Investment Insight

March 2018

Prospects deteriorating

Despite the buoyant mood, the economy in both the US and the Eurozone is now starting to show signs of weakness. As a consequence of the rising interest rates and the abating tail winds from China, this weakness might intensify over the course of the year. This is not exactly good news for the equity markets, which have taken quite a battering of late.

According to the latest sentiment indicators, the US economy is experiencing a really upbeat mood. Contrary to expectations, the closely followed ISM Manufacturing Index rose further in February, to 60.8 points – after previously 59.1 – achieving the best result in over 13 years. What's more, the consumer sentiment indicator of the business research association Conference Board climbed to 130.8 points, a 17-year record. The booming labour market is the main source of the optimism, with the respective sub-indices unwaveringly continuing their upward trend and reaching the highest number of job vacancies since 2001.

However, the mood is better than the actual situation: in fact, from a short-term perspective, real figures have largely been characterised by disappointments of late. For instance, consumer spending declined by 0.1% in January. Accordingly, private consumption started the current quarter rather sluggishly. Investment also lost some momentum, as indicated by the latest monthly figures regarding deliveries of civil capital goods. The fact that new orders are also declining reinforces this impression.

Last but not least, the latest foreign trade data also suggests that caution is warranted. The preliminary assessment by the Commerce Department shows a marked decline in exports for January (-2.2% after +2.5%), indicating negative net exports for the current quarter. All in all, the US economy is therefore likely to grow by just under 2.5% in Q1 2018 (after +2.5% in Q4 2017). While this is solid growth, it will not be enough to meet the high expectations triggered by the latest sentiment indicators.

Like the economic upswing in the US, the European recovery is no longer at an early stage, as the latest data on employment and lending bears out. After all, between 2011 and 2015, it was the initially declining and later stagnating volume of bank loans that was seen as a reflection of the euro crisis. Since then, the tide has clearly turned. In January 2018 alone, the ECB reported lending to the private sector in the amount of EUR 65 billion, i.e. an increase of 0.6% from December 2017. Compared to the previous year as a whole, the increase amounts to as much as 3.3%. The credit cycle has advanced the furthest in the consumer credit segment (+7.3% year on year). This increase is an indication of the current robust consumer demand, but no more. After all, lending data is a lagging indicator, meaning that banks are in general only happy to grant loans once the economic environment has noticeably improved. Likewise, consumers also tend to be cautious in the direct aftermath of a crisis.

Considerable improvement in Eurozone labour market

Consumers' willingness to incur debt in order to purchase goods is largely dependent on their job security. In this regard, the Eurozone has improved considerably. In fact, unemployment is dropping to a »normal level« in an increasing number of countries. In January, the rate fell to 8.6% and has therefore almost reached its historic average (8.5%). Of course, some countries are still battling excessively high unemployment rates, primarily Greece with 20.9%, followed by Spain with 16.3% (although this is down from 26.3%) and finally Italy with 11.1%. Overall, the number of problematic countries is decreasing. Germany has not been a part of this group for quite some time now, with the harmonised ILO statistics showing an unemployment rate of only 3.6%. The German Federal Employment Agency reported a further drop in seasonally adjusted unemployment by 22,000 in February, compared to January. Companies are increasingly employing homemakers, pensioners and students (the »hidden reserve«), in addition to unemployed people. As a result, employment has been rising much more rapidly (January: +60,000, December: +69,000) than the unemployment rate has been dropping for quite some time now.

However, there are increasing indications that the labour market boom is coming to an end. For example, the number of job openings has not been rising as dynamically recently as during the second half of 2017. According to official data released by the Federal Employment Agency and the job index BA-X (including online job offers and offers by private employment agencies), the number of job openings has remained at a high level for the past three months. This is usually a harbinger of declining employment growth. We therefore expect the employment growth rate to decline year-on-year, from 1.5% to 1.0% in the next few months.

On the other hand, signs of slightly accelerating wage growth are emerging. German consumer demand is set to continue its robust expansion, with private consumption likely to be the stabilising force for economic development. We are, however, not quite as optimistic when it comes to export and investment demand, where we anticipate a slowdown in growth as the year continues. In fact, growth figures from the UK and China are already declining. Also, the looming trade conflict with the US could be an additional damper, as is borne out by the latest sentiment indicators. The EUR Economic Confidence Index of the European Commission, which bundles all indicators, fell to 114.1 points in February, for the second consecutive month. This index is therefore following the weakening Purchasing Managers' Indices (PMI) and national business climate indicators.

Supremely relaxed times in financial markets are over

Supremely relaxed times in financial markets are over. This became obvious at the end of February. First of all, Russian President Putin warned »enemies of Russia« that new weapon systems would be installed along Russia's borders. Then US President Trump announced that he would, as part of his »America First« doctrine, impose punitive tariff duties on imports of steel (25%) and aluminium (10%) for an indefinite period. As a countermeasure, the EU is contemplating the introduction of punitive tariffs on the import of US motorcycles and agricultural products. However, this has not deterred Trump. In response, the President tweeted: »Trade wars are good, and easy to win«.

The equity markets were not only impacted but have become exceedingly nervous. This primarily affected export-oriented stock exchanges in Europe; the DAX temporarily fell by more than 5% to below 12,000 points, the Eurostoxx50 and the big US indices lost around 3.5%. Conversely, volatility rose, with the VIX and VDAX returning to levels above 20. Compared to their cyclical peaks, the European markets have already lost 10% to 12% and are now trading below the 200-day lines, which are crucial in terms of chart analysis. The losses of US indices are comparatively moderate, ranging from 5% to 7%. At the same time, the Dow Jones, S&P500 and NASDAQ are still trading 5% to 8% above the 200-day lines. If and when this gap closes, the losses in Europe would probably rise to a massive 20% (+x%) as a consequence of the higher beta.

»A slight rate hike« is enough to hurt real economy and thus also financial markets

Caution is therefore definitely advised. While we believe that fears of a global trade war are exaggerated, this is not the only problem that the equity markets are facing. In fact, the macro environment will also move into the foreground in the coming months. In Europe, the Economic Surprise Index ended its uptrend and returned to zero, which means that positive and negative surprises are balanced. While this barometer remains in positive territory in the US, it has also lost some ground. According to our forward-looking indicators, this trend is likely to continue. Interest rates are a major stress factor, having been on the rise for a while now, albeit moderately to date. However, in a world characterised by record debt and highly leveraged portfolios, this »slight rate hike« would be enough to hurt the real economy and thus also the financial markets.

Along with equities, this would also have a negative impact on corporate bonds, especially as in most sectors the risk premiums are only just above their historic lows. The market consensus is still expecting robust economic development in both the US and Europe; currently, no one really expects any perceptible slowdown. The resulting distortions could therefore be quite significant if – in addition to technical and political factors – the general macro picture also becomes a burden for riskier investments. The tools of monetary policy are very limited, at least in Europe. There would be nothing left to counter a broad-based deleveraging. Even though the latest price slumps in the equity markets seem excessive: we do not see any buying opportunity.

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