



# 2014 outlook: the emergence of a global expansion

The Macro Strategies Group

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After years of a global recovery characterized by fits and starts, we expect more synchronized global growth in 2014. We estimate global GDP growth will accelerate modestly from 2.7% in 2013 to approximately 3.4% in 2014, primarily driven by larger advanced economies. In particular, we are optimistic that US growth will be sustainable. The fading economic drag from government policy and the ongoing housing recovery should help boost US GDP growth toward 3% as the year progresses. The UK is poised for a similar rate of expansion in 2014, and Europe will likely post positive growth in the coming year. After 18 months of recession, even marginally positive economic growth out of Europe will contribute significantly to the global recovery. Japan should experience positive but decelerating growth in 2014; however, there is optimism that economic reforms will work to strengthen growth over time.

So, what impact would a synchronized global expansion have on interest rates, currencies and equity markets? And, what risks should investors be aware of in the coming year? Our macro strategies group answers these questions in the following sections.

## CENTRAL BANKS AND INTEREST RATES

By James Balfour, Senior Global Economist

While we expect global growth to accelerate next year, monetary policy cycles are on different tracks around the world. In the US, the Federal Reserve (the Fed) has responded to increased US economic strength by modestly tapering its quantitative easing (QE) program at its December meeting. We believe the Fed will incrementally decrease its monthly Treasury and mortgage-backed securities (MBS) purchases, with the program terminating by the end of 2014. The Fed has gone to great lengths to separate the start of tapering from the expected “lift-off” date for rate hikes. Since we believe the job market will recover very slowly and inflation will remain subdued, we expect the central bank to hold the federal funds rate at its current level until late 2015. To be sure, US interest rate volatility is likely to increase as time passes, the economy strengthens and the market tests the Fed’s resolve to keep rates low. However, in an environment of stronger US growth, Fed tapering and a low federal funds rate, we expect longer-dated US bond yields to move higher—but not by much more than another 50 to 100 basis points.

The rise in US Treasury yields from May to September lifted yields globally, which put downward pressure on global growth and inflation. Some countries have felt a greater impact than others. Of the advanced economies, the euro zone is showing the most sensitivity to the rise in yields. Higher yields and a stronger euro pose risks to the European recovery. Since exports have been a key driver of the recovery, the European Central Bank (ECB) will likely seek new ways to ease monetary policy in 2014 to combat appreciation pressures on the euro. However, the ECB does not appear ready to initiate an aggressive program any time soon, so Europe’s long-term yields should still rise in sympathy with US yields. European countries with the lowest interest rates, for example Germany, Austria and the Scandinavian countries, are more likely to see rates rise, while higher-yielding countries should be more resilient and may even experience rate decreases, depending on their fundamentals.

Outside of some volatility, Japanese interest rates have remained insulated from the global rise in rates, primarily as a result of the country’s commitment to asset purchases through the end of 2014. Prime Minister Shinzo Abe has committed to fiscal stimulus of about ¥5 trillion (\$50 billion) to help offset the April 2014 hike in the value-added tax (VAT) from 5% to 8%. Asset purchases will likely be extended until inflation reaches the current goal of 2%, but if the VAT hike stalls the economy, an outright expansion of QE by mid-2014 is possible.



During 2013, slower growth in some major economies, including China, put downward pressure on the growth rates of most emerging market (EM) countries. Many EM countries, including Colombia, Russia and Hungary, are poised to cut rates in the near future, while other countries, such as Brazil and Indonesia, are facing inflation pressures and are likely to hike rates. Looking beyond 2014 when global growth is expected to be stronger, most countries should be hiking rates and bond yields are likely to be a bit higher globally.

## CURRENCIES

By Rick Harrell, Sovereign Analyst

Better US growth and a less accommodative Fed will likely cause the US dollar to strengthen versus most major developed market currencies, particularly the euro and yen given the expected policy easing of the ECB and Bank of Japan. And, the US' improving trade balance profile from increased domestic oil and gas production offers further support for the dollar. Within the developed world, the New Zealand dollar is the rare exception that should appreciate against the US dollar, since the currency is positioned to benefit from the nation's ongoing construction boom and increasing trade with China's growing middle class.

Emerging market currencies will face an uphill battle when paired against the US dollar. Indonesia, Turkey, Brazil and South Africa have been among the most reliant on foreign capital to finance growth. However, policymakers in these countries have failed to deliver productivity-enhancing reforms, and as a result, returns on capital have fallen and foreign investment has been slowing. In 2014, we expect countries with growth-friendly policy outlooks and strong current account positions to gain against the US dollar and outperform relative to their EM peers. In particular, Mexico, South Korea and the Philippines fit this profile.

## EQUITY MARKETS

By Richard Skaggs, Senior Equity Strategist

Investors are concluding one of the best years of equity market performance in recent history, with the US, European and Japanese equity markets showing strong double-digit gains. Looking ahead to 2014, the fundamental drivers of this favorable equity market performance—accommodative central banks and moderate but consistent US growth—remain intact. These factors should be supported by new fundamental drivers in 2014, including positive European growth and Japan's accelerating corporate earnings.

Developed market equity valuations have recovered since the financial crisis, and earnings multiples have returned to levels close to long-term averages. If global earnings growth improves in 2014 as we anticipate, investors may be in a position to build on recent gains. Specifically, US earnings growth should continue to follow the mid to high single-digit path of recent years. While European earnings have remained weak, they should improve as the European recovery strengthens.

Robust developed market performance over the past few years has been supported not just by the global economic recovery but also by an attractive valuation case relative to low interest rates and inflation. While the valuation advantages versus fixed income and inflation remain intact, earnings growth will likely become more important for sustained positive performance in 2014.

Emerging market equities have largely sat out the recent rally, with the typical EM economic drivers (the commodity and energy sectors) under pressure. Relatively higher inflation has been a negative factor in some EM nations, pressuring the currencies at the same time. While our fundamental work continues to favor developed markets over emerging markets in the first half of 2014, we recognize that many EM equities carry lower-than-average valuations. When positive catalysts appear, EM equities may be due for some catch-up, as they have generally lagged developed markets since peaking in 2011. Overall, we intend to monitor fundamental macroeconomic developments, with a focus on signs of improving global growth, to assess the trajectory of equity markets as we move into 2014.



## RISKS TO OUR OUTLOOK

By James Balfour, Senior Global Economist

For the first time in years, we see macroeconomic risks tilted to the upside, with diminishing risks for developed economies and increasing risks for emerging economies. Many EM countries appear late in their credit cycles, following a surge of debt creation and weakening profitability. China is in this category; however, China's very aggressive economic reform plans may prove pivotal in managing these headwinds. The primary risk for China is that attempts to constrain credit and adverse short-term impacts from economic reforms combine to cause another negative growth surprise.

We believe developed economies are slowly progressing toward modest but synchronized growth, where consumers gain confidence and companies shift toward more hiring and investment. The favorable outlook for lower energy prices should allow for a more sustainable period of global growth, unlike the recent past when rising energy prices curtailed potential growth rates. That said, we continue to monitor a long list of macroeconomic risks, many of which are for advanced economies. For example, over the longer run, we are cautiously optimistic that increased consumer spending and business investment will extend the current business cycle, but we have not seen these effects yet. In addition, we could experience some short-term volatility due to a jump in yields. Specifically, aggressive Fed tapering could drive a reduction of leverage in financial markets and volatility in asset prices. We could also see another showdown over the US debt ceiling, a fall in Japanese consumer spending driven by the VAT hike, or social discontent across emerging markets as their countries underperform. With ongoing structural issues, Europe also remains a concern.

### SUMMARY

While there are areas of concern, we remain enthusiastic about economic prospects for 2014. Stronger growth should generate stronger corporate profits, a lift in confidence and a more resilient economic environment. Though many countries are engaged in a significant transition of one kind or another, we remain confident that US growth will be sustainable and expect the US to serve as a ballast for the global economy over the next few years. We believe the majority of the world has entered the latter half of the credit cycle, meaning that rising interest rates, moderating liquidity and increasing corporate leverage could lie ahead. We expect stocks to outperform bonds through the end of this cycle, and depending on how companies manage their capital structures going forward, corporate bonds could be poised to outperform US Treasuries for a few more years.



## ABOUT THE AUTHORS

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Jim is a vice president and senior global economist at Loomis, Sayles & Company, where he contributes to the development of the firm's investment strategies and global macroeconomic outlook. He joined Loomis Sayles in 2000 and has held several positions during his tenure at the firm, including economic research analyst and research associate. He has 15 years of investment industry experience, having previously worked as a senior account manager at Brown Brothers Harriman and as a fund accountant at State Street Corporation. Jim earned a BA in business administration from the University of Maine and an MBA from the Carroll School of Management at Boston College.

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