Stock Market Review

# Japan and US outperform Europe

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In last week's article I reviewed the performance of the local equity market during 2013. Although Maltese equities generally performed positively with the MSE Share Index climbing by 14.75 per cent during the year, international markets outperformed Malta.

Among the main global indices, Japan was the star performer with an appreciation of 57 per cent. Stockmarkets in the US also had a remarkable year with the S&P500 up 29 per cent (the strongest annual performance since 1997), the technology index NASDAQ registering a rise of 38 per cent and the Dow Jones Industrial Average advancing by 26 per cent. Similar to the S&P 500, the 30 companies forming the Dow Jones index had their best year since 1995.

European markets, with the exception of Germany, registered milder gains as confidence in the region's political stability and economic recovery started to grow across the region. The DAX in Germany surged by 25.5 per cent but the other markets in continental Europe performed slightly weaker. Spain's IBEX gained 21.4 per cent, the CAC 40 in France climbed 18 per cent and Italy's FTSE MIB advanced 16 per cent. London's FTSE 100 ended the year up 14.4 per cent at 6,749.09 points – its biggest annual gain since the 22.1 per cent rise registered in 2009.

Despite the overall strong gains registered during the year, it was not a consistent upward movement. During the first five months of 2013, US markets were buoyed by the Federal Reserve's quantitative easing measures, which pushed down bond yields and as a result equities became more appealing to investors. In May and June, equities around the world fell sharply when Ben Bernanke, the outgoing chairman of the US Federal Reserve, first suggested the central bank would start to scale back – or taper – its quantitative easing (QE) programme of $85 billion per month. There were widespread fears that a slowdown in the level of QE could hurt demand for shares. However, markets soon recovered despite the US government shutdown in October. The main indices around the world touched record highs when the Federal Reserve announced in December that it would taper its bond purchase programme by $10 billion to $75 billion per month as from January 2014.

Japan's Nikkei index climbed by 57 per cent in 2013 in local currency terms to 16,291.31 points driven by the country's aggressive fiscal and monetary stimulus following the various measures adopted by the newly-elected Prime Minister Shinzo Abe to pull the economy out of its decade-long slump. The Japanese stockmarket is at its highest level in the past six years and the gains registered in 2013 represent the best annual performance since 1972. However, the Nikkei is still sharply below the all-time high of just under 39,000 points reached in December 1989. Abe embarked on huge monetary easing to bolster the economy and boost inflation, which in turn lifted investor confidence. The easing programme also weakened the yen and kept government bond yields at record lows. This led to a surge in demand for Japanese equities.

Meanwhile, the Japanese yen dropped to its lowest level in five years against both the US dollar and the euro helping the country's export sector. The yen slipped by more than 21 per cent against the US dollar and by 26 per cent against the euro during 2013.

While the main European indices enjoyed double-digit gains, within peripheral Europe, it is worth highlighting that two countries which were constantly grabbing the headlines in recent years due to the debt crisis saw their equity markets rally during 2013. Equity markets in Ireland and Greece posted gains of circa 35 per cent in the past 12 months as investors possibly took advantage of the low valuations following the steep declines registered in earlier years. Moreover, the Irish market was also boosted by the news that Ireland became the first eurozone nation to exit its bailout programme in December.

On the other hand, the stockmarket in Cyprus was heavily impacted by the consistent bail-out talks during the year. The Cypriot General Market Index dropped by 10.1 per cent, placing it among the world's worst performing stock indices during 2013.

> **Gold posted its biggest annual loss in more than 30 years**

Meanwhile, the best performing equity market in 2013 was Venezuela as the index of the Caracas Stock Exchange incorporating just 15 shares rose by an extraordinary 480 per cent in the past 12 months. Also worth noting is the performance of Dubai's DFM General Index which surged by 107 per cent buoyed by the recovery in the property market following the 2009 crash.

Emerging markets were significantly impacted by talks of tapering by the Federal Reserve. In fact, stockmarkets in Turkey and Brazil dropped by 18 per cent and 16 per cent during 2013.

In the currency market, the euro gained against the US dollar notwithstanding the confirmation that the US Federal Reserve is the first major central bank to start removing monetary stimulus while the European Central Bank cut rates to a new record low in November. The single currency edged 4.1 per cent higher to USD1.3779. The euro gained 2.3 per cent against the sterling during the year. The euro rose by 5.4 per cent during the first six months but during the second half, the sterling strengthened marginally on evident progress achieved across the British economy.

In the commodity market, gold posted its biggest annual loss in more than 30 years as the price of this metal declined by 28 per cent during 2013. The price of gold endured its worst year since 1981 as the US economy improved, inflation remained low and worries about the financial system and the government shutdown in Washington faded. The price of gold declined in 2013 after 12 successive years of price appreciation. Gold peaked at $1,900 per ounce in August 2011 and has been declining steadily ever since.

Meanwhile, government bond markets suffered as rising confidence in the economic recovery pushed yields on both UK Gilts and US Treasuries above three per cent from a low of 1.6 per cent in May in the US. Eurozone yields also recovered steadily from the near all-time lows in May 2013. A commonly used bond market benchmark – the Barclays Aggregate index – dropped nearly two per cent in 2013, its first annual drop since 1999. Various economists claim that bond investors face further challenges in 2014 as the Federal Reserve starts retreating from its monetary easing measures. If economic data suggests much better growth, this would fuel expectations of a rate hike in the US by the end of 2014. This could then force bond yields to rise much faster than expected, with a subsequent decline in bond prices.

So after such a positive 2013, what are the expectations for 2014?

Many international analysts agree that the focus during 2014 will be on company earnings. At the start of 2013, the price earnings multiple was below the historical average but given the surge in share prices during the year, valuations normalised with the price to earnings multiple now slightly above the historical average. As such, the focus will now be on whether company earnings can match investor expectations. If the European Central Bank manages to tackle the risks from deflation, company earnings should gradually improve. This could be the main catalyst for further gains across equity markets.

Wall Street analysts generally expect a stronger economy during 2014 leading to higher bond yields and further gains for equities. Analysts at JPMorgan, Morgan Stanley and Bank of America Merrill Lynch all expect the S&P to close the year at or above 2,000. Meanwhile, Citigroup, Goldman Sachs and Barclays analysts are more cautious with expectations of a mere three per cent rise in the S&P500 to 1,900 points.

Similarly, most analysts in the City of London expect the FTSE 100 to surge even higher in 2014 and break above its previous record of 6,950.6 points of December 1999. This level was almost surpassed in May 2013. The improving US economy and receding fears about eurozone stability should help the FTSE 100 to continue to rise. Analysts at Citigroup have set a 2014 year-end target for the FTSE100 of 8,000 points, while Goldman Sachs expects the FTSE to trade up to 7,500 points which would represent a rise of 11 per cent from the 2013 closing level.

Notwithstanding that many analysts have a bullish outlook, there are various factors that could lead to a correction in equity markets during the course of 2014. Although the global economic outlook is improving, conditions remain fragile. The biggest uncertainty is possibly whether the Federal Reserve will be able to adjust its monetary easing programme appropriately without stalling the recovery. Additionally, the health of the Chinese economy is another factor that could negatively impact global stockmarket performance in 2014. A sharp slowdown in China would spread quickly across emerging markets and this could fuel deflationary pressures across Europe.

2014 could therefore be a volatile year for equity, bond and also currency markets.

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