Sparinvest

Monthly comment by
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Mid-term elections can lift U.S. shares

The stock market took an undesirable turn in October as most markets lost between 6-10 percent. This development must be seen against a background of a general dependence on monetary policy, especially in the U.S., where the Fed has raised interest rates from 1.25 to 2.25 percent since December last year.

This fiscal tightening has meant that investors have been forced to get used to the fact that higher rates have become an increasingly significant element in competition with the stock market, which, due to current high pricing, is expected to deliver limited yields over the next 10 years. It is no longer controversial to predict a yield on American shares of less than 5.0 percent per year over the next decade. When 10-year U.S. government bonds are expected to deliver 3.0 percent over the same time span, it is no longer obvious that the risk-adjusted return is better in the stock market than in the bonds market.

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There have also been fears that a recession in the U.S. will appear soon because the yield curve has become so flat. In addition, the Fed's guidance is still that short-term interest rates will rise, meaning an inverted yield curve is not far away. An inverted interest rate curve (where short-term interest rates are higher than long-term interest rates) is typically associated with a recession after 12-24 months, as we saw in 1989, 2000 and 2007.

Moderately positive effect of the mid-term elections

The fear of a trade war initiated by the Trump administration has also put a damper on the market. However, we will be living with that fear for some time to come, as the Democrats have their own trade policy hawks (for example, Bernie Sanders) who have contributed to the creation of the trade policy agenda that Trump has taken over.

We have just finished the U.S. mid-term elections, which was held on November 6th. Prior to the elections, the Republicans held the majority in both the Senate and the House of Representatives and were therefore able to push through a series of reforms that have a marked positive effect on the stock market (particularly corporation tax reductions and deregulation). American businesses have benefitted most from these reforms, but at the cost of rising real interest rates resulting from the expectation of a greater public deficit and the accompanying greater burden of debt.

The mid-term elections secured the Republicans' continued control of the Senate, but the Democrats won a majority in the House of Representatives. This means the Democrats now have the power to block further tax reductions and expansionary fiscal policies, both of which could cause interest rates to rise because of a greater deficit. The Democrats can prevent a greater and faster rise in long-term rates, therefore acting as a stabilising factor in the stock market.

Positive statistics after the mid-term elections

The most likely scenario for the stock market after the mid-term elections is therefore also moderately positive. This is supported by a surprisingly positive statistic for the S&P 500 in the periods after a mid-term elections since 1950. In the 17 mid-term elections that the U.S. has had since 1950, there is not a single example of the S&P 500 giving negative returns in the following 6, 9, 12, and 18 months. If we just look at the 6-month return, the lowest was 0.53 percent in 2002-2003, while the highest was 21.47 percent in 1990-1991. The median of 6-month returns is 15.2 percent, which is not a statistic one wants to overlook.

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Yet another argument in favour of the current stock market fall being an opportunity to buy is that the pricing in MSCI World has fallen dramatically this year. Due to strong earnings growth and lower share prices, P/E has fallen from 21.5 at the end of 2017 to its current level of under 17. We actually have to go back to 2014 to see a P/E in MSCI World that was (briefly) so low.

It is also important to point out that the OECD's leading indicators for the U.S. are now starting to rise again after falling briefly, and that the leading indicators from the Conference Board are keeping a healthily high level. Overall, it appears that investors ought to refrain from pressing the panic/sell button.

Have Emerging Markets bottomed out?

In the previous monthly report, I speculated on whether Emerging Markets were starting to look attractive. That was definitely too early. October was also a poor month for Emerging Markets. However, some of the arrows are starting to point in the right direction. Despite a significant risk aversion in October, both the Turkish lira (TRY) and the South African rand (ZAR) rose against the U.S. dollar. Even the eternally falling Argentinian peso rose against the dollar. Perhaps it is just a question of a country-specific view of risk (for example the risk of a Turkish bankruptcy), and that the market now views this risk as being independent of how the rest of the market is performing. It is striking, though, that Emerging Markets currencies are doing well in relation to the dollar at the same time as their stock markets are only falling marginally more than the developed countries' stock markets. In a market with the major falls, we saw in October, one would normally have expected more weakness in Emerging Markets.

Emerging Markets shares are much cheaper than the developed countries' shares, so long-term investors ought to have an overweight in Emerging Markets

As I have written many times before, Emerging Markets shares are much cheaper than the developed countries' shares, so long-term investors ought to have an overweight in Emerging Markets. P/E in Emerging Markets is 12, while the figure for Developed Markets is 17. Emerging Market's CAPE (or PE10) is at 16, while Developed Markets is 23. When measured in both criteria, Emerging Markets is 30 percent cheaper. Earnings are lower in Emerging Markets (16.5 percent against 23 percent in Developed Markets) but that can quickly change when all the one-off effects of the American reforms have come into play.

Seen through tactical glasses, it is still worrying that our newly launched regional MomVol indicator for the Emerging Markets countries' stock markets is still as weak as it is. In my view, a time will come when one should definitely invest in Emerging Markets shares within the following six months, and I am counting on our MomVol indicator to give us advance warning.

The rest of the world lags behind the U.S.

In these weeks, it almost seems like the U.S. is driving the world's economy on its own. The leading indicators for the Eurozone and Japan are falling, monetary growth is falling and our models for industrial production are showing a generally declining growth trend in every part of the world up and including spring 2019.

The reason there are still grounds for optimism despite all this is that these phenomena are typically relatively short-lived cycles. I have long expected a general slowdown from autumn 2018 to spring 2019, even though I have been surprised at the continued strength of the American economy.

The Eurozone has continued with its strong development in this timespan, which typically has longer cycles. The European labour market continues to show positive trends, and lending growth for both businesses and households is also still quite solid.

If one carries on comparing the U.S. with the Eurozone over the coming months, the Eurozone will look particularly uninspiring. Brexit, political disunity on everything from budgets to the immigration crisis and an EU army, as well as low growth, low inflation and low interest rates, combine to make the Eurozone look less attractive over the coming months. However, in my opinion, this picture will only be temporary and a renewed optimism for the Eurozone will appear over the New Year and spring.

Share allocation

The regional momentum and volatility Indicators have generally fallen in October. In the case of the U.S., it is still high (0.73), while it is low for the EU (0.37), Japan (0.47) and the Far East (0.41), and very low for Emerging Markets (0.36). It is solely due to the U.S. weight in the market that the global MomVol indicator (0.67) remains above the 0.6 threshold.

The overall leading indicators (CLI) for the OECD region as a whole are continuing to fall, which, when seen in isolation, means that one should stay away from shares.

Against this background, it therefore continues to be my assessment that we still have a strong stock market momentum in a decelerating global economy, and that one should therefore have a neutral allocation in relation to long-term target allocation.

Editorial deadline: November 8, 2018