

Topics: Geopolitics and markets; red flags raised by the Fed and the BIS on risk-taking

You can be forgiven for thinking that the world is a pretty terrible place right now: the downing of a Malaysian jetliner in eastern Ukraine and escalating sanctions against Russia, the Israeli invasion of Gaza, renewed fighting in Libya, civil wars in Syria, Afghanistan, Iraq and Somalia, Islamist insurgencies in Nigeria and Mali, ongoing post-election chaos in Kenya, violent conflicts in Pakistan, Sudan and Yemen, assorted mayhem in central Africa, and the situation in North Korea, described in a 2014 United Nations Human Rights report as having no parallel in the contemporary world. Only in Colombia does it look like a multi-decade conflict is finally staggering to its end. For investors, strange as it might seem, such conflicts are not affecting the world's largest equity markets very much. Perhaps this reflects the small footprint of war zone countries within the global capital markets and global economy, other than through oil production.

War zone countries as a % of total world...	
Population	11.7%
Oil production	9.0%
Foreign direct investment	3.8%
GDP	3.0%
Trade	2.6%
Gross capital formation	2.4%
Corporate profits	0.8%
Equity market capitalization	0.7%
Interbank claims	0.5%
Portfolio investment inflows	0.4%

Sources: IMF, United Nations, BP, MSCI, Bloomberg, BIS, World Bank, WTO.

The limited market impact of geopolitics is nothing new. This is a broad generalization, but since 1950, with the exception of the Israeli-Arab war of 1973 (which led to a Saudi oil embargo against the US and a quadrupling of oil prices), military confrontations did not have a lasting medium-term impact on US equity markets. In the charts below, we look at US equities before and after the inception of each conflict in three different eras since 1950. The business cycle has been an overwhelmingly more important factor for investors to follow than war, which is why we spend so much more time on the former (and which is covered in the latter half of this note).

As for the war-zone countries of today, one can only pray that things will eventually improve. Seventy years ago as the invasion of Normandy began, Europe was mired in the most lethal war in human history; the notion of a better day arising out of misery is not outside the realm of possibility.

S&P 500 Index around military invasions and conflicts (1950 - 1968)

Index, month of invasion = 100



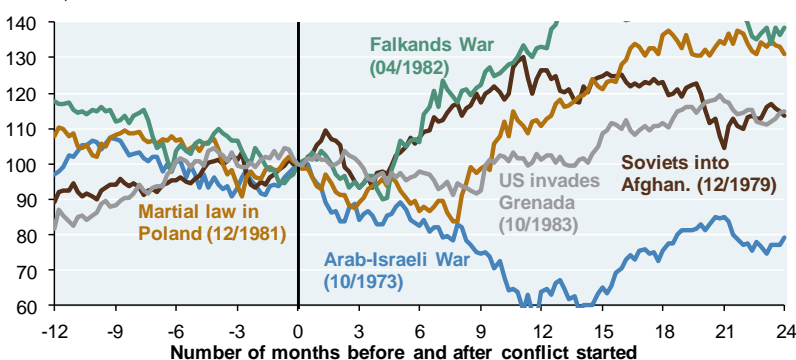
Source: Bloomberg. April 2014. Equity index represents price returns.

Soviet invasions of Hungary and Czechoslovakia did not lead to a severe market reaction, nor did the outbreak of the Korean War or the Arab-Israeli Six-Day War.

We did not include the US-Vietnam war, since it's hard to pinpoint when it began. One could argue that Vietnam-era deficit spending eventually led to rising inflation (from 3% in 1967 to 5% in 1970), a rise in the Fed Funds rate from 5% in 1968 to 9% in 1969, and a US equity market decline in 1969-1970 (this decline shows up at the tail end of the S&P series showing the impact of the Soviet invasion of Czechoslovakia).

S&P 500 Index around military invasions and conflicts (1973 - 1983)

Index, month of invasion = 100

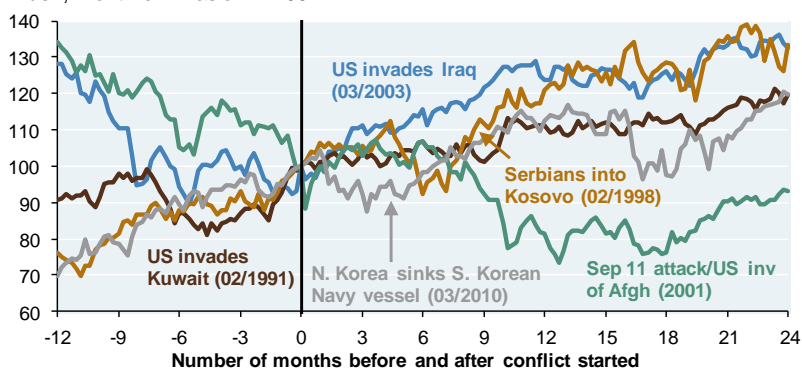


Source: Bloomberg. April 2014. Equity index represents price returns.

The Arab-Israeli war of 1973 led to an oil embargo and an energy crisis in the US, all of which contributed to inflation, a severe recession and a sharp equity market decline. Pre-existing wage and price controls made the situation worse, but the war/embargo played a large role. Separately, markets were not adversely affected by the Falklands War, martial law in Poland, the Soviet war in Afghanistan, or US invasions of Grenada or Panama. The market decline in 1981 was more closely related to a double-dip US recession and the anti-inflation policies of the Volcker Fed.

S&P 500 Index around military invasions and conflicts (1991 - today)

Index, month of invasion = 100



Source: Bloomberg. April 2014. Equity index represents price returns.

Note: it is not possible to invest directly in an index.

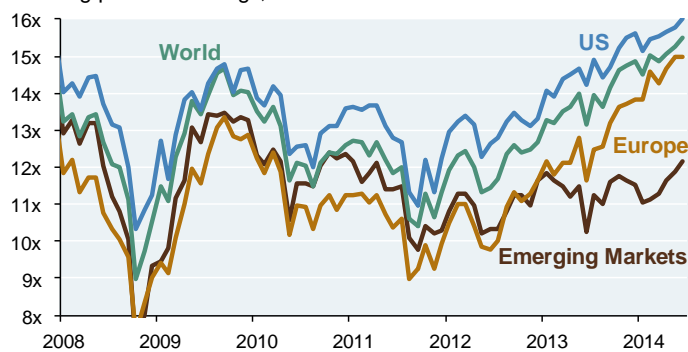
Equity market reactions to US invasions of Kuwait and Iraq, and the Serbian invasion of Kosovo, were mild. There was a sharp market decline after the September 11th attacks, but it reversed within weeks. The subsequent market decline in 2002 was arguably more about the continued unraveling of the technology bust than about aftershocks from the Sept 11th attacks and Afghan War. As for North Korea, in a Nov 2010 EoTM we outlined how after North Korean missile launches, naval clashes and nuclear tests, South Korean equities typically recover within a few weeks.

Prophet warnings. So far, the year is turning out more or less as we expected in January: almost everything has risen in single digits (US, European and Emerging Markets stocks, fixed-rate and inflation linked government bonds, high grade and high yield corporate bonds, and commodities). What made last week notable: concerns from the Fed and the Bank for International Settlements (a global central banking organization) regarding market valuations. The BIS hit investors with a 2-by-4, stating that “it is hard to avoid the sense of a puzzling disconnect between the market’s buoyancy and underlying economic developments globally”. The Fed also weighed in, referring to “substantially stretched valuations” of biotech and internet stocks in its Monetary Policy Report submitted to Congress. What should one make of these prophet warnings?

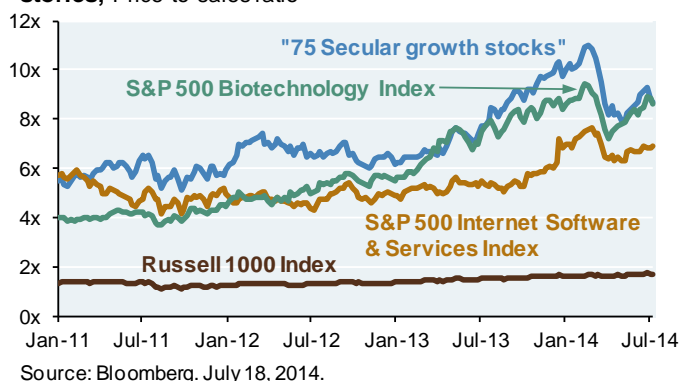
Let’s put aside the irony of Central Banks expressing concern about whether their policies are contributing to aggressive risk-taking. They know they do, and relied on such an outcome when crafting monetary policy post-2008. Instead, let’s look at measures of profits and how markets are valuing them. The first chart shows how P/E multiples have risen in recent months, including in the Emerging Markets. The second chart shows valuations on internet and biotech stocks referred to in the Fed’s Congressional submission. The third chart shows forward and median multiples, an important complement to traditional market-cap based multiples.

Equity valuations across regions

Trailing price-to-earnings, sector-neutral



Source: MSCI, J.P. Morgan Securities LLC. June 2014.

Internet and Biotech stocks: the "secular growth" stories, Price-to-sales ratio

Source: Bloomberg. July 18, 2014.

S&P 500 P/Es: Forward and median trailing

Price-to-earnings ratio



Source: Deutsche Bank, Bloomberg. June 30, 2014.

Past performance is no guarantee of future results. It is not possible to invest directly in an index.

Are these valuations too high? Triangulating the various measures, US valuations are close to their peaks of prior mid-cycle periods (ignoring the collective lapse of judgment during the dot-com era). We see the same general pattern in small cap. On internet and biotech, valuations have begun to creep up again after February's correction, and I would agree that investors are paying a LOT of money for the presumption that internet/biotech revenue growth is "secular" and less explicitly linked to overall economic growth.

As a result, we believe earnings growth is needed to drive equity markets higher from here. On this point, we see the glass half-full, at least in the US. After a poor Q1 and a partial rebound in Q2, US data are improving such that we expect to see the elusive 3% growth quarter this year (only 6 of 20 quarters since Q2 2009 have exceeded 3%). With new orders rising and inventories down, the stage is set for an improvement. Other confirming data: vehicle sales, broad-based employment gains, hours worked, manufacturing surveys, homebuilder surveys, a rise in consumer credit, capital spending, etc. **If we get a growth rebound, the profits impact could be meaningful.** The second chart shows base and incremental profit margins. Incremental margins measure the degree to which additional top-line sales contribute to profits. After mediocre profits growth of 5%-7% in 2012/2013, we could see faster profits growth later this year. With 83 companies reporting so far, Q2 S&P 500 earnings are up 9% vs. 2013.

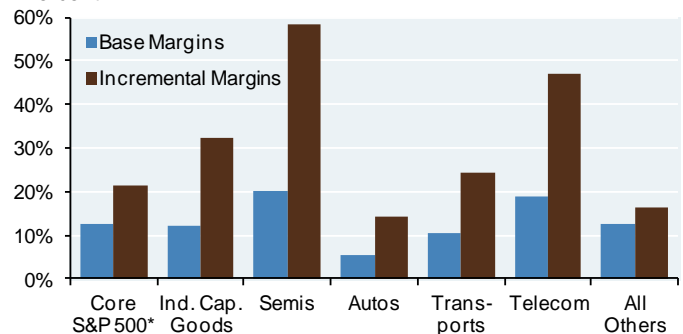
Stage set for a second half US recovery

US Markit manufacturing PMI components, 50+=expansion



Source: Markit. June 2014.

Base and incremental US pre-tax profit margins by sector



Source: Empirical Research Partners. Q1 2014.

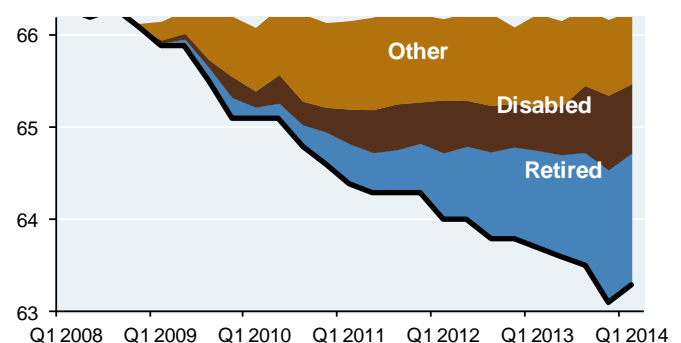
*Core S&P 500 is ex. Financials, Utilities and Energy.

Accelerated monetary tightening could derail interest-rate sensitive sectors of the economy, so we're watching the Fed along with everybody else. Perhaps it's a reflection of today's circumstances, but like Bernanke before her, Yellen appears to see the late 1930s as a huge policy fiasco: when premature monetary and fiscal tightening threw the US back into recession. That's what Yellen's testimony last week brings to mind: she gave a cautious outlook, cited "mixed signals" and previous "false dawns", and downplayed the decline in unemployment and recent rise in inflation. In other words, she's prepared to wait until the US expansion is indisputably in place before tightening.

An important sub-plot for the Fed: **where are all the discouraged workers?** For Fed policy to remain easy, as the economy improves, the pace of unemployment declines will have to slow and wage inflation will have to remain in check. The Fed believes discouraged workers will re-enter the labor force in large numbers, holding down wage inflation. Fed skeptics point out that so far, labor participation rates have not risen, creating the risk of inflation sooner than the Fed thinks. It's all about the "others" in the chart, since disabled and retired persons rarely return to work. If "others" come back, it would show that there hasn't been a structural decline in the pool of available workers. The Fed believes they will eventually return, and so do we.

Labor market dropouts by category

Labor force participation rate, percent



Source: Federal Reserve Bank of Philadelphia, Shigeru Fujita. Q1 2014.

Europe

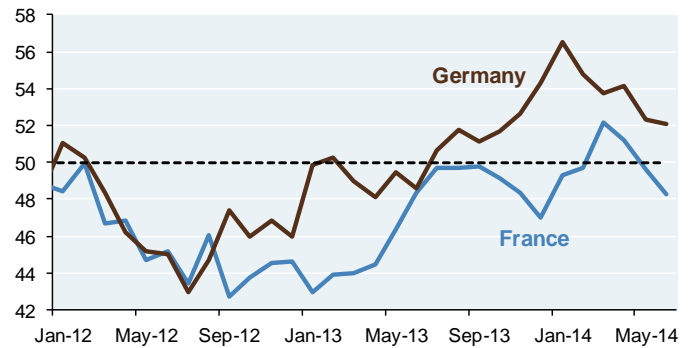
Germany and France are slowing; not catastrophically, but by more than markets were expecting. This has contributed to a decline in European earnings expectations for the year. As shown on page 2, Europe was priced for a return to normalcy, and with inflation across most of the Eurozone converging to 1%, things are decidedly not that normal. Markets are not priced for any negative surprises, which is why an issue with a single Portuguese bank contributed to a sharp decline in banks stocks across the entire region.

Earnings expectations for Europe on the decline
Y/Y MSCI Europe 2014 EPS growth expectations



Source: IBES. July 2014.

Some softer data in Europe, this time in the North
PMI Manufacturing Survey

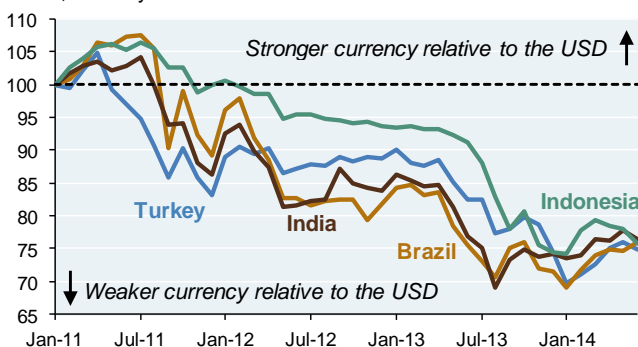


Source: Markit. June 2014.

Emerging Markets

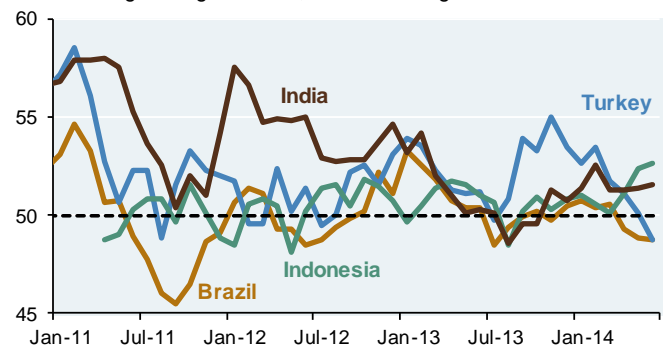
The surprise of the year, if there is one, is how emerging markets equities have rebounded. As we wrote in March 2014, the history of EM equities shows that after substantial currency declines, industrial activity often stabilizes. Around that same time, we often see equity markets stabilize as well, even before visible improvements in growth, inflation and exports. This pattern appears to be playing itself again: the 4 EM Big Debtor countries (Brazil, India, Indonesia and Turkey) have experienced equity market rallies of 20%+ despite modest improvement in economic data (actually, things are still getting worse in Brazil and Turkey).

Big 4 EM Debtors: currency devaluations vs. the USD
Index, January 2011 = 100



Source: respective national banks. June 2014.

Big 4 EM Debtors: a mixed bag of manufacturing surveys
Purchasing Managers' Index, manufacturing level



Source: Markit, J.P.Morgan Securities LLC. June 2014.

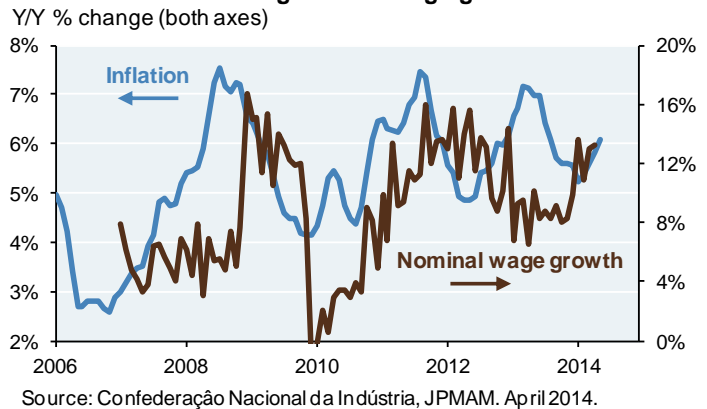
There's also some good news on the EM policy front. In **Mexico**, it appears that the oil and natural gas sector is being opened up after a 25% decline in oil production since 2004. This would effectively end the 75-year monopoly that Pemex has over oil production. Other energy-related positives: Mexico has shifted the bulk of its electricity reliance from oil to cheaper natural gas over the last decade, giving it low electricity costs along with its competitive labor costs. Factoring in new energy investment, new telecommunications and media projects opened to foreign investment and support from both private and public credit, we can envision a 2% boost to Mexico's GDP growth rate in the years ahead. This can not come soon enough for Mexico: casualties in its drug war rival some of the war zone countries on page 1.

Now for the challenges. Brazil has bigger problems right now than its mauling at the World Cup. With goods exports, manufacturing and industrial confidence slowing and wage/price inflation rising, Brazil is about to experience a modest bout of stagflation. Markets don't appear to care (yet).

Brazil: industrial confidence at lowest level since 2009

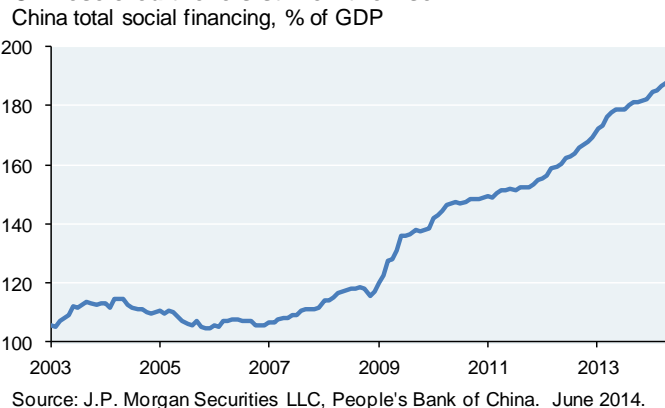


Brazil: inflation and wages are rising again



As for China, growth has stabilized (7%-8% in Q2) but we should be under no illusion as to why: credit growth is rising again. China ranks at the top of list of countries in terms of corporate debt/GDP. I don't know what the breaking point is, but we're a long way from pre-crisis China when GDP growth was organically driven and less reliant on expansion of household and corporate debt¹. There's some good news regarding the composition of growth: investment is slowing in manufacturing and real estate, and increasing in infrastructure; and while capital goods imports are flat, consumer goods imports are rising, suggesting a modest transition to more consumer-led growth. But for investors, the debt overhang of state-owned enterprises and its impact on the economy is the dominant story to watch. That explains why Chinese equity valuations are among the lowest of EM countries (only Russia is lower; for more on its re-militarization, economy and natural gas relations with Europe, see *"Eye on the Russians"*, April 29, 2014).

Chinese credit levels still on the rise



Global manufacturing surveys point to H2 2014 rebound



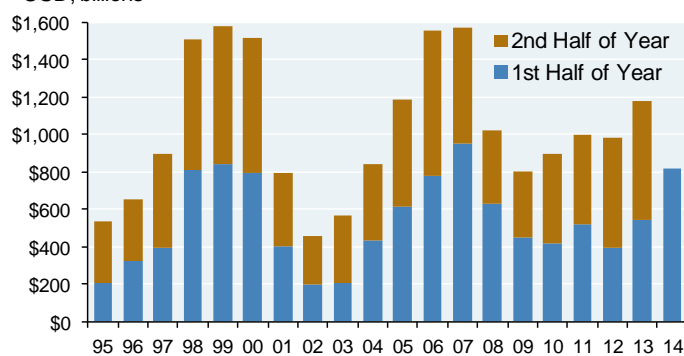
On a global basis, demand and inventory trends suggest a pick-up in economic activity in the second half of the year. If so, our high single digit forecast for 2014 equity market returns should be able to withstand the onset of (eventually) tighter monetary policy in the US. The ongoing M&A boom (see chart on next page) probably won't hurt either.

Michael Cembalest
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¹ According to Gavekal Dragonomics Research, rising debt is not just a China issue. Leverage across Emerging Asia ex-China has risen and is now at levels last seen before the 1998 financial crisis.

US M&A deal volume on the rise

USD, billions



Source: Dealogic and UBS. July 2014.

War zone countries. The list was compiled using a variety of sources (Council on Foreign Relations, CIA Factbook, etc). Criteria for inclusion: active civil wars, cross-border wars and invasions, revolutions and insurgencies. I included North Korea, which is in such a constant state of extreme repression and torture such that it can be thought of as being in a de-facto civil war (military spending/GDP of 30%-40%, troop to population ratio of 5%; both 5x-10x US, China and Russia levels).

Countries included: Afghanistan, Democratic Republic of the Congo, Central African Republic, Colombia, Palestinian Territories, Iraq, Israel, Kenya, Libya, Mali, Nigeria, North Korea, Pakistan, Somalia, Sudan, Syria, Ukraine, Uganda and Yemen. Close call but excluded: Philippines. Included until (diminished) FARC guerrillas agree to a peace deal, the final terms of which are currently being negotiated: Colombia.

Acronyms:

BIS: Bank for International Settlements; EM: Emerging Markets; EPS: Earnings per share; P/E: Price-to-earnings multiple; EM: Emerging Markets; PMI: Purchasing Manager's Index; VAT: Value-added tax

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