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Current Situation

Summer has gone and the fourth quarter is already knocking on investors' doors. Over the past 9 months long dated government bonds have outperformed stocks. Most equity indices have achieved positive results with the USA (S+P 500), Spain, Switzerland and Italy between +7% and over 8%. Japan was flat and Germany was down by 4% and the UK by 1.2%. The Euro has lost nearly 9% against the US Dollar, while the Dollar Index has taken out its resistance at 86 as forecasted in the last report. Over the course of the last 3 months with the exception of Japan (+7%) most stock markets have been consolidating. Europe also for political reasons finished slightly in the red.

The market development has been more or less consistent with the economic trends and latest financial forecasts. Solely the vast majority of analysts have been caught on the wrong foot with their consumer price predictions for 2014-15. The answer was the widely unexpected resurgence of the bull markets in sovereign bonds until today. Surprisingly, the political and military turmoil around the Ukraine at least until now has only caused minor damage for the EU economies and if, then more for Germany as a prime export partner to Eastern Europe and Russia.

Over the last couple of weeks the political controversy between Germany, the ECB and France, how to revitalize the EU economy, has come to the fore. Italy and Spain so far have stayed put, although a solution of the burdensome employment problem is in their own national interest. A recent trip to Italy has once more confirmed that the rural landscapes of Italy economically and morally are in desperate conditions. Was there not the tourism, Italy would already today be stuck in a deep recession, which anyway will happen over the course of the winter. The failure of the late corrupt governments to restructure and renew the socio-economic ground rules has left deep wounds and more scars in an already fable Italian economy. Pigs might fly, if the new government under Matteo Renzi would succeed in giving the country a new reliable and strong social and economic future.

Another summer field trip to Vancouver, Los Angeles, Atlanta and their surroundings have revealed interesting insights and observations into Americas "Main Street", which are far from the pictorial images that "Wall Street" seems to make us believe. In addition there seem to exist various and important similarities between the USA and Germany. The allover infrastructure of transportation and utilities is in critical condition or appears to be somewhat antic. 6% unemployment seems to be a non-removable base here and there, because these people for various reasons should not be employable any more in our quickly changing world. On the other end of the spectrum, there is full employment and a lack of high skilled labor weighs negatively on the future economic expansion.

Thirdly, the vastly growing aging population especially in the USA seems to be widely held under cover by the media and by politics, because it does not fit into a newly defined bright and beautiful Google and Facebook society. However, the baby boomers born until 1960, will be retiring, aged 65, from now on until 2025. It will be millions of so called middleclass people, who are still residing in for them today oversized single family homes. They are often part of huge plantations built in the 60ies with no or only small shopping and health facilities. Downsizing is difficult, because city near condominiums in many cases are far more expensive than the actual value of their existing homes. In addition lower spendable income and rising healthcare cost or the loss of mobility will refrain this large and formerly powerful generation from remaining an important contributor to future consumption.

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Also for that reason the idea of a resurgence of economic growth and price inflation should remain wishful thinking among the “Wall Street-Washington-Connection”. The opposite will probably happen. While the EU should face deflation and a recession early next year, the USA presumably will only be plagued for a long time by a subnormal economic expansion with inflation rates moving towards 1% in 2015.

Economic Outlook and Financial Markets

Therefore the allover 2015 economic outlook within the G7 universe does not seem to be too bright. On top, the end of the QE program in the USA has caused liquidity frictions since the inception of tapering for countries like Turkey, Brazil or Russia, which persistently rely on the inflow of foreign capital. The result is a renewed pressure on their currencies, interest rates and on their future economic expansion. These are also countries, which are important trading partners for the EU economies and for Germany in particular.
The EU at this juncture is stuck in a precarious situation. Frau Merkel and Treasurer Herr Schäuble, mainly for internal party reasons, still insist on the strict adherence of the austerity program. The CDU fears that its right wing could get lost to the AfD- the Alternative for Germany, if they would give in. France, on the contrary is forced to act after the fatale spring election, if it will not risk following Italy into a recession. The existing government therefore must abolish the binding austerity criteria for 2014 and 2015, in order to get space to implement the first reforms on trade and labor. The rest of the periphery should follow. It then would also free the ECB to install a full-fledged QE program, in order to expand its balance sheet. So far the TLTRO and the asset backed programs have failed to stimulate the still too weak credit growth in the EU.
In a nut shell: The EU should politically be facing a hot winter. It is not clear yet, whether the political rational for the sake of the EU societies and economies or the internal party doctrines will prevail. This is not the best of all worlds for the EU equity markets and investors should generally prefer long dated government bonds and cash over stocks, until the dust has settled.
The economic outlook for the USA is not really brilliant but at least more predictable. With abating gas and food prices the financial space for private consumption should widen gradually. As credit at reasonable interest rates is available for industry, housing and private households, capital investment should also help the economy to continuously expand into the winter. With the expectation of further falling US inflation and slowly rising corporate earnings both long dated treasury bonds, stocks and $-cash should still merit investors’ attention. Large capitalization stocks should be favored as small-cap stocks still continue to lag the broader market.
The US Dollar should further attract foreign money and the Index (DXY-86) should further proceed with new readings of 90 to 92, giving the EU a new target of 1.20.

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