Sparinvest

Monthly comment by Chief Strategist, David Bakkegaard Karsbøl

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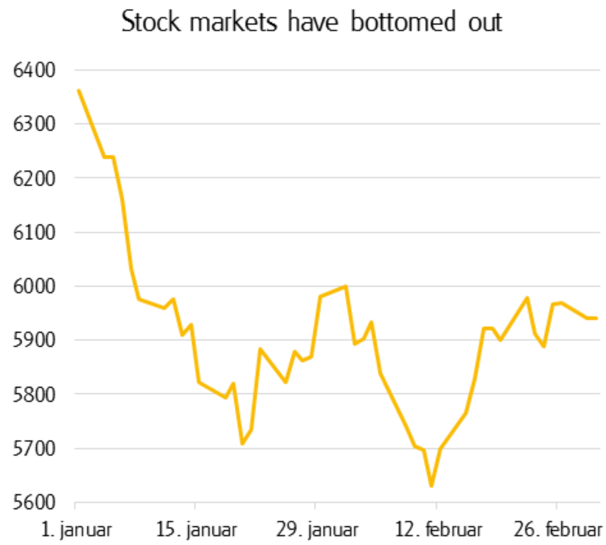
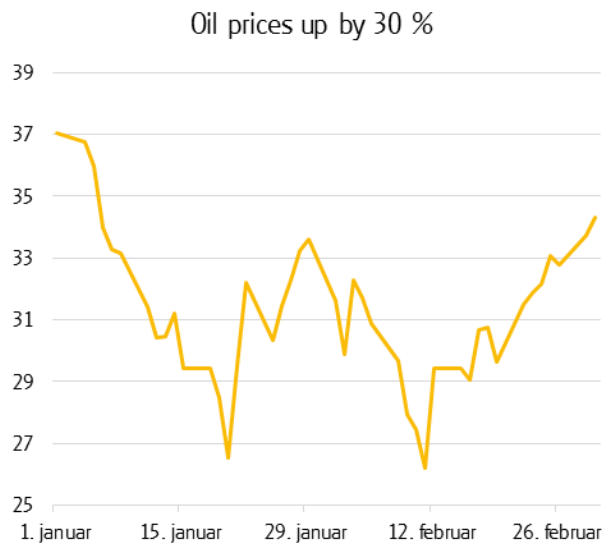
Optimism returns

The month of February has seen optimism return to the markets. Shares have returned from their bombed out position at the beginning of the month, and the high-yield market has finally also got its act together and reduced credit spreads. What looked like a high-risk situation for the financial system back in January now appears to be quietly settling down.



Oil prices have risen by 30% since bottoming on February 11, and the VIX index has fallen from almost 30 at the beginning of the month to under 18. If we look at the American Association of Individual Investors survey, the proportion who are 'bullish' increased from record-low levels (worse than in 2009) to 'more moderate but still pessimistic' levels.



Nervousness in bank bond has passed

In January and early February, the prices of bank bonds, from some of the largest - and thus most important - financial institutions, decreased to levels associated with extreme nervousness in the market. This was particularly the case with the so-called Additional Tier 1 bonds (COCO's or hybrid capital) issued by Deutsche Bank. AT1-bonds are a relatively new instrument and there has been market uncertainty about their reliability.

When the issuer can decide whether (or not) to pay the coupons of such bonds, investors should be mentally prepared for them not to be 'safe' investments. At the very least, they should not be relying on the cash-flow from them. Deutsche Bank AT1 bonds fell dramatically - from 93 at the beginning of the year to 70 on 11th Feb (They are now back up to 80). This suggests that the market had priced these bonds apparently without taking too much notice of the fact that issuers such as Deutsche Bank could opt to defer or suspend coupon payments.

It is uncomfortable to witness the situation whereby the return requirement for bonds issued by some of the largest financial institutions in the world rises by as much and as suddenly as it did in January and early February. When such things happen, being nervous about financial stability is a natural consequence. The market is, however, redirecting nervousness to where it belongs – namely more to investors in AT1-bonds than to investors in other types of bonds issued by banks.

A 30% increase in oil prices

The price of energy has been one of the main factors in the market in recent months, and the oil price alone has, at times, almost been able to dictate the direction of the stock market - especially in combination with the prospects for Chinese shares. Oil stocks abound, and the forward curve for oil has collapsed, signalling that the market has accepted the idea of an abundance of energy for several years.

Until now, most oil producers responded to low prices by producing even more oil to generate sufficient revenue to service their debt and / or investors' expectations for cash flow. Now, however, it appears that US oil production has begun to decline for the first time in half a year.

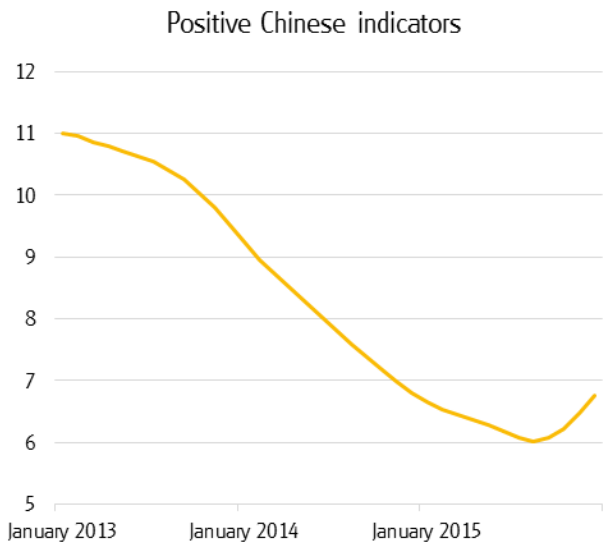
The higher price of energy has not yet led to any significant changes in the way energy-related HY bonds priced. The market is still in shock, and it will require both higher and more stable energy prices, before we get a repricing of the entire sector.

My assessment is that energy prices will continue to rise moderately towards the end of the year. This is based on a perception that the market has overreacted and is still in shock and on expectations of a recovery in economic activity worldwide throughout the rest of the year. However, as a result of large stockpiles, the price of oil will struggle to exceed 60 USD a barrel this year.

Moderately rising oil prices will not only have a positive influence on the energy-intensive segment of HY-bonds, it will also be much-needed positive news for the lion's share of emerging-market countries, many of which, as energy producers, have been hit hard by low energy prices.

China - no hard landing this time around

Also with regard to China, the picture is now looking rosier. In the month just ended, the OECD published its leading indicators for China for the months of September through to December. The indicators are published every three months, because they contain both quarterly and monthly data points. In recent months, I have expressed the opinion that the bottom in economic activity in China is already behind us, and this view is now confirmed now by the OECD (at least the leading indicators), which suggest that the bottom may have been seen in August.



Already in January and February there are indications of trends that should improve economic activity in China - despite the rather weak PMI surveys for both the manufacturing and service industries. The latest figures for monetary growth – significantly higher than expected – and the reduction of the Reserve Ratio Requirement for the biggest Chinese banks should be supportive for the Chinese stock market and growth. In a similarly positive vein, the growth in new lending in China has also been exceptionally strong in recent months.

Therefore, while the PMI data is still quite low - borderline worryingly so - there are still several significant indicators pointing in the right direction for China. My assessment is that China is too influenced by the pessimism and that PMI data will recover in the coming months.

American recession cancelled

Speaking of pessimism, I will also take the opportunity to cancel - or at least postpone - a US recession. Readers of the monthly report have regularly been warned of a weak first quarter in the US, and just as often reminded that the second quarter will see much enhanced US growth. Right now we see weak PMI and ISM data from the US, especially from the manufacturing industry. However, I expect that these will recover to substantially stronger levels Q2 and remain at comfortable levels for the rest of the year.

My assessment is based on the fact that the unemployment rate is still falling in the US (despite layoffs in the energy sector), and for unemployment to fall just before a recession it is extremely rare - if not unheard of. Furthermore, if we were going to see a recession in 2016, it should have begun in the first quarter, which was weak due to the previous over-optimism in 2015 (leading to larger than needed inventories) as well as the strong dollar. On the whole, this scenario has remained constant in the second half of 2015. The impact of the strong dollar on sales (and thus the annual growth in production) should therefore soon have ebbed away.

Additionally, there are still a number of structural factors which suggest that growth will remain at a good level - if only after the first quarter. First, housing prices are still rising, and both mortgage applications and building permits are high. Second, interest rates are still very low and surveys of the major banks suggest that they expect both to increase lending (and ease lending conditions) partly to boost consumption - over the coming months.

Long-term inflation expectations in the United States have also increased significantly since the beginning of February, and these tend to be positively correlated with growth expectations.

Uncertainty in the EU

European assets are currently facing a greater number of uncertainties. The British vote on future association with the EU in June, along with the handling of large migration flows from the Middle East and North Africa, as well as increasing nervousness in the PIIGS are the main sources of uncertainty.

Schengen cooperation has *de facto* collapsed, and the EU has not been able to find a common solution for the handling of the large migratory flows. Already, figures from Frontex show that that in the months of January and February (usually months with relatively few migrants due to inclement weather) 10 times as many migrants have crossed the Mediterranean as in the same months in 2015. There is therefore nothing to suggest that the problem of migratory flows is easing. With reception centres across Europe bulging, and with plummeting polls at home, the German Chancellor, Angela Merkel, in particular is urging the Eastern European countries and Austria to find their "own" solutions to significantly reduce the migratory flows through those countries.

The European idea of free movement of goods, capital and labour has been challenged, with large blocks of European countries now openly acting against EU law, as well as international and European conventions on human rights.

The EU has, in other words passed from one near-catastrophe (PIIGS crisis in 2011-2012) to another (migrant crisis and the risk of Brexit). The uncertainty is obviously great, and the market may have difficulty in finding anything to be impressed by in the political handling of these problems. However, in my opinion, the risk is considerably less now than in 2011-2012. There are big differences in the investment implications of a situation in which the EU would implode in a number of sovereign bankruptcies and a situation where the EU - in its current form - ends because one of the biggest countries pulls out. One assumes that the UK will – in the same way as Norway or Switzerland – maintain a link with the rest of the EU in case of border disputes etc.

The foreign exchange market has so far responded by keeping the EUR more or less unchanged against the USD over the past 12 months and interest rate markets are probably more affected by lower inflation expectations than by nervousness in credit spreads across Europe.

It is also important to mention that our models for the leading indicators in Europe (as with to the models for industrial production) show moderate improvements in the rest of 2016. Long-term investors should therefore maintain exposure to European stock markets.

Possible benefit of Brexit

As for Brexit, latest polls show that it's a close call between the "outs" and "ins" with a small overweight to the "ins". Britain is one of the largest contributors to the building of Europe, and also one of the member countries that is most influential in urging others in the direction of deregulation and market-based solutions. There has long been a conflict between the

”Anglo-Saxon” and the ”continental” approaches to cooperation and visions of how the European social model should evolve.

The issues of social services, financial regulation and immigration policy in particular have separated Britain from the Franco/German axis. And so in June, British voters will decide whether they want to pull out of cooperation - ”Brexit”.

Britain has benefited from having unfettered access to European goods and capital markets, as the country has a relatively large current account deficit, which has been largely financed by institutions in the Eurozone via foreign direct investment (FDI). An announcement of Brexit will probably lower FDI, which will weaken the balance of payments further and probably also the British pound. The pound has already fallen by about 10% since mid-2015, so the question is how much is already priced in. Both the British Prime Minister, David Cameron, and the ”outs” are in favour of free trade and deregulation, so it seems unlikely that a British departure should result in tariff barriers and/or technical barriers to the Eurozone, but an agreement with the EU after a departure would take a long time - perhaps two or three years - to negotiate, and this process would in itself be a source of uncertainty for the market.

Another uncertainty is the treatment of the financial sector, which constitutes a larger share of GDP in the UK than in any other European country. The EU has long treated the UK financial sector as the ‘poor relation’, and thus a departure will probably - from a regulatory perspective - be positive for the British financial sector. However, it could also be that, because of differences in regulatory approaches, Britain could, in future, find itself hit by more difficult access to continental European financial markets.

My overall assessment of the possibility of Brexit is that the net result would be one of long term benefit to the UK, since they would be able to deregulate the economy (the financial sector in particular) more than during the EU membership and that British politicians across the board are dedicated to free trade. The worst danger in Brexit thus becomes the uncertainty that is undeniably involved with withdrawal and the subsequent protracted negotiations with the EU.

Momentum indicator is still out of the market

Our MomVol indicator remains out of the market at a value of 0.37 (which is somewhat higher than last month) by the end of February. The threshold value is 0.6, which means the indicator suggests that you should remain out of the equity market for the next few months. If markets are moderately positive during March, the indicator may well start to give a buy signal towards the end of the month.

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: March 4, 2016