September 2015

Equity markets: First signs of a trend reversal?

- China sends shockwaves through the market
- US interest-rate hike: Is it going to happen? Will it be delayed?
- Markets oversold as sentiment collapses

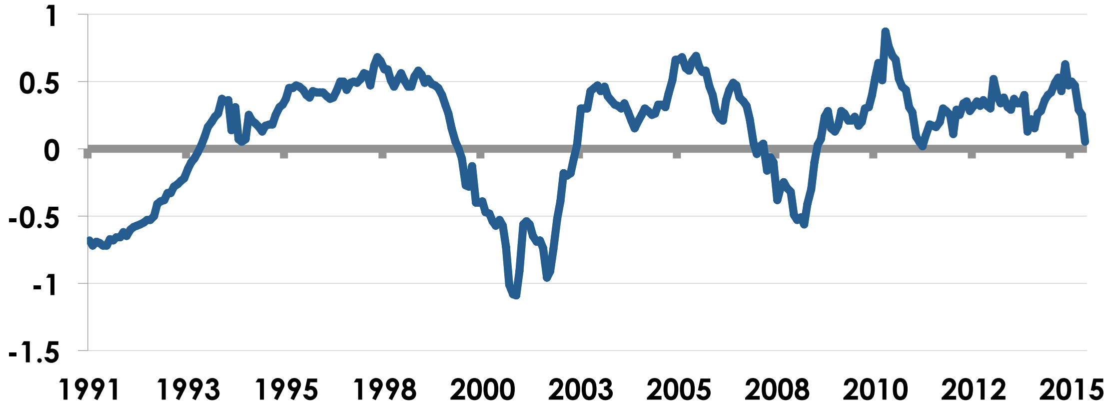
In the August edition of our “Monthly Analytics" we made the following comment on our assessment of the situation in terms of market psychology – one that now looks almost prophetic: “The situation in China will presumably only have a negative impact on the sentiment measured by our model (risk appetite indicator) if the Chinese government is obliged to sell large quantities of US Treasuries in order to shore up its own equity market”. As we now know, events in China have moved far more quickly and resulted in a sudden change of mood, triggering the steepest decline in global equity markets seen in the past three years. The warnings about the negative consequences of weaker Chinese growth for the global economy rose to a clamour. In no time at all, the turmoil that initially only gripped Chinese stock markets spilled over onto other international bourses. The People’s Bank of China (PBoC) decided not to support the domestic equity market, but to primarily protect China’s currency, the renminbi, but only after marginally devaluing the currency beforehand. Without the intervention of the PBoC, the massive capital outflows would have made a further, and probably uncontrolled, depreciation inevitable. In order to be able to protect its own currency, the Chinese central bank had to sell US Treasuries worth as much as USD 100 billion. The distortions in financial markets created by these interventions have taken on almost historical proportions. For example, the VIX volatility index, often called the “fear index” of stock markets, recorded its highest percentage increase within the space of just two days. In a monthly comparison, the index posted its highest rise since 1990. This development also created havoc for commodity prices, which experienced a real fire sale. In August the oil price fell another 20%, although it did then rebound by 17% towards the end of the reporting month. On balance, August 2015 will go down in stock market history as the worst month for the past three years. So is it actually possible to identify the exact reasons for such a sharp price correction? In any case, the scale of the collapse cannot be explained either by the fundamentals or by behavioural economics.

US interest-rate hike: Is it going to happen? Will it be delayed?

It is not only China’s economy that is worrying investors. There is another factor keeping them on tenterhooks: for some time now they have been preoccupied about whether – and exactly when – the US Federal Reserve will raise interest rates in the USA. Based on systematic processes that analyse the fundamental stock market environment, we expect the US Fed to raise reference rates in December 2015 at the earliest, and probably by 0.25%. Our analysis leads us to believe that an interest-rate hike as early as September is unlikely.

Another argument for the Fed deferring interest rate increases is also the persistently low inflation rates in the USA and Europe – even if the slight uptick in Europe’s inflation has caused a slightly stronger fall in the indicator “Monetary environment” (baseline effect). The development of wage costs in the USA and in Germany is far more important for the interest-rate decision in our view. Although these are showing a noticeable increase, this rise has not yet trickled through into core inflation. The situation is unlikely to be affected much by the next US job market report, due to be published before the Fed makes its next decision on interest rates. The fact that inflation is still below average is one of the main reasons why the component “Monetary environment” continues to generate a positive signal for equities. The subindicators “Consumption” and “Industrial sentiment” also signal a positive climate for equities. The recently rather weak figures for private consumption – primarily in the USA – could be offset to some extent by the recovery in the “Industry” component. After a dip in growth during the second quarter, the indicator for the manufacturing industry has now moved back into the green zone as well. Since private consumption accounts for almost two thirds of US GDP, however, the slight deterioration in consumer confidence means

GFAS fundamental: Is there a sell signal developing?



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

that no immediate acceleration is expected in the pace of America's GDP growth. This eases the pressure on the Fed to raise interest rates.

In the cold light of day, the only component still arguing in favour of equities is their valuation. Even taking into consideration the recent sharp corrections on stock markets, equities are still expensive by historical standards. Despite the occasional signs of a slowdown, the fundamental environment is for the moment favourable for equity investments, even if our indicator points to a falling trend. If things don't change, before the end of the year we could see the first sell signal for equities since the end of 2008.

Markets oversold as sentiment collapses

Even though the market psychology has softened a little in recent months, it was impossible to predict such a massive "earthquake" on stock markets. The fall in investor sentiment during August was therefore extremely rapid. Within the space of a month, the five indicator groups that make up the risk appetite indicator we use all declined. The groups "Market breadth" and "Hedging demand" suffered a real collapse. Both are responsible for investors' risk appetite falling into negative territory for the first time since the end of January. However, since the collapse in share prices has been so pronounced and so rapid, the sell signal produced by the risk appetite indicator is currently being neutralised by a so-called "oversold signal". This stops us from acting in a procyclical fashion and blindly following the panicking masses. We retain our exposure to equities until the "overbought situation" has rectified itself. A decision on whether to reduce our equities exposure depends in particular on the development of our indicator readings and investors' risk appetite. However, concrete signals will be only be available in two weeks' time.

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