FRANK TH. ZINNECKER

ZINNECKER MONTHLY 05 / 2014

Current Situation

For more than 5 months economic and political data have not painted a conclusive picture on which direction the Western financial markets will take. Central bankers, market makers, their research departments and investors have been left with the impression of perplexity about the future direction of the large economies. The majority so far has acted upon the assumption of a more restrictive monetary policy in the USA, the reacceleration of economic growth and rising inflation in the Western hemisphere and of allover growing company earnings. It, however, has just not materialized yet. As a consequence the financial markets have acted controversially. Government bonds on average have outperformed equities especially in the EU periphery with emerging bond markets like Turkey and Brazil joining in at a later stage. Western equity markets have flip-flopped over the entire time span ending on average flat to only slightly up. Several attempts by hedge funds to sell short the equity markets have failed; most recently in the middle of April when a heavy M&A wave hit the pharmaceutical sector. It has demonstrated how much corporate and institutional liquidity is at the sidelines ready to enter the markets as soon as a window of opportunity will open. M&A activities should take place more so among the multinational large capitalized companies this year as long as interest rates stay low. Therefore it is not a surprise that these companies have again begun to outperform the broader equity indices in April. The DJ Global Titans Index closed at a yearly new high of 238.43 - a positive sign for the strength of this bull market in its fifth year. This, however, has not yet answered the question on when the equity markets will finally leave their high consolidation patterns and which will be their fundamental drivers?

Economic Outlook

The political crisis in the Ukraine will intentionally not be covered. It is of minor importance for the future development of the financial markets. Due to intense diplomatic care the situation should not get out of hand and an escalation towards an act of war obviously is of nobody's interest.

Although politicians and economists would like to see rising inflation reality for the time being paints a different picture. The latest figures from the USA and more importantly from the EU with only 0.7% for April still point into the direction of deflation. The growth rate of the broadly defined EU money supply M3 together with private credit lending has steadily declined since 2012 - a dangerous way in front of the exuberant unemployment in the EU. It therefore will put the ECB under pressure to dramatically relax its still restrictive monetary policy in the months ahead, despite the fact that Spain and Portugal are already on the way of a relatively stronger economic recovery in 2014 and 2015 compared to their peers in the EU.
The fundamentals in the USA are by far more encouraging. The Federal Reserve gave an upbeat view on the US economy's prospects as it announced in its latest

Holzhecke 7 – D 60528 Frankfurt am Main
Telefon (069) 59 79 30 31 - Fax (069) 59 79 34 40 - Mobil (0171) 79 78 174
Email: frankzinnecker@t-online.de

statement a further reduction of the bond purchases by another 10 billion to $45 billion, which should end this program as soon as October. The severe winter behind should lead to a stronger economy in the quarters ahead with growing exports and a pick-up of investment spending.
More important also for the EU, France, the second largest economy in the EU, seems to finally move away from political and economic agony. After the recent shake-up of the government the new Prime Minister Valls has pushed through parliament a “Stability Program” of 50 billion euro, in order to tackle the government deficit, unemployment and the decline of the French domestic industry until 2017. It is a first meaningful step to break up the political and industrial incrustation being in place since the days of General de Gaulle. More steps, however, should follow in order to revitalize the labor market, to enhance productivity and profits thru tax reduction and privatization of state holdings. The takeover attempt of the indebted industrial enterprise Alstom by the US giant General Electric should also have appeared as a wakeup call for the French public. The globalization will not stop before the doors of France nor of Italy, which sooner or later will also be forced to join in with comparable programs.

Financial Markets

The Western financial markets should therefore be driven in the months ahead by a combination of a shift in the EU monetary policy with rising money supply and by the revitalization of the US economy with rising capital investment and company profits.
The interest rate convergence in the EU bond markets should smoothly phase out over the course of the summer. Long term government bond yields should stay at these low levels as long as the ECB policy will not be altered. US long term government bond yields are still fixed between 2.5 and 3% and should gradually challenge the upper end of the bracket in the months ahead. They eventually will break on the upside, if the US economy should turn out to be more robust than actually estimated.
This interest rate picture should be good news for the future of the equity markets. All market participants are aware of the fact, that equities historically are not cheap and that the future earnings and dividend momentum will be the unconditional driver of the next bull market leg in equities. The institutional liquidity is there to propel the stock markets to new index highs.
In the USA a new sustainable liquidity stream could loom in case that interest rates should pass those rates guaranteed by pension providers and life insurers. The low interest rate environment over the last 10 years has led to an abnormal high risk aversion at pension funds. The reason for this lies in the funding process. Now with the eventual reverse of this process, i.e. rising interest rates, pension funds will have to reserve less for their long term liabilities, which then would free incoming cash for a higher portion of riskier assets. It will not happen today but it could become an important source of funds for equity investments over the course of coming years. It had happened in the sixties and again in the eighties of the last century. The situation is similar with EU life insurers and private pension providers.

Frank TH. Zinnecker
1.5.2014

Holzhecke 7 – D 60528 Frankfurt am Main
Telefon (069) 59 79 30 31 - Fax (069) 59 79 34 40 - Mobil (0171) 79 78 174
Email: frankzinnecker@t-online.de