Sparinvest

Monthly comment by
Chief Strategist, David Bakkegaard Karsbøl

Economic tailwind for shares

Jerome Powell is the new Fed head

Donald Trump has now made his decision regarding who will succeed Janet Yellen as the new head of the US Central Bank. The choice fell on Jerome 'Jay' Powell, who I discussed in the previous monthly report. As this is the middle of the road choice, it is probable that Powell will not subject the markets to greater surprises as he is largely 'more of the same'. The appointment defies Trump's own party, who mostly wanted a hawk – in other words, a head who would have quickly normalised monetary policy.

So far, Powell has only expressed truisms in connection with his appointment, but we can presume he will not be responsible for any notable surprises in the effort to control the slow normalisation of American monetary policy over the coming years.

Interest markets will be unaffected by the appointment, and it is still expected that interest rates will be raised twice from the present level of 1.5 percent to 2.0 percent by the end of 2018.

Probably the biggest unresolved question related to Powell's nomination is his support of the so-called Dodd-Frank act to regulate the American banks. The Republicans – and the Trump administration – have often expressed ambitions about deregulating large chunks of the Dodd-Frank act, which they see as an administrative burden for U.S. banks that increases the cost of financing American businesses.

Powell is in line with Yellen on this question, which probably reduced her possibility of being re-elected as the head of the U.S. Central Bank after she expressed her support to Dodd-Frank at this summer's Jackson Hole conference. U.S. bank shares delivered greater returns in relation to the broad market after Powell's appointment, so the market does not expect major problems from his resistance.

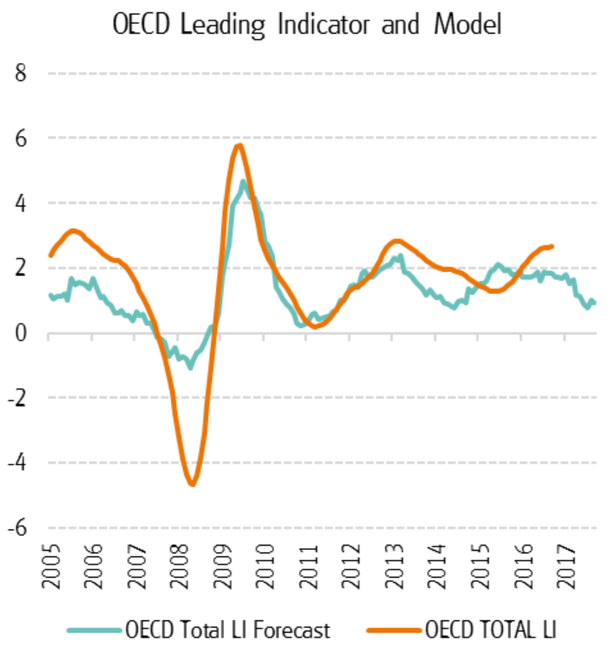
Tax reform in the USA

In October, we learned more about Trump's promised tax reform. Corporation tax looks like being reduced to 20 percent, rather than to the 15 percent he promised in the election campaign. Considering the current U.S. corporation tax of 35 percent is at the higher end of the spectrum, this helping hand will be of particular benefit to American small and medium-sized businesses. Unlike bigger companies, these have not had the opportunity of optimising their tax payments across national borders and laws.

It is still an open question as to whether the tax cuts will be phased in or given in one go in the near future. The latter option might prove too costly for the national budget. On the other hand, the economy will react faster to the cuts, which can be valuable for the republicans in forthcoming elections.

The combination of low inflation and low interest rates supports risk

Key figures from both the USA and the Eurozone continue the solid trend seen in recent years. The American labor market is getting tighter almost monthly and is breaking one historical record after another – yet wage increases and inflation remain moderate. In other words, there are no grounds for more than symbolic and gradual rate hikes in the USA.



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With a nice upward curve in the bonds market, a nominal (in other words, including inflation) BNP growth of 4.1 percent and a strong growth in the leading indicators from both the OECD and the Conference Board, it comes as no surprise that the US stock market is reaching new heights almost on a weekly basis.

If we look at the Eurozone, the picture is more or less the same in the near future. As I have described previously in the monthly report, it is my continued impression that the Eurozone is in a cyclical sense a couple of years behind the USA. Unemployment in the Eurozone is still falling systematically but due to the southern European countries, it remains relatively high at 8.9 percent.

The coming months will herald strong growth in both the USA and the Eurozone. However, our models indicate that US growth in particular will be significantly weakened after the New Year. This applies regardless of whether we look at the models for orders for consumer goods, general demand or industrial production.

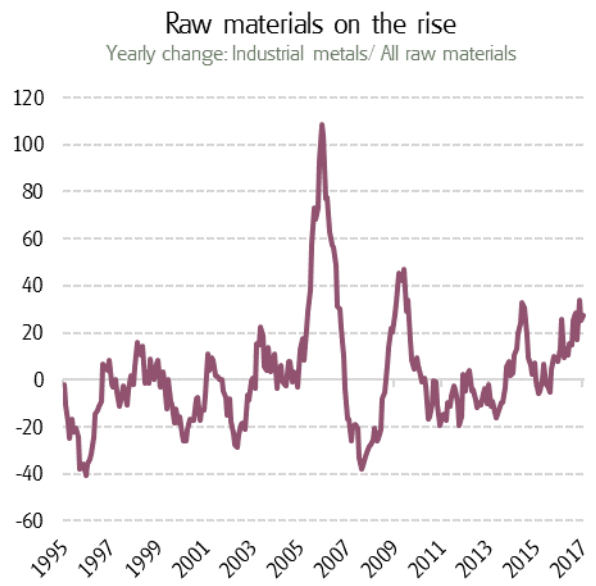
The model for leading indicators in the USA further supports this conclusion. However, it is still too early to expect anything other than a temporary downturn in growth rates. There is no discussion of a recession in the next 12 months. The Eurozone looks slightly healthier. The leading indicators will also fall over the next 12 months, but not to the same degree.

Thus, there is continued macroeconomic support for risk-heavy asset classes – including shares, which are also experiencing solid earnings growth.

Fewer ECB acquisitions

In October, the ECB decided to halve their monthly acquisition of European government bonds to EUR 30 blilion. At the same time, assurances were made that repayments would be reinvested in order to maintain the ECB's portfolio, which already amounts to over EUR two trillion.

Although when seen in isolation this is an expected tightening, the ECB's monetary policy will continue to be quite lenient, thus contributing to supporting risk-heavy assets.



Raw materials are rising in price – buy EM

As mentioned above, the gathering strength of the global economic recovery has not yet resulted in significantly higher inflation, but the entire commodities edifice has begun to show signs of movement. Energy prices show moderate increases since the beginning of 2016, but industrial metals (copper, aluminum, nickel and zinc) are rising faster than other raw materials, which is a typical sign of a strong global economy.

The long-term investor should maintain a relatively large allocation of EM shares

Following the financial crisis, the excess return on industrial metals compared to other commodities has been very closely correlated with greater Emerging Market shares returns in relation to the developed markets. Since EM shares are still very cheap and are finally experiencing high earnings growth (and greater growth than the developed countries' stock markets), the long-term investor should maintain a relatively large allocation of EM shares.

Venezuela throws in the towel

An expected - but still negative – piece of news from the EM countries was that Venezuela's President Maduro finally decided to throw in the towel over the country's debt. It has been a long time since Venezuela has had a stock market, but Venezuelan bonds have been included with significant weight in various EM bond benchmarks. Due to the very high interest rates in Venezuela's issues, asset managers with underweight have had difficulty hitting their benchmarks as long as Venezuela did not go into receivership.

Now, what could actually have happened at any time in the past ten to fifteen years has become reality, and investors will experience some drastic 'haircuts' (write-downs) on their investments. If history can be used as a guideline for future development, a great many investors will be prepared to invest in the reconstructed bonds, just as they did three times in a single decade with Argentina. Venezuela will then be able to continue on its irresponsible and ill-conceived journey towards planned economics and dictatorship, to the detriment of the vast majority of the population.

The leading indicators show continued growth, which further supports my assessment that one should continue to maintain an overweight to shares

MomVol indicator

Our so-called MomVol indicator assumed a value of 0.83 at the end of October, which is lower than in the previous month, but still solidly above the threshold of 0.6, under which one ought to be underweight the stock market.

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