From greed to fear and back again?

February 2020

- Coronavirus dominates market headlines
- Recession fears dominate capital markets
- FED Action expected
- Fiscal stimulus might be on the cards
- Unchanged asset allocation

A bull market correction?

Until only a short while ago markets were dominated by the „fomo" mantra, which translates into „fear of missing out". The best reason to buy a stock was the fact that it had gone up a lot in the past. Greed has now been replaced by fear and it is probably fair to say that financial markets are behaving in a manic-depressive fashion due to ever more dependence on monetary stimulus. However, it goes without saying that the current turmoil is caused by the so-called Coronavirus and it's hard to assess economic consequences. We do not want to appear cynical but it looks as if overheated markets were only searching for a reason to sell off and made a find in this highly infectious virus disease. As a consequence, government bond yields have fallen significantly while high yield spreads have risen. The contrary movement of government bond yields and high yield spreads is typical for a phase characterized by fear of recession and deflation. If one takes the past as a reference, high yield spreads have not yet fully discounted the worsened economic outlook and are set to widen further. As a consequence, equity markets are also very likely to let off more steam before continuing their uptrend. In our view, the medium to longer trend is still up as we believe that the FED Put is still in place. By the time long government bond yields have fallen enough and the yield curve inverts again we expect the FED to step in by cutting rates as they did in January 2019. On top of that, we would not be surprised to see fiscal spending to counteract the negative economic impact of the Coronavirus. Similar to 2018 and 2019 markets might go from greed to fear and back again.

Sound Capital Investment Navigator

Valuation Bonds: --

	low		Yields		high
	- -	-	0	+	+ +
New	X				
Old	X				

	low		Spreads		high
	- -	-	0	+	+ +
New	X				
Old	X				

Valuation Equities: 0

	expensive		Shiller PE		cheap
	- -	-	0	+	+ +
New	X				
Old	X				

	low		Risk Premium		high
	- -	-	0	+	+ +
New					X
Old					X

	Contraction		Leading Indicators		Expansion
	- -	-	0	+	+ +
New			X		
Old				X	

	Euphoria		Risk-Index		Panic
	- -	-	0	+	+ +
New			X		
Old		X			

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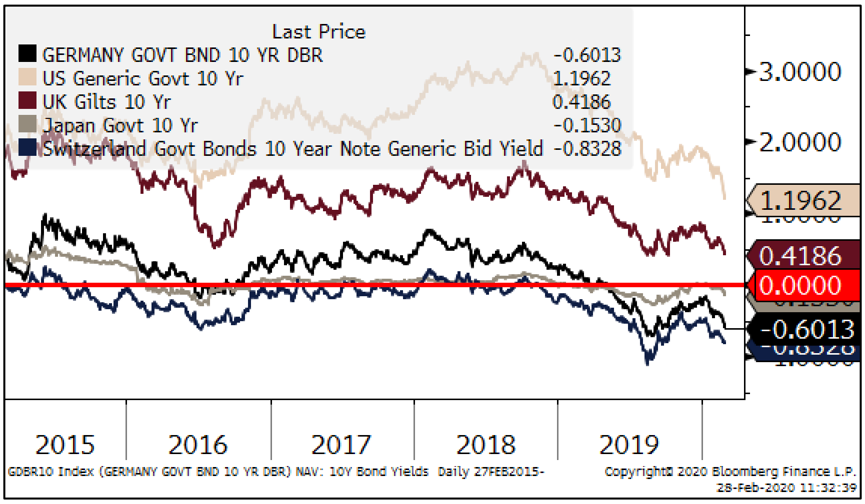
Since our last report we saw changes in only two of our indicators: While the leading economic indicator gave a negative signal and moved down one notch to neutral, our risk indicator was moved to neutral from negative. This results in an unchanged overall assessment of our Navigator.

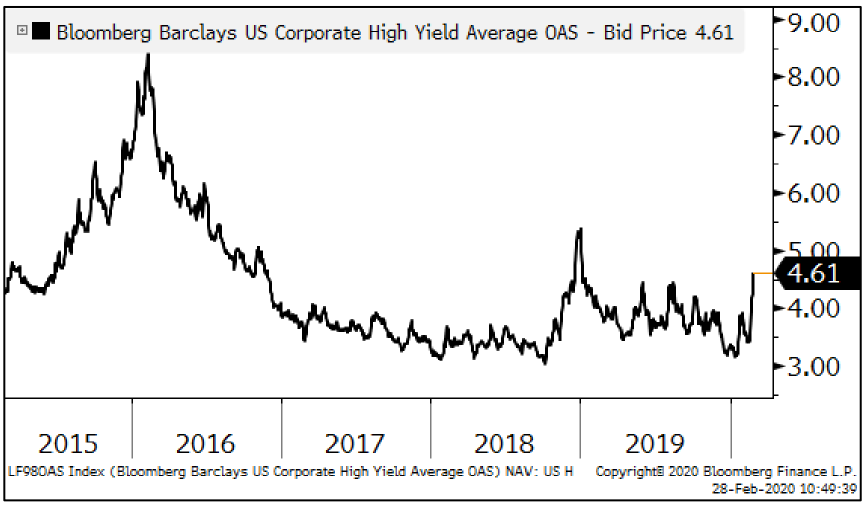
As we locked in profits by reducing risk substantially on the level of asset allocation and asset categories before the current market turmoil started, there is no need for us to act now: Liquidity remains overweight and bonds heavily underweight. Equity weightings remain neutral while alternative investments remain overweight.

Interest rate level (indicator --) / Spreads (indicator --)
assessment unchanged / assessment unchanged

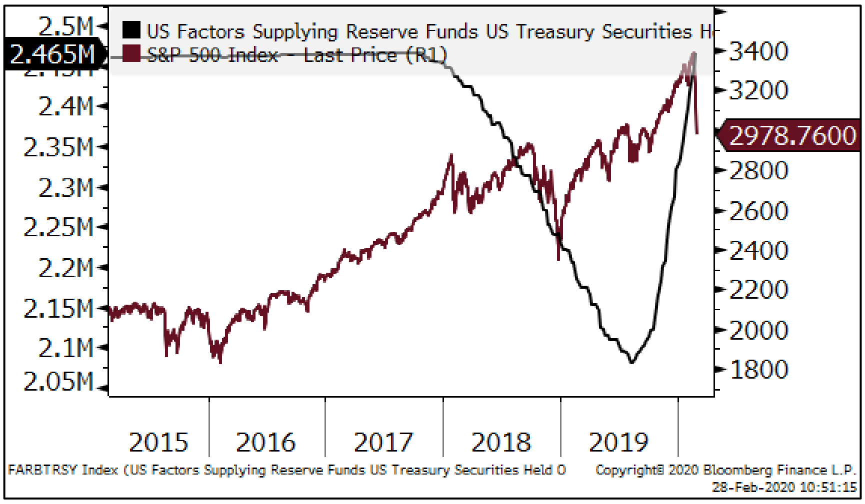
Yield levels of all government bonds have decreased since the beginning of the year confirming last year's trend. Yields fell most significantly in the US where yields of 10-year government bonds are down this year by 0.72% after already falling by 0.77% last year. Government bond yields are negative again in Japan (-0.15%), Germany (-0.60%) and most significantly in Switzerland (-0.83%).



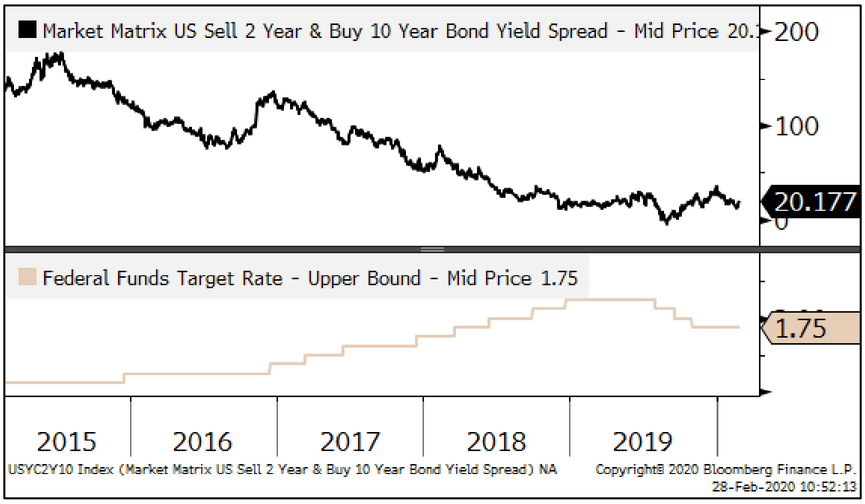
After having fallen last year (-1.9%) spreads of high yield bonds have gone up significantly since the beginning of the year (+1.25%). The decline in government bond yields is accompanied by rising high yield spreads which is typical for a phase characterized by fear of recession and deflation. Looking at the past (for example 4th quarter 2018) high yield spreads have not yet fully discounted the worsened economic outlook and are set to widen further.



One should never underestimate the influence of central banks. The underlying graph shows that for example the FED has significantly increased its holdings of US treasuries. However, it seems questionable (particularly in case of a recession) that high yield spreads can be managed as efficiently as government bond yields.

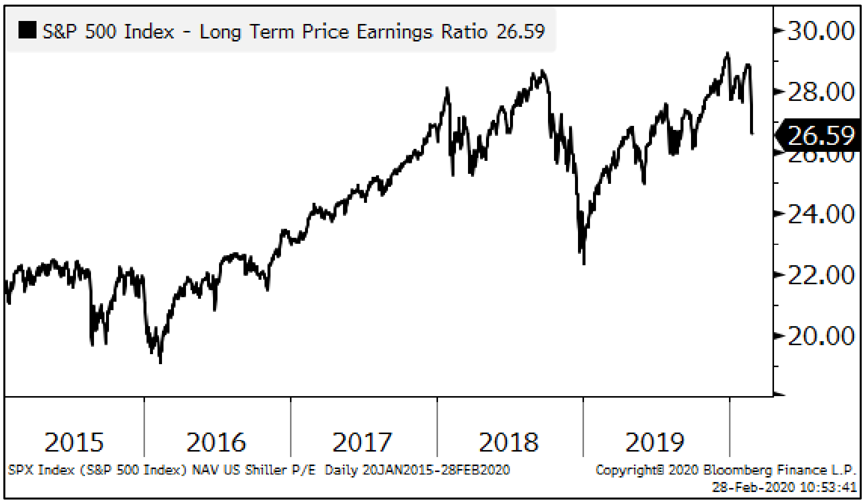


The yield curve has not inverted yet. However, the pressure on the FED to lower rates is set to increase once it falls behind the curve again. We would not exclude a replay of markets going higher once central banks go “all in” again.

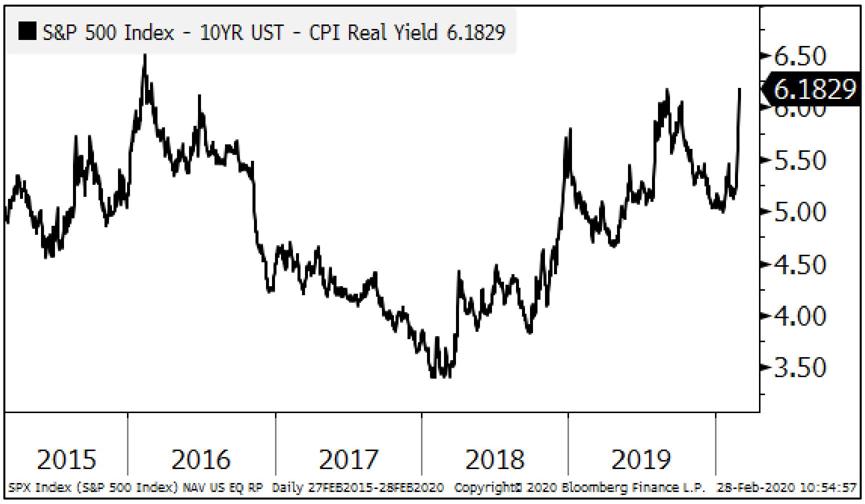


Shiller P/E ratio (indicator --) / Risk premium (indicator ++)
assessment unchanged / assessment unchanged

Despite lower levels, the absolute valuation of equity markets as measured by the cyclically adjusted price-to-earnings ratio still looks unattractive.



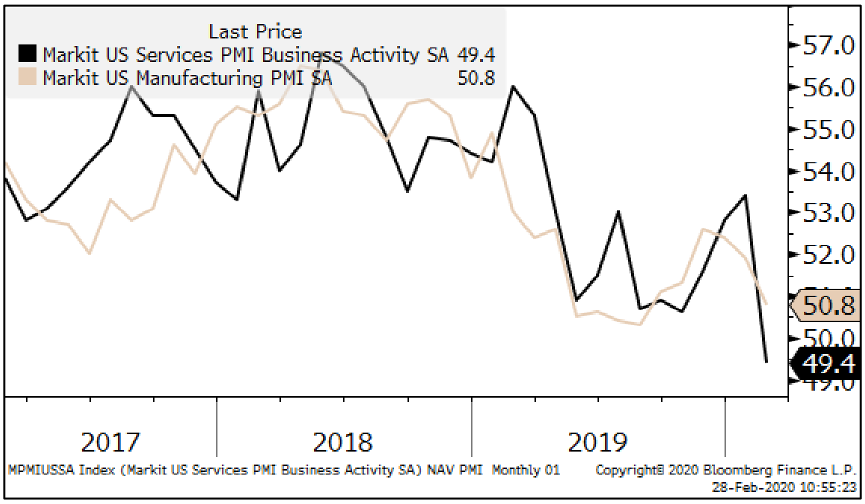
On the other hand, relative valuation of equity markets as measured by the equity risk premium looks attractive as it is going up in parallel with falling equity markets.



Macro leading indicators (assessment of indicator 0)

assessment reduced to 0 from +

Incoming PMI data for February do not look good for the manufacturing and the service sector and have led to increased fear of an imminent recession. As we assume that the effects of the Coronavirus are temporarily we give the economy the benefit of the doubt and change the assessment to neutral from + only.



Risik index (indicator 0)

assessment increased to 0 from -

Our anticyclical risk-index has improved from negative to neutral. However, looking at the put-call-ratio it still looks too early to become outright positive.