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More and more red flags

At the crossroads: first the hard facts, then the sentiment…

A guest contribution by Uwe Günther

Apple, the darling of the stock market, sheds around USD 50,000,000,000.00 in value, pillars of the US economy such as IBM and General Electric are under constant pressure and drop by 20% in 2018 alone, Goldman Sachs and Deutsche Bank shares suffer share price falls of between 20% and 50% in a few months. The omnipresent Facebook shares "correct" by 35% in four months. And the global economic engine China is under threat due to a trade dispute and real estate bubble and sees its stock market fall by more than 25% in a few months. Large chunks of debt-financed Chinese assets are invested in well-known ghost towns:

the default rate of bond obligors in China has already significantly exceeded that of the previous year. These are just a few of the many cases well-covered by the media - the problem is that these isolated cases are growing into a global problem.

Knowing smiles and perplexed amazement

From the perspective of a columnist, it is particularly interesting to observe how the "extreme fringes", no, not in the political scene, but the die-hard bears and die-hard bulls among the commentators are positioning themselves. Something interesting is happening here... oh wait, close to nothing. Crash prophets cheer, if at all, very cautiously so far. These see themselves probably confirmed and see, from their point of view, the logical development of the months so far only as a prelude to greater things. And those claiming that "every day is a buying opportunity in the stock market" are also exercising unusual restraint and silence.

If you were an observer, investor or financial expert back in the 2000s or 2008/2009, you will certainly remember the "buy on dips" mentality well. This seemed to be a no-brainer at the time, not least because many investors were sitting on profit positions and many thought they could risk some of it. After all they were still doing well! This cognitive dissonance bubble then burst rather painfully, as is well-documented, because the big money had other ideas and a large part of the book profits disappeared. Today, the wisdom is more likely to be: sell on each recovery rally.

Stop that thief!

So who has spoiled the party for the stock market? From my point of view, the main culprit can be identified very quickly and easily - it is the interest rates! Remembering that the bond market has a dramatically greater impact on the economy than the by size much smaller stock markets, the sharp increase in interest rates, especially in the shorter US dollar maturity range, is making its first clear impact. After years of a de facto zero interest rate policy, the yields of bonds with maturities ranging from a few months to 2-5 years literally exploded. Given that both debt-financed securities purchases (close to record highs), corporate financing (also for zombie companies), and relative investment decisions between asset classes are based on these, the result is not really surprising.

The new interest rate situation literally takes us to a new world (or vice versa back to the old world) and makes inflated valuations not worth the paper they are written on.

Why did it take until now?

Historically, there has always been a close correlation between the dynamics of interest rate changes and stock market performance. And even the time lag of approx. 6-12 months between cause and reaction is typical. In addition, Trump's tax cuts had a further delaying effect. Even we did not think it possible that a government would proceed with this act of self-inflicted harm caused by collapsing tax revenues. The long-term damage to the US and the global economy will be severe.

So what happens next?

One cannot repeat it often enough: extreme asset valuations are only sustainable if supported by short-term internal opinions and market sentiment. And it is still true - a share price does not give us any direct indications as to the attractiveness of the respective business model or company! Amazon, Tencent Holding in China or SAP in Germany have excellent business potential even if their share prices have halved! Interim recoveries are very likely until the “smart money” investors (SMART Money Flow Index) has given enough hot potatoes to late-cycle private investors.

Any changes in sentiment should be watched closely. If they tilt to the extent that market volatility rises sharply, this could have a particular impact on the following types of investments:

- **High-yield bonds and so-called junk bonds as well as investment grade bonds at the lowest level of the quality scale (BBB).**
- **Technology and e-commerce providers (so far hedge fund "darlings")**
- **Passive index funds under stress suddenly become very active...**

The following asset classes could benefit from a further stock market downturn, an approaching recession and the concerted central bank rescue efforts to be expected as a result. In the first phase of a possible market sell-off, however, these are likely to perform in line with less attractive asset classes before a significant decoupling from these could begin.

- **US government bonds (currently extreme short positions)**
- **Precious metals, commodity mines (extreme short positions in Gold)**
- **Equities and bonds from selected emerging markets**
- **Alternative premium strategies**

Conclusion: If you follow the wisdom of Warren Buffet "be fearful when others are greedy and greedy only when others are fearful" you will likely be fine in the future.

All the best and good luck in all your present and future endeavours!

Uwe Guenther and the BPM Team

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