BLUE HORIZON
Wealth Partner AG

The Fed calmed the markets – but for how long?

- The period between May 21 and June 24 saw strong market moves in which equity, bond and gold markets sold off and the USD rallied. In July equity markets and Gold then recovered while the USD sold off. Bond yields, which had leapt in May and June, plateaued at higher levels.
- The likely most significant event of the past month occurred on July 10 when Fed Chairman Ben Bernanke voiced his reassurance that the Fed would continue to be accommodative for the foreseeable future. This has calmed markets greatly. We think that the start of Fed tapering later this year would be consistent with Bernanke's comments. We further see Fed tapering later in the year as the most likely scenario, given the current growth trajectory of the US economy. In our view, the Fed communication in May was by no means ill-considered. By issuing it the Fed was intentionally steering yields higher- - though not by too much - and implanting the idea of monetary tapering into the minds of market participants.
- We expect rising volatility of financial markets in the second half of the year on the back of the above-mentioned monetary tapering. As discussed in previous issues of the Wealth Management Review, we remain positive overall for equity markets and the USD, and we see the major losers to be bonds and Gold. Yield curves will continue to steepen, i.e. long-dated bond yields will rise more sharply than short-dated bond yields.

Macroeconomics and financial markets

The US economy digested the fiscal drag in the first half of 2013 and is steering towards real GDP growth of 2%. The expected growth will not be sufficient to reduce overcapacity in a meaningful way. Similarly progress in the labor market has not been sufficient to lower the unemployment rate to acceptable levels. In Europe too leading indicators improved somewhat, e.g. the Markit Eurozone PMI index rose above 50 for the first time since January 2012. A PMI level above 50 indicates that the economy is growing. The PMI rose for the fourth successive month, up from 48.7 in June to 50.4. This is consistent with initial signs of economic stabilization in Europe. China's growth continues to slow down, but a collapse is unlikely in our view. In general, we observe that growth in emerging markets slowed significantly. Major reasons are lower commodity demand, especially from China and drying capital flows, since among other things risk reward in developed equity markets looked more attractive. In addition, rising inflation and wage pressure has depressed corporate earnings and led some central banks to become more hawkish or even to tighten monetary policy. Examples are India, Indonesia, Turkey, Brazil, and China. Compare our June Wealth Management Review for China's central bank intervention on the interbank market.

Outlook

We expect Fed monetary tapering to begin later this year. In our view the Fed has willingly and successfully steered markets towards higher yield levels and has started to prepare markets for the coming withdrawal from ultra-expansionary monetary policy. Since the Fed's exit from quantitative easing will be a gradual and rather cautious process accompanied by stronger economic growth, we expect market adjustments to happen in a more or less orderly manner. However, as the May-June sell off demonstrated, financial markets will act nervously at times and tend to overshoot on certain news.

We believe that the growth gap between the US and Europe will remain for the foreseeable future. It is not yet clear, but will prove to be very important, whether the emerging markets - most notably China - will be able to regain positive growth dynamics or slow down even further. We consider the growth risk for emerging markets as one of the major risk factors for global growth and financial markets.

On balance, we still see the best risk-reward in equity and we believe that equity markets can sustain the positive trends, albeit at a slower pace and with higher volatility. As economic growth has been diverging between the US and Europe and monetary policy is starting to diverge, we expect the USD to strengthen. As Figure 2 shows, the yield differential between the US and Germany has widened significantly. That development reflects the above-mentioned divergence and supports the USD vis-à-vis the Euro.

Fig. 1: Major equity markets in 2013

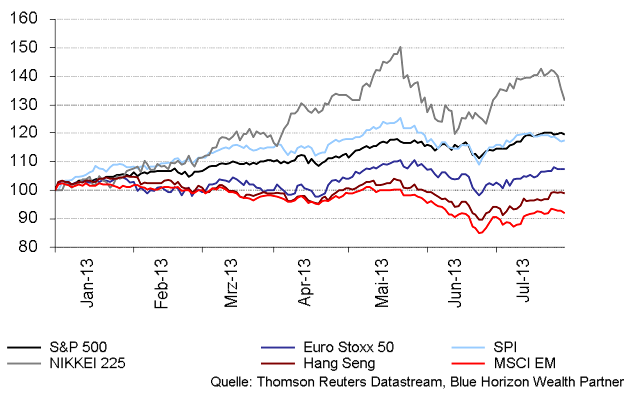
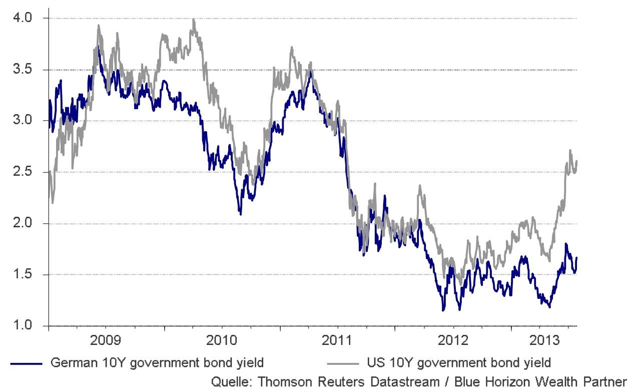


Fig 2: US Treasury yields



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