



## Monthly comment by Chief Strategist, David Bakkegaard Karsbøl

February 2015

### The Greek can is kicked down the road

During February, nothing in the Eurozone has had as much attention as Greece. European finance ministers have now (as of February 20) signed an agreement with the Greek government to delay repayment of the massive bail-out loan from the Troika (IMF, EU and ECB) for a further four months. (The loan was due for immediate repayment.)

The preliminary agreement also includes a provisional target for the reduction of Greece's massive surplus on state finances (before payment of foreign creditors). In return, the Greek Government undertook inter alia, to increase the efficiency of tax collection and combat smuggling.

A number of conditions must now be agreed by the Greek government. Although these conditions are secret, it is the market's clear view that they are merely a formality and that Greece has 'kicked its can down the road', gaining a reprieve of four months.

Thus, calm is restored to Greek-related assets. Greek government bond yields fell after the conclusion of the agreement, and Greek shares also by rose more than 10 per cent.

That said; we still expect the problem to re-emerge before the four months are up. The Syriza government has promised too much in the election campaign to be able to lie down submissively in front of the Troika. Conversely, the Troika also has too much at stake to be able to relax its requirements of reform and financial restraint from the Greeks too much. Too much leniency in the face of Syriza runs the risk of sparking off similar protest movements in Spain and Italy, which have the potential to grow big and put the (small) progress towards reform achieved to date at risk.

My overall assessment is that Greece has won more in the agreement than the Troika, and that this has actually only deferred the hassle of finding a real solution which, of necessity will mean unpleasantness for both Greece and the Troika.

### Eurozone figures keep improving

Leaving aside the fuss in Greece we see the Eurozone continuing to improve. As previously mentioned, I expect increasing growth rates until the summer of 2015 where we can expect industrial production growth of almost three percent.

As the New Year began, we could already see improvement in PMI, ZEW and IFO figures for both the Eurozone and Germany, and during January and February, the figures continued to show improvement in the overall picture. Therefore, we expect the coming months to see further strengthening of economic growth.

### Leading indicator, Eurozone consumer spending



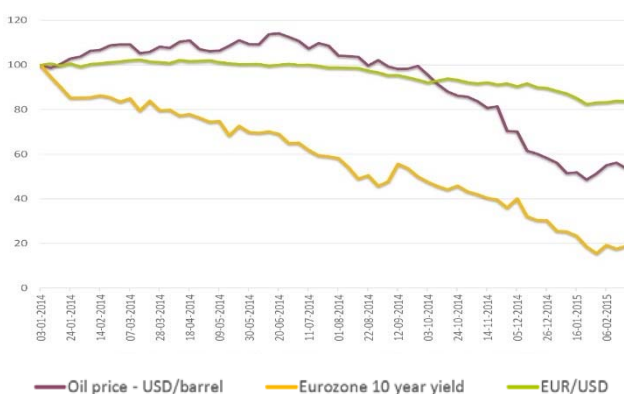
If we look at indicators that are important for the slightly longer growth perspective, there is also good news here. The figures for the number of Europeans intending to buy a new car and for those intending to buy a new house have increased significantly over the past year. Granted, the actual figures for house purchase have not improved significantly, but car sales in the Eurozone have actually already recovered considerably, and the data shows that there is significant correlation between the intention to buy a house and actual future home buying. As house prices rise on all national European markets, and as mortgage rates have fallen hugely during the last six months, we can look forward to a positive trend in home equity values in Europe over the next year or two.

It is still my opinion that the Eurozone is going to do well in 2015. In an investment climate characterized by an extreme pessimism for the prospects of European assets (especially in relation to market expectations for the US), any incremental improvements will be viewed as positive surprises over the coming months.

The economic reasons for the improvement in Eurozone growth prospects - apart from increasing house prices in all Eurozone countries - are primarily the low Euro (which has improved the competitiveness of European enterprises) and low energy prices, which gives more spending power to consumers.

Disinflation (ie lower growth in consumer prices) or deflation (falling prices) also assists consumers when nominal wage increases are unchanged. Real wages rise, and therefore we continue to expect a moderately strong growth in consumption. Latest figures for growth in real consumption were 2.8%, the highest growth since March 2007.

### Three important Eurozone stimuli - oil, interest rates and EUR depreciation



## Over Optimism in the United States and American Consumer Shares

As discussed in last month's report, it appears that the United States is characterized by a moderate over optimism. The major strengthening of the dollar is gradually becoming a heavy towing anchor for US companies which are now taking a hit on exports.

In addition, it seems that the banks' readiness to provide consumer credit is declining. This typically affects consumption growth after a period of 3-6 months, and this, in my opinion is not priced in to US stocks. Consumption-related stocks in particular may be hit by a return to a greater degree of realism. MSCI Consumer Staples for the United States basically has not seen earnings growth since the end of 2012. It should worry investors in the consumer-related stocks that the index at a P/E of 21.

The P/E for the MSCI USA, based on the next 12-month's earnings, has risen to 18.1 - the highest in 13 years. Such a high level indicates an optimism that can not necessarily find justification in the economic development that the US faces in the next 12 months.

The trend in rising house prices in the US is also declining - from a breathtaking 13% in late 2013 to around 4%. This is still considerably higher than inflation, but it will not provide the same support for consumption as before.

I expect, therefore that the growth in both consumption and industrial production will slow down until the autumn of 2015 and the Federal Reserve might well postpone the first rate hike for many years, but as the labor market tightens, we inevitably move closer and closer to the point where it will be forced to raise interest rates.

## Shares - strong momentum in Europe

One must say that the European stock market got a much needed kick-start from the announcement of the ECB's Quantitative Easing program. The strong momentum generated by this continues into February, and it is my expectation that European equities may provide significant excess returns in comparison to US equities in the rest of the year.

There are other reasons for expecting excess returns. Firstly, there is a significantly higher unemployment rate in the Eurozone than in the United States, thus reducing the likelihood of wage pressure (and hence downward pressure on corporate

margins) and rate increases for European businesses. Secondly, the Euro declined significantly, which increases competitiveness. Thirdly, interest rates declined considerably, resulting in lower financing costs for European businesses. Fourthly, it is the market's (but not necessarily my) opinion that the ECB's QE programme will stimulate growth and willingness to assume the stock risk. Fifthly, European shares are simply less expensive than US equities.

### MSCI Europe (USD)/MSCI USA (USD)



### The Danish Krone - solid as a rock

Over the past month, a large proportion of the Danish media has published sensationalist articles regarding the pressure on the Danish Krone after the Swiss National Bank (SNB) gave up the ceiling of the Swiss franc (CHF) and let it appreciate by almost 40% on the same day.

Certainly many foreign investors would like to participate in a similar upturn in Danish Krone against the Euro. However, the bulk of demand for the Danish Krone has presumably come from domestic investors who can, for example, move their bond exposure from Euro-denominated assets to DKK denominated assets and still receive the same - or higher - interest rates. At the same time, they can secure an in-built option for the (low) likelihood event that the National Bank would let the Krone follow the CHF higher.

In all probability it is unlikely that the Danish Krone in all probability will budge. Its peg to the Euro is politically determined

and Lars Rohde (Head of Denmark's National Bank) would automatically lose his job if he let the Krone appreciate. A political decision to allow Krone appreciation is not imminent. The fixed exchange rate has been operating for 23 years, without too much trouble and if it ain't broke, don't fix it.

It is possible that the fixed exchange rate has not always been optimal for the Danish economy, but it is certain that there currently is no compelling arguments for abandoning it.

The pressure on the Krone will therefore in all probability diminish further. Already now we can see considerably less pressure in the forward market for the EUR/USD currency junction where there is less willingness to pay so much in 'differential rates' to buy Danish Krone in the future.

The cross rate, EUR / USD has also risen again (ie USD has fallen back) to 7.46 - the highest since June 2014.

### Slight rise in inflation expectations

Long-term inflation expectations, which are an essential input in the central banks' decision-making, have moved higher since late January. In the United States they increased by almost 20bp. and in Europe they increased by about 8pb. In Britain, they rose by 56 bp.

To me it seems paradoxical that inflation expectations should rise more in the US than in Europe, when macroeconomic data clearly has surprised more positively in the Eurozone than in the US (where they actually have a negative surprise during January to February).

As a result of higher inflation expectations, interest rates in Europe have also already risen slightly - not least in Denmark, where the upward pressure on the Krone (see above) has slowed since mid-February.

It is my assessment that interest rates are going to stay weak over the next few years. It's probably difficult to get the market to depart from the opinion that Europe is chronically growth challenged, and that therefore long-term interest rates must remain low. Nevertheless, increasing economic activity towards the autumn probably could convince at least some part of the market about the need for a generally higher and steeper yield curve in the Eurozone.

### Corporate bonds

The High Yield market as a whole has seen great returns since mid-January. Unfortunately, our own High Yield funds still have a large exposure to the energy segment, which is still suffering

from low prices. We have therefore had to be content with a flat development.

However, our Maturity Funds have performed well, and our Investment Grade funds have actually fared brilliantly. Macroeconomic factors remain supportive for corporate bonds. Both the ECB and the Federal Reserve's recent lending surveys show that European and US banks still expect to relax their lending standards over the coming months.

Moreover, interest rates remain low, which encourages investors to take on more risk to get a return.

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