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Financial Markets Monitor April: upside-down scenario

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On 3 April, we held our monthly Investment Committee meeting. Only three weeks after the previous one – three weeks that were tightly packed with issues, as we can see in the performance data of the most important asset classes. Equities and high-yield bonds have lost value, whereas Eurozone government bonds and emerging markets bonds have recorded gains. An upside-down scenario, compared to previous months.

However, we have become slightly more cautious with regard to the assessment of the market (52% instead of 55%). My interpretation is that most Committee members are trying to reconcile two different approaches here. As Daniel Kahneman said, this might be a case of "quick thinking, slow thinking". On the one hand we know that in the current phase of the cycle we have to stay on course, on the other hand, our brain stem is telling us: "Danger! Liquidate position!" Very often in such situations, the impulsive behaviour wins. I think that not the least due to the discussion of the issue by the Investment Committee, it will be possible/easier to act rationally and not listen to this impulse.

The next part was, as always, the presentation on the current momentum by our Chief Economist. In summary, these were the most important points:

- We are in a textbook late boom phase. The economy is still growing strongly on a broad basis. At the same time, the momentum is rolling. The following chart shows the average of numerous similar indicators as calculated by ZEW Institut (Zentrum für Europäische Wirtschaftsforschung; Centre for European Economic Research); it depicts the average assessment of the current business climate and the expected business climate for the USA, the Eurozone, Germany, France, Italy, the UK, and Japan. It shows how the index has increased over the past months and remained above the values that we had grown accustomed to since 2008. The index is still clearly above the zero line, which suggests continued expansion. At the same time, the line has now started to dip. We all know the typical economic cycle and thus the phase after the boom, i.e. recession. The question in the coming months will be at what point in time we will have to accept it.

Source: EAM, Datastream

- The monetary policy is becoming noticeably more restrictive. Most recently, the Bank of Japan also announced that it was thinking about an exit strategy for its asset purchase programme. The ECB is expected to terminate its programme also in the coming twelve months, and the Fed, the Bank of England, and the Bank of Canada will soon raise their rates.
- Also, the US government seems to be set on starting a trade war. While since our last meeting exceptions to the announced tariffs have been decided on for Europe, more extensive measures were released for China. Thus, President Trump seems to be turning to the real enemy. In addition to the extent of the measures (USD 60bn instead of USD 4bn are now subject to the new regime), the composition of the US cabinet has also changed since our last meeting. The number of hardliners who think a trade war can be won has increased. Whoever thinks a war can be won, is also ready to fight it.

Overall, we are still in a situation that seems very favourable on the surface. The problem of the current environment is its asymmetry. Everybody knows the script of an economic cycle. It is all about how long one can stay on the gas in such an environment. The times of positive growth surprises are gone. At the same time, we can see the usual signs of this phase of the cycle, such as higher inflation, short but substantial set-backs in prices, and the broadening of the multitude of opinions. All of this is asymmetric. Many sources of negative surprises are juxtaposed by few sources for positive surprises. It is becoming more difficult to stand by one's conviction.

This is how we entered the discussion about our risk.

The biggest risk we can see is a price slump without a cause due to high valuations – not uncommon for this phase of the cycle. The argument is the same as before. Rational thought prescribes an overweight in risky assets, but the gut feeling becomes more and more queasy in doing so.

In terms of effect and probability, the next important risks are a global trade war, a strong increase in interest rates, and, the golden oldie, a hard landing in China. While this scenario only comes with a minor weighting, it has the biggest negative impact in absolute terms.

We are accordingly positioned against this backdrop:

- In the bond segment, we have reduced our positions in the past weeks. We are keeping interest duration short and spread duration neutral, with a long bias. Since the trend-following system has been long in the past three working days, the positioning with respect to interest duration is slightly long, as are all the models. From our point of view, the market for credits is still well supported. The search for yield continues, the redemption in Europe are 22% below last year in 2018, the ECB is still buying at this point and even increased the share of the CSPP within the APP above 20% in March. In the USA, the tax reform by the Trump cabinet should fill company coffers with more money. This prompts allocation to credits. However, we are currently making a conscious decision to withdraw from illiquid titles. If something were to happen, we would not want to be caught at the illiquid end of the market.
- We have not changed out asset allocation in the past three weeks. We remain prominently weighted in risky assets (equities from the developed and emerging markets, high-yield bonds). At the moment, we are not planning on using the low prices of the past days to buy and step up positions.

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Gerold Permoser has been Chief Investment Officer at Erste Asset Management since early April 2013.

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