May 2015

Investors upbeat - Fed in a quandary

- Typically unsettled climate in April
- Real economy bamboozles the Fed
- Investor sentiment climbs to new heights

Market developments in April followed a similar pattern to the previous month: during the first three weeks, the overall mood on financial markets was fairly upbeat. Both equities and bonds posted modest gains, and there was very little volatility on the currency front. But markets were hit by a wave of sudden and strong turbulence in the final week of April, a month when the climate is typically quite unsettled. One of the biggest drags on performance was the disappointing economic data coming out of the USA, which put pressure on the US dollar relative to the Euro. At the same time, the figures released for the Eurozone were better than expected. In particular, they did not show any further slide into deflation. This effectively put even greater downward pressure on the greenback. On top of that, the US Federal Reserve hinted that the timing of the expected interest-rate hike might be pushed back even further. Unlike previous months, however, this news actually triggered a share price rally. Defensive stocks suffered even more than cyclicals, despite them usually experiencing stronger demand during times of growing uncertainty. Bond markets were also just as unpredictable as April's weather, retreating slightly even though the overall newsflow seemed to make a move in the opposite direction seem more likely. Given this backdrop, the Swiss franc once again gained ground. Events during the last four trading days of the month left both the Swiss Market Index and the Dow Jones Euro Stoxx Index nursing losses of -0.57% and -1.67% respectively. By contrast, the S&P 500 Index finished the month in positive territory, with a gain of 0.85%.

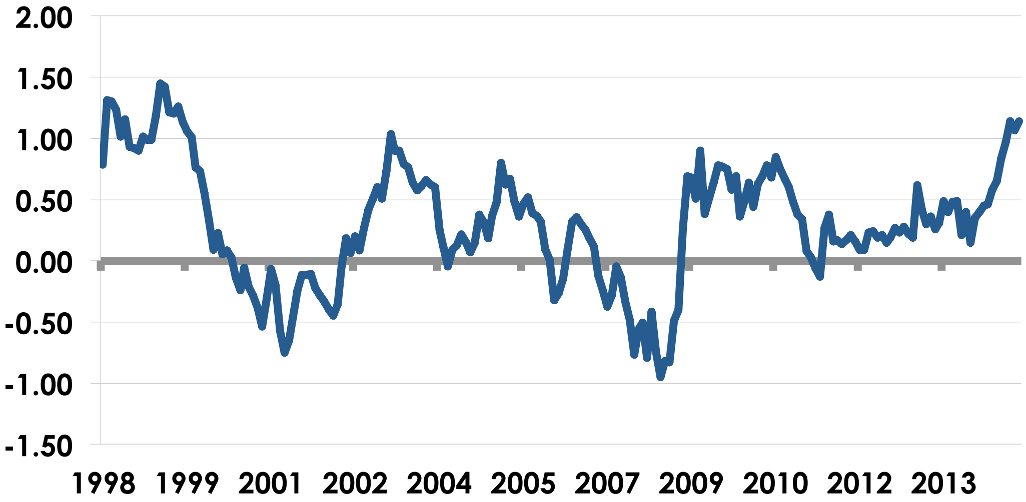
Real economy bamboozles the Fed

The appeal of equity markets continues to be supported by monetary conditions. As in previous months, the inflation outlook for Europe, and increasingly for the USA as well, is quite modest. This is the best possible scenario as far as central bank policy is concerned. As a result, the sub-indicator "Monetary stock market environment" produced by our team has climbed to its highest level since 1999. Much to the chagrin of central banks and investors, however, the effects of a loose monetary policy on the real economy are much less pronounced than had been hoped for.

For some months now, the US Fed has been "threatening" to raise base rates, but has repeatedly pushed back the date for implementing the first hike. Most market players now expect the FOMC to make the first hike at its September meeting. However, a look at the trend in the real economic sub-indicators "Industry" and "Consumption" in our model shows that this step looks to be anything but certain. In fact it clearly shows the challenges the Fed is facing. For example, the indicator "Consumer sentiment" recently showed clear signs of stabilisation, signalling an attractive environment for equities. Above all, this indicator is being supported by low unemployment and strong consumer confidence, which essentially warrants an interest-rate hike. At the same time, the data for actual consumer spending are rather weak. Based on the data we have analysed, it is not enough to attribute this fall simply to the cold winter or to the fact that only poorly paid jobs were created during the economic recovery. The muted level of consumption is in fact also reflected in downstream areas. For example, the "Industry" indicator compiled by our team has now dipped into negative territory, which is not favourable for equities. It is noteworthy that the downtrend has hit many areas of the industrial sector. Many of the statistical and time series we have analysed for the month of April reveal weaker values than the previous month. One particularly noticeable trend is that spending on capital investments is currently at an extremely low level. In our opinion, the factors just described argue against an imminent interest-rate hike. The Fed is therefore in a quandary: How can the upbeat consumer sentiment be converted into actual spending and produce the desired growth?

In addition to the “Industry” component, the “Valuation of equity markets” component within our model also points to a less benign climate for equities. As a result, only two out of four indicators now support the

GFAS Fundamental (monetary environment): at the highest level since 1999



*** From a fundamental perspective, indicator readings above zero signal a positive climate for equities**

investment case for equities. However, since the monetary indicator played a disproportionately strong role in the past, the fundamental overall indicator remains clearly positive. As far as the fundamentals are concerned, therefore, short-term corrections in equities present attractive buying opportunities.

Investor sentiment climbs to new heights

To put it in a nutshell: the erratic and barely explicable swings on financial markets during the final trading days of the month of April failed to spoil investors' positive mood or their strong appetite for risk. On the contrary, all five indicator groups of the risk appetite indicator produced by our team still stand at higher levels than both one or three months ago.

It is particularly impressive to see how well the indicator group “Money flow” managed to cope with the final trading sessions. Despite weak economic figures and a clearly identifiable increase in the risks associated with equity investments, cyclical companies performed better than stable and more defensive stocks, as already mentioned. On top of that, the indicator groups “Market breadth” and “Desire for hedging” currently show a high risk tolerance on the part of investors. The upward trajectory of equity markets over the mid-term continues to be broadly supported and there is only minimal demand for the hedging of market risks. Only the indicators “Market risk” and “Surprise effect” suggest a certain degree of caution among investors. Another encouraging feature in the past month, however, was the fact that the partly disappointing figures on the economic front were offset by corporate results that came in above expectations.

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