Taking Stock of the Market’s Mood

International stocks continue to outperform, while U.S. equity returns may be choppy and more subdued going forward.

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Key Takeaways

• The global synchronized recovery, driven by China’s massive credit stimulus in early 2016, has resulted in the first extended period of international stock outperformance since 2011.

• U.S. equities have also been strong, but with economic momentum peaking, expect more subdued and more volatile performance in the near term.

• Aside from unpredictable geopolitical events, two potential longer-term risks are an inverted yield curve in the United States and a collapse of China’s credit impulse.

• With international stock valuations lower than the U.S., now continues to be a good time for investors to re-evaluate the balance of their global equity exposure.

The set of questions I’m asked by a network producer in preparation for a TV appearance is always a good window into the mood of the market. Prior to a recent interview, for example, I was asked to answer three questions: what are your top-conviction ideas; has your forecast or strategy changed since the start of the year; and what key risks does the market face?

The time constraints of a live broadcast don’t always allow me to answer these questions in detail. So I’d like to take this opportunity to provide readers with a more comprehensive reply. Keep in mind that these are my opinions and not necessarily the consensus view of Fidelity Investments.

“What are your top-conviction ideas?”

As regular readers of my commentaries will know, my top-conviction idea continues to be favoring international stocks relative to U.S. equities, for the following reasons:

• Since early 2016, the global business cycle has been in a synchronized upturn. The impetus: the resurgence of China’s economy (not the U.S. election, as many believe).

• Most global economies are earlier in the business cycle than the U.S. Therefore, they have fewer late-cycle headwinds like rising inflation and rising interest rates.
• Profit growth abroad has rebounded as much as it has in the U.S. (if not more), but with the benefit of doing so at a point of lower valuations than U.S. equities.

• From 2011 through early 2016, U.S. stocks consistently beat non-U.S. equities. But those who believe in mean reversion expect this gap will eventually close. It may already be happening, as both international developed-market and emerging-market (EM) stocks have beaten U.S. equities on a 12-month and year-to-date basis (see Exhibit 1 below).

• The international rally likely has more room to run. As of mid-May, EM stocks are up 46% from their February 2016 low, which has led to $29 billion of EM equity inflows. In comparison, the 157% EM rally from 2008 to 2010 led to $155 billion of inflows. So, the EM recovery we’ve seen to date hardly seems excessive on that basis.

• I especially like Europe, as I have all year. The Eurozone’s manufacturing and services indicators have been strong, its inflation index and economic growth are recovering, consumer confidence is rising, and the outcome of the French election was greeted favorably by the market.

EXHIBIT 1: After a multiyear cycle of underperformance, international stocks have been more competitive during the past 12 months.

| U.S. AND INTERNATIONAL STOCK RETURNS (PERIOD ENDING MAY 19, 2017) |
|-----------------------------|-----------------|-----------------|-----------------|-----------------|
|                             | 5-Year Return   | 3-Year Return   | 1-Year Return   | Year-to-Date    |
| U.S. Stocks                 | 15.4%           | 10.4%           | 19.2%           | 7.2%            |
| International Developed     | 10.3%           | 2.4%            | 20.0%           | 13.8%           |
| Emerging Markets            | 4.7%            | 1.4%            | 30.8%           | 16.1%           |


“Any changes to your 2017 forecast?”

My forecast for the markets has really not changed since the start of the year.

Interest rates and the Fed: At 2.23% as of May 19, the 10-year U.S. Treasury yield appears fairly valued and is near the middle of its 2.0% to 2.6% range since the U.S. election. I believe it offers value at the higher end of that range, but not as much at the lower end. The fate of the 10-year yield rests mostly with the Federal Reserve (Fed)—not in terms of whether it makes its second rate hike of 2017 in June (largely expected), or even a third time in 2017, but in terms of how many times it raises rates over the rest of the cycle. For now, the market is in sync with the Fed, but what about in 2018 and beyond? The Fed funds curve is pricing in three to four more hikes over the next two years. If that remains the case, the 10-year yield should stay anchored between 2% and 3%.

But if rates rise more substantially, the yield curve could potentially invert (meaning shorter-term yields exceed longer-term yields) in 2018 or 2019. As students of history know, an inverted curve has a good track record of preceding recessions.

U.S. equity momentum: U.S. equity returns could be choppy and more subdued going forward, for two reasons. First, the global economy has likely reached peak reflation—the point in the cycle when economic momentum reaches its maximum acceleration (not to be confused with peak output). Second, the market needs to “grow” into its new valuation. Since the November 2016 election, the S&P 500’s trailing price-to-earnings ratio (P/E) has jumped nearly three points (to 21x) in anticipation of better earnings growth. But the S&P 500 will need to grow into its higher valuation. I think it will, and the earnings recovery has been impressive so far. Nevertheless, price gains may lag earnings growth for a
while as the P/E ratio comes back down.

**Earnings**: Year-over-year earnings-per-share (EPS) growth for Q1 2017 is currently at 14%, tracking the historical pattern of estimates being low at the start of earnings season and then rising during reporting season (the estimate was 9% on March 31).\(^1\) Granted, the comparison to Q1 2016 EPS growth (~7%) is easy, but the overall pattern looks good. For the full year, assuming the usual seasonal drift holds, 2017 calendar-year EPS should be about 8% above 2016, and 2018 should come in about 6% above 2017.

**The U.S. dollar**: After a two-year rally, the U.S. Dollar Index reached a 14-year high of $103.8 on January 3, but closed at $97.1 on May 19. I’ve been a dollar bear all year, and I continue to expect it to drift lower in the months ahead. That has bullish implications for international stocks, and it should be pointed out that they’ve been outperforming in local currency terms as well.

“What risks might the market face?”

Other than external shocks (geopolitics, natural disasters, etc.), which are almost impossible to quantify, one potential risk is for U.S. stocks to become excessively valued. The S&P 500’s P/E of 21 has already priced in a hefty level of earnings growth. But if earnings disappoint, it leaves the U.S. stock market vulnerable. Another risk

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**EXHIBIT 2**: China’s GDP improved following its credit expansion in early 2016, but its credit growth has tailed off considerably since then.

![Graph showing GDP, TSF, and Credit Impulse](image)

would be the consequences of an excessive monetary offset (e.g., aggressive escalation of interest rates) by the Fed, in response to fiscal stimulus that puts inflationary pressures on the economy. That could cause the yield curve to invert and lead to a recession in 2018 or 2019. I don’t anticipate that any of the risks I’ve mentioned will come to pass, but they are risks nonetheless.

Keep an eye on China
Whenever I’m interviewed, the conversation tends to center on how the latest developments in Washington will affect the stock market. While the timing and magnitude of any U.S. fiscal reform are important, I try to point out that the global synchronized reflation that started in Q1 2016 has more to do with China than with the U.S. election. So, if you want to know how sustainable the bull market is, keep an eye on the Chinese economy. China’s reflation in early 2016 has been front-and-center in driving the global economy higher. This was done via a massive “credit impulse” (i.e., an expansion of credit growth relative to GDP).

However, China has tightened its monetary policy a bit and this credit impulse is waning, which could be negative for its economy. This is illustrated in more detail in Exhibit 2 (see page 3). The top panel of the chart shows the annual growth in new credit (measured in trillions of renminbi, or RMB) and inflation-adjusted GDP. The point is to show how much new credit is needed today to produce GDP growth compared to 10 years ago. In 2007 it took 6.9 trillion RMB in new credit to produce 5.5 trillion RMB in GDP. This year it has taken 18.6 trillion RMB to produce 6.4 trillion RMB. In other words, the credit multiplier keeps declining.

The bottom panel of the chart shows the credit impulse in the bars (new credit growth relative to GDP), and the year-over-year percent change in the line. As you can see, 2016 marked the third major credit impulse since 2007 and, historically, the rate of change has oscillated between −10% and +20%. So now, here we are after the third peak with credit growth near zero, which raises the question of what comes next—a soft landing or a hard landing? This scenario isn’t the end of the world per se, and is not by itself a reason to expect the global economy to reverse course. But it is further evidence that we are past the point of peak reflation, and that the level of gains investors enjoyed during the past five quarters may not be repeatable in the near term.

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Endnotes

1 Source: FactSet Earnings Insight, as of May 5, 2017.

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