Monthly comment by Chief Strategist, David Bakkegaard Karsbøl

September 2015

Weak market characterized by fear

After the extreme volatility of August, September was certain to be a calmer month, but the market is still characterized by fear, and although the VIX is declining, it is still significantly higher than at the beginning of August.

Emerging markets in particular are exhibiting nervousness these days. One factor is that earnings growth in the MSCI Emerging Markets has been flat in recent quarters, partly because investors in emerging-market countries fear that higher interest rates in the US will result in capital heading out of the EM nations and into the United States. In addition, there is great uncertainty about the economic situation in China, the regional lead economy on which many other emerging countries largely depend.

It is interesting to note that Europe seems to have regained its 'safe haven' status. At least, the euro is rising and the PIIGS' spreads in the bond market are relatively stable. At the same time, most leading indicators suggest that we still expect growth in Europe.

Unless we see a fairly sharp increase (5-7%) in global stock markets over the last two trading days of the month, our "MomVol" indicator (discussed in last month's report) at the end of the month is still indicating a 'sell' signal. So it is still not the right time to take on additional risk.

USA - difficult fourth quarter ahead

The Federal Reserve chose to postpone the otherwise long-awaited rate hike that was due in September. The next time we expect them to consider the issue will be in December. (They also have a meeting in November, but there is no press conference planned, and it has never happened that interest rates have changed without one.)

According to the fixed income market, over the next 12 months, the Fed will raise the rate by 45 basis points. This is expected to happen in December.

The US is currently facing weak numbers – primarily due to the strong US dollar, which weakens US competitiveness. Dollar strength has also been mentioned as a separate issue several times in recent minutes of FOMC meetings. In addition, there has been a weakening trend in US demand. For example, we were able to observe declining growth in retail sales and higher stocks of unsold goods.

Given that – around six months ago – growth in manufacturing was significantly higher than the growth in demand, the slowdown means that the manufacturing industry is now forced to lower industrial production growth. This process will probably last until the end of Q1 2016. Against this background, we expect weak PMI and ISM figures from the US until the end of the year.

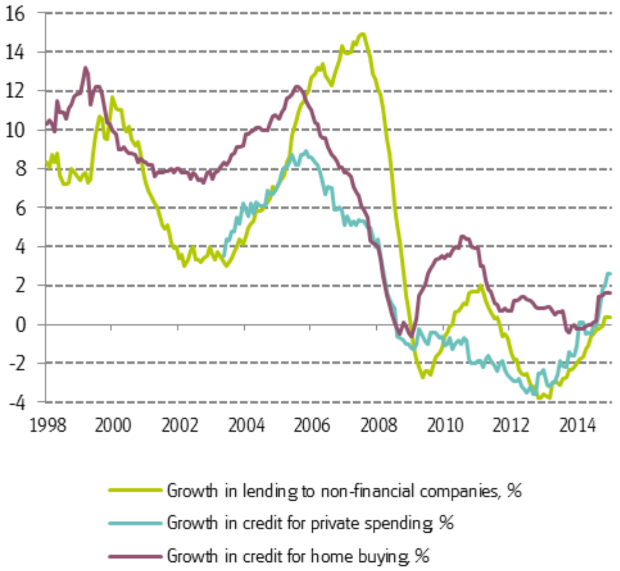
Under these circumstances, the reaction from the FOMC may well be to postpone rate increases until well into 2016, when growth in the US really returns. However, in the meantime, we expect a relatively weak, global stock market.

Europe still recovering

European data has generally surprised on the positive side during September. Annual growth in GDP (Q2) came out at 1.5% vs. the predicted 1.2% and I still hold the view that by the year end we may be looking back at growth of fully 2% in the Eurozone. The number of car registrations rose by 11.2% in August compared to a year ago, and industrial production rose by 1.9% against expectations of only 0.7%.

In addition, we have received new figures for lending within the European banking system. Overall, what we see here is a normalization of growth rates in lending, which is a marked improvement after the long and hard 'de-leveraging' process that has been in place since the euro crisis in 2011.

Figure 1 – Growth in European lending



In Europe our leading indicators are still pointing in the right direction. One of the main indicators - IFO Expectations for Germany - is high and rising, whilst the ZEW Eurozone is high and falling.

In Greece, the government has been re-elected, and has thus gained a renewed mandate to continue the current line. Greek banks were hit hard, while other Greek companies were not particularly affected (relative to the rest of European equities).

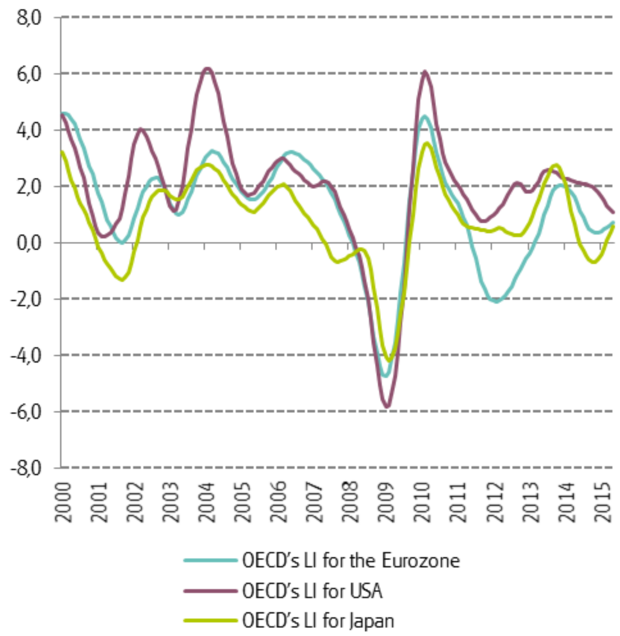
In Spain, Catalonia's Separatist leader, Artur Mas, held a non-binding referendum for the region, which resulted in a majority vote for independence from the rest of Spain. Mas is now being sued in the Spanish Supreme Court, which will probably do nothing to dampen tempers. In addition, our model for Spanish industrial production shows that we can expect a significant deceleration over the New Year and further into 2016, and the OECD's leading indicators for the country are on the verge of being negative again.

OECD leading indicators

Part of our effort in the field of macroeconomic analysis has been to extend the OECD's benchmark, leading indicators for the major countries in the world. The OECD publishes first indicators only after they also have the latest updated quarterly figures, which are included in the indicators. Unfortunately, this delay means that by the time they are published, the figures are a little too old for their purpose - to provide a reliable illustrate how economies will develop in the coming months. However, we have been successful in estimating these indicators with great explanatory power up to 'present'.

At the current time, estimates for OECD leading indicators are upwards for Germany, France and Japan. Those for the United States are higher, but they are flat to slightly declining. This picture is also confirmed by our models for industrial production.

Figure 2 - Development in OECD's leading indicators



A trough in China?

During the second quarter we have seen an increase in monetary growth from about 10% to over 13%. In addition, the last three months have seen a sharp rise in new lending by the largest banks - from an annual increase of approximately 10% in 2014 to over 25% in the latest figures. The so-called Monetary Conditions Index, which measures changes in Chinese companies' financing options has also increased.

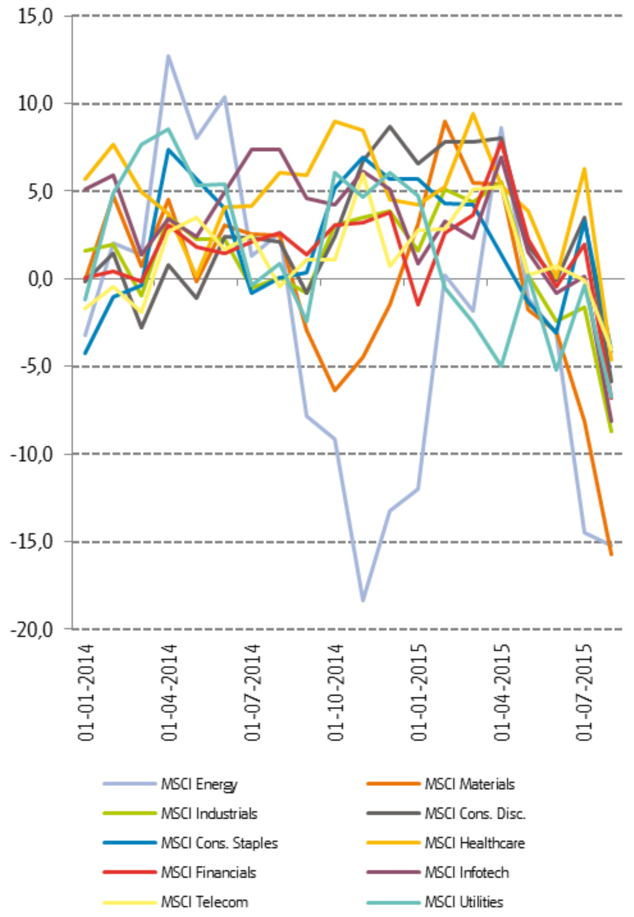
When Caixin PMI is below 50 (which is zero), it is obviously worrying for Chinese growth going forward, but the growth in money supply and new loans will probably mean that development will be stabilized within a short period of time - as we have seen several times before in China.

This does not mean that the demand for commodities and energy from China will return to the frenetic pace of the previous year.

Equities

As discussed above, our MomVol indicator shows (with very high probability as at the end of the month), that one should proceed with reduced risk. It is interesting to see how the former seemingly invulnerable sectors like biotech and healthcare are now demonstrating high volatility again, when the rest of the market falls.

Figure 3 – The 10 MSCI World sectors, 3 months change in %



If the return from equities relies on macroeconomic developments, then we can expect to see weak returns until the New Year.

If we look at likely relative returns from a regional perspective, one should still favour a European and Japanese exposure, since both EM equities and the US face problems. The strong dollar is putting pressure on the US earnings and the weak EM currencies are reducing EM-stock market returns in EUR-terms.

Corporate Bonds

With the prospect of an interest rate hike in the US, assets in emerging markets have suffered in recent months. The Fed's purchasing programme (QE) has led to a record increase in lending in emerging countries. Now, however, the investment tide is in ebbing, and spreads for special EM High Yields have started to expand.

This development may be amplified by the fact that a number of large HY issuers are in trouble. Petrobras (Brazilian energy company), Abengoa (Spanish energy company), 1MDB (Malaysian energy company accused of fraud), Glencore (Swiss commodity broker) are all examples of quite large issuers in the HY-sphere, where a bankruptcy could send tremors through the market. The entire energy sector is highly pressurised by current energy prices and particularly as a result of their volatility.

The global high-yield market has seen negative returns over the past four months, and often capital flows track the performance of the various asset classes. We must therefore probably expect further capital outflow from the HY market. Our managers are already working to reduce risks to better address the above problems.

Global Investment Grade (IG) market has so far delivered an excellent return, but here, too, EM names in particular risk being affected going forward. That is why our IG funds are also in the process of reducing risk, which has generally been above benchmarks.