



Monthly comment by
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A phase shift for the OECD leading indicators?

In the short-term we are not facing a severe decline in the so-called Composite Leading Indicator (CLI), which measures the future state of the economy, and in my opinion an imminent phase shift will be relatively short-lived – if it ever comes.

We have not yet received fresh figures from the OECD for May but when we look at other leading indicators from the different countries - and particularly the US - there is no indication that we are already heading into a 'deceleration phase' where the CLI is high and decreasing.

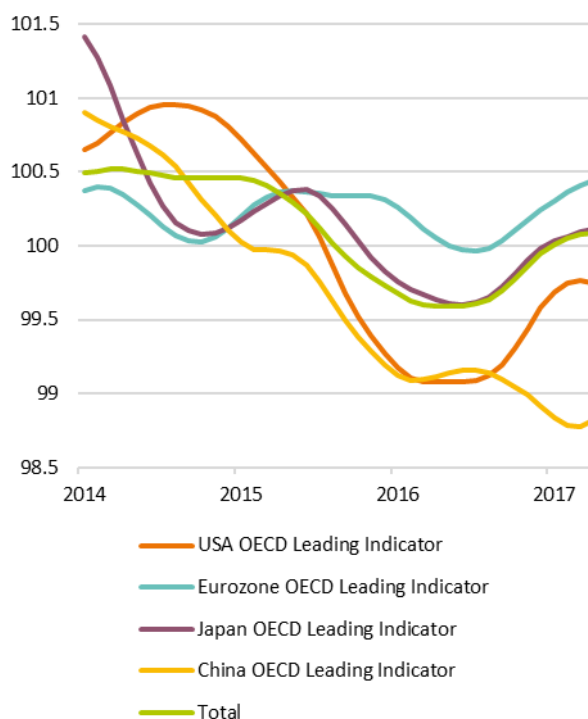
The Eurozone CLI is rising sharply and does not look like it will be peaking any time soon. Japan may be a little closer to reaching a peak but we are not likely to see one within the next two months. China's long and stable decline was reversed last month by a slight increase.

The leading indicator from the Conference Board continues to grow rapidly in the US both in terms of the annual change and also the annualised 6-month change, which bodes well. In addition, the ISM Manufacturing Survey has been stable for the last two months at a perfectly respectable level of around 55. The NAHB survey, which measures the expectations in the construction industry, is also at a very high level. In my opinion, the modest decline in building permits we have seen in recent months will be temporary.

OECD's Composite Leading Indicators are very much dependent on how industrial output is going to evolve. One of the reasons why we see trends in deceleration for the US economy may be that the manufacturing industry has gone from being overly pessimistic in 2016 to being overly optimistic. Our own industrial production models also show clear trends towards deceleration over the next 12 months. However, ISM non-manufacturing, which covers services, shows a healthy 56.9.

The indicator is a GDP-weighted version of the various regional leading indicators, and its move closer to a deceleration phase is solely due to the fact that the regional indicator for the United States is declining – and that the United States is so significant.

OECD Leading Indicators, trend-adjusted
USA, EU, Japan and China

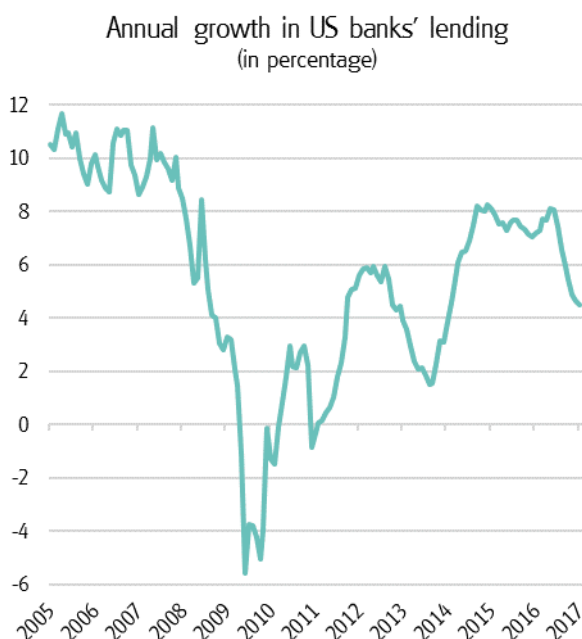


Decrease in US lending growth

Some analysts have noted that there is currently a fairly sharp fall in US lending growth and several have concluded from this that US growth will be slightly challenged in the near future. However, if we look closer at the growth we see that the decline in US lending growth is primarily related to two factors:

1. A lower value of US banks' holdings of government and mortgage bonds (hardly surprising in a period of rising interest rates)
2. A weak rise in loans for car purchases (also hardly surprising given the previous enormous increase in these loans over the past two years)

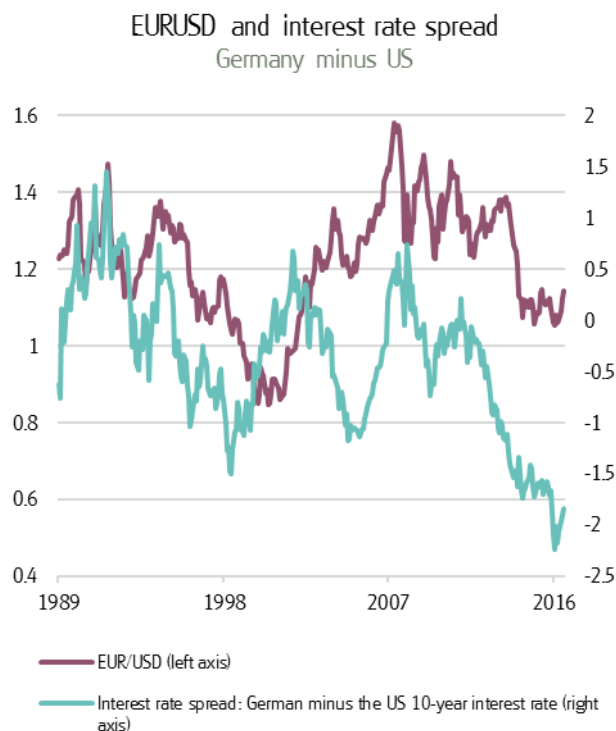
My assessment is that we should not be particularly concerned about deceleration right now, and that after the summer we will see a stabilisation consistent with normal growth in the US economy.



Draghi is moving the market

On June 26, Mario Draghi held a speech that was regarded by the market as markedly tough talk. Draghi explained that the deflationary forces in the economy had gradually been replaced by inflationary forces, and that there could be a positive surprise with regard to growth.

Draghi, who usually defends the status quo (a very soft monetary policy) surprised the market, which responded by pushing German 10-year interest rates 25 basis points higher over the following five trading days. The euro also rose sharply and reached its highest level for over a year.



At the same time, the market's reaction has reduced the historically high spread between US and German 10-year government rates, which is perhaps the most significant event after Draghi's speech.

Looking at the spread between 10-year rates, since the financial crisis this has had almost only one direction: enlargement in favour of the United States. It has been a nearly constant symbolic indication from the market that European growth perspectives were regarded as hopeless in relation to American growth perspectives.

With the slightly asymmetric image of the leading indicators (at least OECDs) as described above, the narrowing of this spread can easily continue in the coming months. This will probably lead to further strengthening of the euro unless Draghi suddenly changes his tone. As US stocks are still more expensive than European equities, it is still my assessment that European-based investors in particular should have an overweight to European shares in relation to the MSCI World Index (MSCI World), and correspondingly an underweight to US stocks. This also reduces volatility from the implicit currency exposure of US stocks.

Two Italian banks acquired by Intesa - less macro risk?

The two struggling Italian banks, Banca Popolare di Vicenza and Veneto Banca, were taken over by Intesa in late June. The takeover took place after the Italian state injected 17 billion euros into the banks to recapitalise them and make them a more attractive takeover proposition for another bank.

The acquisition, together with the recapitalisation of Banca Monte dei Paschi di Siena, means that a significant part of the dark cloud still hanging over Italian banking from the financial crisis is now on the verge of disappearing. It is not a pretty sight to see taxpayers' money being used to support commercial companies but it cannot be denied that the market can now breathe a sigh of relief.

The entire EU regulatory setup for solvency-pressed banks has probably been violated but it has happened in accordance with the spirit that still prevails here 10 years after the financial crisis: it is better for taxpayers to pay up than to expose the banking system to a violent shock – which it most certainly would have if the three newly acquired Italian banks would be taken over or closed down in accordance with regulations.

It is worth noting that the Italian 10-year interest rate spreads in relation to Germany have narrowed after the acquisition, so the market does not see any major macro risks related to Italy after the acquisition. In a larger perspective, this inelegant but effective solution can also help convince the market that Europe is becoming a more attractive investment proposal relative to the United States, which has been able to attract most investors in the wake of both the financial crisis and particularly the euro crisis.

Keep overweight to shares

Our MomVol indicator assumed a value of 0.92 at the end of June, which is unchanged from the end of May and still solidly above the threshold of 0.6, under which one should be underweight the stock market.

The indicator's signal is further supported by the fact that most of the OECD's leading indicators are still in the expansion phase, so the stock weight should be maintained in July.

Editorial deadline: July 7 2017

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