BLUE HORIZON
Wealth Partner AG

Stronger growth and dovish central banks

- **Leading June indicators were strong and, together with dovish central banks, provided good support for equity markets. The Nikkei outperformed and increased by 3.6%, followed by the emerging markets indices and the US S&P500 index, which rose by 2.7% and 2.1%, respectively. The EuroStoxx50, however, lost 0.2%.**
- **US yields rose in June, driven by the short end of the curve, i.e. 2Y yields climbed 9 basis points and 10Y yields only 6 basis points. In contrast, European yields fell on the back of the ECB announcements.**
- **After the ECB's June 5 meeting the Euro weakened but managed to recover somewhat in the second half of June, finishing the month slightly stronger compared to end of May. In past few days the Euro softened again.**
- **In its July 3 meeting the ECB did not announce further policy changes but provided more details on its TLTRO (targeted longer-term refinancing operation) program, which suggests that it may be somewhat more generous than previously thought. The overall program could amount to EUR 1 tn.**
- **Meanwhile, at its June 17-18 meeting the Fed kept rates unchanged and confirmed its tapering policy, reducing bond purchases by another USD 10 bn to USD 35 bn as of July.**
- **There are obvious geopolitical risks, but they do not seem to greatly concern financial markets. In this issue we discuss the recent developments in Ukraine as well as in Iraq and Syria and possible implications.**
- **Our outlook remains positive for equity, credit, and the USD. Stronger macro data may lead to a first Fed rate hike in the second half of 2015. We continue to see rising yields and an underperformance of US government bonds. An upward move in real rates may trigger a further sell-off of gold, which had recovered significantly in June and at the beginning of July. It seems that outflows out of gold ETFs have started to accelerate again in recent weeks.**
- **The major risks for our positive equity outlook are a strong bond sell-off, geo-political dangers, an unexpected slow-down of economic growth, and the possibility that the US Fed might suddenly take a more hawkish stance.**

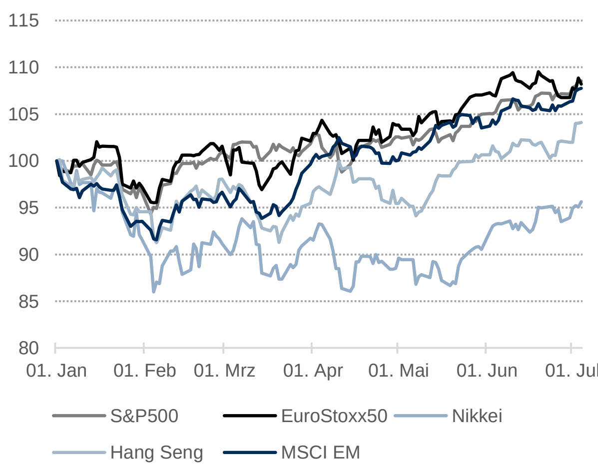
Macroeconomics and financial markets

June macro-economic data were very firm. PMIs mostly improved; the US ISM index, for example, remained at an elevated level of 55.3 in June, slightly below the 55.4 reading in May. The US nonfarm payrolls rose by 288,000 workers in June, beating the consensus forecast by a wide margin and following a gain of 224,000 in May. Since US GDP fell by a remarkable 2.9% QoQ annualized – the most significant swing in GDP growth for a long time – everything points to a significant positive growth figure for Q2. While weather conditions account for a large part of the Q1 drop, economists are still hard put to explain why Q1 growth fell so steeply.

The official Chinese PMI came in at 51.0 in June after 50.8 in May, the strongest reading this year. Meanwhile the European PMI disappointed and fell to 52.8, down from May's 53.5. However, the PMI sub-index measuring the growth in new orders improved, which signals better growth prospects later this year.

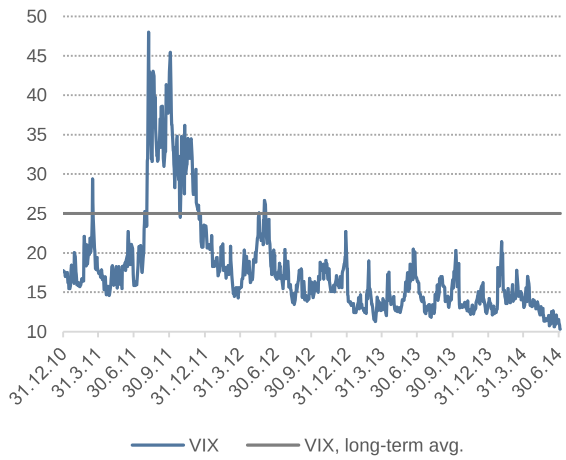
Since the ECB is very concerned about low and falling inflation rates, analysts and market participants are paying close attention to European inflation figures. According to the latest estimates, inflation remained stable in June at 0.5% YoY, which is in line with consensus forecasts. While inflation in Germany rose somewhat, other member countries such as Spain and Italy experienced falling inflation rates. Spanish inflation fell to 0.0% YoY vs 0.2% YoY and Italian inflation fell to 0.2% YoY vs 0.4% YoY.

Fig. 1: Major equity markets, 2014



Source: Datastream, Blue Horizon Wealth Partner AG

Fig 2: VIX Index



Source: Datastream, Blue Horizon Wealth Partner AG

The ECB

The ECB met on July 3 for the first time after their June meeting and the announcement of the new TLTRO program, which is designed to boost bank lending in Europe. Mr Draghi revealed additional details of the program, which appears to be very complicated. However, Mr. Draghi also revealed that the program will be a little more generous than previously thought. It may reach a volume of EUR 1 tn. Furthermore, the ECB announced that from January 2015 it will publish an "account" of each governing council meeting, which represents an alignment with the practice of other central banks. It has not yet been decided whether the votes of each of the 24 members will be made public. Also, the frequency of the meetings will change from a 4-week cycle to a 6-week cycle. Mr Draghi reiterated that quantitative easing, i.e. the ECB's engaging in a broad-based asset purchase program, is not off the table. The ECB is ready to deploy such a program if the inflation outlook should change. The next inflation forecast will be published in September.

The Fed

Meanwhile the Fed acted largely as expected at its July 17-18 meeting. Policy rates remained unchanged and the tapering program is on schedule. The Fed funds target rate remains within a range of 0 to 0.25%. Bond purchases were cut another USD 10 bn to USD 35 bn, starting in July. Regarding the economy, the Fed is still concerned about the labor market, despite the falling unemployment rate. As previously mentioned, the Fed sees considerable slack in the labor market in relation to discouraged workers, for example, which is not reflected in the official unemployment rate. In our view, based on recent robust US data, it is likely that we will see a first Fed rate hike as early as the second half of 2015.

Geopolitics

While markets remain very benign regarding the recent developments in Iraq and Syria as well as in the Ukraine, both conflicts warrant careful attention. Short-term global contagion may not look very likely, but these conflicts have the potential to persist for the longer-term. The intensification which is possible in both cases could cause severe global unease.

Ukraine

In Ukraine it appeared on the surface that some de-escalation had recently occurred. After talking to Vladimir Putin, Ukraine's President Petro Poroshenko declared a unilateral ceasefire in the east to give anti-government insurgents time either to leave Ukraine or to give up their weapons. For his part, Vladimir Putin appears to have ruled out a full-frontal invasion, at least for the present. On June 24 he asked the upper house of parliament to cancel his authorization for military force in Ukraine. However, after a ten-day ceasefire, which was largely ignored, fierce fighting resumed in eastern Ukraine on July 1.

It seems that while Putin may have no appetite for invading Ukraine outright at the cost of additional fiercer sanctions from the West, he may apply a more flexible strategy. This may include deploying pro-Russian paramilitary forces to destabilize and effectively control the eastern part of Ukraine, and in addition he could raise gas prices, putting economic pressure on the new Ukrainian government. This strategy would allow him to keep all options open for the future and to avoid further Western sanctions. As far as the West is concerned the question is how much appetite it has for tougher measures. The recent cycle of threats of more sanctions followed by meek postponements suggests not very much.

ISIS

In Iraq and Syria, after long years of instability and the US-led war, a new extremist group has emerged and gained amazing power. ISIS (Islamic State of Iraq and Greater Syria) has managed to gain control of eastern and northern Syria as well as eastern and northern Iraq. In addition to large territorial gains, ISIS managed to get hold of US military equipment apparently including six Black Hawk helicopters. Also, its fighters launch frequent bomb attacks in Baghdad, keeping Iraq's capital in a state of fear. ISIS is reported to have up to 11,000 fighters and is extremely ruthless. It has occupied a territory the size of Jordan with a population of 6m. It imposes taxes on the population and has built up a secret service. Even al-Quaida has distanced itself from ISIS and considers the movement too violent. Even more worrying than its recent successes in Iraq and Syria is the fact that ISIS has clear global goals, which include spreading the jihad throughout the world. ISIS is, therefore, not only a threat to the stability of the Middle East but a global terrorist threat, which needs to be taken very seriously.

Outlook

Our outlook remains positive for equity, credit, and the USD. Stronger macro data may lead to a first Fed rate hike in the second half of 2015. We continue to see gradually rising yields and US government bonds underperforming other markets. An upward move in real rates may trigger a further sell-off of gold, which had just recovered significantly in June and at the beginning of July. It seems that in recent weeks outflows out of gold ETFs have started to accelerate again.

The major risks for our positive equity outlook are a strong bond sell-off, geo-political factors, an unexpected slow-down of economic growth, and the possibility that the US Fed might suddenly take a more hawkish stance.

Fig. 3: US and German 10-year yields

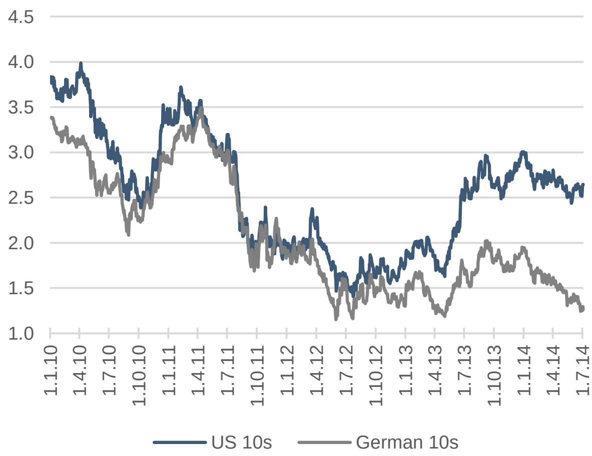


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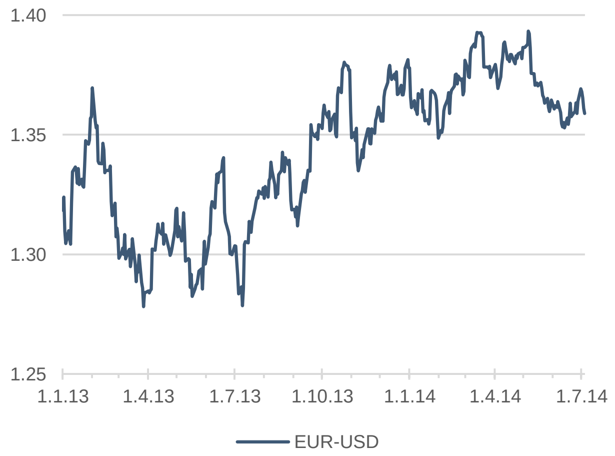
Fig 4: EUR-USD exchange rate



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