Momentum Shifts to Developed Markets as Global Real GDP Reaccelerates; Equity Markets Rally, Cyclical Names Resilient Despite Taper Uncertainty, Shutdown Aftermath and Emerging Market Fears

Signs pointing to a broadening synchronized global expansion led by developed markets like the U.S., Japan and the Euro-zone helped to drive equity markets higher in the third quarter. Multiple indicators including global composite purchasing managers' indicators and the OECD's broad leading indicator, have all improved. Although emerging economies continue to grow at a faster absolute rate than developed markets, recent data suggest the momentum has shifted in favor of developed markets, marking a turnaround from recent years. We believe that the expansion in economic activity will continue, and that the pace of growth should gradually pick up.

The U.S. housing recovery, while still strong, showed signs of slowing as mortgage rates increased, reducing affordability. However, housing price appreciation continued to benefit the deleveraging and wealth effect stories. Consumer leverage ratios have improved toward historic norms and net worth levels reached a new high, both indicating the emergence of the U.S. from financial malaise. The U.S. labor markets continue to generate slow but steady improvement.

U.S. GDP growth was 2.5% in the second quarter and could approach 3.0% in 2014. As long as consumer and investor confidence is not significantly impacted longer-term by the political dysfunction in Washington and the partial U.S. government shutdown related to the budget and debt ceiling debates, we think the U.S. economy stands a chance to reach escape velocity.

On September 18, the Federal Reserve maintained the pace of monthly asset purchases at $85 billion, comprised of $45 billion in Treasury debt and $40 billion in mortgage backed securities. This was not in line with market expectations for a $10 billion monthly reduction, the so-called "taper". In the press conference following the announcement Fed Chairman Bernanke said that the labor market had not improved enough to justify a taper and that it more or less felt it needed to push back against the back-up in bond yields that occurred since May on taper-talk, as the higher level threatened to choke off credit. The Fed got what it wanted – a sharp rally in 10-year Treasuries with the yield falling to 2.69%, from 2.85%. The Fed lowered its overly optimistic economic growth targets for this year, saying it will need to see a move up in inflation, and an overall improvement in the labor market (not just a reduction in the unemployment rate) for tapering to eventually begin.

In Japan, Prime Minister Abe's efforts to revive growth in the world's third largest economy appear to be working. Japan's GDP advanced 3.8% in the second quarter after gaining 4.1% in the first quarter. Exports surged almost 15% in August, the sixth straight monthly advance and the most since 2010, led by a rebound in shipments to the U.S. and China, and as a result of a weaker yen. Tokyo's metro government launched a Special Zone for Asian Headquarters project, in an attempt to attract more than 500 foreign companies to establish their headquarters in Tokyo. Incentives for the project include lower corporate tax rates as well as subsidies that cover the costs related to hiring and obtaining residency status for their employees. Structural reform such as a broad corporate tax cut may be needed to boost growth and offset the increase in Japan's sales tax to eight percent from five percent later this year.

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Growth in China continued to firm, after decelerating earlier this year. Manufacturing reached a six-month high in September and GDP accelerated to 7.8% in the third quarter, supported by simultaneous improvements in both external and domestic demand.

Economic growth in the Euro-zone returned to positive territory in the second quarter. Eurostat reported the 17-nation euro-area generated a 0.3% gain in GDP in the quarter ending June, after six quarters of contraction, the longest recession since World War II. Business cycle data reached the highest levels in over two years, and continue to point to a tentative recovery with more and more countries emerging from recession. Germany, Europe's largest economy, has led the currency union's recovery to date, while other large European economies like Spain and Italy are still languishing. Overall, a gradual recovery appears to be taking hold across Europe aided by lower market volatility and reduced policy uncertainty, although risks in the periphery remain. In September, S&P placed its rating on Portugal on watch for a possible downgrade. Challenges to fiscal reform measures and weaker-than-expected economic growth could lead to the country requiring a second support program after the current one expires in June. Last month, ECB President Draghi said that although reliance on ECB funding has been steadily declining, he's ready and willing to provide another long-term refinancing operation to banks if needed.

In emerging economies, the impacts of the U.S. central bank unwinding its monetary stimulus are generating volatility. Rising yields on U.S. government bonds have triggered outflows from emerging markets and as a result currencies like the Indian rupee and Turkish lira have depreciated to record lows against the U.S. dollar. Emerging market central banks from Indonesia to Brazil stepped up efforts to counteract the currency declines by raising rates and intervening in markets by providing dollar liquidity. Countries with the weakest current account positions have seen the sharpest falls in their currencies, bringing back memories, and fears, of the Mexican peso crisis in 1994 and the Thailand baht crisis in 1997 - 1998. Longer-term, emerging economies will need to boost productivity enhancing investments to overcome bottlenecks in transportation and energy for example, and develop and educate their human capital. Supportive dynamics in the current cycle include the fact that reserve and debt levels, as well as political stability are radically better than 15 or 20 years ago across most emerging economies. Additionally, as compared to being pegged to the U.S. dollar in the past, most emerging economies allow their currencies to float, providing flexibility and limiting the impacts from a falling currency. However, even with these areas of support, we maintain a zero direct weight in emerging markets given the risks of capital flight and higher rates, and instead favor exposure through multi-national firms.

With improving conditions in the U.S., Asia and Europe, we expect the global economy to resume above-trend growth next year. We continue to believe that the momentum in developed market economic growth remains supportive of equities and especially cyclically sensitive sectors such as industrials, technology, materials, consumer discretionary, energy and financial services. However the pace of gains in the next phase of the market cycle will likely require a continued improvement in earnings growth and therefore market returns will likely be more moderate compared to the gains achieved over the year-to-date period in the more aggressive, hopeful phase of the market's rally. Cash balances for most large and mid cap companies remain high which is supportive of growth in capital spending, as well as share buybacks and dividend increases.

In fixed-income we continue to prefer duration managed credit risk over interest rate risk. Our exposures are diversified across sectors and credit qualities and include traditional sources of income like investment grade corporate bonds, and non-traditional areas such as multi-sector fixed income exposure and positions in senior floating-rate instruments. The currently high level of slack in the U.S. economy continues to promote low inflation expectations, with higher inflation being pushed out to a longer-term risk. Lastly, we continue to believe that rate-sensitive areas of fixed-income such as Treasuries will continue to face pressure.