October 2015

Systematic approach: the best solution for chaotic stock markets

- Uncertainty is toxic for financial markets
- Despite growth dip: equities still attractive
- Historical comparisons support a countermovement

A month ago it was concerns about China's growth that dominated stock market events. In the first week of September, however, attention switched to the much-anticipated interest-rate decision by the US Federal Reserve (Fed). The scenario already sketched out by our fundamental indicators was ultimately confirmed: interest rates were not raised – yet again. In theory, this should have immediately eliminated one of the key factors making investors so nervous. In practice, things turned out differently. Investors interpreted the statements made by the Chair of the US Fed Janet Yellen to mean that US economic growth could well be affected by the sluggish pace of the global economy, persuading the Fed to delay even further the first and long-awaited hike in interest rates. However, the Fed's decision did little to calm investors' nerves, but actually fuelled the overriding atmosphere of confusion. The situation was made worse by the Volkswagen scandal, the collapse of commodity stocks and the US election rhetoric regarding the imposition of price ceilings on pharmaceutical products. With the risk aversion of investors already quite high, the selling pressure on equities continued to build. On top of that, the rebound that usually follows such a price correction failed to materialise. Eurozone equity markets retreated 3.93% in September, and Switzerland's SMI lost 3.53%. The US stock market came off more lightly, with a decline of just 2.64%. The prevailing uncertainty also undermined bond markets: the yield spreads between investment-grade corporate bonds and sovereign bonds widened again significantly. By contrast, everything was relatively quiet on the currency front for a change.

Despite growth dip: equities still attractive

Apparently the Fed also seems to be rather worried about the outlook for global economic growth – perhaps even more concerned than it actually needs to be, based on our fundamental subindicators. The readings for the "consumer sentiment" indicator, for example – which is important for the US economy – are still very encouraging. Both consumer spending and current surveys on US consumer sentiment point to robust growth during the third quarter. Even in Europe, the confidence of end consumers improved, even though it is still below pre-crisis levels. Solid sentiment should provide a further boost to corporate earnings growth and thus provide some support for equity markets. On the other hand "industry", the second key component for the real economy, once again shows a relatively low propensity to invest. Inventories are too high in the USA especially, and this is likely to continue to hold back growth over the coming months. The first signs of this are already coming from the regional purchasing managers indices for US manufacturing. In Europe, however, the manufacturing industry continues to recover from the crisis. Overall, an analysis of the "industry" component provides neither a positive nor negative signal for equities.

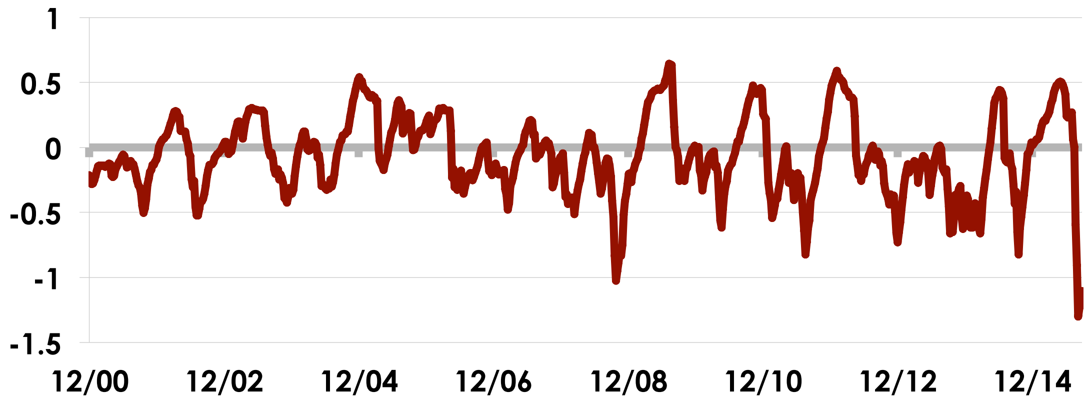
Not only the "industry" but also the "valuation" subindicator shows that markets are fairly valued at present. Just a month ago, the data we collected made the markets look too expensive in our eyes. Given the persistently low interest rates, the sharp drop in share prices and virtually unchanged earnings prospects, the subindicator "valuation" has significantly improved. It should be noted here that the values in recent months were not particularly high by historical standards. We therefore believe it's misleading to attribute the current global stock market correction to excessive valuations. The investment case for equities is also still being well supported by our subindicator “monetary environment”. Inflation rates are still at rock bottom, both in Europe, Japan and overseas. The slight upward pressure on wages evident in many countries has therefore yet to filter through into inflation rates.

Whereas we were concerned back in August that the fundamentals might be providing a selling signal for equities, this area of our Global Factor Asset Selector is already sounding the all-clear again for the month of September.

Historical comparisons support a countermovement

The bull market that has now held sway for more than six years is definitely not only the one that is most reviled, but for the past few weeks also the one that investors most distrust. For example, the market psychology subindicators that are recorded as part of our risk appetite indicator are currently caught in a downward spiral whose velocity we have never – or only very rarely – seen before. Investors have been gripped by extreme risk aversion virtually overnight – or so it seems. All five indicator groups that contribute towards the risk appetite indicator have deteriorated over the past four weeks. Investor sentiment seems to have almost hit rock bottom, which always tends to produce chaotic conditions on stock markets. In such an environment, the important thing is therefore to keep a cool head. In this context it’s good to know that we

Risk appetite indicator (hedging demand): Panic provides hope for a stock market recovery



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

employ systematic, quantitative processes designed to protect even experienced investors from behaving too emotionally. Admittedly we also feel tempted occasionally to bail out and escape the turbulence on financial markets: However, our own research has provided us with more than enough convincing evidence that such procyclical conduct seldom produces good results. Even so, our subindicator “hedging demand” currently highlights just how worried investors are at present about a possible stock market crash. Such a strong overshoot of this indicator is unprecedented historically speaking. Two other subcomponents, “market breadth” and “market risk”, underscore investors’ strong risk aversion. In fact, the dip in investor sentiment would have triggered a sell signal for equities back on 28th August were it not for the extreme scale and speed of the price collapse. This “oversold” constellation meant that the market psychology sell signal was overridden, and we are therefore hanging on to our equity positions for the time being. In the past, this fine-tuning of the sentiment indicator has in many cases accurately signalled a countermovement on equity markets and resulted in an average return of more than 7% when markets were “oversold”. Assuming that the countermovement kicks in, our future positioning will depend on the extent to which sentiment can (or cannot) be restored.

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