

UNDERSTANDING THE CURRENT MARKETS WITH TWO CHIEF ECONOMISTS

Jeremy Schwartz — Global Head of Research
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Last week Professor Jeremy Siegel and I spoke with Megan Greene, Chief Economist at Manulife Asset Management, and Worth Wray, Chief Economist at Evergreen GaveKal, about their views on the markets, [Federal Reserve \(Fed\)](#) policy, emerging markets and investment opportunities around the globe. **Siegel's Market Recap** While everyone is focused on the timing of the first [interest rate](#) hike, the Fed continues to emphasize that this normalization cycle will involve a gradual pace of rate hikes. Historically, a gradual set of rate hikes is favorable to equity markets. The [S&P 500](#) is currently valued at 17 times earnings¹, which is reasonable, given the low interest rate environment. The S&P 500 [price-to-earnings \(P/E\) ratio](#) arguably could approach a fair value of 19 times earnings in this environment. That said, Professor Siegel believes it might be challenging for stocks to make progress over the next few weeks, given rate hike fears. **The Fed's Reaction Function** Megan Greene believes the Fed should wait to hike rates as long as possible, particularly after the market action last week, although it might feel the need to defend its credibility and hike rates in December. The only metric in which the Fed should be thinking of hiking rates is unemployment and—given that we are adding jobs in the low-wage sectors—there is no upward pressure to [inflation](#). Additionally, the U.S. will likely import [deflation](#) pressures from Europe and Japan, given their respective focus on [quantitative easing \(QE\)](#). U.S. [core PCE](#) is 1.2%—well below the Fed target—making the case for a later hike even stronger. **Europe's Success: Will They Take More Action?** Greene credits the European Central Bank's (ECB) QE with two great successes: 1) the euro is a lot weaker and countries in the eurozone can export their way out of [stagflation](#) —in other words, countries can take advantage of the weaker euro and export more to address weak growth concerns; 2) lending data is not contracting as severely. The ECB has been buying 60 billion euros monthly and is expected to do so until September 2016; it is heading down the path of the Bank of Japan (BOJ) of essentially monetizing debt. Yet despite that progress, Greene expects the ECB will have to expand and extend the duration of its bond-buying program—perhaps by adding [corporate debt](#) to the purchase list. As a result of the aggressive QE, Greene expects the euro to trade down to parity by year-end. **Greece Out of Headlines—but for How Long?** Greene pointed out that Greece is off the headlines today but that the underlying issues remain unsolved and that Greece will likely be back in the headlines again soon. She believes there is a greater than 50% chance Greece will ultimately exit the euro, as Syriza, the political party that is currently in power, doesn't believe in the third bailout. A problem with Greece is the implementation of the required measures, as it is hard to believe that the people who voted against the austerity measures will be supportive, and she sees Greece falling behind the requirements of its bailout package by the end of this year. Ultimately, Greene believes the European crisis will be with us for a long time, as other countries see Greece exiting the euro and thriving under its own independent currency regime. **Emerging Market Outlook** The Chinese equity markets have revealed concerns on growth and China's ability to engineer its economy. Wray believes that the Chinese economy has been too reliant on old-economy sectors like materials and industrials and Beijing has been over-reporting growth to their detriment. Wray believes that the yuan could potentially depreciate in the magnitude of 10%–30% over time, given that Fed rate hikes might exacerbate capital outflows from China. He also feels that the concerns surrounding China are overblown, and while a slowdown is inevitable, it is a welcome development of more representative growth. Greene believes that emerging market (EM) countries will have capital outflows, but those are unlikely to be as severe as the 2013 [taper](#) tantrum. Fundamentals have improved and are different from 1997²: • More floating [exchange rate](#) • More foreign exchange (FX) reserves • More [current account](#) surpluses **Lessons from the Reserve Bank of India** Wray believes that the Fed should take its cue from the Reserve Bank of India (RBI) and its governor, Raghuram Rajan, in terms of maintaining independence and defending its credibility by sticking to its exit plan. When Rajan took the helm of RBI in September of 2013, the rupee was in free fall. He quelled market fears

by establishing the RBI's credibility as an inflation-fighting central bank, which manifested in a stable currency. Despite [volatility](#) in EM ahead of the Fed liftoff, Wray believes that this turmoil offers opportunities to invest in Indian equity markets. **Positioning around Globe** Greene's preferred positions are European equities and Japanese equities over U.S. equities, given the support these markets are getting from their central banks and their weak currencies—trends she expects to continue for both Europe and Japan. Wray's team is suggesting cash as a primary defensive strategy right now, as they believe there will be better prices available. But one market segment his team recently added to on the pullback is [master limited partnership](#), which have been hit with the fall in oil. His team finds the yield levels attractive.

[Read the Conversations with Professor Siegel Series.](#)

¹Source: Bloomberg, as of 8/29/15. ²1997: Asian financial crisis

accompanied by deep currency devaluations.

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