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Current Situation

Moving towards the holiday season investors and their bankers are furthermore confronted with a confusing mixture of fundamental and market data. There has been a divergence between “Wall Street” and “Main Street”. The description of the economic future through financial analysts, politicians and their central bankers has for quite some time not been mirrored in today’s economic and market reality, neither in the USA nor elsewhere in the world. This inconsistency and the longer it might exist, has created confusion among investors how to be financially positioned and protected against possible market setbacks over the summer and fall.

Under the still widely clamped liquidity umbrellas of the central banks the asset classes of bonds, stocks and real estate, altogether, have been in bull markets ever since 2009 and are meanwhile richly valued. Interest rates are at record lows and various bond markets have reiterated new bull market legs. Many stock markets, ahead of all the USA, have reached record highs or at least have achieved recovery highs exceeding those highs of 2007. The reader might believe that we are located in the best of all worlds because the central banks are holding their hands over the global investment community being aware of their global obligation and responsibility as a lender of last resort. At the end, however, it could turn out to be just wishful thinking.

Economic Outlook

There are two schools of thought that trouble the investment community at the start of the summer. The one, we name it Wall Street, is convinced that the US economy and also the rest of the world have left the trough during the first half of the year. Employment and salaries will grow substantially, so will do corporate profits. Finally, rising inflation should enable the Fed to slowly reduce its influence by raising their interest rates and relax. The latest statistics seem to confirm these assumptions: US GDP growth for the second quarter of 4% on a yearly basis and not 3% after a revised figure of only -2.1% for the bad winter quarter and inflation slightly up at 2.1% at the end of the month.
The other school, we name it Main Street, is much more concerned about the actual state of the economies worldwide. The USA as the prime driver of world economic growth has had a strong consumer driven recovery after the harsh winter, however, the slow recovery of the housing sector and capital spending has left doubts about the sustainability of the rebound. Furthermore the recent economic development in Europe has raised question marks about the strength of the recovery in the EU, where France has failed to implement the strongly needed reforms and where the EU will be confronted with the consequences of a more extensive embargo against Russia; not to mention the future export expectations of Germany with a revised global growth rate of only 2.4% for 2014 against 3% at the start of the year. At best,

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an EU growth rate of only 1% should be expected in 2014 and no further growth in employment.
Japan today is trapped in a far more delicate situation than France, as the Japanese government has already proved that “Abenomics” was a fake. It just has been incapable to implement the dreadfully needed socio-economic reforms promised to the nation 18 months ago. Japan has meanwhile adopted the folly of national pauperization and the question must be allowed, how much longer this shabby system can survive. The Chinese economy has improved somewhat recently, but it is not assured that it will become a trend.
To put it in a nut shell, the world and the USA, too, is growing too fable for the time being as to avoid a further sliding towards deflation. It is not the best of all worlds for globally growing corporate profits and employment.

Financial Markets

Risk oriented investors have reached the junction, where they have to answer the crucial question, how full or empty the bucket still is after an extended 68 month bull market in stocks and low risk government bonds at yields below inflation. What are the risk-reward-criteria under these given conditions and how much risk must he take to fulfill his performance requirements over the next 12 months.
The answer lies between future economic growth and inflation expectations on one side and how the Fed and other central banks will cope with the changes and how they will respond from now on. The economic appraisal, however, will differ, because the USA presumably is 18 months ahead of the EU in terms of the economic cycles. The Fed probably will be forced sooner than later to review and alternate its existing monetary policy, while the ECB is not only confronted with anemic economic conditions but also with unemployment and deflationary tendencies in various parts of the EU. The ECB has not yet resolved the diverging interest rate levels between France, Italy, Spain or Portugal, which permanently create credit disadvantages among competing companies in single countries. It therefore is just a question of time, when the ECB finally will initiate a QE-program and start buying government bonds from the EU periphery. As a consequence the implementation of a restrictive monetary policy in the EU will be years away. The divergent positions of the EU and the USA are presumably an important reason for the beginning of the revaluation of the US Dollar. The US Dollar Index (81.45) is about to break on the upside with a then readable upside potential of 86.

After Investors have been puzzled with the allover equity and bond performance since January, they are worried at record low interest rates and high equity levels what will come next. The months through November have historically been times of market anomalies which were difficult to handle strategically and tactically. Investors would like to get a correct answer, where the world economy will be heading for in 2015, before they will return to the capital markets. Will it be a substantial global recovery of economic growth accompanied by rising prices and employment and restrictive monetary policies (Wall Street) or, as up to now, will the deflationary economic cycles with unresolved employment problems and further loose monetary policies persist (Main Street)?

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In the EU, at least, the risk again is at hand that the economy and this time together with Germany will fall back into recession next year. Policy makers will finally be forced to implement withstanding structural and political solutions, if they do not want to risk rising social aggravation. The EU governments, therefore, have to ultimately abandon their austerity policies and to install large economic stimulus packages, instead. These programs should easily be financed at record low interest rates.
Until then it seems to be wise to withdraw proceeds from the equity markets and low investment grade bonds. Cash reserves and investments in government bonds could offer an alternative solution.

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