectives

Monthly digest of market research & views

Issue 13, May, 2014

A Time for Reflection: Liquidity Creation Is Not Having the Same Effect on Equity Markets

By Brian Fabbri

Visiting Research Fellow, CAMRI & President, FABBRI Global Economics

Equity markets foretold stronger growth

In the May 2013 issue of CAMRI Global Perspectives,* I wrote that equity markets in most major economies throughout the world were rallying significantly. The major exception was the equity market in China, which had been slumping for the past few years. The issue then and now is that equity markets were a reflection of economic activity and therefore they were implying that global economic growth should begin to accelerate. In May of 2013 economic growth in the advanced economies was either stagnating or advancing well below potential.

How did that forecast fare?

Economies in the advanced world through Q1 2014 continue to grow at minimal rates and certainly not the robust rates implied by last year's equity market performance.

The Taper Tiger became a Kitten

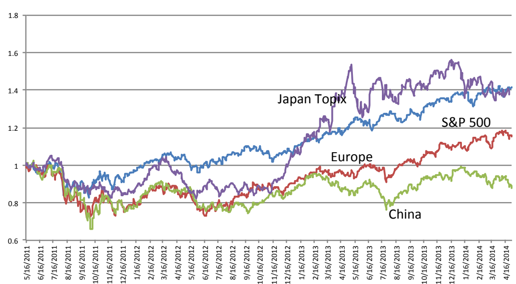
Last year I indicated that the disparity between robust equity market performance and dismal economic activity was primarily due to the enormous increase in global liquidity created by the major economies' central banks, and the restrictive fiscal policies conducted by governments in both the developed and developing regions. The latter restrained economic growth, and the former funded asset appreciation.

This year major central banks in the developed world continue to expand their balance sheets, albeit at a slightly slower pace than last year. The 'taper terror tiger' turned out to be a 'taper kitten'. The Federal Reserve in the US has reduced the size of its monthly security purchases to $45 billion per month from its peak of $85 billion per month. And, they are projected to trim purchases by $10 billion per month at each of the next 5 FOMC meetings, but their actions have had no discernable impact upon capital market prices, aside from the initial negative impact on US bond prices. Moreover, the aggregate developed world's central bank balance sheet continues to expand.

Equity markets are slumping in 2014

A comparison of global equity market performance in the first four months of 2014 (as shown in chart 1) reveals that the explosive appreciation in wealth in the US greatly simmered this year (1.9%); doubt replaced optimism in Japan (-11%); China kept stumbling (-9.5%); and only Europe enjoyed a relatively healthy increase (4%). This modest global equity market performance suggests that the equity markets have fully factored in a moderate improvement in world economic growth in 2014 and are not anticipating much faster growth in the years beyond.

Global Comparison of Equity Market Performance in past 3 years



The outlook for economic growth in 2014-15 is mixed

According to the IMF** and several other leading economic forecasting services the outlook for global economic growth this year and next is positive, but diverse. World economic growth is forecast to recover from a relatively low rate of 3% growth in 2013 to a modestly stronger 3.2% in 2014 and 3.7% in 2015.

The expected increase in world economic growth is primarily due to anticipated acceleration in growth in the West. US economic growth is forecast to increase from dismal to moderate rates, and in Europe, its regional economy is expected to emerge from its long recession.

In the East economic growth is projected to decelerate rapidly: especially in Japan after the imposition of the increase in the consumption tax in Q2 2014; and in China where growth is forecast to continue to moderate over the next few years after a decade of relatively rapid growth.

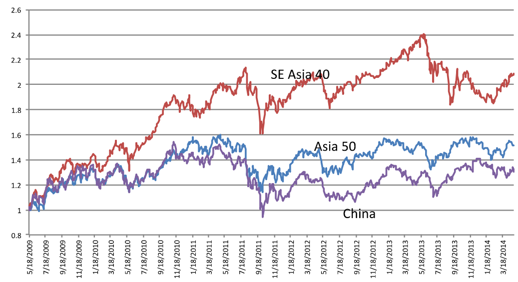
World commodity prices are forecast to continue declining

One inconsistency in the IMF outlook needs to be highlighted and that is their forecast for a continued decline in commodity prices. Historically there has been a very high positive correlation between commodity prices and industrial production. If commodity prices are expected to fall in a rising world economic growth scenario, then either services are anticipated to account for all of the projected growth, or the supply of commodities is suddenly expected to increase significantly.

Asia is expected to benefit from the west

Economic growth in emerging Asian economies from Korea to Thailand, barring any prolonged uncertainty from recent military action, is expected to improve, or at least to maintain their recent rates of growth. The prediction for relatively higher rates of growth in emerging Asian economies is predicated on the assumption that they will benefit more from faster economic growth in the advanced western economies than they will lose from the slowdown in growth in the major economies in the East.

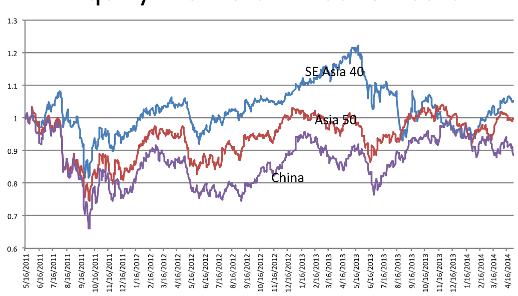
Comparative Performance of Asian Equity Markets in Past 5 Years#



Emerging equity markets in Asia are not optimistic

Investors in Asian equity markets are not optimistic about the prospects for improving economic growth in Asia. Judging from the comparative performance shown in chart 3 only the new Asian tigers have had any equity price appreciation this year, 10.5%. Over the past three years this group

Comparative Performance of Asian Equity Markets in Past 3 Years



of new emerging economies' equity markets have thoroughly outperformed the older tiger economies and China. Although their equity markets are much more volatile than the older tigers' markets, their economic growth as a group in 2012 and 2013 was double that of the old tiger economies, albeit, it was not as robust as China's. The IMF anticipates that their growth will continue to exceed that of the old tigers that have reached a mature stage of economic development.

One critical caveat to the estimates for the new tigers, which will restrain both economic growth and equity performance in 2014, is the political discord in Thailand. This economy is suffering through another military coup after months of violent political disruption and it will take a toll on economic growth this year.

Growth of Major Global Regions (%chg)

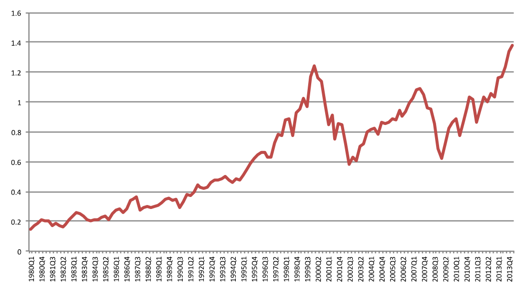
	2011	2012	2013	2014*	2015*
United States	1.8	2.7	1.8	2.4	2.9
Europe	1.6	-0.7	-0.5	1.0	1.2
Japan	-0.5	1.4	1.5	1.2	0.8
China	9.3	7.6	7.6	7.3	7.0
Old Tigers	4.2	1.8	2.7	3.1	3.5
New Tigers	4.3	6.2	5.1	4.5	5.3
World	3.9	3.2	3.0	3.2	3.7

*estimates by IMF and Fabbri Global Markets

China's equity market continues to languish

China's economic growth is forecast to diminish slowly over the next several years as its leaders stress structural changes instead of economic growth. Extremely large pools of debt, much of which is probably in default, are besetting the economy and making global investors wary. The government has to choose how to motivate more strict bad debt write offs in order to free up the banking system to extend more growth oriented credit. They must also rein in the burgeoning pile of off balance sheet credit, which has funded real estate speculation and the financing of unprofitable and superfluous public sector projects.

US Total Market Capitalization Relative to NGDP@

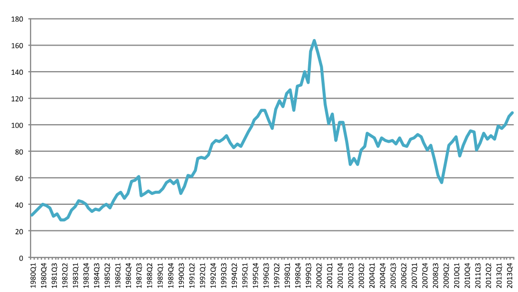


@Sourse: Fed. Res. Flow of Funds; 2014Q1 Market capitalization is in estimate.

Liquidity creation is not having the same beneficial effect on markets

The expansion of major central bank balance sheets is not having the same positive effects on equity markets that it did last year. Judging from the modest world economic growth improvement forecast in table one it appears that equity markets have more than fully incorporated these forecasts into market valuations.

Tobin's Q through 2013Q4 is Signaling over value@



@ Source: Fed. Res. Flow of Funds; 2014Q1 is estimate.

Two prominent valuation metrics

This conclusion is supported by two of the most prominent and respected market value metrics. For example, as shown in chart 4, the total capitalization of the US equity market has soared to an estimated 126% of US nominal GDP. The theory behind this ratio is that the market (viewed by total equity capitalization) should grow along with the nominal growth of the economy. This ratio has averaged 65% over the past 60 years implying that there was opportunity to invest in equity throughout most of this period. Famous and successful investors such as Warren Buffet have often used this ratio as a guide to stock market attractiveness, or vulnerability.

A second metric with a similar result is presented in chart 5: Tobin's Q. This Nobel Prize winning economist created this valuation metric, which compares the aggregate replacement cost of US corporate assets with their market capitalization. A value above 1 is a warning that market values are too high relative to replacement cost. Historically, Tobin's Q has averaged 0.7 implying similar to the TMC metric that there has been opportunity for investment in US equities over long periods of time and this is consistent with the long term positive returns in US equities.

Conclusion: equity markets are vulnerable

These valuation tools suggest that the US equity market is presently more than fully discounting expected modest future economic growth and corporate profitability. Consequently, it implies that the equity market is vulnerable to the time in the not so distant future when the Federal Reserve starts to raise its base interest rate, and begins to shrink its balance sheet.

*CAMRI Global Perspectives Issue 3, May 2013.

**International Monetary Fund World Economic Outlook, April 2014.

#SE Asia 40 (the New Tigers) is the S&P stock market indexes for Philippines, Thailand, Indonesia, and Malaysia.

Asia 50 (the old Tigers) is the S&P stock market indexes for Singapore, South Korea, Taiwan, and Hong Kong.

For more information, please contact
camri@nus.edu.sg

	KEY INDICATORS TABLE (AS OF 23 May 2014)							
INDEX	**LEVEL (LC)**	**%1MO (LC)**	**%1MO (USD)**	**%1YR (LC)**	**%1YR (USD)**	**INDEX**	**LEVEL**	**%1YR**
S&P500	1900.53	1.57%	1.57%	17.58%	17.58%	3MO LIBOR	0.23	-15.91
FTSE	6815.75	2.62%	2.87%	5.83%	17.76%	10YR UST	2.53	25.61
NIKKEI	14462.17	-0.58%	-0.29%	1.52%	1.44%	10YR BUND	1.41	-2.09
HANG SENG	22965.86	2.93%	2.93%	5.60%	5.73%	10YR SPG	2.99	-30.45
STI	3278.02	1.68%	2.00%	-0.38%	0.45%	10YR SGS	2.34	45.64
EUR	1.36	-1.36%		5.37%		US ISM	54.90	9.80
YEN	101.97	-0.56%		-0.05%		EU PMI	52.50	14.30
CMCI	1502.76	-0.51%		2.38%		JP TANKAN	12.00	250.00
Oil	104.35	2.87%		10.72%		CHINA IP	8.70	-6.50

Source: Bloomberg

APPENDIX

GLOSSARY OF KEY TERMS (Source: Bloomberg, with tickers in parenthesis. In US$ where applicable)
S&P500: capitalization-weighted index of the prices of 500 US large-cap stocks (SPX)
FTSE: capitalization-weighted index of the prices of the 100 largest LSE-listed stocks (UKX)
NIKKEI: capitalization-weighted index of the largest 225 stocks of the Tokyo Stock Exchange (NKY)
HANG SENG: capitalization-weighted index of companies from the Hong Kong Stock Exchange (HSI)
STI: cap-weighted index of the top 30 companies listed on the Singapore Exchange (FSSTI)
EUR: USD/EUR exchange rate: 1 EUR = xx USD (EUR)
YEN: YEN/USD exchange rate: 1 USD = xx YEN (JPY)
CMCI: Constant Maturity Commodity Index (CMCIPI)
Oil: West Texas Intermediate prices, $ per barrel (CLK1)
3MO LIBOR: interbank lending rate for 3-month US dollar loans (US0003M)
10YR UST: 10-year US Treasury yield (IYC8 – Sovereigns)
10YR BUND: 10-year German government bond yield (IYC8 – Sovereigns)
10YR SPG: 10-year Spanish government bond yield, proxy for EU funding problems (IYC8 – Sovereigns)
10YR SGS: 10-year Singapore government bond yield (IYC8 – Sovereigns)
US ISM: US business survey of more than 300 manufacturing firms by the Institute of Supply Management that monitors employment, production inventories, new orders, etc. (NAPMPMI)
EU PMI: Purchasing Managers' index for the 17-country EU region (PMITMEZ)
JP TANKAN: Bank of Japan business survey on the outlook of Japanese capital expenditures, employment and the overall economy, quarterly index (JNTGALLI)
CHINA IP: China's Industrial Production index, with 1-month lag (CHVAIOY)
LC: Local Currency