August 2018

Risks – warded off but still threatening

- "Everything is fine" mentality has the upper hand
- Central banks underestimate the inflation risk
- No confidence in the rally

July was not an easy month for all those worried about mounting risks in the financial system. The global economy is continuing to grow despite the current trade disputes. US GDP growth, for example, posted an impressive rise of 4.1% in the second quarter of 2018. The half-year results published by US corporations showed strong growth rates, despite not always managing to beat high analyst expectations – especially in the case of technology stocks. On the interest-rate front, yields are stuck in a sideways movement, even though inflation continues to creep higher. Corporate bonds are currently showing very low credit spreads. This effectively means that investors reckon there is only a very small risk of slower economic growth, with a subsequent deterioration in company balance sheets. But perhaps investors are seeing things through rose-tinted glasses, where all risks are simply blocked out. Very little attention is being paid to the crisis between the USA and Iran, the escalating trade dispute between the USA and China, or the sharp rise in inflation. Apparently global financial markets are caught between favourable economic data at present and perils looming in future. For once the optimists had the upper hand, however. America's S&P 500 Index and the Eurozone's EuroStoxx Index both posted gains. The Swiss Performance Index even advanced 5.5% over the course of the month thanks to a strong performance from Roche, Nestlé and Novartis.

Central banks underestimate the inflation risk

The import tariffs on Europe's manufacturing industry seem to have been forgotten for the time being, even though many commentators once again do not give credit to President Trump's words – and President Macron even rejects the deals made between the US President and Jean-Claude Junker. However, it is already possible to see that tariffs introduced to date will eventually push up inflation. The pricing policy of many companies, as well as surveys of company managers, mean more price rises are on the cards. This is exacerbated by the stimulus provided by the US fiscal policy, which comes at a time when America does not really need it. It is actually a bad timing, as the labour market is in rude health. The US Fed predicts an unemployment rate of only 3.4% towards the end of the year. The last time it was this low was back in the 1970s. Perhaps we have almost reached the point where the so-called Phillips curve has an effect again. This theory states that when an economy comes close to full employment, wages and inflation move upwards at the expense of growth, as companies keep competing for the same labour whose supply starts to narrow. This correlation has not been functioning for over a decade now, but our "Monetary environment" subindicator shows that many time series are currently anticipating precisely this effect. The result would be a more restrictive monetary policy, which again would have negative consequences for equities – especially if this occurred when markets are overvalued – as flagged by our subindicator "Valuation". The continuing good health of the real economy, as evidenced by the subindicators "Industry" and "Consumption", are unable to compensate for this trend. Our fundamental model is thus still warning us to act cautiously and keep a low equities quota.

Monetary policy environment: Inflation is likely to continue to rise. Even the ECB President Mario Draghi said in his last press conference that core inflation in the Eurozone may well surpass the target corridor of 2% in the second half of the year. As a result, the ECB will continue to gradually wind down its expansive monetary policy. According to our subindicator, this is not a good omen for risk assets.

Industry: Even if the manufacturing sector continues to expand, a noticeable slowdown is becoming increasingly likely. Germany's Ifo business sentiment index was unable to recover from the severe collapse in June. In addition, the assessment of the current status in the USA has been declining for the past six months. The subindicator continues to support equities for the time being, but will not be immune to the effects of the slowdown.

Consumption: Spending by private households is declining. In particular, America's housing market is losing momentum. The number of newly built and sold single-family dwellings has been revised downwards for the first three months, and only showed an annualised rate of 2.7%, despite the low baseline figure from the previous year making a comparison more favourable. Even so, consumption continues to be a major support for equity positions.

Valuation: Most of the earnings growth reported in half-year figures were in line with expectations. However, valuations already appear to be discounting even higher future earnings growth. Equities are still overvalued on the whole.

No confidence in the rally

The markets are enjoying a bull run, but investors still seem rather sceptical. According to our risk appetite indicator, the willingness to take risks was even lower than in the previous month. Rising prices combined with a cautious attitude or weak sentiment are often interpreted as a good sign for markets. But since this is neither an example of

Risk appetite indicator: indicators fall further despite higher prices

	Anzahl Indikatoren	Aktuelle Signale	1 Woche	1 Monat	3 Monate
MONEY FLOW	31	Sell	↗	↘	↘
SURPRISE EFFECT	18	Buy	↘	↗	↗
MARKET BREADTH	24	Buy	↗	↗	↗
HEDGING DEMAND	6	Sell	↗	↗	↘
MARKET RISK	37	Sell	→	→	→
OVERBOUGHT / OVERSOLD		Neutral			
RISK APPETITE INDICATOR	**116**	**SELL**	↗	↘	↘

a recovery from an overbought situation nor a broadly supported rally mirrored in the risk appetite indicator, we are not getting any buy signal. On the contrary: the subindicator "Money Flow" in particular warns against investing more money in higher-risk investments. The market risk components and hedging demand also sound a note of caution. This means that just over three quarters of the model now calls for a defensive investment approach. Our priority is therefore the preservation of capital rather than an increase in value.

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