ARVEST

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Briefing from the ARVEST Investment Committee

The first months of this year were exciting for the financial markets with investor focus on economic data from the US. In December of last year, the Fed considered the US economy to be sufficiently robust for a first increase in the prime rate. US industrial data published thereafter showed constant weakening. Various investment letters began to warn of an inevitable recession. They relied, for example, on the PMI survey published by the renowned Institute for Supply Management. Investor sentiment deteriorated rapidly. Various investment banks reduced their recommended equity allocation. Global risks, declining corporate earnings and persistent uncertainty regarding commodity prices were used as arguments for selling equities.

We also discussed whether to reduce the equity allocation in managed portfolios. Is market opinion correct and is it therefore still advisable to sell? Or should we consider the price declines as a buying opportunity?

In our view, sentiment was worse than actual conditions. Economic data deteriorated without doubt. The risk of a recession in the US also increased according to our own indicator-based analysis. However, we lacked crucial recessionary signals, which could justify a fundamental change in our assessment of the phase of the economic cycle.

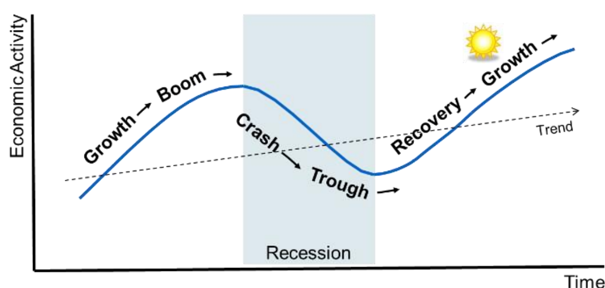
In a recession, data must deteriorate pervasively over the entire economy, persistently over several months and the slow-down must be pronounced in its effect. We were unable to determine the first of the three conditions with respect to the US economy. Particularly, the weakness in industrial production did not seem to be sufficient to bring the entire US economy into recession. The labour market and the large service sector remained robust and corporate losses were concentrated in the energy sector.

With regard to global risks for the US economy the question of the true engine of the world economy needs to be answered. Until the rise of China as a global economic power over a decade ago, the US was the undisputed driver of the global economy. Thereafter, buoyed by strong growth in China emerging economies grew much faster than developed countries. However, for some years, this difference in growth is decreasing because of slower growth in emerging countries. Because of their often one-sided economic orientation emerging countries like Russia, South Africa, Saudi Arabia or Brazil currently face the need for major structural adjustments. This bears risks

in implementation. Central banks respond to these risks and declining risk appetite in financial markets with cash injections at an extraordinarily high level.

Two further points encouraged us to hold on to our constructive assessment with respect to the US economy and to consider the market correction as a buying opportunity. The broad discussion of global risks implied that they were already largely priced into risky assets. Secondly, we must keep in mind that because of its size the US economy is still relatively independent of exports. There is even a good chance that the US consumer may once again become a relevant support for the global economy. The US locomotive could regain traction.

Future Prospects



The ARVEST Investment Committee assesses the overall global economy to be in a growth phase leaning towards weakness rather than boom. Since March we observe increasing signs of a stabilisation of US industrial growth. According to leading indicators a recession is not likely to be expected in the near future. The European economies will likely continue to recover. We expect only slightly lower economic growth in the Chinese economy.

Apart from economic development the ARVEST Investment Committee considers valuations of various asset classes when forming its investment policy. According to our preferred valuation methods stock markets are still fairly priced relative to cyclically adjusted corporate profits if we take low inflation and low interest rates into account. We hardly observe any irrational prices which market participants are often prepared to pay during a boom. On the contrary, market participants are quite sceptical or only show optimism in the short term. This does not apply to bond markets which can certainly be described as overpriced. In February, for example, 29% of government bonds of all developed countries had a negative yield to maturity.

The ARVEST Investment Committee pays special attention to regime changes that could affect currently meaningful valuation methods. The probability that commodity prices finally bottomed out in the last quarter increased substantially as we already discussed in our previous Investment Commentary. We did not notice any further significant developments in the last quarter. Given the current low interest environment the ARVEST Investment Committee prefers stocks and cash over bonds.

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On behalf of the Investment Committee
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