Sparinvest

Monthly comment by
Chief Strategist, David Bakkegaard Karsbøl

# Positive surprises in the US - Including the labour market

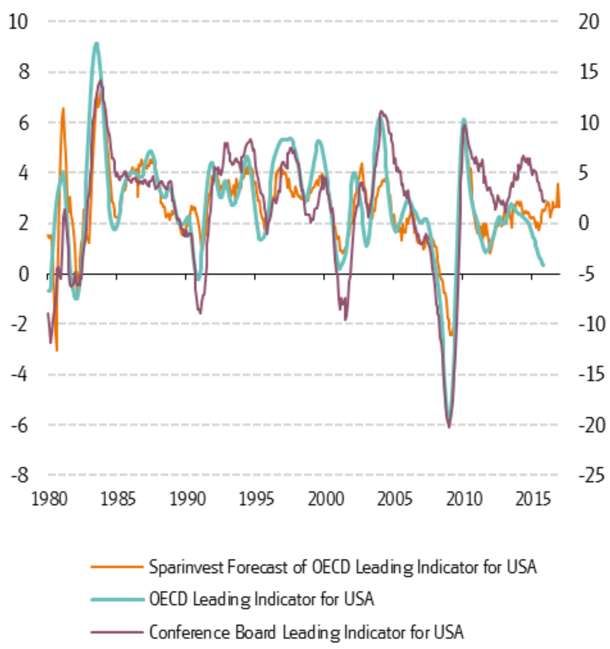
The world economy is showing more signs that are positive. In the US, there is solid optimism on the labour market, which has seen a large increase in the number of job seekers. China also shows signs of growth with an increase in house building and declining oversupply of homes relative to monthly sales. A positive development in China can rub off on Australia and Brazil, but it also benefits emerging market equities, which have also delivered an excess return of around 6%, relative to the equities of developed countries.

The US economy has been under pressure since late 2015. I have often warned that this pressure would continue into the first quarter of 2016, but now there is fresh wind in the sails of US manufacturing. Our models for industrial production shows that we can expect a sharp acceleration in the growth rate from the second quarter and out as far as the eye can see (approximately one year). This scenario is rein-forced by the fact that the US dollar has fallen by about 5% against the euro over the past month.

Our model for orders for durable goods supports this message indicating that we can expect solid growth in this sector. However , our model for car sales in the US, shows growth in this sector will be close to zero in the coming 12 months, which will certainly be disappointing for some investors in US assets.

Other leading indicators in the US paint a somewhat mixed picture. The benchmark OECD Composite Leading Indicator (CLI) is updated only up to the end of December, but still shows a downward tendency. The Conference Board Leading Economic Index (an average of 10 indicators of annual growth) shows that we probably may see a bottom in the first quarter, but we only have data to February, so it is still too early to say. The ECRI leading indicator, which is based on weekly data brings us more up to date – to March – and this shows a fairly strong acceleration during that month. Our own models that try to forecast developments in OECD CLI, (being the US benchmark indicator) shows that CLI should increase steadily over the next 12 months and that the lowest point is already behind us.

The worst is over




If we look at the labour market, it is not difficult to trace the up-turn in confidence. One good sign is the increased unemployment rate in March, but this is due to a sharp increase in participation rate in the United States, which has been declining steadily since the financial crisis. In other words, the number of jobs on offer has increased sharply since the autumn of 2015. In fact, we have to go back to 2000 to see a similarly important positive development over a six-month period. It suggests, in other words that a solid optimism now pervades the US labour market, which is also corroborated by a number of surveys. The so-called Quit-rate (how many people voluntarily resign their jobs in favour of something else) is now back at pre-crisis levels, and the same applies to small companies' recruitment intentions (NFIB Small Business Hiring Plans).

## FOMC will regret retreat

Although the dollar fell in March, the American central bank remains concerned because of its continuing high level. Firstly, this places great pressure on the American manufacturing industry, and secondly, from a global, financial perspective, it has a particularly destabilizing effect on the many EM countries and smaller companies that have issued USD-denominated debt as it becomes more difficult for them to service this debt as their own currencies (and earnings) decrease. In addition, the FOMC has probably been overly influenced by the temporary slowdown in economic activity in the first quarter without anticipating the improvement that is underway in the second and third quarter.

Since our models indicate somewhat stronger growth in the US over the next 12 months, we must expect higher inflation as a corollary - both as a result of an even stronger labour market, but also due to higher activity, which is normally closely correlated with inflation.

Another reason to expect further inflation is that the recent downward pressure that has been exerted on US inflation by low energy prices will probably decline sharply over the next 10 months, so that we will actually see energy prices begin to contribute to upward inflationary pressure in late 2016 .

These conditions are already being priced into the swaps market, where, according to the so-called 5Y5Y inflation swaps, the market's long-term inflation expectations have risen from around 1.8% in February to 2.1% now.

Against this background, one should not be surprised if the hawks in the FOMC soon begin to plead for higher interest rates again. I find it surprising that short-term interest rate expectations have not yet reflected this to any significant degree, and it is also possible that participants in this market want to see data improve before they change their minds. Nevertheless, I am tempted to say that the dollar's strength may return in the second quarter.

## EU cooperation under pressure

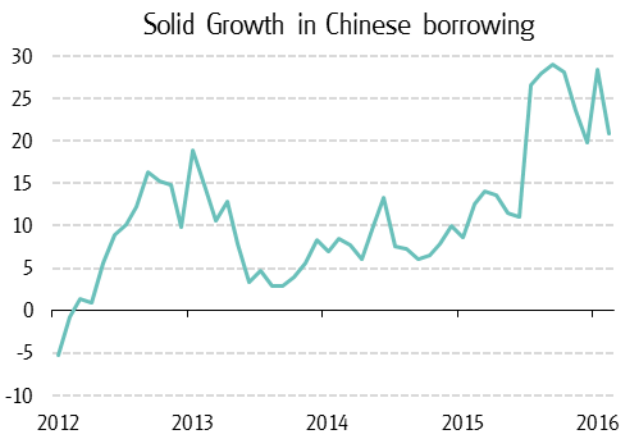
European cooperation is threatened by many difficult issues. The agreement with Turkey on the return of migrants has come into force, but it is too early to say whether it will actually work as intended. A number of Eastern European countries, and Austria, have gone it alone by closing national borders for migrants, which is contrary to the Schengen agreement. Opinion polls regarding the Brexit vote in June are more or less unchanged compared to the last sampling. 42% of Britons want to leave the EU, 45% want to remain, and 13% are still undecided.

In addition, the OECD CLI for the major European countries show a temporary peak in autumn, since when they are pointing downwards. Our models strongly suggest that the figures will improve during the rest of 2016, but the possibility cannot be excluded that the credit spread between southern Europe and northern Europe will expand over the coming months – an effect that has already led to German yields approaching the lows of April 2015.

On this basis, is Europe a suitable destination for investors' money? The evidence suggests that it is. The trade-weighted and inflation-adjusted value of the euro has increased by 8% since bottoming out in April, and the Sentix Investor Sentiment indicator remains well above zero (although it is lower than in 2015).

## China on track

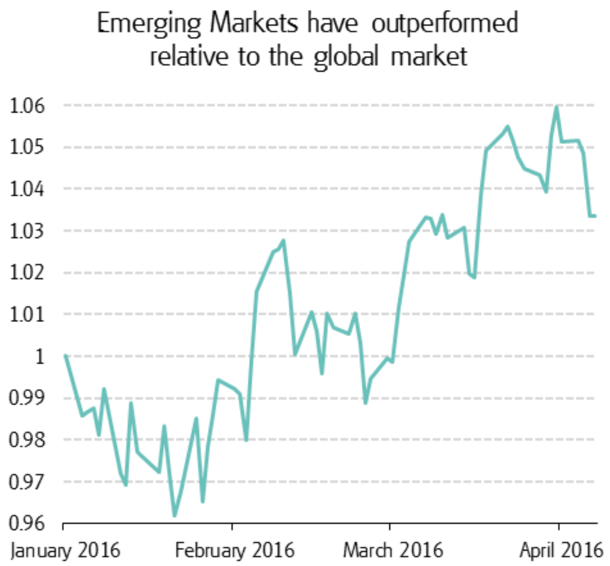
As mentioned in last month's report, China is regaining positive momentum. House building is on the increase, and there is no longer such a large oversupply of homes relative to monthly sales. In addition, we continue to see prices rising again in the Chinese real estate market, which helps to support the Chinese perception of personal wealth and thus their consumption patterns.



A number of effects can be expected from higher (if only temporarily) Chinese growth and a likely increase in demand for raw materials. Australia and in Brazil probably experienced the most widespread pessimism regarding the drop in Chinese demand to the point where these countries ended all exploration activities dedicated to uncovering new resources.

## Emerging Markets at last showing excess returns

Another consequence of higher – or more stable – growth in China is that the entire sector of EM equities can finally shake off its bad reputation. So far in 2016, EM equities have actually delivered excess returns of around 6% relative to developed countries' shares, so now we are beginning to see a strong relative performance in EM equities.




In the last four years, the price of the MSCI Emerging Markets has been chronically depressed, relative to the MSCI World, and there are still large differences in the Price/Earnings. MSCI Emerging Markets is trading at a Price/Earnings of 13.7, while the MSCI World is trading at a Price/Earnings of 19.7.

With stronger Chinese growth (or at least no prospect of a hard landing), several of the most pressured EM countries will perform better, and this is already being reflected in the stronger relative returns.

## Long-term rates

Lower production prices in the Eurozone have helped to push inflation expectations down, thus further depressing long-term rates. The yield on German 10-year government-bonds are now almost back at the same low level as in April 2015, and the yield on 40-year Japanese government bonds is only 0.5%, although this bond has almost as much volatility as the stock market .

Interest rates reflect a combination of low-inflation expectations and expectations of low economic activity over the coming years. We can add that the FOMC have continuously reduced their long-term growth expectations for the US economy and that the current net supply of Treasuries has dropped considerably as a result of the major acquisitions programs from the ECB, the US Fed and the Bank of Japan.

If, however, inflation begins to rise again, such buying programs will also be reduced, which could quickly produce an about-turn in interest rate developments. My assessment is still that one should expect that long-term rates are close to the bottom.

## Momentum indicator still out of the market

Our MomVol indicator is still out of the market - despite a very strong month in March, when virtually every stock market index rose. This is also because some very strong months have now slipped out of scope of the indicator's calculations. If the stock market continues to rise in April, the indicator will most likely begin to show again that the time is right to buy shares.

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