Sparinvest

Monthly comment by
Chief Strategist, David Bakkegaard Karsbøl

A possible economic slowdown will be short-term

In the last monthly comment, I used the starting point of the OECD area's leading indicators to describe how the global economy had moved into a new phase of the trade cycle (expansion), as well as how this phase has historically favoured high-risk active classes. This phase usually lasts nine months but the newest and revised OECD figures indicate it already looks like the rate of increase in the leading indicators is cooling down so much that a peak can be close – and might even be reached as soon as next month.

If this happens and we enter into a new phase (deceleration), it will be atypical because the current phase has been relatively short. This will have significance for how to best allocate resources.

To a large extent, this applies to the allocation of shares and convertible bonds. If necessary, these must be scaled down from overweight to underweight. In the expansion phase, global equities normally yield 0.49% more in return than their long-term monthly returns, whereas in the deceleration phase they normally yield 0.93% less.

> *"It is difficult to imagine a serious economic downturn in the near future"*

A phase shift can also have great significance for the allocation of long bonds. Long bonds normally suffer in the expansion phase with a monthly return of 0.46% less than the long-term monthly return (which to a greater extent is dependent on price fixing – in other words, interest rates) but in the deceleration phase they normally yield a monthly return of 0.14% more than the long-term monthly return.

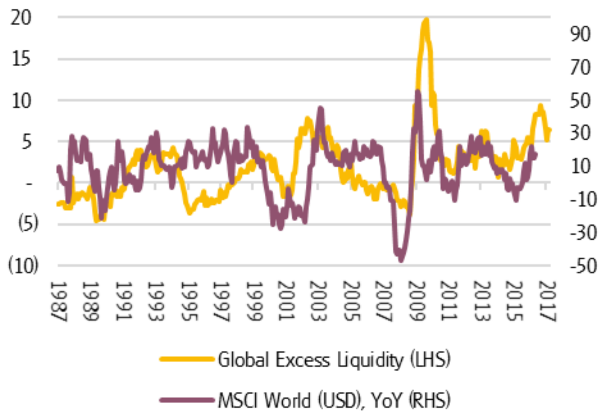
When one looks at the other indicators such as various surveys from PMI and NAHB, industrial production, exploitation of capacity in the USA and the Eurozone as well as the IFO investigations' expectations component in Germany, it is difficult to imagine a serious economic slowdown in the near future.

Nevertheless, the bond market is showing a certain scepticism. The long inflation expectations (5Y5Y) have been showing a weak downward trend over the latest months and yield curves have slowed somewhat since President Trump's inauguration. This is particularly true in the USA, where the bond market probably over-estimated Trump's ability to get the most inflationary initiatives from the election campaign implemented.

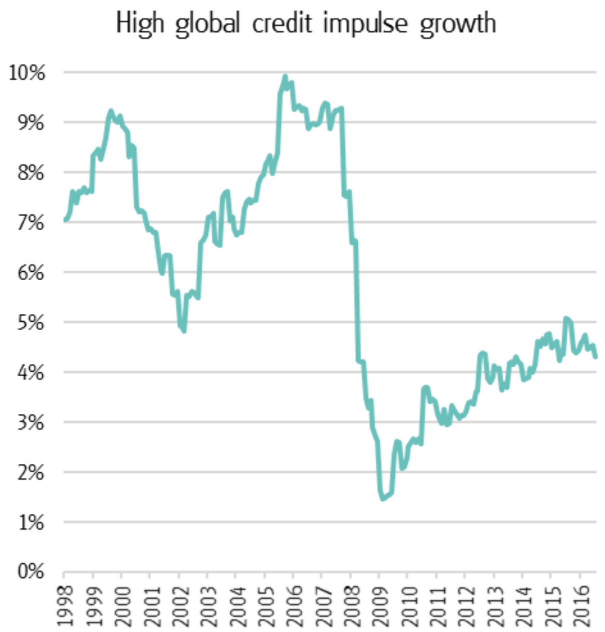
Continued significant surplus liquidity and credit impulse

Our models for surplus liquidity (defined as how much faster the M1 money supply grows than inflation and production in society) are designed to show whether the liquidity still supports high-risk active classes. Now, money supplies are growing so quickly that global surplus liquidity (see figure 1) is growing at an annual rate of about 6.5% - and the trend shows a relatively steady acceleration since the end of 2013.

Abundant surplus liquidity usually supports the stock market



If we look at the global credit impulse as an indication of the size of the lending increase in relation to gross domestic product in the four major regions (USA, Eurozone, Japan and China), the picture still looks quite favourable with a credit impulse of almost 5%.



One can add a caveat here: China is pulling the heaviest load with regard to both surplus liquidity and credit impulse. Chinese money supply increases by 18.5% a year, which is both high and decreasing. On the other hand, both the British and Japanese money supply is increasing, and the Eurozone and US monetary growth is stable at solid levels.

"If we see a top in the leading indicators – and therefore a phase shift – it will probably be relatively short-lived"

This suggests if we see a peak in the leading indicators – and therefore a phase shift – it will probably be relatively short-lived. One possibility is also that the OECD's next update will include a review of already published data so the upward trend is maintained. So far, I still feel moderately optimistic.

Positive European growth spiral

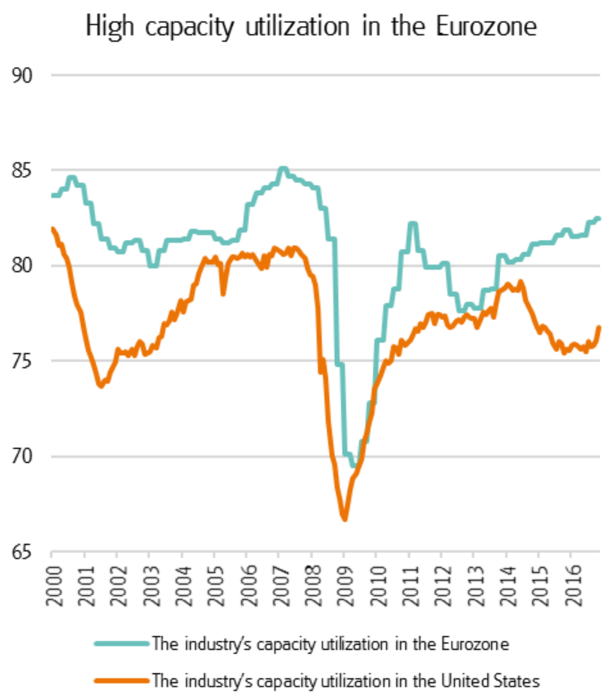
After disappointing levels in mid-2016, Eurozone retail sales are now back in top form with growth of 2.5%. This is also reflected in the PMI retail zone, which for once has lasted for 50 consecutive months.

The Eurozone Sentix Investor survey, which measures the future prospects of institutions and private investors, continues its growth in May with 28.4. This is the highest level since 2007. There was a surprise 9.3% fall in unemployment in the zone, taking it to the lowest level since 2009.

Capacity utilisation in the Eurozone has now reached 82.6%, which is the highest level since 2008 and, significantly, higher than in the USA's level of 76.7% - despite their higher inflation and wage growth.

"The Eurozone is heading for a period of growth lasting many years that will be similar to the one the USA has benefitted from since the middle of 2009"

If we ignore any phase changes in the OECD's leading indicators (which in my opinion, are likely to be short-lived), the Eurozone is heading for a period of growth lasting many years that will be similar to the one the USA has benefitted from since the middle of 2009.



This is because there are so many positive indicators that also mutually reinforce each other – just as they did in a negative spiral after the Euro crisis in 2011.

Banco Popular de Espanol – bad news for bondholders, good news for the market

In early June, Banco Popular was taken over by Banco Santander. Banco Popular had many bad loans and significant exposure in Andalusia, which is sometimes called "the outskirts of Spain". Shareholders' values were written down to zero, as were both the AT1 capital and the T2 capital.

Santander made a capital increase of Euro 7 billion in connection with the acquisition. Bank bonds issued by Santander are now trading higher due to the greater security in Santander's capital structure.

Banco Popular has long been one of the problematic southern European banks whose bonds traded at prices that symbolised a major – and still unresolved – issue that has its roots in the 2011 Euro crisis. Because the bank has now been taken over painlessly (for taxpayers, at least), this indicates that the European Banking Union is not completely irrelevant and that the Single Resolution Board (which deals with bank solvency problems) actually did a good job in this case.

The market reaction has generally been calm. A problem was resolved satisfactorily, and thanks to the low volatility and current optimism the market can look forward to the fact that several of southern Europe's solvency-driven banks may get similar treatment.

MomVol indicator

Our MomVol indicator showed a value of 0.92 at the end of May, which is a slight decrease from the end of April and still solidly above the 0.6 threshold, under which we should be underweight in 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 stock weight should be maintained in June.

Editorial deadlinwe: June 7 2017