WEEKLY ECONOMIC COMMENTARY

This Week's Economic Review and Outlook

May 2014

Making a positive impact on as many lives as I can.

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Weekly Economic Commentary | Week of May 5, 2014

Highlights

- Key emerging market central banks have raised rates within the past year in an effort to combat inflation, the threat of inflation, or current account imbalances.
- Most developed market central banks are on hold or easing.
- The divergence among global central bank policies creates both risks and opportunities for global investors, and especially active managers who invest globally.

Central Bank Pulse

Typically, the week after the release of the monthly employment report is quiet for U.S. economic releases, and this week -- the week after the April employment report was released on Friday, May 2, 2014 -- is no different. The highlight of the week is Federal Reserve (Fed) Chair Janet Yellen's testimony before the Joint Economic Committee (JEC) of Congress on Wednesday, May 7, 2014. The Q&A portion of the testimony will be closely watched, as then Fed Chair Ben Bernanke's comments during the Q&A portion of his appearance at the JEC in mid-May 2013 sparked the "taper tantrum" in the U.S. Treasury bond market that drove the yield on the 10-year Treasury from 1.75% to 3.0% between early May and early September of 2013. Although the labor market is clearly improving, most market participants expect Yellen to maintain her dovish tone on the labor market and economy at this week's testimony, as there is still plenty of evidence that the labor market is not "back to normal" (see *Weekly Economic Commentary: What's the Yellen Surprise?,* March 24, 2014).

With little on the domestic economic calendar this week aside from the Yellen appearance and another 80 or so S&P 500 companies reporting first quarter results (with 75% of companies having already reported), market participants are likely to turn their attention overseas. In all, 11 central banks around the globe are meeting this week to set policy, including five developed market central banks:

- The European Central Bank (ECB);
- Bank of England (BOE);
- Bank of Korea;
- The Reserve Bank of Australia; and
- Norges Bank, Norway's central bank.

Six emerging market central banks also meet:

- Poland;
- Czech Republic;
- Indonesia;
- Philippines;
- Malaysia; and
- Peru.

Click here for Figure 1.

Q1 GDP Tracker

As this report was being prepared, Indonesia reported its first quarter GDP figures. The report showed that Indonesia's economy -- the 13th largest in the world -- expanded by 5.2% in the year ending March 31, 2014, a solid reading, but still below expectations of a 5.6% gain. Most of the weakness was concentrated in exports, which, in turn, is likely related to the slowdown in Chinese economic activity over the past year. Indonesia's first quarter report is the only GDP report from a top 20 economy scheduled for this week. China, South Korea, the United Kingdom, and of course the United States have already reported Q1 GDP figures. Next week (May 12-16, 2014), Japan, the Eurozone, Russia, and Poland will report first quarter GDP. Figure 1 notes the release dates and consensus forecasts (as compiled by Bloomberg News) for the world's 20 largest economies. Unless otherwise indicated, the actual GDP readings and forecasts are year-over-year readings. As we noted in the April 14, 2014, *Weekly Economic Commentary: Gauging Global Growth in 2014 & 2015*, developed market economies are poised to accelerate in 2014, while emerging market economies have seen their growth estimates for 2014 revised downward in recent months.

In addition, central banks in Australia, Japan, and Thailand will release minutes of recent policy meetings this week, providing market participants with some color around rate decisions made earlier this month and in April 2014.

Although none of the 11 is expected to change policy this week, central bank policies have diverged since the end of the Great Recession in early 2009. At first, most emerging market and developed market central banks were cutting rates to reinvigorate their economies. Later, as growth returned, so did inflation and imbalances in trade and currency movements, which caused several central banks to change policy. Some cut rates or eased policy, but others, including the ECB and the People's Bank of China, tightened between 2009 and 2011.

Global Divergence

Today, among the central banks of the 20 largest economies in the world -- which together account for 90% of global gross domestic product (GDP) -- there continues to be a divergence among global central banks on rate policy [Figure 2]. Central banks in Russia, Brazil, Turkey, India, and Indonesia have all raised rates within the past year in an effort to combat inflation, the threat of inflation, or current account imbalances. Note that all of these central banks are in emerging markets. But not all emerging market central banks are raising rates. Mexico, Thailand, and Poland have recently cut rates, as have several central banks not in the top 20 (Chile and Hungary, for example).

2 Central Bank Policies Continue to Diverge

Central Banks

Raising Rates/ Tightening Policy	On Hold	Cutting Rates/ Easing Policy
Russia	China	U.S.
Brazil	Norway	Japan
Turkey	Switzerland	Eurozone
India	Canada	Sweden
Indonesia	U.K.	Mexico
	Argentina	Australia
		Poland
		South Korea
		Thailand

Source: LPL Financial Research, FactSet 05/05/14

On the other hand, most developed market central banks are on hold or easing, including the Fed, ECB, and Bank of Japan. We list China as "on hold" but in reality, China could ease policy at any time, and the central bank may or may not be part of that easing, as China's centralized economy lends itself to a much higher level of government involvement than most other nations. Indeed, in late April, China's central bank -- the Peoples Bank of China -- cut reserve requirement ratios for rural banks only. Also on the "on hold" list is the United Kingdom's BOE, but stronger recent economic data and surging property markets have market participants pricing in a BOE rate hike by the end of 2014.

Global Scope

On balance, the divergence among global central bank policies creates both risks and opportunities for global investors, and especially active managers who invest globally. These conflicting interest rate paths -- along with the currency and economic changes they generate -- have created an uptick in volatility in financial markets that is likely to continue for several quarters. But this increased volatility may also create opportunities for active investors with strong insight into the international economic, currency, and policy environment to add value, which is why LPL Financial Research continues to believe in active management in this space.

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Gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period, though GDP is usually calculated on an annual basis. It includes all of private and public consumption, government outlays, investments and exports less imports that occur within a defined territory.

This research material has been prepared by LPL Financial.

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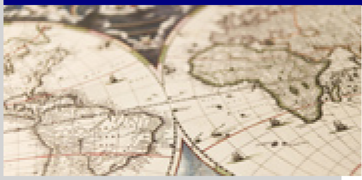
Not FDIC or NCUA/NCUSIF Insured | No Bank or Credit Union Guarantee | May Lose Value | Not Guaranteed by any Government Agency | Not a Bank/Credit Union Deposit

Tracking #1-270302 (Exp. 05/15)



Weekly Market Commentary | Week of May 5, 2014

Highlights

Earnings forecasts are being cut sharply overseas, raising the questions of how much of a value international developed market stocks are and whether they can outperform the U.S. market in 2014.

Global Earnings Picture Reveals Dramatic Regional Differences

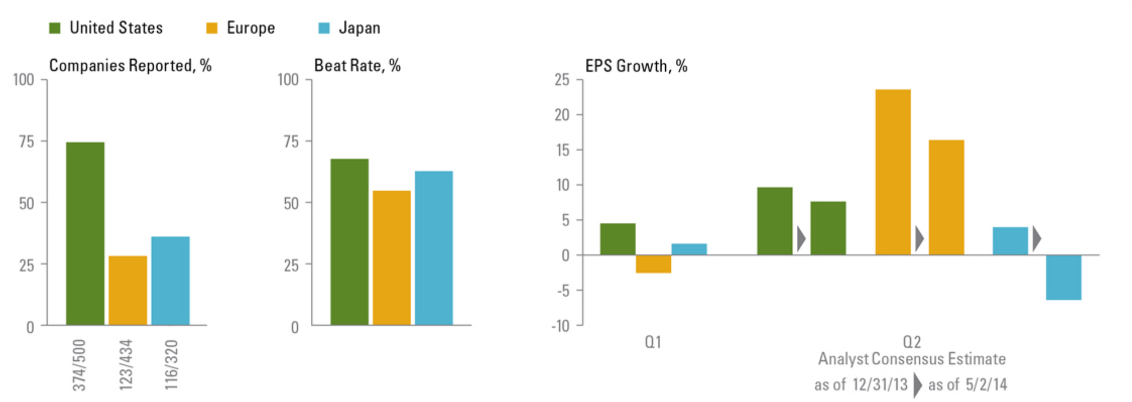
At the beginning of the year, many investors believed analysts' forecasts for a faster pace of earnings growth combined with lower valuations would lead to stocks in Europe and Japan outperforming U.S. stocks. Now those earnings forecasts are being cut sharply, raising the questions of how much of a value international developed market stocks are and whether they can outperform the U.S. market in 2014.

Four times a year investors focus on the most fundamental driver of investment performance: earnings. For U.S. stocks, the earnings reporting season has produced nearly all the gains in the stock market over the past four years with nothing but volatility, on average, during the other weeks of the quarter. The earnings season in the United States is now nearly over with 374 of the S&P 500 companies-representing 80% of the market value of the index-having reported. While the earnings season will only reach the halfway point this week in Europe and Japan, the difference so far between their earnings results and guidance and U.S. markets is striking. High hopes of an overseas earnings rebound are being disappointed, which may be creating a performance headwind.

There are three areas of key regional differences in the global first quarter earnings season: expectations, growth, and guidance [Figure 1].

- **Expectations**. The United States, Europe, and Japan have seen most companies exceed analyst estimates for the first quarter. The United States has the strongest first quarter beat rate at 68%. This is above the long-term average of 63% and the average over the past four quarters of 66%.
- **Growth.** Relative to Europe and Japan, the United States has the best first quarter earnings per share growth rate; although at only 4.5% it is a bit soft and must improve in coming quarters to lift stocks. We believe it may as the weather that had a dramatic effect on first quarter economic activity gives way to pent-up demand in the second quarter. The United States looks to continue to be on track for the 5-10% growth in earnings we forecast for the year in our *Outlook 2014: The Investor's Almanac*, published in November 2013. However, the decline in European earnings from a year ago and paltry 1.6% growth in Japan raises serious doubts about the likelihood of achieving the analysts' expectations for powerful, double-digit growth for the year.
- **Guidance.** Analysts are expecting U.S. companies to produce about 8% growth in earnings from a year ago in the second quarter, down two percentage points from the start of the year. However, analysts are more aggressively cutting their estimates for companies in Europe and Japan. Overall estimates for the second quarter have been cut by seven to 10 percentage points already-with more cuts likely to come as the earnings season continues in the weeks ahead. Estimates for 2014 are also likely to come down sharply for Europe and Japan from about 17-18%.

1 First Quarter Global Earnings Season Varies Dramatically Across Regions



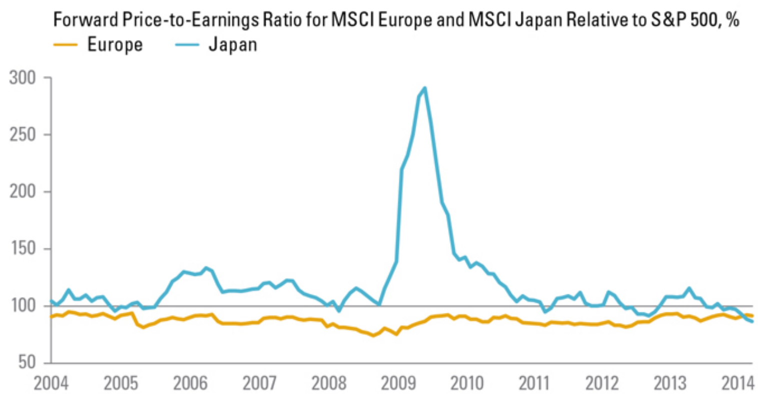
Source: LPL Financial Research, FactSet Data Systems, Thomson Financial 05/05/14

Indices: S&P 500, MSCI Europe, MSCI Japan. One cannot invest directly in an index.

Past performance is no guarantee of future results.

The decline in expectations raises questions about the "discount" in valuation, or forward price-to-earnings ratio (measured by the current price per share divided by the expected earnings per share over the next four quarters). Stocks in Europe and Japan currently trade at about a 10% discount to U.S. stocks [Figure 2]. However, if earnings expectations continue to decline, those forward valuations will climb as the price is divided by lower earnings. This may result in a rise in relative valuations that could significantly reduce or even eliminate the "discount" of Europe or Japan to the U.S. market.

2 Are Europe and Japan Really Trading at a "Discount" to the United States?



Source: LPL Financial Research, FactSet Data Systems 05/05/14

That said, with Japan trading at the biggest discount to the United States in the past 10 years, it appears investors may already have adjusted their expectations for relative earnings growth and are more guarded about future prospects than analysts. However, it is hard to see these regions outperforming the United States on ongoing sharp downward revisions to analyst earnings expectations. We remain convinced that developed foreign stocks will have a hard time outperforming U.S. stocks in 2014, but may not lag dramatically like they did in 2013.

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The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

Stock and mutual fund investing involves risk including loss of principal.

Earnings per share (EPS) is the portion of a company's profit allocated to each outstanding share of common stock. EPS serves as an indicator of a company's profitability. Earnings per share is generally considered to be the single most important variable in determining a share's price. It is also a major component used to calculate the price-to-earnings valuation ratio.

The P/E ratio (price-to-earnings ratio) is a measure of the price paid for a share relative to the annual net income or profit earned by the firm per share. It is a financial ratio used for valuation: a higher P/E ratio means that investors are paying more for each unit of net income, so the stock is more expensive compared to one with lower P/E ratio.

INDEX DESCRIPTIONS

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure *performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.*

The MSCI Europe Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of the developed markets in Europe. The MSCI Japan Index is a free-float adjusted market capitalization weighted index that is designed to track the equity market performance of Japanese securities listed on Tokyo Stock Exchange, Osaka Stock Exchange, JASDAQ and Nagoya Stock Exchange.

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