Sparinvest

Monthly comment by
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Nervousness before the American presidential election

The stock market is nervous in the month before the American presidential election. In less than three trading days the VIX rose from under 12 to over 20 at the start of September. This was presumably related to insecurity in connection with the FED's interest rate decision in September but the rise would probably not have been so extreme if there had not been a looming presidential election.

Most US opinion polls show Hillary Clinton leading Donald Trump by about three percent. The situation looks like being solidified in her favour after the first TV debate where both candidates participated. The bookmakers have given Hillary Clinton a 79% chance of winning on November 8th, with Donald Trump's chances calculated at 21%. The recognised statistician Nate Silver, who runs the analytics blog www.fivethirtyeight.com, has Hillary Clinton at 70% and Trump at 30%.

> *US opinion polls show Hillary Clinton leading over Donald Trump.*

What do the presidential candidates actually stand for?

One of the uncertainties associated with the American presidential election is the ambiguity about what the candidates actually stand for and what they will work to achieve. Both candidates have presented extremely contradictory claims and U-turns without turning a hair. Hillary Clinton has often referred to a campaign website that is apparently deliberately misleading and Donald Trump has done so many backward flips with his messages that it is quite simply anybody's guess what to expect from him if he gets elected.

My overall evaluation is that Hillary Clinton is "business as usual" in relation to the current Obama administration. She is more or less a mainstream Democrat who represents the elite and is not planning to revolutionise American politics. Nevertheless, the first point on her website (www.hillaryclinton.com) is the importance of getting rich companies and Wall Street to pay their "fair share". However, with a Republican-controlled congress it is difficult to see how any real number of her key causes can become law. In this way, her presidency can resemble her husband Bill's, who was thwarted by a Republican congress in getting much legislation passed.

It is difficult to say anything about what will happen with Donald Trump as president. On the one hand he supports lowering taxes on the smallest companies (as does Clinton) and he has announced that he will lower the very high US corporation tax from 35% to 15%. If that can be pushed through it will undoubtedly be a great help to American businesses but it is by no means certain that even a Republican congress can secure a majority to find the public cutbacks that would finance a business tax relief programme of this size. On the other hand, Trump has advocated deeply damaging protectionist policies that nominally are intended to shield American businesses against competition but actually risk causing an international trade war and, over time, undermine US business competitiveness.

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Stock market risks remain unchanged despite the election

Are there greater risks connected with being an investor in stock now than under normal circumstances? I do not believe so. Elections are held regularly in the USA, Europe and Japan. There are also referendums, wars and acts of terror. But the long-sighted investor should focus exclusively on the price of investment stock.

Although stocks are currently priced relatively high, in reality there are few useful alternatives for securing even an average return on investment. The risk involved in long-term bonds simply does not match their returns at held-to-maturity. Also, the price of corporate bonds is not very attractive.

Having said that, one can actually also see quite a high risk in being outside the stock market in connection with the US election. If investors are already nervous and have not fully invested in relation to their long-term goals and risk willingness, and Donald Trump becomes president and subsequently proclaims his support for carrying out corporation tax reductions from 35% to 15%, it is very difficult to imagine that the stock market will not rise dramatically.

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Referendum in Italy

On December 4th there will be a referendum in Italy on constitutional amendments that will weaken the power of the senate. Italy is currently governed through a two-chamber system that was designed to create a broad basis for collaboration after the end of the Second World War. Unfortunately, it has also led to almost constantly changing governments and a lack of political ability to carry out necessary reforms, particularly in the Italian labour market.

The Italian Prime Minister, Matteo Renzi, has said he will resign if he is unable to secure a majority for carrying out the constitutional reform, but after many months (years, even) of low growth and disappointing indicators, it now looks as if he will lose and be forced to resign.

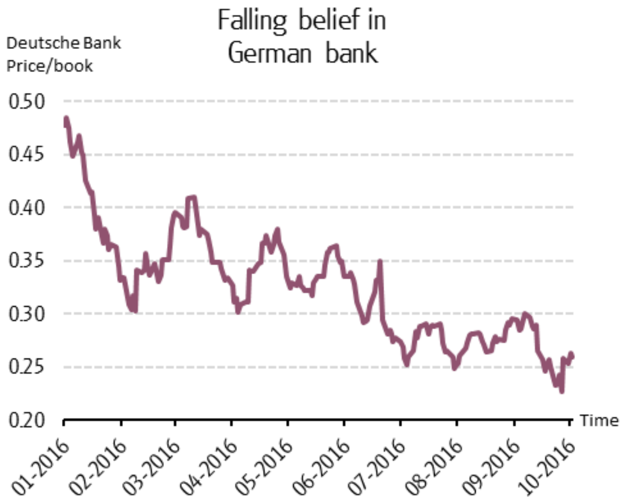
With an enormous burden of debt, no growth and one of the most over-regulated labour markets in the world, Italy is in desperate need of reforms – but it looks more and more likely that the constitutional reform will fall. This may also adversely affect the Italian government's room for manoeuvre in relation to a shaky banking system, where Banca Monta dei Paschi di Siena (BMPS) is in the headlines almost daily. Its shares trade at a price/book value of 0.05, which has to be said is as close to death as a listed bank can get.

All the above can continue to attract still negative publicity (both BMPS and the Italian referendum) so it will probably keep the European government bonds yields in check for some months ahead.

> *Italy is in desperate need of reforms*

Deutsche Bank fined by US authorities

Few, if any, banks can be said to have the same importance to the banking system as Deutsche Bank. Its derivatives book alone is reputed to have a total gross exposure of 42 trillion Euros, which is nearly three times as much as the Eurozone's total gross national product. The bank trades at a price/book value of 0.26 because the stock market is worried that it will be forced to participate in a capital expansion (where the existing shareholders will be considerably watered down). The bank's situation is not improved by the fact that the US authorities have fined it 14 billion Euros for fraudulent dealings and sales of loans in connection with the financial crisis nearly 10 years ago.



The rumours say that the fine is now a little over 5 billion Euros, which the bank has already set aside. This has caused the bank's share price and corporate bonds to rise over the past few days. However, it is clear that Angela Merkel and the German authorities are keeping a close watch on the situation. My assessment is that Merkel and her authorities will not permit the American authorities to be the spark that ignites yet another financial crisis in the Eurozone. It is possible that EU legislation makes it impossible, or at least difficult, to save the bank, but it is simply too big and important to be allowed to fold. In other words, European investors should keep their nerve – even though they shouldn't necessarily buy Deutsche Bank shares.

European investors should keep their nerve.

Watch out for inflation and long-term yields

As previously discussed, we are rapidly approaching the point where the annual increase in energy prices is really beginning to be significant. In just one month the level where the annual increases will start to decline rapidly, which will continue up to and including February 2017. Against this background, there can be a rapid but temporary rise in inflation, which can cause nervousness in the long interest. Despite the situation in Italy, oil prices will probably contribute to an upward pressure. However, I expect this pressure to be strongest in the USA, where the macro-economic indicators are currently stronger than in Europe (see below also).

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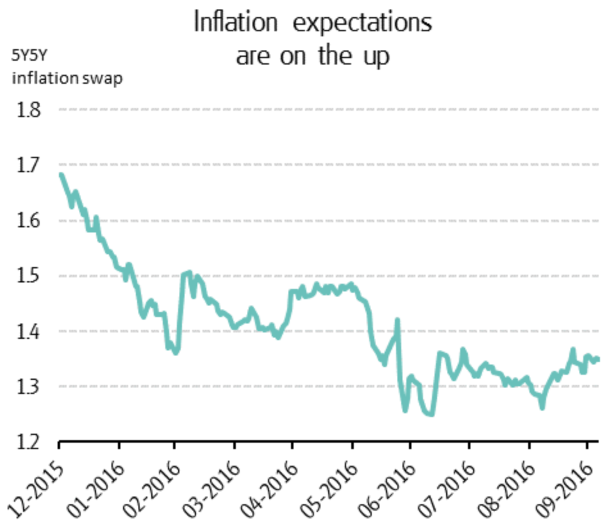

Indicators point to continued rises

Our indicators show that we can continue to expect a rise in the leading indicators in the three biggest countries/regions in the OECD: USA, Europe and Japan. In addition, our model for industrial production shows that growth will be greatly accelerated in the USA in particular, where there will be strong growth in manufacturing.

Emerging markets stocks are doing well

Emerging market shares have been doing well over the past few months. This is primarily due to energy and commodity prices have risen noticeably, but a contributory factor can also be that investors are returning to an asset class that has simply been hated by many over a long period of time and is therefore priced too cheaply in relation to developed market stocks. EM stocks are still considerably cheaper than DM stocks and with higher energy and raw material prices, earnings growth can quickly return. Therefore one can easily imagine further progress for EM stocks.

Editorial deadline: October 6, 2016