April 2018

Global Equity Outlook Q2 2018

Volatility returned to global equity markets in the first quarter of 2018 after an unusual period of calm. After climbing substantially in January, global equities corrected in early February and then churned upward and downward for the remainder of the quarter. For the full quarter, the overall market decline turned out to be quite modest. The S&P 500 was down 1.2%, while non-U.S. developed markets (as measured by MSCI EAFE) were down 1.5%. Emerging markets actually posted a small 1.4% gain during the quarter.

Going forward, we believe the positives for the global equity markets in 2018 are equally balanced with the negatives. On the positive side, the world economy continues to benefit from synchronized growth. Developed market GDP is forecast to grow close to 2.3% and emerging markets GDP is forecast to grow close to 4.4%. These numbers are higher than what was forecast six months ago. In addition, earnings growth is forecasted to be strong for 2018. According to our calculations, 2018 earnings growth is expected to be 20% in the US, 16% in Emerging Markets, 11% in Europe, and 16% in Japan (ex-financials).

In spite of robust global growth, inflation remains muted at 2.1% for the average developed market and 3.9% for the average emerging market. Outside of the U.S., monetary policy continues to be loose, boosting liquidity in most areas of the world, including the Euro-zone and Japan. On the negative side, monetary policy is beginning to be reversed. The US Fed has raised rates six times since the end of 2015 and will probably raise rates four times in 2018. Eventually, the European Central Bank and the Bank of Japan will have to figure out ways to exit their unconventional monetary policies. Additional headwinds for the global economy may be created by the introduction of protectionist trade policies or by unresolved issues relative to Brexit.

Then there is the question of market valuations. As of the end of March 2018, the trailing price-to-earnings ratio was 23x for the U.S., 17x for Europe and 15x for emerging markets. All of these were above their 10-year averages.

We continue to favor Emerging Markets, which offer several positives, including reasonable valuations, stabilized growth expectations, narrowing sovereign risk spreads, and solid price momentum. Moreover, for emerging market commodity exporters, export prices have been increasing relative to import prices.

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In Latin America, we continue to favor Brazil, which benefits from declining domestic interest rates, narrowing sovereign risk spreads, and strong equity price momentum. Within Asia, Taiwan offers attractive valuation ratios and favorable risk indicators, including a low beta vis-à-vis MSCI ACWI and a large current account surplus (equal to 12.5% of GDP). Malaysia is also overweighted as GDP growth forecasts have been upgraded by 0.6% over the past six months and the market's beta risk is modest.

In the developed markets, although we recommend some exposure to Continental Europe, which comprises 20% of the world's stock market capitalization and where growth is picking up, we are a little more cautious than consensus. We are underweight some of the European markets that have become relatively expensive, including Belgium and Denmark. We are also underweight in Germany and France, where price momentum is weak and company earnings revisions have been unfavorable.

The U.K. continues to be underweighted. It is running a large current account deficit and local currency price momentum and company earnings revisions have been weak.

In developed Asia, we continue to overweight Japan based on reasonable valuations, low beta risk, a modestly undervalued real exchange rate and solid local-currency price momentum. Singapore and Hong Kong have reasonable equity valuations and have attractive indicators of growth (including large upgrades to 2018 GDP forecasts) and risk (including low betas and sizeable current account surpluses). Australia is also an overweight due to inexpensive valuations and a positive terms-of-trade trend (due to firm global commodity prices).

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Contact Us:

inquiries@dcmadvisors.com
www.dcmadvisors.com

475 Park Avenue South, 9th Floor
New York, NY 10016
(917) 386-6260