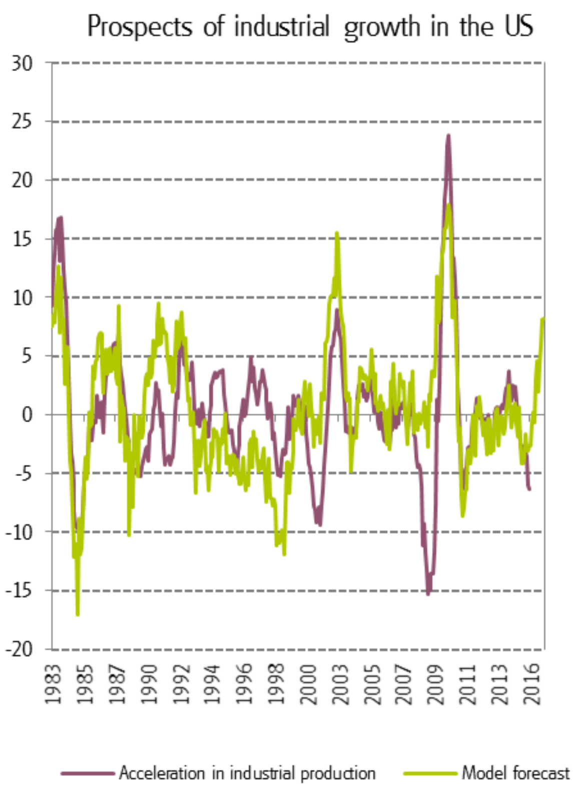
# Monthly comment by Chief Strategist, David Bakkegaard Karsbøl

February 2016

## Use slump in shares to buy

### Press the panic button?

Followers of the monthly report will know that I have warned about a progressive weakening of the US economy (especially within US manufacturing) up to and including the first quarter of 2016. The first time I warned about this was over a year ago. Since then, I have regularly maintained that the weakening would be severe in the New Year 2015/2016, but also – by regularly updating my models in order to "anticipate" the more distant future, I would suggest we are likely going to see a strong acceleration of US growth after the end of Q1 2016.




Stock market performance during January has caused several clients and business partners to ask whether equity exposure should be reduced. The argument for this is that the fear of further weakening in the US may affect consumer confidence negatively leading to weaker consumption and thus lower earnings, for example, for European companies. This permits a negative spiral to be set in motion that could strengthen and extend any stock-market decline.

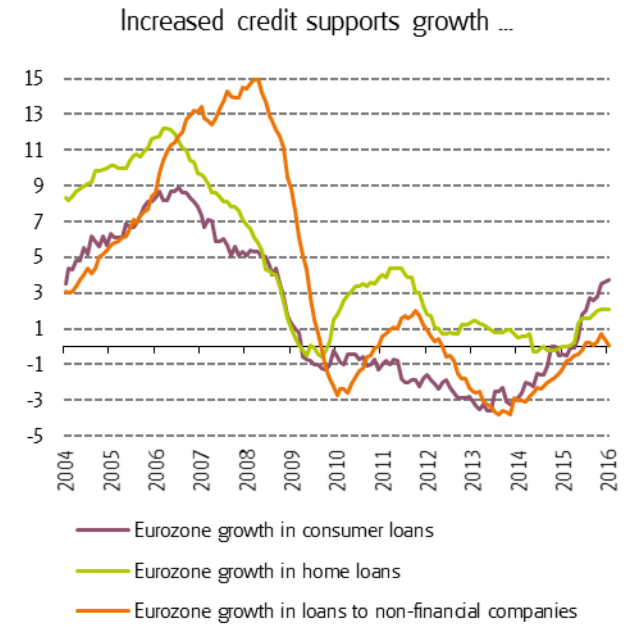
In isolation, there is nothing wrong with the above logic, but one could equally well argue that equity markets across the board are now priced 10% lower, making the future return potential so much the better. Moreover, it is unlikely that the earnings potential of - for example - Developed Markets shares fell by 10% in just a few months.

Obviously, it is possible that our models are wrong, but – almost unanimously – they say that the macro-economy in the US, Europe and Japan will deliver solid activity in the rest of 2016. This applies both to our models for industrial production, where the United States looks set to deliver the biggest positive surprise, and to our models for Leading Indicators for the three countries/regions.

My assessment is still that the current weakness in the stock market is a buying opportunity, and that we should use it to increase exposure to stocks at prices that are more attractive.

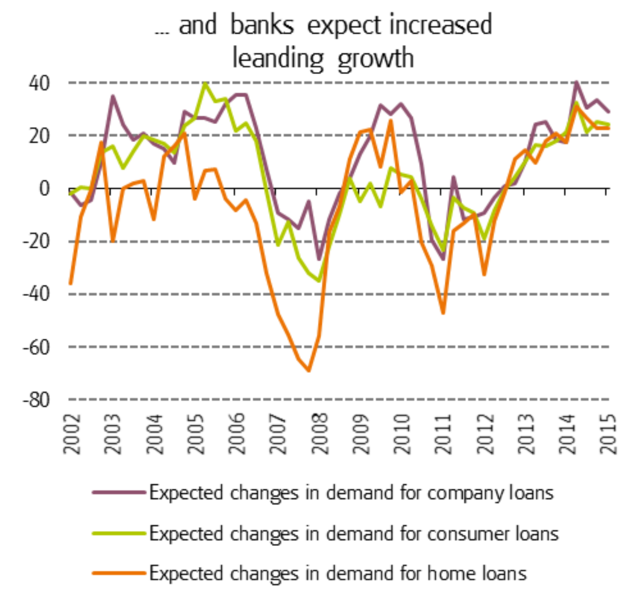
## Eurozone normalization - credit growth is back

Loan growth in the Eurozone is now really beginning to reappear. This has also been a recurring theme in the monthly report, and it is a sign of further credit growth over the coming quarters, which will support consumption, investment and lead to GDP growth in the broader sense.




The latest ECB Lending Survey shows that the banking system's outlook for demand is at near record high levels, and historically, this usually results in the banking system actually delivering higher growth in lending. In particular, we can expect more consumer loan applications in the coming months, and loans to non-financial companies seem to be on the increase.

Retail Growth in the EU is already recovering quite nicely, although it has fallen from almost 4% in mid-year to 2% now (as of December). Because of the New Year stock market decline, and talk of recession, it is possible that we will see some weak figures from the retail trade in January and February, but they should then recover for the rest of the year - or at least until the summer.




From having been almost completely flat in the period 2012-2015, lending to Eurozone households saw an increase in 2015 of 1.9%. Similarly, lending to non-financial companies decreased in the same 3-year period, but ended up by showing a moderate increase in 2015.

## American labour market less robust

Bank lending growth in the US is also continuing at a strong level, but the labour market is beginning to show signs of weakness – mainly due to layoffs in the energy sector. Thus there is the threat of an upward trend in the so-called 'Initial Jobless Claims'. Contributing factors are the slump in the Energy sector, weak orders and high stock levels particularly in the manufacturing industry (due to the strong USD). Within the services industry there is no major impairment to track, and this includes the vast majority of jobs in the United States.

The overall downward trend in the unemployment rate, however, appears to be on the wane. The unemployment rate has been stable at 5.0% in the past three months, and with the first, slightly elevated numbers in Initial Jobless Claims now emerging, one should probably not be surprised to see an increase to 5.1% when we get the January figures.

The Federal Reserve has also been in a near full-on retreat in terms of the rate hikes planned for 2016. These were primarily based on expectations of stronger 'data' - including a tighter labour market. In other words, the market called FOMC's bluff and, according STIR Futures, we can now expect a 3-month interest rate of 80 basis points at the end of 2016 - far from the 3-4 rate hikes, signalled by the FOMC only a few months ago. According to the interest options market, the probability of another hike in 2016 now only 53%.

## Has China growth reached a temporary bottom?

China is still the focus. In fact, you could be forgiven for thinking that it is the Chinese stock market that controls western markets these days. The fall in early January has continued to the end of January. The Shanghai Composite has fallen by almost 25% since the start of the year. At the turn of the month, there are signs of stabilization, but Chinese equities are still relatively overvalued; so long-term investors should not find them particularly interesting at this time.

However, the price of iron ore stabilized in early December and has now increased by over 16% from the undeniably very low levels. This may be an early indicator that Chinese growth is stabilizing (temporarily - because the long-term trend will be downwards). Other indications are that the money supply in China is rising at a significantly stronger rate than at the beginning of 2015 and apartment prices are now not only increasing in the so-called Tier 1 cities, but also in Tier 2 cities.

In addition, the growth in new loans in China has been very large compared to the years after 2009. Growth in the second half of 2015, remained at 20-29%, which should also help to buoy up economic activity in 2016.

The main reason to expect a temporary bottom or stabilization of Chinese growth at this time, however, is our expectations for economic activity in the EU, US and Japan. We expect all to show good growth rates, especially in the second half of the year. If this scenario materializes, it's hard to imagine any major calamities in China this year.

## High Yield market begins to look attractive II

I've recycled the heading for this section from last month's report, where I argued that spreads and the effective interest rate for our broad High Yield benchmark (Bank of America Merrill Lynch Global High Yield Index) are now approaching levels that should be of interest for long-term investors.

Most of the spread widening and negative returns were due to the energy and commodity sector's performance in 2015, when the leading indicators largely fell for the largest countries/regions in the world. The sector should be somewhat stronger in 2016, supported by growing economic activity.

The thesis last month was that long-term investors should begin to increase exposure to high yield bonds through a careful and continuous increase throughout the first quarter of 2016. I stand by this assessment. Prices will very possibly be lower in February than in January, but this makes them all the more likely to develop in an upward direction.

## Falling interest rates and lower inflation expectations

As discussed above, the fixed income market was always sure that there would not be so many rate hikes as the FOMC indicated. It will most likely prove to be justified, for in January, we have seen significant declines in long-term inflation expectations and the central banks leaning heavily on their monetary policy.

When central banks want to achieve an inflation rate of 2%, the long-term expectations for this are a very important guideline because inflation expectations have often proved to be self-fulfilling. In a single month in the Eurozone, we have seen a decrease in long-term inflation expectations of 20 basis points (5Y5Y among professionals). We will therefore soon see whether the ECB will take serious action to launch more 'unconventional activities to create greater liquidity and higher inflation' as hinted at in their last news conference

Also in the United States, inflation expectations have declined about 20 basis points since early January, which, in itself, is a reason to be reticent about the promised rate hikes.

The lower inflation expectations have also manifested themselves in long-term government bond yields, where the German 10-year yield, for example, has almost halved to around 29 basis points at the start of February.

## Momentum indicator again out of the market

At the end of January, our MomVol indicator remains out of the market at a value of only 0.23 (only slightly higher than last month). The threshold value is 0.6, which means the indicator suggests that you should stay out of the market for the next few months.

After sharp falls, it will often take some time for the indicator to turn around and be positive on the stock market. We saw this in late 2015 and in early 2016, so I do not expect MomVol to call a bottom, and it should be understood that this is not the intention anyway. Rather, the indicator should be as a relatively efficient way to avoid very large declines and volatility in the stock market.

Editorial deadline: February 4, 2016