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A controlled defensive approach

The stock markets are currently hardly reacting at all to positive news from the political sphere. There are various reasons for this: The global economy seems to have already peaked. Sentiment indicators are weakening, in Europe in particular. In the USA, interest rates have risen significantly. A defensive approach to asset allocation will allow investors to avoid significant setbacks.

The US economy grew by 2.9% in the final quarter of 2017. Statistics were corrected upward, mainly as a result of a further increase in consumption. The weak retail sales in January and February were an indication, however, that this strong pace would not continue through the start of the new year. The more comprehensive figures that have now been published even show significant slackening. According to these figures, real consumption declined by 0.2% in January and stagnated in February. Even after a recovery in March, quarterly average private consumption cannot be expected to have increased by much more than 1.0%. In light of these trends, little GDP growth can be expected for the quarter just ended. The recent positive trend in corporate investments is hardly sufficient to offset the temporary weakness in consumption. Our forecast of an increase in the range of 1.5% to 2.0% therefore remains unchanged.

No soaring growth in sight for the US economy

The outlook for the second quarter is more positive. Firstly, we expect a noticeable recovery in private consumption. The recent seasonal pattern is one indication of this, while the record figures for consumer sentiment indicate a return to growth rates of 2.0% to 3.0% as well. Secondly, a further increase in corporate investments can be anticipated. Since the headwind from foreign trade will also most likely slacken, GDP of 3.0% to 3.5% is possible for Q2.

However, no soaring growth is in sight for the US economy because in the second half of the year, we expect the pace of recovery to decline. The reason for this is unrelated to the volatility in the consumption and investment data: Financing conditions are increasingly deteriorating and will have a negative impact on economic growth. The same applies to corporate capital goods demand and to housing construction investments. For example, the reference interest rate for 30-year mortgage loans has risen significantly to 4.70% in recent months, thus reaching its highest level in over four years. Even if interest rates do not rise any further, the higher costs of credit are likely to dampen housing demand in the coming quarters and thus to constrain growth.

The survey of the EU Commission – the last in the round of monthly economic indicators for the Eurozone – confirmed the decline in sentiment. Economic confidence in the Eurozone fell from 114.2 to 112.6 points, thus, like the composite purchasing managers' index, posting the third decline in a row. Moreover, the detailed survey left no doubt that the decline in sentiment is largely attributable to the manufacturing sector. Production expectations have fallen in this sector, particularly in regard to the automotive industry. In contrast, the services sector, and above all the construction industry, are still maintaining confidence.

The last thing Italy needs is a political stalemate

A comparison of the Eurozone countries reveals few differences. Apart from the Netherlands as a positive exception, most of the remaining countries, including Italy, are clustered around the Eurozone average. The political disruption left behind by the Italian parliamentary elections on 4 March has not yet had a lasting impact on business sentiment. But the fact that the winning parties (the Five Star Movement and the Northern League), normally considered adversaries, joined forces to elect the presidents of the Senate and the Chamber of Deputies even renders possible the financial markets' worst-case scenario: a government made up of the two protest parties. However, election law reform and new elections at the start of 2019 currently appear more likely.

For now, it appears that there will be a fairly long-lasting stalemate without a solid government. The last thing Italy needs, however, is a political vacuum, given that the country's economic performance was only moderate at the start of the year: Industrial production, new orders, new car registrations, retail sales and employment figures all declined in January. Sentiment indicators are now also heading south. Particularly business expectations softened in March, as in most other Eurozone countries. This was apparently due to the declining demand for the country's exports. A stronger euro has traditionally had particularly negative consequences for Italy.

In Italy, as in the Eurozone as a whole, the pace of growth can thus be expected to slacken over the course of the year. This is particularly problematic for Italy's economy, the Eurozone's third-largest, as it has already been experiencing below-average growth recently. Should growth slow more than expected, Italy could quickly be hit by stagnation – and that would tend to aggravate the political crisis.

A defensive approach to asset allocation is highly recommended for now

The geopolitical tensions on the Korean peninsula have recently eased somewhat. The trade dispute between the USA and China is still ongoing, but both sides continue to leave the option of a negotiated solution open. This should bode well for the stock markets; however, the performance of the equity markets has not been satisfactory to date. This is due partly to negative headlines from the technology sector, with the Facebook scandal, in particular, leading to profit-taking among the technology shares which had been so popular for so long. However, added to this is the unfavourable fundamental outlook. Trends in economic data and surveys in Europe have taken a downward turn.

In the USA, the tax reform is still providing support, but financing conditions will increasingly strain the economy. US interest rates have risen significantly across the entire range of maturities. At the same time, the yield curve is at its flattest since fall 2007. In our view, the knockout argument that there is »no alternative to equities« no longer applies in an environment of this kind. On the contrary: The risk-reward ratio has clearly shifted toward safe harbours. With bond yields above 2.30%, US investors could increasingly turn from equities to US bonds.

Other safe harbours such as German bunds, with yields around 0.50%, are less attractive at present, but can also be expected to benefit. On the one hand, if the economic trends prove more favourable than expected, yields could rise. On the other, such an interest-rate shock would have a greater negative impact on the equity markets than on the bond segment. Therefore, a defensive approach to asset allocation is still highly recommended for the time being.

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