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Review

The Western equity markets under the lead of Wall Street have entered their third month of a broad market correction with a still relatively high market volatility. The government bond markets have recovered from most of their losses especially in Europe after the further interest rate increase by the FED. The expectation of only moderately rising inflation rates within a good economic climate throughout 2018 has reignited institutional interest in longer maturities.
The equity markets, indeed, had to digest a couple of serious news last month. The message of the political approach of the two Korean nations and the first meeting after 2007 have disappeared in the announcement of Mr. Trump to place import tariffs on steel and aluminum. Although this action has mostly appealed to China and other Asian states, the European exporting nations have reacted sensitively to the fear of a general reduction of free trade. Accordingly, the German equity market has especially been hit. Moreover, the Italian election results and the start of the third German GroKo could not lift the already depressed sentiment.
During the market correction, the value of the Yen in its function as a safe haven currency has steadily risen against the US Dollar, to the traditional disadvantage of the Japanese equity market with an index loss of over 10%. The insignificant increase of the ounce of Gold was a surprise for many market observers. Therefore, investors should regard it as a positive signal that the current stock market retreat has been a normal technical correction from overbought market conditions.

Economic Outlook

Despite further interest rate decisions of the FED and the legitimate concern about the future of free trade, the fundamentals of the global economy remain sound. The US economy should grow by about 3% this year. The reduction of taxes and the dismantling of regulation has increased the attraction of investing in the USA. It should push corporations to shoulder parts of the financing needs for the mega infra structure projects in progress. It also could become a huge creator of new full time jobs. The future constellation does not automatically mean inflation to rise above targeted levels, which should put a lid on long-term interest rates at around 3%. Europe and Asia economically proceed positively, possibly at lesser growth rates than in the USA.
Fundamentally, a sound background to send the equity markets back to their established long-term upward trends, once the technical correction will be over! According to history, however, the grade of future stock market advances should gradually decelerate in times of rising interest rates. Late cycle equity markets have always been quite rocky. On top, two themes could put a strain on the stock markets and their valuations.
First, the concern about the future of free trade is legitimate, after the declaration of President Trump to impose tariffs on steel and aluminum. All nations have agreed upon free trade under the most possible waiving of trade barriers and upon the principle of fairness. That is exactly, where he has set his partially comprehensible arguments, whether Europe likes it or not. Various countries and China, in particular, have developed trade practices and have violated internal patent laws on products,

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technology and services in the past. Germany for instance has indirectly supported these practices for many years, in order to get an entry into the Chinese market. It is also a fact that the unweighted average of tariffs from the EU to the USA are at 5.2% and only 3.5% in reverse. Therefore, the EU and Germany in particular should be open to renegotiate the old trade agreements with the USA, which in the end should turn out to be beneficial for both parties, their economies and the European capital markets. The comments of the EU president Juncker weeks ago in respect to this subject were political not very helpful, to put it mildly.
Second, the data abuse of 50 million Facebook users by the British consulting firm Cambridge Analytica has opened a political discussion about data safety and the protection of internet users. It has become obvious that lawmakers worldwide have fallen behind and that a legal regulation on an international basis has long become overdue. This problem moreover demonstrates that the acuteness of a legal frame for the entire complex “artificial intelligence” cannot wait forever. Internet of things and digitization on the way to industry 4.0 are two-sided coins and their achievements can become disruptive in an unwanted way without an internationally accepted legal game plan. These companies have recently moved into the political and fiscal focus and will stay there. Although many leaders will be able to grow their fortunes still at double-digit rates, it should have, however, a negative impact on their still high stock valuations from now on.

Capital Market Outlook

The equity markets have already entered the third month of the market correction that meanwhile has equally captured the whole segment of internet of things. The global stock market contraction should only be temporary and slowly phase out over the coming weeks, when the dust on various political and economic irritations will settle and the allover economic dynamics will return to the focus of investors. It should apply to the US equity markets in the first place, although they had reached breath taking record highs at the end of January after a 2-year run with the DJIA (24.103) reaching at 26.600 from 15.500 at the beginning and the NASDAQ index (7.063) at 7.600 from 4.200 index points.
The equity correction is a global phenomenon and has had its impact on Europe and Germany in particular with a loss of over 11% from its January high. Many EU stock markets had internationally underperformed since April of 2015 and many markets failed to achieve new all-time highs until today. There are fundamental reasons for that as already widely described in this publication. The EU equity markets, which do not have a financial independent existence, will revive of course with the US markets and will profit especially, when foreign capital will return to Europe.
The ongoing correction should last another couple of weeks until the next quarterly earnings will be released in April and May. The equity markets should need some time of technical repair with a calculated additional market risk of around 5%. Due to calculations from the technical research, the markets would then have touched important technical long-term support levels and should then resume their uptrends during the summer.
After the recent action in tech and internet stocks, the discussion of a change in leadership from growth to value investing will arise. There are many fundamental reasons that support this idea, but it is premature to call for a change already today.

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