Sparinvest

Monthly comment by Chief Strategist, David Bakkegaard Karsbøl

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Indicators for manufacturing - promising for the European Union

The indicators for the manufacturing industry still point to a stronger European growth over the summer and actually until the very end of 2015 (where the models' horizons end). It is Germany in particular, which is about to experience a return to growth after a weak end to 2014. Next comes Italy, which is also good because the country could do with a little momentum. France is hopelessly behind, and, according to the models, is barely performing well enough to 'flatline' for the rest of the year.

If we look at the US, the picture now clearly shows a V-shaped recovery is in prospect. Unfortunately, we have not yet seen the bottom, which by all accounts, is going to occur in the late summer of 2015. However, the models indicate that the US economy can come back strongly towards the end of the year.

Emerging Markets looks more and more promising, and stock prices have also been reflecting this, but there should still be something to pick up. The models show that the Asian countries in particular will experience even stronger growth, which is essential for long-term investors. It is primarily the growth of the Asian countries that will determine the returns from Emerging Market equities relative to those from developed countries' stock markets.

Given that EM equities are still relatively cheap, compared with those of developed countries, it makes sense to expect strong returns for both EM equities and EM currencies over the coming months.

Outlook for production growth

	Growth change	Current growth	Estimate (2015)
EU	3.1	0.1	3.2
Germany	3.7	-0.1	3.6
France	0.5	0.5	1.0
Italy	4.2	-2.2	2.0
Spain	2.2	-0.6	1.7
USA	0.5	4.4	4.9
Japan	3.9	-1.1	2.9
Emerging Markets	2.8	3.1	5.9
Asia	3.0	5.3	8.3
Latin America	5.7	-1.4	4.3
World	1.9	2.5	4.4

Beware of inflation in Europe

There is no doubt that the announcement of the ECB's purchase programme (QE) has had a major impact on the pricing of European assets. European equities, bonds and property have increased considerably during the past six years, since speculation about the purchase programme began.

One of the results is therefore record low interest rates, especially in the bonds that are 'eligible' (ie approved) to be purchased as part of the ECB's purchase programme. As a result, we now see that the lion's share of European, long government bonds traded at a yield of less than 0.5%. With market expectations of long-term inflation standing at 1.68% (according to the so-called 5Y5Y inflation swaps), investors are therefore almost certain to lose in real (inflation-adjusted) terms by investing in long-term bonds.

It could be even worse if inflation expectations - and thus long-term rates - rise. Already, we are seeing signs that – only a few years back – were considered early indicators of higher inflation: 1) tighter labour markets, 2) higher wages, 3) lower currency and 4) static import prices (no longer falling). Oil prices, which have a relatively large impact on the general price development in EUR, increased by almost 30% since mid-March.

The Eurozone unemployment rate has now fallen to 11.3%. OECD estimates the NAIRU (i.e. the level of unemployment below which upward wage pressure begins to occur) to be at 9.7%. At the current rate of improvement in the labour market, we can expect to begin to experience a greater upward pressure on wages within the next 18 months. This will also coincide, according to our preliminary data, with the expiry of the ECB's purchase programme. As the market always tries to anticipate the course of events, however, it would probably be unrealistic to expect that it would take such a long time before long-term rates begin to rise again. Like so much else in the market, it is a matter of timing.

My best guess at when we will see interest rates beginning to rise again is that it will happen over the summer of 2015. The European economy, by all accounts, has improved significantly while, at the same time, the United States seems to have 'bottomed out' from the current mild setback.

The importance of higher interest rates

While short-term rates (as determined by the central banks) will remain low for some time yet – especially in the euro zone – the consensus is that long-term rates are also close to the bottom. This is quite important for the long-term investor's asset allocation. In the past decade, there has been a fairly close correlation between the development of long-term interest rates and the returns demonstrated by Value-investment strategies relative to Growth investment strategies.

Value-companies (ie equities that are cheap on P/B, P/E, P/S or dividend yield) typically have a relatively large share of their future earnings in the near future, while for Growth companies, typically traded on the basis of an anticipated growth in earnings, a higher proportion of future earnings is projected further into the future.

In order to estimate the present value of companies, their total future cash flow must be discounted to the present. Therefore when the yield curve falls, the value of Growth companies tends to increase relative to Value-companies (and vice versa). The huge drop in interest rates that we have seen since 2007 is coming to the end of the road. Of course, we may still see lower interest rates as a result of the ECB's purchase programme and a general scarcity of bonds which meet the purchasing criteria of the programme (i.e. highest credit quality that specifically Germany can provide), but the long-term, fundamentals must necessarily point to higher interest rates.

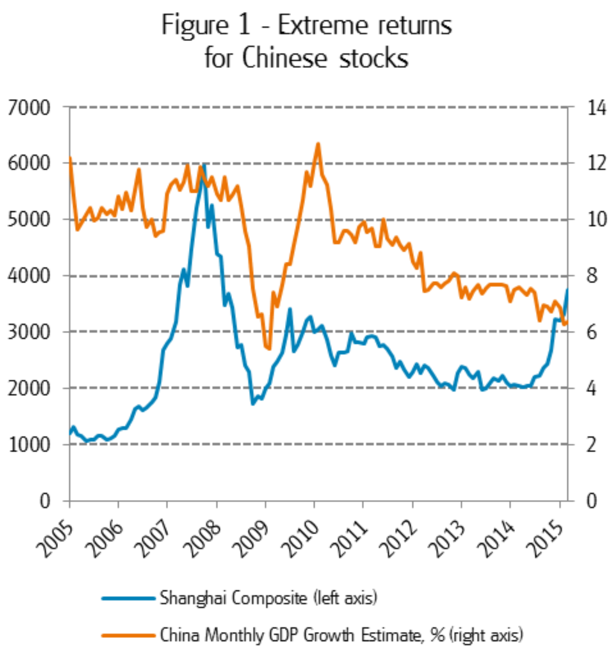
The strained development in Value stocks therefore seems destined to end in the foreseeable future. We have already had a foretaste of trends that can cause Value-equities to outperform relative to the general market and to Growth equities. We saw this in particular from mid-2013 to mid 2014. However, with the large decline in interest rates that occurred in late 2014 and into 2015, this outperformance trend for Value-equities reversed. With flat-to-rising interest rates in prospect, Value investors can therefore see the light at the end of the tunnel.

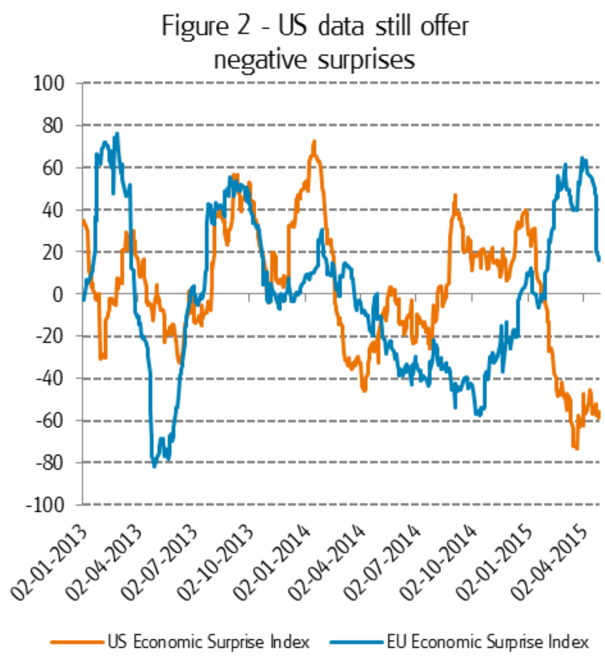
China - a bubble in stocks?

There has been a lot of light at the end of the tunnel in China in the past year. Not the economy, but for equity investors, as the Shanghai Composite has delivered a return of over 100% in less than a year. As is the case in Europe and the United States, the stock market in China has been gradually driven higher – primarily by expectations of government, fiscal and/or monetary stimulus programmes.

In response to the weakening in the economy – with lower property prices and lower activity in the otherwise red-hot real estate market – the Chinese authorities have taken the following steps. They have lowered the requirements for the banking system reserve ratios by 1%; injected USD 60 billion into the banking system (by converting bank bonds to equity) into three of the most significant 'policy banks', and introduced a new refinancing programme, which is reminiscent of the ECB's LTRO programme. The number of new accounts set up at Chinese brokers suggests that the Chinese have turned their backs on casinos and are now putting all their chips on one board: the stock market.

For long-term investors Chinese equities are beginning to look dangerous. First, there is a distinct whiff of speculation when they can rise so much in so little time. Second, they have gone from being relatively inexpensive to being relatively expensive. And third, it is feared that, due to the general weakness in the Chinese economy, the authorities may be forced to launch more frequent and bigger stimulus programmes to keep the stock market party going.





USA - further weakening in the data

As discussed in recent monthly reports, I expected a general weakness in the US data. This is now well under way, but as mentioned above, is likely to continue for some months yet.

The strong dollar and a general over-optimism at the turn of the year, as well as the expectation of imminent tightening of monetary policy, has led investors to take a break from an otherwise extremely satisfactory development in recent years. Job figures for March were quite weak, and ISM data also showed a weakening trend. Retail sales have now risen only 1.3% in a year, and capacity utilization, and building permits and house building have also disappointed.

It is important for me to emphasize that the United States, in my opinion, is not heading into a recession. There is just a general weakening in relation to the high expectations that the United States started the year with. In my assessment, the United States for the year as a whole show a decent growth, but we will see some disappointment over the summer.

Greece

The situation in Greece is still acute. Greece's nominal GDP is still 25% lower than before the crisis and the debt to GDP ratio has almost doubled. At the same time, expectations for GDP growth for 2015 in Greece during the month of March decreased from around 1.3% to about half as much.

Judging from interest rate developments in the euro area sovereign debt, Greece is still an isolated and therefore manageable problem. Greek government bond yields have fallen slightly in recent days, but they are still significantly higher than the government bond yields of other countries, and the co-variation with these is quite limited. In other words, the market does not currently expect that the opposition to austerity and reforms demonstrated by Greece will spread to the other southern European countries.

In the last week decided the Greek prime minister, Alexis Tsipras, decided to sideline Yanis Varoufakis, the Finance Minister who has previously been primarily responsible for negotiations with the Troika. Until now, negotiations have not borne the fruit expected from the Greek side, and dissatisfaction with the results are seen now in opinion polls in Greece. That Varoufakis's role is now limited has been interpreted positively in the market, which can now envisage a final and acceptable agreement between Greece and its creditors. However, there is no doubt that there is still a long way to go.