Monthly comment by
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Keep an overweight in shares – but be careful

I have recommended an overweight in shares in monthly reports for more than a year – and this month is no exception. However, it is now necessary to be particularly attentive. If my assessment of a short-lived deceleration is incorrect, a phase shift - see box - may have a significant impact on the returns in the various asset classes.

Long bonds in particular can go from being losers (in expansion) to winners (in deceleration). German 10-year interest rates have already risen about 70 basis points since the expansion phase began in mid-2016, where long-term investors could look forward to a return at expiry of -0.2 percent per annum.

"Momentum shares and minimum volatility shares in particular can benefit from a phase shift"

If we look at factor returns, especially momentum shares and minimum volatility shares can benefit from a phase shift, while small cap shares in particular have historically been challenged. Given that the small cap segment has already performed exceptionally well over the past year, this could be a reason for long-term investors to consider scaling down on small cap exposure.

High Yield corporate bonds are expensive

Poor outlook for the long term investor

Phase shift – the deceleration will be short-lived

The phase shift in the OECD Leading Indicator (CLI) that I have written about in recent monthly reports has now taken place. The expansion phase (where the CLI is high and rising) was quite short in relation to the average length of the phase and I still believe there is a high probability we will also experience a relatively short deceleration phase (where the CLI is high and decreasing).

This is because the CLIs for both the Eurozone, Japan and China are still rising and the US leading indicator from the Conference Board is rising rapidly. Also, when we look at the individual components of the OECD CLI we can see that many are also continuing to rise, or have at least stopped falling. This applies to both the stock market, the curve slope, the number of building permits and consumer confidence.

Against this background, the deceleration phase in the US is likely to be relatively short-lived and subsequently replaced by a new expansion phase. The great importance of the US means this analysis also applies to the OECD's overall CLI.

High Yield corporate bonds will also be affected by a long-term phase shift. In a deceleration phase their typical monthly return is 0.69 percentage points lower than their average long-term return. Since this segment has also performed very well over the past year and now looks quite expensive, it also makes sense for long-term investors to reduce their exposure. High Yield bonds are now trading to an option-adjusted spread (OAS) against government bonds of just 3.67 percent, which is very close to being a historically poor risk premium in relation to government bonds. Similarly, the effective interest rate also hit a record low at the end of July with a level of only 5.14 percent. Yet another relationship that ought to be of concern to long-term investors is the Moody's report claiming that June saw the highest percentage of "covenant-light" issues (i.e. with poor access to creditor collateral) ever recorded.

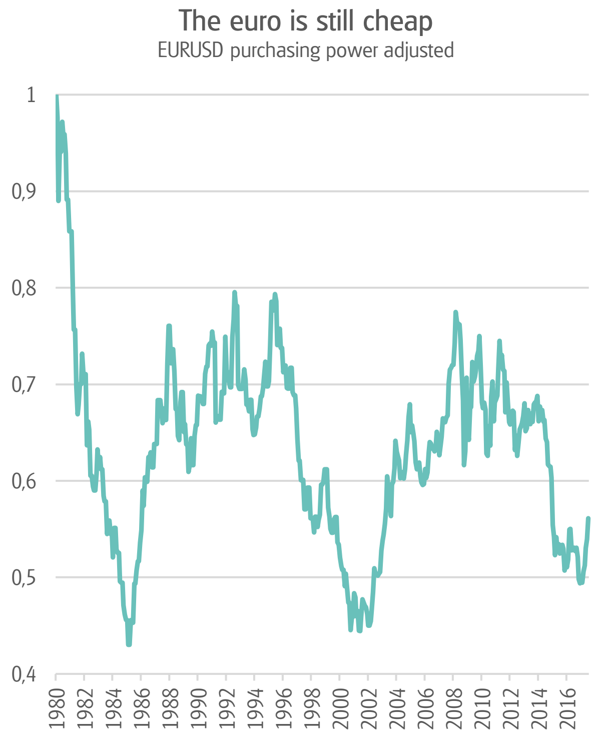
Strongest Eurozone growth since 2011

Despite the phase shift in the CLI for the OECD area as a whole, the CLI for the Eurozone continues to rise and other indicators are currently also solid. Eurozone consumer confidence is at its highest since 2011 and unemployment continues to fall.

GDP growth for the Eurozone was 2.1 percent at the beginning of August (for second quarter growth), which is also the highest since 2011. On top of this, high-frequency data shows we can expect an even higher growth rate when the figures for the third quarter are made available.

> *" It is my assessment that in six to twelve months the euro will be even higher than its current level"*

As a consequence of the good European key ratios - and weaker expectations for the US economy - EURUSD has risen to its highest level for more than two years. In addition, the very large spread between German and US long-term interest rates has begun to normalise slightly.

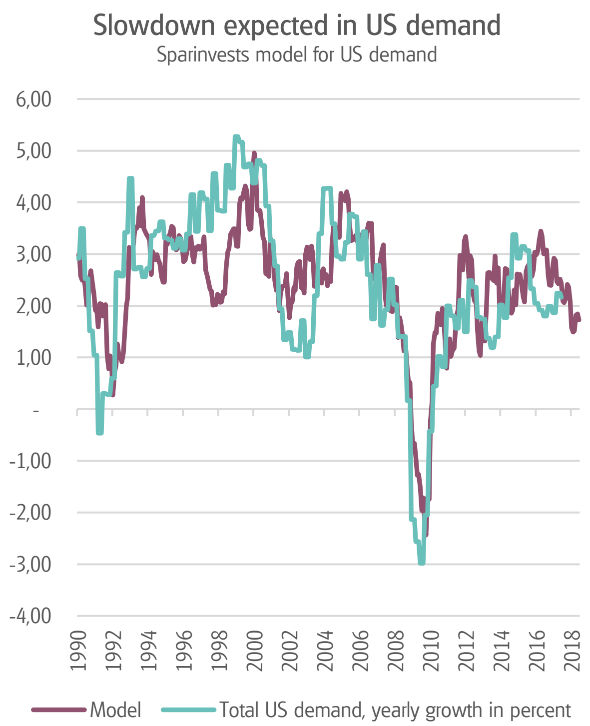


EURUSD seems overbought at present but in terms of purchasing power the euro remains relatively cheap compared to the US dollar (see graph). It is therefore my assessment that in six to twelve months the euro will be even higher than its current level.

The end of strong returns on shares

Although global surplus liquidity (defined as the difference between inflation-adjusted money supply growth and GDP growth) has almost halved over the past 12 months, it remains healthy. This probably means that we should not expect the same strong returns in the stock market over the next 12 months that we have had over the past 12 months.

Global credit impulse (defined as lending growth relative to nominal GDP) has also been declining slightly in recent months, primarily due to US figures. However, at the present time this is not cause for concern.



Our model for total demand in the US also shows a tendency towards a slight slowdown to about 2 percent over the next 6-12 months. Our model for US car sales in the table below shows that we can expect the last 12 months of strong deceleration to stabilise. We can expect a greater decline in European car sales, where current growth of around 6 percent is predicted to fall to close to zero. The current turmoil in the automotive industry (where Tesla shareholders are currently happiest) is set to continue.

" The growth rates in industrial output for Europe and Japan will probably converge towards 2 percent"

Current industrial output growth is quite high across regions. Only in the US is growth around 2 percent. It is about twice as high in Europe and Japan. According to our models, we face a deceleration over the next 12 months, especially in Europe and Japan. For these two regions, growth rates for industrial output will probably converge towards 2 percent, which is also a more natural level given their respective levels of GDP growth.

For the United States, we can probably look forward to a slight increase in growth. With regard to order growth in the manufacturing industry, the situation looks a bit more serious, as both the US and Europe can expect a sharp deceleration over the next 12 months. Negative growth in orders for both Europe and the US cannot be discounted.

Are expectations too rosy?

Given our above model predictions, it is a good idea to compare expected development with the various leading surveys. PMI surveys (composites) in both the US and Europe are well above 50, which is the dividing line between expected decline and upturn for participating businesses.

The Eurozone PMI survey is already falling. In April it was up to 56.8, which was the highest for several years. In my opinion this survey will gradually decrease to 51-53 over the coming months as expectations for European industry hit reality.

Similarly, US expectations will moderate slightly. Also, given the above-mentioned phase shift for US leading indicators, it would be natural to expect a moderation in economic activity.

The indicator point to shares

Our MomVol indicator assumed a value of 0.96 at the end of July, which is higher than in the previous month and still solidly above the threshold of 0.6, under which one ought to be underweight the stock market.

" For August, it is still my assessment that one should keep an overweight in shares but also be prepared for a possible reduction after August"

Unlike the indicator's signal, the OECD's CLI has changed phase. This means investors should be on their guard. For August, it is still my assessment that one should keep an overweight in shares but also be prepared for a possible reduction after August.

Editorial deadline: August 4, 2017

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