Sparinvest

Monthly comment by
Chief Strategist, David Bakkegaard Karsbøl

US behind the growth in stocks

The market tumult in Emerging Markets looks like it is taking a break due to September's noticeable rise in the price of commodities. Crude oil especially rose by 16% since the middle of August. However, industrial metals do not look like they are moving much so in my opinion one should still be sceptical about EM currencies and bonds. For example, it is difficult to justify the Turkish lira rising by 10% against the US dollar when nothing particularly positive has happened in the meantime.

The South African rand, which was hit by the unrest as well, has also made a modest improvement, and CDS prices for both countries have fallen slightly. But the fundamental problems still exist and, as expected, a number of Turkish banks have also been downgraded by the Fitch rating agency.

By using draconian and desperate measures that are unworthy of a constitutional state, Erdogan is now stamping down on businesses who are reacting to rising costs by raising their own prices. It is difficult to see how this can benefit Turkish commerce, which needs stability and predictability. This is why we have maintained a significant underweight of Turkish issues in our bond funds. Generally speaking, even though we went into the EM meltdown with a modest exposure to the riskiest bond issuers, we also took the opportunity to increase risk in our EM portfolios so it is now more aligned with the investment universes.

To cross or not to cross? The Italian government's Rubicon decision

Judging by the Italian 10-year interest rates, there is still unrest in Italy. The government have still not yet managed to pass its new budget, which will hinge on the Five Star movement's demand for a basic income guarantee for the poorest Italians and Lega's demand for massive tax cuts. Both will put great strain on the Italian state budget and despite assurances that the budget deficit will remain within the Maastricht criteria's 3% of BNP, the bond market is decidedly sceptical.

The head of the budget committee, Claudio Borghi Aquilini, has gone so far as to reassure the market that they are not "crazy" and there is no "Maduro's Venezuela" syndrome. Of the two initiatives, Lega's tax cuts are undoubtedly the most market friendly, and in my view it is a positive sign that Lega's position in the opinion polls has strengthened noticeably since the election. They now stand to gain around 32% of the vote if there was an election tomorrow. Despite the government being labelled as populist, in my opinion Lega's ideological origins are sufficiently market friendly to ensure the process does not get out of control.

Unfortunately, Borghi is known for his Euro scepticism and as he pronounced at the same time that Italy could solve its debt problems if it had its own currency, interest rates on Italian state bonds rose again. Even though statements like that are not exactly conducive to the country's economy's attempts to stabilise the markets, it is still my assessment that Borghi's comments should be seen more in terms of the usual Italian bragging rather than a real threat.

In any case, the Italian budget process will come to operate at the limit of what is acceptable for the EU, and actual clarification will be both slow and gradual

Having said that, the government will soon have to decide whether to cross their virtual Rubicon and declare war on the EU elite in Brussels by passing a budget deficit greater than the permitted 3%, or whether to restrain themselves and find another way. In my view, to be a bit cheeky, they will adopt the southern European tradition of saying one thing and approving another. In other words, they can pass a law that on paper just about satisfies the EU's bureaucrats and then let the costs grow in anticipation of a dispensation.

In any case, the Italian budget process will come to operate at the limit of what is acceptable for the EU, and actual clarification as to how the situation will develop will be both slow and gradual. If a centre-left government in Italy had suggested what is currently on the table, Brussels would probably not have batted an eyelid. However, the government's well-known EU scepticism and confrontational attitude means we will now only get a gradual clarification over the coming months. This clarification will have more influence on the euro, the EU area's swap rates, country-wide yield spreads and stock markets – and particularly Italian bank shares, as Italian banks own a large proportion of the sensitive Italian government bonds.

NAFTA becomes USMCA

It was a great step forward for the North American partnership when the USA, Mexico and Canada were able to sign the USMCA (USA-Mexico-Canada) trade deal at the end of September. Overall, the USMCA is not much different to the NAFTA agreement it replaces but Trump will be able to sell the new deal to his voters as a significant improvement of the American position. One of the most significant changes is probably that the signatory countries commit to declaring when they start negotiations with "non-market economy" countries – a condition generally considered to be directed against China.

In the long-drawn-out prelude to an all-out trade war, Trump has managed to close a deal with South Korea and initiate fresh negotiations with both the EU and Japan. China has been put on ice and the recent steps must be given time to work, as well as indicating Trump's fierce determination to secure improvements.

Developments in the trade war will not have any significant consequences for assets in the developed markets but Emerging Markets can easily still be affected

In my view, the fear of a trade war is still putting a limited damper on the market. As we start to see that Trump's policies have just been minor adjustments in the deals with the other developed countries, any fears must primarily be concentrated on China-related activities.

China has good reason to be fearful but here it is also my impression that Trump's real goal is to achieve a new agreement that gives the USA greater concessions than have formerly been discussed in relation to the USMCA and South Korea, and potentially with Japan and the EU. Against this background, I do not expect that developments in the trade war will have any significant consequences for assets in the developed markets, but Emerging Markets can easily still be affected.

USA and the risk of "melt up"

Recently, a rather worrying phenomenon is characterising the USA in particular. There is a very great difference between the so-called "soft data" (surveys, expectations etc.) and so-called "hard data" (directly measurable developments). In other words, both ISM and PMI figures are very high at the moment in the USA in relation to what the hard data ought to be showing. Soft data includes investor confidence, and the S&P 500's rocket-like rise makes it hard to blame investors for being optimistic.

Over the course of this year, a handful of very big shares (FAANG and Mircrosoft) have generated the entire S&P500 return, while more or less the whole of the rest of the American market has been subdued

Among the share-supporting trends, I would like to mention; NFIB Small Business Optimism, consumer confidence, Trump supporters' Make America Great Again, deregulations, tax cuts, the stock market's powerful momentum, continued stimulating monetary policy (low interest rates), very strong earnings growth, very low unemployment, higher wage rises and greater equity in the housing market.

At the present time, most of these trends are historically strong. So strong, in fact, that it is difficult to see how they can get any stronger. However, taken together, they have contributed to strengthening American shares in particular over recent years and we have seen almost euphoric tones among investors in the segment of big growth shares in the tech industry. Over the course of this year, a handful of very big shares (FAANG and Mircrosoft) have generated the entire S&P500 return, while more or less the whole of the rest of the American market has been subdued.

As previously mentioned, the development of FAANG shares looks like an echo of the IT bubble because the pricing of these shares deviates markedly from the rest of the market – even though it is not as serious as during the IT bubble. In my view, there is therefore a risk of a "melt up", where this segment first becomes even more highly priced followed by a correction that can be caused by factors such as new competitors, regulations, changes in consumer behaviour, or something else entirely.

Regional MomVol indicator

I would like to introduce a new parameter in the form of regional MomVol indicators. The purpose of these is to describe the relationship between momentum and volatility in the five regions: USA (0.93), EU (0.55), Japan (0.60), Far East Ex Japan (0.59) and Emerging Markets (0.46). Values are measured at the end of September and are based on developments in more than 200 regional and global stock market indices.

It is with concern that we conclude that only the United States as a region currently qualifies for an exposure to shares

The threshold for a purchase/long signal for our MomVol indicators is 0.6, so it is with concern that we conclude that only the United States as a region currently qualifies for an exposure to shares. The least promising market is still Emerging Markets, which has been weak - but also cheap - for decades, and its regional MomVol indicator has been out of the market for five consecutive months.

The MomVol indicator for the United States actually rose slightly, as did Japan's. However, the latter was largely due to a weakening JPY, which caused significant increases in Japanese shares in local currency. Apart from Japan, both the Far East and EU decreased compared to last month.

Share allocation

The stock market had a good September. Our MomVol indicator showed a value of 0.73 at the end of the month, keeping it above the 0.6 threshold, which – according to the indicator – one ought to be invested in the stock market. As mentioned above, this was almost entirely due to the strength of US shares, which also represent a very large share of the market value of the global shares market.

On the other hand, the leading indicators (CLI) for the OECD area as a whole continue to decline, which, when seen in isolation, means one should stay away from shares.

Against this background, my opinion continues to be that we have a strong stock market momentum in a declining global economy. It is therefore advisable to have a neutral share allocation in relation to long-term target allocation.

Editorial deadline: October 8, 2018