Sparinvest

Monthly comment by
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A 30 years downward trend in interest rates have been broken

Wage inflation breaks the downward trend in interest rates

At the end of January, the markets were set for a perfect storm. A decades-long trend of falling interest rates and falling inflation – and inflation expectations – seemed to have ended, as the 10-year US government bond yields looked like breaking the downward trend they have had since 1987. Interest rates went up to the trend line at the end of the month several times but although the macroeconomic figures were good, none of them were solid enough to send interest rates up enough to break through the trend line.

However, this all changed on February 2nd when we obtained the US labour market's key figures. These were generally good, but one thing in particular stuck out: the annual growth in the American hourly wage. For years after the crisis, wage inflation was low despite a steadily tightening labour market. Several analysts declared that the so-called "Philips curve" (the usually negative correlation between unemployment and wage inflation) was dead but the latest figures seem to show that it has arisen from almost a decade of slumber.

With an annual wage increase of 2.9%, where analysts only expected 2.6% (and where the previous month's wage increase was even upwardly revised), it can now no longer be claimed that wage inflation is dead. This good key figure was the trigger for the US 10-year interest rate eruption. Over a couple of days, the interest rate rose by 0.1 percentage points. Generally speaking, this is not unusual. What is unusual, though, was the breach of the downward trend line that has existed since 1987, and that the stock market also had a nervous eye on.

Then the volatility arrived

There is normally a positive correlation between interest rates and shares. In connection with rapidly rising interest rates, we experienced a fall in shares, and the fall gathered pace as the stock market began to realise that years of lenient monetary policy were coming to an end.

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It also looks as if the period of exceptionally low volatility has ended. As late as January, the VIX index was being traded right down to 9.2 – the lowest ever, which in itself should be a warning for both sceptics and long-term investors.

As US interest rates broke higher, it was only three days before the VIX index rocketed up to almost 50 before settling again. However, we cannot expect to see moderate volatility in the coming quarters. Shares are too expensive and markets are too affected by central bank policies. As the central banks are dramatically changing their monetary policy compared to the major QE programs, it will of course result in permanent state of heightened alertness among investors.

It is very much about American shares, which have benefitted most from the US central bank's loose monetary policy, and at the same time run the risk of pressure on earnings from wage growth (see below).

Hysteria heads towards realism

The market's behaviour has been typical for this point of the business cycle. Fundamentally, the market – as it always is this late in the cycle – is afraid that in the eyes of the central banks the economy will overheat. This will result in monetary policy being tightened too fast and too much, so the economy reacts negatively. It is my assessment that there are many months – and probably even quarters – before one can say the American central bank has tightened monetary policy too much, and it will be many years before the effects of this hit the Eurozone.

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Nevertheless, the market has undoubtedly entered a new phase where, for the first time in many years, this worry is starting to become relevant. In the USA, shares investors have to also contend with a poisonous cocktail of very high pricing as well as lower margins caused by wage pressure that now seems to be making an appearance. Wage inflation will start to make itself felt in company margins within a few months, and this will throw sand in the machine of American returns. In 2018, it will not be enough to ruin the picture of a strong rise in earnings. In my opinion however, the primary reason for weak earnings growth in 2019 will be major wage increases.

To be completely clear, I would like to reiterate that our models' long-term return expectations for American shares is a 4% annualised nominal return over a 10-year period. Over the last nine years, investors in American shares have been able to enjoy an annualised return of 18% (in USD). All good things come to an end.

The market's reaction to the good macroeconomic ratios was undeniably negative - despite the fact that wage growth is actually positive and healthy for an economy. If it were not for already expensively priced risky assets, the market reaction would not make sense. But stocks, for example, were expensive because of a far too lenient monetary policy, and underlying support from the central banks cannot now be counted on to the same extent. It creates nervousness - not to say hysteria - because the stock market now has to stand alone so focus is naturally much more on the extent of earnings growth.

The invincible convertible mortgage loans lost

In the last month's report, I described how the otherwise invincible convertible long-term Danish mortgage bonds had resisted the tendency towards interest rate hikes in the rest of Europe and were apparently being traded in a parallel universe. I also questioned whether investors in this segment properly understood the risk involved in these bonds.

In the course of January and early February, however, the virtual penny started to drop as this segment has fallen by several price points. Convertible mortgage bonds tend to accelerate losses when higher interest rate hikes occur over a short period of time.

This is because part of the extra returns that investors can expect in a quiet and stable market in this segment stem from an option that allows the borrower to redeem the bond early (equivalent to buying the bond) at 100 point. The lower the bond is traded under 100, the lower this option is also priced, which leads to higher interest rate sensitivity on the bond – which naturally leads to higher losses when interest rates rise. The opposite also applies when interest rates fall, which is why stable interest rates are most favourable for convertible bonds.

The credit spreads in Danish convertible mortgage bonds are still very narrow (despite the recent expansion), which means that continuing losses in this segment are to be expected in relation to the rest of the mortgage market. As the segment's expected extra returns have disappeared, our bond team has reduced its allocation and it is still too early to increase it again.

Is there any reason to change expectations?

We are heading for a normalisation of monetary policy, so we can expect to see rising interest rates together with increasing volatility and uncertainty over the coming months. Nevertheless, the economic indicators will probably be quite healthy up to the summer of 2018. From here on, I expect quite a pronounced deceleration from industrial production in particular, coupled with the current over-optimism being replaced by moderate expectations.

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My assessment is that inflation, inflation expectations and interest rates will be on the rise over the coming months. However, as economic growth is likely to decrease (without being negative) after the summer, interest rates will probably peak in the spring and then be replaced by a slight downward trend.

As we approach 2019, US growth in particular may be challenged because the US economy is already running close to full capacity. The picture is somewhat different in Europe, where the labour market can still get much tighter before we notice a significant wage inflation.

The MomVol indicator

Our MomVol indicator assumed a value of 0.9 at the end of January, which is higher in relation to the previous month but still solidly above the threshold of 0.6, under which one ought to be underweight the stock market.

The leading indicators show continued growth, which further supports my assessment that one should continue to maintain an overweight to shares. However, long-term investors ought to reduce their exposure to US shares, where there is limited long-term potential and the danger of damage from both volatile monetary policy and the USD exchange rate.

Emerging Markets shares still offer the best long-term returns due to considerably lower price levels. European shares are still cheaper than US shares and European investors also do not have to contend with USD currency rate concerns.

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