BLUE HORIZON
Wealth Partner AG

Golden May for investors

- May was a Goldilocks month. On the back of slightly improving economic data and dovish central banks, bond and equity markets rallied in tandem. The S&P500 index rose 2.3% in the month, the EuroStoxx50 3.1% and the Japanese Nikkei 2.3%. Emerging and frontier market indices rose 3.5% and 6.1% respectively. At the same time yields fell further. The 10-year German government bond yields declined 0.12%-points and the 10-year US treasury yield even fell by 0.2%-points.
- At its meeting on 5 June the ECB delivered on its "promise" to implement unconventional policy measures. It introduced negative rates of -0.1% on deposits, which is a historic step, and a 4-year funding package for banks, called TLTRO (targeted longer-term refinancing operation), which will most likely prove to be the more important measure.
- The ECB's announcement early in May, that it would take measures in June, led to the long awaited weakening of the EUR. The EUR fell by 1.6% vis-a-vis the USD and extended its losses in the first days of June. Gold failed to benefit from the dovish ECB, dropped by 3.8% in May and is currently trading around USD 1,250.
- In the absence of any substantial progress regarding the Ukraine crisis, the rhetoric has eased somewhat. As we expected, the West is apparently not pushing too hard to implement biting sanctions, and Putin likewise does not seem inclined to escalate the situation for now. However, we have seen no lessening of Russia's hunger for more influence in, and even control of, the eastern part of Ukraine. There has been a corresponding market reaction. While the ruble fell further in May, by 3.7%, the Russian RTS equity index advanced by 12.1%.
- Our outlook remains positive for equity, credit, and the USD; we see gradually rising yields, a weaker Euro and a further drop in the gold price.

Macroeconomics and financial markets

PMIs overall were very solid in May. The US ISM rose to 55.4 from 54.9 – despite great confusion and two corrections by the calculation agency. Also, US nonfarm payrolls rose by 217,000 workers during the month, exceeding the 215,009 increase expected by economists. The Chinese PMI also rose to a five-month high of 50.8, signaling a slightly improved growth outlook.

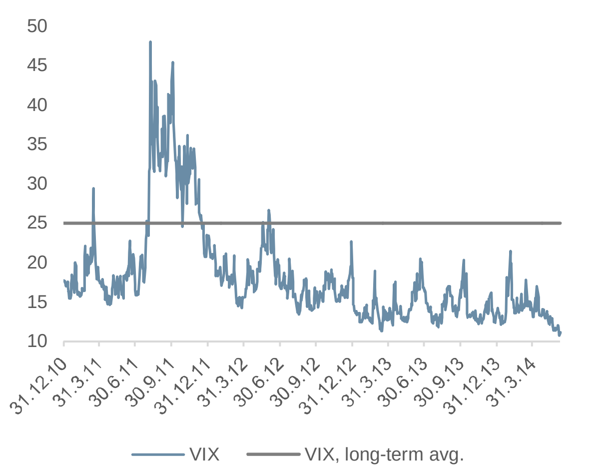
The market was in a state of eager expectancy following the ECB's statement early in May that it would announce decisive steps at its meeting on 5 June. In anticipation of the meeting, equity markets traded up, yields dropped and the euro started to weaken. As mentioned earlier the ECB's major concern has been deflation risk and the strong euro. A further very important point that did not feature so prominently in discussions was the credit crunch in Europe for small and medium enterprises (SMEs). This is especially difficult for the ECB to address directly since it involves the banking sector, which ultimately is the body providing credit to SMEs. We discussed the issue in our WMR of April 2013.

The ECB made an attempt to tackle all three issues in an unprecedented way. The board decided to introduce a negative interest rate of -0.1% on deposits and to introduce a 4-year funding package for banks, called TLTRO (targeted longer-term refinancing operation). We think that while negative deposit rates are a historic decision, the more powerful and targeted instrument will prove to be the TLTRO. The way it works is that the ECB will lend to banks as much as EUR 400 bn later this year at a fixed rate of only 0.25% for loans extending until September 2018.

Fig. 1: Major equity markets, 2014

Source: Datastream, Blue Horizon Wealth Partner AG

Fig 2: VIX Index



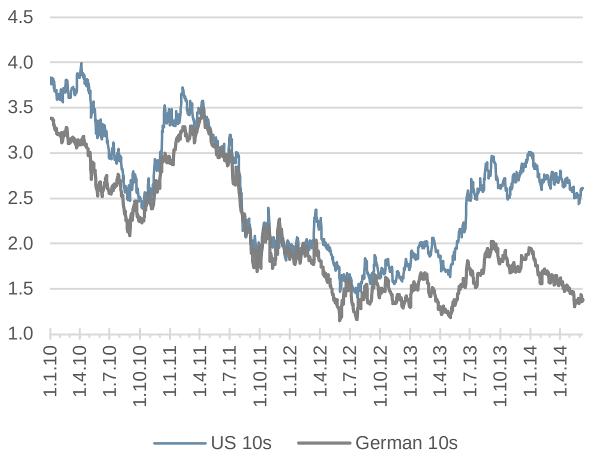
Source: Datastream, Blue Horizon Wealth Partner AG

These conditions are without doubt very favorable. In return, Banks have to make a commitment to increase lending to private firms and households, excluding mortgages. This measure clearly targets SMEs, especially in the periphery. It remains to be seen what impact it may have on the European economy overall, but it looks to us like an innovative way for a central bank to incentivize banks to lend more to entities cut out of the credit cycle. As the market reaction shows, the market participants have welcomed the ECB decision, and the euro has moved in the desired direction.

Outlook

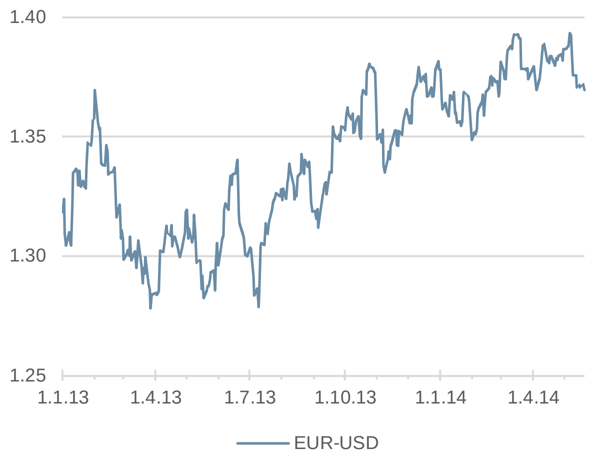
By and large, leading indicators are consistent with our expected low-growth scenario. With central banks remaining accommodative (ECB and BoJ) and the Fed on a slow and cautious tapering path, risky assets should stay well supported. The diverging monetary policies of the US on the one hand and Europe and Japan on the other should prove to be supportive for the USD. At the same time, yield spreads between the US and Europe have widened significantly. While fixed-income markets, especially following the recent ECB decision, remain sharply focused on buying Euro bonds, we see increasingly interesting buying opportunities for non-USD investors in the USD fixed-income markets. The yield spread coupled with potential gains on the currency may lead to greater demand for US bonds.

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

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