Sparinvest

Monthly comment by Chief Strategist, David Bakkegaard Karsbøl

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American monetary policy again in focus

After Greece's agreement at the beginning of July, the markets have begun to refocus on other, more significant relationships. Thus, the American central bank resumes its place at centre stage. In July, the FOMC amended the wording of its usual statement by adding the word 'some' about the improvements in the labour market.

The fact that the U.S. labour market has experienced a tremendous improvement over the last six years is beyond discussion. In any other cycle, the Fed would have raised interest rates long since, and it is the continuing low level of inflation which is holding Janet Yellen back from doing this today.

The market took the latest statement as reflecting a tightening up of the rhetoric, but the latest figures for the change in costs related to the labour force (Employment Cost Index) was not only far lower than expected – it was the lowest ever at 0.2%. There is something fundamentally strange in the decoupling that has occurred in the relationship between the labour market and wages. Given the current unemployment rate in the United States one would expect significantly higher wage pressures. It is still my opinion that we are going to see these higher wage pressures, and that now we have seen the bottom in wage inflation. I would not be surprised to see the figure revised in a month's time.

However, the market was taken by surprise and sent the expectations for interest rate rises down further. Thus, market prices for short interest rate futures suggest only a 38% probability of an interest rate increase from the fed in September. There is no doubt, however, that austerity is now just around the corner, and if that does not happen in September, it will happen in October, November or December.

EUR/USD

The prospects for a tightening of U.S. monetary policy have already strengthened the U.S. dollar substantially since mid-2014. As I have previously written, there has been a historically large increase in the dollar – both against the Euro, and most other currencies. After a period of consolidation since it bottomed in the month of March, the EUR/USD has increased. However, we are now seeing the dollar strengthening again, and the euro weakening as a result of lower inflationary expectations and thus lower expectations for future European interest rates.

We have previously seen long periods of dollar strengthening, and it would not be surprising to see it recover its recent strength and continue another year (as happened in the first half of the eighties or the latter half of the nineties). With the return of rate hikes in the United States as the theme in the market and the prospects for a recovery of the U.S. economy (see below), it is therefore probably time to revise my positive Outlook on EUR/USD. I am therefore now neutral again – despite the continuous improvement of the European economy.

Continuous improvement in the Euro Zone

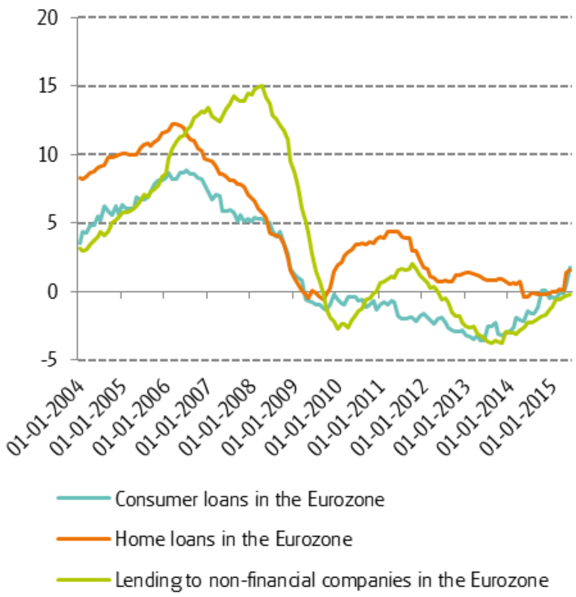
The positive spiral continues in the Euro Zone. Virtually all important key figures are pointing in the right direction. Unemployment continues to fall (now 11.1%), and total employment in the Euro Zone is rising now faster than at any time since 2008 (an annual increase of 0.8%).

Apart from a single quarter in 2011, the Euro Zone's manufacturing industry capacity utilisation is at the highest level since 2008. Industrial production is even in a good stretch for the Euro Zone. According to our leading indicators, Germany, Italy and Spain, in particular, look set to deliver solid growth for the rest of the year, while France is still dragging its heels.

We look at the construction sector, there also appear to be signs that it is on track for a speedy recovery. The number of important building permits in the Euro Zone has increased by about 13% in a year, and even Spain is now seeing a return of building activity in an otherwise completely depressed market.

After nearly four years of stalemate, the Euro Zone's bank lending to households has increased to stand at 1.2% (this change could have a significant effect on consumption growth in the future). Loans to consumers have increased by 1.8% in a year, which is an even more powerful change from the trend after the Euro crisis in 2011. Loans to non-financial companies have also improved by exhibiting a smaller decline (-0.2%), but this trend is also in strong recovery, and during the summer we will probably see growth rates on the right side of 1%. These figures do not sound like much, but when you compare them with the development from 2011-2014, the improvement is almost in a different league, and this will in all likelihood will be of great importance for the Euro Zone's growth in the next few years.

Figure 1 - Lending growth in the Euro Zone

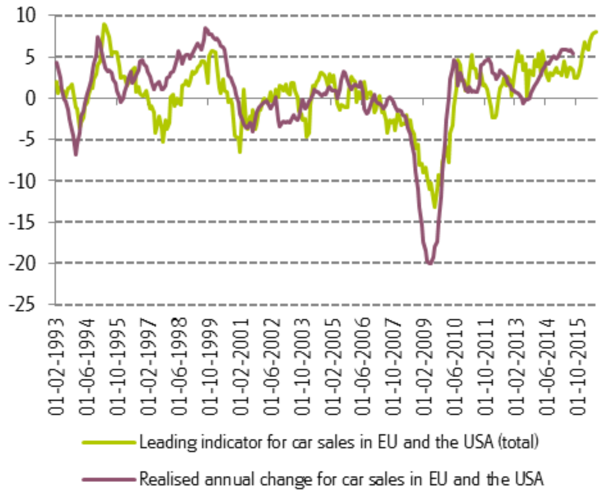


Looking at the ECB's Lending Survey for the largest European banks, the latest figures show that although the change in the lending market is not expected to be as positive over the next three months as in the previous three, nevertheless the demand for loans from both households and businesses is expected to be at near record levels.

The global economy

It's not just Europe that is on the mend. If we look at our global indicators, there is not much to be pessimistic about in the coming six months. Our leading indicators of total car sales in the European Union and the United States shows that we can expect growth of almost 8% over the next 12 months.

Figure 2 - Car sales in EU and the USA

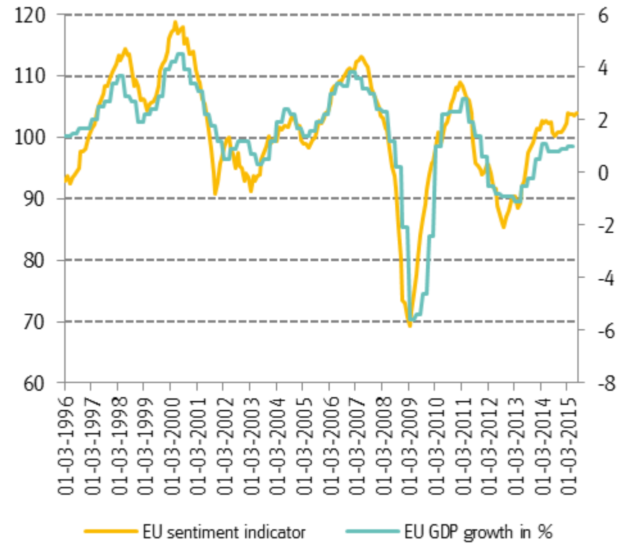


The leading indicators for industrial output suggest further recovery, into 2016, from what is already a respectable level – particularly for United States. In addition, Japan also seems set for a virtually constant increase in the growth rate of industrial production over the coming 12 months.

High rates of growth in M2 money supply from the ECB (5.2%), FED (5.8%), the PBOC (3.4%) and BoJ (3.8%) – along with moderate inflation – has resulted in huge growth in real (i.e., inflation-adjusted) money supply for three out of the four biggest central banks.

By looking at the so-called 'excess liquidity' (i.e. how much the real money supply growth exceeds the GDP growth in the countries concerned), we can get an idea of how big an effect the central banks' policies may have. Periods of high excess liquidity tend to be followed by high returns in the stock market and higher long-term yields and curve steepening for bonds (and vice versa).

Figur 3 - EU GDP growth and sentiment indicator



It is therefore a sign of solid economic growth and relatively strong equity markets, that we are now seeing a G4 (GDP-weighted) excess liquidity of 3.7%. It will probably mean that the stock markets and real estate markets, especially in the Euro Zone and Japan are going to do pretty well over the coming 12 months.

With respect to real estate markets, the Dallas Fed has just published the latest quarterly figures for House prices (up to and including March-2015). In Europe, it is virtually only in France, where house prices are still falling nationally. In all other locations, prices are now rising nicely. Even in Italy, prices have now risen 2.4% since the bottom in the housing market in Q3 2014.

Given the normal seasonal variations, house prices will almost certainly show a rising trend, when we get figures for Q2 2015. Here again, we are talking about a good spiral, because banking and mortgage systems security is enhanced by rising house prices, and the value of home equity. So this development is likely to give impetus to the already rising rate of consumer spending in both the Euro Zone and in the United States.

Disappointing EM figures stem from China

In Emerging Markets, I must admit that our leading indicators have done little to capture the changes in growth seen over the last 12 months. In the first six months of this period, growth in emerging countries' industrial production was at 4.1%, before dropping to an average of 3.3% in the second half of the period (until now). The model for EM countries had predicted an increase in growth of almost 2% points. At present, the model predicts an average increase in the growth of industrial production for EM countries of 1.67% points over the next 12 months.

If the EM countries' model has been wrong, it is firstly because it is not infallible (R ˆ 2 of about 50%, which is at the low end) but also because both China and the Latin American countries have disappointed. China in particular plays a major role for those of the other emerging-market countries, which are raw material producers, and there is no doubt that the lower Chinese GDP growth means weaker demand for raw materials and energy, which has had a decisive effect on the other EM countries.