Sparinvest

Monthly comment by
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Trade war tweets are theatre thunder

Less fear and more buy-backs

July has seen a number of contradictory statements from Trump about trade policy. As in so many other matters, the market has gradually become accustomed to a great deal of unpredictability from Trump with regard to trade policy. The assumption seems to be that there will definitely be some form of punitive customs duty on a range of goods, particularly from China. The Chinese response, however, is expected to be moderate and more or less designed to be a symbolic gesture to ensure that the Chinese leadership does not lose face.

By far the majority of economists still agree that a trade war makes no sense, but that the socio-economic losses arising from the current measures are negligible. In reality, the current perception of the trade war is that it is theatrics, the primary purpose of which is to show Trump's voters that he is "doing something" for them. Ironically, in many cases they will be the biggest losers as a result of the reactions from USA's trading partners.

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The fact that the stock market has become accustomed to Trump's volatile Twitter rhetoric can be seen in the healthy rise of almost 3% in the MSCI World (EUR) through July. The rise is not due to a fall in EUR, which has been fairly stable. Rather, it was driven by large American shares, as the S&P500 rose by nearly 4%.

Although the American tax reforms in particular are carrying the current optimism, it is also a great help that the big American IT companies have implemented major buy-back programmes in the first and second quarters, as well as announcing record-sized re-purchasing programmes for the rest of the year.

Higher inflation expectations

US optimism is associated with the expectation of higher inflation. The so-called 5Y5Y inflation swaps (the market's expectation of where inflation levels will be in the timespan from five years' time to ten years' time) are being traded at 2.46. This is clearly higher than the American Central Bank's long-term goal, and they are also slightly on the rise.

Even though the manufacturing industry's ISM Price Paid Survey is falling, it has been over 70 for the whole year. 50 is the demarcation line for between expected, falling and rising prices. Actual US inflation is now at 2.9%. The somewhat less volatile core inflation is "only" at 2.3% but our model shows that it will crawl up towards 2.5% over the next couple of months, which the Central Bank ought not to be comfortable with.

The tendency for expectations of higher interest has not yet spread to Europe, where rates are still lower than in the USA

Expectations regarding short-term interest rates also rose in July in reaction to the higher interest expectations, which are controlled by the US Central Bank. In addition, the tendency to a falling curve slope in the USA looks like it will be broken in the middle of the month, where long-term interest rates rose markedly.

The tendency for expectations of higher interest has not yet spread to Europe, where rates are still lower than in the USA. Nevertheless, in July the curve slope (the difference between two-year and 10-year rates) rose considerably more in Europe than in America.

Strong earnings growth continues

One of the reasons for this can perhaps be found in the fact that European earnings growth (33% year/year) is significantly higher than in the USA, Japan and the EM countries, who are all at around 17-19% year/year.

In most cases there is a fairly clear correlation between the leading indicators in the major regions and the earnings growth in their companies. Therefore, in my opinion, there is a risk that the stock markets will trade on the steam from the leading indicators, which generally rose across all regions from the middle of 2016 until now. They are now falling in Europe and Japan but are still continuing to rise in the USA, although at a greatly reduced rate. With regard to the USA, I also expect their leading indicators to fall within a month or two.

Firstly, this means that earnings growth will most likely be falling in around 6-9 months' time, although in all probability it will continue to be positive. Secondly, global GDP growth will presumably also be falling in around half a year.

Updated models

As well as falling indicators, falling growth in European retail trade is also a challenge for future growth. At the present time, we see a pronounced weakness in European trade with a growth of only 1.2%. American retail growth is right up at 6.6%, which is presumably due to an incredibly tight labour market, great optimism and the tax reform that Trump implemented.

Matters looks serious for Europe because consumer growth is a significant driver for growth in production. If companies experience weak consumption, they naturally reduce their production to avoid producing for the warehouse.

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When European companies experience a weak rise in consumer growth they will reduce growth. According to our models, it looks like the majority of these reductions will take place from now until the new year. In other words, European GDP is rapidly on its way to a lower gear – and this view is also supported by the OECD leading indicators.

It will not be so bad in the USA, which is experiencing much tighter labour markets (only 3.9% unemployment and a veritable explosion in newly advertised job positions). Even though our models for industrial production also point towards a certain level of deceleration (falling growth rates), it will not be nearly as pronounced as in Europe. Firstly, as already stated, the leading indicators are still rising; secondly, consumer growth is much higher; thirdly, levels of optimism among American consumers and companies are approaching record heights.

The EU continues to weaken

Predicting currency movement is generally futile but due to the differences between the US and the European economies as mentioned above, in my opinion the Euro is on its way to being weakened. The yield spread largely favours the US Dollar and considering the continued deceleration in the European economy in particular and the difference between levels and changes in the OECD leading indicators for the two regions, it is very difficult to imagine that this picture will change over the next six months.

Share allocation

The stock market was quite strong in July and our MomVol indicator showed a value of 0.67 at the end of the month. This is just over the 0.6 threshold for when – according to the indicator – one ought to invest in the stock market.

On the other hand, the overall leading indicators (CLI) for the OECD region continue to fall, which, seen in isolation, means that one should stay away from shares.

Against this background, I believe that we have a strong stock market momentum in a decelerating global economy, and that one should therefore have a neutral allocation with regard to long-term target allocation.

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