Challenging environment on the Stock Exchange

Gerhard Winzer

The recovery from the slump on the equity markets we saw at the beginning of the year is coming to an end. The rally is losing steam. The search for new supporting factors in addition to the expansive central bank policies is difficult. In line with the general strategy “sell on highs”, we took the recovery profits generated by the neutral weighting and reduced the equity allocation by about a third.

The environment remains challenging for the financial markets. Productivity growth is globally falling, the economic indicators remain subdued, corporate earnings are on the decline, inflation in the Eurozone and in Japan is too low, the US central bank has retained its tendency to increase interest rates in contrast to other central banks, the restructuring process in China is bumpy, the high credit growth in the emerging markets has caused the pressure to cut debt to rise, the fall in commodity prices continues to have a net negative effect on the global economy, the effectiveness of the central bank policies has declined, and the anti-establishment movement will become directly relevant to market participants in the shape of the Brexit referendum and the US presidential elections.

Improvement of the current situation on the financial market

At least the financial market has seen an improvement since mid-February. Spreads and volatilities have fallen, while share prices have increased. Remarkably, the yields of safe government bonds have decreased and the yield differential between short-term and long-term government bonds has declined further at the same time. The so-called maturity premium (compensation for the holding of long-term as opposed to short-term bonds) is negative, while the priced-in rate of inflation has edged a bit higher since mid-February. Also, the (real) yield of inflation-protected bonds has fallen. In summary: **A decline in interest rates across the entire maturity spectrum has reduced the deflation risk and risk aversion of investors.**

No sustainable recovery

Various other important developments complement the picture and help us assess whether the recovery of risky asset classes can last:

- The economic policy in China is more expansive. This manifests itself not the least in higher government spending. However, a boom like in the noughties cannot be repeated.
- The Chinese currency has stabilised. In line with this development, worries over chaotic depreciation have declined. However, the currency commands a strong trade-balanced valuation and exerts downward pressure.
- Expectations of a rate hike in the USA have fallen. The main reason is the unrest and fragility on the financial market. At the same time good employment rates suggest slight interest rate increases.
- The dovish signals from the Fed have caused the trade-weighted US dollar to weaken. Due to the proclivity of the Fed towards interest rate hikes, however, the US dollar will not be able to depreciate sustainably.
- The increase in commodity prices that we have experienced since the beginning of the year takes some of the pressure off of commodity-producing countries and companies. The strongly falling investments and the reduction of overcapacities are slowly but surely eroding imbalances. However, a new growth driver similar to the Chinese investment boom in the noughties is not in sight.
- Other important central banks such as the European Central Bank and the Bank of Japan have further expanded their already very expansive monetary stance. For example, both banks pursue a negative interest rate policy and have signalled low/negative interest rates for the foreseeable future. In addition, the ECB will be expanding its bond purchase programme with regard to volume (EUR 80bn monthly) and quality (including corporate bonds). Mentioning the possibility of helicopter money alone has sent the signal that the ECB still has enough tools at its disposal to reach its goals. The effectiveness of the central bank policies is a fact (see the increase in implied inflation), but it is waning.
- The purchasing managers index for the manufacturing sector increased slightly in March. However, the trend is a negative one, without any structural improvement in sight. Global real exports are shrinking, as are the export prices of goods; global industrial production growth is subdued.
- Overall the economic indicators are not as surprising as they were in February anymore, but they remain negative (i.e. disappointments).
- The latter situation is due to the fact that the economies in Japan and the USA have disappointed. The recovery of the US economy from its weak Q4 2015, until recently the consensus narrative, did not materialise in Q1. Japan has only just avoided a technical recession.

Conclusion: an improved economic outlook was not the driver for the breather in the risky asset classes. The price rises have no trend or cyclical character built in. Rather, they represent a recovery in the wake of a panic-induced slump. This is mainly due to the even more expansive central bank policies, which cause falling interest rates across the maturity spectrum and thus reduce the deflation risk.

Asset allocation: given the challenging environment, we have reduced the equity allocation below the neutral weighting. At the same time we stepped up the allocation in CEE government bonds (including Turkey and Russia) due to low euro interest rates, the overcoming of the recession and falling inflation in Russia, and cuts of the key-lending rates in CEE.

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.