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Decoupling of financial markets from the real economy

May 2020

- Unprecedented fiscal and monetary stimulus measures
- Monetary expansion as the main driver of the countermovement
- Massive expansion of money supply not inflationary for the time being
- Unchanged asset allocation and assessment of asset classes

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Stock market and unemployment race each other

The economic data is terrifying: in 2020, global economic growth is expected to reach the lowest level since World War II, while unemployment (especially in the US) has reached levels unseen since the great depression. The strong countermovement in stock markets these days is causing many observers to shake their heads. However, experienced market participants should know better and refer to the monetary expansion as an explanation. The size and scope of global measures is simply unprecedented in economic history. By the end of next year, the US Federal Reserve's balance sheet is expected to triple to USD 12 trillion through purchases of securities, which means that the central bank's balance sheet is about to reach half of the country's gross domestic product. The expansion of the banks balance sheet will not remain without an impact on money supply (M1), which has expanded by about one-third since the beginning of the year. The growth of money supply stands opposite a massive decline in economic output. This results in excess liquidity, which inevitably pushes up prices on financial markets. The so-called quantity equation also explains why the measures taken by the central banks so far had no inflationary effect. The expansion of the money supply took place at a time when the velocity of money was declining sharply, which can be attributed to the "lockdown" but also to cautious consumer sentiment which is still prevailing. Money not spent does not have an inflationary effect. However, it is likely to become uncomfortable for stock markets and other risk assets once the consumption-driven US economy bounces back strongly and inflation and economic growth start to race each other. The negative development to be expected on financial markets under these circumstances should then again lead to disbelieving amazement. Some readers may counter these arguments, which are derived from a simple model, with the fact that the current situation triggered by a pandemic is particularly complex and cannot be pictured by any economic model. We counter this somewhat casually by simply pointing out "how the land lies".

Sound Capital Investment Navigator

Valuation Bonds: 0

	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

Since our last report our set of indicators remains unchanged:

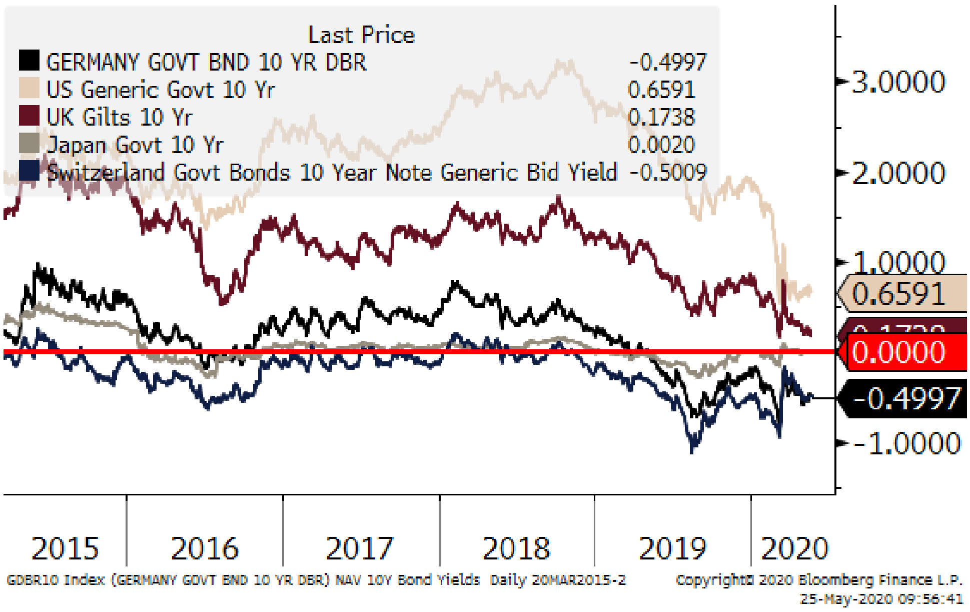
We continue to assess all asset classes neutrally, meaning that weightings of liquidity, bonds, equities and alternative investments remain unchanged.

In terms of asset classes, there are only two changes in the fixed income space: The rating of inflation-linked bonds is reduced from neutral to negative, while high-yield corporate bonds are upgraded from very unattractive to unattractive.

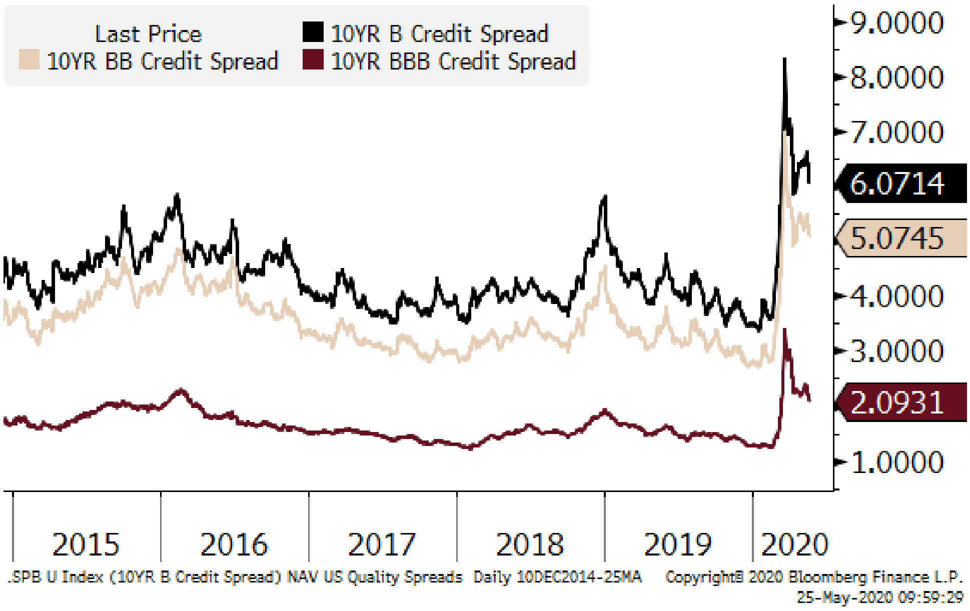
Interest rate level (indicator --) / Spreads (indicator ++)

Assessment unchanged / Assessment unchanged

The interest rates on government bonds are still at an extremely unattractive level.



On the other hand, credit spreads on corporate bonds are still extremely attractive. In this area, we prefer to pick "investment grade" bonds, while we continue to avoid high-yield corporate bonds for fundamental reasons (in anticipation of sharply rising default rates).

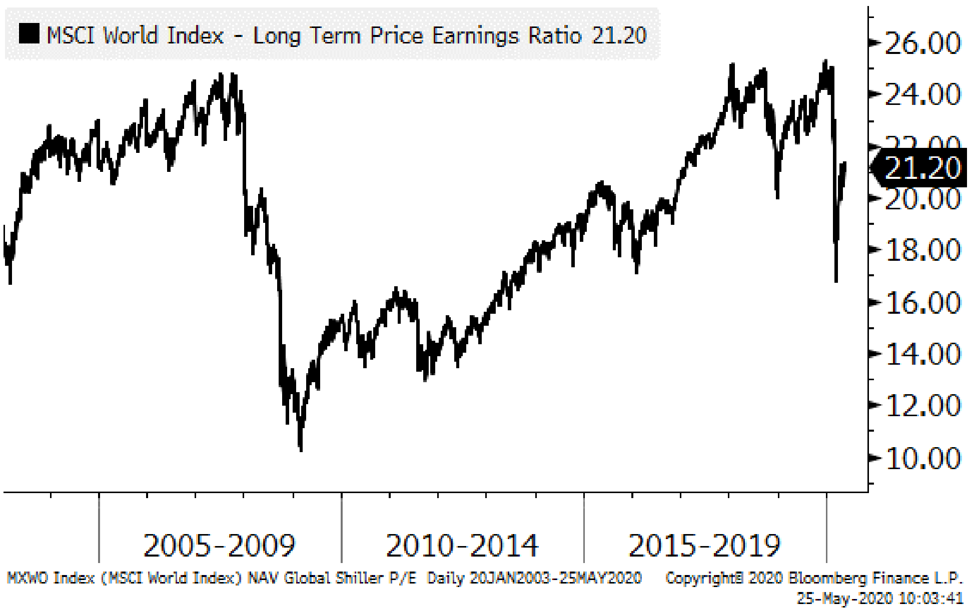


Shiller P/E ratio (indicator 0) / Risk premium (indicator +)

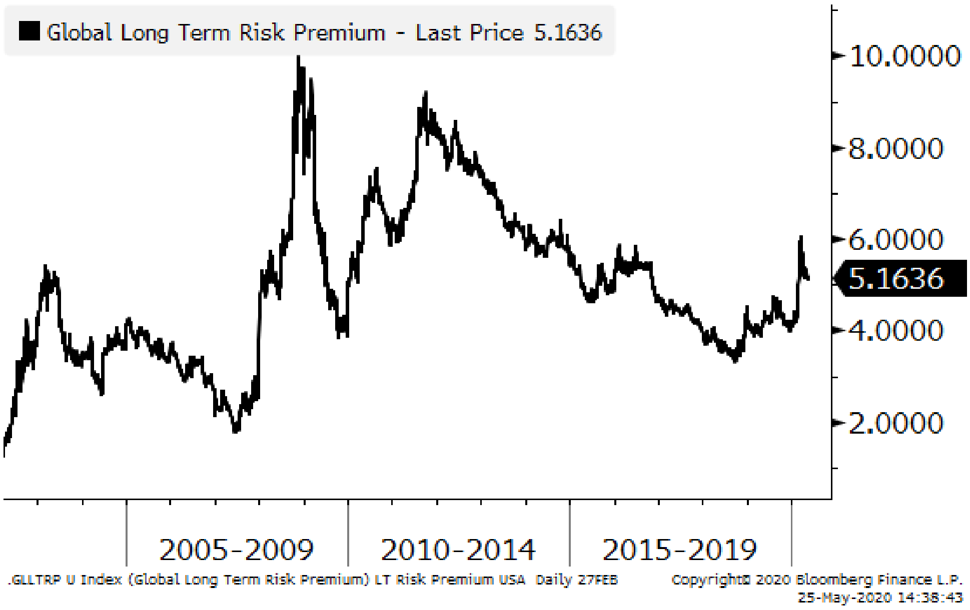
Assessment unchanged / Assessment unchanged

We strongly believe that cyclically adjusted earnings must be used to assess the absolute and relative valuation of equities. This is the only way to take sufficient account of the long-term nature of the discounting of future corporate earnings. Economic performance should not be distorted by particularly high (boom) or particularly low (recession) profits.

Due to the significant recovery of the stock markets, the absolute valuation of equities is still in neutral territory, but close to touching the expensive range.



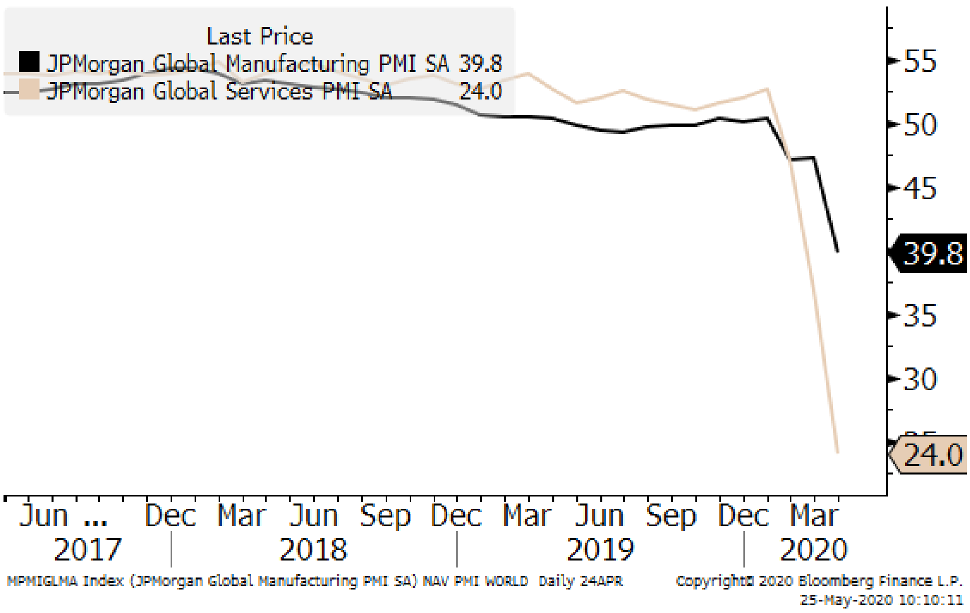
Risk premiums have also declined due to the rise in share prices. However, they are still at an attractive level.



Macro leading indicators (indicator --)

Assessment unchanged

Global purchasing managers' manufacturing data plummeted from 47.3 to 39.8 in April. With a decline from 36.8 to 24, the situation in the service sector looks even more catastrophic.



Risk index (indicator ++)

Assessment unchanged

In certain areas of the market, namely volatility (VIX) and option trading (put/call ratio), the situation continued to calm significantly. However, investor positioning and investment flows still show a defensive attitude. Therefore, the contrary risk index remains in extremely positive territory.