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Market Monitor: positive for risky asset classes

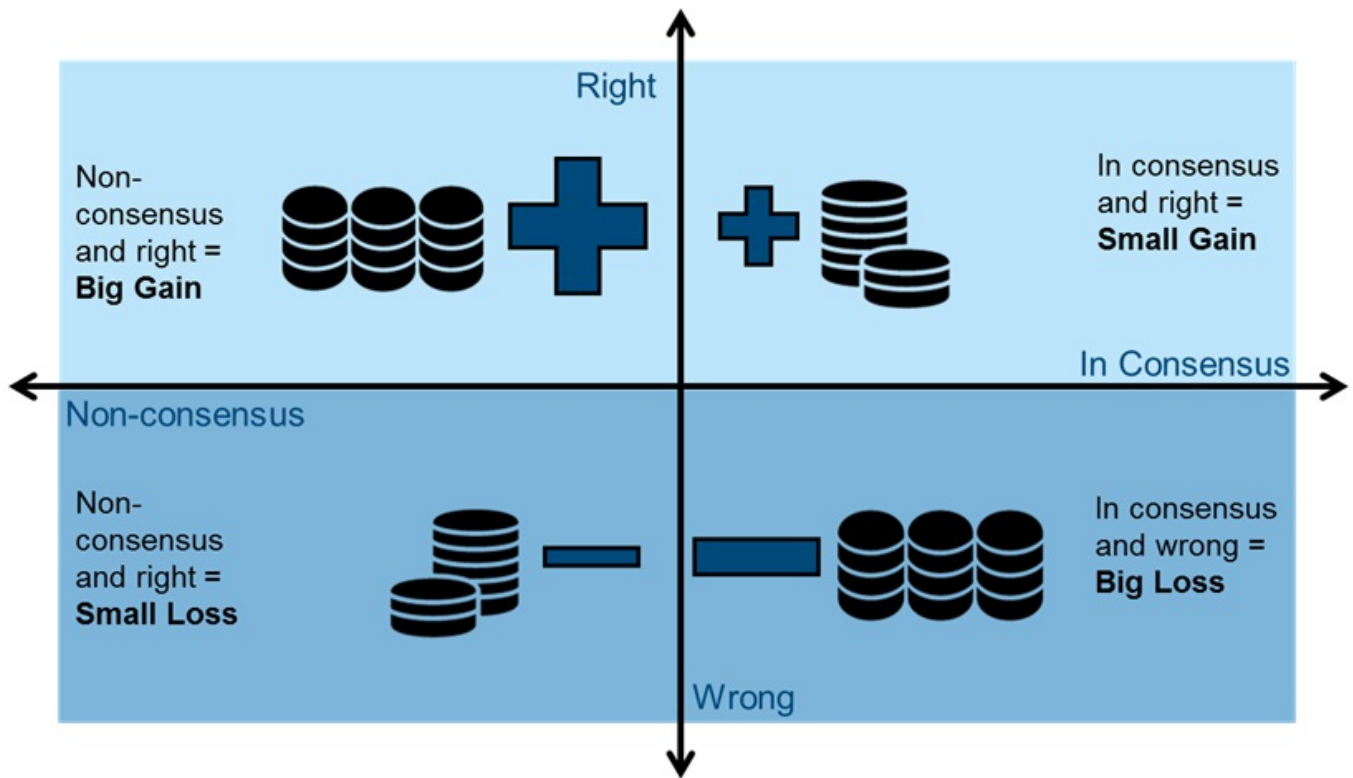
Gerold Permoser



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Once a month the Investment Committee of Erste Asset Management convenes in order to discuss the medium-term market outlook. We are going to start a new blog, where we will report on what drives our investment professionals and what risks they see.

A quick word on the structure of the Investment Committee. Our idea is based on the so-called market consensus, i.e. the expectation(s) of the market. Opportunities and risks of an investment ultimately hinge on market expectations and the opinion of the fund manager with regard to those expectations. The following chart summarises the various scenarios: if the market expects something to happen (N.B. in fund management jargon, an event is “priced in”) and the fund manager does so, too, the return potential of an investment that bets on this event is limited. However, if the fund manager holds a different opinion and is right, the return potential is high.



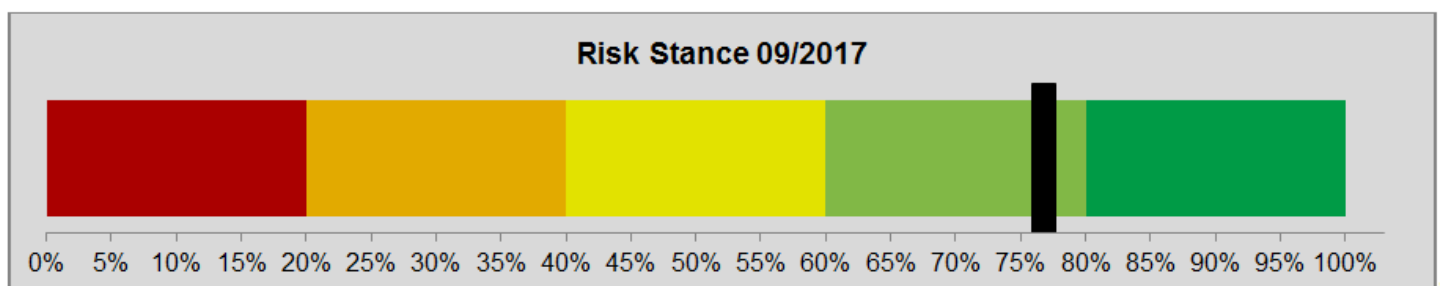
The current market expectation - positive for risky assets

At the moment, the market has a very positive environment for risky assets such as equities and high-yield bonds price in.

- **The global economy is growing.** All countries covered by the OECD (i.e. the industrialised world plus emerging markets) are showing positive growth rates. This generally supports equities.
- **Inflation is very low,** and no significant acceleration of inflation is expected for 2018, either. This gives the central banks room for manoeuvre to carefully raise interest rates, it caps potential yield increases, and also does not burden equity markets.
- The **only fly in the ointment of this positive picture is the interest rate cycle in the USA** and the developed world, which very recently has turned from extremely expansive to restrictive. The US central bank, i.e. the central bank of the world, is currently in a cycle of raising interest rates and is about to start reducing its balance sheet total. The European Central Bank (ECB) will soon announce the reduction of its bond purchase programme. In a phase of interest rate increases^[1], equities on average yield lower returns than in a phase of rate cuts. But at the moment, the monetary policy is not yet restrictive and is not yet burdening the performance of equities. Also, the central banks are aware of the risk associated with interest rate increases and therefore act very carefully by communicating every step in advance in order to rule out (unpleasant) surprises.

We share the constructive assessment by the market

We basically share the positive assessment of the market and are positioned accordingly across our portfolios. For example, the average risk stance of our Investment Committee (consisting of 13 individuals) is easily established. It is clearly positive.



Why are we not more upbeat despite the aforementioned, positive picture? There are a few reasons:

- We are aware that our assessment is very close to the market consensus. Risky assets hold upward potential. However, the relative return potential is asymmetric and therefore indicates extreme return values as unlikely.
- Many economic indicators are elevated and have more downside than upside potential. A lower IFO or ISM index would not

be a disaster at this point though.

- In the Eurozone, economic growth is currently high and broadly based; all countries, including France and the peripheral economies, are growing. The appreciation of the euro on a real effective basis, i.e. adjusted for inflation differentials as measured by a basket of currencies, of 7% since February should at least dampen the growth story in the Eurozone.
- Lastly, we can see more risks than opportunities for our outlook despite, or maybe because of, the positive picture. Among the risks that we have addressed are possibly negative effects caused by the tapering of the central bank balance sheets (quantitative tightening), an unexpected increase in inflation (the US central bank envisages higher growth for 2017, but expects the unemployment rate to remain roughly the same), and a more mechanistic Fed that operates less on the market in the wake of the newly to be appointed four (of a total of seven) Fed governors. The main upward potential that we have discussed hinges on the possible success of the Trump administration in implementing its comprehensive tax reform as planned.

Overall the Investment Committee continues to rate risky assets as positive despite the aforementioned risks.

[\[1\]](#) A phase of interest rate increases is defined as lasting from the first interest rate increase to the first interest rate cut.

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Gerold Permoser

Gerold Permoser has been Chief Investment Officer at Erste Asset Management since early April 2013. He is responsible for all asset management activities and investment strategies for all investment funds held by the Erste Asset Management Group in Austria, Germany, Croatia, Romania, Slovakia, the Czech Republic, and Hungary. Before joining the company, he served this function at Macquarie Investment Management Austria KAG. Permoser has gathered experience in investments since 1997.

He began his career as a fixed-income analyst at the Creditanstalt in Vienna. He moved to asset management at Innovest KAG in 2000. He made significant contributions in the investment field there and advanced to CIO (director of asset allocation and research). Gerold Permoser studied at the University of Innsbruck and is a CFA charter holder. He offers training at the University of Vienna and at various post-graduate institutions for analysts and portfolio managers (i.e., at VÖIG, the Association of Austrian Investment Fund Companies).