Sparinvest

Monthly comment by Chief Strategist, David Bakkegaard Karsbøl

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Spring in Europe

The trend of strengthening European data continues and during March we have experienced a bonanza of good news. The unemployment rate for the month of January for the Eurozone as a whole showed a higher than expected fall – to 11.2%. Sentix investor confidence came out at 18.6 - the highest level since 2007. The level of new car registrations in the 27 EU countries is growing solidly by 7.3%. Total employment grew in the fourth quarter by 0.9%. The German ZEW's expectations for future growth rose sharply to 62.4. Construction activity rose in the Eurozone by 3.0%. Eurozone consumer confidence rose to its highest level since 2007. Markit PMI data for both service industries and manufacturing was better than expected. Basically, on the whole, there hasn't been a single, disappointing figure from the Eurozone over the past month.

Our model for industrial production shows that Germany is regaining strength, and that it will be 'full steam ahead' over the summer. This has just been confirmed by the key IFO Expectations figure which is now showing decent progress after a pitiful autumn and early spring. Furthermore, we saw that the annual growth rate for the German retail sector rose to as much as 5% - the highest number since the euphoria after the German reunification. German house prices have now risen by more than 30% since 2010, and all indications are that, as a result of the low interest rates and stronger banking system, they will continue to rise.

With regard to industrial production, the prospects for the Eurozone as a whole are still quite good for the next 12 months. At present, growth in industrial production is virtually zero, but this is likely to increase to 2-3% over the summer for both the Eurozone as a whole and Germany.

USA - mixed numbers

There are different, macro-economic cycles, which are of different length and different degrees of fluctuation. Currently, we see two cycles in the United States, pointing in opposite directions. The short, industrial production cycle (12-36 months) indicates a moderate downward for the rest of the year because the dollar's strength has weakened American competitiveness, and because US industries in recent months have produced too much relative to the demand that they had counted on.

The longer cycle consists of the housing market and the labour market, which certainly are both are on the mend – and, by all accounts, will continue to be healthy in the next two to three years. Data from March confirms this picture. Most recent ISM figures (November) for the industry have fallen sharply (but still indicate expansion), but the labour market is still showing monthly improvement. The unemployment rate in the US is now down to 5.5%, and the OECD estimates that the US NAIRU (i.e. the unemployment rate below which you will typically begin to experience wage pressure / inflation) is at 5.45%. In other words, over the past twelve months, we have come significantly closer to a (moderate) inflationary scenario, given that the unemployment rate in the US has fallen from 6.7% to 5.5%. Similarly, non-farm payrolls, indicate that many new jobs are still being created.

Among the slightly weaker US data, we find that capacity utilization in the manufacturing industry has fallen to 78.9% in February. We are talking here about a relatively big drop compared to the generally healthy increases we've seen in capacity utilisation since 2009. The weakness of industrial cycle will probably persist until 2016, but in my estimation, the important and somewhat slower cycles from the housing and labour markets will contribute so positively that after summer we will see a revival in American manufacturing.

Interest rate hikes in the United States – a problem for US stocks?

At the last FOMC meeting, the controversial word – 'patience' (i.e. regarding future rate hikes) – was removed from the summary. Initially, this caused the market to expect impending increases in the Fed's interest. However, because of the weak development of the manufacturing industry, the market is in the process of sending rate expectations lower. We can deduce from the market for interest rate futures that the market now expects an interest rate of only 68 basis points at the end of 2015. In other words, still higher than the current 25 basis points - but also lower than 'almost one percent', as was expected at the end of 2016.

The expectation of rate hikes - when they come - may have caused some investors in US stocks to lift the foot from the accelerator a bit. In any case, we can see that the so-called 'margin debt', i.e. the debt used by investors to invest on the New York Stock Exchange, is showing a downward trend. This is a clear warning sign for US equities. So far, we are not talking about a serious fall, but it will definitely be difficult to achieve solid returns if the margin debt not stabilize and possibly begin to rise again. Empirical evidence shows that the evolution of margin debt is one of the main factors explaining the return developments in US equities in the short term (i.e. over approximately 12 months). Given that the dollar has also risen sharply, thus undermining American competitiveness of companies, there is reason for concern. If you are still exposed to US stocks, these should be reduced now in favor of European equities.

European shares - still promising

ECB's quantitative easing programme has now been implemented, and the bank has been provisionally purchased various EUR-government bonds for a total of 26.3 billion euro. According to the ECB, the programme will continue through to September 2016 with a provisional figure of 60 billion euros a month set aside for the purpose.

The market has already priced bonds higher in anticipation of the programme, and that is the reason why, for example, 10-year German government bonds (around 25% of what the purchase programme is allocated to) are now trading at a yield of only 23 bps.

When the return on bonds is so little going forward, investors resort to other asset classes, and here's why shares are particularly relevant for Eurozone investors. In past monthly reports, I have recommended a greater exposure to European equities. This is still my recommendation.

It remains true that many macroeconomic factors are pointing in the right direction for European equities. Higher house prices, higher consumption willingness, more employment, higher output, lower euro, lower energy prices and lower interest rates are just a sample of the macroeconomic factors that support an exposure to European equities.

Value and small-cap stocks in particular should get most benefit most from a broader European recovery. The small cap-factor has been virtually non-existent (i.e. small-cap companies have had close to the same return as the overall market) in Europe since the end of 2010. The euro crisis probably neutralized the factor by giving larger companies better financing terms relative to smaller ones. This now appears to be declining, as European banks are now looking to increase lending again – much of which will come in the direction of small-cap companies.

Similarly, one can say that the future European recovery also will favour Value-companies that which have also been undergoing a difficult time since 2011.