

<https://blog.en.erste-am.com/financial-markets-monitor-august-we-remain-optimistic/>

## Financial Markets Monitor August: We remain optimistic

Gerold Permoser



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On 7 August, our Investment Committee convened for its monthly meeting. The month since the previous meeting on 7 July had been a positive one for investors willing to take risks. Thus, the optimistic risk stance of our team paid off in July. It is therefore not surprising that the team remains optimistic. In August, the risk stance is currently at 75% (previous month: 73%). This means that as a group, we are still optimistic. In terms of positioning, it means that we continue to prefer risky asset classes such as equities and corporate bonds.

Source: EAM

While the risk stance remained unchanged relative to the previous month, the internal structure of opinion inside the group had been shifting considerably. A few months ago, almost all team members were unanimously bullish. Meanwhile, this assessment has morphed into a bimodal distribution: one part of the team is very bullish, the other one is neutral. On aggregate, this results in a moderately bullish stance, but the underlying story is different – and the basis of an interesting discussion.

The conclusion is that as a team we remain optimistic and still prefer risky asset classes. As customary in the current stage of the cycle (late boom), the diversity of opinions in the team (in other words, the uncertainty) increases. The important message is that at this point nobody is risk-averse, i.e. more cautious than neutral in their positioning.

### The market environment

In his presentation on the drivers of the economic status quo, Gerhard Winzer, our chief economist, pointed out a moderate improvement in the economic environment relative to the previous meeting.

- In the USA, the economy is still growing at a strong rate and clearly above potential. The fiscal impulses facilitated by the Trump cabinet have set the economy on a path towards overheating. The labour market is very tight, and the signs of moderate wage pressure are becoming more plentiful. Inflation is on the rise, but still moderately so.
- In Europe and Japan, the weakening experienced in the first half of the year has been absorbed: the growth expectations for the second half have not been subjected to any more negative revisions recently and are still above the potential growth estimated for the Eurozone in absolute terms. Also, at least the direct effects of a trade war with the USA have been avoided for the time being.
- In China, on the other hand, we have encountered a rising number of signs indicating economic weakness, but on a positive note, we have also seen reactions to these trends. The interest rates have been cut, the currency has depreciated, and a fiscal support package has been announced (the contents of which cannot be assessed at this point though). This brings about short-term support but does not change the fact that the question about China's long-term growth model remains unanswered and any solution will have been made more difficult by these short-term measures.

Overall, we can say that in the USA the economy is firing on all cylinders, and while the rest of the world has experienced some weakening, it remains robust and is performing well in absolute terms. This scenario continues to suggest that risky asset classes can achieve good returns in the foreseeable future.

As always, we subjected this assessment to a critical evaluation in the following discussion, challenging it from various angles.

- As far as the decisive factors are concerned, the image is pretty much in line with the aforementioned scenario. Globally speaking, equities with small cap, value, and momentum exposure have underperformed in recent weeks – a performance pattern that generally fits a weaker global economy. At the same time, these patterns are still in their initial stages, which indicates a very moderate downturn as opposed to a slump.
- From our equity team's point of view, the reporting season that has just come to an end is painting a similar picture. With the majority of figures in, we can see that US, European, and Japanese companies have reported very good quarterly results. Most companies exceeded earnings and sales estimates by analysts; however, US companies more so than European or Japanese ones.

Index	Positive sales surprise	Positive earnings surprise
USA – S&P 500	70.54%	83.45%
Europe – STOXX 600	60.84%	52.34%
Japan – NIKKEI 225	58.56%	61.74%

Source: EAM

- The commodity markets have been sending signals that are at odds with our picture. Based on the GSCI index in EUR, commodities had lost about 0.4% since the previous meeting. Given the connection with the positive market phase since the beginning of 2016, the performance should have been positive in the past weeks. A closer analysis reveals the fact that cyclical commodities (industrial metals and energy) as well as gold had performed negatively. In the sub-segment of cyclical commodities, the energy outperformed industrial metals in relative terms. We interpret this fact as based on the recent weakening in China. This should come as a burden to cyclical commodities in general. The driving factors of the oil price are largely idiosyncratic: the new US sanctions imposed against Iran, the imminent IPO of Saudi Aramco, and the resulting production decline in Saudi Arabia support the oil price.

Source: EAM

What our discussion showed, in a nutshell, was that our picture pretty much fit the market movements in the previous weeks. The performance of commodities somewhat defies the overall positive picture. From our point of view, this strongly suggests that the markets are currently particularly uncertain about the situation in China and that a significant decline in economic growth cannot be ruled out.

#### Risk matrix

This brings us to the last point of our discussion, our risk assessment.

Source: EAM

- As described above, we regard China as very big risk for the coming three months. The most recently published economic indicators suggest a downturn in economic growth. The Surprise Index for China, which reflects the degree to which positive economic indicators have recently surprised or disappointed, has fallen from a very high level at the beginning of 2018 to a meanwhile very low value. In other words, the Chinese indicators have turned massively within a short period of time.

Source: Citi Economic Surprise Indices

We believe that in addition to the still open question of what long-term growth model China can find and how it will ensure its transition to that model, cyclical uncertainties have re-emerged. China's problem is that any short-term weakening of the markets will be construed as potentially heralding an imminent hard landing as long as it is unclear what path China will take in the long run. Therefore, negative data from China tend to rattle the markets. As pointed out earlier, the Chinese government has meanwhile tried numerous measures in an effort to support the economy with positive impulses. On aggregate, these measures will probably cause some tailwind for the economy; however, in the long run they do not reduce China's worries but reinforce them, since the economy is drifting further and further away from "healthy" growth.

- The other big risk that we can see at the moment is the trade war between China and the USA. The agreement between EU Commission President Juncker and US President Trump had taken Europe out of the firing line. The markets are still unclear as to whether this agreement was based on a more conciliatory approach by Donald Trump (positive for the markets) or on a focus on the real enemy, China (negative for the markets). But this does not change the fact that on aggregate the topic is a burden for the market. In my opinion, this is due to a number of factors, as illustrated by the following chart.

Source: EAM

- The chart at the top left corner shows the share price performance of European car manufacturers relative to the overall market in the year to date. As you can see, the car manufacturers start underperforming moderately from March onwards. In May, the performance differential widened significantly over a few days. We think that this was due to the fact that the share prices of European car manufacturers were affected twice by the discussion about US tariffs. First, directly; tariffs on car imports are clearly negative for the respective companies. But in addition, car manufacturing today is based on a highly integrated, international just-in-time value and supply chain. Rising prices or obstructions in one area of the process have an impact on all areas and parties involved. The supply chain is only as strong as its weakest link. As a result, supply chains that are based on a high level of international integration in the automotive industry are particularly hard hit by barriers to trade.
- Second, trade wars always also come with unwanted side effects. The chart at the bottom left shows the development of soy prices. Soy is one of the products that China imports from the USA. It was definitely not US President Trump's goal to harm "his" soy farms.
- The last point is reflected very clearly in the right chart. Since 2000, there has been a significant correlation between the performance of the equity market and the development of global trade volumes. The economic growth over the past 20 years has largely been based on the increasing degree of globalisation and integration of the global economy. If this development were to be reversed, it would harm the financial markets.

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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).