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Financial markets 2018: reasons to be cautiously optimistic

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So far, we have seen a succession of mini shocks and losses across more and more asset categories in 2018. In October, the momentum shares were the victims. Among them is the technology sector. In line with this development, investor confidence in the financial markets has been falling and it is hard, without a good overview, to keep an optimistic stance.

Reasons for a cautiously optimistic stance

Growth

A number of important leading indicators such as the purchasing managers index for the manufacturing sector suggest a gradual weakening of real global economic growth. The absolute level, however, remains good, i.e. above the long-term expected value (i.e. the potential). It is important to point out that recessions are rarely ever predicted. The real GDP growth rate of only 0.2% q/q in the Eurozone was hopefully only an outlier.

Liquidity

The central banks in the developed economies have been gradually reducing their very supportive monetary stance. Key-lending rates are being raised and the net purchase programmes are expiring. The most important central bank, the US Fed, has increased the target band for the Fed funds rate to 2-2.25 percentage and has indicated further increases to above 3 percentage. On aggregate, the monetary policies still have a net expansive effect. However, if the key-lending rates were to be raised too quickly to excessive (i.e. restrictive) levels with the central bank money supply being reduced too quickly at the same time, markets could come under increased pressure and/or a recession could be set off.

Asynchrony

The US economy is booming while the rest of the world is showing signs of weakness. This has put pressure on those economies in particular whose debt is in US dollar (higher interest rates), whose economic growth is sliding (low income growth), and where imbalances exist (current account and budget deficits). That being said, the USA has also seen an increasing number of economic weakening. The property and automobile markets are stagnating, capex growth in the corporate sector has fallen, and inventories contributed a full 2 percentage points to the excellent economic growth of 3.5 percentage (q/q, annualised) in Q3. Another problem might be created by the weakening of the Eurozone and China falling short of expectations.

Valuations / spreads

Valuations were clearly above average at the beginning of the year for many asset classes, i.e. the spreads (i.e. risk premiums) priced in were very low. Some asset classes even reached a cyclical low (for example, the spreads for US corporate bonds at the beginning of February amounted to only 0.9 percentage points (currently: 1.23 percentage points). At the moment, some asset classes are "cheap". This applies in particular to emerging markets.

Positioning

The positioning towards risky asset classes has decreased over the year. However, we have not seen the last optimists "capitulate" yet, which would trigger further losses.

Strategy

Until the beginning of October, momentum shares were one of the few asset classes to earn positive rates of return. Once the earnings expectations cannot be

revised upwards any longer (because of the already high level), the momentum strategy breaks. Generally, a sector regrouping then takes place amid elevated levels of volatility (i.e. price fluctuations).

Yields

Remarkably, credit-risk-free government bonds have not recorded any significant decline in yields despite share price losses and the increase in risk. In the USA, the yield of inflation-protected Treasury bonds has increased from 0.42% to 1.04% in the year to date. This increase is not dramatic, but it does lead to a decline in the net present value of future earnings and exerts pressure on spreads to widen. This could be due to the booming US economy, increases in key-lending rates, and the drastic expansion of the budget deficit in the USA.

Politics

The political sphere constitutes an important reason for the widening of the required spreads (escalation of the trade conflict between the USA and China; unsustainable budget policies in Italy; risk of a disorderly Brexit).

Oil price

While the oil price declined in line with equities in October (to currently USD 76 per barrel of Brent), the risk of an oil price increase due to a supply cut that would dampen purchase power remains in place.

Feedback

The tightening of the financial environment causes a dampening effect on the economy. This effect is clearly negative in Turkey, moderately negative in Italy, and so far, minimal in the USA.

Inflation

The development of inflation is crucial. As long as it remains low in the developed economies, the central banks have wiggle room to suspend the cycle of rate hikes in case of a drastic tightening of the financial environment.

Conclusion

The base case scenario (still) holds. The leading indicators just suggest a moderate weakening of economic growth, the central banks act cautiously, and the fallen market prices already have a number of possible negative developments priced in.

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