June 2015

The old problems won’t go away

- Bonds underperform equities for once
- US consumers reluctant to spend
- “Greek tragedy” leaves investors increasingly cold

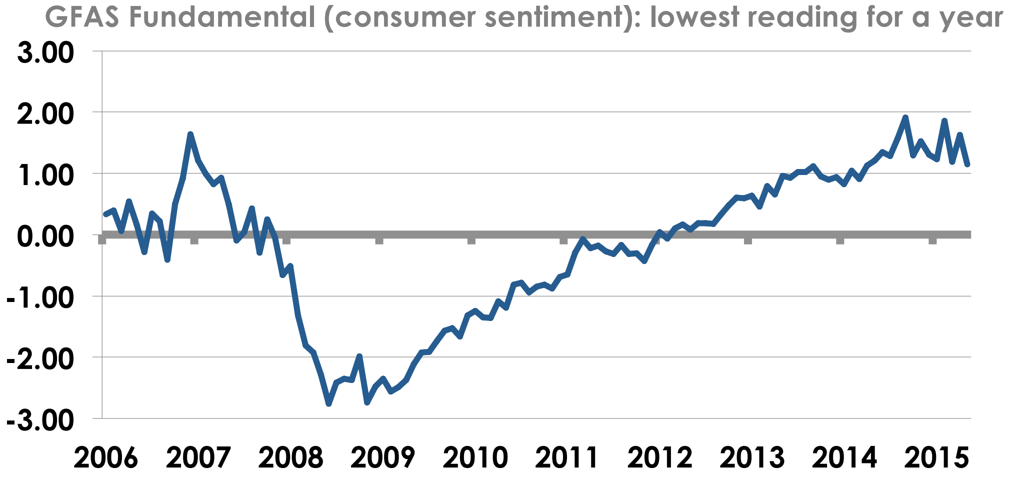
Both equity and forex markets suffered a heavy bout of volatility during the last trading days of April, while bond markets scarcely moved. A few days later, at the start of May, demand for fixed-income securities literally collapsed, triggering the steepest rise in yields for the last 15 years. One explanation cited for this fire-sale was the modest rise in inflation expectations for the Eurozone from -0.1% to 0.1%. In fact, the main problem facing financial markets right now is not the substantial change in fundamental market sizes, but simply the lack of market depth. One of the main reasons for this is that many big investors decided to pull out from certain markets some time ago – mainly due to regulatory reasons – or have had to scale back their respective allocations. As a result, even inconsequential events or selling orders can trigger major (and generally exaggerated) distortions, which mostly settle down again quite quickly. This time, for example, bond yields once again normalised swiftly after a brief digression, which in turn helped to restore calm on equity markets and allowed prices to stabilise a little higher just before the end of the month. It wasn’t until the very last trading week that prices came under fresh pressure due to renewed concerns about a Greek sovereign default. The Dow Jones EuroStoxx finished the month 0.43% lower, while the S&P 500 managed to hang on to its gains and advance by 1.05%. The picture was mixed in Switzerland. While the SMI large caps index bucked the European trend with a rise of 1.77%, the SMIM mid caps index retreated 0.88%. Despite the sharp dip in equity markets towards the end of May, the performance of long-dated bonds from issuers with good credit ratings lagged behind equities, for once.

US consumers reluctant to spend

Concerns about Greece continue to overshadow the stock market, even though there have been no new developments in reality. Market participants generally agree that the Greek government will not stump up the EUR 1.6 billion in payments due to the IMF at the start of June. Since the rest of the fundamental environment in Europe has changed very little, the “Greek tragedy” continues to have a disproportionate effect on short-term stock market trends.

On the other hand, the slower pace of economic growth in the USA is becoming increasingly apparent. This weakness has recently put hefty downward pressure on the “Consumption” sub-indicators of our model, while in previous months it was mainly the “Industry Sentiment” component that was the weakest element. In addition, the decline in consumer spending by private households – the main driver of the US economy up to now – can already be measured on several fronts. Both the current rate of consumption and the leading indicators for consumer sentiment are signalling the likelihood in the months ahead of slower growth than both analysts and the US Fed had hoped for. It seems that private households are not willing to spend more of their more generous disposable income, but prefer to put it into savings, despite low interest rates. One exception here is the housing market, which has recently started to pick up momentum again.
Although private consumption is tailing off a little, it continues to provide important support for equity markets. However, the main driver of the current rally continues to be the “monetary environment”. In May, for example, the value calculated for this component by our model rose once again and now stands at its highest level for the past 16 years. Above all, the monetary situation has further improved in the Eurozone.

This time, however, the main stimulus came not from inflation, which was once again slightly positive, but from the monetary policy of the European Central Bank. The biggest impact here comes from the ECB's large-scale bond-purchasing programme, which is literally flooding markets with liquidity. This is providing enough fuel to propel financial markets even higher.



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

According to our model, the only negative factor affecting the appeal of equities is their valuations. This group of indicators is signalling that equity valuations will continue to rise, in other words investors are prepared to pay increasingly higher prices for the prospect of future corporate earnings growth. This is occurring despite the fact that the lack of earnings growth is being concealed by share buyback programmes. Given the slower pace of consumer spending and the lack of upward momentum in the indicator group "Industry", the excessive valuations are likely to continue for the time being. As in recent months, from a fundamental perspective monetary policy will therefore continue to be the main driver of the current bull run.

"Greek tragedy" leaves investors increasingly cold

As already mentioned, news from and about Greece is often cited as the main explanation for sudden price swings. However, the Greek crisis seems to be making less and less of an impression on investors. On the contrary, according to our risk appetite indicator, investor sentiment has consolidated further within the space of a month. All the relevant values in the five indicator groups have improved and once again finished the month of May at a level that is positive for equities. One surprising trend here is that cyclical stocks managed to keep pace with more defensive stocks, despite the gloomier prospects for global economic growth. Another positive sign is that institutional investors are essentially holding on to their equity investments, even though equity funds have recently recorded the highest redemption rate by private investors since 2009.

From a psychological perspective, the only thing that could have a slightly negative impact on European investors is the fact that the number of companies whose share prices are contributing to the market rally is much smaller in Europe than in the USA.

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