DIPL.-KFM.
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ZINNECKER MONTHLY 11 / 2014

Current Situation

The latest economic statistics have hardened my conviction that the world has entered a period of slower growth with a deflationary bias that will continue well into 2015. The USA so far has been faring best with a stable GDP growth of around 2.5%, while Asia is slowing down and Europe is heading for trouble. The US economy has received tremendous support from shrinking oil imports, smaller current account deficits and a rising Dollar. All of these factors heavily weighed on the decline of oil and gasoline prices. Together with rising employment they have created additional consumption growth and US consumer confidence has hit a 7 months high. The EU economy, however, has deteriorated from month to month. Starting with Italy, which de facto is in a recession since this summer, got another hit when several Italian banks did not pass the ECB stress test. France is closely following with the manufacturing index further weakening and last but not least the heavy weight Germany, where the key business sentiment index IFO has declined six months in a row. The EU economies are not only at the brink of a severe recession but they also could be facing the risk of long term deflation, as already witnessed in Japan.

Economic Outlook

EU politicians have so far treated these emerging problems with benign neglect, as most Europeans, especially the Germans, have historically only had a traumatic experience with inflation and hyperinflation. The real issue of today, however, is the risk of long term deflation. If consumers and enterprises expect prices to fall, they will stop spending. Demand sinks, structural unemployment will rise and loans will default. This is what happened in America during the great depression in the thirties of the last century.
It is worrisome that out of 46 countries observed by their central banks 30 are already below their envisaged inflation targets, including Germany but also the USA. What will have to happen that the socialist EU governments most notably France and Italy will finally wake up and realize that the decades' long redistribution of wealth over debt creation and subsidies and the interventions will eventually lead to the demise of all social achievements. The latest concerted management shakeup at Sanofi S.A. has once more demonstrated how the old French system functions. Italy's Banca Monte dei Paschi together with other EU banks is practically bankrupt. Another sovereign debt crisis even after the stress test therefore cannot be excluded in total, if policy makers do not find an appropriate and ultimate solution of ending the still existing EU banking crisis. BASF, the largest chemical company and Germany's economic bell weather, already warned that 2015 will become a difficult year because of its deteriorating European business. The situation in general is worrisome.
Upcoming inflation numbers with a red 0 could create such a wakeup call for the EU and its ECB. Policy makers then are requested to act immediately. The USA because of her traumatic deflation experience would presumably counterattack any impending

risk of lasting deflation with another QE program possibly linked with a nationwide infrastructure program. The ECB as a lender of last resort, even against the will of Germany, not only would have to nationalize those troubled banks but also to implement conventional QE, i.e. buying sovereign bonds in order to reach its targeted goal of the expansion of its balance sheet by € 1000 billion. This drastic action would then politically be necessary in order to prevent the EU system from collapsing and to prevent any country to leave the currency system.

Financial Markets

Although the current EU economic outlook, admittedly, is not that bleak yet, EU politicians, however, do not seem to have understood the pending economic and social risks and still fight yesterday's wars. The ongoing crisis, however, has foremost a political dimension and instead of playing games with each other, they should pretty soon be forced to take mutual action.
The USA, however, is still in a stronger and more favorable fundamental position. The latest US stock market recovery after the mid October "flash-crash" was a powerful demonstration of the viability of the US financial system, where various industrial groups and stocks have achieved new all-time highs. From a technical perspective the US stock market should therefore still to be considered as a bull market, although the valuation is already extensive and technical market indicators like volatility, market breadth and transaction volumes hint towards a market in its late cycle. The European stock markets, in contrast, have already built rounding tops over the summer and are about to commence bear market configurations reflecting the weak and somehow unpredictable economic cycle and the future corporate earnings. The Japanese stock market is positioned somehow in between, which has been consolidating since May of 2013 until today.
At this juncture it is difficult to develop already today an adequately balanced portfolio strategy for 2015, as in many cases investors still do not see the wood for the trees. There still is a too large political and economic uncertainty overhanging the financial markets. Whether and when the economic rationale of politicians will finally prevail and the credibility in the ability of proper political management will return, has still to be answered. The public, however, should hopefully get a positive idea of this in the weeks ahead. Concerning the USA, the midterm elections in November should also give a hint to where America will be heading until the next presidential elections in two years.
Until then prudence should be warranted with a meaningful cash position. Long dated government bonds in the EU periphery and Dollar denominated sovereign and high grade bonds should still be favored, as the yield and credit spreads have widened significantly from the lows of June. The US Dollar should reiterate its recent strength as the EU after Japan will also try to export deflation over a strategic devaluation of the Euro. It will probably be too early to buy the equity markets as a whole, because they have turned into markets of stocks. The proper stock selection has been a prerequisite for sustainable equity returns for all of this year. The company selection, as in the past, should be guided by financial quality, earnings and dividends visibility, market leadership, product innovation and management quality.

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30.10.2014

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