January 2015

Weak finish to 2014 – a bad omen for stock markets?

- Unexpected market volatility in December 2014
- Attractiveness of global equity markets reaches a four-year peak
- More benign environment, despite a sense of uncertainty

Financial markets had a rollercoaster ride in 2014. While equity markets in Switzerland and the USA recovered relatively quickly from temporary setbacks, price corrections were rather more severe in the euro zone, the UK and the emerging markets, as well as in a number of other asset classes. For example, the price of crude oil tumbled without warning, while gold had another disappointing year. In the fixed-income segment, interest rates continued to fall unexpectedly, resulting in significant price gains for bonds with good credit ratings and longer maturities. By contrast, high-yield bonds hit some heavy turbulence in the second half of the year, with the prices of most securities only managing a partial recovery by the end of the year.

Even though 2014 was a turbulent year overall, the volatility that gripped markets in December was surprisingly severe, especially since our systematic analysis had led us to expect a calm finish to the year. The sudden collapse of the oil price, however, seemed to unsettle investors far more than generally expected. It also fuelled concerns that the sharp drop in the price of black gold could be attributable to slower economic growth – with inevitable consequences for corporate earnings. As a result, most of the major stock market indices finished December in negative territory. The worst-hit category was emerging markets, with a decline of almost 5%. Equity markets fared slightly better in the euro zone (EuroStoxx 50: -3.21%) and Switzerland (SMI: -1.83%). Only America's S&P 500 Index finished the month virtually unchanged.

Attractiveness of global equity markets reaches a four-year peak

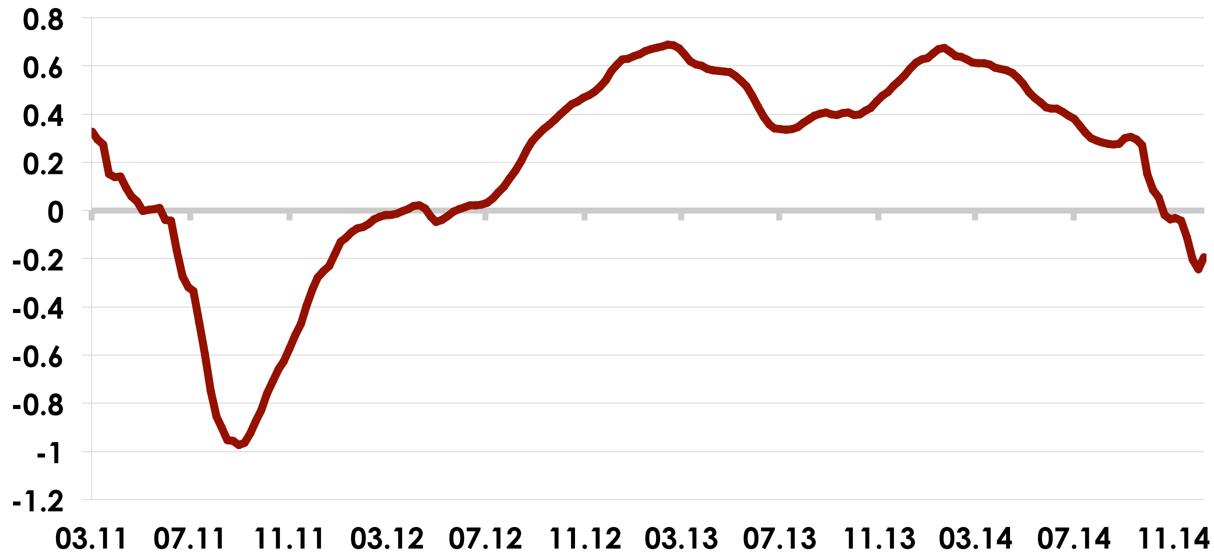
Stock markets started and finished the year in negative territory for the first time since 2008. Who can fail to remember the devastating performance of share prices that followed this phenomenon? So is this a bad omen? A cool-headed comparison of the current fundamentals with 2008 reveals that the basic circumstances are significantly different. Back then, our fundamental indicator measuring the attractiveness of equity markets stood in negative territory, sending a warning to steer clear of equities! However, our current research shows that the global equity markets are currently the most attractive they have been for the past four years. With the exception of "valuations", the other three components in our model point to further upside potential for the major stock market indices. While the "consumption" component has eased off a little from a level that was verging on overheating, the "industry sentiment" component improved further - in particular, the capacity utilisation of the US economy has significantly revived in the last month. On top of that, the "monetary environment" component is still the driving force, thereby continuing to underpin the strong appeal of equity investments. In conclusion, this is the best time for equity investments since April 2009 as far as fundamentals go. For a long while the monetary indicator was supported mainly by low inflation rates in Europe, but is now also being supported by a sharp drop in inflationary pressure in the USA. The main trigger for lower inflation expectations is likely to have been the drop in the oil price, which has two knock-on effects: Firstly, lower fuel prices lead to a direct reduction in measured inflation. And secondly, the weaker demand for manpower and the reduced investment requirement in the US shale oil industry help to ease the general pressure on prices. Presumably the US Federal Reserve will therefore hold off even longer with its widely anticipated interest-rate hike.

More benign environment, despite a sense of uncertainty

As far as fundamentals are concerned, there are no obvious threats looming for stock markets. The trend that affected most of 2014 is therefore likely to continue: volatility on global equity markets will mainly be triggered by market psychology factors. Once again in 2015, such triggers could be relatively insignificant events which, amplified by computerised or high-frequency trading, result in "flash crashes" and could potentially have a lasting effect on investors' risk appetite.

At the moment, however, their appetite for risk is fairly stable. Four out of five components in the risk-

Risk appetite indicator (market risk): Investors demand significantly higher yield premiums



*** From a market psychology perspective, indicator readings above zero signal a positive climate for equities**

appetite indicator compiled by ENISO Partners have improved slightly within the space of a month. In particular, there has been a strong recovery in the "market breadth" component, which had been a cause for concern for some time. Furthermore, more money is flowing into riskier investments such as small caps and high-yield bonds. Only the "market risk" component shows that investors increasingly expect higher yield premiums for assuming risks. Despite a general sense of uncertainty, investors seem to be showing a steadier nerve than expected. It remains to be seen how the threat of a "Grexit" from the euro zone, the oil price trend and forthcoming announcements by the European Central Bank will affect investors' risk appetite, or whether one of these events could accelerate the positive trend or conversely trigger a correction.

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