Sparinvest

Monthly comment by
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Low volatility for August – the calm before the storm?

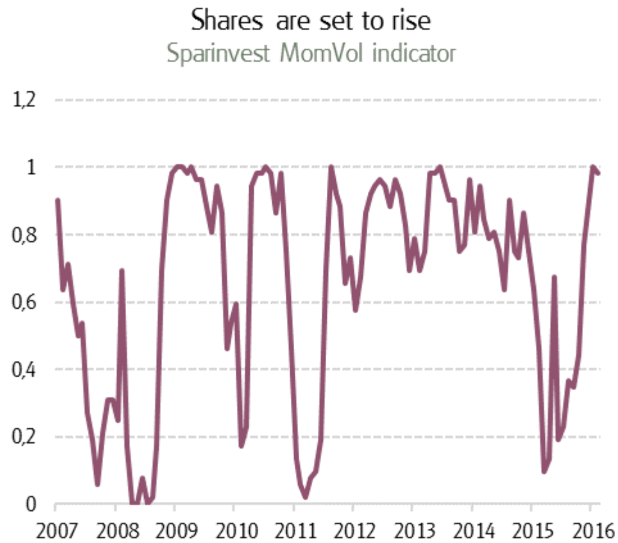
August was characterised by unusually low volatility in the stock market. For most of the month the volatility index (VIX) for S&P500 moved in a range between 11 and 13. Normally, this figure is between 13 and 18. The interest market was also marked by low volatility, where it was possible to observe almost unchanged long interest in Europe and the USA.

This was due to the fact that the economic data for Europe and the USA was generally as expected throughout August. Even though Nonfarm Payrolls disappointed in the USA at the start of September, the market has not regarded this as significant because the figures for the previous month were relatively strong.

Nevertheless, there are many reasons why this could be the calm before the storm. Firstly, we have the American presidential election, which in itself can cause greater volatility for American stocks and interest rates in particular. Secondly, the American data looks like it will improve greatly over the coming months, which can cause higher interest expectations and therefore greater volatility for the stock market. Thirdly, our models show that the leading indicators are on their way up in the USA, Europe and Japan. This will be a much-needed change from the past many years, where leading indicators have been slow but continuously falling. Fourthly, energy prices – as discussed in several previous monthly reports – will bring about a greater positive net contribution to overall inflation figures in the space of just a few months (culminating in early 2017), giving rise to concern that the bond markets will be exposed to a greater shock at a time when very low inflation is priced into the long-term rates.

Still strong momentum in the stock market

Despite the above-mentioned challenges lying ahead for the stock market, our MomVol indicator remains very positive, with a value of 0.98 out of a possible 1.00. Since 1970, statistics show that returns in the month following a MomVol indicator value of between 0.9 and 1 have averaged 2.4% in terms of US dollars. 77% of the months have given a positive return. It therefore looks like September will be a good month for the stock market.



MSCI World (EUR) delivered a return of only 0.12%, which was not due to any significant degree of currency fluctuations. The trend in the stock market is still positive with a broadly based momentum across the global stock markets, which continues to indicate a certain amount of risk willingness. Oil prices (WTI) rose by 8.7% in August, which contributes to the overall indication of risk willingness and a degree of optimism.

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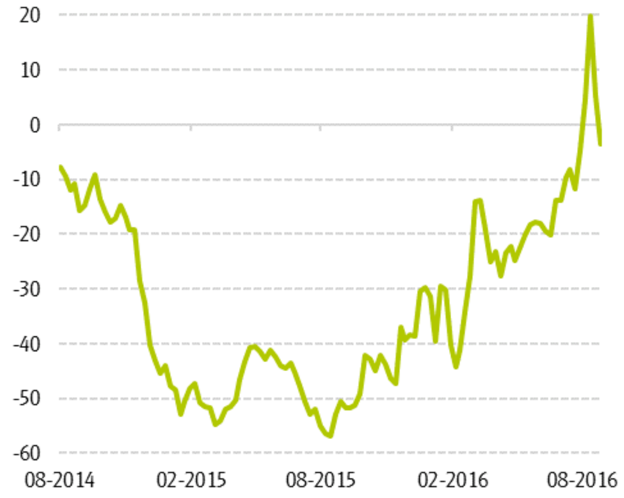
The oil price is a sign of optimism

Year on year rise in oil price (WTI)



Another relationship that supports an overweight of equities is the fact that our models for leading indicators are pointing upwards for the next 12 months. There tends to be a fairly high correlation between leading indicators and the stock market – perhaps for the simple reason that the stock market itself is included as a component of the OECD's leading indicators that we seek to emulate.

As previously discussed, I expect the US dollar to be strengthened as a result of higher interest rate expectations, which will weaken US corporate earnings capacity. Furthermore, American companies are expensive – or even priced to perfection, so I continue to recommend an underweight of American equities, which are particularly susceptible to increased volatility.

The shock of Brexit has worn off

In the currency market, the British pound has finally found buyers after almost constant weakening following Britain's decision to leave the EU. The most liquid British real estate funds were also growing through August and are now almost back to pre-Brexit levels. In other words, the market is looking kindly on Brexit.

> *The market is looking kindly on Brexit*

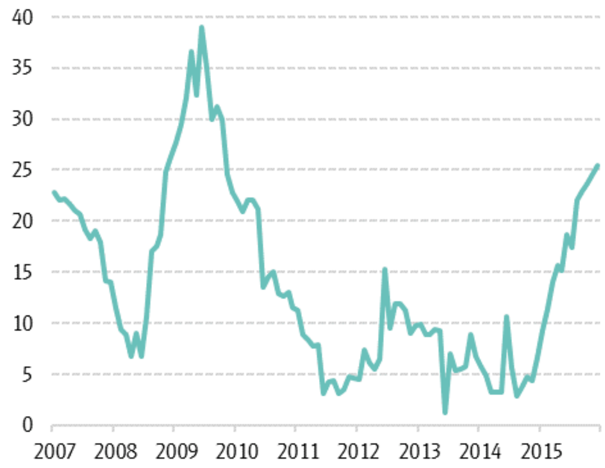
MSCI United Kingdom has actually increased by approximately 8% from before the vote, which is roughly equivalent to the fall in the pound.

Significant stimulus in China

M1 money supply is currently growing by 25% per annum in China, and it is precisely this monetary growth that is an important component of the leading indicators in China. PMI for Chinese manufacturing surprised positively in August with a value of 50.4. Although this may not sound impressive, it is actually the highest level since the end of 2014. The Chinese manufacturing industry seems to be overly pessimistic in relation to the actual development of demand, both with regard to the OECD area's retail growth and China's own retail growth. Therefore, it seems increasingly likely that we will see higher growth in China's manufacturing industry over the next 12 months.

Sharp increase in Chinese money supply

Yearly change in Chinese M1 money supply



There is no doubt that China's growth model is challenged by excessive reliance on debt-financed investments, especially in infrastructure and real estate - and similarly for small investments in production of other goods. In the longer term I expect growth to converge down to 3-4% as a result of demographic developments (aging and retirement) and politically determined misallocation of capital to less productive sectors. However, it does not seem likely that China will run into serious problems over the next 12 months.

MinVol and Quality run into heavy weather

We at Sparinvest have been working with factors for a number of years now, not just implementing factors in our portfolios that we can see via academic and imperial studies contribute to greater returns in the long run, but also by modelling according to when factors work – and more.

The two factors that have worked best over the last two to three years are MinVol (equities with relatively low volatility) and Quality (equities with low debt, high ROE and low earnings volatility). For example, since the start of 2014, MinVol shares have given more than 20% greater yield in relation to MSCI World (7.4% annualised). However, over the last two months MinVol have lost over 4% in relation to MSCI World, which can be an indication that more of the same is on its way. Our models for MinVol show that we cannot expect a yield greater than MSCI World for the next 12 months. In addition, our models for Quality equities show that these will be even more challenged over the next 12 months, where a greater yield will be replaced by a loss in relation to the benchmark.

> *It seems that momentum, value and small cap will work even better*

For the MinVol factor, this is particularly due to the fact that it is primarily, if not almost completely, controlled by three parameters: leading indicators, long interest rates and inflation. All these relationships have shown significant falls over the last two to three years and it is difficult to imagine a macroeconomic environment that could have been more supportive of the MinVol factor. Now this looks about to change, which suggests we will increasingly experience momentum, value and small cap working even better.

The Quality factor and the variables that drive it can in many ways be compared to MinVol, which is the reason for defensive equities as consumer-related equities and the like will be challenged over the next 12 months.

The interest market – have we reached the bottom yet?

Interest rate expectations in the USA rose slightly throughout August and it is increasingly likely that the Fed will raise interest rates this year. The bank's president, Janet Yellen, has also recognised the improvements in the US labour market and still indicates that interest decisions are dependent on continued improvements.

Another relationship that can be a great influence on the American interest market in particular is a regulatory reform of the so-called Money Market Mutual Funds (MMMFs), where institutional investors have had the possibility of conducting short positionings of money. In order to ensure financial stability, from 14th October 2016 the Securities and Exchange Commission will permit these funds to apply extraordinary charges, for example a surcharge for investors wishing to withdraw their money. They can also deny investors permission to withdraw their money. This has led to a very substantial fall in assets for MMMFs and a more or less corresponding rise in assets for funds with short-term government securities. At the same time, interest on short-term commercial papers has risen significantly in relation to the Fed interest rate objective. It is my assessment that the market is in the process of adjusting to the new regulatory situation and there will be no major issues over October 14th. However it cannot be uled out that the market (particularly currency and interest rate markets) may experience increased volatility and higher interest around the date when the new regulations come into force.

> *It is increasingly likely that the Fed will raise interest rates this year*

In conclusion, I will repeat my warning from the latest monthly reports: in the next few months we will experience a larger positive net contribution to inflation as a result of higher prices for energy and raw materials. It is not difficult to imagine the bonds market being shocked by inflation figures, which can easily be over 2% when they have bought long receivables with 0% interest or lower.

Editorial deadline: September 6, 2016