BLUE HORIZON
Wealth Partner AG

The bull market is back – but for how long?

- **The sharp correction at the end of July and beginning of August was – as expected – only short-lived. The bullish mood gained strength again as markets became more relaxed about the geopolitical developments – although most of these came no closer to resolution – and dovish central banks coupled with better US growth data helped to reestablish market participants' confidence.**
- **The ECB took additional measures to prevent inflation from falling further and to boost lending in Europe. At its 4 September meeting, ECB president Mario Draghi announced cuts in the ECB's main refinancing rate, the marginal lending facility, and the interest rate on deposits, all by 10 basis points to 0.05%, 0.30% and -0.20%, respectively. In addition, he announced a broad-based asset-backed securities (ABS) buying program, which will inflate the ECB's balance sheet. While Draghi was reluctant to call this measure quantitative easing, it is in our view precisely this. The latest measures add to the already announced TLTRO program, which incentivizes banks to lend to smaller and medium-sized companies.**
- **While financial markets seem to have calmed down regarding geopolitical concerns, the actual geopolitical situation has not really improved much. There is mounting evidence that Russia is deploying troops in eastern Ukraine, and the relationship between Russia and its major western counterparties has cooled down further. Also, there is little indication that IS (Islamic State or ISIS) has been weakened much by US military interventions, and there are hardly any signs of imminent peace in the Gaza conflict. This, in our view, demonstrates that the political and humanitarian dimensions per se do not have an impact on global financial markets.**
- **After the ECB decision, the USD's rally accelerated and the EUR-USD exchange rate fell below 1.30. The divergence in monetary policies between the US and Europe continues to strengthen the USD.**
- **Commodities prices in general remained on the weak side. Gold prices – despite the uncertainties – remained almost unchanged and fell in the first two weeks of September by 2.5%. Oil prices also fell sharply with the price for Brent falling below 100 USD/bl.**
- **While we remain constructive for risky assets, especially for equities in general and in emerging markets in particular, as well as on the USD, we see the July correction as a warning sign. After a multi-year rally, financial market participants may become a bit more worried about valuations and the sustainability of the rally. Stronger US data may also start raising fears of an earlier than expected Fed rate hike.**

Macroeconomics and financial markets

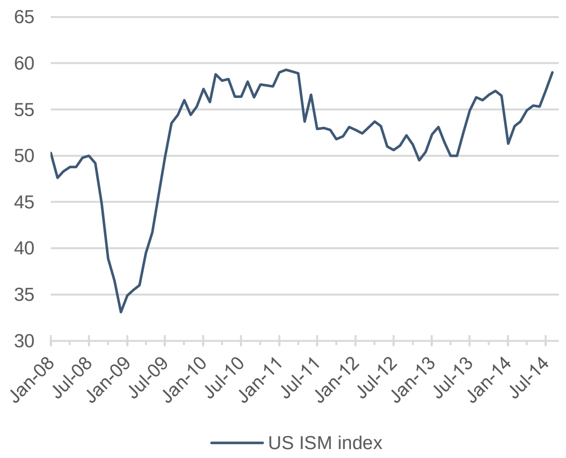
The economic indicators have by and large confirmed recent trends: US growth is picking up and European growth is stabilizing at low levels. While the US ISM index rose higher than expected to 59 after July's 57.1 (see Fig. 1) and signals the fastest growth in three years, non-farm payroll figures for August were disappointing, coming in at 142,000, and thus below both expectations and the levels of previous months. These data suggest that US growth is picking up but is unlikely to exceed 3%, which is considered trend growth. This may not be enough to bring the US labor market to full employment, especially considering that a sizeable part of the workforce dropped out of the official US labor market statistics. The Fed is very much focused on this phenomenon and will want to see proof that the slack in the labor market is taken up. Meanwhile the European Market PMI fell to 52.5 in August from 53.8 in July and was below expectations.

As already indicated, August saw equity markets rebound strongly after the sell-off at the end of July and beginning of August. The S&P500 gained 4.0%, the EuroStoxx50 1.9% and the MSCI Emerging Markets 2.3%, while the Japanese Nikkei lost 1.3% in August.

The USD continued to strengthen and received a strong boost from the ECB decision on 4 September. The EUR-USD exchange rate dropped considerably immediately after the ECB meeting and fell below 1.30. We expect further USD strength going forward.

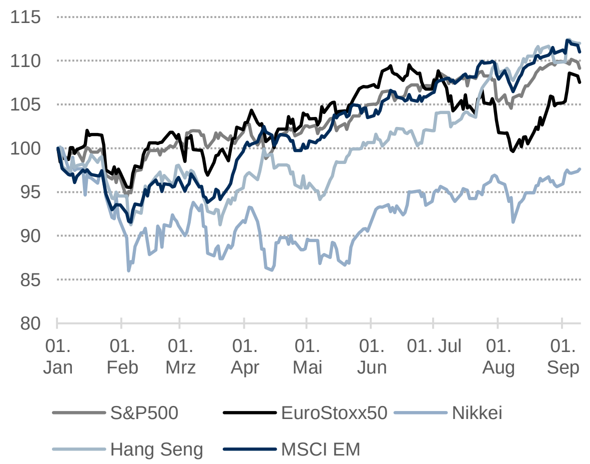
August was also another strong month for fixed income markets. US 10Y government bond yields fell 21 basis points and European counterparts even fell by 27

Fig. 1: US ISM index



Source: Datastream, Blue Horizon Wealth Partner AG

Fig 2: Major equity markets in 2014



Source: Datastream, Blue Horizon Wealth Partner AG basis points. Short-term rates, i.e. 2Y government bond yields, also fell by 4 basis points in the US and 5 basis points in Europe. German 2Y rates even dropped below zero, yielding -0.03%. In other words, investors are willing to pay to hold those bonds. The US-German yield gap widened further to reach 145 basis points for 10Y government bonds at the End of August.

It is interesting to see that the Fed managed to introduce its tapering policy very well, i.e. with only limited impact on the US bond market. While short rates rose somewhat, the long end of the curve rallied from the end of last year, pushing 10Y yields back down to about 2.5%. The flattening of the yield curve supports the recovery of the real economy, since lending costs remain low.

The end of July sell-off widened credit spreads. This also proved to be short-lived and credit spreads across the board retightened in August.

ECB and Quantitative Easing

As mentioned above, at its 4 September meeting the ECB announced not only that it would cut rates but also that it would start buying asset-backed securities (ABS). While Draghi was reluctant to call this measure quantitative easing, in our view this is precisely what it is. So far the ECB has been very reluctant to introduce quantitative easing measures, following its US and Japanese peers. The former started very early on in the crisis to expand its balance sheet by multiples, and the latter embarked on aggressive balance sheet expansion in 2013. In contrast, the ECB has even reduced its balance sheet since 2012. Quantitative Easing measures are very controversial in Europe, the central bank hawks in Germany in particular being very critical of such measures. Quantitative easing means that a central bank buys a specified amount of financial assets from banks and other private institutions in order to raise the prices of those financial assets while simultaneously increasing the monetary base.

Leaving aside for the moment the debate among European central bankers and economists about the merits and dangers of quantitative easing, the ECB has surprised the market and made it clear that it is committed to start the program very soon, i.e. in October. It has promised to announce more details at its next regular meeting on October 2. Mr Draghi indicated he would like to bring the ECB's balance sheet back to its 2012 size, which would correspond with roughly EUR 750 bn of bond buying. The current size of the ECB's balance sheet is EUR 2 tn. The volume of the program is, therefore, not very impressive. In addition, debate is going on as to whether it will be feasible for the ECB to buy that amount of ABS in an already relatively thin ABS market. Total ABS issuance in the first half of the year was EUR 114 bn, of which the ECB already retains 70% as collateral in return for its regular money market lending facilities. The ABS market has shrunk dramatically in recent years and nowadays accounts for only a fraction of its pre-crisis size.

The objective of the ABS program is not to increase bank liquidity per se, since the banking system is already awash with liquidity and is receiving an additional projected EUR 400 bn from the targeted long-term refinancing operation (TLTRO) announced in June of this year. The objective is rather to help banks to get rid of risky assets, which incur large capital charges and limit their ability to take additional balance-sheet risks. So far the ECB has restricted itself to dealing with the highest-quality ABS, which do not come with high capital charges. Consequently, the ECB will have to start buying more risky mezzanine or even equity tranches of such paper, which provide more meaningful capital relief for banks.

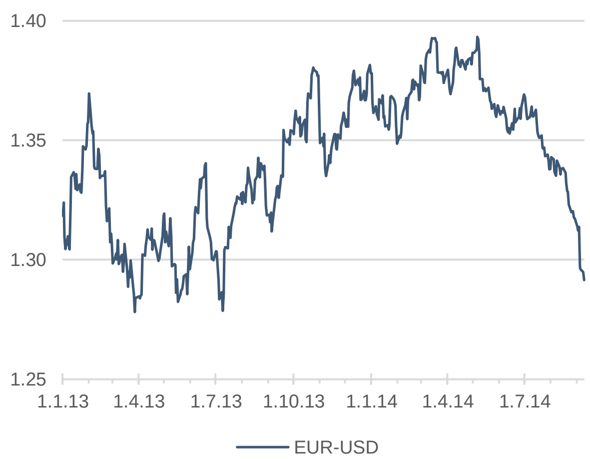
If the ECB decided on a larger balance sheet expansion in the future, this would inevitably imply direct buying of government bonds. Such a measure, however, remains fiercely controversial within the ECB, and Mr Draghi would need to overcome huge opposition to implement it.

The probably most important immediate impact of the ECB's announcement was that the Euro weakened significantly. Right after the meeting (see Fig. 4) the EUR-USD exchange rate fell by 1.6%. The ECB certainly welcomes this, as it helps the export industry and pushes inflation up by raising import prices.

Fig. 3: The price of gold

Source: Datastream, Blue Horizon Wealth Partner AG

Fig 4: EUR-USD exchange rate



Source: Datastream , Blue Horizon Wealth Partner AG

Outlook

The End of July sell-off was – as expected – only short-lived but still leaves us with the feeling that after the multi-year rally, markets may have become more vulnerable to shocks. Future shocks may result in deeper corrections, not least because valuations have risen far higher. Nevertheless, we remain of the opinion that equity valuations overall are not in bubble territory and that at least in the US the current phase of the cycle provides growth opportunities and potential for improving earnings. Also, monetary policy remains accommodative for the foreseeable future. The ECB just announced another rate cut and quantitative easing measures and the Bank of Japan is likely to take additional policy measures as well. In contrast, we continue to believe that a Fed rate hike is likely in Q3 2015 with many observers fearing an even earlier rate hike. In our view, an earlier than expected Fed rate hike remains the major risk to financial markets, together with adverse geopolitical developments.

On balance we also think that credit should remain well supported since, despite stronger growth in the US, corporate balance sheets are still very conservatively managed. We do not anticipate a significant re-leveraging of corporate balance sheets in the near future.

Diverging monetary policies will continue to support the USD and we see significant further upside.

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