PULSE RATE TUESDAY, 15 AUGUST 2017

RISK AVERSION IN FINANCIAL MARKETS RISING

- Equity markets corrected to their June levels (maybe because of North Korea).
- Mid-term (3M+) we expect equity markets to reflect economic fundamentals and not geopolitics.
- Fed rate hike in 2017 less likely, but still expect tapering this year.
- Short-term (<3M) we remain cautious on equities

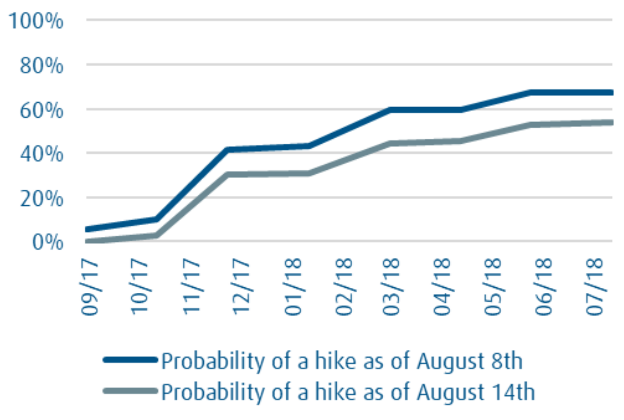
Geopolitical tensions led to a mood swing in financial markets. US Equity Markets corrected to their June levels, still performing more than 9% since the beginning of the year. Gold is on its way to USD 1'300, but still below the top of one month ago. US 10-year treasuries are yielding 2.2% - the level they reached two weeks ago. The Media and Wall Street always look for a reason of lower prices. Although the rhetoric between North Korea and the US was shocking, we saw plenty of negatives and uncertainties uprising over the past months – none of them caused the markets to correct. So, are Wall Street and the media right? Is nuclear war looming? Or is it just a bull market correction?

After the sabre-rattling between North Korea and the US, the UN Security Council imposed new sanctions against the regime of North Korea. North Korea announced to have a strike plan ready mid-august just ahead of the joint annual military exercises between South Korea and the US scheduled for August 21st. Political leaders all over the world have been willing to calm down the situation. Although we heard such threats many times in the past, what changed for sure is North Korea's weapon technology. The pentagon recently reported that North Korea will be able to launch a nuclear missile as soon as next year.

The responses of capital markets are rather limited: South Korean issuers have widened by 20bp p.a. Markets are therefore pricing-in a diplomatic solution to this conflict. However, history proved that investors and their predictions are not the font of all wisdom. Political uncertainties have been used to buy on dips and, as alternatives to equities are rare, there is a strong support for equities. Clearly, tail-risks are rising: the Volatility Index of S&P 500 (VIX) spiked to 15% from 10%. Markets are still distorted due to excessive central banks policies resulting in crowded trades and low volatility. For example, European high-yield bonds are now yielding less than 10y US Treasuries. Total sovereign and private debt are reaching record levels – higher than before the financial crises in 2008.

We therefore concentrate on the fundamentals. Inflation came in weaker than expected and lead markets to predict an interest rate hike less probable for this year – down from 40% to 30%. Markets expect core inflation's return to 2% to take longer than previously anticipated. Nevertheless, we still see the Fed on track with one hike in December due to continuous labor market gains – under the condition that core inflation stabilizes.

Companies' earning growth is moderating, but still supportive for equities. Momentum signals lost their steam e.g. by crossing the 50d moving average and the Relative Strength Indicator back on levels of 50%. Our negative outlook on equities since the beginning of the month has paid off nicely and we are rather cautious for the upcoming weeks.



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