March 2018

A short storm or a new weather front?

- No fundamental reason for mechanical sell-off
- Growth momentum justifies a tighter rein
- Investor sentiment: bruised but not broken

When the US stock market sky-rocketed at the beginning of the year, we merely shook our heads. We were no less sceptical at the start of February when equities temporarily lost up to 10% of their value. Equity prices were the cause of the correction and not the other way round. The spectre of inflation – and hence the prospect of higher interest rates – immediately reared its head. Ten-year US Treasury yields climbed to nearly 3% – certainly not an insignificant rise, but far from justifying such a powerful correction. Only on closer inspection was it apparent that purely mechanical triggers had prompted the sell-off and, as is so often the case, led to a snowball effect. Positions were hastily sold in order to limit the damage. On the other hand, our Risk Appetite indicator gave an anti-cyclical buy signal, which proved correct over the rest of the month. Good economic prospects around the globe and the robust investor sentiment prevailing up to that point were not entirely forgotten. Prices of the major equity indices recovered as the month progressed. Even so, not all the lost ground had been made up by the end of the month. By the last day of trading the S&P 500 – the equity market with the highest valuation – had recovered the most ground, ending February with a loss of only 3.89%, while Switzerland's main index, the SMI, dropped 4.60% and the European Dow Jones EuroStoxx 3.79%.

Growth momentum justifies a tighter rein

Remarkable changes have taken place in the financial markets since the collapse of Lehman Brothers almost ten years ago. At that time, our fundamental model for asset allocation control generated a clear buy signal for equities, even though the real economy was floored. A liquidity glut and historically extremely low valuations made this possible. Today, by contrast, valuations all around the world are stretched and the US Fed will probably have to tighten monetary policy three or four times this year. A month ago, markets were expecting two or perhaps three further hikes. Inevitably this will deprive financial markets of liquidity. Against this background, we continue to receive a sell signal for the "Valuation" component. Recently, this has been confirmed by the "Monetary Environment" component. On the other hand, the real economic components "Consumption" and "Industry" show a very positive picture for equities. Because the macroeconomic situation appears so good, the two negative components are currently more than offset, therefore our systematic assessment still favours exposure to equities. But history also shows that a bull market supported by valuations and monetary policy is less volatile than one sustained by the real economy.

Monetary policy environment: A further increase in inflationary pressure is evident at both producer and consumer price level. Particularly in the US, this trend seems to be strengthening and demands a response from the monetary authorities. The Fed's more restrictive policy and fact that long-term interest rates have already risen are pushing the components into territory that is clearly negative for equities.

Industry: In the US, as well as traditional capital goods, there is again greater interest in the technology sector. The positive trend of American industry is strengthening as a result. The Industry component is supported by strong demand in Europe and also in emerging markets.

Consumption: US consumption remains strong. Europe continues to gain ground. The consumption outlook benefits in particular from recovering labour markets in France, Spain and Italy. This component continues to offer the most support for equity markets.

Valuation: Markets are still considerably overvalued, despite the significant dip seen in February. All regions are cheaper than they were a month ago. The US market remains the most overvalued.

Investor sentiment: bruised but not broken

The unexpected sell-off of equities arose neither from a period of euphoria nor from negative market sentiment. Precisely because it came as such a surprise, sentiment – according to our Risk Appetite indicator – deteriorated in no time at all. The decline was so sharp that we received an anti-cyclical buy signal. Since then, the anti-cyclical signal has neutralised and sentiment has brightened once more. However, uncertainty is still so great that all five sub-indicators have deteriorated compared to the previous month and mostly show a

Risk appetite indicator: Sell signals on four out of five sub-indicators

	Number of Indicators	***Current Signal***	*1 Week*	*1 Month*	*3 Months*
MONEY FLOW	*31*	Buy	↗	↘	↘
SURPRISE EFFECT	*17*	Sell	→	↘	↘
MARKET BREADTH	*24*	Sell	↗	↘	↗
HEDGING DEMAND	*7*	Sell	↘	↘	→
MARKET RISK	*37*	Sell	→	↘	↘
OVERBOUGHT / OVERSOLD		Neutral			
RISK APPETITE INDICATOR	***116***	**BUY**	↗	↘	↘

weak sell signal. On balance, however, the buy signal remains in place for the time being. Only the way in which the recovery proceeds from here on will tell us whether sentiment will continue to gather strength or whether it is out for the count. If sentiment does not recover, we would reduce positions based on risk considerations.

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