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Tug of war between optimists and pessimists

- The announcement by the US Fed on May 22 of a move towards less accommodative monetary policy, i.e. less bond buying later this year, has had a big impact on financial markets. Bond, equity and gold markets sold off. Not only did 10Y benchmark rates rise by 0.55 percentage points in the US, 0.45 in Switzerland, and 0.30 in Europe, in addition credit spreads widened. Major equity markets lost between 3% in the US and 10% in emerging markets.
- We expect continued volatility and nervous trading, but we still see the best risk reward in equity markets. We continue to prefer US and Japanese equity over emerging markets and Europe. Gold and other commodities will remain under selling pressure, while oil could recover somewhat. The USD may turn out to be the major beneficiary of a less accommodative US central bank.
- In this issue we will also highlight the recent developments in China. The country's economic growth slowed down, and leading indicators suggest that there will be no meaningful acceleration any time soon. The Chinese Hang Seng equity index has fallen by almost 9% since January. In addition, the Chinese economy is currently undergoing structural changes, which are having a strong impact on global markets.
- It is noteworthy that MSCI, an important provider of financial market indices, announced on June 11 that it had downgraded Greece from the developed market index to the emerging markets index. This is the first time that a nation has been downgraded from developed-market to emerging-markets status. Greek bond spreads subsequently widened. Since many institutional investors have to follow MSCI indices when constructing portfolios, there will be shifts in demand. However, the overall effect on demand for Greek stocks and bonds remains unclear, since Greece's weight in the emerging markets index will attract demand from emerging markets investors.
- We currently observe a new wave of political protest in a number of different regions, including Brazil, Turkey, Egypt, Bulgaria, Greece, Indonesia and some Arab countries. The reasons for the protests vary widely, but all manifest discontent with the political and/or economic situations. It is remarkable how rapidly the protests seem to spread, in part as a result of efficient social media communication. In addition, the protestors are often a highly heterogeneous group rather than belonging to specific sections of the population. We think it is very important to keep track of these developments. In 1989 such protests led to the fall of the Soviet regime and the tearing down of the Berlin wall. At the time of writing, Egypt's military have ousted President Mursi and paved the way for new elections.

Macroeconomics and financial markets

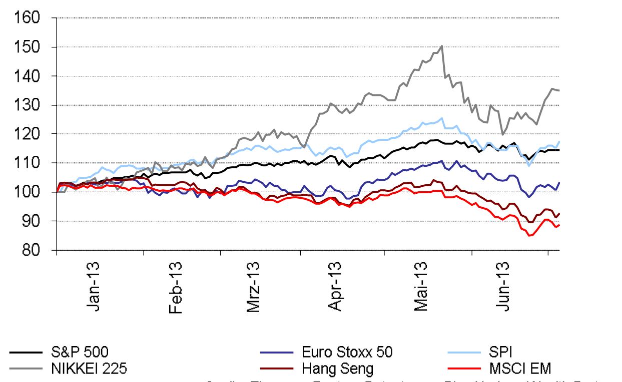
In our view the macro-economic picture has not changed much in recent weeks. The US economy has proved to be most resilient, despite a significant growth-dampening effect from tighter fiscal policy. Europe, by contrast, is finding it hard to escape recession. Chinese growth has also slowed, as we discuss in a separate section below. While the US is years away from a booming economy, the Fed indicated for the first time on May 22 that they could reduce bond buying later this year, given that growth continues to accelerate. This has caused significant sell-offs in bond, equity, and commodity markets.

We think there are two opposing views on macroeconomics and the Fed announcement: the pessimistic and the optimistic. It seems to us that equity markets have been driven by pessimists, while bond markets have been driven by optimists. We believe that sooner or later one of the two views will prevail, and we think that the optimists'camp will come out on top. But first, why do we think there are two camps with such different views?

Let's start by considering the pessimists. They regard the recent equity market rally as driven purely by the huge amount of liquidity and artificially low interest rates, which pushed share prices up while ignoring weak fundamentals. They feel that, since excessive monetary stimulus was the sole driver for the equity markets, less stimulus will logically result in falling equity prices, reflecting poor fundamentals and a weak growth and earnings outlook.

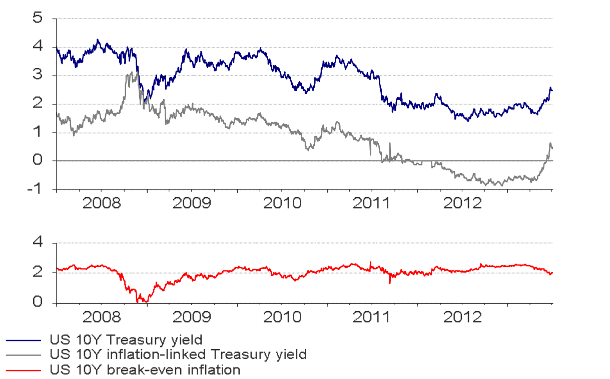
In contrast, the optimists think that, at least in the US, monetary policy has helped to bring the US economy back to the growth path, even if that growth path is relatively flat. Some of the optimists were even surprised by the Fed's GDP growth forecast of 3.25% for 2014, which is clearly above consensus expectations.

Fig. 1: Major equity markets in 2013



Quelle: Thomson Reuters Datastream, Blue Horizon Wealth Partner

Fig 2: US Treasury yields



Quelle: Thomson Reuters Datastream / Blue Horizon Wealth Partner

Based on strengthening fundamentals, not very demanding valuations of equity, the relative attractiveness of equity vis-à-vis cash and bonds, the optimists see further upside potential. They argue that less bond buying by the central bank will still keep monetary policy very accommodative and that first-rate hikes are not to be expected before 2015.

But why do we see bond markets being ruled by optimists when 10Y Treasury yields rose very rapidly from 1.95% to 2.50% in just a couple of days? Fig. 2 shows that the sell-off was characterized by rising nominal yields and rising real yields at the same time. The real yield is derived from the so-called inflation-indexed US Treasury bonds, which pay out a fixed coupon plus a variable compensation reflecting the current inflation rate. In contrast nominal Treasury bonds pay out a fixed coupon, so that the resulting nominal yield of such bonds combines a real component with a component reflecting investors' inflation expectations. In brief, real yields reflect investors' real growth outlook and the difference between nominal and real yields investors' inflation expectations. So what does the bond market sell-off tell us? Bond investors expect real growth to rise, while at the same time inflation expectations remain low and have recently been pitched even lower. In other words, bond markets foresee stronger growth without inflationary pressure, which would be a very favorable outcome. By the way, the gold bears in our view clearly belong to the optimists' camp too.

We believe the bond market is right: overcapacity and high unemployment should prevent inflation from rising by much. In addition, the US economy has shown remarkable resilience, and leading indicators suggest that it is gaining speed. Also, rising policy rates in the past were more often than not characterized by stronger equity markets (compare our Wealth Management Review, May 2013), since economic recovery provides the basis for new business opportunities and earnings growth.

However, we acknowledge that due to the sheer size of the monetary expansion the outlook very much depends on how the Central Bank manages to withdraw excess liquidity prudently, without endangering still fragile growth dynamics and without excessively scaring financial market participants. Since this will remain a delicate process, it is safe to assume that financial markets will remain volatile as the process unfolds.

What is going on in China?

China has been a remarkable success story. An autocratic communist system welcomed private business initiatives and allowed markets to develop, but continued to control the economy in a very particular way. This, combined with China's sheer size and its 1.4 billion inhabitants, accounting for roughly 20% of the world's population resulted in its dominating a number of world markets, especially as an exporter of manufactured goods and as an importer of intermediate goods and commodities. The Chinese economy grew at a breath-taking speed with double-digit growth rates for decades. In recent years, however, GDP growth slowed markedly (see Fig. 3) and there are signs that real-estate markets in economic centers have been overheating. Lending, which grew stronger than GDP in the last decade, also seems to be slowing down. It's worth remembering that the collapse of excess lending and an overheated real-estate market were at the core of the US banking crisis of 2008.

Another remarkable event happened on June 20, when lending among financial institutions froze and interbank lending rates suddenly soared (see fig. 4) — another parallel to the US crisis, during which interbank lending almost stopped and libor rates rose far above secured lending rates. In contrast to the US, the Chinese Central Bank itself stopped lending, which caused the ripple-on effect and rumors about possible bank failures. On June 24, the Chinese stock market fell by more than 5%, the largest drop for many years. It seems that the Chinese Central Bank, which has returned to the lending market since then, wanted to send a warning signal to financial institutions. It seems to us that the Chinese authorities have become worried about excessive lending and overheating business sectors. While we believe that China has the means to manage bad bank loans and can distribute resulting losses in a non-disruptive fashion, such balance-sheet repair usually takes some years. This could result in more muted growth dynamics in the years to come.

Fig. 3: Chinese GDP growth and leading indicator

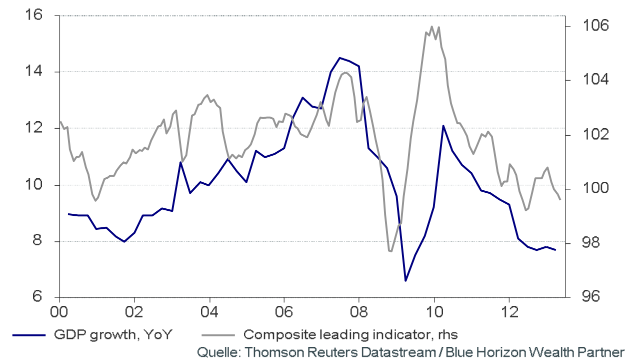
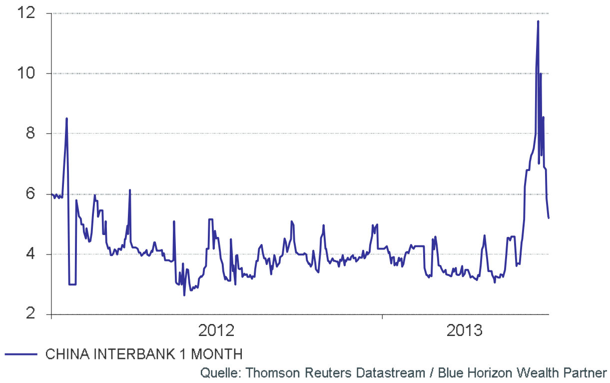


Fig 4: Chinese interbank lending rate



While China may take some time to digest the rapid growth and lending of the past, there is another structural change going on in China. Growth was driven by industrialization and infrastructure build-up, and what was produced was mostly exported. It seems that the economy is now shifting towards more domestic, consumer demand. The strongly rising middle class in China is asking for a higher share of production for its own purposes. At the same time there is a greater need for services, which is triggering an expansion of the tertiary sector. Also, production costs in China have risen and we already observe that production of less sophisticated products is moving to other countries with lower labor costs, like Vietnam and Cambodia.

The above-mentioned cyclical and structural changes occurring in China seem to be having an effect on other emerging markets and can at least partly explain the disappointing performance of emerging equity markets. Major victims are the commodity providers, like Brazil and South Africa. Moreover, commodity markets have suffered from lower Chinese demand, with mining companies and the Australian Dollar under pressure. Companies which are able to capture the rising Chinese consumer demand could, however, prove to be the beneficiaries of this development.

Outlook

As already pointed out earlier, we see diverging growth trends between the US and Europe. Structural changes in China and slowing growth will lead to slowing commodity demand and influence trade flows. Commodities and commodity-rich countries are likely victims of this process. Oil may be an exception since hunger for energy is likely to stay high, and political tensions may mean that oil prices will reflect a political risk premium. We regard most segments of the bond market as being priced to perfection and dislike the pure risk reward. Yields are likely to rise further. We still see best risk reward in equity markets but expect markets to be highly volatile going forward. We prefer the US and Japan over Europe and China and commodity- rich emerging markets. We stay positive on the USD. Gold remains vulnerable to further sell-offs.

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