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Is this the end or just a pause in the equity rally?

- US macroeconomic indicators strengthened in May, while European indicators continued to disappoint. We expect a further widening of the growth gap between the US and Europe (see fig. 1).
- Ongoing sluggish growth in Europe draws attention to severe unsolved structural problems there, which we discuss in this issue.
- Equity markets sold off significantly in the second half of May with the Nikkei hit hardest, losing more than 7% in a single day. The major reason for the sell-off was the debate within the FOMC about the exit from QE (quantitative easing).
- We believe that equity markets are just pausing and will continue to perform well in the coming months. The markets which most significantly outperformed, i.e. the Nikkei and the Swiss Performance Index, were also subject to the most marked correction. This suggests that the correction was partly driven by profit-taking.
- Our expectations regarding the direction of equity markets are based on our view that reducing the speed of monetary easing should not be confused with central banks stepping on the brakes. Less accommodative monetary policy, especially if combined with improving economic conditions, should still have a supportive effect on equity markets.
- Major bond markets also sold off. 10Y US treasury yields rose almost 0.5 percentage points from the beginning of May. While this can certainly be attributed in part to the expectation of less Fed bond buying, it is still remarkable that the sell-off can be fully attributed to rising real yields with inflation expectations remaining firmly anchored (see fig. 5).
- The gold price recovered after the April sell-off but recently lost regained territory. The gold price has fallen almost 20% since the beginning of the year. In our view, the debate about less aggressive monetary policy measures and rising real interest rates makes the Gold market vulnerable to further declines.

Macroeconomics and financial markets

The recent performance of the US economy has been stronger than expected, especially in light of strong fiscal headwinds. It is especially encouraging that the labor market has been improving, although the unemployment rate still remains historically high at 7.5%. The Conference Board's consumer confidence index rose to a five-year high of 83.7 in May (see fig. 3), with both current conditions and future expectations showing improvement. The index nevertheless remains well below pre-crisis levels. Also house prices started to rise again in 2012 (see fig. 4). In Europe, however, the expected recovery seems to be put off from quarter to quarter. And even if Europe as a whole starts to grow again, peripheral Europe will have to suffer long-lasting and deep recessions during the process of cleaning-up balance sheets and de-leveraging.

Monetary policy – quo vadis?

Equity markets reacted very nervously on learning that the Fed had discussed potentially dropping QE (quantitative easing) later this year. While the change in direction of monetary policy, especially in light of the sheer size of the bond-buying program, should not be taken lightly, we would not overestimate the likely impact on markets.

In order to explain our thinking we can use the term **"escape velocity"**, which has only recently become popular among economists. In physics, 'escape velocity' refers to the speed necessary to break free of a gravitational field without further propulsion. In economics we can apply the concept to an economy which achieves self-sustained trend growth. 'Self-sustained' refers to a situation where no fiscal or monetary stimulus is needed.

Fig. 1: Widening growth gap

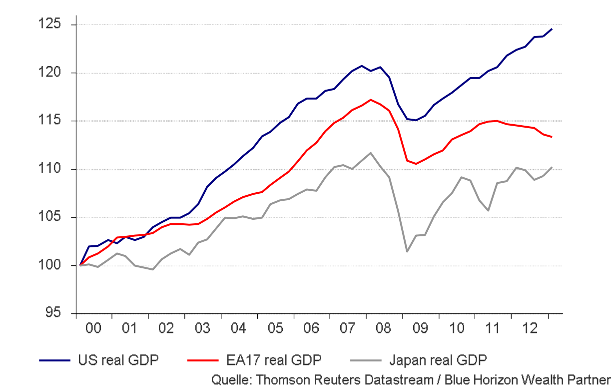


Fig 2: Major equity markets in 2013

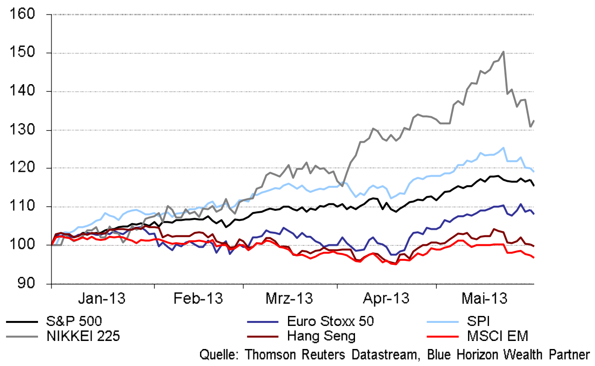


Fig. 3: US consumer confidence

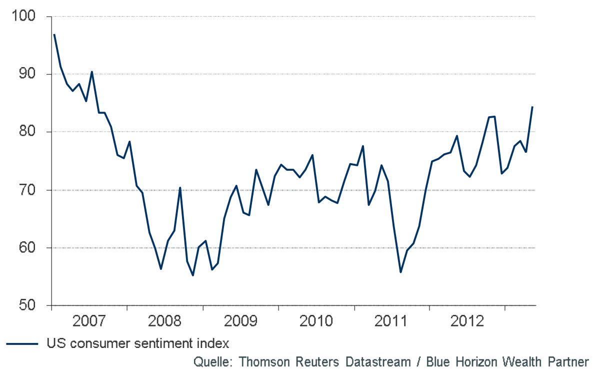
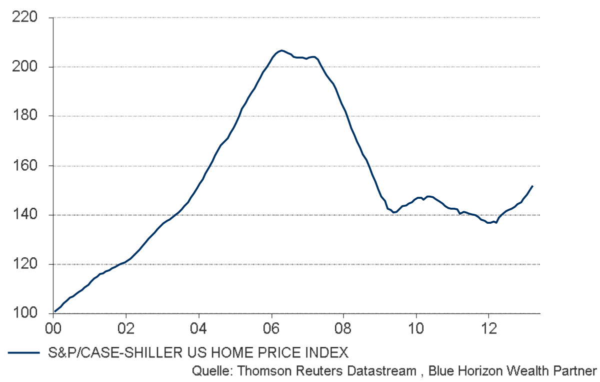


Fig 4: Rising US home prices



There is almost unanimous consensus among economists and politicians that the US, Europe, and Japan will need a long period of time, i.e. years, to reach their escape velocity. Let's try to bring the potential exit from QE into perspective. We may see less bond-buying initially, i.e. a very careful reduction in the speed of monetary policy. According to the Fed, this will only happen if we continue to see job growth. We also have to be aware that central banks, especially given the fragile state of the global economy, have no incentive to appear too hawkish and run the risk of financial market turmoil endangering the first stages of stabilization of real economies. In other words, we expect central banks to slowly and carefully reduce the pressure on the accelerator. It will take a very long time for central banks to start applying the brakes.

The monetary tightening cycle will carefully eliminate bond-buying and then start raising interest rates again. If we look back to the Fed's recent monetary tightening cycles, we observe that the S&P500 usually rallied during the tightening phase (see fig. 6). In addi-

Fig. 5: US 10Y treasury market

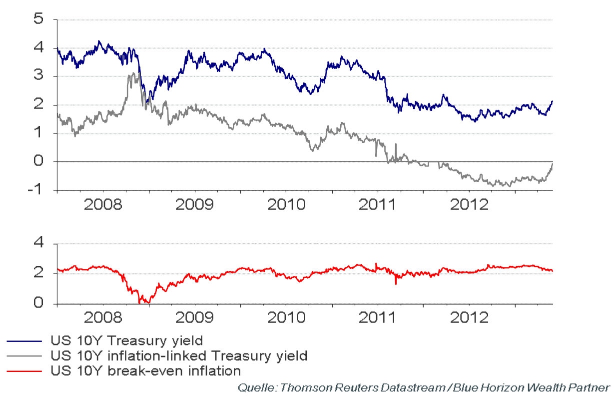


Fig 6: Fed rate hiking and equity markets

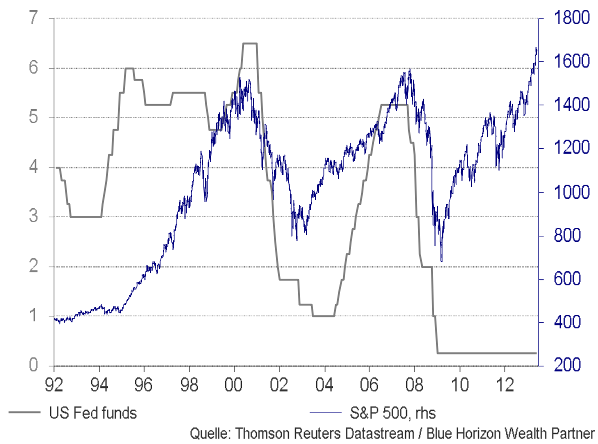


Fig. 7: EUR-USD exchange rate

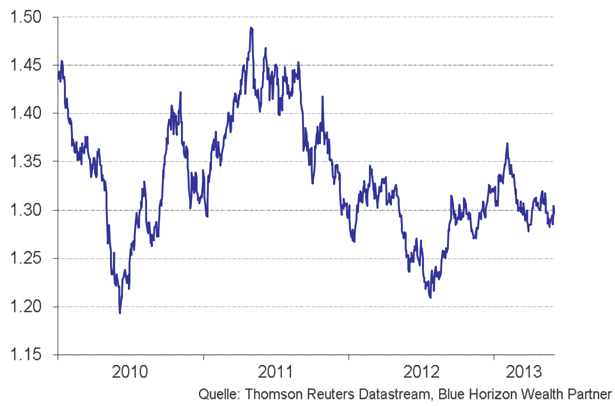


Fig 8: EUR-CHF exchange rate

tion, the removal of monetary stimulus very often happens "at a measured pace". This was the famous phrase the former Fed chairman Alan Greenspan used to comment on the rate hikes between 2004 and 2006. It took the Fed two years, from June 2004 to July 2006 to hike Fed funds rates from 1% to 5.25%. During that period the S&P 500 rallied almost 30%. Note, however, that in earlier hiking cycles equity markets did fall.

Taking all this into consideration, we expect rising uncertainty and market volatility when the monetary policy stance shifts, especially given the sheer size of central bank market interventions. Since central banks have been active in bond markets in the first place, it is safe to assume that the impact on fixed-income markets could be far more severe. The past has shown that in many cases equity markets performed well in such times.

Furthermore, it is also safe to assume that the Fed, due to the growth gap described, will lead the monetary tightening cycle with consequences for the EUR/USD exchange rate. While more aggressive Fed easing compared to the ECB has helped to keep the USD on the weak side – or at least stable at about 1.3 to the EUR since 2012 (see fig. 7) – a less accommodative Fed could lead to a stronger USD in the medium term. This would be warmly welcomed by the European exporters.

Are European politicians sleepwalkers?

In its May 25 issue the Economist covered the situation in Europe. We would like to recommend the articles to our readers. In our view, in addition to some structural economic problems, Europe is primarily faced with severe political issues, as the title "The Sleepwalkers" suggests.

After six quarters of shrinking GDP, very high unemployment, especially among young adults, mounting public debt, major pension and health funding problems, undercapitalized banks, and a credit crunch, Europe urgently needs fundamental economic and political reforms.

At the core we think that Europe urgently needs to clarify and fix the following issues:

- Streamlining decision-making processes and clarifying what authority should lie with the Union and what authority with the respective states.

- Transferring authority should be accompanied by transferring responsibility. If member states are allowed to exceed budgets and accumulate excessive public debt, it should be their responsibility to solve the debt problem in the first place and not the responsibility of the community, i.e. the German taxpayer. If, in contrast, the EU decides to transfer fiscal authority to the federal level, member states should bite the bullet and let the Union decide on national taxes and budgets.
- In contrast to the US, the European banking system is still in a very weak und fragile state. The clean-up of bank balance sheets was not thorough enough and transparency regarding the strength of banks' balance sheets is lacking. This leads to huge uncertainties and an inability on the part of the banks to take on new risks. This is one of the major reasons why there is so little bank lending in Europe.
- Transfers play an important role within Europe to ensure economic convergence. At the same time there is a danger that transfers are inefficient and do not achieve the intended result. In addition, large-scale redistribution between member states almost always leads to political power struggles.

We have argued before that we do not see the Eurozone or the ECB as the core of the problem. We think, however, that the introduction of the Euro accelerated the need for deep-rooted political and structural reform in Europe. Inefficiencies, bureaucracy, difficult decision-making processes, unclear lines of responsibility between member states and the federal level lie at the heart of the problem. The monetary union and the current debt and banking crisis highlight the urgent need for structural reforms.

Outlook

The two-speed world economy, structural problems in Europe, vulnerable banks, huge public debt burdens, the uncertain outlook for China, and open questions around how and when central banks will exit their ultra-expansive monetary policy look like a very dangerous environment for financial markets. And in fact – it is. However, we continue to believe that risk-reward considerations favor being long equity markets and that valuations are not yet overly demanding. We are shifting our expectations to an outperformance by US equity markets. In addition, in the medium term we see the prospect of the USD strengthening against the EUR, especially if the Fed decelerates their quantitative easing earlier than the ECB. We expect Gold and the Swiss franc to weaken further.

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