Monthly Newsletter Savings and Investments

Stable market performance despite many concerns

September 2019

Market overview

The summer ended recently, but the time when investors were able to enjoy a quiet summer were over in the beginning of August as the last month of summer was very volatile for financial markets. The month started with increased trade tensions after US announced an intention to impose additional tariffs to Chinese imports that were not yet subject to tariffs. This triggered China, which later quite hardly responded back by announcing additional tariffs. It was only at the end of the month that both countries adopted a slightly more peaceful tone but the damage to business and investor sentiment had already been done. The renewed escalation of trade tensions and the growing economic consequences triggered profit-taking in global equity markets in August. However, despite this trade war escalation and other concerning factors such as weaker economic data, political uncertainty, tension in bond markets, various recession-related talks in media, September began and continues with financial markets being relatively calm. In the coming months, new monetary and fiscal stimulus should support the global economy but these measures doubtfully will be able to fully offset the negative effects and hence the economic slowdown should continue. We continue to think that these downside risks warrant an element of caution. However, we should note that we chose to keep risk tolerance towards risk assets, such as equities, slightly underweighted but not fully underweighted. If the situation improves/worsens, our next step may well be to revert to a more optimistic/cautious view of stock markets.

Stock market indexes' performance (until 31 August 2019)

Region	Index	Currency	Performance							
			2019 Aug	2019 YTD	12 Months	2014	2015	2016	2017	2018
USA	S&P 500	USD	-1,8%	16,7%	0,9%	11,4%	-0,7%	9,5%	19,4%	-6,2%
Europe	MSCI EURO	EUR	-1,4%	12,4%	-1,1%	2,3%	6,1%	1,7%	8,7%	-14,2%
Eastern Europe	MSCI EM Eastern Europe	USD	-5,7%	9,8%	7,5%	-40,0%	-8,1%	33,0%	12,9%	-8,3%
Asia	MSCI EM Asia	USD	-4,0%	2,2%	-9,4%	2,5%	-11,8%	3,8%	40,1%	-17,3%
Latin America	MSCI EM Latin America	USD	-8,5%	1,4%	5,6%	-14,8%	-32,9%	27,9%	20,8%	-9,3%

Major events and expectations

Trade conflict. After increased tensions in August, lately the tone of US and China has clearly shifted and both sides seem to take small steps to reduce tensions before next month's meeting in Washington. One reason is probably that both sides more clearly are seeing signs that the conflict has started to affect the real economy.

ECB. After September 12th meeting ECB announced about lowering deposit rate from -0,40% to -0.5% and launching new stimulus programme (restarting bond purchase program with EUR 20 billion per month starting from November 1st till as long as needed) to fight recession. The ECB also lowered its growth and inflation forecasts, as it warned that economic conditions have deteriorated. The ECB stated that rates will be as low, or lower until inflation is below or close to 2% (updated forecast of inflation is 1,2% in 2019, 1,0%

in 2020, 1,5% in 2021). Given the lower inflation forecast, this is a quite remarkable statement. With the global outlook facing more and more headwinds and given the current low global inflation environment, it seems very difficult to reach an underlying inflation close to around 1.8-2.0%. Rates will indeed be low for a very long time, potentially several years.

The FED. In July the Fed cut its key interest rate first time since 2008 crisis. This month (September 17-18) Fed is meeting again and the question is probably no longer whether it will cut its key rate again, but how much. We maintain our expectations that the Fed will cut rates by 0.25% in September, December and March. One outcome of a slower economic cycle is lower corporate earnings expectations. In this situation, share prices can benefit from lower key interest rates, which improve the valuations of equities compared to bonds. This is why investors are hoping for more and bigger future rate cuts by central banks such as the US Federal Reserve.

Low or negative yields. The downturn in global yields is being driven by expectations of both key interest rate cuts and new bond purchases by central banks, as well as a dose of market worries since various types of investors need to adjust their portfolios to new fixed income and stock market conditions. For example, negative yields are a growing problem for savers and asset management companies, which have pledged to pay their investors a given long-term return. The search for investments other than bonds is intensive. The stock market should provide healthy returns over time, but it also increases the risk level in a portfolio. As long as central banks are finding it hard to push up inflation to their targets and while economic conditions weaken, we will probably have to live with low interest rates.

Inverted yield curve. The US Treasury notes yield curve inverted last month. The slope of the yield curve shows the difference between yields on short- and long-term securities. When a short-term bond has a lower yield than a long-term bond, the slope is positive (the market expects higher future interest rates and bond yields). Last November, the yield on a 10-year US Treasury note was 3.23%. Today the 10-year Treasury yield has halved to around 1.7%. This is about the same as the yields on 2-year Treasury notes. When the yield on a long-term bond drops below that of a short-term bond, the yield curve is described as negative or inverted. What caught widespread attention is that an inverted yield curve has historically been a sign of future recession. However, the signal value of such an inverted curve is being questioned nowadays.

US economy is slowing, but not stalling. Most recent economic data from US have shown that US economy is not immune to global trade tensions. The manufacturing part has weakened as shown by the drop of US Manufacturing purchasing managers' index (PMI). After peaking at 61.3 in August 2018 the index has fallen for five straight months to 49.9 in August, its lowest reading since September 2009. There are also increasing signs that the manufacturing weakness is spreading to other areas of the economy as service sector and consumer confidence. However, the latter two remains quite strong. Domestic demand remains relatively resilient, with stronger retail sales in July, showing that so far the strength of the labour market and rising wages continue to outweigh trade and recession concerns. In this context, we continue to believe that the US economy is slowing, not stop growing.

In Europe – weaker economic data (especially in Germany). The Q2 GDP readings confirmed the economic slowdown in Europe, as growth slowed to 0.2% compared to 0.5% in Q1. GDP statistics in the biggest Europe's economy, Germany, showed the decline by 0.1% during Q2 compared to Q1. Foreign trade, but also weak consumption, were the main factors behind the country's weak Q2. This economic slowdown has fueled stimulus hopes of possible fiscal package if the situation deteriorates further. Overall though, August's composite PMI release for the Eurozone showed that growth stabilized in August. It confirms that Europe's economy is slowing but not yet approaching a recession, with the service sector continuing to grow.

Brexit – likelihood of "hard Brexit" decreased. The British Parliament voted for and the new law has entered into force requiring the British Prime Minister to reach a new agreement with the European Union by October 17 or else request a three-month postponement of British withdrawal until January 31, 2020. After that the likelihood of "hard Brexit" has decreased and the likelihood of an extension on the official deadline on Brexit (October 31) has increased. But Parliament is now being shut down until mid-October, and it remains unclear how this story will end. Considering that Parliament will be suspended until just two weeks before the official deadline, there is still a risk that there may not be enough time to secure an extension from the EU. Yet most economists predict that the EU would grant the UK an extension if requested, as it is also in the EU's interest that the UK does not crash out of the union.

To summarize, despite the escalations on various risk factors, equities have increased during last weeks. However, we are still concerned about the macroeconomic outlook, and that we think the upside potential in equities is limited. Yes we have seen some stabilization in European leading indicators, the service sector for the US still looks fairly strong and yes, central banks are becoming more expansionary. But dig a little bit deeper and things are deteriorating in our view. New manufacturing orders are dropping, employment components of the leading indicators for the service sector and small companies are moderating, the manufacturing sector continues to be under a massive pressure, and PMI readings points uniformly towards slowdown. It seems that the rise in equity prices is driven by the lack of alternatives to invest in, as investor do not see better opportunities in other asset classes. It is called TINA (There Is No Alternative) effect. But we do not see sustainable background for the gains in equities in the absence of a significant improvement in in macroeconomic data (which we do not see as very likely at the moment). Q3 earnings season, which will start in October, will put focus back on fundamentals and it might be trigger for a downturn in equities.

Overall, we expect a deceleration of global economic growth from 3.7% last year to 3.1% in 2019. We then expect a marginal speed-up in 2020 and 2021, driven by improved growth after Europe bottoms out this year and a speed-up in some emerging markets. This will be enough to maintain global growth, despite continued controlled deceleration in both the US and China. But the image of a tired global economy with clear downside risks – especially political ones – is likely to dominate financial market conditions this autumn.

Glossary

Terms used	Explanation
Fiscal policy	Fiscal policy relates to government spending and tax collection. Fiscal policy refers to the use of the government budget to influence economic activity. For example, when economic growth is slowing down, the government can step in and increase its spending to stimulate demand and economic growth. Or it can lower taxes to increase disposable income for people and businesses.
Gross Domestic Product (GDP)	The monetary value of all the finished goods and services produced within a country's borders in a specific time period, though GDP is usually calculated on an annual basis. It includes all of private and public consumption, government outlays, investments and exports less imports that occur within a defined territory.
Monetary policy	Monetary policy is the process by which the monetary authority (usually the central bank) of a country controls the supply of money (the size and rate of growth of the money supply), for the purpose of promoting economic growth and stability. For example, if the money supply grows too fast, the rate of inflation will increase and the economy will "overheat". If the growth of the money supply is slowed too much, then economic growth may also slow. The main tools to control money supply include open market operations (buying or selling assets), changing interest rates and changing reserve requirements for commercial banks.
Purchasing managers' indexes (PMIs)	An indicator of the economic health of the manufacturing sector. The PMI indexes are based on five major indicators: new orders, inventory levels, production, supplier deliveries and the employment environment. A PMI of more than 50 represents expansion of the manufacturing sector, compared to the previous month. A reading under 50 represents a contraction, while a reading at 50 indicates no change.
Yield	The income return on an investment. This refers to the interest or dividends received from a security and is usually expressed annually as a percentage based on the investment's cost, its current market value or its face value.