BLUE HORIZON
Wealth Partner AG

Stronger equity markets despite weaker economy – Credit crunch for European SMEs

- Most macroeconomic indicators disappointed in April, which suggests that Europe will remain in recession longer than anticipated and that the US and Chinese slowdown may be more pronounced. Central banks continue to be accommodative, with Japanese Abenomics running full speed and ECB's rate-cut decision on May 2. We still expect that the current weakness will prove to be temporary and that the global economy will resume its slow growth path in the second half of the year.
- Despite weaker growth prospects, equity and high-yield markets performed well in April, with some weakness and heightened volatility in the first part of the month. On the back of relative valuation, exceptional monetary stimulus, and slowly improving economic data we remain constructive for equity markets.
- The gold price dropped markedly in April, losing almost 15% between the end of March and April 15, when it reached its low of USD 1,358. Since then, gold has recovered somewhat and is currently trading at USD 1,467. We see heightened risks of a further drop in the gold price and recommend reducing gold holdings during the current recovery phase.
- SMEs in Europe, especially in weaker economies, face very tough funding conditions. In our view, tackling this issue should become a priority for the ECB and European governments. The situation warrants innovative thinking about new ways to provide lending facilities.

Macroeconomics and financial markets

Macroeconomic data disappointed in April. Europe remains in a recession, China's growth has slowed, and many US leading indicators have softened. The US ISM purchasing manager's index, for example, dropped from 51.3 to 50.7 (see Fig. 1). A level below 50 indicates a shrinking economy. As a result, many forecasters have revised global growth prospects down slightly for 2013. However, despite the ongoing fiscal drag, the US economy looks more robust than others. The US housing market continued to improve and recent US labor market data surprised on the upside. Applications for US unemployment insurance payments fell by 18,000 to 324,000 in the week of April 27, the fewest since January 2008. Non-farm payrolls expanded by 165,000 workers in April following a revised 138,000 increase in March. As a result, the US jobless rate fell to a four-year low of 7.5%. This indicates that companies feel more confident and are starting to hire again.

It is remarkable that inflation in Europe and the US underwent a further drop, partly driven by falling commodity prices. This is good news for consumer purchasing power but indicates continuing weak demand and overcapacity (see Fig. 2).

Central banks have remained very accommodative. The Fed reiterated its willingness to introduce additional bond buying and on May 2 the ECB decided to lower the interest rate on the main refinancing operations by 25 basis points to 0.50% and the rate on the marginal lending facility by 50 basis points to 1.00%. Equity markets had a volatile start in April but performed well in the second half of the month. European equity managed to outperform US equity (compare our discussion in our March Wealth Management Review). The Nikkei and the Swiss SPI continued to outperform other markets with emerging markets lagging behind. In addition, the VIX index stayed very low, which is another indication of relaxed investor sentiment (see Fig. 4).

Fig. 1: US macro-economic indicators

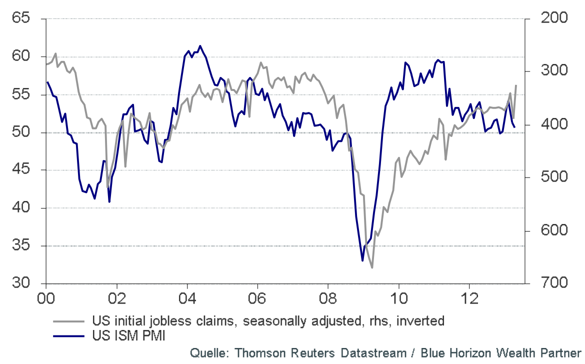


Fig 2: US and EU inflation

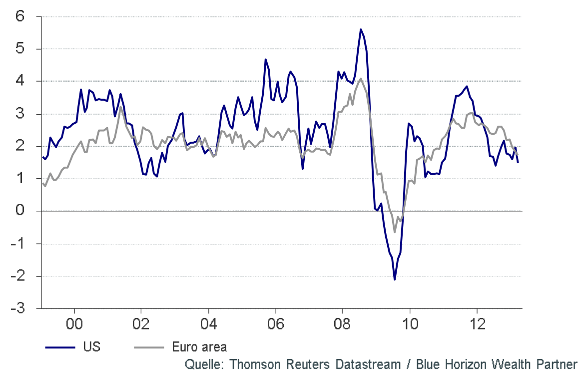


Fig. 3: Major equity markets in 2013

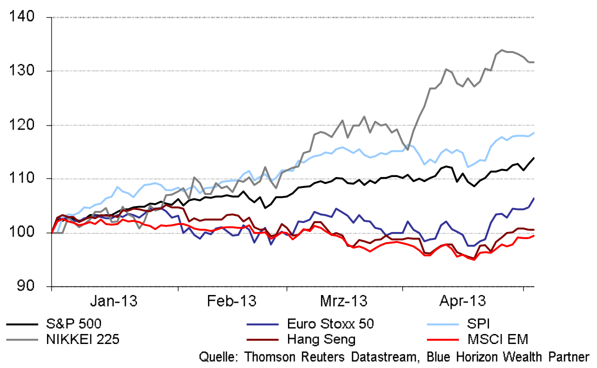
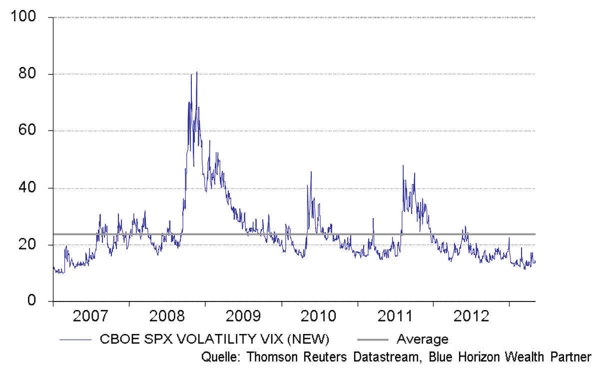


Fig 4: VIX index - S&P500 implied volatility



The gold market after the April slump

We discussed the tensions in the gold market in our February Wealth Management Review. In April the gold price fell by about 15% within a couple of days to reach its low of USD 1,358 on April 15. This was a drop of about 30% from gold's all time high of USD 1,898 on September 5, 2011. In the past several days, the gold price has recovered somewhat and is currently trading at USD 1,465 (see Fig. 5).

It is often the case that large sell-offs cannot be attributed to a single event. There was, however, some speculation about individual central banks, especially the Cyprus Central Bank, selling part of their gold reserves. Moreover, investors continued to redeem gold ETFs (see Fig. 7). Other reasons may be that goods price inflation has remained muted, the chances for an economic recovery have increased, and gold has been underperforming other assets markedly in recent months. Fig. 8 illustrates how gold performed relative to US equity (the S&P500 index) and

Fig. 5: Gold price in USD

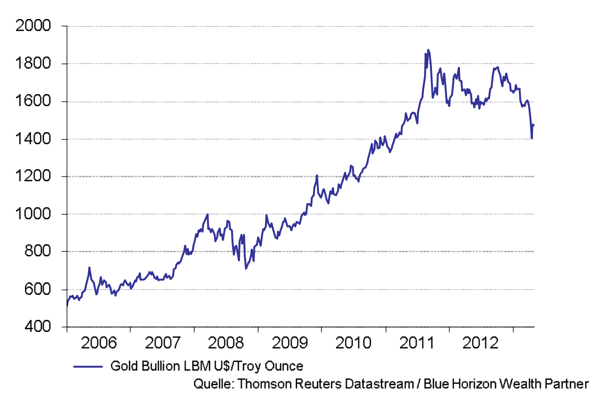


Fig 6: Real gold price, adjusted for inflation

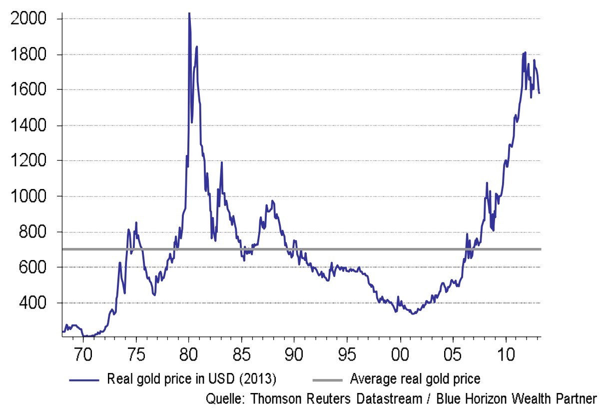


Fig 7: Gold ETF flows

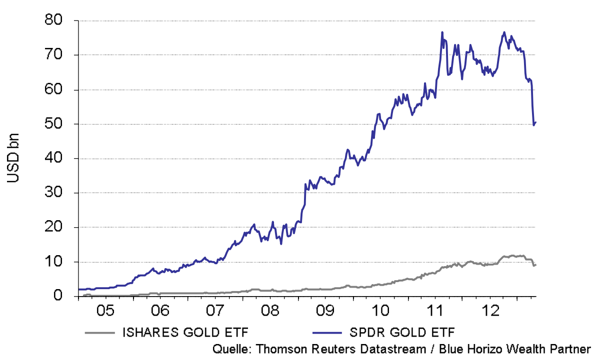
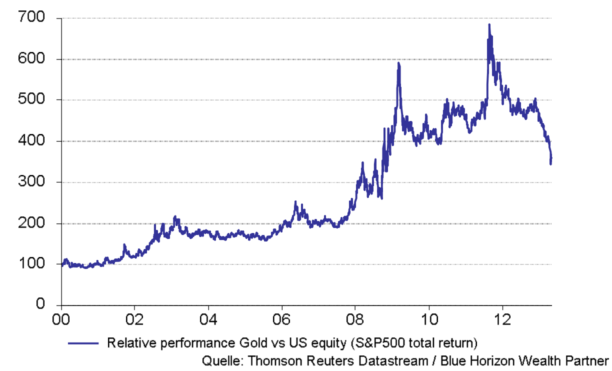


Fig. 8: Relative performance of gold vs US equity



that gold started to underperform equity in 2009, with accelerated underperformance since the end of 2012.

We would also like to highlight the long-term real gold price development, i.e. the changes in the gold price adjusted for consumer price inflation. As Fig. 6 shows, the gold price usually fluctuates between USD 400-1,000 in today's USD terms. It is also reasonable to assume that the average real return of a non-interest-bearing asset should be zero over the longer term, at least as long as the world reserves of the asset do not shrink over time.

In recent years as well as in the late 1970s and early 1980s the gold price significantly broke out of this band. In the 70s and 80s, after Bretton Woods and the gold-price standard were abandoned, inflation accelerated sharply, encouraging the gold price to surge. After Fed chairman Paul Volker tamed inflation, the gold price fell sharply and entered a bear market, which lasted two decades.

While we are very aware that the ultra-expansive monetary policy continues to create the fear of a monetary collapse, which may continue to support gold prices, we see increasing risks that investor demand could falter, so that we could experience another gold sell-off. In our view, downside risks for gold dominate, which is why we recommend reducing gold exposure.

Credit crunch for European SMEs

Despite floods of liquidity in the banking system, there is no guarantee that credit conditions will improve for the real economy. We refer to an article entitled "Mend the money machine" in the Economist of May 4. Central banks can directly influence money markets, to a lesser extent also bond markets. However, especially those companies which do not have access to capital markets, i.e. small and medium-sized companies (SMEs), rely on bank lending. Banks are currently facing a number of challenges. Investors are much more cautious about giving money to banks, especially the weaker ones, which results in an increase in the banks' overall funding costs. In addition, many banks are having to re-risk their balance sheets, partly because of the above-mentioned funding issues and partly because of tighter capital rules. The problem is especially severe in Southern Europe, where borrowing costs for sovereign debt as well as for local banks have risen substantially, which has driven corporate funding costs even higher. SMEs, especially in weaker economies, consequently face increasing difficulties in obtaining affordable funding. ECB's president Mario Draghi, in his speech on May 2, mentioned that the ECB is considering how to address the issue and to ease credit conditions for SMEs in Southern Europe.

One possibility could be a funding assistance program for banks' lending to SMEs, similar to the one already introduced by the Bank of England. In addition, we would also argue that there should be room for new private initiatives allowing private investors to meet private funding needs. In fact, we would like to draw attention to some of the crowd funding platforms and peer group networks which are still relative young and small, but which are working in the right direction.

Outlook

Despite economic weakness, we remain constructive for equity and high yield markets. We acknowledge that valuations look less attractive than they did twelve months ago, but we still see additional upside potential on the back of attractive relative valuations of equity against cash and high-quality bonds, continued monetary stimulus, and our view that the current economic slowdown will only be temporary. As mentioned, we do see considerable downside risk for gold and would recommend reducing gold exposure in the current recovery phase. Within equity markets we continue to favor developed markets and are neutral with regard to European vs US equity markets.

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