BLUE HORIZON
Wealth Partner AG

Better economic data – worsening situation in Ukraine

- Leading US indicators recovered, indicating that the soft patch in Q1 may have only been temporary. European indicators also showed improvements. Chinese growth data, however, remained on the weak side. The leading indicators are still soft, despite improving somewhat in March. At 7.4% in Q1 2014, Chinese GDP had grown at its slowest pace for 18 months.
- Despite stronger growth in the US and Fed tapering, the Euro managed to stay on the strong side and even traded up to slightly below 1.4 against the USD. In its meeting on 8 May the ECB signaled its readiness to implement further easing steps at its June meeting, not least because the council, first, shares "... dissatisfaction about the projected path of inflation .." and, second, it views the current Euro exchange rate as a "serious concern". As a result, the Euro weakened somewhat.
- Equity markets remained range-bound in April, slightly up month over month. The S&P500 index gained 0.4%, EuroStoxx50 1.7% and the Nikkei 225 lost 3.5%. Better growth data were offset by concerns about the Ukraine crisis and fears that the Fed could become more restrictive. Short-term interest rates remained stable, while US and German 10Y yields fell by about 10 basis points in April.
- The situation in Ukraine worsened as Ukraine military forces took action against pro-Russian separatists in the Eastern part of the country. It cannot be ruled out that Russian forces might intervene and take over parts of Ukraine, which would most likely lead to additional sanctions by the West. Although we do not see a huge risk of major contagion at this point, the situation does have the potential to unnerve markets.

Macroeconomics and financial markets

After very disappointing growth in Q1, leading US indicators recently suggest that economic activity is picking up. The US non-farm payrolls caused surprise on the upside with 288,000 new jobs created in April. The US unemployment rate continued to drop and at 6.3% was at its lowest since September 2008 (compare Fig. 2). Furthermore, the US ISM index rose to 54.9 in April from 53.7 in March (compare Fig. 1).

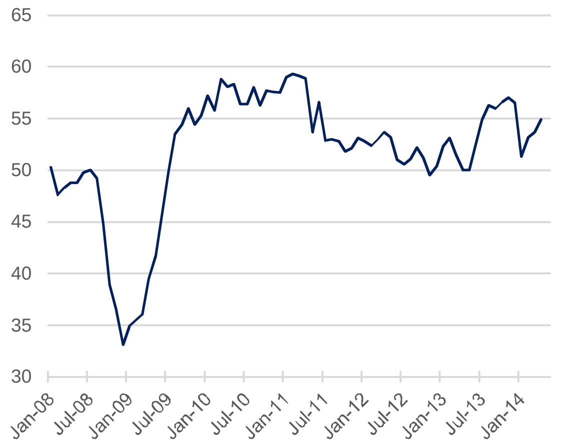
We saw some signs of stabilization in the Euro area. Greece returned to capital markets and was able to raise EUR 3 bn of five-year bonds at a just under 5% in a heavily oversubscribed issue. Portugal has also indicated that it is planning to tap the market for a ten-year bond. The ECB signaled easing measures for its next meeting on 5 June. It clearly communicated its discomfort with the low current and projected inflation and the strong Euro, which dampens growth prospects, especially because of its negative effect on exports.

Chinese growth data remained soft. At 7.4% in Q1 2014, Chinese GDP had grown at its slowest pace for 18 months. This comes partly as a consequence of the rigorous restructuring program implemented by the Chinese government to address a number of structural weaknesses. To achieve its aim the government is willing to accept a temporary phase of growth below its target of 7.5%. It has, however, taken some light measures to foster growth, including cutting taxes on small firms and speeding up investments in railways. Markets are keeping a close watch on China's economic dynamics, not least because this provides a very important means of assessing whether the more general weakness within emerging markets is nearing an end.

The situation in Ukraine worsened

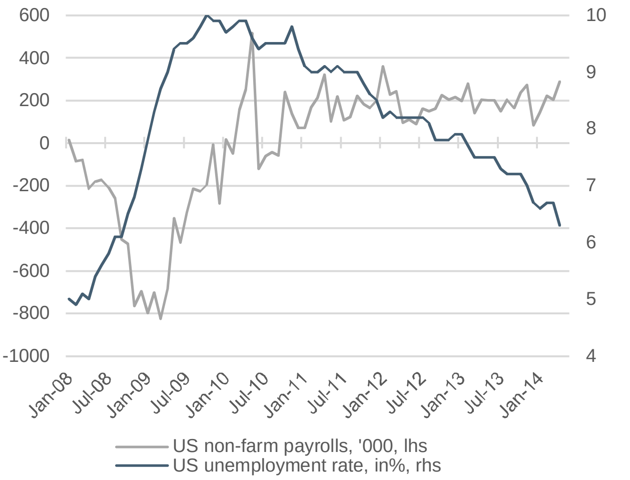
During April, the situation in Ukraine worsened as Ukraine military forces took action against pro-Russian separatists in the Eastern part of the country. It cannot be ruled out that Russian forces may intervene and potentially take over parts of Ukraine, which would most likely lead to the imposition of additional sanctions by the West. Although we do not see a huge risk of major contagion at this point, the situation has the potential to unnerve markets. Whether further parts of Ukraine are taken over by Russia is probably not as important for financial markets as the question of how the West would react and whether Russian energy supplies might be disrupted.

Fig. 1: US ISM index



Source: Datastream, Blue Horizon Wealth Partner AG

Fig 2: US labor market improves



Source: Datastream, Blue Horizon Wealth Partner AG

Government bonds still supported by economic and political uncertainties

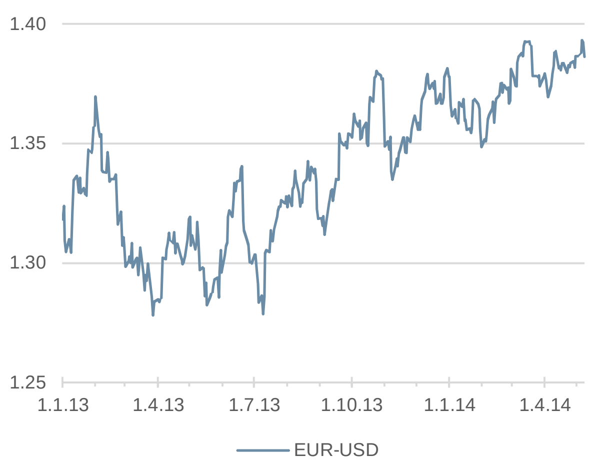
While some leading indicators have been positive, there is still much uncertainty about the future growth path. Also, rising tensions in Eastern Ukraine have raised investors' concerns about military escalation, in addition to which the US and EU have imposed sanctions on Russia. All this has been supportive for government bonds and has forced benchmark yields to drop further (compare Fig. 3).

2Y US government yields exhibited relatively large fluctuations in April and traded between 0.35% and 0.45%. Overall the 2Y yield remained more or less unchanged over the month at around 0.42%. At the same time, US 10Y yields continued to fall from 2.72% at the end of March to roughly 2.62% by the end of April. As seen in figure 4, the short end of the curve has remained stable since the end of 2013 – due to an unchanged interest-rate policy by the US Fed –, while the long end of the curve has dropped, leading to a yield curve flattening. Overall we do not see current yield levels as sustainable and expect yields to gradually rise over the rest of 2014. If the Fed continued its current tapering pace, its bond-buying program would be over by the end of the year. In our view, the Fed will only start hiking rates if the economy continues to improve and only after the bond buying program has ended, i.e. at the earliest in 2015.

Fig. 3: US and German 10-year yields

Source: Datastream, Blue Horizon Wealth Partner AG

Fig 4: EUR-USD exchange rate



Source: Datastream , Blue Horizon Wealth Partner AG

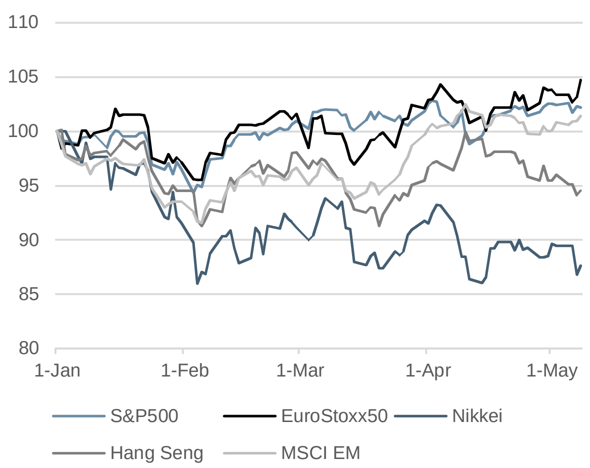
Credit remains well supported

Credit spreads continue to be well supported and remain within tight trading ranges. The recent increase of M&A activities signals that corporates have become more upbeat and risk-taking. This usually comes with increasing corporate leverage and is a concern for many credit investors. For now, we do not expect an immediate drastic widening of credit spreads, since corporate balance sheets are able to digest some additional leverage and investors are still searching for yield.

Equity markets remain range-bound in April

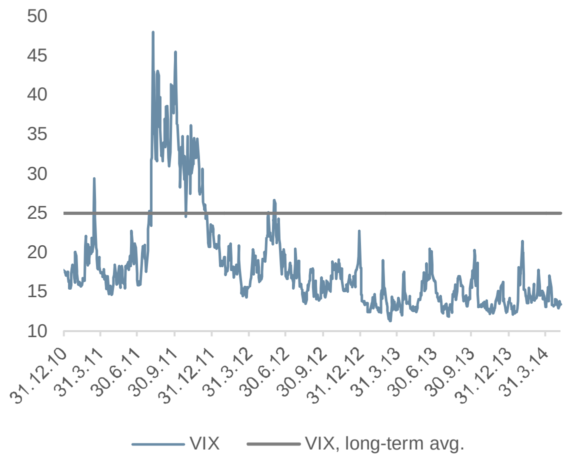
Throughout the year, equity markets have remained range-bound. Developed as well as emerging markets are slightly up year-to-date. The noticeable exception is the frontier market index, which has increased about 10% YTD. In our view, the outlook for equity markets in general remains positive, since we have seen growth acceleration in the US and stabilization in Europe. This provides good opportunities for further earnings growth. We also see the recent pick-up in M&A activities as a sign of rising corporate confidence. After very strong equity market performance in 2013, we foresee more moderate returns in 2014, i.e. single-digit returns. The major reasons for the reduced equity return expectations are geopolitical concerns, especially regarding Ukraine, and fears of further restrictive monetary policy accompanied by rising yields. Despite these concerns the VIX index –

Fig. 5: Major equity markets, 2014



Source: Datastream, Blue Horizon Wealth Partner AG

Fig 6: VIX Index



Source: Datastream, Blue Horizon Wealth Partner AG a measure of the cost of insurance against equity sell-offs – remains low and far below its long-term average of 25.

The outlook for emerging markets continues to be mixed. Growth concerns are still predominant, and many emerging markets have suffered from low demand for manufactured goods and commodities. In addition, many international investors saw a better risk-return in developed markets and shifted their portfolio allocations away from emerging markets. However, this market correction provides interesting opportunities based on attractive valuations in absolute terms and in relative terms vis-à-vis major developed markets.

Outlook

We remain confident that growth is picking up in the US and is further stabilizing in Europe. We expect the Fed to continue its tapering policy through to the end of 2014. Depending on further macro-economic developments, the Fed is likely to start hiking rates in 2015. At the same time, we expect the ECB as well as the Bank of Japan to remain very accommodative. We might even see additional monetary easing decisions on the back of weak economic data in Europe and Japan. This should lead to a stronger USD and weaker EUR and JPY. Further tapering coupled with stronger US growth should also lead to rising US yields, although at a moderate pace.

Risky assets, equities and credit, are likely to remain supported by a better growth outlook and higher earnings potential. However, markets are facing headwinds from rising yields and less accommodative US monetary policy. In our view, this may lead to more moderate return expectations, i.e. single-digit returns for developed equity markets coupled with higher volatility. We favor equity over credit on the back of relatively rich valuations of credit and increasing M&A activities. We remain confident, however, that credit markets will digest recent M&A activities well.

Commodities are expected to remain on the weak side. Supply and demand considerations still do not favor industrial metals. Gold, despite its recent safe haven surge, remains vulnerable to further sell-offs due to further economic stabilization and rising real yields. Food prices, however, have risen in recent weeks due to El Niño forecasts and, in our view, are likely to continue to trade up going forward.

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