Sparinvest

# Monthly comment by Chief Strategist, David Bakkegaard Karsbøl

March 2014

## What turmoil in Ukraine?

The month of February has been dominated by news in Ukraine, but there is little evidence that the market has taken the skirmishes seriously to date. Russian stocks have fallen 10-15%, but other stock indices have remained relatively constant, and the VIX (a measure of expected stock market volatility for the S&P500) is virtually unchanged at 14-16.

You would think that a conflict that is reminiscent of the Cold War, and which has the potential to become one of the largest military confrontations since World War II, would strike fear into the hearts of equity investors. That has not happened, which probably indicates that most see this conflict in Ukraine as little more than sabre-rattling and displays of muscle rather than the prelude to greater military action.

No one has any financial interest in escalating the conflict. Russia's economy is relatively weak due to low energy prices and higher mining costs; about a dozen (mostly eastern) European countries obtain over 70% of their gas supplies via Russian pipelines (e.g. through Ukraine). In addition, the UK has benefited from Russian investments through London stock exchanges, and the U.S. is militarily occupied in the Middle East and does not need additional exposure.

However, there is still the risk of local Eastern Ukrainian separatists escalating the conflict now that Crimea has declared its independence. Short Ukrainian government bonds are trading at a yield-to-maturity of nearly 50%. So the market sees a significant risk of bankruptcy and/or restructuring. Although the EU is said to have a significant interest in seeing Ukraine refinance its debt in the short term, the market also sees the risks of undermining of the Ukrainian tax base as a result of the conflict.

## Weak macro data has disappointed

During the second half of February and the first half of March, we have seen some small disappointments in particular U.S. economic indicators, including ISM data. Some of these are explained by the unusual weather conditions, in the form of cold and snow, but there have also been disappointments that were not directly related to the weather. What data from the U.S. have in common is that whilst levels are not decidedly low (there is still talk about progress across the board), the signs of recovery have probably not been as broad-based and strong as analysts had hoped for. However, stock markets have given a decent return over the last month, so the enthusiasm here is intact (see the different market valuations in figure 1).

If we look at Europe, the macroeconomic data actually surprised on the upside - according to Citigroup Economic Surprise Index. This is probably mostly due to better-than-expected figures on retail PMI data and fixed investment in the euro zone. Our own indicator for euro zone industrial production shows we should expect that the current growth of about 2% should continue for the rest of the year and that industrial capacity utilization will continue to increase (see figure 2). With an expectation from analysts of about 1.1% GDP growth in the euro zone in 2014, it thus appears that the market may be pleasantly surprised in the future.

Figure 1 - Relationship Between Cape and Earnings Growth

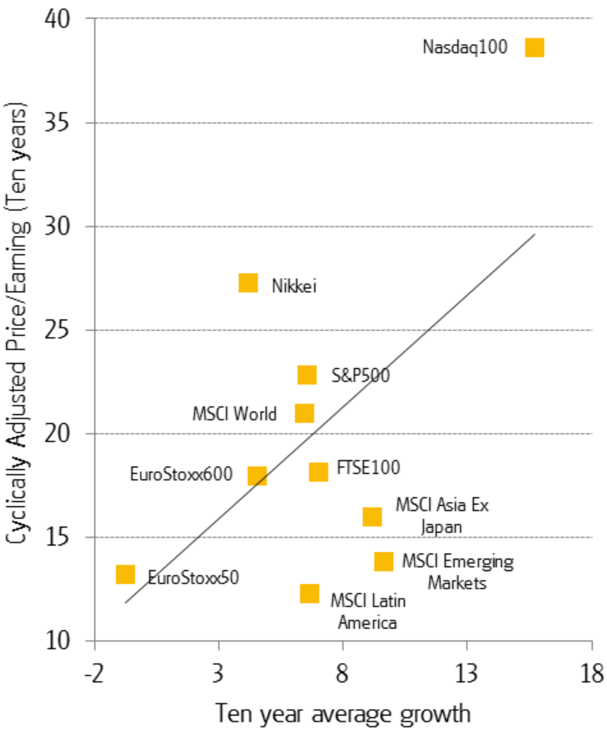
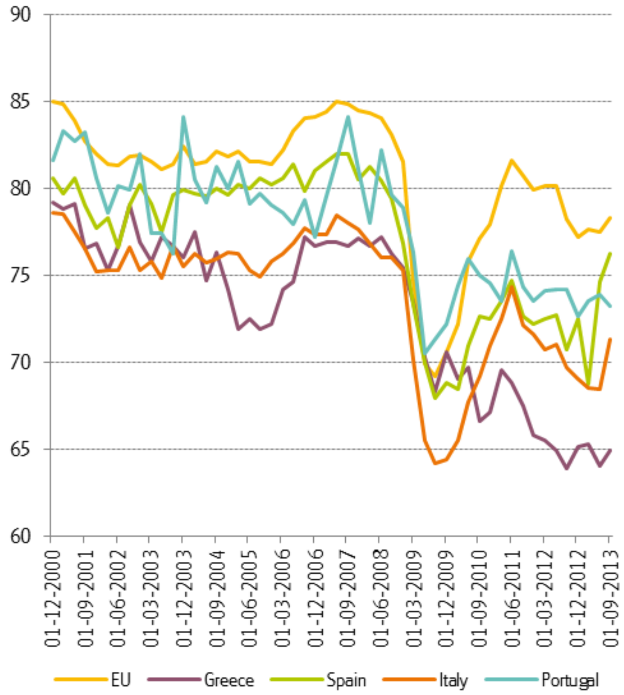



Figure 2 - Increasing Industrial Capacity Utilization in the PIGS countries




## Currency: further yen weakening on the cards

Eyebrows were raised in the market in early March when Japan's balance of trade figure for the month of January came out. The trade balance had already worsened dramatically in December - partly as a result of increased energy imports – and at that time indicated the largest trade deficit since records began in 1985. The figure for January (-1.589 billion yen) was even worse than in December (-638 billion yen) and expectations (-1.411 billion yen). Consequently, the already weak balance of payments also sank further, and it now seems that we should not expect that Japan's trade balance will return to surplus anytime soon.

This is an important development because the yen has traditionally had the status of 'Safe Haven'. In other words, the yen has usually increased in value every time the stock market and other risky asset classes have taken a dive. With the aggressive monetary policy being implemented by the Bank of Japan under Kuroda, this status may be further undermined. Kuroda has promised to double the money supply over a two-year period, and he is well on his way to achieving this. In addition, Prime Minister Shinzo Abe has led the market to anticipate the implementation of massive fiscal stimulus and reform. The stimulus is well underway, but the reforms remain to be seen. The intention of causing inflation has partially succeeded, and Abe hopes that inflation will also spill over into higher wages, although this has not so far materialized.

## EUR/USD to new highs

The EUR has appreciated further against the USD in the last month. This is probably because, as mentioned above, the U.S. macro data have disappointed, while European figures were in line with expectations – or better. Plus there have been changes in relative monetary policy expectations. In Europe these are now considered to be more stringent (compared to the euro zone economic situation) than in the U.S. We have previously written that we expected the euro's strength to ebb away as a result of continuing low inflation in the euro zone which brings with it expectations of expansionary monetary policy (low interest rates, acquisitions programs and possibly OMT, Outright Monetary Transactions). Against this background, it comes as a surprise to us that the EUR/USD rate has now risen further, but our expectation is still that the U.S. dollar will strengthen over the coming year and that Europe's export markets should benefit from this in the future.

## China remains a cause for concern

China continues to be a major concern for the market – apparently more so than developments in Ukraine. China's growth forecast is being revised downwards continuously, but it remains high compared to all developed economies. Copper prices took a sharp plunge of 8 per cent over three days in expectation of lower Chinese construction activity and due to the fact that copper stocks in China are already large, having been used as collateral for speculation.

In addition, a number of Chinese data have also shown a troubling tendency to weaken over the past few months. The annual change in industrial production is at its lowest level since 2009, money supply growth is historically low (second only to the periods 2000-2001 and 2011-2012). Meanwhile, the Yuan fell by around 1.5% against the USD, which does not sound like much - but it's the biggest two-week change since China began to let the Yuan rise in 2005.

If we look at China's retail sales, it appears that the Politburo has been unsuccessful in encouraging the Chinese to increase consumption growth. Although the growth of retail sales is 11.8%, it is actually the weakest growth since 2004. The annual growth rate of investment in fixed assets was 17.9%, the lowest in 13 years.

Although all these figures show an overall trend of weakening economic activity, it is important to emphasize that China's economy - due to its size and overall high growth - is still one of the most important growth factors globally.

A mild financial slowdown will be an advantage for investors with Chinese credit exposure because it will force debtors to be more vigilant. Although our bond team also believes that the slowdown in China, and the increased focus on the extent of bank lending, is good for investors in Chinese corporate bonds at the micro-level, they have reduced exposure to Chinese credit as a result of the more challenging Chinese macro developments.

## Europe's road to reform

Spain's economy is making steady progress. Exports have improved significantly, and recent figures for the retail industry have stabilized after years of decline. Moreover, it appears that the housing market also is stabilizing, and personal income has actually increased by 3.4 % over the last year.

Thus reform measures seem to be working in the Spanish economy. A number of labour market reforms have made it more attractive to hire and invest in Spain. Now the government is also about to introduce a tax reform aimed at reducing the cost of permanent employment as well as reducing income tax for the lowest paid. Spanish tax reform will be financed mainly by increased sales taxes and charges (see figure 3).

Similarly, Italy is picking itself up after a prolonged period of very weak macro data and great skepticism about public finances. The new Prime Minister, Matteo Renzi, has just introduced a tax reform – similar to Spain's – which will reduce the cost of permanent employment and reduce taxes for about 10 million Italians. The plan is to finance this by cuts in public budgets and the increased taxes on capital gains.

The third- and fourth-largest European economies are thus on track to implement major reforms that will further reduce unit costs and encourage investment. Bond markets have acknowledged reform successes by sending the already low interest rates for European new issues even lower, and this is of course gives further support to the European economies.

## The equities landscape

Monetary policy remains an important and supportive factor for the equity markets, but there are big differences in how they have responded to this stimulus. As previously discussed, we find U.S. stocks in particular very expensive and thus our funds' exposure to the United States is relatively small.

We have higher hopes for European equities, which have high operational gearing (i.e. the ability to expand production significantly without major additional cost) and particularly for emerging market equities which are historically cheap. Of course cheapness of these markets also reflects fears of further escalation in Ukraine and further weakening in China.

However, on close inspection, it remains our view that the global economy will be growing in the next six months. This will be especially supportive of EM equities, including – to some extent – Chinese equities, although the Chinese stock market will probably continue to be one of the weakest markets.

Besides the improvement in the outlook for the global economy development, it is also a supporting factor that (at least in developed countries) stock markets' momentum is intact. Only one month – January – has been negative in the last six months. Market corrections are often characterized by an increasing proportion of negative months. So with this in mind, we expect equity markets across the board will do fine in March-April.

## Corporate bonds

As mentioned earlier, we do not believe that the Chinese slowdown is a substantial risk to corporate bonds at this time. Rather, it may actually be a positive development, especially for Chinese issues.

We continue to see that new issues of Investment Grade quality offer the best expected risk-adjusted return, but we recognize that the current levels of interest and issue quality (with covenants) eventually force one to question the long-term returns that can be achieved with a benchmark-hugging strategy.

## Government bonds

European government bonds have delivered excellent results during the year. Effas index of +10-year European government bonds has risen by 6.7% since the start. This is probably because, as discussed above, the European states are steering a stable path to reform, and because the market is worried about developments in Ukraine and in China.

Emerging market government bonds over the same period decreased, but the yield differential between developed- and emerging-market government bonds is starting to look quite interesting.



Figure 3 - Unit Labor Costs in the EU