soundcapital

Manic depression?

February 2019

Change of opinion at the FED

Fall in U.S. high yield spreads

Decline in interest rates on U.S. government bonds

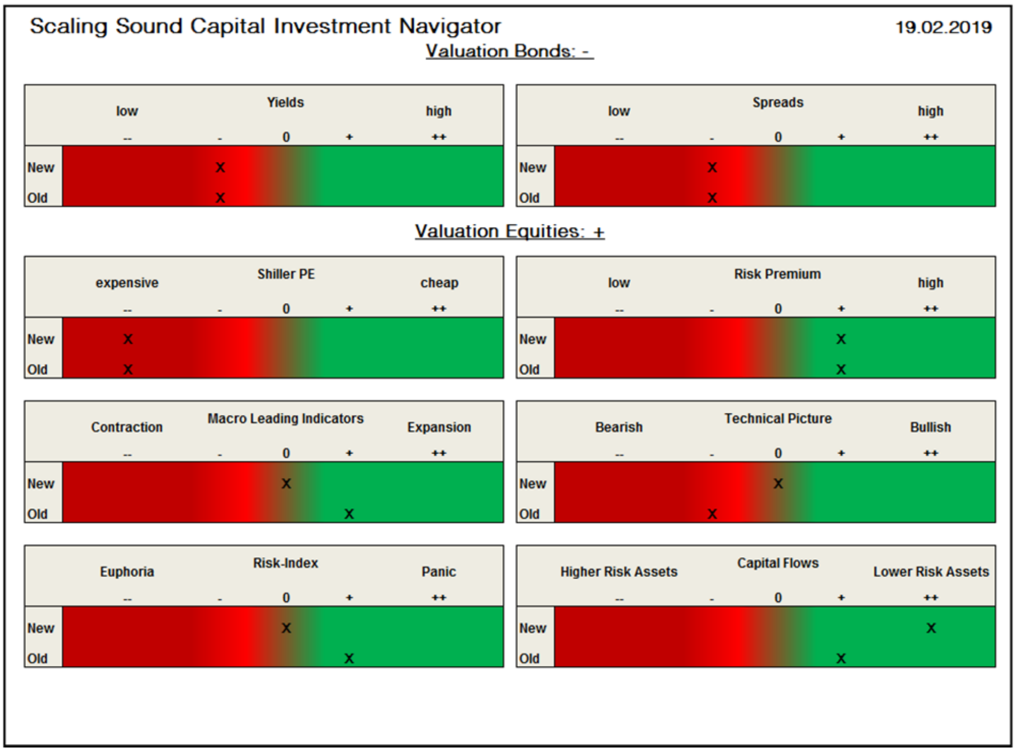
Shares downgraded from overweight to slightly overweight

Cash and gold upgraded from neutral to slightly overweight

Sudden counter-movement after December crash not supported so far by euphoria

Our last issue was titled "Surrender", and after the fact we can state that we were correct in this assessment. The steep upmove of stock market since the beginning of the year has not been driven by euphoria and certainly not by mania. Nevertheless the current issue of Navigator is titled “Manic Depression?”. Capital flow levels and high cash quotas of investors point towards a continuation of this uptrend, which is not in line with fundamentals. It is therefore not surprising that our negative assessment of the economic outlook is partially offset by a very positive assessment of the capital flows. Accordingly, we are reducing our equity weights from “overweight” to “slightly overweight”, and increase the weights of cash and gold from “neutral” to “slightly overweight”.

Sound Capital Investment Navigator



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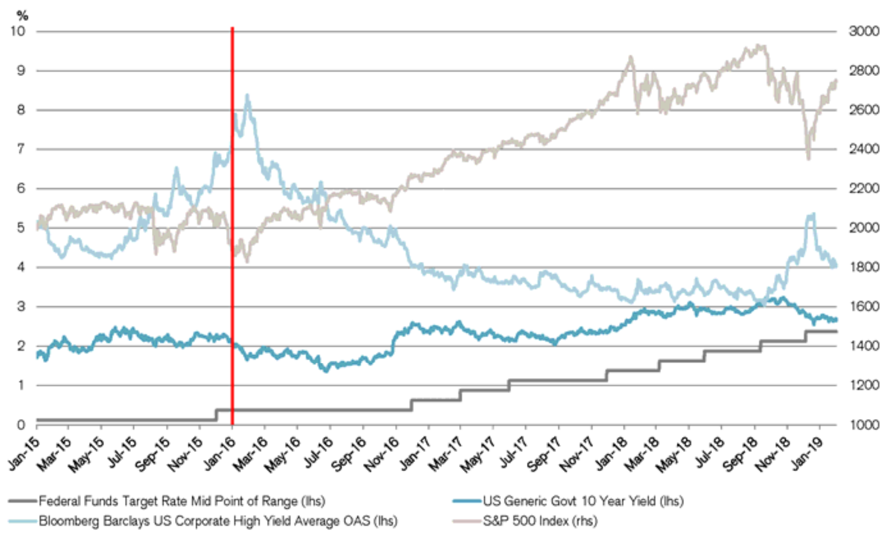
Sound Capital Investment Navigator

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

The strong upward movement of the S&P since the beginning of the year has been fueled by both falling yields on U.S. Treasury Bills and yields on high-yield corporate bonds in the U.S. This is a special constellation since normally government bond prices tend to rise during periods of weaker economic growth while high-yield corporate bonds prices rise during periods of positive economic development. The strongly synchronous decline in PMI data for all major economies since the beginning of the year suggests a return to a difficult environment for high-yield corporate bonds. In addition, the FED has procyclically raised interest rates four times during 2018, significantly increasing the likelihood of a sharp economic downturn.

Rates vs. S&P 500



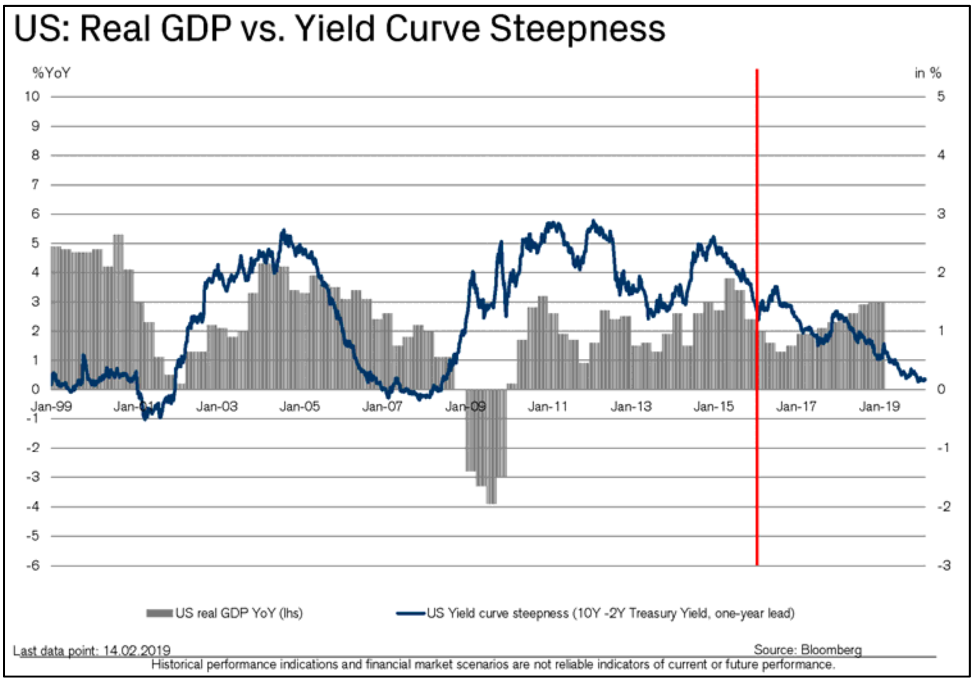
Last data point: 14.02.2019

Source: Bloomberg

Historical performance indications and financial market scenarios are not reliable indicators of current or future performance.

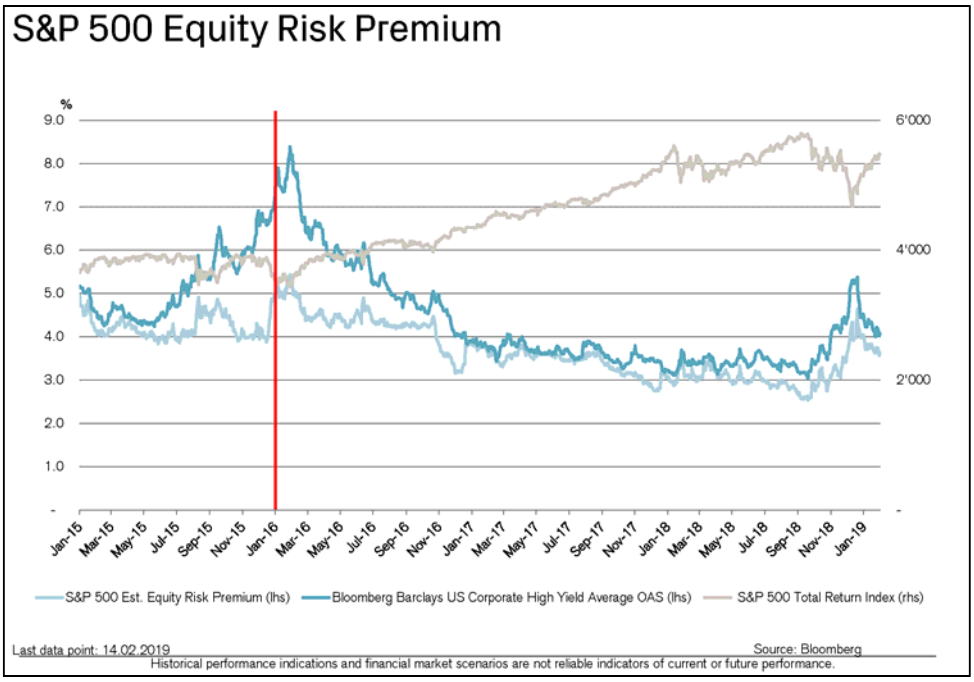
The FED should not act for the next few months as promised. This indicates that the U.S. yield curve is only exposed to the development of interest rates on long-term U.S. government bonds for the time being. If the trend that has persisted since December of last year continues, it will probably only be a matter of time before we are confronted with an inverse yield curve. Under these circumstances, the likelihood of a recession would increase dramatically.

We would also like to take this opportunity to point out that a comparison of the current situation with that at the beginning of 2016 shows the following clear differences: 01/16 comparatively steep yield curve; 01/19 yield curve flat, tending toward inverse. 01/16 FED funds at 0.25% and only one interest rate hike at the end of 2016 to 0.5%; 01/19 FED funds rate reaches 2.5% after four interest rate hikes in the previous year. High-yield spreads 01/16 at approx. 8%; 01/19 at approx. 4%. Risk premium U.S. equities 01/16 above 5%; 01/19 below 4%. This data shows that we are further advanced in the economic and interest rate cycle now than we were at the beginning of 2016. A significant economic downturn has thus become much more probable. Given these circumstances, it is therefore comparatively unlikely that the current difficult economic situation will see a favourable resolution as it did back then.



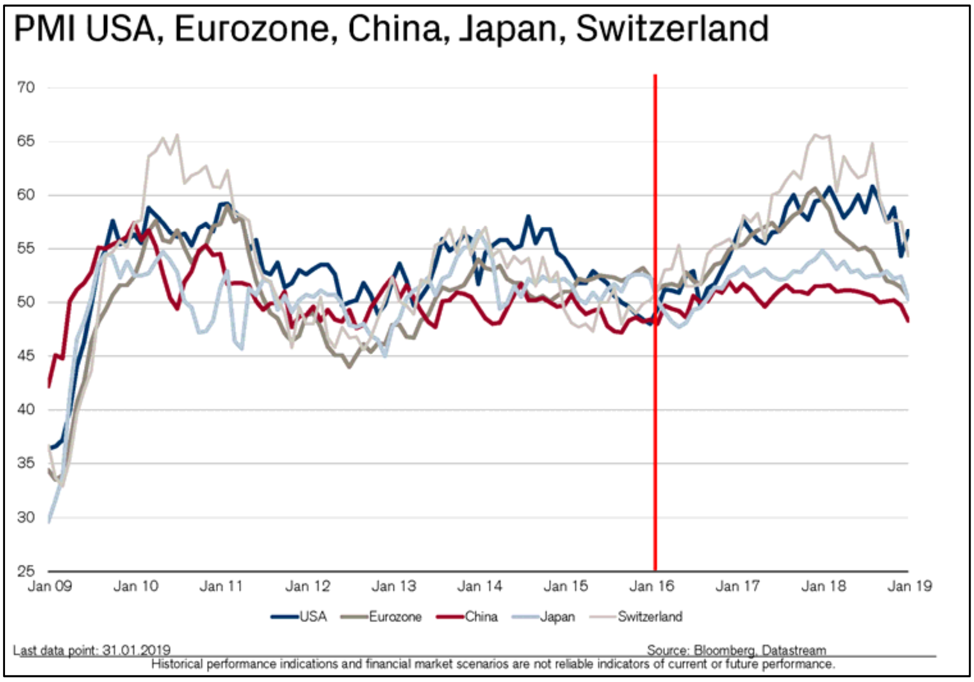
Shiller P/E (assessment indicator --) / risk premium (assessment indicator +)
Assessment unchanged / Assessment unchanged

The absolute valuation of the U.S. stock market (measured by the Shiller P/E ratio) remains unattractive. The relative valuation of equities against government bonds, measured by the risk premium (S&P 500 earnings yield minus 10-year U.S. government bond yield) is still attractive, although it has been declining since the beginning of the year.



Macro leading indicators (assessment indicator 0)
Assessment reduced from + to 0

The majority of global macro early indicators (with the exception of China) are expansionary but have weakened significantly since the beginning of the year.



Technical Picture (evaluation indicator 0)
Assessment unchanged

Most chart technicians have missed out on the abrupt change in trend since the beginning of the year and now assess the situation neutrally.

Risk index (assessment indicator 0) / Capital flows (assessment indicator ++)
Risk index assessment reduced from + to 0 / Capital flows assessment increased from + to ++

The strongly rising stock markets since the beginning of the year were accompanied by an improvement in sentiment while, at the same time, equity investments suffered from significant outflows. Due to the continuing lack of enthusiasm for equities, the current rise in equity prices may continue despite all the prophecies of doom.