NOTOS NEWS | FINANCIAL MARKETS

The S&P 500 stock index is up about 10% this year reaching a new all-time high. But given the worrying level of corporate and public indebtedness in the United States which has refused to budge despite the booming economy, the market might underestimate the risks of rising interest rates and a slowing economy.

US STOCKS REACH NEW ALL-TIME HIGH

The S&P 500 stock index is up about 10% this year reaching a new all-time high. Reasons are plenty:
US corporate profits have peaked in the second quarter of this year, finance is still historically cheap - despite rising interest rates - and consumer sentiment marks its highest level in almost 15 years. Additionally, we are in the tenth year of undeterred economic growth.

TURNING TIDES CONCERNING INFLATION

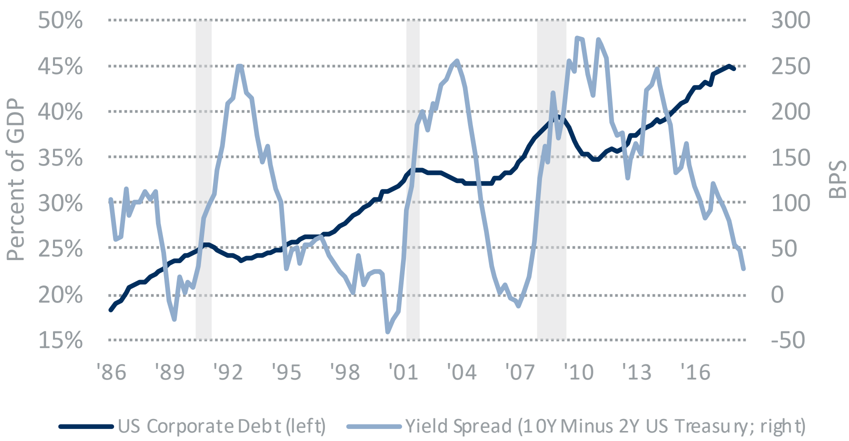
The booming US economy did not fall from the sky. The financial crisis of 2008 induced the US administration and the Fed to implement expansionary fiscal and monetary policies. Although the Fed started to gently raise interest rates two years ago, the cost of corporate finance across all ratings classes is still at historic low levels. Likewise, interest for government debt has remained quite moderate, as the 10y treasury bond rates remain shy of surpassing the 3% hurdle. The current high GDP growth rate of 4.2% q-o-q in the second quarter of this year is not surprising, given such an environment. The real surprise, however, is that US inflation has remained astonishingly low for quite a long time. Since price increases stayed well below the Fed's target rate of two percent until recently, the Fed was not under much pressure to reverse its expansionary policies. Although, figures show that the annual core inflation has begun to surpass the target rate in March this year, mounting up to 2.4% in July and thus challenging the Fed's so far accommodative policy stance.

TOO HIGH CORPORATE AND PUBLIC DEBT

Fostered by low costs of finance, leverage in the United States has never been this high before, be it

For more information please contact:
Michel Hoffmann
newsletter@notos-group.com
+49 40 609 455 00

WORRYING LEVELS OF US CORPORATE LEVERAGE AND TREASURY YIELD SPREAD



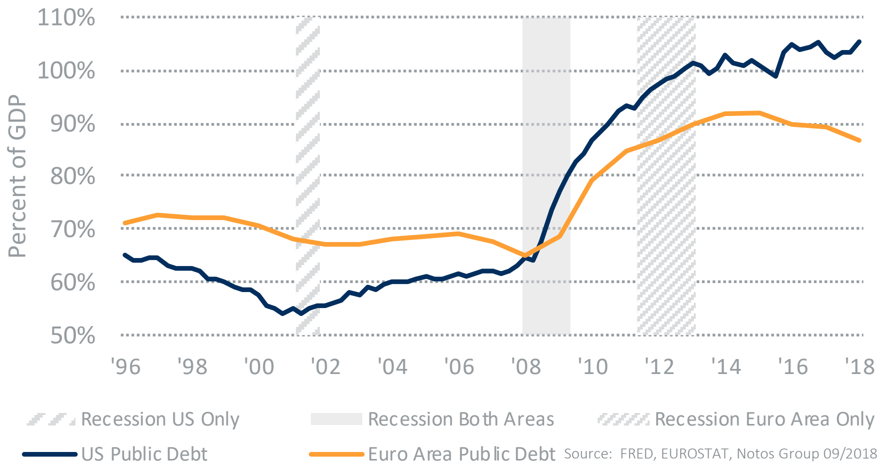
Source: FRED, Notos Group 09/2018

corporate or public debt. The graph on the previous page shows that after a short and hefty fall following the financial crisis in 2008, US corporate debt has steadily been gaining weight, meanwhile amounting to 45% of GDP.

Likewise, US public debt has increased from a pre-crisis level of about 65% of GDP to about 105% recently, as depicted by the graph to the right. Considering the latest tax reforms implemented and infrastructure measures planned by the US administration, US public debt is not apt to abate in the future.

By comparison, public debt in the Euro area, before the financial crisis of 2008, was at about the same level as the United States and it reached a high of 92% of GDP in 2015. However, as a result of the austerity policies introduced back in 2012 when the Euro debt crisis hit the single market, government indebtedness has fallen back to below 90% as of today.

STRONGLY INCREASING PUBLIC DEBT AFTER THE 2008 FINANCIAL CRISIS



Source: FRED, EUROSTAT, Notos Group 09/2018

THE CHALLENGE FOR THE FED

On the one hand, the Fed has to handle the risk of an overheating economy similar to the situation seen before the financial crisis in 2008. On the other hand, if the US central bank plays it safe and raises interest rates too rapidly, the thus increasing interest burden might thwart corporate America and the federal government.

By contrast, the Euro area seems to be better prepared in this regard, since deleveraging and fiscal restraints retained the upper hand, at least on the public debt side. But the Euro area faces different economic and political challenges which will most probably prevent the European Central Bank from abruptly turning its back to its current ultra-expansionary monetary policy.

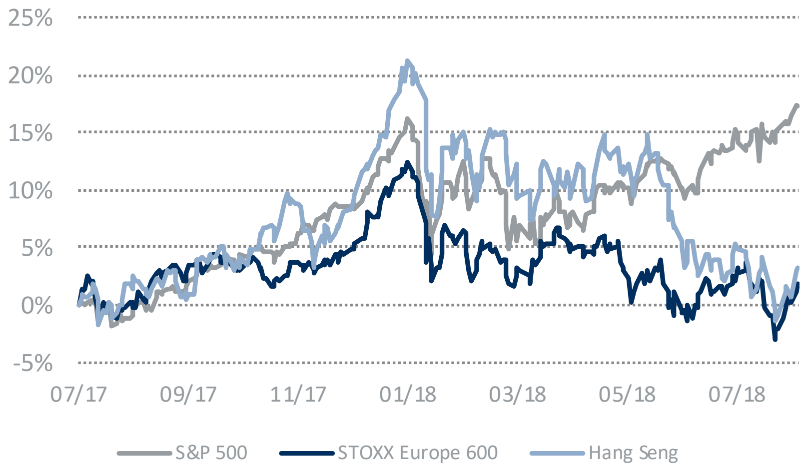
DELEVERAGING IN GOOD TIMES SAVES HEADACHES IN BAD

Deleveraging would be the logical consequence of higher interest rates and the complementary cooling economic growth. Although deleveraging is everything but pleasant, there is no alternative when the macroeconomic environment deteriorates.

Corporations usually seek to hold their interest burden at an ‘affordable’ level in line with their earnings or operative result. If this is not the case and the debt burden becomes too high, such companies will get punished by investors, banks and the public market in terms of higher risk premiums and overall fewer financing avenues. If the earnings decline as a consequence of a slowing economy, companies may face higher costs for capital and may have to resort to drastic measures in order to stay solvent. In the worst-case scenario, banks might even become less willing to lend to companies in order to reduce or maintain their risk, possibly triggering a credit crunch.

Same applies to the government as public borrower. When economic growth starts to weaken, public spending has to be reduced to maintain the current level of debt to GDP - and that even before taking into account the effect of rising interest rates. However, as governments should and would act rather anti-cyclically, the public sector is well advised to decrease spending in boom times to maintain scope for action in economically less prosperous circumstances too.

S&P 500 OUTPERFORMES STOXX EUROPE 600 AND HANG SENG INDEX



Source: Reuters, Notos Group 09/2018

Why this pessimism about the sustainability of debt when the US economy seems to be doing fine? We believe that a growth rate of three or four percent, as seen recently, is 'unnaturally' high for a developed and saturated economy like the United States and will have to come down to rather moderate levels in the mid- to long-run. The question remains how smooth this adaptation process will be and whether to expect major financial turmoils or 'just' lower growth rates.

TROUBLESOME FLAT YIELD CURVE

US corporates may be regarded as highly vulnerable currently with their all-time high leverage. Like the graph on the first page illustrates, during periods when leverage was high and the economy tanked - such as at the beginning of the 1990s, in 2001/2002 and during the financial crisis of 2008/2009 - corporations deleveraged quite rapidly. Given that US companies are significantly higher leveraged today than before the Lehman crisis, the consequences of a recession could be even worse this time.

The second line in said graph showing the yield spread between 10y and 2y US treasury bills reveals an almost flat yield curve today, meaning that market participants receive a very low interest premium for tying up capital in longer-term investments. In the past, such yield curve occured when the Fed was about to tighten its monetary policy in reaction to cooling down an overheated economy.

This yield curve even had predicting power in the past: Every time it turned inverse, the stock markets plummeted about six months later.

And we are currently just about 25bps from this point.

WHAT IS TO CONCLUDE FOR THE STOCK MARKET

The US stock market seems to be unperturbed about the outlook at present. The US financial markets' outperformance in recent months was substantial, especially compared to European and Chinese markets. Up to now, the S&P 500 beat the STOXX Europe 600 by 13% and the Hang Seng Index by even 15%, as shown in the graph to the left.

Fundamentally, Europe's relative underperformance may be a result of the uncertainty surrounding Brexit and the direction of newly elected Italian government's policies. Similarly, China faces the unknown outcome of its discourse with its biggest trading partner.

This contrasts with the US economy which may for much longer profit from the recently implemented tax cuts, besides the already mentioned sound fundamentals. But given the worrying level of indebtedness which has refused to budge despite the booming economy, the market might underestimate the risks of rising interest rates and a slowing economy. From an investor's perspective, this might be the right time to diversify across assets and reduce market risk through hedging.

DISCLAIMER

This document has been prepared and approved by Notos Consult GmbH and is for informational purpose only. The information presented in this report is intended for the recipient to whom it was delivered. Reproduction or distribution of this document in whole or in part is not permitted without the express written consent of Notos Consult GmbH.

This document contains forward-looking statements. We caution the reader that forward-looking statements are not guarantees of future performance. Past returns are no indication of future returns. The development of the industry, markets and companies described in this document, may differ materially from the forward-looking statement contained herein.

Information and opinions contained in this document have been compiled from sources believed to be reliable. Unless otherwise stated, any statements herein are based on our own estimates at the time of publication. Notos Consult GmbH makes no representation as to the accuracy or completeness of any of the information contained herein and accepts no liability for loss arising from the use of the information provided.

This document is not an offer of any kind. This report has been prepared separately from any proposed offering of any security and as such information herein must not be relied upon as having been authorized or approved by the issuer of such security.

PUBLISHER

NOTOS CONSULT GMBH
BALLINDAMM 17
20095 HAMBURG
GERMANY

CONTACT

T +49 40 6094 550 – 0
F +49 40 6094 550 – 92
INFO@NOTOS-GROUP.COM

REGISTERED OFFICE: HAMBURG
REGISTRATION COURT:
AMTSGERICHT HAMBURG | HRB 120813

MANAGING DIRECTORS:

DR. JENS ROHWEDER
DR. CHRISTINA STAHN