Financial Markets Monitor July: an independent view

Gerold Permoser

In the beginning of July our Investment Committee held its monthly meeting. Despite a largely negative month on the markets, our risk stance has hardly changed relative to the previous month.

It declined slightly from 75% (6 June) to 73% and thus continue to signal a clear willingness to assume risk. Sticking to one's opinion in spite of volatility makes sense in uncertain times if the data set has not changed. Which takes us to the question: has our economic scenario changed?

Source: EAM

The market environment

In order to answer this question, we started our meeting as always with an introductory presentation by our chief economist, Gerhard Winzer. The biggest month-on-month change was a set of weak economic data from China, which had immediately triggered fears of a drastic economic downturn in China, i.e. a so-called hard landing. Since the turbulences around the depreciation of the CNY in summer of 2015, this risk has been on the radar of pretty much every investor. Our take: a month of weak data does not make a recession. Also, in the event of a continued economic decline we would rather expect to see another round of fiscal and/or monetary stimuli rather than a recession. Against this backdrop, the depreciation of the CNY in recent weeks can be regarded as intended stimulus that is in line with this interpretation.

The stimulus of the Chinese economy through the foreign exchange rate is a topic that takes us to another significant change that has occurred in recent weeks, i.e. the "global trade war". This topic is, of course, not a new one. However, in the meantime it has become clear that words are being followed by actions. After the first round of punitive tariffs mutually imposed on each other by the two opposing parties, President Trump explained: "Therefore, today, I directed the United States Trade Representative to identify USD 200bn worth of Chinese goods for additional tariffs at a rate of 10%. … After the legal process is complete, these tariffs will go into effect if China refuses to change its practices, and also if it insists on going forward with the new tariffs that it has recently announced." The concept of a vicious circle cannot be described more fittingly.

What does this mean, overall?

- The global economy is still growing at substantial rates. However, we are clearly at a late stage of the cycle, with the growth momentum weakening. This also fits our opinion that the market seems to have formed a "working hypothesis", according to which a recession should be expected in the USA for 2020. The still strong growth rates are glossing over the fact that the discrepancy in momentum behind global growth has been on the rise. Whereas the USA is growing significantly above potential, the rest of the world is trailing or in (economic) decline.
- Global inflation is currently on a moderate increase. The rise in prices in the USA is strong, driven domestically, and sustainable, since the economy is operating above potential. Here, too, the rest of the world is trailing the USA.
- In this environment, we expect further interest rate increases in the USA. At the moment, the market envisages a Fed funds rate of slightly above 2.5% at the end of 2019. From our point of view, the risk is clearly that this rate may be reached earlier than expected, because the US Fed wants to prevent overheating. Given that the ECB's communication has become more cautious recently, in Japan rate hikes are not foreseeable, and the People's Bank of China is even expanding liquidity, the interest rate differential and the expectations concerning future interest rate differentials are diverging more and more.

As a result, we have included two additional risks in our risk matrix: desynchronisation and Trump 2.0.

- **Desynchronisation:** seeing that the data for the US economy, China, and Europe are drifting apart, there is the risk of strong feedback effects resulting from this development. The channel through which this tends to occur is the US dollar, which is still the global lead currency. Higher US Fed funds rate practically translate into less USD liquidity at a higher price. Assuming that the US central bank cannot keep an eye on the rest of the world while implementing its policies in a time of "America first", we may run into problems. This risk would manifest itself first on the emerging markets. They are affected by a more restrictive US monetary policy from two angles, as exporters and as US debtors: global trade is done mostly in USD and declines in phases of restrictive US interest rate policies; and debt becomes more expensive as interest rates are rising and total debt increases in local currency.
- **Trump 2.0:** the aggressive fiscal policy of the Trump cabinet is coming at an inconvenient time for the US economy, which is already operating at capacity. In simple terms, the US economy cannot produce more since all employable people are already working and all machines are running. Even an immediate investment boom could not change that at short notice since investments take time to result in higher investment potential. Therefore, a large part of the demand created by the tax cuts can be expected to manifest itself abroad, which is exactly the opposite of what President Trump wants. This scenario entails the risk of a further honing of the economic and political course of the government, which would be negative both for the economy and the financial markets.

Factor view

In the financial world, much like everywhere, it is advisable to take an independent look at things. This way, the habitual can be challenged and improved on. To this end, we use factor information in order to deduce the market status quo. – The hypothesis being that factor performance (i.e. the drivers of factors such as value, size, quality, momentum) depends on the economic cycle and has to be aligned with it.

To highlight this angle, our chief analyst and factor specialist, Harald Egger, gave a presentation on the current factor performance and its underlying patterns. In 2018, growth, quality, small caps, and momentum had been the top-performing factors across practically all the regions we monitor. Egger suggested that this pattern indicated that growth was clearly weakening without tipping into recession. This, then, painted a picture similar to our economic outlook, albeit in simpler terms.

Post-election Turkey

The development of Turkey after the elections at the end of June was another topic to which we dedicated ample time. Our Chief Equity Strategist, Peter Szopo, summarised our opinion in a blog entry about this issue.

Risk matrix

As always, the last point on the agenda was a discussion about our risk matrix.

- On the one hand (and as explained above), two new scenarios had been taken into the risk matrix. On the other hand, a substantial number of risks had moved into the dangerous area (high impact and high probability). The 13 Committee members rated the risks higher than in the previous month. However, the risks that were regarded as particularly large remained unchanged relative to the previous month.

What is our positioning?

As far as our asset allocation is concerned, we continue to see opportunities among the risky end of investments. Among them are equities as well as high-yield corporate bonds, whereas we regard government bonds from the Eurozone as unattractive due to their low yields.

On the sovereign front, we are almost neutral in duration, with a moderate long position in the Eurozone (17% of the maximum bandwidth) and a moderate short position in the USA (-24% of the maximum bandwidth) balancing each other out. In line with this set-up, our curve positioning differentiates as well. In the Eurozone, we expect the curve to steepen from the long end, whereas in the USA we envisage a flattening from the short end. In terms of countries, we continue to bet on the higher yields in Spain and France, while our positioning in Italy is neutral. We do not expect the situation to worsen (again) over summer. Accordingly, we want to benefit from the high yields of Italian bonds. That being said, we are not taking an overweight as we think Italy remains fragile, and the political crisis may heat up again in autumn.

We expect the spreads of EUR high-yield bonds to narrow slightly in the coming three months. Emerging markets remain vulnerable (Turkey, Argentina, Indonesia, South Africa). We therefore continue to expect elevated volatility and maintain a cautious positioning. However, we can also see that many emerging markets have already corrected significantly and thus offer a commensurate degree of upward potential.

On the equity front, we have reduced our overweight in cyclicals in recent weeks. This is not only due to economic expectations, but also to the discussion about trade war. Cyclicals tend to be more export-oriented and thus more affected by negative developments in international trade. A good example for significant dependencies is the car industry, which, while often producing locally, is still exposed to international supply chains.

Legal note:

Prognoses are no reliable indicator for future performance.

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).