FirstPoint Financial

WEEKLY MARKET THOUGHTS

November 3, 2014

Liftoff!

Bull markets are fun. While the world's stock markets struggled during the first half of October, they have equally soared during the second half. This past week, the markets, like a strong Saturn rocket booster, lifted off and powered higher on a consistent basis. The S&P 500 closed the month of October at 2018, lifting off from the low on October 15th of 1862, representing an upward charge of 8.4%.

Within my piece written on October 13th near the lows for the month, I stated:

Bull markets climb a wall of worry, and there is plenty to worry over currently. I don't casually dismiss the problems the world is facing – there are very good reasons to recognize all of the issues that surround us. But, there are ***strong historical reasons to consider putting some capital to work in the global financial markets***.

We don't want to get carried away with self-congratulatory statements – the markets make us all humble over periods of time. The real questions I wish to address are – ***why did the global equity markets rally over such a short period of time, and what should investors consider following the 8% rally in stock prices since the low?***

Why the Correction

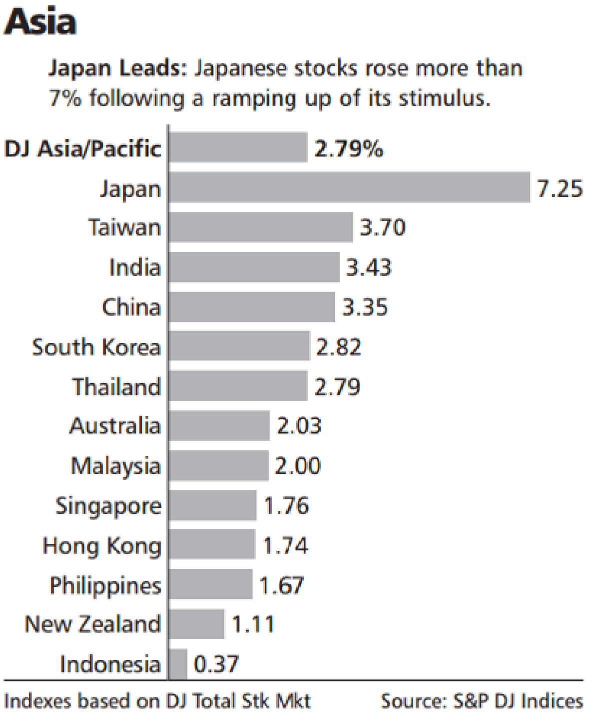
To determine what investment action may currently be appropriate, we need to attempt to understand why the correction in stock prices occurred from September to the middle of October. The reason most attach to the recent market selloff was rising concern about overall global economic growth. Europe remains on the brink of recession, China's growth has been systemically slowing and Japan's growth has been so weak that the risks of price deflation continue to haunt policymakers' thoughts.

Have all of these worries vanished? Of course not. But, economic news released over the last two weeks have highlighted continued growth. As the world's economies grow, company profits should also grow. As profits grow, stock prices tend to rise.

- U.S. GDP Growth: The U.S. economy grew by 3.5% in the third quarter in spite of weakness in a number of foreign economies. Investors were reminded that, while important, exports don't truly drive U.S. economic activity. Exports represent slightly less than 14% of overall economic activity in the U.S. If Europe's and China's growth rates are declining, the overall effect on corporate profits in the U.S. should prove limited.

- The end of QE3 Activities: Historically, the markets have reacted negatively when the Fed has ended prior quantitative easing episodes. Investors feared that this was going to be the case this time around. Through announcements over the last two weeks, the Fed helped alleviate those fears with a brighter-than-expected announcement on jobs and economic activity.

- Japan's deflationary pressures: On Friday, officials in Japan announced a new round of Quantitative Easing (just in time to take the place of U.S. QE activities). In addition, an announcement was made that Japan's government was going to change the asset allocation to stocks within their government-wide pension program. Up to this time, 25% of the fund's assets had been dedicated to stock holdings. The new allocation to equities will be 50% going forward. This isn't small potatoes. The fund's assets are $1.2 trillion. Doing the math shows that Japan's national pension system will allocate an additional $300 billion to stock holdings, half Japanese stocks and the other half foreign stocks. Asia's stock markets reacted very positively on Friday of last week to this news (see chart to the left).



Source: Barron's

- While growth problems persist in Europe, the banking system "stress test" results heartened investor's attitudes towards the European banking system. Regulators studied the financial condition of 123 banks in Europe and asked which of those banks would struggle to survive in another financial melt-down similar to 2008/2009. 25 banks failed the test, deemed as the most strict capital test the banking system has yet faced (although, still not as strict a test as I would like to see). Greek and Italian banks fared the worst (no surprise, there). The German and the Spanish banks did the best.* While economic growth in Europe remains poor, their financial system appears to be able to withstand an economic downturn.

- Corporate earnings. U.S. 3rd quarter earnings reports are well along. The average S&P 500 company has reported earnings gains of 6.5 % over last year's earnings. Additionally, more than 71% of companies reported have announced higher-than-expected earnings gains. Lastly, the quality of the earnings gains has been good. Sales growth rates (the more sustainable measure of rising earnings, as compared to profit margin expansion) have been stronger than expected, rising by 5.1% on average from last year, leading analysts to the overall belief that recent earnings gains may indeed be sustainable going forward.

With the above factors driving stock prices higher over the last two weeks, has risk left the marketplace? No. Has economic clarity improved over the last two weeks? Yes.

Buying Cheap Assets

Is now the time to put significant capital to work in the U.S. equity markets? Following are returns of various markets since the first of the year (local currency) and since the recent lows seen on October 15th (returns price only).

Market	Year to Date Return	Return since 10/15
S&P 500 (U.S.)	+9.0%	+7.8%
DAX (Germany)	-2.4%	+8.8%
CAC (France)	-1.3%	+7.5%
FTSE (U.K.)	-1.3%	+5.4%
Nikkei (Japan)	+0.8%	+9.0%
EEM (Emerging Markets)	+0.8%	+3.7%

As can be seen, the rally in equity markets since the middle of October has been broad-based, led by Japan and the markets in Europe. Valuations in these markets were, and still are, lower than those in the U.S., for good reason. Based on long-term historical norms, equity valuations appear cheap in many foreign markets, but not in the U.S. I have written on this valuation disparity extensively in the past.

Of course, when making an investment decision, knowledge of historical returns is not a driving factor. Valuation and identifying catalysts that can unlock value are. The emerging markets are currently selling at 12x earnings, about 10% below their long-term average valuation standard. As a comparison, the U.S. market is currently selling at 17x earnings, about 10% higher than its longer-term average. Additionally, as a whole, emerging economies are growing about twice as fast as the average national growth rate in Europe and the U.S.* For those who enjoy purchasing assets on the cheap, the ***emerging markets stand out as a potential opportunity.***

Enter Emerging Markets

So, “value” is present within the emerging market space. What catalysts can we identify that may eventually unlock this value? The shorter-term story aside, let’s take a peek at the longer-term reason many investors would consider placing some risk-based capital in the emerging markets.

Most of our regular readers know that I have been a fan of the emerging markets for some time. Over the long-term, I believe capital flows towards investments and countries where that capital will be well treated. What do I mean by this? Capital loves growth. Capital loves stable monetary policies and financial flexibility. The emerging economies possess both catalysts.

The Growth Story – Short-Term Outlook

“Real” (after inflation) economic growth is commonly measured by “real” GDP growth rates. The IMF (International Monetary Fund) is calling for the average emerging economy to grow in excess of 4% over the next 12 months. The same group is expecting the average Asian economy to grow in excess of 6% over the same period. This compares to overall economic growth of less than 3% in the U.S. and less than 1% in Europe. If we look at current valuation, as measured by P/E ratios, the emerging markets are selling at 3x GDP growth (P/E ratio of 12x and GDP growth of 4%) on average, whereas a combination of European and U.S. markets are selling at 7x GDP (P/E ratio of 14x and GDP growth of 2%). Emerging markets offer a higher economic growth profile for less money.

The Growth Story – Long-Term Outlook

Over the long-term, "real" GDP growth is driven by the size of a nation's workforce and the productivity of that labor force. Most emerging economies possess younger population bases than developed markets. The average ages in major developed economies are: U.S., 37; Japan, 47; and Germany, 45. Average ages in emerging economies are: India, 26; Brazil, 30; and Indonesia, 28.** As the developed economies population bases age, the workforces of the emerging economies will continue to grow over the next number of years, providing their economies with an expanding numbers of workers.

Additionally, the productivity of the emerging economies workforces has been rising rapidly. Productivity has grown in the developed economies by an average of 1.9% per year over the last 13 years (since 2000). The average emerging economy's per capita productivity growth rate has been well above 3% per year over the same period of time. In many cases, it appears these strong productivity trends will continue over the next number of years.

Time for Action?

Is now the time for investors to purchase additional exposure to the emerging markets? This depends on the investor's needs – your Wealth Advisor can help determine whether this would be a good option. But, in general, purchasing assets at reasonable values that could provide good, long-term growth tends to be a good recipe for investment success.

Just For Fun

With our optimistic bias towards the emerging economies, I found the following quotes to be interesting.

With a population of more than 600 million people, an emerging middle class that is driving strong consumption, and a robust and resilient economy, Southeast Asia represents a compelling growth opportunity for Starbucks.

Howard Schultz

The world is clearly emerging before our eyes. The shifts ahead, the opportunities ahead are massive.

Carly Fiorina

Emerging markets are hugely important.

James Dyson

We'll be back next week.

William B. Greiner, CFA
Chief Investment Strategist

More Information

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Market Insight

*Data sourced from Barron's

**Data sourced from Central Intelligence Agency

P. S. Please feel free to forward this commentary to family, friends, or colleagues. If you would like us to add them to the list, please reply to this e-mail with their e-mail address and we will ask for their permission to be added.