BLUE HORIZON
Wealth Partner AG

# The growth and monetary policy gap is widening

- **As anticipated in our Wealth Management Review of last month, the sharp sell-off in September and early October was followed by a pronounced recovery in the second half of October. The US S&P500 index even reached its annual peak and is up 12% year-to-date. Further easing measures by the Bank of Japan boosted the Japanese equity market, with the Nikkei climbing almost 16% since mid-October. This move has pushed the year-to-date performance up to 4.6%. In contrast, recession fears in Europe have been weighing on European stocks. Even after the correction the EuroStoxx50 remained down 3.4% in October, and similarly the German DAX failed to fully recover its losses and was down 1.6% in the month**
- **Again in October we saw stronger macro indicators in the US and weak indicators in Europe, which confirms that the growth gap between the two major economic areas is widening.**
- **This has also been reflected by central bank policies. While the Fed in its October meeting announced the end of quantitative easing and appeared slightly more hawkish, the Bank of Japan (BoJ) announced an expansion of its bond-buying program, and the ECB indicated – a little more cautiously – its willingness to expand its balance sheet further.**
- **By and large we remain positive for equity and credit markets and believe that Europe will be able to evade a third recession within a seven-year period (2008-2015). We believe that further ECB policy measures, together with a weaker Euro, and lower oil prices will help to avoid outright recession. Volatility is here to stay, and events like the September sell-off are likely to recur, especially when we are nearing the Fed hiking cycle in the first half of 2015. We agree with what has become a broad consensus view of a stronger USD. US Treasury bonds, gold and oil will remain vulnerable and we expect that the Gold price will break below USD 1,000 in the next couple of months.**

## Macroeconomics and financial markets

US October leading indicators were stronger overall. The ISM manufacturing index rose to 59.0 from 56.6 in September and has beaten consensus expectations by a wide margin. Non-farm payrolls rose by 214,000 after 256,000 in September (revised up from 248,000). Meanwhile the US unemployment rate unexpectedly fell further to 5.8%. The economic outlook in Europe, however, remained bleak. The Eurozone market manufacturing PMI fell slightly to 50.6 from 50.7. The German IFO business climate index also fell, from 104.7 to 103.2.

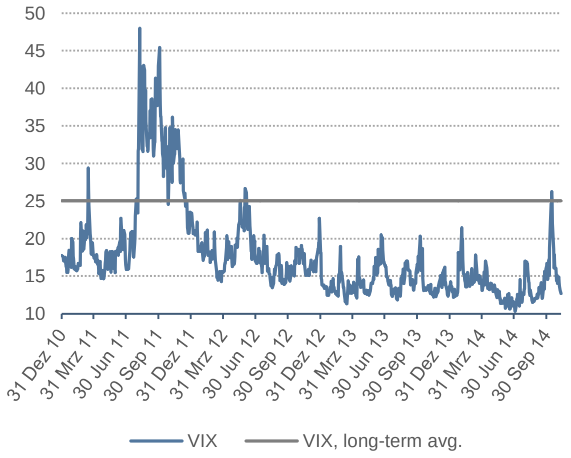
As a result, we can conclude that the growth gap between the US and Europe is further widening. While we expect about 3% growth in the US next year, Eurozone growth will be half that at best. Indeed the Eurozone faces a heightened risk of falling back into a recession.

At its meeting of 28-29 October the US Fed announced the end of its bond-buying program and a reduction of its monthly mortgage-backed securities purchases from USD 15 bn to zero. At the same time, while acknowledging labor market improvements the Fed reiterated that it would keep its benchmark short-term rates near zero for a “considerable time”. We see this as consistent with our expectations of a first rate-hike mid-2015.

In contrast, the BOJ and the ECB have been very dovish. The BoJ announced that it would increase its bond-buying program by JPY 30 tn to JPY 80 tn p.a., and would also raise the maturity of its JGB buying. At the same time, the Japanese government pension fund (GPIF) said it would lower its target holding of domestic bonds by 25% in favor of domestic and foreign equities. The GPIF is the largest pension fund in the world with assets of almost JPY 127 tn or roughly USD 1.2 tn. In effect, the BoJ buys bonds from the GPIF and the GPIF takes the cash to buy equities. This has been the major boost for Japanese equities.

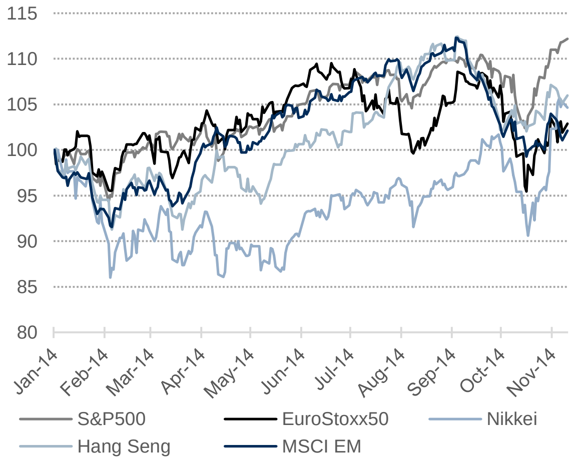
At its 6 November meeting the ECB did not take any additional measures to either make its TLTRO program more attractive or include other fixed-income instruments in its buying program. A next step, early next year, could well be to include non-financial corporate and supranational bonds in its asset purchases. As a further step the ECB could also include sovereign bonds later in 2015. The decision

Fig. 1: VIX, implied equity volatility index




Source: Datastream, Blue Horizon Wealth Partner AG

Fig 2: Major equity markets in 2014



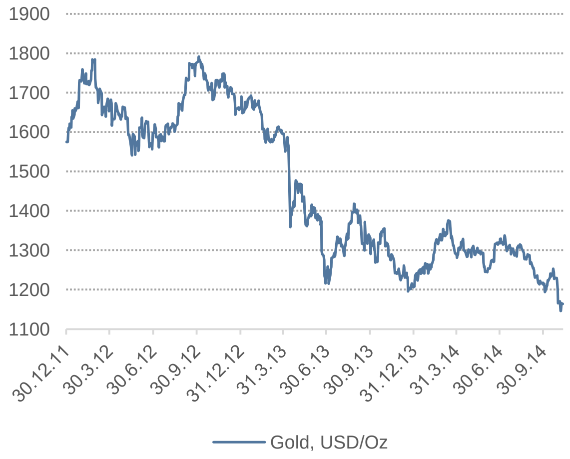

Source: Datastream, Blue Horizon Wealth Partner AG to expand the quantitative easing program, and especially to include sovereign bonds, is very controversial in Europe and faces fierce opposition, especially from German Bundesbank officials. Therefore, future action will depend to a large extent on how strong Draghi is as the ECB leader. Since the ECB Council voted unanimously to expand the balance sheet from the current EUR 2 tn to EUR 3 tn over the course of the next two years, one could conclude that Draghi's positon may be stronger than many think.

## Gold

We continue to see Gold as vulnerable. Real rates in the US have been rising and inflation continues to be well maintained. As a result Gold has fallen out of favor for many investors. A notable exception is the Swiss Gold Initiative, which has brought about a referendum, to be held on 30 November, when Swiss voters will decide whether to accept or decline a new law requiring the SNB to hold 20% of its balance sheet in Gold. This would make the SNB hugely vulnerable to the violent swings of the Gold price we have been observing over the last few years. In addition, in a period of falling gold prices, the SNB would be forced to compensate losses due to falling Gold prices with additional Gold purchases. Even more dangerously this would impair the SNB's freedom to use its balance sheet for monetary policy measures.

We expect the Gold price to fall below USD 1,000 in the coming months. This is all the more likely since Gold has become very expensive vis-à-vis Silver. The Gold-

Fig. 3: Gold price




Source: Datastream, Blue Horizon Wealth Partner AG

Fig 4: Gold-Silver ratio

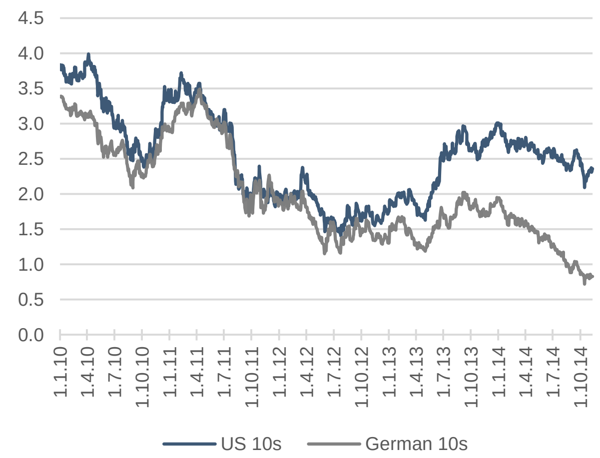

Source: Datastream , Blue Horizon Wealth Partner AG

Silver ratio has historically often been much closer to the ratio of 1:10, which reflects the ratio of natural reserves of gold vs those of silver. Recently this ratio shot up to 1:75, indicating that gold has become very expensive compared to silver, see Figure 4.

## Outlook

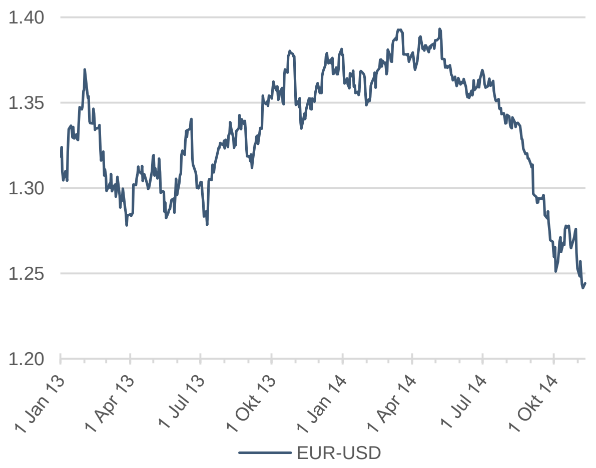
As expected, last month's sell-off proved to be a correction. By and large we remain positive for equity and credit markets and believe that Europe will be able to evade a third recession within a seven-year period (2008-2015). We believe that further ECB policy measures, together with a weaker Euro, and lower oil prices, will help to stave off outright recession. Volatility is here to stay and things like the September sell-off are likely to recur, especially when we are nearing the Fed hiking cycle in the first half of 2015. We agree with what has become a broad consensus view of a stronger USD. US Treasury bonds, gold and oil will remain vulnerable, and we expect that the gold price will break below USD 1,000 in the next couple of months.

Fig. 5: 10Y Government Bond yields




Source: Datastream, Blue Horizon Wealth Partner AG

Fig 4: EUR-USD exchange rate




Source: Datastream , Blue Horizon Wealth Partner AG

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