

<https://blog.en.erste-am.com/market-monitor-risky-markets-have-come-far/>

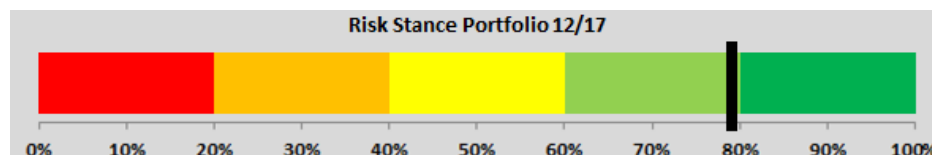
Market Monitor: risky markets have come far

Gerold Permoser



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Earlier this week, we convened the last Investment Committee of 2017. The general risk appetite of the team has not changed vis-à-vis the previous month (from 78.85 percent to 79 percent on our 0 – 100 percent scale). The team continues to see the future optimistically, with a resulting “risk on” stance.



Source: Erste AM

For the first time, we asked the individual members what risk stance they were expecting for the Committee overall. The result: on average, team members tended to think they were taking more risk than the group. While the team members are still optimistic we regard this as ambitious in comparison with the market. From our point of view this is another indicator as to how far the current cycle has come already.

Risk of correction on the rise

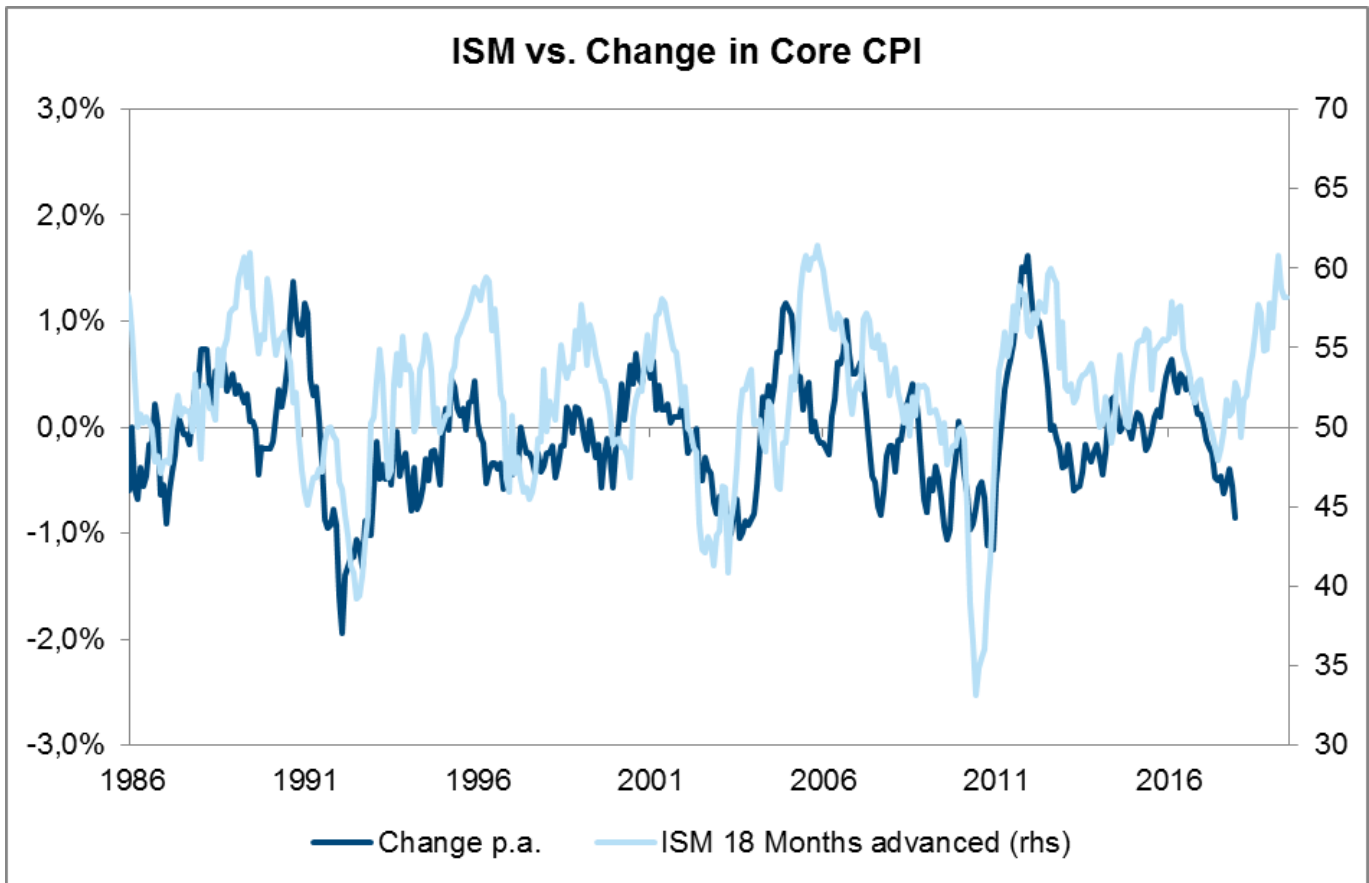
The following discussion focused mainly on two topics. On the one hand, the tax reform in the USA should enable US companies to boost their profits in 2018. On the other hand, the valuations of many asset classes are being perceived as high. The risk of even relatively unimportant events triggering a correction has thus increased. All in all, the good economic performance still suggests optimism, and to allocate significant weights to risky asset classes in the portfolio. That being said, the air is getting thinner.

Our inflation outlook for 2018 made up a large part of our discussion. In summary, a lot of signs suggest that the rate of inflation will rise by about 0.5 percentage points next year.

Reasons for higher inflation in the USA

- The good economic situation
- Less pressure from the labour market
- The weaker US dollar
- Higher import prices
- Higher commodity prices

As an example, please have a look at the following chart that juxtaposes the ISM index, i.e. the sentiment index of 400 US purchasing managers (18 months from the present), and the core inflation rate. In view of the most recent economic development, higher inflation rates would not come as a surprise.



ISM = Institute of Supply Management; CPI = Consumer Price Index

Source: Erste AM

Note: Past performance is not indicative of future development.

US central bank could come under interest rate pressure

If this forecast were to be matched or even exceeded, the US central bank would come under pressure to raise interest rates more significantly than currently expected by the market (N.B. December 2018 Fed Fund futures are at 1.795 percent) or communicated by the Fed itself (mean of the Fed Dots for end-2018: 2.125 percent). This would definitely be negative for US Treasury bonds and instruments with a higher beta* relative to them, such as government bonds or corporate bonds with investment grade rating.

*Beta is the ratio that measures the relative bandwidth of fluctuation of a security with respect to the overall market.

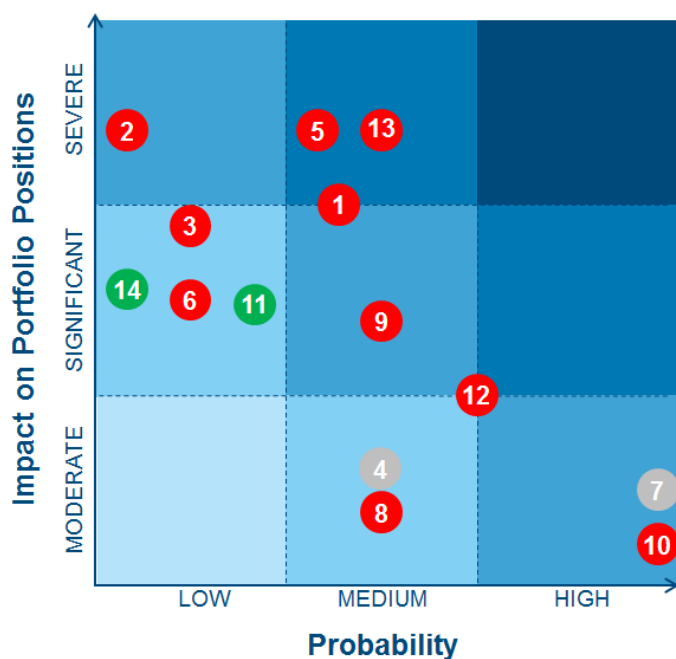
Bitcoin gains not sustainable

The second big discussion was about bitcoin. At our previous Committee, we decided to thoroughly analyse bitcoin as investment class and how one could invest in it. In the meantime, a number of instruments have cropped up that facilitate investments in bitcoin. Some of the members of our Investment Committee have already invested in bitcoin. Those happy few can celebrate a 115 percent gain since the previous Committee. Of course, such numbers make it difficult to scrutinise the issue seriously. To paraphrase Donald Rumsfeld, and with a touch of polemics, I would associate “Shock and Awe” with bitcoin. To word it politely, we do not regard the latest gains of bitcoin as sustainable.

The last item on the agenda was the discussion of our event list. What topics will be driving the markets in the coming 12 to 18 months?

EIC Events & Risks Assessment Matrix

(3 Months+ View)



- (1) Italian Elections, May 2018: European disintegration; banking crisis; sovereign debt crisis
- (2) North Korea: escalation (asymmetric)
- (3) Inflation Jump US, hawkish FED Dec 2018
- (4) German Government: (+/-) European disintegration or solution
- (5) China: growth disappoints; credit bubble bursts; collapse of shadow banking
- (6) High valuations repricing
- (7) Trump: US internal political turbulences
- (8) Catalan elections Dec 21: European disintegration
- (9) US fiscal reform: inflation; sector rotation weighs
- (10) Normalization: rising rates; slower CB liquidity g.
- (11) Brexit: Hard, soft or not?
- (12) US debt ceiling: Government shut down?
- (13) Short gamma investors: triggered downward spiral (knock in structures, risk parity-, target volatility & protection strategies; bail in instruments etc.)
- (14) Goldilocks extended

EIC = Erste AM Investment Committee

Source: Erste AM

Note: Prognoses are no reliable indicator for future performance.

Prior to discussing the contents, I would like to explain the modus operandi of the matrix. The topics are in order of frequency of being named by the individual team members. This is what the numbers in the circles refer to. The colour of the circle indicates whether we regard the event as clearly positive (green) or negative (red) for the financial markets, or in between (grey). The Probability axis indicates how likely such a result of the event is. The axis Impact on Portfolio Positions shows how strongly the respective event could potentially affect our portfolio.

Elections in Italy as biggest market risk

The most commonly cited event risk were the elections in Italy, which according to the constitution have to be held by 20 May. A medium probability and a high impact of a result that is negative for the financial markets make the elections one of the big issues for the first months of 2018. After the elections in France, the Netherlands, and Germany and the end of the turbulences caused by the struggle for independence in Catalonia, the market has come to largely ignore the political risks in the Eurozone again. This results in the risk of getting caught on the wrong foot.

P.S. In the 24 hours prior to me writing this article (7 December 2017, 19.30), bitcoin has increased almost continuously for 23 hours by a total of 31 percent and has then dropped by 10 percent in the last 60 minutes.

Legal note:

Prognoses are no reliable indicator for future performance.

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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).