Shaky markets ahead – Fed tapering and Middle East tensions weigh on investors' sentiment

- Despite stronger economic activity, especially in the US, equity markets sold-off in August. Fed tapering fears, combined with higher bond yields and rising tensions in the Middle East, have been weighing on market sentiment. Over the weekend President Obama said he would be prepared to order military action against Syria but would first seek approval from Congress.
- We expect Fed tapering to start before year end, probably even at the next Fed policy meeting on September 17. In addition, there are uncertainties with regard to the US approaching another debt limit in October, and Germany's election of the federal parliament on September 22.
- US 10-year yields currently trade around 2.8% and seem to be trending towards 3%. Implied inflation rates, however, remain firmly anchored around 2%, suggesting that markets expect higher growth without inflation picking up.
- Gold rebounded and temporarily broke the USD 1,400 mark. Oil prices spiked on the back of Middle East tensions and remain clearly above USD 100.
- We take a cautious stance and recommend that tactical traders reduce risk. In the bigger picture we believe that the market correction will be only temporary, and will be followed by stronger equity markets in the fourth quarter of this year. As a result, our recommendation for equity investors is to buy the dips. We similarly think that if current uncertainties fade, gold prices could fall again, and we recommend selling gold into strength.

Fig. 1: US ISM index and initial jobless claims

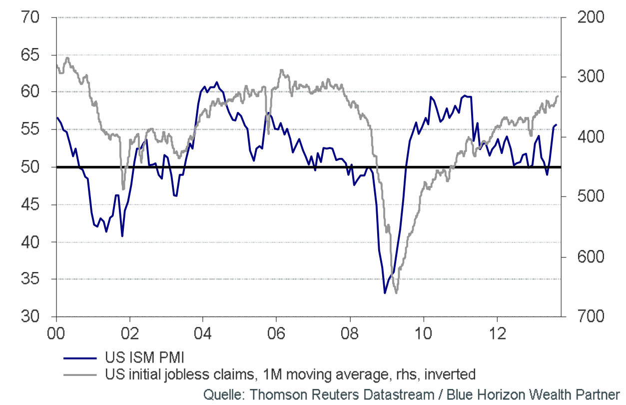
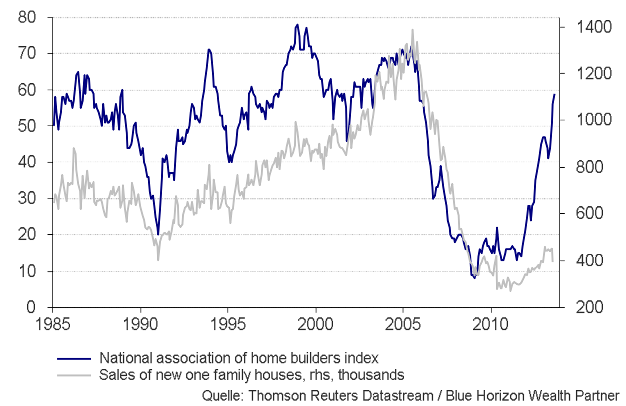


Fig 2: US housing market indicators



Macroeconomics and financial markets

Macroeconomic indicators improved by and large during August, though the pace of the recovery remains relatively slow. Still, the US economy is outpacing the economies of Europe and Japan. The US ISM purchasing managers' index climbed to 55.7 in August after 55.4 in July and 50.9 in June. Also, US initial jobless claims continue to fall and the US housing market is recovering. The National Association of Home Builders market index has recovered strongly from its lows, and the sales of new single-family homes have picked up (see figure 1 and 2).

Despite stronger economic data, equity and bond markets sold off in August. After the Fed announced its tapering plans, equity markets sold-off following the release of stronger economic data. This is rather unusual, but stronger growth data obviously sparked rising tapering fears. We still expect Fed tapering to start in the coming months, probably even as early as September.

In August most equity markets fell. The S&P500 lost 2.9% and underperformed the EuroStoxx50, which fell 1.7%. The Japanese Nikkei index fell 2.0% while the Swiss Performance Index (SPI) lost only 0.6%. The volatility index VIX (the cost of buying insurance against falling equity markets) rose to 17 but remains clearly below its long-term average (see figure 6).

Consistently with the divergences in growth trends and central bank policies between the US and Europe, US treasuries strongly underperformed German bunds (see figure 3). The US 10y yields almost doubled and currently trade around 2.8%. It looks as if US 10y yields could approach 3% in the near future. At the same time, as figure 4 shows, implied inflation expectations (the difference between nominal and real yields) remain well anchored around 2%. While special supply and demand situations in the inflation-linked treasury market may distort the implied

Fig. 3: US treasuries underperform German bunds

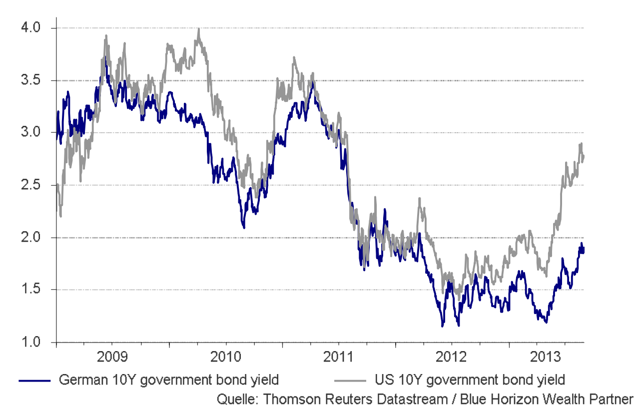
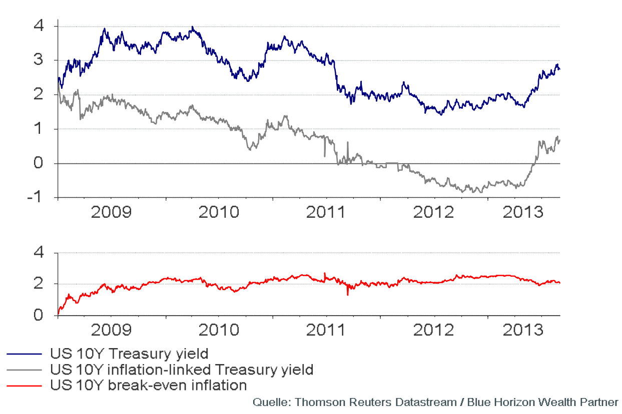


Fig 4: US real vs. nominal yields



inflation rate and thus draw too rosy a picture, the market still remains relatively relaxed with regard to inflation fears. This is certainly consistent with the fact that the US economy still has a lot of underutilized capacity and high unemployment.

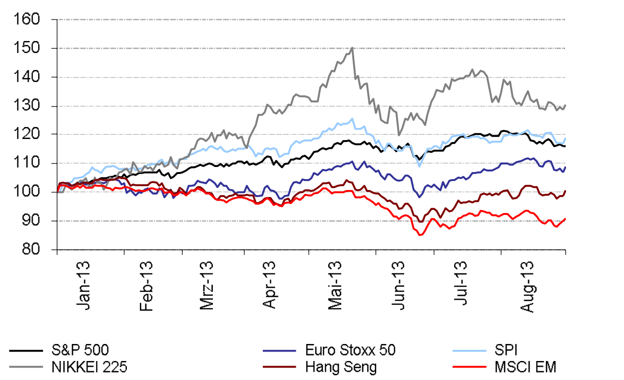
While we believe that the US Fed is not unhappy about bond yields being higher than two months ago, we could soon see yield levels which exceed warranted yields, given the current state of the US economy. Rapidly rising yields can dampen growth and spark equity market corrections. It will be interesting to see whether and how the Fed might protest when 10y yields climb above 3%.

In the meantime emerging markets continued to suffer from capital outflows, deterioration of earnings and weakening currencies, especially in those countries with high trade-account deficits. Emerging markets equity, however, did fall a little less than the equity markets of developed countries in August, i.e. by 1.7% compared to 2.1%.

In the US there is another risk looming, which could unnerve markets. Last week treasury secretary Jacob Lew indicated that the US could hit the debt limit by mid-October. As a result, the US government has to seek approval from Congress to raise the debt ceiling by the end of September. As Democrats and Republicans are deeply divided on fiscal policy matters, such decisions have hitherto been delayed until the last minute, which has led to a high degree of uncertainty and nervous trading.

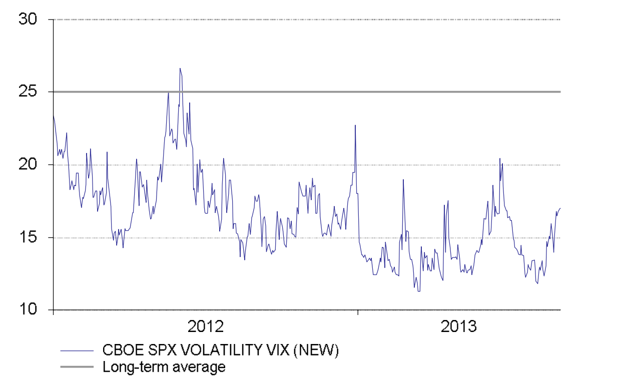
It is expected that in a few weeks' time Barak Obama will decide on another important matter, the successor to Fed chairman Ben Bernanke, whose term ends in January. The two major candidates are Larry Summers and the Fed's current vice chairman, Janet Yellen. Larry Summers has impressive intellectual baggage and academic qualifications, while, Ms Yellen brings applied central bank policy experience to the table. Many commentators assume that Barack Obama inclines rather

Fig. 5: Major equity markets in 2013



Quelle: Thomson Reuters Datastream, Blue Horizon Wealth Partner

Fig 6: VIX implied volatility index



Quelle: Thomson Reuters Datastream, Blue Horizon Wealth Partner towards Ms Yellen. If you compare the likely policy stance of the two, the differences are not so obvious. In the past, both of them seem to have favored accommodative monetary policy measures to support growth. While the liberal economist in us would prefer a more hawkish central bank leader, this could prove to be supportive for growth and equity markets in the medium term.

Outlook

We believe that the current uncertainty around Fed policy and the likely impact of tapering on growth, will lead to shaky financial markets generally. Bond yields could very well rise even higher and equity markets will remain unsteady with heightened risks of market corrections. Political uncertainties, above all the situation in Syria, but also the German elections, the appointment of a new Fed chairman, and another potentially fearsome fiscal debate in the US, will additionally weigh on investors' sentiment. At the same time, the above-mentioned uncertainties should support gold and oil prices.

We believe that the overall outlook for equity markets will remain positive in the medium term. Shifts in the monetary policy regime always lead to uncertainties and undermine market sentiment. However, as we have argued in previous editions of the Wealth Management Review, we think that better growth as well as cautious and slow Fed tapering will allow equity markets to perform well in the coming quarters. Therefore, we would see potential equity market corrections as opportunities to buy into dips. Likewise, as uncertainties may evaporate later this year, we would anticipate rising risks for gold and would sell into gold market strengths.

Our view on the EUR-USD exchange rate has received little recent corroboration. The EUR has instead rebounded since the beginning of July and stabilized at about 1.32. The USD has not proved able to benefit from the stronger US growth dynamics and the rising yield advantage. In recent days, however, the USD has regained some strength, and we expect it to gain further strength going forward.

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