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A brighter financial environment

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The financial environment has brightened up. Equity and commodity prices have increased. At the same time, spreads and (implied) volatilities have declined. The positive development across many parts of the world has been supportive to the optimism of investors with regard to an improvement of the economic environment. In conjunction with the surplus liquidity, they cover up the warning signs though.

Negative developments

This is remarkable, given that we have seen a few negative developments unfold as well. The likelihood of another rate hike in the USA has increased, the yield differential in the USA between Treasury bonds with long and short maturities is on the decline, and the Chinese currency has depreciated again vis-à-vis the US dollar. Also, some important leading indicators such as global purchasing manager indices are falling, and company earnings are receding. In addition, the rate of inflation priced in by the bond market is on the decline.

Investor negligence?

This situation prompts a number of questions. Are the markets anticipating an improvement or does the surplus liquidity push security prices up? Have the markets become less fragile, or have the market participants become negligent to the risks?

US rate hike in line with the environment

A number of members of the FOMC of the US Fed have signalled that the conditions for another raise of the Fed funds rate in the USA may be right in the coming months. Indeed, economic growth seems to have been increasing from +0.8% in Q1 to +2% in the ongoing quarter (q/q, annualised). There are also signs suggesting a rise in inflation and further improvements of the labour market. Also, as pointed out above, the global financial markets have calmed. It seems that the market understands the conditions for a rate increase and is therefore able to handle it. A possible increase of the Fed funds rate will accordingly not be interpreted as hawkish (i.e. as fighting inflation), but as in line with the improved environment.

US dollar dampens extent of interest rate increases

The US dollar will keep a lid on the number of rate hikes, because currencies and interest rates are communicating vessels. In the current environment, rising expectations for rate hikes in the USA have caused the US to appreciate. This, in turn, dampens the economic activity, the inflation pressure, and as a result the potential for said rate hikes.

Economic stimulus in China

In China, some economic data, such as investment activity, industrial production, and retail sales, were on the disappointing side in April. In spite of that, worries over a further weakening of the Chinese economic growth have declined, because the increase in lending, the leap in planned new investments, and the improvement of the retail sector suggest a stabilisation of economic growth in Q2 and Q3. Trust in the Chinese stop-and-go economic policy (currently: go, i.e. stimulus) has increased.

Fiscal package in Japan

The Japanese economy recorded a surprising increase of 1.7% (annualised) in Q1 relative to the previous quarter. The consensus had expected stagnation. In the current quarter, the economy will probably shrink, not the least due to the earthquake. At the same time there are signals that suggest that the VAT hike scheduled for April 2017 may be pushed back to October 2019 and an additional fiscal package may be passed. Also, there is speculation about further measures to be taken by the Japanese central bank.

Solid growth rates in the Eurozone

The Eurozone recorded strong growth of +2.1% in Q4 (annualised). The potential growth rate is estimated at +1.0%. In the ongoing quarter the growth rate is homing in on a good +1.5%. The expansive policy of the ECB is working, albeit only to a limited degree. Interest rates on loans have fallen significantly, and investment growth has increased. At the press conference on coming Thursday the president of the ECB will probably be signalling that the improvement is expected to continue (and the very low inflation to rise) without additional stimulus measures.

Fiscal policy in the Eurozone not restrictive any longer

Greece and the creditors have come to an agreement on the political level: given that Greece fulfils the criteria of the aid programme, the next payout to Greece will be effected in June. This will enable Greece to service all its debt. Remarkably, also, Italy, Spain, and Portugal have been given more time by the European Commission to reduce their budget deficits. This supports

growth.

Interim president Temer

Brazil is caught up in a severe recession. At the same time the budget deficit has increased to 10% of GDP. Expectations for the situation to improve are huge in view of the impeachment proceedings in connection with Dilma Rousseff and in the wake of the appointment of interim president Temer.

New insolvency law in India

In India the insolvency law has been revamped. Estimates put the share of bad loans at 11% to 20%. The obsolete, dysfunctional insolvency law has so far prevented investment activity from improving. With the new law, hopes are for lending to soar and new sources of capital such as insurance companies to emerge.

Crisis – response – improvement – negligence

The classic cycle of: crisis (most recently at the beginning of the year) – response (expansive central bank and economic policies) – improvement (rising asset prices) – negligence (vis-à-vis risks) is intact. The financial markets remain susceptible to a correction. Along with the possible interest rate increase in the USA on 15 June, the BREXIT referendum in the UK represents an important risk factor. Therefore we remain defensive in our portfolio structure.

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