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Review

Despite rising interest rates, the positive momentum of the global equity markets has lasted throughout January, however with different speeds. Led by the USA again with new all-time highs and monthly returns between 6 and 8%, various emerging stock markets have followed with gains between 4 and 8% topped by Russia with a monthly gain of over 10%. Drivers were once more newly raised global economic growth forecasts for 2018, the positive influence of the US tax reform and the reignited risk appetite of investors for lack of alternative investment opportunities like fixed income securities. The European equity markets again have lagged behind with monthly index gains between 1 to 3%. The poor performance mainly attributes to the strong Euro, the uncertainty about the future direction of the ECB policy and the political squabbling about the forming of the new German government.
Accelerating economic growth has revitalized commodity and crude oil prices and the fear of rising inflation, which has further driven up interest rates of government bonds over all maturities. The weakness of the US Dollar with the move over 1.20 to the Euro has surprised the investment community especially in Europe, which has already begun to impair corporate earnings of export driven companies.

Economic Outlook

The global economy is in full swing with all its late cycle characteristics. Many capital market observers and economists have already begun to discuss the aspects of an overheating and the following consequences on the emptied labor markets, inflation, interest rates and the impact on future earnings and the today's stock market evaluations. Many of my colleagues are digging out economic statistics of former business cycles with their boom, bust scenarios trying to deduce from them the impact on the ongoing economic cycle. There is a serious logic behind this analytical approach; however, they seem to suppress the fact that this cycle is not comparable with any of the past cycles after the war. The world is in the midst of an industrial revolution, the Industry 4.0, which will create massive productivity gains with lasting deflationary effects. It will change the social and economic long-term structures of the Western societies for years to come. After the Dot-Com bubble and the financial tsunami of the years of 2000 and 2008 the Western economies are only about to return to normal conditions and stand on a slow and low inflationary course of repair. This applies for Europe, in particular, with its dramatic economic imbalances from North to South and from East to West.
In addition, there are 161 million powerful US consumers, which are part of the Generation X (average age 45) and the Millennium Generation (average age 27). It is the generation of heirs, which will turn out to be the wealthiest income group ever. This trend does as well exist in the Western World although at a slower pace. It should keep the economies growing for a long time.
The US tax reform and the administrative changes in Europe should support the efforts of the necessary rebuilding of infra structures in these countries as an unconditional prerequisite of future wealth. Therefore, 2018 and 2019 should become

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strong private income and earnings' years, which are only partially reflected in the long-term outlook of todays' equity markets, especially in Europe.

Capital Market Outlook

Capital market strategists and market technicians are concerned about the state of the bond and equity markets 9 years after the trough. Starting with the USA, they presume that both markets are richly valued and that certain equity indices and groups like semiconductors and certain internet companies have already reached excessive price levels. In this context, there is a risk of a crash as in 1987 or a breakdown of a bubble as in 2000.
The US treasury markets have been expensive and unattractive already for quite some time. The Fed probably has been too cautious for too long to act more aggressively towards normalized interest rates and monetary conditions. Faster rising treasury yields are reflecting now the more aggressive stance of the Fed, which seems to be prudent. The ECB is still reluctant, but it is just a question of weeks or months, until it finally will revert its existing monetary policy. This step is overdue. Negative interest rates have not been a solution in order to cure the structural dislocation of the EU banking system. The markets should welcome the return to normalized monetary conditions. It would help the European government bond markets to regain their adequate pricing power.
It is correct, that certain US stock indices and stocks have recently reached excessive valuations and are definitely ahead of their short-term fundamentals. Therefore, a price adjustment should be overdue and could trigger an allover correction in breadth. It seems that the US stock markets have already entered a midterm correction. This move should not confuse investors with the risk of a dramatic downturn or a breakdown of a bubble, because the long-term fundamentals will remain positive.
History tells that the European equity markets traditionally have been following the US equity markets. It would be a surprise if this would be the case this time. The Continental equity markets have consistently underperformed in relation to the USA. They have not been able to reiterate their bull markets after their peaks of 2015. If, however, it were to happen again then investors should blame the ongoing structural, economic and political inconsistencies in Germany and in many parts of the EU and the strength of the Euro.
A stock market correction of even 10 % after the end of the earnings season should however create a renewed opportunity for long-term investors to increase their equity positions against cash or fixed income securities. I am convinced that at worst it could be a midterm correction within a structural equity bull market for many years to come.

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