Financial Markets Monitor June: a lot going on

Erste AM Communications

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An Investment Committee again! A month can pass quickly, especially if there is a lot going on in the markets. In light of recent market events (Italy, Turkey, Argentina), I was surprised that our risk stance has not changed since our last Investment Committee meeting. Obviously, it takes a lot to get us out of bed. With 79% of the possible bandwidth, our risk stance is not only unchanged from the previous month, but also very optimistic.

Source: EAM

Despite the turbulence around Italy, if you look at the performance of the most important asset classes since our last meeting, actually, not much has happened. Equities, corporate bonds, high yield, and even euro government bonds are about where they were last. If German government bonds did not stand at + 1.7% in three weeks, one could believe that nothing has happened. But one thing after another.

The market environment

Global economic growth can be described as robust in recent months but flattening in its momentum. What is new is that the homogeneity between countries and regions is not as high as it was a few months ago. Especially between Europe and the USA, meanwhile, we can see clear differences. In the US, the economy is on fire. Driven by the expansive fiscal policy of the Trump administration, the US economy is currently growing at around 3% p.a. In Europe, however, signs are pointing to a flattening of growth momentum.

This picture is also confirmed in the case of inflation. In the US, actually measured inflation rates are rising. In addition, many leading indicators of inflation point to price pressures in the coming months. The danger of overheating of the economy is there. In Europe, the picture for the leading indicators is much more relaxed.

The same applies to other important economic indicators such as the labor market, budget and current account deficits. The divergence is growing. It is therefore understandable that these differences are also reflected in the most important financial indicator for the economic divergence of two countries, the exchange rate. The USD gained about 7% against the EUR in recent weeks. A vote in the committee has shown that a clear majority assumes that the USD, while priced in a lot, has more potential for strength by the end of the year.

A similar picture shows the nominal, effective USD exchange rate. Here, the performance of the USD against a basket of currencies, usually weighted with the significance for a country's trade, is measured. The USD has also appreciated against this basket of currencies in recent months. The USD strength is very broad based. This resulted in two conclusions in our discussion:

o First, it will be virtually impossible for President Trump to achieve his interpretation of America First. With an economy in the fast lane and a firmer currency, it will simply be impossible to balance the current account. Accordingly, it can be assumed that the topic of trade barriers will boil again in the coming months.

o On the other hand, a stronger USD and higher interest rates mean that the USD is getting scarcer. As a global reserve currency, the USD is the "lubricant" of the global economy. Accordingly, all those who depend on a sufficient supply of USD are "at risk". The first candidate would be international trade, which is largely settled in USD. At present, there are still no signs of weakening, although the recent decline in the especially export-sensitive German Ifo index can certainly be interpreted as a sign in this direction. The second candidate is countries with high USD-denominated foreign debt, whose debt service is hampered by a "shortage" of USD. The recent turbulence in Turkey and Argentina shows that there are risks here.

Risk: It's back!

Countries with high levels of foreign debt are also the perfect keyword to describe the discussion of the biggest risks over the next three months. De jure, the Euro is indeed the home currency of the Euro countries, but in practice it is a foreign currency, since no Euro country can print Euros. And that brings us to Italy and the heart of Italian misery. After Italian government failed on 28 May for a short time, yields on Italian government bonds rose sharply. Yields on 2-year Italian bonds were around 0.25% on Thursday 23 May. The following

Tuesday, the corresponding value was 2.7%. Italy had to pay more for borrowing in its home currency than Turkey, which had to pay about 0.5% less for the same duration in EUR. Italy now has a government and the situation has calmed down a bit. The unanimous tone of the discussion, however, was that the topic is not off the table and will remain one of the major risks in the coming months.

Positioning:

We still see equities as the most attractive asset class. Mostly, because the macroeconomic environment is favorable for equities despite the heterogeneous development, and partly because the mood in the markets is supportive. High-risk bonds, such as high-yield bonds, are also among our favorites. We try to avoid government bonds, especially from the Eurozone. On the one hand, because credit-worthy securities (such as Germany) would be disproportionately affected by yield increases, on the other hand, because we expect the situation in Italy to remain tense.

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