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Investment Insight

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2018 starts on a positive note

Indicators in the USA, China and Europe still point to growth as we enter the new year. However, higher interest rates and waning optimism could slow the economy – the financial markets above all – as the year progresses.

Same procedure as last month: as has frequently been the case of late, the US labour market report for December contained few surprises. With 148,000 new jobs, employment growth in the final month of 2017 was significantly below the consensus estimate of 190,000. But this cooling was likely part of the unavoidable volatility triggered by hurricanes Harvey and Irma in September. New jobs in that month plummeted to 38,000, but shot back up to 211,000 and 252,000 in October and November respectively. The average of 162,000 for the last four months of the year fell just shy of the 2017 monthly average of 171,000.

These figures stabilised the unemployment rate for the 4th quarter as a whole at 4.1%, the lowest rate for 17 years and just three tenths away from the all-time low of the past 50 years of 3.8% in April 2000. The wage increase in December of 0.3% over November was also within the expected range. The persistent low annual rate of 2.5%, however, is likely to rise over the course of 2018 as indicted by record low unemployment and business surveys. In the most recent survey conducted by the National Federation of Independent Business (NFIB), the sub-index on plans to increase wages rose from 17 to 23 points, a 28-year high.

The ISM Purchasing Managers Index recorded positive but unspectacular readings for the first week of 2018. Although the service-sector sentiment barometer unexpectedly fell from 57.4 to 55.9 points, the industry counterpart surprised observers with a rise from 58.2 to 59.7. Both indicators continued their overall upward movement – which we see as a sign that the US economy is off to a brisk start in the new year. We can therefore expect to see GDP growth of around 2.5%, the 2017 annual average, for the coming quarters (annualised quarter-on-quarter). There is no end in sight to the expansionary phase that started in 2009.

Service providers in China are a tangible counterbalance to industry's flagging momentum.

As in the USA, the economy in China also appeared robust at the start of the new year. The Chinese purchasing managers' indices released by the National Bureau of Statistics (NBS) and the Caixin news agency registered high levels. The Caixin service sector barometer recorded its highest level in over three years of 53.9 points (following 51.9 points). We see this as a clear signal that China's service providers are a tangible counterbalance to industry's flagging momentum. In our opinion, this consequently means it is ever more likely that final quarter GDP growth only fell by one tenth of a percentage point, from 6.8% to 6.7%.

Government headwind on the Chinese real estate market will likely decrease in 2018. Efforts over the last two years significantly reduced vacancies and reined in soaring prices. Average real estate prices in the four largest cities rose by just under 30% year-on-year in 2016, and remained close to that level in 2017 (+0.8%). This reduced the risk of further restrictive intervention in the housing market accompanied and brightened real estate market prospects. Overall, there is a good chance that the government can achieve or slightly surpass its predicted growth target of 6.5% again in 2018.

Eurozone GDP growth for 2017 was certainly over 2.0%, with expectations ranging from 2.3% to 2.5%, due not only to the economic upswing but also to a special development in Ireland. That country's GDP is a cue ball in transactions of major international corporate groups; in the 3rd quarter, it shot up by 4.4% over the previous quarter. Eurozone GDP growth in all four quarters of last year is expected to have been in the 0.6%-0.7% range. The composite purchasing managers' index (EMI) which closely correlates with GDP also finished 2017 at a six-year high of 58.1 points. The economic environment remained positive at the beginning of 2018, financing terms are favourable, fiscal policy is moderately expansionary and political risks appear manageable.

The French upswing continues to hold potential.

However, there is a catch. Early indicators have meanwhile reached such highs that the chance of any more positive surprises has dwindled; instead any minor uncertainties are now enough for a setback. This was already evident in national business sentiment indicators in December. The IFO index, for instance, ended its uptrend, consolidating at 117.2 points (following 117.6). Industry confidence also declined slightly in France, Italy, the Netherlands and Belgium in December. In France, the Eurozone's second largest economy, however, this was more than offset by the other sectors. Overall business sentiment in France climbed to a new ten-year high of 112, following 111 points. France provided the best surprise in 2017, considerably boosting the Eurozone's favourable economic performance in the second half of the year. Its upswing remains strong. There is still room for improvement particularly in the labour market, with a jobless rate above 9.0%.

The European markets broke away from the positive global trend in December due to the strong euro, flagging considerably. This was offset, however, by the DAX and Eurostoxx50 kicking off the year on a high note, recouping all losses of the previous two weeks within three days. At the same time, the Japanese benchmark index registered 23,714 points – its highest level since the beginning of 1992. The Dow Jones, S&P500 and NASDAQ also passed important marks in the USA (25,000, 2,700 and 6,600, respectively). But the party spirit is not likely to continue much longer. Market data shows that all stock markets are overbought and sentiment among US investors has not been this euphoric for seven years. So many expectations and hopes have been priced into current stock market valuations and risk premiums on corporate bonds that positive surprises are increasingly unlikely.

US government bonds in particular have become more attractive.

In contrast to the majority of market observers, we therefore assume that 2018 will run a different course than 2017. We expect stock markets to suffer major blows and interim price declines of 15%. The investment environment has also experienced changes recently. Safe government bonds can be expected to move back into investors' focus; US government bonds in particular have become more attractive. Two-year US treasury notes are meanwhile yielding almost 2% compared to 1.20% a year ago, and five-year treasuries 2.30%. This is still not a lot, of course, but it entices investors into profit-taking on the equity market and shifting to safe government bonds. The bond markets in both the USA and Germany are likely to benefit – we do not agree that it's time to bid farewell to safe havens.

BANTLEON BANK AG
Bahnhofstrasse 2 | CH-6300 Zug
Telephone +41.41.728 77-58 | bantleon@bantleon.com