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# Twilight over the Capital Markets

Gerhard Winzer

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Are we now on the other side of the recent price decline in the risky asset classes? Global equities, bonds with default risk, and emerging markets have been recording significant gains. Has the fundamental situation improved, or had the assets excessively negative events priced in?

The driving factors for the global economy and the financial markets are the weakness of the emerging markets, the possible spill-over effects for the developed economies, and the expectations of a raise of the Fed funds rate in the USA.

**Stimuli in China**

The Chinese currency is currently slightly stronger vis-à-vis the US dollar than after the depreciation in August. This has led to a decrease in worries over a depreciation spiral. Also, the foreign exchange reserves in China have declined less significantly than anticipated, and the Chinese equity prices have been rising for numerous weeks. The risk that would emanate from hefty capital outflows is therefore less pronounced. The economic data are mixed. Chinese economic growth has stabilised in Q3. The weakening of the growth rates of industrial production and investments is offset by considerable growth in the tertiary sector. Hopes are for the fiscal and monetary stimuli to suffice in order to facilitate a soft landing for the economy. That being said, the leading indicator published by the National Bureau of Statistics of China was falling until August. At the very least, money supply growth accelerated in September.

**Improved financial environment**

The so-called financial conditions have improved worldwide, while volatilities and spreads for default and liquidity risk have decreased. Of course, in parts this is a tautology (prices are up because prices are up). Still, the sell-off of assets has stopped, which calms the global financial markets. The risk for the global economy, which stems from the turbulences on the financial markets, has declined.

**With a forked tongue**

The expectations of future hikes of the Fed funds rate in the USA have fallen further. In the environment of economic weakness in the emerging markets, this acts as relaxant. However, the signals from the FOMC of the US Fed are mixed. Whereas some members have declared themselves in favour of a rate hike before the end of the year, others favour the zero interest rate policy that has been in place. In other words, the forward guidance, i.e. the preparation of the market for the future monetary policy, is not working anymore. This may potentially come with destabilising effects.

**Falling economic indicators**

Important economic indicators such as the purchasing managers index provided by Markit and the leading indicators of OECD are locked into a falling trend. In line with this situation, many organisations – most recently the IMF – have revised their estimates for global economic growth downwards.

The weak growth rate of industrial production comes with global repercussions. While the falling goods prices cause the purchase power of consumers to increase, the sales and profits of companies have come under pressure. The crucial question is whether in the coming quarters the pressure for lower corporate expenses (lower capex, lower employment figures) will increase.

**Summary**

**Capital markets are in a “twilight zone”. In this zone it is not clear, if the sun goes up or the night lies ahead. The abatement of the panic on the financial markets is indeed supported by an improvement of the determining factors (China, spill-over, Fed). This means that at hindsight a relief rally could easily be justified. However, the fundamental situation has not changed. This suggests that investors should remain cautious vis-à-vis risky asset classes.**

## Legal disclaimer




## Gerhard Winzer

Gerhard Winzer has worked at Erste Asset Management since March 2008. Up until March 2009, he was Senior Fund Manager in Fixed Income Asset Allocation; he has been Head Economist since April 2009.

He holds a degree from a polytechnical college and studied economics and business at Vienna University with a special focus on financial markets. He holds a CFA charter and participated from 2001 to 2003 in the doctoral programme for finance at the Center for Central European Financial Markets in Vienna.

From July 1997 to June 2007, he worked in research at CAIB, Bank Austria Creditanstalt, and UniCredit Markets & Investment Banking. His last position was as Executive Director for Fixed Income / FX Research and Strategy. He was responsible for research on asset allocation at Raiffeisen Zentralbank (RZB) in Vienna from July 2007 to February 2008.