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INVESTMENT COMMENT

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Optimism yes, euphoria no

You can almost set your watch by it. As soon as the leaves start falling from the trees, the thermometer drops and the days become ever shorter, private investors, institutional investors, and the media all start asking the same question: Will there be a year-end rally in equity markets this year? The pondering always takes the same form: Will it come, will it not come, is it perhaps already over?

The year-end rally is a phenomenon that embodies the vague hope that global equity indices, or at least individual stocks, will surge once again in the final trading weeks of the investment year, thereby ensuring a glorious annual finale. Past experience shows that these expectations are not wholly without foundation. Anyone who pores over statistical time series will see that December has historically proven to be one of the strongest stock market months of the year.

Over the last five decades, equity markets have performed more strongly in the final month than over the year as a whole in more than two thirds of all cases. This phenomenon is true of the indices of all large and developed equity markets. What's more, the stronger performance towards the year-end has not been restricted to just "good stock market years" – this final surge has also been evident in years where markets have trended sideways or even performed negatively.

But what are the underlying reasons for prices often rising at the end of the year? One reason frequently cited for the year-end rally is the practice of so-called "window dressing". This refers to the tendency of many institutional investors to incorporate the year's top performers into their portfolios at the year-end, in order to give investors a positive impression when year-end reports are sent out: Fund managers can then proudly announce in their annual reviews that they have bet on the right horses. No fund manager will go on the record and admit to this practice, but it is probably widespread in the industry. There is no conclusive evidence to support this assumption, however. Another attempt to explain the year-end rally points to the tendency of investors to raise fresh risk capital at the start of the year, before then increasingly adopting an early positioning in equities at the year-end. Another explanation is rooted in investor psychology, and points to the generally more positive level of basic sentiment in the final phase of the year, which is connected to the upcoming Christmas and New Year festivities.

So how are the omens set for a year-end rally in 2017? The basic parameters needed for a continued rise in prices are essentially in place: The global economic recovery is intact, inflation remains moderate, and earnings are developing positively in the majority of industries and sectors. Europe and the emerging markets are currently the key driving forces behind global economic growth, which currently lies at 3.5% p.a. Sentiment indicators around the world – and again, this is particularly true of core European countries – have been steadily rising ever since mid-2016. The various geopolitical concerns that have reared their heads over the course of 2017 have had no (or at least only short-term) repercussions for markets. Basic optimistic sentiment has not been unsettled by the political uncertainty triggered by the elections to the Bundestag in Germany, or by international crises such as the North Korea conflict, or by the ongoing absence of the stimuli for the US economy promised by President Donald Trump. What's more, there is no evidence of any real

headwinds from the monetary policy side. The US central bank (Fed) has already prepared the markets for another rate hike in December, and so the definitive announcement of this move is unlikely to have any negative repercussions. The appointment of Jerome Powell as new Fed Chair-elect should likewise be viewed as a sign of continuity. Powell is considered a close confidant of incumbent Fed Chair Janet Yellen, and is accordingly expected to adhere to her existing policy line. In other words, he will avoid any excessively rapid increase in interest rates, to avoid jeopardizing the robust US economy. Market participants have also taken in their stride the announcement by the European Central Bank (ECB) that it will exit the QE program in a phased manner. Although the ECB will continue to spend billions on the purchase of securities next year too, the volumes involved will shrink significantly. From January 2018 the guardians of European monetary policy intend to purchase government bonds and other securities to the tune of EUR 30 billion a month. Up until December 2017, the monthly invested amount will remain at EUR 60 billion. What's more, the ECB is retaining the option of expanding both the scope and duration of its asset purchase programme in the event of the economic situation deteriorating.

That said, investors would be well advised to put this widespread optimism in the proper context. And not just over the next few weeks, but – much more importantly – also going forward into 2018. The global bull market has now continued for quite a while, and confidence has grown, but we are still a long way removed from a state of dangerous euphoria or any final phase of market hype. Time and again we have seen the upward movement punctuated by phases of weaker prices, and not all supposedly positive corporate news has been unreservedly accepted as such. When corporate Q3 results have been released, we have frequently seen how the shares of companies that have "only" fulfilled the expectations of analysts and portfolio managers have actually come under selling pressure. Pauses in momentum of this kind are very important, and testify to healthy markets. They show that market participants are still viewing developments with a critical eye, and are still carefully reviewing and scrutinizing all the available facts. At the same time, two fairly common features of a giddy bull market have been conspicuous by their absence this time around – M&A transactions being executed at levels that offer huge rewards to shareholders of the takeover candidate, and a large number of IPOs being priced in the fantasy zone. Both of these phenomena would be indicative of a dangerous overheating of equity markets.

Summary

Based on convincing fundamental data and dwindling political uncertainties, the 2017 stock-market year will fit seamlessly into an intact bull market. But the importance of what actually happens in the remaining weeks of the year should not be over-exaggerated. Above all, investors should keep a wider perspective. The current bull market is healthy and well-founded. We are a long way removed from a state of dangerous euphoria or even frenzied market hype as a precursor to an impending severe correction. Even if some stocks will benefit from "window dressing" as they do toward every year-end, while others succumb to last-minute profit-taking, the wider picture is the one that matters. And as things stand, that picture gives us reasons to be confident.

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