BLUE HORIZON
Wealth Partner AG

Some stabilization after the Greek compromise

- Financial markets stabilized after Greece signed up to an agreement with Europe on 13 July. In return for a financial package of up to EUR 86 bn over three years, Greece agreed to implement a number of major reforms. These reforms include measures which had been fiercely rejected by the Government and then by the voters in a referendum only a view days previously. The big question remains, though, whether the Greek government will be able to stay in office, since the reform package is strongly opposed by a major part of the Syriza party. Even if Prime Minister Tsipras managed to stay in power, would he be able to implement the hugely controversial reforms.
- Following solid growth figures in June, July data were somewhat softer, confirming the low growth recovery scenario. Europe appeared to be on more solid footing, while the Greek manufacturing PMI fell right off the cliff to reach a record low of 30.2. China's growth indicator also worsened further.
- In July most developed equity markets performed positively, while emerging markets equity lost 6.9%, driven by the negative performance of the Chinese and Russian stock markets. The EuroStoxx50 and the SMI outperformed and rose 5.2% and 7.4%, respectively. The S&P500 index rose 2.1% and the Nikkei225 index 1.7%.
- The yield curves flattened further, probably also because of the disappointing growth outlook. The German 10-year benchmark yield fell 16 basis points and the US equivalent 13 basis points, while 2-year yields rose slightly.
- Gold experienced another major sell-off and fell 6.4% in July. Between July 10 and 20 the Gold price fell by roughly 68 USD/oz or 6%. Oil prices fell by 12% and other commodities also sold off in July. For example, industrial metals fell 7.3%.
- The EUR slightly declined vis-à-vis the USD. Most commodity currencies, such as the AUD, CAD and the RUB, depreciated in July vs. the USD and lost between 4 and 8%. The Swiss Franc softened somewhat and fell 2% against the EUR.
- We believe a Fed rate-hike in September has become very likely. While we expect volatility to pick up thereafter, we stay constructive for equity and credit markets. In our view, the US recovery will be slow and growth rates will remain at or below trend growth. Also inflation is likely to stay low. This would allow the US Fed to move at a measured pace and take its time when normalizing interest rates. As already discussed, we believe that global equity markets can continue to perform positively. We still favor markets with supportive central banks, especially Europe and Japan, over the US and we are tending to greater caution with regard to emerging markets. The beginning of the Fed rate-hike cycle should lead to a further strengthening of the USD. US bonds are likely to underperform and the first Fed rate hike could even become a catalyst for more severe repricing of the US bond curve.

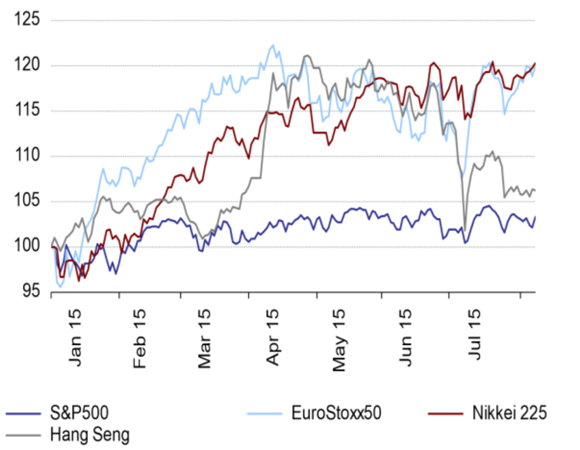
Macroeconomics and financial markets

Overall growth indicators were softer in July. Especially some of the US data were disappointing. The US ISM index was slightly lower at 52.7 after 53.5 in June. Non-farm payrolls rose by 215,000 in July, which was somewhat slower than in the previous month (223,000) but still sufficiently strong to suggest that job recovery is continuing on a solid footing. The employment cost index in the second quarter rose only slightly by 0.2% QoQ vs. 0.6% in the prior quarter. This may partly explain the recent rally at the long end of the US yield curve, as wage inflation appears to be less of a concern than previously thought.

The Markit European composite PMI retreated slightly to 53.9 after 54.2 in June. This indicates that the rate of expansion declined somewhat but remains close to the four-year high. Spain showed the strongest reading while the Greek PMI fell to a record low of 30.2, which is a worrying indicator of the depth of the recession.

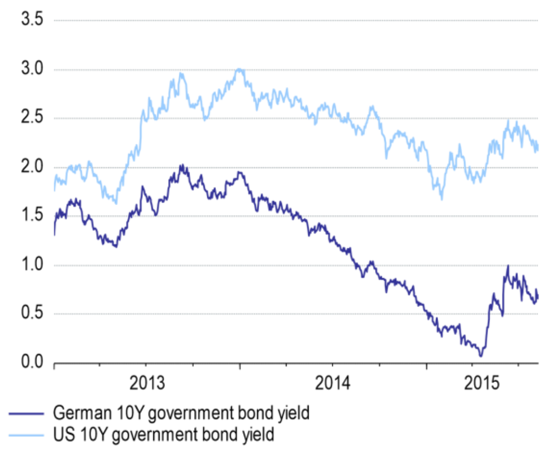
The Swiss economy continues to suffer from excessive currency strength. Swiss leading indicators showed a mixed picture. The Swiss manufacturing PMI fell further to 48.7 in July from 50 in June, while the KOF leading indicator rose to 99.8 from 89.7 in June. This surprising increase is, however, due to a select number of sub-indices, which rebounded from very negative readings in previous months. The KOF leading indicator is now at about its long-term average. Meanwhile Swiss real retail sales dropped 1.8% in May after a drop of 0.1% in April. The April figure was revised down from 1.6%. The deflationary pressure continued with the CPI falling 1.3% YoY after 1.0%.

Fig. 1: Major equity indices in 2015



Source: Thomson Reuters Datastream / Blue Horizon Wealth Partner AG

Fig 2: 10Y bond yields



Source: Thomson Reuters Datastream / Blue Horizon Wealth Partner AG

The Chinese manufacturing sector continued to suffer. The manufacturing PMI fell to 47.8 in July from 49.4, signaling that the manufacturing sector is bound to shrink. New domestic and export orders fell, which led to cuts in production and employment.

The US Fed

We see a high probability of a US Fed rate-hike in September based on continued labor market improvements and recent comments by Fed representatives. When assessing the market reaction of the first rate-hike after a prolonged period of unprecedented ultra-expansionary monetary policy, we have to remind ourselves that this event has long been anticipated and discussed by market participants. Therefore, it will not come as a surprise, and initial market reactions will probably be rather moderate. In general and from past experience, we expect US bond yields to rise, with the yield curve flattening and US bonds underperforming foreign bonds. Credit spreads and equity markets tend to become more volatile but perform positively overall. Emerging markets tend to underperform developed markets in such a rate-hike cycle. In addition, the USD is expected to strengthen, especially since the Bank of Japan and the ECB will continue their quantitative easing policies.

Far more important than the question of when the first rate-hike will appear is the question of the speed and overall extent of the hiking cycle. This obviously depends on the robustness of the US growth path and the inflation outlook. In recent quarters US growth disappointed and inflation was also slow to accelerate. Currently it looks to us that this pattern could persist for some time, especially when rising interest rates and a stronger USD provide additional headwind to the US economy. In turn, this suggests to us that the hiking cycle will be rather slow and moderate. The dynamics between rising rates and the strength of the US economy will be very important to determine how risky assets, i.e. credit and equity markets, will perform. The worst scenario would be a Fed concerned about rising inflation when at the same time the US economy finds it hard to accelerate.

Outlook

We believe a Fed rate-hike in September has become very likely. While we expect volatility to pick up thereafter, we stay constructive for equity and credit markets. In our view, the US recovery will be slow and growth rates will remain at or below trend growth. Also inflation is likely to stay low. This would allow the US Fed to move at a measured pace and take its time when normalizing interest rates. As discussed previously, we believe that global equity markets can continue to perform positively. We still favor markets with supportive central banks, especially Europe and Japan, over the US and we tend to more caution with regard to emerging markets. The beginning of the Fed rate-hike cycle should lead to a further strengthening of the USD. US bonds are likely to underperform and the first Fed rate-hike could even become a catalyst for more severe repricing of the US bond curve.

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