BLUE HORIZON
Wealth Partner AG

ECB's rate cut and the Iran deal bolster markets

- The ECB's surprise rate cut on 7 November gave markets for risky assets a further boost. Credit spreads tightened across the board and major equity markets rose. The S&P500 climbed 3%, the EuroStoxx50 0.8%, and the Japanese Nikkei a remarkable 9.3%. Emerging markets, however, failed to benefit from the broad-based rally and fell 1.5%, and then, after Fed tapering fears reemerged last week, the other markets gave back some of their gains.
- On November 24 a ground-breaking deal was concluded between the six world powers, led by the US, and the new Iranian regime. The aim of the agreement was to freeze Iran's attempts to build a nuclear bomb in return for temporary relief from international sanctions. Although this can only be seen as an interim deal to be followed by further complicated negotiations of uncertain outcome, it nevertheless sparks great hopes that one of the gravest current geopolitical risks has been significantly mitigated.
- In Germany, coalition talks between CDU and SPD finally – on November 27 after five weeks and a concluding 17-hours session – resulted in a proposal for a new coalition government. The agreement is, however, subject to a referendum among the SPD's 470,000 party members. The outcome, expected on December 14, is far from certain. Moreover, the new Grand Coalition would work on the basis of an agenda full of very questionable economic initiatives, which could well set back some of the economic progress made in the past decade.
- We remain cautiously positive for equities, but we recognize US fiscal hazards and Fed tapering as the major risk factors which might lead to market corrections. Divergences in monetary policy between the US and Europe should support the USD vis-à-vis the EUR. We see Fed tapering (and as a result rising real interest rates), and also improving economic data, as major risks for Gold, and we expect the Gold price to fall below USD 1,200 sometime soon.

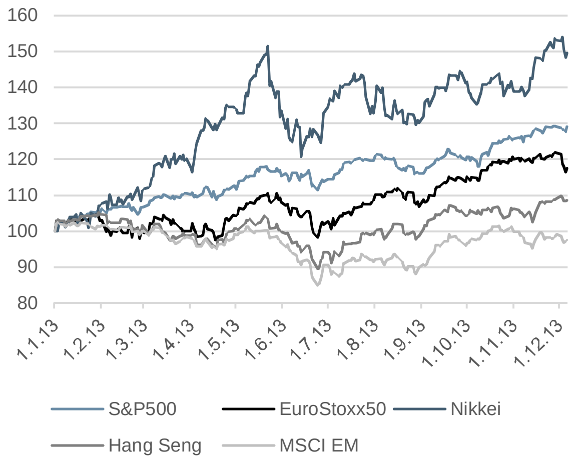
Macroeconomics and financial markets

After the surprise rate-cut decision on November 7, when the ECB reduced its major policy rate from 0.5% to 0.25%, it was no surprise that the ECB left rates unchanged at its latest meeting on December 5. More interesting were the ECB's revised 2014 forecasts and its first-time forecast for 2015. The ECB predicts only a very shallow recovery from the past double-dip recession. Having fallen by 0.4% in 2013, GDP will rise only 1.1% in 2014 – a slight upward revision of the 1% forecast in September – and then increase by 1.5% in 2015. Mr Draghi reiterated that the risks are still skewed to the downside. Since the ECB's major concern is falling inflation, inflation forecasts took center stage. The inflation outlook remains worrying. The ECB expects inflation to stay clearly below its target of “below but close to 2%”. Headline inflation is expected to be 1.1% only in 2014 – revised down from the figure of 1.3% predicted in September – and picking up only marginally to 1.3% in 2015.

Why is the ECB so worried about low inflation? Firstly, the ECB has to deal with an economic area with great regional variations of productivity and GDP growth. Differing productivity requires employees in low-growth areas to accept lower wages to remain competitive. Inflation would allow real wages in peripheral Europe to fall without major protests from the employees. Nominal wage cuts, by contrast, are usually much harder to achieve. Secondly, an average inflation rate of about 1% in Europe is very likely to result in outright deflation in crisis-prone peripheral countries. Falling prices, however, make it much harder for those countries to reduce their debt levels and encourage consumer and investment demand.

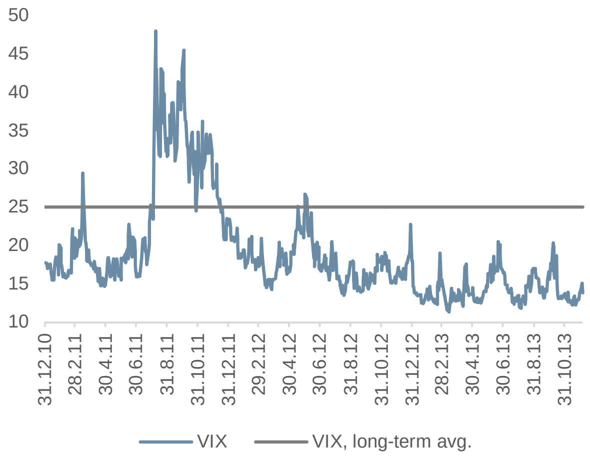
Following ECB’s latest rate cut especially, Mr Draghi is now running out of conventional ammunition. Despite the fact that he reiterated that the ECB has additional means to act and is prepared to use them, it seems that the ECB directorate is divided regarding the right course of action. It may well be that the ECB will keep its unconventional powder dry for a longer period. This, however, is bad news for one of the most pressing issues in Europe: the dismal state of large parts of the banking system and the resulting credit crunch for small and mid-sized corporates.

Fig. 1: Major equity markets in 2013



Source: Datastream, Blue Horizon Wealth Partner AG

Fig 2: VIX implied volatility index



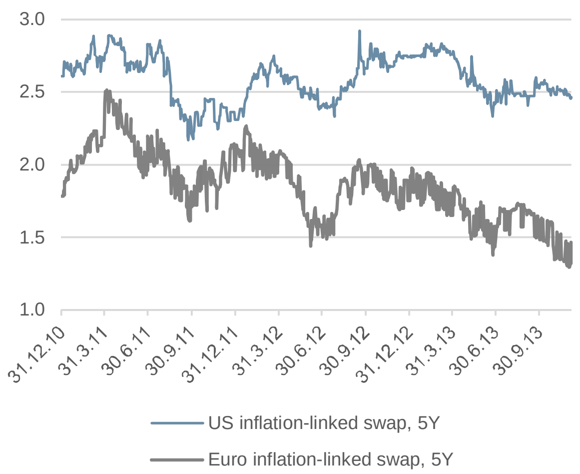
Source: Datastream, Blue Horizon Wealth Partner AG

Outlook

As we approach year end we see the likelihood of either a major correction or a strong year-end rally as rather low. Major risks are a renewed US fiscal debate and a Fed tapering announcement. It may well be that the deeply divided political forces in the US will not be able to find a compromise solution to the fiscal debate. The government is only funded until January 2014 and the debt ceiling will be reached in February. Our base case is that the fiscal talks will end successfully, albeit with some noise, but not as disruptively as hitherto. The more serious risk for markets – at least temporarily – is the start of US Fed tapering as the US economy continues to recover. The initial market reaction could be quite damaging but we would see such a situation as a buying opportunity, since historical evidence suggests that economic recovery is usually good for equity markets, despite more restrictive monetary policy. In addition, while equity markets are no longer cheap, they do not look overly expensive and are very attractive vis-à-vis cash and bonds.

We remain bearish on government bonds and expect the US-Treasuries to underperform Bunds. Credit spreads will stay tight and may even tighten further in 2014. As discussed above, we expect the gold price to break below USD 1,200 and the USD to strengthen.

Fig. 3: Euro and US inflation expectations



Source: Datastream, Blue Horizon Wealth Partner AG

Fig 4: Gold price in USD/Oz.

Source: Datastream, Blue Horizon Wealth Partner AG

Blue Horizon Wealth Partner AG
Sihlhaldenstrasse 10
CH-8803 Rüschlikon / Zürich
info@bluehorizon-wp.com
www.bluehorizon-wp.com

Important Legal Notice