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Current Situation

The Western capital markets continued their upward movement started since the beginning regardless of political events in Ukraine and Greece in February. Once again, the monetary and economic factors have gained the upper hand. The Eurozone bond and equity markets, the Japanese stock market, Switzerland, despite the strong Swiss franc, the United States and finally the U.K. moved to new highs. As mentioned in previous publications it seems to prove true again that years ending with a „5“ happen to be good years for the stock markets, at least until today.
Various factors have encouraged this development. Market participants have accepted that the deflationary forces in all economies should make a rate hike in the USA and the rest of the world unlikely. The global imbalance between supply and demand for goods and services is simply too big. Therefore producer price increases despite rising wages are not currently enforceable. This also applies to the price of oil, which interacts with a rising US dollar as a global economic recovery stimulus, especially for the countries of the EU. In addition, on top of the late QE programs of the USA, Japan and as of March 1st the ECB as well will create a further glut of liquidity, which will continue to support the capital markets in the Western world.

Economic Outlook

The EU's agreement with Greece has calmed the situation for now, but it still remains to be seen, if the new Greek government can deliver after all that squabbling with the EU. The big test will be at the end of June 2015 where negotiations start again. At the end a “Grexit” still could happen. That could be painful for the EU and the IMF but it would not be felt any longer as a disaster and it would not threaten the continuous unification process of the EU. All member states seem to be aware of that. A much bigger issue seems to be the situation in Moscow now, where the unrest in Ukraine might not be the main focus of the Putin government any more. After the assassination of the former minister Nemtsov, who has been a very visible system critic and opposition politician, the question will inevitably arise how the balances of power in Moscow are distributed and how Putin can continue to play his very dominant role. A destabilization of the internal security of Russia would come at a very inconvenient time for the USA and Europe. These two issues will potentially impact the capital markets negatively over the coming weeks.
The economic outlook differs through the regions. The USA revised the GDP numbers for Q4 down from 2.6% to 2.2% despite decent growth in consumption (2.5%) and fixed investment (4.5%).This does not change the assumption that growth will accelerate in the coming quarters in the USA. The growth in the UK was 2.6%, the highest increase since 2007, surpassing all other countries in Europe. The Eurozone economies might have finally turned the corner helped by decent export growth. Especially Germany can expect a decent economic recovery later this year.

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The Chinese administration continues to focus on growth supportive measures such as tax breaks for small businesses to ignite growth. Japan will continue its ambitious program to get the economy growing despite a reduction in consumption (-4.5%) and a continuous deflationary pressure as of the last quarter of 2014.

Financial Markets

The positive economic outlook, together with rising profits and dividends should continue to support the equity markets. The strong equity market performance especially in Europe and Japan makes those markets a bit overextended near term. But given the fact of relatively attractive valuations compared to the USA, the markets should continue their positive performance in due time. In the US this may be slightly different, because the markets have been moving up for a longer period and the economy is already on a growth path where the rest of the world will have to catch up.
All private and institutional investors are now faced with a situation that has not existed in the recent capital market history. The years of decline in bond yields and inflation rates after the Lehman crisis have led to an unprecedented reduction in the risk-free rate for deposits, which is currently less than 1%. This is especially true for the EU but also for Japan. In the EU this has got enormous consequences. First, the yields of long-term government bonds in the EU periphery should further converge to those of Germany. Although the 10-year bond yields of Italy and Spain are now at 1.37% and Portugal at 1.82%, the Bund yield is still far below that. The ECB’s QE program will accelerate that process of convergence. Second, given this background equity markets with their dividend yields look very attractive and so do stock market valuations, especially if they are adjusted to the new risk free return of 0 to 1%. Without any change in the fundamental outlook the valuation adjustment could give the markets a 10 to 15% upside, so looking at the DAX a target of 13000 is possible.
Many European investors who have been investing primarily in fixed income instruments now have the option of virtually interest-free government bond or high grade corporates or equities as a long-term investment. The pressure would increase significantly, if the banks began to take fees for current account deposits, which is already reality in Switzerland. That would be for many European private and institutional investors completely new territory and will ultimately force them to increase their ultra-low holdings in equities to earn some sort of return to match their future expenses. Given that potential of buying power behind the equity markets, short term corrections should therefore be used to increase the equity exposure.
As I said, years with the "5" at the end have statistically been positive investment years in the US. That should also apply to our capital markets.

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