BANTLEON
Institutional Investing

Investment Insight

January 2018

Turbulent times

The »too good« US labour market report fuelled fears surrounding interest rates, and bond yields increased significantly in the USA and Europe. This also meant a return to volatility on the equity markets. Investors should pay particular attention to signs of an economic slowdown in the medium term.

The US labour market report for January had several surprises in store. For instance, at 200,000, the number of new jobs greatly exceeded both the forecasts (180,000) and the prior-month figure (160,000). The increased momentum in wage growth was even more pronounced, with the annual rate rising to 2.9% in January (after 2.7%) – the highest growth rate since the recession in 2009. A clear upward trend can suddenly be made out in wage growth, which is causing increasing inflationary pressure as well as pushing private consumption – and thus also GDP growth – through rising household incomes.

The US economy is also currently being driven by the recovery in investment activity, which started last year, following the weak investment of 2015 and 2016. However, it could now be greater than previously assumed, driven by the tax reform. With publicity in mind, a rising number of businesses are announcing their intention to increase capital expenditure in reaction to the tax incentives. If this actually means real additional projects, and not just spending that was planned anyway, this boost could push GDP growth beyond our previous projection of 2.8%, to the 3.0% mark. This is also supported by the ISM Purchasing Managers' Index for manufacturing, which remains close to its long-term high at 59.1 points.

Growth also remains strong in the Eurozone. GDP grew by 0.6% q-o-q in the final quarter of 2017, only slightly down on the previous two quarters (each 0.7%). This Q4 figure may possibly be corrected upwards by a tenth, as the previous quarters' figures were. In any case – 2017 was the most successful year the Eurozone has experienced since the financial crisis of 2008/2009, with a year-on-year increase in GDP of 2.5%. Consumption, investment and export demand are all currently on the rise.

All major countries are making their contribution. Although Spain's economy has lost somewhat in outperformance terms, France proved itself once again with GDP growth of 0.6% in Q4, thereby establishing its middle ranking in the Eurozone ever more firmly. In particular, investment demand among French companies rose by more than 4.0% over 2017 as a whole. However, this success is unlikely to have much to do with the new President's reform zeal. Instead, the second-largest economy of the currency union is profiting from the global economic revival and reaping the fruits of the previous government's labour (ending the uptrend of non-wage labour costs). Non-wage labour costs in France are now 2% lower than in 2012. In Germany, by contrast, they have risen by 14% in the same period. This meant a recovery for French companies' profit margins – which have been under immense pressure since 2009. France is also among the countries that have gained the most from the ECB's expansionary monetary policy. Nowhere else in Europe are banks so willing to grant loans at attractive terms. The volume of loans granted to companies has increased by 16% since the end of 2013, while it has stagnated in the Eurozone.

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Growth in the currency union is likely to accelerate overall in the first quarter of 2018. This is indicated, among other factors by the cyclical high for the composite Purchasing Managers' Index, the all-time high for the IFO assessment of the current situation and the strong uptrend in new orders in Germany. However, there have also been a few disappointments recently among the pleasing economic data. For example, the latest European Commission survey of 70,000 businesses and consumers on »economic confidence« in the Eurozone declined to 114.7 (from 115.3). Although this is not dramatic, it fits in with our prediction that the sentiment indicators will reach their peaks this quarter. Accordingly, we assume that the Eurozone's rate of expansion will slow down from the second quarter.

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The good US labour market report sparked a sell-off on stock exchanges worldwide. The equity indices lost up to 13% of their value within a very short time, while the bond markets saw an increase in risk premiums on corporates. Stock market traders feared the end of an era. They had been spoiled for years by the ideal scenario of solid economic development without any inflationary pressure, and a loose central bank policy. This period does indeed seem to be nearing its end, with increasing yields on the US and European interest rate markets.

Rises in interest rates are not generally a problem for the equity markets, but drastic rises are a different story. They mean abrupt changes in valuation ratios, more expensive share buybacks and a shorter supply of liquidity as a fundamental resource. This leads to nervous markets, which in turn increases volatility tremendously – as we have seen in the past few days. Was this panic attack a one-off or the beginning of a new era of rising interest rates and falling equities? None of the above! We see no reason for a key rate hike, because the economic impetus will soon die down. Fears surrounding interest rates will subside and government bond yields may decline. However, this does not mean a permanent »all-clear« for the stock markets; they will still be vulnerable in periods of weaker growth.

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