Sparinvest

Monthly comment by
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Equity market upturn continues unabated

In November, equity markets set new records in most regions even despite widespread scepticism in bond markets, which notwithstanding a modest rise in long-term yields are still not impressed with the global economic outlook.

Some investors have asked whether it is a good idea to maintain an equity exposure at a time when markets are so expensive and when equity markets rally to new record highs. There are several reasons why it still makes good sense, despite these conditions, to have a solid portfolio allocation to equities. Firstly, suggesting that equity markets are trading at the highest level ever is incorrect, as this should in fact be the case fairly often with an asset class delivering an average return of 7-8%.

A quick look at S&P500 shows that towards the end of the period 1988-2019, 19 of 32 stocks traded at an all-time high. Still, it seems that allocation to S&P500 has only caused a loss six times (1990, 2002, 2003, 2004, 2008 and 2018) during an entire calendar year.

It would therefore be more relevant to look into how expensive equity markets are relative to earnings and equity in the underlying corporations. In those terms, equity markets are fairly expensive (MSCI World is trading at a PE ratio of 19.7 corresponding to a required return of 5.1%). However, when the alternative consisting of e.g. 10Y Danish government bonds is trading at a yield of -0.3%, we still have a long-term return gap between the two asset classes of 5.4% in favour of the equity market.

Whereas the valuation and pricing of the different asset classes have an undeniable impact on investors' long-term returns, the short-term macro-economic environment and the economic cycle are far more important determinants of returns. This is particularly true of leading indicators, which often have a very significant impact on the risk premiums (i.e. the long-term return potential) of the different asset classes.

Recovery soon to be verified by indicators as well

For the first time since early 2018, it now seems that we may finally see recovery in leading indicators for the OECD area in terms of the composite leading indicator (CLI). In recent monthly commentaries, I have noted an increasingly lower rate of decline in CLI, and at the publication of the October number in mid-December, it is my assessment that the probability of a recovery is more than 50%. This indicator is subject to a high level of inertia due to the OECD's equalisation, and there is therefore often a very small probability of an imminent recovery.

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The reason for foreseeing recovery is that the overall macroeconomic momentum in especially manufacturing no longer shows signs of deceleration. In addition, several of the well-known components of the leading indicators are all showing recovery tendencies. Particularly US building permits for October have been a positive surprise. With respect to building permits, the change is quite pronounced, as this indicator trended slightly downwards, causing concerns from the spring of 2018 and until June 2019. Subsequently, the number of US building permits have gone up by an entire 18.6% and is now at a record high since 2007.

The slope of the US government bond yield curve is one of the components of the OECD CLI, and concurrently with the rising long-term yields and the Federal Reserve's easing rhetoric, the curve has steepened. The same applies to the other regions.

The PMI numbers from both the US and the eurozone now reflect that the CLI is bottoming out and will deliver growth on its next release (or the subsequent). The manufacturing industry (primarily the car makers) is under great pressure as a result of the weak demand and overproduction in recent years, resulting in quite a few layoffs but not enough to call an outright deterioration of the labour market.

Against the above backdrop, we will, in my assessment, see a moderate improvement in the overall economy, with an underlying V shaped recovery in manufacturing (i.e. a sharp decline followed by a sharp rise), whereas the economy in general, which has not suffered to the same extent, will see a much more moderate recovery.

Who is discounting what and how much?

Equity markets (MSCI World, EUR) have already delivered a return of 28.5% ÅTD up to end-November to a certain extent in anticipation of a strong recovery. In the short term, equity investors therefore face the risk that the forthcoming recovery will not be strong enough to fulfil the expectations already discounted in equity markets.

The same dynamics apply to corporate bonds and to some extent also emerging markets government bonds. In these cases, credit spreads have tightened fairly drastically compared with the macro economic development in the past year. Also here, investors risk disappointment if we do not experience an ordinary robust recovery in the next 18-24 months, which is the time it usually takes for the CLI to rise from bottom to peak.

At the other extreme, the market for ultra-secure bonds prices in levels that resemble depression. The reason is of course the consistent central banks purchases but the steadily low inflation numbers have also contributed. However, the fact remains that real interest rates are historically low. In Germany, the spread between the 10-government bond yield and current inflation is around -1.5%. In the US this gap is not quite as extreme, as the real interest rate is around 0%, but this is nonetheless also at the low end of the historical spectrum.

Two major factors may decide the strength of the recovery

That the CLI will flip soon is a given in my opinion. The uncertainty is rather associated with the strength of the subsequent recovery. In that context, particularly two factors will be decisive.

Firstly, there is the outcome of the negotiations between China and the US about a trade deal. No doubt that the closing of a trade deal alone will eliminate much uncertainty, but the scope of the deal will be extremely important.

If the existing tariffs are rolled back entirely, this will further boost the current uptrend in equity markets. If the trade deal assumes a more symbolic character, Trump will no doubt announce the deal as being a great triumph but the real economic impact will be limited, and the positive market effects will mainly come from lower uncertainty.

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Secondly, the Chinese decision-makers still have significant influence on the world economy. The so-called credit impulse in China has on several occasions proven decisive to both growth and markets. The credit impulse is a measure of credit growth relative to the size of Chinese GDP. A high credit impulse has historically meant that Chinese businesses and states have launched very large investment programmes that have affected demand for commodities, currencies and pricing.

The Chinese credit impulse has on three occasions in the past 10 years (2009, 2013 and 2016) had a major impact on the global economy, and although it turned positive during autumn, its size is not impressive. A clarification of the trade relationship with the US within the next 12 months would have a strong positive impact, however.

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Equity allocation

Regional momentum and volatility indicators (MomVol) have fallen slightly, but are still very high and above the threshold value of 0.6 at end-November for which reason we expect robust equity markets in December, other things being equal. The OECD leading indicator for the entire OECD area is still on the decline, albeit at a somewhat slower pace than previously. There is a real possibility that leading indicators may bottom out over the next 1-2 months, something equity markets are trying to accommodate. Against this background, I recommend investors to maintain a neutral equity allocation relative to their long-term target allocation but with an upward allocation in high-risk assets and a downward in secure assets.

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