Sparinvest

Monthly comment by Chief Strategist, David Bakkegaard Karsbøl

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ECB's supportive hand

The stock market was in the process of recovering as we approached the middle of October, and the volatility in August and September had subsided. Inflation expectations in the Euro zone had improved (i.e. increased) by more than 10 basis points in just three weeks, and the general macro-economic indicators were reasonably good (although slightly on the weak side) in the first part of October.

Therefore, it came as something of a surprise at the ECB press conference on October 22 that Mario Draghi decided to suggest that the ECB's monetary policy could face an even greater reduction. Draghi indicated that the ECB's inflation expectations were stable, but also that they saw 'downside risks' (i.e. greater risk of a fall than a rise in inflation). One sign is the stubborn 'output gap' in the Euro zone (which indicates that growth is lower than it should/could be).

The market was particularly surprised to learn that the ECB had discussed a further lowering of the deposit rate at the ECB. The mere fact that this was mentioned as a possibility caused the EUR/USD to fall by 2% in a few minutes, and European equities also rose correspondingly fast by 2%. Both of these trends (weakening of the Euro and stronger equities) have continued to the end of the month. In addition, the 10-year interest rate has declined by about 20 basis points since the press conference on October 22.

Has the MomVol indicator turned?

As described above, we have had a strong month for equities - particularly in Europe, where most stock indices rose by about 10%. Our MomVol indicator has probably not had sufficient time to react, and I anticipate that the end of the month it will still be recommending reduced equity risk.

Fundamentally, however, the situation is somewhat different in that it is difficult to find any other fundamental arguments against exposure to the stock market than the likelihood of the US central bank raising interest rates in December or January.

Europe still improving - better than the market (and the ECB) view

The US slowdown is also evident in Europe, and, as noted above, the macro-economic indicators proved to be slightly weaker in October than in September. However, this does not change the fact that they were still relatively strong and able to surprise the majority of analysts on the upside.

For some months now, we have been working on a project that designed to enable us to predict how the OECD leading indicators would develop for the largest economies in the world. The project is not complete (and may never be!), but the first results are now available, and they show that we should be optimistic about the next 12 months (see graphs).

According to our macro models, the outlook for the European economy is better than it has been in several years. France in particular stands out. Until a few quarters ago the country was almost abandoned by the market. However, President Hollande has responded to the weakest confidence metrics for any president in the history of the Fifth Republic by changing policy away from a reactionary leftist doctrine and towards something that his Prime Minister, Manuel Valls, found almost reminiscent of the Anglo-Saxon liberalism usually so much maligned in France. So far, significant French reforms have not materialized, but from a cyclical perspective, these developments definitely turned for the better during the past year.

In recent months, Germany has taken in hundreds of thousands of refugees and migrants. While some of these will give a much needed increase in the workforce, many will become a financial burden in the coming years. However, due to the way we calculate GDP, government expenditure on integration and management of the many newcomers, certainly seems supportive of GDP figures in the coming quarters. In addition, the leading cyclical indicators for Europe's largest economy are also pointing in the right direction.

With the latest weakening of the euro (helpful to Europe's competitiveness) as well as indications of continued/increased monetary stimulus from the ECB, European growth could be entering a golden period. In this context, I can not help but fear that the ECB has simply underestimated the Euro zone's forces and permitted a build up of inflationary pressure while monetary policy has been historically accommodative.

USA - temporary weakening spiced with rate hike?

'Beware the New Year'. That, in all its simplicity, is my message regarding the US economy. The weakness that we have seen in the US in the past two to three months is temporary and primarily related to the optimism in manufacturing. In recent months we have also seen a weakening in the figures for the services industry, but in general these figures are somewhat higher than for the manufacturing industry, and services are also less affected by the strong dollar.

Our manufacturing-based models indicate that the manufacturing industry will come back strongly after the end of the first quarter of 2016. This will probably prompt analysts and respondents in various year-end surveys (ISM and PMI) to adopt a somewhat brighter outlook.

The Fed is now indicating that a rate hike at the meeting of 15-16. December is not yet off the table. This initially surprised the market. But, given the underlying strength of the US economy and the likely resumption of growth in industrial production in the second quarter, it is likely that the Fed has decided to begin to tighten monetary policy in order to nip inflation (and especially wage inflation) in the bud.

Short-term optimism in China, long-term pessimism

In the last Monthly Report, I aired a cautious optimism about short-term opportunities for the stabilization of growth prospects in China. I would like to maintain this optimism. China's economy is undoubtedly dependent on what the Politburo decides, but it is also dependent on international economic development, which looks quite strong beyond the next 12 months (see graphs).

Moreover, China's Monetary Conditions Index has improved further, as have the reserve requirements for Chinese banks. Bloomberg's monthly indicator of Chinese (official) GDP growth is at a respectable 6.55%. The main indicator of concern in the short term is the so-called Li Ke Qiang Index, which, during the month of September, has sunk to the lowest value since 2005, when the index began.

That said, there is still reason to expect that Chinese growth will slowly converge down to a level that is more common for economies of such size and level of development. Demographic trends and overcapacity in various sectors will automatically lead to such a development, and China's extreme appetite for commodities will not return in the foreseeable future.

Outlook for equities

Given that, according to our models, European macro-economic data will surprise most positively, relative to expectations and relative to Japan and the United States, investors should maintain an overweight to European equities. In addition, European equities remain cheap, relative to other regions.

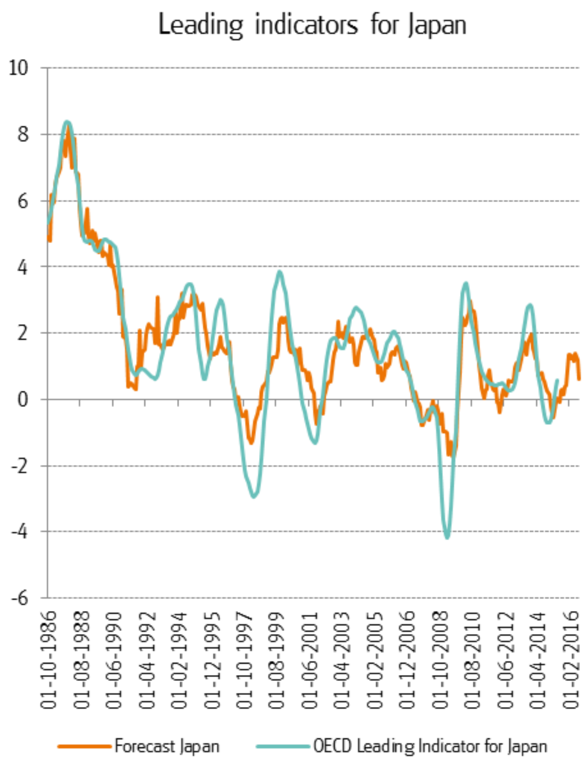
Against the background of our macro models' predictions, the most likely scenario over the next 12 months is that the stock market will deliver solid returns. As mentioned earlier, the only shadow currently hanging over equity markets (especially EM), is that the Fed is about to raise interest rates, which make risky stocks relatively less attractive.

Beware of long-term bonds

In Monthly Reports over the past six months, I have repeatedly warned against rising long-term rates. Over the last four months, long-term rates have fallen - and this despite the fact that 5Y5Y inflation EUR swaps (the market's long-term inflation expectations in the Euro zone) have increased by 20 basis points in October alone. But if our macro models have got it right, inflation expectations, and thus interest rates should be almost constantly rising over the next 12 months.

In fact, according to our models, we are facing a situation which is comparable to what happened during 2013 when

US 10-year yields almost doubled from 1.7% to 3% and German 10-year yields went from approximately 1.25% to 2%. Maybe the development will not be quite as dramatic, but in macro-economic terms, the odds are certainly not in favour of long government bonds in the coming 12 months.



EUR/USD

In light of the impending and increasingly inevitable rate hike in the US as well as ECB talk about further easing, it is likely that the EUR/USD will remain under pressure. But this is entirely due to the monetary aspects of the currency pairs. When you look at our macro-models, the level of growth is likely to increase from current levels by the greatest amount in the Euro zone. Therefore, I maintain a neutral expectation on EUR/USD.

Publication date moved

In order to get a more accurate reading from our MomVol indicator we need to incorporate data that will not be finalised until soon after the turn of the month. Therefore we will move the publication date of the Monthly Report until just after the month-end. This means that the next Monthly Report first will appear in early December.