Equities break out of 5-week lull as goldilocks backdrop continues

Global equities, which had been trading in a narrow range around all-time highs since the end of May finally broke out, adding 2.1% during the week. The stand out performers were higher beta emerging markets, Eurozone equities as well as tech stocks which benefitted from falling bond yields. Treasury yields fell and the dollar softened following US Federal Reserve chair Janet Yellen testimony on Capitol Hill. Chair Yellen offered reassurance on the state of the US economies and repeated the Fed's belief that soft wage growth and inflation data will prove to be transitory. However, in a dovish twist she added that the Fed could change course if needed (i.e. tighten policy less). The overall message was therefore one of modest economic growth and very gradual tightening, essentially a continuation of the goldilocks phase markets have enjoyed all year. Last week also marked the start of Q2 earnings season in the US. Investors will be paying close attention to see whether Q2 numbers can follow-on from a very strong Q1 in which S&P 500 companies earnings rose 14% y-o-y. Commodity prices were also buoyed by the weaker dollar, oil prices in particular performed well.

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Second quarter earnings come into focus

At the start of the first quarter earnings season we argued that for the strong rally in global equities not to unravel that earnings growth needed to come through. And it did, Q1 was one of the strongest earnings quarters in recent years. Since the end of Q1, global equities have risen another 5.6%. The situation is therefore similar to three months earlier, earnings growth is required to validate the continued strength in share prices. Estimates for Q2 earnings growth are c7% y-o-y for the S&P 500 index and there is a good chance numbers will again beat expectations. The tailwinds for US corporates this year have been; 1) a softer US dollar (boosting revenues of sectors with a high overseas revenue share, such as the tech sector), 2) stronger economic growth compared to Q2 2016, but with wage growth remaining around 2.5% meaning that margins are likely to have expanded, and 3) looser financial conditions. Despite the Fed hiking rates twice already in 2017, the weaker dollar, narrower credit spreads and lower Treasury yields means that financial conditions are significantly looser than they were 6 or 12-months earlier. Overall we expect a positive earnings season and for markets to continue to hover around the top end of their ranges. However, while a successful earnings season can drive markets in the near-term, last week's moves show that central banks, and the Fed in particular will dictate the direction over the longer-term.

Past week global markets' performance

Index Snapshot (World Indices)

Index	Latest	Weekly Chg %	YTD %
S&P 500	2,459.3	1.4	9.8
Dow Jones	21,637.7	1.0	9.5
Nasdaq	6,312.5	2.6	17.3
DAX	12,631.7	2.0	10.0
Nikkei 225	20,118.9	1.0	5.3
FTSE 100	7,378.4	0.4	3.3
Sensex	32,020.8	2.1	20.3
Hang Seng	26389.2	4.1	19.9
Regional Markets (Sunday to Thursday)			
ADX	4518.1	2.8	-0.6
DFM	3537.4	4.0	0.2
Tadawul	7313.4	1.5	1.4
DSM	9469.9	6.1	-9.3
MSM30	5121.38	0.0	-11.4
BHSE	1317.4	0.5	7.9
KWSE	6788.5	1.6	18.1
MSCI			
MSCI World	1,948.1	1.8	11.2
MSCI EM	1,047.1	4.4	21.4

Global Commodities, Currencies and Rates

Commodity	Latest	Weekly Chg %	YTD %
ICE Brent USD/bbl	48.9	4.7	-13.9
Nymex WTI USD/bbl	46.5	5.2	-13.4
Gold USD/t oz	1228.7	1.3	7.1
Silver USD/t oz	16.0	2.4	0.4
Platinum USD/t oz	921.3	1.6	2.0
Copper USD/MT	5858.0	0.8	6.5
Alluminium	1908.75	-0.6	12.7
Currencies			
EUR USD	1.1470	0.6	9.1
GBP USD	1.3098	1.6	6.1
USD JPY	112.53	-1.2	-3.9
CHF USD	0.9635	-0.1	5.8
Rates			
USD Libor 3m	1.3036	-0.1	30.6
USD Libor 12m	1.7398	-1.0	3.2
UAE Eibor 3m	1.5477	0.1	4.9
UAE Eibor 12m	2.1542	0.3	2.8
US 3m Bills	1.0316	0.5	107.4
US 10yr Treasury	2.3319	-2.2	-4.6

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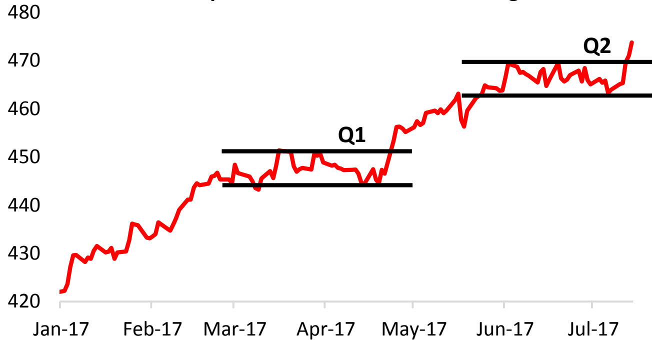
Q2 earnings will determine near-term performance, but recent moves suggests the Fed will remain the main determinant

Déjà vu as equities break-out ahead of Q2 earnings…

Global equities have remained range-bound around all-time highs since the end of May. However, just as Q2 earnings season kicked off last week, investors mustered the confidence to force the market higher. We witnessed a similar occurrence around the time of Q1 reporting season (see chart below). At that time equities had rallied 6% y-t-d (and significantly more since the US Presidential elections) and were awaiting confirmation of the rally in the form of earnings data. It turned out that investor optimism was justified, Q1 was a stellar quarter for US corporates (and indeed corporates globally) as S&P 500 companies recorded 14% y-o-y earnings growth. Of course base effects played a big role back then thanks to Q1 2016 marking the trough in last year's earnings recession. Clearly investors are expecting a repeat of Q1 as the global equity index headed higher last week. Expectations for Q2 earnings growth are around 7%, we expect these to be beaten.

Global equities break-out of recent range

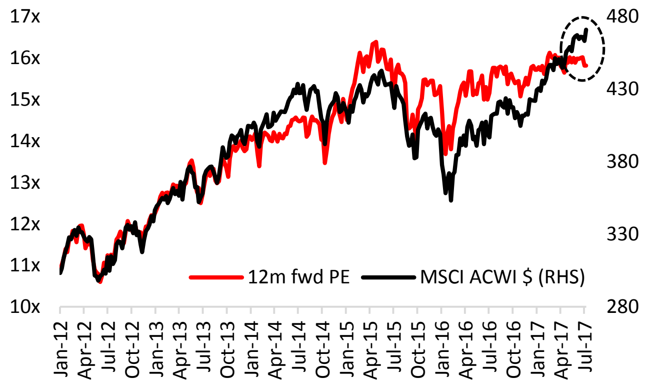


Source: Thomson Reuters

The reason why earnings growth is so important, is because it has been absent for such a long time. Using the below chart as a rough guide, it becomes clear that over the past 5 years global equities (the black line) have risen almost purely because of multiple expansion. The consensus forward price earnings ratio (the red line) rose from roughly 11x to 16x during this time. This tells you that extraordinarily easy monetary policy by major central banks across the world pushed investors into riskier assets. As a result the price appreciation of equities far outpaced the underlying earnings growth.

What is different now, is that in Q2 2017 global equities were driven entirely by earnings growth (the circled area on the chart), this marks a significant departure from previous years. Global equities rose 3.5% during the quarter, without the PE ratio budging (in fact recently it has even fallen). This is especially important because central banks are gradually becoming more hawkish in a coordinated fashion. The Fed is already tightening policy, the Bank of Canada last week followed suit with its first rate hike in 7 years, Bank of England governor Carney has hinted at raising interest rates while the ECB is also testing the market's response to tapering of its asset purchase program. Given that falling bond yields thanks to Central Bank liquidity drove the rally in equity markets post-global financial crisis, all things being equal, a scaling back of that liquidity should force markets lower. Of course, all things are not equal insofar as earnings growth is coming through, helping to keep equity valuations in check.

Earnings growth contribution keeping PE down

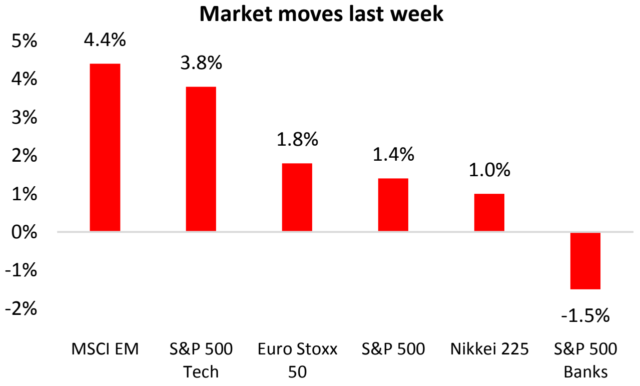


Source: Thomson Reuters, IBES, MSCI

…however, ultimately, the Fed decides

It seems plausible to us that last week's jump in global equities can be seen as a front-running of Q2 earnings season. Equities are the most optimistic asset class, often outpacing fundamentals and hoping that they catch up. However, a look beneath the surface (of headline moves) suggests that the Fed remains the main driver for now. Yes global equities rallied to new highs, but the outperformers (emerging markets, US tech stocks and Eurozone equities) were the parts of the market most geared towards a dovish Fed, while the underperformers, especially US banks are the beneficiaries of a more hawkish Fed. So while Q2 earnings growth will likely be the market's near-term focus, the Fed will continue to determine the direction of global equities through to year-end and beyond.

Market moves last week



Source: Thomson Reuters

Summary market outlook

Bonds	
Global Yields	US Treasury yields ended the week lower helped by dovish comments by Mrs Yellen and the continuous softness in inflation data. We expect Treasury yields to remain supported in the near term unless there is a sharp jump in inflation/inflation expectations. By contrast, German bunds were sold in anticipation of a potential ECB tapering announcement. While the ECB is likely to stay dovish, we expect the Treasury-Bund spread to continue to tighten.
Stress and Risk Indicators	The VIX remained low in the absence of any major surprises in economic data. Current levels are very low given the ongoing global political uncertainty and we therefore expect volatility to rise.
Equity Markets	
Local Equity Markets	GCC equity markets rallied during the week, driven by earnings expectations, the jump in oil prices and weaker dollar. Overall, we remain neutral on GCC equities given the potential for further dollar strength and range-bound oil prices. We maintain our tactical call on Saudi equities on the back of their inclusion onto the MSCI watch list for potential promotion into the MSCI Emerging Markets index.
Global Equity Markets	Global equities rallied as Mrs Yellen hinted at the possibility of more gradual tightening in the event inflation remains subdued. Softer than expected inflation data also added to the markets' dovish interpretation of Mrs Yellen's comments. US markets rallied with the Nasdaq and S&P 500 rising by 2.6% and 1.4% respectively. Emerging markets were the best performers during the week, helped by the weaker dollar. Overall for equities globally, we expect some consolidation to take place in the near-term.
Commodities	
Precious Metals	Gold prices edged higher as weak retail sales and inflation data raised doubts on Fed's ability to reach its targets. We stick to our overweight recommendation on gold as a risk hedge against ongoing political and potential for inflationary risks.
Energy	Energy prices rebounded last week, supported by dollar weakness and falling US inventories. We expect some upward normalization to take place. However, rising US production will act as a ceiling on oil prices.
Industrial Metals	Industrial metals performed well amidst the weaker dollar last week. We do not recommend industrial metals exposure due to ongoing concerns around Chinese demand.
Currencies	
EURUSD	The euro strengthened slightly against the dollar on account of dollar weakness and rising expectations of a more hawkish ECB stance. On a long term basis, we expect the euro to weaken given the divergence in central bank policies in Europe versus the US.
Critical levels	R2 1.1525 · R1 1.1497 · S1 1.1417 · S2 1.1364
GBPUSD	The pound rallied strongly versus the dollar on the back of the dollar's slide. We expect sterling to remain under pressure due to political uncertainty and Brexit negotiations.
Critical levels	R2 1.3228 · R1 1.3163 · S1 1.2985 · S2 1.2871
USDJPY	The yen appreciated versus the dollar buoyed by lower US yields and weak dollar demand. However, bias for yen weakness remains given the potential for dollar strength.
Critical levels	R2 114.10 · R1 113.32 · S1 112.01 · S2 111.48

Forthcoming important economic data

United States

	Indicator	Period	Expected	Prior	Comments
7/18/2017	Export Price Index MoM	Jun	0.10%	-0.70%	Light week in terms of data releases.
7/18/2017	NAHB Housing Market Index	Jul	67	67	
7/19/2017	Housing Starts MoM	Jun	6.20%	-5.50%	

Japan

	Indicator	Period	Expected	Prior	Comments
7/19/2017	Machine Tool Orders YoY	Jun F	-	31.1%	Focus will be on the BoJ MPC meeting.
7/20/2017	Exports YoY	Jun	9.5%	14.9%	
7/20/2017	All Industry Activity Index MoM	May	-0.8%	2.1%	
7/20/2017	BoJ MPC Meeting	20-Jul	No change	-	
7/21/2017	Nationwide Dept Sales YoY	Jun	-	0.0%	

Eurozone

	Indicator	Period	Expected	Prior	Comments
7/17/2017	CPI YoY	Jun F	1.3%	1.4%	Attention will be on the ECB MPC meeting and inflation numbers.
7/17/2017	CPI Core YoY	Jun F	1.1%	1.1%	
7/18/2017	ZEW Survey Expectations	Jul	-	37.7	
7/20/2017	ECB MPC meeting	20-Jul	No change	-	
7/20/2017	Consumer Confidence	Jul A	-1.1	-1.3	

United Kingdom

	Indicator	Period	Expected	Prior	Comments
7/17/2017	Rightmove House Prices YoY	Jul	-	1.8%	Inflation and retail sales data will be closely tracked by the market
7/18/2017	CPI YoY	Jun	2.9%	2.9%	
7/18/2017	CPI Core YoY	Jun	2.6%	2.6%	
7/18/2017	RPI YoY	Jun	3.6%	3.7%	
7/20/2017	Retail Sales Inc Auto Fuel YoY	Jun	2.6%	0.9%	

China and India

	Indicator	Period	Expected	Prior	Comments
7/17/2017	Retail Sales YoY (CH)	Jun	10.6%	10.7%	Market focus will be on the China GDP release.
7/17/2017	Fixed Assets Ex Rural YTD YoY (CH)	Jun	8.5%	8.6%	
7/17/2017	Industrial Production YoY (CH)	Jun	6.5%	6.5%	
7/17/2017	GDP YoY (CH)	2Q	6.8%	6.9%	
This week	Exports YoY (IN)	Jun	--	8.3%	

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Sources

All information in this report has been obtained from the following sources except where indicated otherwise:

1. Bloomberg
2. Wall Street Journal
3. RTTNews
4. Reuters
5. Gulfbase
6. Zawya

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