Monthly comment by
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Drop in stock prices after Brexit can be a buying opportunity

The British referendum on the country’s continued membership of the EU will take place on June 23rd this year. The ”Stay” faction is currently leading the polls with 47% against 41% for the ”Leave” faction. 11% are therefore still unresolved. The British pound (GBP) has partly reflected an increase in the ”Stay” faction’s election forecast by rising slightly from its low in early April.

Some studies show that analysts fear that a British withdrawal will trigger a 15-20% drop in European shares. I find it hard to see what would cause such a drastic development, besides the fact that the market always contains a degree of volatility that we as investors have to accept as a fundamental condition.

Such a reaction would, in my view, be excessive, and can be seen as a buying opportunity like the one we saw at the beginning of 2016. I do not fear a “Brexit” to the same extent as other analysts apparently do, because I do not expect British or European company earnings to be significantly affected in the event of a British withdrawal.

Strong forces in the UK are critical of the EU co-operation for the ”right” reasons. They want more free trade, fewer adjustments of national legislation and conditions – or, indeed, any at all – and a more lenient regulation of the financial sector. Neither the EU nor the United Kingdom wish to establish trade barriers and the like that could really destroy trade and harm British and European corporate earnings.

Britain has been a voice of reason in the EU (often together with Denmark and other northern European countries) for keeping the EU on the straight and narrow with regard to free trade and regulation. However, the EU is becoming increasingly more bureaucratic and expensive. My biggest fear of a possible British withdrawal is that EU cooperation loses a sensible voice in terms of these issues.

Whatever the outcome of the British referendum, it is unlikely that Britain could or should withdraw from the EU within at least two years of the vote, as there are too many and too complex problems to be solved before a final withdrawal.

Positive signs in the US increase pressure for higher interest rates

The US dollar has fallen against the euro from the end of April. Although long-term yields have risen, the STIR Futures market still shows no sign of an expectation that the US Federal Reserve will start to sharpen its rhetoric again.

There are no shortage of signs that further tightening is necessary. The number of Americans registering as unemployed fell in mid-April to the lowest level since 1973. Bearing in mind that the population of America is now approximately 50% greater than in 1973, we have probably never been able to observe so few recently laid off per capita in the US before now.

In addition, the employment rate has finally begun to rise again. The US employment rate (those working and seeking work in relation to people of working age) has fallen almost continuously since 2000, when it peaked at 67.3%. Until now, this declining trend has only been interrupted by a slight increase in the 2005-2007 bubble years. However, in the past six months it has risen from 62.4% to 63.0% - as much as it had fallen in the previous two years. In other words, there is a fairly significant shift in the number of people seeking work, which is probably the best indicator of US jobs optimism we can get.

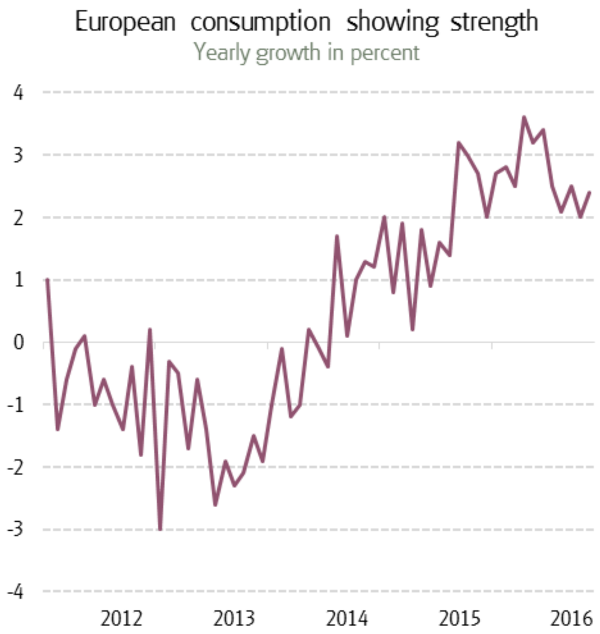
The trend is also supported by the so-called “quit rate” (the proportion of people who voluntarily quit their jobs in favour of something better). The quit rate is back to the same level as it was before the crisis.

With so much optimism on the US stock market, the growth of pressure towards higher wages cannot come as a surprise. In 2015, the average growth in real wages per hour worked rose by over 1%. This may not sound like much but it is more than at any time since the financial crisis of 2009. According to the Bureau of Economic Analysis, household nominal income (i.e. not adjusted for inflation) increased by 4.2% over the last 12 months – which clearly indicates healthy progress.

Despite the steady improvement in the US labour market, interest rate expectations for the US short-term rates (3 months) are relatively unaffected. In the course of April, the outlook for 3-month interest rates in December 2017 only increased by 12 basis points. As previously described in the monthly report, I expect that especially the second and third quarters in the United States will be much stronger than the first quarter, and will potentially positively surprise the analysts. Therefore, I also expect that interest rate expectations for December 2017, for example, can quickly rise by another 12-25 basis points in the coming months.

Strong European growth in sight

A brief commentary on the European labour market is also appropriate. Here too there are signs of ongoing improvements in the labour market but unemployment is still very high - even when taking into account that European unemployment has historically been quite high. It will probably be another two or three years before we will really be able to experience wage pressure in European economies, which also still suffer from very low productivity growth.

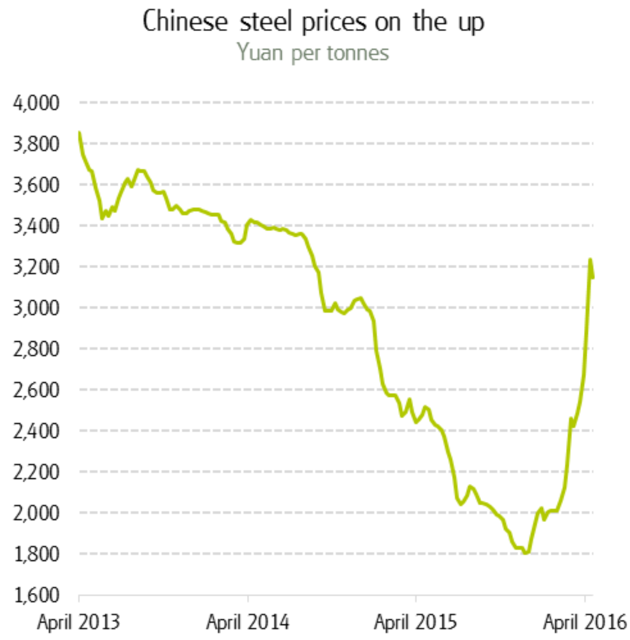


Nevertheless, things are going the right way. The Eurozone unemployment figures for March came out at only 10.2% against the expected 10.3%. In addition, nominal incomes of Eurozone households are currently rising by over 3%. With inflation at about zero, this provides a solid real increase in purchasing power.

It is therefore not surprising that Eurozone retail remains well above 2%, despite recent pessimism. Due to the strong increase in real wages, rising property prices and strong growth in consumer loans (5% for the entire Eurozone), it is my assessment that Eurozone consumption in the rest of 2016 will show strong growth.

Recovery in China rubs off on EM equities

Since the start of the year, Chinese steel prices have increased by over 50%. In April alone, prices rose by 25%. In addition, a very large number of the 70 largest cities in China are experiencing property price rises of more than 0.5% per month. In other words, optimism is back for China and it will no doubt rub off on the rest of the EM segment, where many are heavily dependent on Chinese growth.



Much of the EM equity market is directly or indirectly related to how the Chinese economy is developing, and it is one of the reasons why EM equities have provided an approximately 5% higher return than the MSCI World since the New Year. Another reason could be that the South American economies are no longer shrouded in extreme pessimism. The new Argentinian president (Mauricio Macri), the showdown with corruption in Brazil, (Dilma Rousseff) and elections in Venezuela (although they still have Nicolas Maduro as president) have all helped to create light at the end of the EM tunnel.

Beware of inflation in a few months

The big fall in energy prices is over. In fact, oil has increased by approximately 70% from its February low. The lasting and large reductions have had a significant and negative pressure on inflation figures in most countries. The negative effect on inflation figures has been particularly pronounced in the first half of 2015 and this has been declining strongly, although it still exerts a negative influence. At constant energy prices, we can expect a positive contribution to inflation in just six months, after which the effect can become strongly positive.

Although the world central banks claim that they only glance at core inflation when they decide monetary policy, it is a truth with modifications. Also, overall inflation is included in many models and settlements between market partners about more or less everything under the sun.

My assessment is that there may be a danger that the bond market in particular is lulled asleep slightly due to the negative impact on inflation from lower energy prices, and I therefore question whether the bond market is ready for higher inflation. At the time of writing, market expectations for 3-month interest rates in December 2017 is 1.1%, but I would not be surprised to see this expectation rise by 25-50 basis points over the next three months.

The reason for my expectation is that the US economy will improve significantly in the second and third quarters, and that by all accounts energy prices will go from giving a negative contribution to inflation going forward in a few months to giving a strong positive contribution.

What the Taylor rule says right now

If we look at the central banks' monetary policy in a larger perspective, it can typically be characterised as following the so-called "Taylor rule": central banks do not want to deviate too much from an inflation rate of 2% and an unemployment rate about 5% (depending on region and country). If inflation rises too much, the central bank will raise the interest rate, and vice versa. If unemployment rises too much the central bank will lower central interest rates, and vice versa.

Technically, the Taylor rule lets these two considerations (to both unemployment and inflation) be represented by the fact that the central bank must minimise the squared distance between the actual unemployment rate and the long-term average unemployment for the economy, as well as the squared distance between actual inflation and the 2% target.

At the time of writing, the Taylor rule would suggest that interest rates in the US should be increased by not less than 3.34%, while the ECB should raise interest rates by 0.6%. In Denmark (who admittedly does not lead an independent monetary policy) interest rates should be raised by 1.35%. In other words, the market should be worried that interest rates particularly in the US will be raised significantly over the coming months and quarters. Although the US Federal Reserve has been trying to prepare the market to this end, the market outlook is still very low. The STIR Futures market is still only expecting that interest rates will be raised by 0.6% points up to December 2017.

Higher inflation due to higher energy prices and relatively high underlying core inflation may well be the trigger for new and tougher rhetoric from the US Federal Reserve in the coming months. This could very well help to kick-start a new round of dollar strength.

Momentum indicators are still out of the market

Our MomVol indicator is still out of the market - despite a very strong month in April, when virtually every stock market index rose. This is because some strong months also slipped out of the indicator calculations. If the stock market continues to rise in May, the indicator will most probably show that seen from a short-term tactical perspective one should buy shares.

Editorial deadline: May 9, 2016