

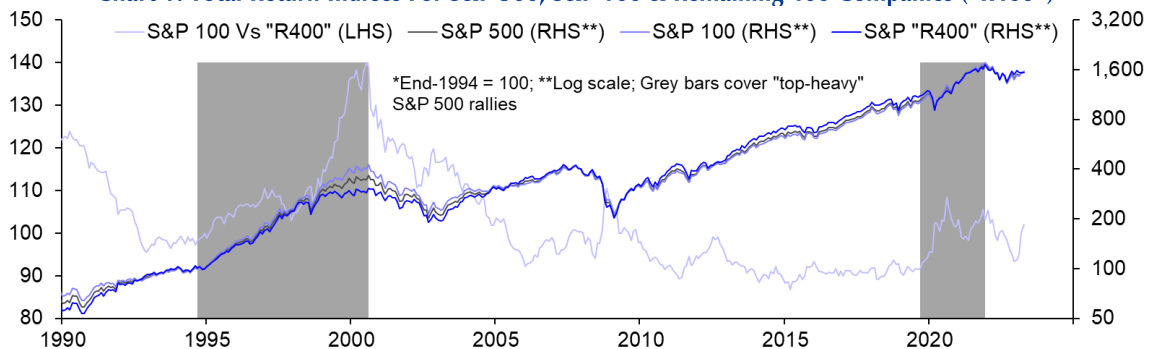


GLOBAL MARKETS CHART BOOK

US equity rally may be on shaky foundations

- **Recent gains in the US stock market have been unusually narrow, and we don't think the conditions are yet in place for a broad-based rally.**
- **A striking fact about the recent gains in US equities is that they have been driven by a remarkably small number of companies.** A capitalisation-weighted portfolio of the largest five companies in the S&P 500 – many of which seem to have been boosted by optimism around apparent breakthroughs in “artificial intelligence” – would have returned a staggering ~50% year to date, more than ten times the (capitalisation-weighted) return from the other 495 companies in the index.
- **That raises the question of whether the rally is on sustainable footing. On that front, it's worth noting that there have been long-lasting top-heavy rallies in the past.** The bull run in the S&P 500 in the mid-to-late 1990s was characterised by a significant and sustained outperformance of the largest companies. (See Chart 1.) Something similar was the case between 2019 and 2021 as well (at least looking through the short-lived COVID-related sell-off in 2020).
- **But investors might be wise not to draw too much from those comparisons.** The rally of the mid-to-late 1990s, unlike the current one, still saw strong gains outside the very largest companies, even if they were smaller than those of the mega-caps. And when smaller stocks *did* get side-lined – during the “dotcom bubble” of the late-1990s/early-2000s – the rally subsequently, and famously, reversed quite sharply.
- The 2019 – 2021 rally arguably provides more cause for optimism: it broadened out over time, even if it eventually foundered on the rapid rise in interest rates in 2022. But that broadening was because investors' optimism about the economy grew, boosting small-to-mid cap stocks that had been struggling. If we're right that growth will falter later this year, a similar outcome this time around seems unlikely. **Instead, we suspect that some pain is on the way for the S&P 500, and global equities generally, over the rest of this year.**
- **Global Monetary Policy** – Monetary tightening seems to be nearing its end.
- **DM Bonds** – Yields have generally risen as investors have pared back expectations for rate cuts.
- **EM Bonds** – Dollar bond yields have risen but local-currency bond markets have been more mixed.
- **Global Equities** – Global equities have been broadly flat overall, although some indices have made gains.
- **Forecast Summary**

Chart 1: Total Return Indices For S&P 500, S&P 100 & Remaining 400 Companies (“R400”)



Sources: Refinitiv, Capital Economics

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Global Monetary Policy

- Developed market central banks have continued to tighten this month. And, amid signs that economies are proving more resilient than anticipated, investors have raised their expectations for policy rates further ahead, especially in the US and UK (2 & 3). That’s mostly come through paring back expectations for rate cuts, however; another hike by the Fed, for example, is still not fully discounted (4). Investors don’t seem think the ECB has much further to go either (5). And investors still expect much lower peaks – and faster subsequent rate cuts – in general across DMs than they did in March prior to the banking sector turmoil.
- Economic resilience and stubborn inflation have challenged our own view that central banks would be cutting rates later this year. Indeed, we’ve recently pushed back our forecasts for rate cuts by the Bank of England, for example. Nonetheless, our central scenario remains that the Fed, at least, will cut rates later this year as inflation there falls and the US economy slows, and that other central banks will join in in 2024.
- Meanwhile, of the major emerging market (EM) central banks we track, four have hiked rates, while Hungary cut its policy rate. Most, however, have left policy on hold, and we think that tightening cycles are almost over (6). That said, we expect most central banks in Latin America and Emerging Europe to keep rates high for a while yet, to avoid a resurgence in inflation. But central banks in Asia, where inflation is falling more convincingly and is closer to central bank targets (7), may begin easing in the near future.

Chart 2: OIS-Implied Policy Rate In One Year (%)

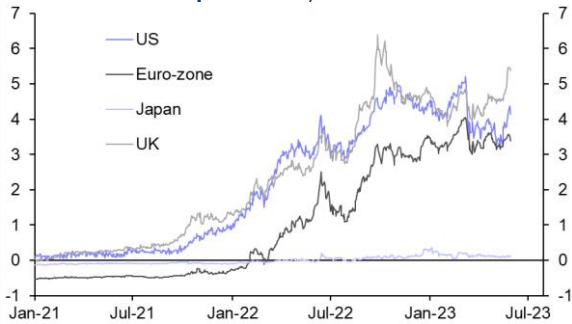


Chart 3: OIS-Implied Policy Rate In One Year (%)

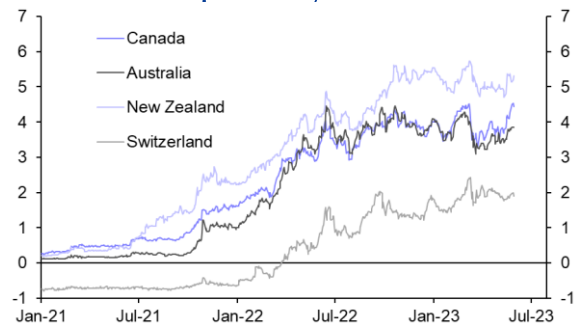


Chart 4: US Federal Funds Rate (%)

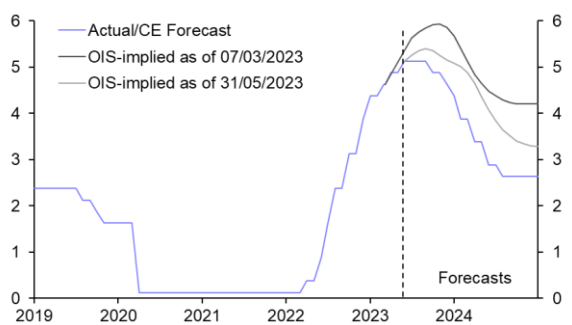


Chart 5: ECB Deposit Rate (%)

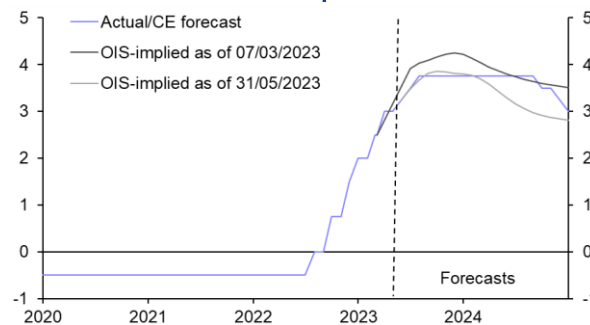


Chart 6: CE EM Interest Rate Diffusion Index (No. of EM Central Banks Hiking Rates less No. Cutting)

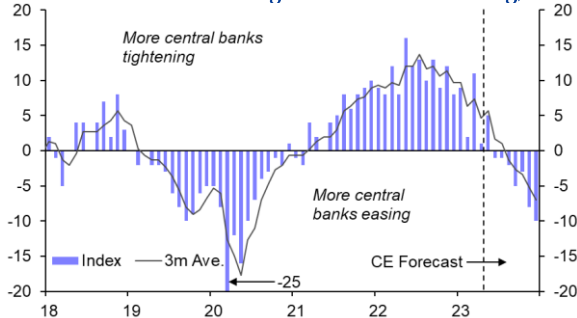
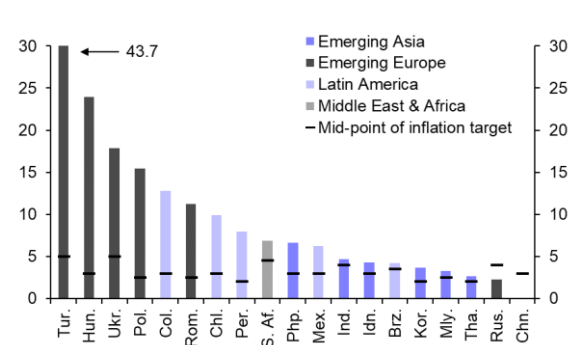


Chart 7: EM Headline Inflation Rates (%)

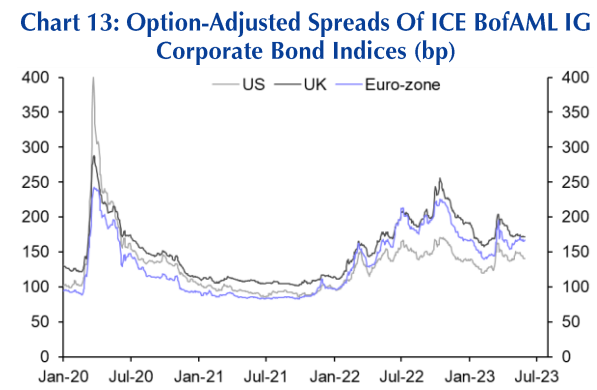
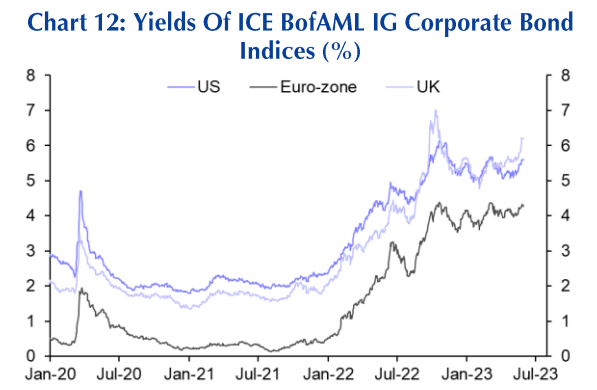
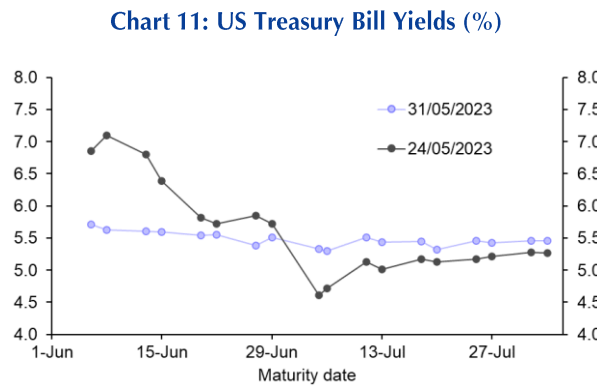
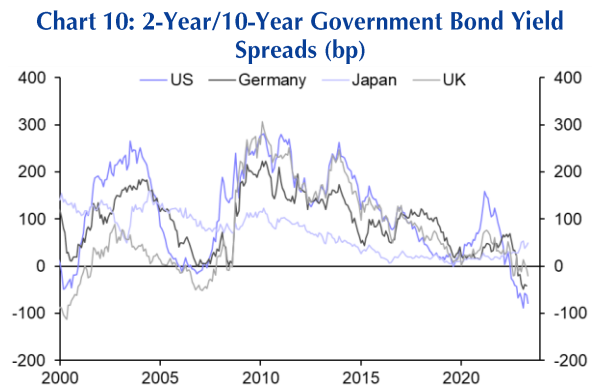
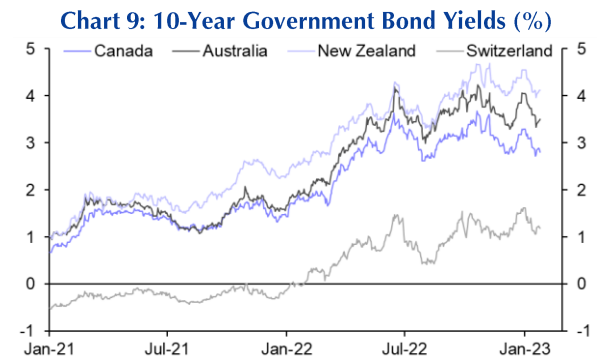
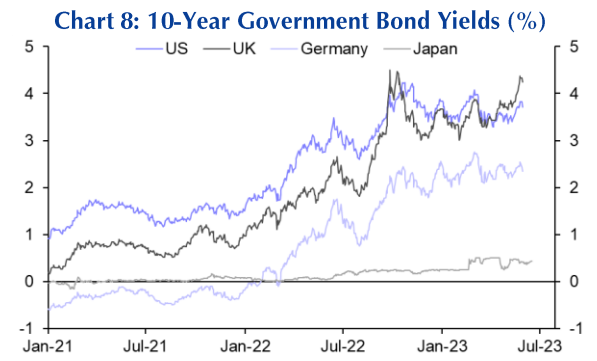


Sources: Refinitiv, Capital Economics



Developed Market Bonds

- Despite falling over the past few days, the yields of long-term developed market government bonds have generally risen this month, especially in the US and the UK (8 & 9). The rises in yields have been particularly pronounced at the front ends of yield curves, meaning those curves have become more deeply inverted in most major economies (10). The 10-year UK Gilt yield is now around the height it reached during the late-2022 Gilt market meltdown, although this time we suspect this reflects upwardly revised expectations for the central bank’s policy rate rather than a large risk premium. In the US, the yields of bills maturing in June – which had risen sharply amid worries about the debt ceiling – seem to have broadly normalised as a deal has emerged (11).
- Our central forecast is that the Fed is done hiking and will cut rates this year more quickly than investors anticipate, and that long-dated bond yields in most economies will fall as a result. But we have recently revised up our forecast for the 10-year Gilt yield, as it has become clear that the Bank of England will tighten more than we’d previously anticipated; that remains a key risk to our yield forecasts elsewhere too.
- Meanwhile, the yields of corporate bond indices have generally risen this month (18) due to higher “risk-free” rates (12 & 13). We think they might rise a bit further, but due to wider spreads as growth falters.



Sources: Refinitiv, Capital Economics



Emerging Market Bonds

- EM local-currency bond markets have been a mixed bag this month. The average 10-year yield in major EMs has changed little, despite higher US yields (14). But yields rose sharply in South Africa as investors have worried about the country’s public finances and economic outlook. By contrast, yields in Turkey fell sharply after the election there (15), although they have probably been affected by financial repression. In general, 10-year yields remain elevated in EM Europe and Latin America, but less so in Asia (16).
- Meanwhile, the yields of sovereign and corporate dollar bonds have risen, judging by the aggregate indices we track, largely as a consequence of higher US Treasury yields and despite mixed moves in spreads (17 & 18). The spread of the JPM EMBI Global Africa Index to Treasuries fell more than that of other indices, but it remains high compared with its post-GFC average, as does that of the EM Europe Index (19).
- With many major emerging market central banks set, in our view, to keep policy rates high for a while yet, sharp falls in yields over the rest of this year seem unlikely. That’s especially the case if, as we expect, growth falters and spreads to developed market bonds rise a little. That said, we remain of the view that policy turnarounds will eventually happen, and that this will help EM bond yields to fall.

Chart 14: 10-Year Local-Currency Government Bond Yields (%)

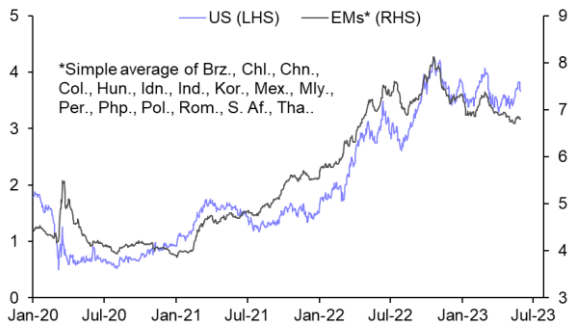


Chart 15: 10-Year Local-Currency Government Bond Yields (%)

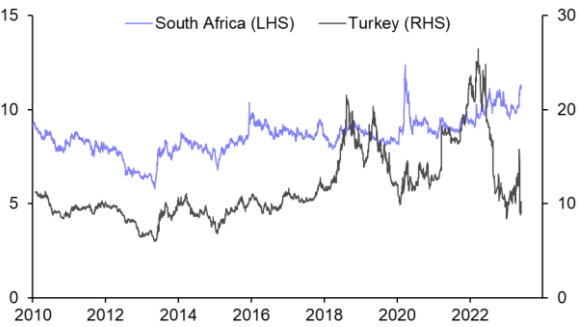


Chart 16: 10-Year Local-Currency Government Bond Yields (%)

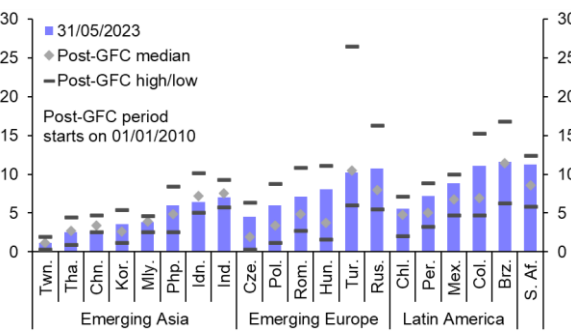


Chart 17: Changes In Yields Of JPM EMBI Global Indices Since 30th April 2023 (bp)

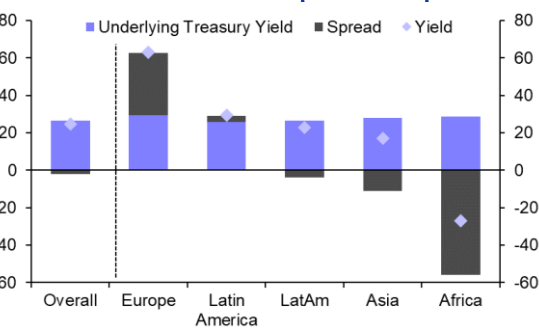


Chart 18: Changes In Yields ICE BOFA EM Liquid Corporate Plus Bond Indices Since 30th April 2023 (bp)

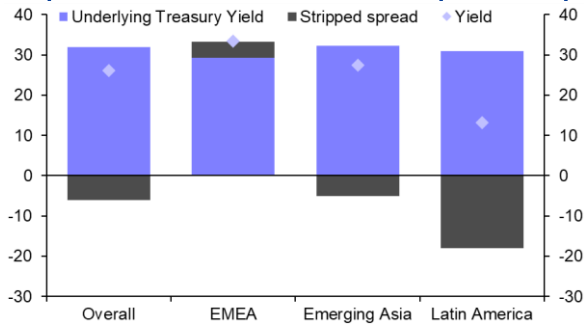
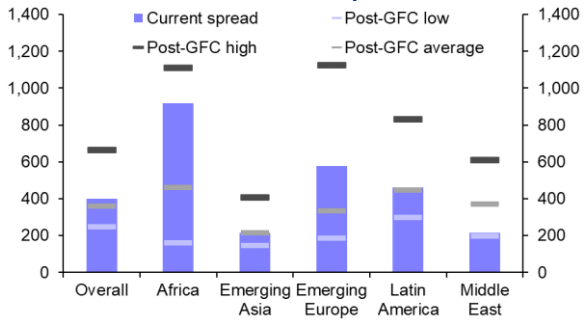


Chart 19: Spreads Of JPM EMBI Global Indices To US Treasuries (bp)



Sources: Refinitiv, Capital Economics



Global Equities

- Global equities, as measured by the MSCI All Country World Index, have been broadly flat this month. But there has been significant divergence across economies: equities in Japan have made large gains in local-currency terms (due largely to a weaker yen), those in the US have risen slightly, while those in Europe have generally fallen **(20)**. Equities in emerging markets have diverged too; the MSCI Latin America Index has made gains, despite generally lower commodity prices, but the EM EMEA Index has struggled **(21)**.
- The “tech” sectors of the market have done better than most **(22)**, despite higher interest rates **(23)**, reportedly due to some optimism related to artificial intelligence. This has been particularly concentrated among US companies, although these sectors have also done well in the emerging world **(24)**.
- Equity markets still seem to be priced, in our view, for a fairly “soft landing”, at least in developed market economies. After all, earnings expectations still haven’t fallen very far and, indeed, seem to have *risen* in recent weeks **(25)**. Measures of equity risk premia are also still fairly low. As such, if growth falters, which we think it will, equity prices could fall over the remainder of this year.

Chart 20: MSCI Developed Market Equity Indices (Local Currency, 1st Jan 2021 = 100)

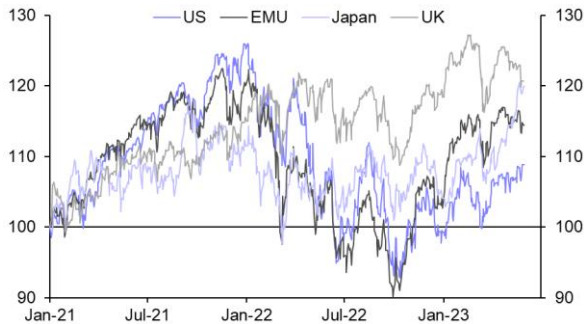


Chart 21: MSCI Emerging Market Equity Indices (Local Currency, 1st Jan. 2021 = 100)

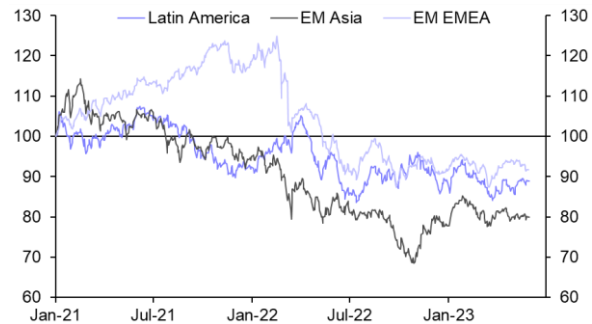


Chart 22: Changes In MSCI World Aggregate & Sector Indices Since 30th April 2023 (Local Currency, %)

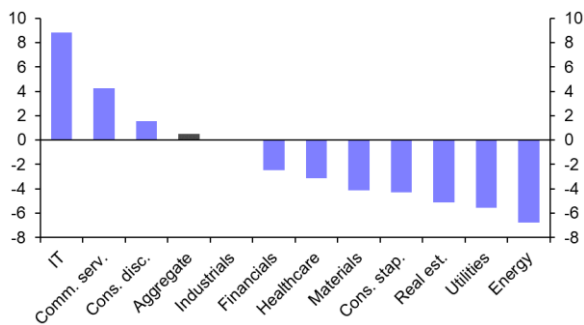


Chart 23: MSCI World IT Sector / MSCI World Ratio & 10-Year US TIPS Yield (%)

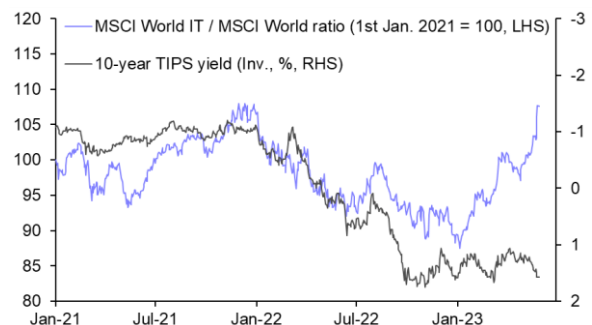


Chart 24: Changes In MSCI EM Aggregate & Sector Indices Since 30th April 2023 (Local Currency, %)

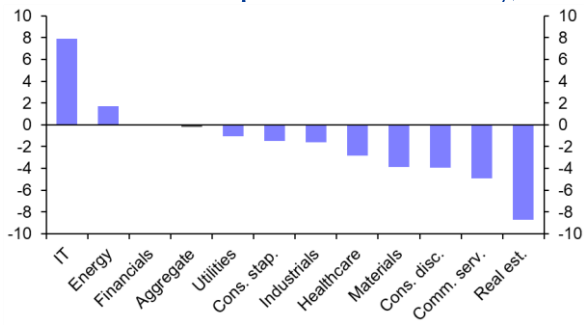
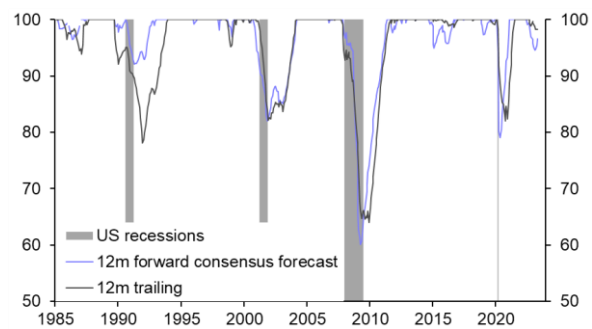


Chart 25: S&P 500 12m EPS (% Of Previous Peak)



Sources: Refinitiv, Capital Economics



Forecast Summary

	Forecast Summary			
	Latest 30 th /31 st May 2023	End 2023	End 2024	End 2025
Stock Market Indices (Local Currency)				
US – S&P 500	4,200	3,800	4,500	5,000
Germany – DAX 30	15,853	14,800	18,200	21,110
UK – FTSE 100	7,515	7,300	9,000	10,500
Japan – TOPIX	2,131	1,880	2,300	2,650
Canada – TSX Composite	19,740	19,000	23,500	27,420
Australia – ASX 200	7,091	7,000	8,500	9,730
Emerging markets – MSCI	58,764	57,800	68,425	77,750
Emerging Asia – MSCI	901	900	1,050	1,175
Latin America – MSCI	87,615	83,800	107,175	124,225
Europe, Middle East & Africa – MSCI	482	450	575	650
10-Year Government Bond Yields (%)				
US	3.65	3.25	3.00	3.00
Germany	2.26	2.25	2.00	2.00
Italy	4.08	4.25	4.00	4.00
UK	4.18	4.00	3.25	3.00
Japan	0.43	0.50	0.50	0.50
Canada	3.21	2.75	2.50	2.50
Australia	3.60	3.25	3.00	3.00
China	2.71	2.90	2.70	2.60
Brazil	11.64	12.60	11.60	11.20
India	6.99	6.75	6.50	6.50
South Africa	11.34	11.5	10.5	10.0
\$\$-Denominated Government Bond Yields (%)				
Emerging markets – JP Morgan EMBI Global	7.90	7.70	6.25	6.25
Emerging Asia – JP Morgan EMBI Global	6.11	6.00	4.95	4.95
Latin America – JP Morgan EMBI Global	8.50	8.40	6.90	6.90
Europe – JP Morgan EMBI Global	9.70	9.10	6.70	6.70
Africa – JP Morgan EMBI Global	13.10	13.30	10.20	10.00

Sources: Refinitiv, Capital Economics



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