BLUE HORIZON
Wealth Partner AG

Growth risks dominate political risks

- Financial markets have been very volatile in the first quarter, and although we expected more volatility in 2014 than in 2013 (see the December WMR), we did not expect that it would be caused by such marked weakening of growth indicators and erupting political tensions in the Ukraine.
- On the back of weaker growth data and the Ukraine crisis, bond markets rallied, US 10Y yields fell about 30 basis points to 2.73, and equity markets traded very nervously but by and large sideways. Developed markets equity sold off in January, rebounded in February and were about flat in March, ending the first quarter slightly positive. Emerging markets by and large followed the same pattern but have fallen slightly since the beginning of the year. Meanwhile oil prices rose only slightly in Q1 – by 3.5% – and even fell in March. In the same period, Gold prices surged 6.7% but gave back some of their gains in March, falling 2.7%.
- The major victims of the Ukraine crisis have been – not surprisingly – the Russian rouble, which lost 7% vis-à-vis the Euro, the Russian RTS equity index, which fell 15%, and Russian credit spreads, which widened by about 100 basis points in Q1.
- Our conclusion from the financial market movements – falling yields and flat equity markets – is that market participants have been far more concerned about weakening growth than about the Ukrainian crisis. This is based on the fact that especially the oil market – usually a reliable political risk indicator – behaved relatively benignly.
- On page 3 we discuss the Ukrainian crisis in greater depth and also cover potential contagion effects.
- Monetary policy held some surprises. Janet Yellen, for instance, new head of the Federal Reserve and generally considered to belong to the Fed's dovish camp, came out with surprisingly hawkish statements after her first meeting as chairwoman, indicating earlier rate hikes than markets had anticipated. Meanwhile, Jens Weidmann, the German hawk in the ECB and one of the strongest opponents of quantitative easing measures, stated that he could back quantitative easing under certain conditions if a stronger Euro continued to push down import prices.
- Overall we stay positive for equity markets, the USD, and to a lesser extent for credits, and we remain bearish for Gold, the Japanese yen, and government bonds, especially Treasuries.

Macroeconomics and financial markets

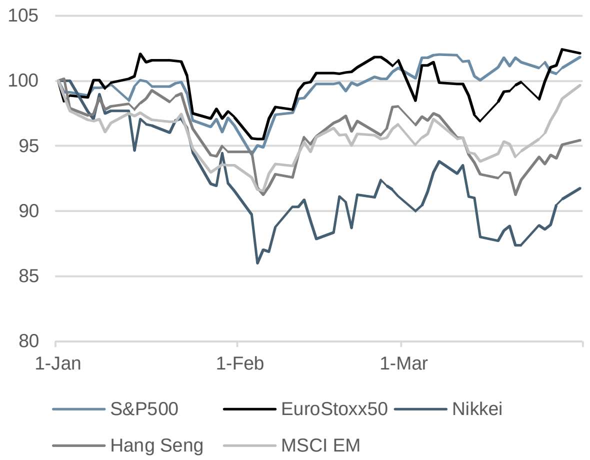
Economic growth in Q1 is expected to be disappointing. Extreme weather conditions in the US have certainly had an impact. It is expected that real GDP growth will come out at only 1.5% while many forecasters expected 2014 GDP growth of 3%. How strong the weather impact has been will only become clear in the course of Q2. Still, some indicators are coming in stronger and suggest that growth dynamics is picking up. For example, the ISM index just rose to 53.7 from 53.2 a month earlier, signaling increasing growth momentum. Likewise US March payroll figures are expected to be on the strong side.

Meanwhile Q1 growth in the Euro area is expected to be only 1%, while a continued drop in inflation has been sparking deflation fears and may lead to further ECB easing. Euro area inflation fell to only 0.5% in March.

Growth concerns regarding China have been allayed somewhat since the official Purchasing Managers' Index for manufacturing edged up to 50.3 from 50.2 in February, which is the first time the indicator has risen since November. This indicates that the Chinese economy may have stabilized

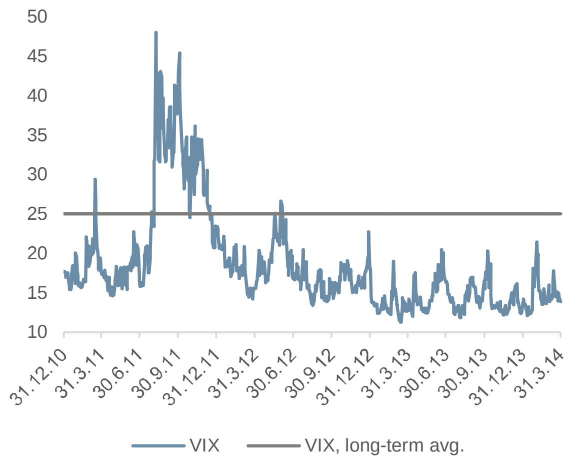
Fed chairwoman Yellen had been highlighting the potential for earlier rate hikes following the policy meeting on March 19, but she took a softer approach in a speech on March 31 in Chicago, emphasizing continued slack in the labor market beyond that suggested in the unemployment rate and the payrolls numbers. Her comments indicate that the Fed will remain concerned

Fig. 1: Major equity markets, 2014



Source: Datastream, Blue Horizon Wealth Partner AG

Fig 2: VIX Index



Source: Datastream, Blue Horizon Wealth Partner AG about the status of the labor market, even if headline figures further improve, and will stay accommodative for longer.

The Ukrainian crisis

The crisis in the Ukraine is reviving old – almost forgotten – East-West tensions and reminds us of the cold war ongoing between World War II and the break-up of the Soviet Union in 1991. While Russia is pursuing an aggressive imperialistic policy, defending its vital economic and strategic interests in the former Soviet Union states, the West is protesting on grounds of violations of international law and human rights principles. While Russia secured access to the Black sea and its hub for the Black Sea fleet, the West has no real vested interest in the Ukraine. Nevertheless the West took some decisive steps to protest against the annexation of Crimea, e.g. excluding Russia from the G8, freezing assets of and imposing travel bans on some Russian oligarchs.

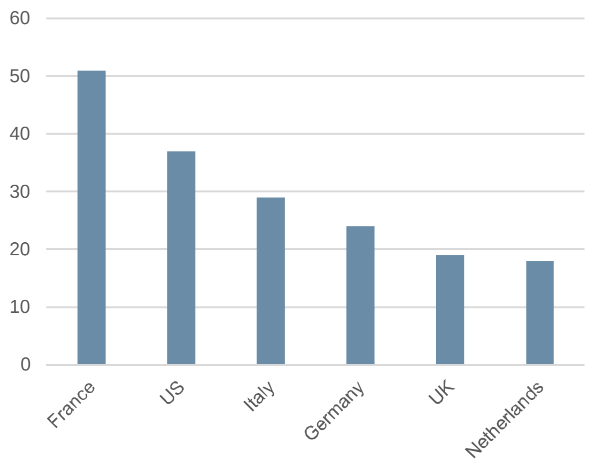
Global financial markets reacted relatively benignly and we believe that the growth slow-down in the US probably had a larger impact on yields and equity markets than the Ukraine crisis. However, Russian markets have been hit much harder: the Russian rouble fell 7%, the Russian RTS equity index 15%, and credit spreads widened over 100 basis points in Q1.

The Ukraine crisis certainly represents a major risk to financial markets. How might the crisis develop and what impact could it have on markets? It cannot

Fig. 3: Russian rouble's decline

Source: Datastream, Blue Horizon Wealth Partner AG

Fig 4: Bank lending to Russia, USD bn



Source: BIS, Blue Horizon Wealth Partner AG be excluded that Putin may decide to annex further parts of the Ukraine. The most likely target is the Eastern part of the country with its large Russian-speaking population, a majority of which is distinctly pro-Russian. If that happens, the West could be inclined to impose more severe sanctions, including even — if it has the courage — a ban on Russian gas supplies. This could be followed by retaliatory sanctions imposed by Russia, which would severely harm international corporates active in that country.

If escalating economic sanctions were to isolate Russia, depriving it of oil and gas revenues and disconnecting it from the financial system, Russia would at least for some time be able to live off its foreign reserves of USD 453 bn.

The West, especially Germany, however, relies heavily on Russian gas supplies, especially in the wake of the German government's 2011 decision to phase out nuclear power. Certain Western companies are heavily involved in Russia and could suffer from large write-downs of their investments in the country. Other potential victims of escalating tensions are European banks, which hold large amounts of Russian debt on their balance sheets (see Figure 4).

In our view, while the situation in Ukraine has the potential to escalate and to unnerve global financial markets, we believe that since the West is probably insufficiently motivated for drastic escalation – partly because it would be very costly for Europe – the crisis will most likely remain contained. The West is likely to impose more "light" sanctions and protest on all diplomatic fronts, while Russia will sit out the situation waiting for the water to calm down.

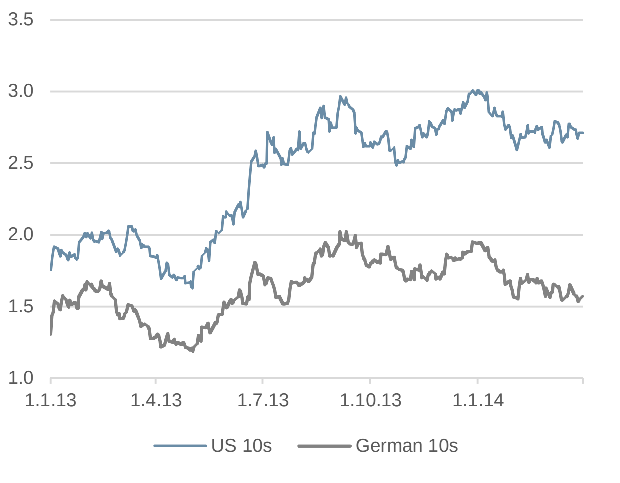
Outlook

Despite unanticipated economic weaknesses in the first quarter we remain positive on the growth prospects for the US and to a lesser extent Europe. Only second-quarter figures will reveal, however, what the impact of bad weather really has been on US Q1 growth. Despite continued Fed tapering, central bank policy will stay accommodative for an extended period of time, which is going to support risky assets, equity but also credit markets. Since equity valuations are not yet stretched, we remain positive for equity markets in general, but we also have to accept the accompanying volatility. We also believe that we are moving away from general risk-on and risk-off trading, and we expect idiosyncratic risks to become more important.

In our view, with improving growth figures in Q2 and Q3 and potentially some additional Fed tapering, yields will edge higher. As monetary policy in the US becomes less expansionary relative to Europe and Japan, we expect the USD to gain vis-à-vis the Euro and the Japanese Yen. We expect the EUR-USD exchange rate to fall below 1.30 in the course of the year.

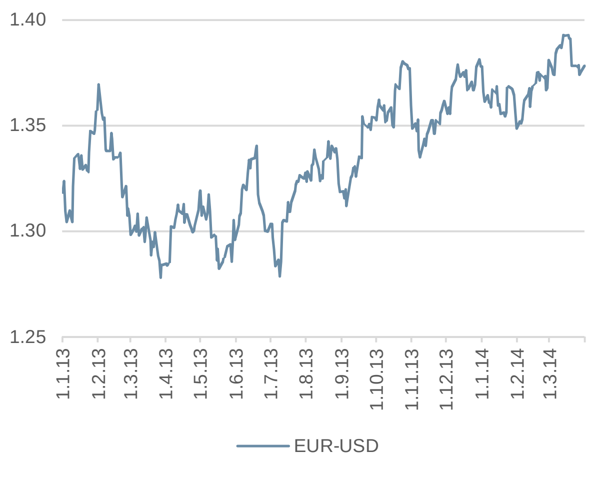
We consider the major risks to our base case scenario to be further escalation of the Ukrainian crisis with severe mutual economic sanctions and rising energy prices, and a further weakening of Chinese growth.

Fig. 5: US and German 10-year yields



Source: Datastream, Blue Horizon Wealth Partner AG

Fig 6: EUR-USD exchange rate



Source: Datastream , Blue Horizon Wealth Partner AG

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