June 2016

Equity markets at a crossroads?

- Merry month of May: strong end after a weak start
- Foundations are still shaky
- Risk appetite indicator: "extreme" lack of concern

The start of the "merry month of May" was not quite as bright as anticipated, with prices stuck in negative territory up to the middle of the month. There seemed to be no obvious grounds for the subsequent share price rally: neither the economic data published in the USA nor in other regions of the world were able to provide any positive impulse. On top of that, opinion polls showed that the probability of the UK leaving the European Union had risen above 50%. But as has happened so often in the recent past, share prices still managed to register gains from one day to the next, despite the fairly gloomy environment. Most stock indices advanced more than five percent over the course of just eight trading days. The US stock market is now trading at the higher end of the sideways corridor it has been stuck in for almost two years, not far off its previous historical highs. European and Swiss equities also began to move against the mid-term downward trend line observed on charts. The EuroStoxx rose 1.07% and the S&P 500 1.53%, while the SMI jumped 3.22% in May on the back of the strong performance of the two pharma heavyweights Roche and Novartis.

Foundations are still shaky

The Chair of the US Fed Janet Yellen thinks the US economy is ready for another interest-rate hike, and is thus considering raising interest rates by a quarter percent as early as June. We will probably never know whether she is prepared to do this because she is convinced that the US economy is growing strongly enough, or whether she simply wants to begin normalising interest-rate policy. Our own systematic assessments make us rather critical of another interest hike, as America's real economy is not as robust as hoped. Industry, for example, is still showing some recessionary trends and even on the consumer front we are seeing some clear signals of a sharp dip in the rate of consumption. In addition, the valuation of global equity markets is much too high by historical standards. However, the fundamentals still seem to be sending out signals that are positive for equities, but this is down to the monetary policy adopted by central banks.

Monetary environment: The inflationary pressure already highlighted by our data series for some months now continued to build during May. Rising prices for oil and commodities pushed up production costs. For example, the price index published for the industrial sector by the Institute for Supply Management rose from 33.5 to 59.0 points between January and May (a reading above 50 signals rising inflation). Coupled with a tight US labour market, inflationary pressure and the probability of a more restrictive monetary policy are therefore increasing. The fact that the monetary environment still provides the biggest support for equity markets is due to the virtual lack of inflation in Europe and Japan, giving central banks much more room to manoeuvre.

Industry: Industrial sentiment is still weak in the USA. Nor is Japan's manufacturing industry able to benefit from the expansionary monetary policy pursued by the Bank of Japan. As a result, the purchasing managers index has dropped to its lowest point in more than three years. By contrast, the currency devaluations in a number of emerging markets now appear to be bearing their first fruit. The data we have collated on both order intake and production are starting to improve again. Along with Europe, emerging markets provide the main glimmer of hope in the data series for these components, but on balance they are not enough to compensate for the weak figures coming out of the USA and Japan.

Consumption: Disposable income has fared even worse than reported a month ago. As a result, this component weakened overall. Private household spending rose slightly, mainly due to rising fuel costs and higher selling prices for detached houses. On balance, consumers seem to be taking a slightly more critical view of their situation.

Valuation: The overvaluation of equities has become even more pronounced due to the share price rally at the end of May already mentioned. Once again company earnings failed to keep pace with share price gains. In the USA especially, equities are too expensive historically speaking, judged by a number of valuation ratios. But equities in Europe and Switzerland can no longer really be described as attractively valued either. Equities currently only look fairly cheap in the emerging markets and Japan.

Risk appetite indicator: "extreme" lack of concern

The volatile market movements towards the end of 2015 and the start of this year made it quite clear that these are far from normal times for financial markets. The latest developments can be seen as confirmation of the observed irrationality. After going through a weak phase till mid-May, investor sentiment improved rapidly up to the end of the month, according to ENISO Partner's risk indicator. All five indicator groups

Risk appetite indicator: all five indicator groups point to "buy"

	Anzahl Indikatoren	Aktuelle Signale	1 Woche	1 Monat	3 Monate
MONEY FLOW	31	Buy	↗	↗	↗
SURPRISE EFFECT	17	Buy	↗	↘	↗
MARKET BREADTH	24	Buy	↗	↗	↗
HEDGING DEMAND	7	Buy	↗	↘	↗
MARKET RISK	37	Buy	↗	↗	↗
OVERBOUGHT / OVERSOLD		Overbought			
RISK APPETITE INDICATOR	116	SELL	↗	↗	↗

used to assess investors' risk appetite over the short term (i.e. three months) are signalling a marked improvement. Investor confidence, which has been very weak until just recently, is therefore already starting to return. The rapid and significant price gains, accompanied by a sharp rise in risk appetite, have triggered alarm bells in ENISO Partners' market psychology models. At the end of May, we therefore saw another sell signal for equities. So far the US equity market has still not managed to break away from the sideways trend that it has been locked in for the past two years. We fear that prices may crumble again before the equity market is able to break out of its sideways correction.

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