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WEEKLY INVESTMENT COMMENTARY

Improving Global Growth: What it Means for Investors

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Markets Little Changed as Investors Await More Data

Stock prices bounced around a bit last week as investors digested some mixed economic and corporate earnings reports, but ended the week just about where they started. With several high-profile events and data releases due this week (including a Federal Reserve policy meeting and the release of July's employment data), it seems that markets have paused in advance of some potentially bigger news. For the week, the Dow Jones Industrial Average was up 0.1% to 15,558 and the S&P 500 Index was down fractionally to 1,691. Thanks to advances in the technology sector, the Nasdaq Composite climbed 0.7% to 3,613. In fixed income markets, Treasury yields climbed modestly (as prices fell), with the yield on the 10-year Treasury climbing slightly from 2.48% to 2.57%.

Weakening US Growth Presents Risks

As we have discussed on numerous occasions, investors remain highly focused on Fed policy – specifically, what will happen to the economy and the markets when the central bank pulls back on its asset-purchase programs. These concerns are certainly valid as the economic data continues to be mixed. Last week, we did see two strong reports—new home sales and durable goods orders were both solid. On the negative side, however, existing home sales were weak and the Chicago Fed National Activity Index (a forward-looking metric that has historically done a good job of forecasting future growth) came in weaker than expected. This marked the fourth month that this index had a negative reading, and it suggests to us that after a weak first quarter and an even weaker second quarter, the third quarter is off to a sluggish start.

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This weaker trend in economic data raises the prospect that corporate earnings estimates may need to be scaled back. So far, second-quarter earnings results have been passable, but it is important to remember that companies are beating already-lowered expectations. Analyst expectations for the third and fourth quarters are considerably higher and may need to be ratcheted down if growth disappoints. This scenario creates a potential risk for US stocks.

Better News for Global Growth

The good news, however, is that we are seeing some encouraging signs from outside the United States. In Europe, Spanish labor market and German business data suggest that the region is stabilizing. Should this trend continue, it could mean that continental Europe (which represents approximately one-fifth of global GDP) will stop being a drag on the world economy.

A more likely catalyst for improved global growth is Japan. Last week, Japan reported modest inflation, a good sign that stimulus efforts by the Japanese government and Bank of Japan (BOJ) are starting to work. Faster growth in Japan would have a real impact on global growth as Japan is the world's third largest economy.

Furthermore, the extraordinary efforts of the BOJ should help mitigate the potential loss of monetary liquidity that could come about if and when the US Fed does pull back on its bond purchases. The BOJ is currently purchasing seven trillion yen a month worth of bonds. To put that number in perspective, relative to the size of the Japanese economy these purchases are roughly three times the size of the Fed's monthly purchases. Additionally, while the Fed is likely to slowly taper (or slow the rate of purchases) over the coming months, the BOJ has indicated that it intends to keep up its bond-buying program for at least another two years.

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Focus on International Stocks, Mega Caps and Technology

From an investment perspective, we believe there are two significant implications of improving growth from abroad. First, for those investors who are dramatically underweight international equities, this may be a good time to consider increasing their allocations to non-US stocks. Second, if we do see improving growth from the rest of the world, large and mega-cap US stocks (particularly those in the technology sector) would be poised to benefit, since these companies derive a significant portion of their revenues from overseas.

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