Sparinvest

Monthly comment by
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Was Powell's investor guarantee worthless?

In November 2018, the head of the American Central Bank, Jerome Powell, changed his tune when he indicated that we were closer to a natural interest rate than the market had first thought. In other words, the situation could be interpreted as Powell reacting to the stock market's unease over the last months by easing up on any ambitions about overly tightening monetary policy.

At that time, one could speculate whether Powell, in the same way as his predecessor, had issued a kind of guarantee in the form of a put option for share investors, his monetary policy reactions (in other words, easing) thus protecting them from larger price drops.

In my view, the negative yields are first and foremost due to the fact that share investors went into 2018 with too much optimism

Just before Christmas, the American Central Bank raised interest rates to 2.5 percent, which was more or less as expected. Despite this, the stock market fell significantly over the Christmas period, making the total MSCI World fall by 8.5 percent in December.

The VIX index rose to over 35 over the course of December, after which it fell back again to around 25, which is still high. There is no doubt that the market is quite nervous about the recent months' developments. In my view, the negative yields are first and foremost due to the fact that share investors went into 2018 with too much optimism.

This was certainly the case in the Eurozone, but it also applies to American investors. There is still an unfortunate tendency for particularly the European confidence indicators to be very high in relation to actual developments in the hard data, which means there is still a basis for disappointment in the shares that the survey covered.

In my opinion, on the whole, Powell and the Fed have done what has been expected of them and are therefore not responsible for the poor yield on risky asset classes. If we look at the market for interest rate futures in the U.S., a complete halt on interest rate hikes and at least one rate reduction before December 2020 have been priced in.

Big drop in interest rates and rate expectations

There is growing skepticism about the prospects for growth and inflation in the coming year. We have seen the long-term inflation expectations (5Y5Y swaps) fall significantly over the past months in both the U.S. and the Eurozone. From the end of September 2018, U.S. inflation expectations have fallen all of 0.35 percent to around d 2.1 percent, which is bordering on alarming for the Fed.

Developments in long-term interest rates are also marked by weaker prospects for growth and inflation. The 10-year American rates have fallen by 0.3 percent in December alone

The Eurozone is only 0.15 percent down to around 1.5 percent, but this should also worry the ECB as it has not done anything other than phase out its bonds programme. In my assessment, the first months of 2019 will deliver disappointments from the European economy in particular. The drop will probably continue, and for the same reason one should not be surprised to see more ECB buying programmes.

Developments in long-term interest rates are also marked by weaker prospects for growth and inflation. The 10-year U.S. rate has fallen by 0.3 percent in December alone. The fall in interest rates in the German government bonds is more limited but the interest rate is already below 0.2 percent. It cannot be ruled out that we will see negative 10-year interest rates in Germany again over the course of spring.

Shut-down: the wall has hit a wall

One quarter of the U.S. federal government has been shut down and some state employees are not receiving their wages. The reason is the so-called 'shut-down' caused by the now Democrat-controlled Congress's refusal to approve Trump's budget proposal, which contains demands for funds to build a wall along some of the U.S.'s southern border to Mexico.

It looks like the Democrats have got Trump on the run – and this is just the beginning

The Democrat's new majority in the House of Representatives means it looks like they can pass a budget that provides funding to re-open the currently closed federal state functions without also providing money for the wall. If Trump decides to veto this proposal in an attempt to maintain the possibility of pushing through funding for the wall, it will probably undermine his popularity even further.

It looks like the Democrats have got Trump on the run – and this is just the beginning. The coming months will see the House of Representatives launching one investigation into Trump and his staff after another.

In other words, the wall has hit a wall and the Democrats are going to stick a spanner in the works of everything that is going well for Trump. The witch hunt he keeps claiming he is a victim of has not even started yet, so we will be seeing more desperate and unbalanced tweets and statements from him as the Democrats really start to increase the pressure.

In my opinion, this has the potential to undermine confidence in the U.S. economy at a time where confidence is still quite strong but where the cracks are already starting to show due to weaker developments in the labour market and falling earning expectations for American businesses.

Still too much optimism – especially in the Eurozone

One of my biggest worries about the coming months is the far too rose-tinted expectations for the European economy. Even though Italian 10-year rates have fallen significantly, and the debt markets apparently believe they have got a grip on their budget in the negotiations with the EU, their PMI figures for December showed that the Italian economy is close to a recession.

The same applies to France, who has also had to deal with the 'yellow vests' and street riots. In addition, Great Britain will somehow (i.e. with or without a deal with the EU) leave the EU at the end of March. The Brexit negotiations have been marked by equal portions of cynicism from the EU and incompetence from Great Britain, and there is therefore massive uncertainty as to Britain's status after March.

In my opinion, the European figures will be the biggest disappointment for the market in the coming months

The OECD leading indicators for the EU have fallen for 11th months in a row, so in other words we will be seeing falling growth for at least another 6-9 months. Are the Eurozone's economic players prepared for this scenario? Apparently not. Despite downward trends since the spring, all five expectation indicators from the EU Commission that have quantified expectations for industry, the service sector, business climate, consumers and investors since 1985 show expectations are still very high compared to actual developments in the more tangible time series for the Eurozone's economy.

It is the same picture in the U.S., although not nearly to the same degree. Therefore, in my opinion the European figures will be the biggest disappointment for the market in the coming months.

First 'soft' data from the American labour market?

As if all this was not enough, perhaps we will now start to see the first faint signs of an American labour market that has peaked out after a quite unique development since 2009. Both the so-called Continuing Claims and Initial Jobless Claims (still unemployed and first-time unemployed) are on the rise. We cannot yet conclude that the strong downward trend in these two unemployment indicators has broken but the latest weeks' figures can be worrying.

When the labour market performs poorly, companies are less inclined to hire more employees in the following months

In addition, the NFIB indicator's hiring plans (the intentions of small and medium-sized businesses to hire more employees) have fallen from an otherwise record level. To round off, one can normally observe that when the labour market performs poorly, companies are less inclined to hire more employees in the following months.

Against this background, I expect to see U.S. unemployment figures for December or January rise to 3.8 percent, leading to headlines about the labour market once again delivering 'soft' figures.

Share allocation

After the significant drop in December, all the regional Momentum and Volatility indicators (MomVol) show values under 0.65, which is the threshold for whether or not to invest in shares. U.S. shares still have a greater momentum than the rest of the world. European shares are weakest. Even though they are under the threshold, EM shares are remarkably unaffected by the market's tumult in December.

The overall MomVol indicator fell to 0.29 at the end of December. I based my argument that despite low and falling leading indicators, one could have a neutral share allocation in relation to long-term target allocation on the fact that the stock market still had a certain amount of momentum (the MomVol indicator lay just over the threshold) over the past few months.

However, against the background of this report I am now changing my recommendation to being underweight in shares and other risky asset classes in relation to long-term target allocation.

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