Sparinvest

Monthly comment by
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The fixed income market wins the first round against the central banks

Interest rates continued to fall in June, helped along the way by statements from the biggest central banks. German two and 10-year government bonds fell by 0.08% and 0.12% respectively over the month, while their American equivalents fell by 0.16% and 0.12%. The largest part of the drop can be accounted for by the director of the European Central Bank (ECB) Mario Draghi's speech at the annual meeting of central banks. Here he stressed that the central bank's members are keeping to their goal of achieving a medium-term inflation level of just under 2%. Over the course of the year the market has lowered its inflation expectations, as expressed through the expected five-yearly inflation levels in five years. This has fallen from 1.6% entering into the year to 1.21%, and the fall gathered speed noticeably up to Draghi's speech.

It must be disappointing, and perhaps even frustrating, for the ECB that the market still does not expect them to reach their targets

In our eyes it was this market expectation in particular that brought about Draghi's strong rhetoric, where he made clear that they still have a fully functional arsenal and the will to use it. Specifically, he stated that interest rate reductions and quantitative easing (QE) can be both necessary and reasonable in order to honour their mandate. He also mentioned that the parameters for their use of these tools is specific in relation to the conditions they are facing. By saying this, he is more than implying that they can extend the parameter for the QE programme, for example with how big a share of the individual countries' bonds they are permitted to own. When parameters can be extended without any particular difficulty by the same institution that is obliged to keep within the same parameters, the term "elastic" takes on a whole new meaning.

The market reaction to the speech was dramatic, and in classic "QE" style: a large rise in share prices and a large fall in interest rates across the curve. Inflation expectations also rose intraday by 0.17% but at their highest they were still 0.7% from the ECB's target. It must be disappointing, and perhaps even frustrating, for the ECB that the market still does not expect them to reach their targets. All things being equal, it must be expected to increase the strength of their actions.

Trump stomps around in trade policy

It was not only the central banks setting the agenda for the financial markets at the end of June. President Trump also made his presence felt by putting the current trade war with China on hold. At the end of the month, Trump announced that as a consequence of re-starting negotiations with China, he was going to hold back the planned USD 300 billion customs increases.

The stock market reacted positively and MSCI (World (EUR) ended by rising 4% over the course of June. The volatility index (VIX) fell from 18 to 15 in the same time period.

I still expect Trump to drag out negotiations with China until we come so close to the November 2020 election that he can boost his chances of re-election by using his signature to create a healthy rise in the stock market. For this reason, I do not think we can expect any final clarification before late 2019 or even perhaps the start of 2020.

Now there is weak over-pessimism

Over the last couple of months there have been a number of headlines about the crisis in both the European and the American manufacturing industry. In particular, the PMI figures for the manufacturing industry also reflect quite a high level of pessimism. The weak development is completely in line with our models for industrial production and order intake, and these continue to show that we should regard the current economic activity as the worst we will come to experience this time around.

It seems realistic that we will reach the bottom over the course of the next 2-4 months

Despite the OECD's retail growth rate moderating itself somewhat, it is still positive. After adjustments for inflation, it continues to be just under 1%. On the other hand, the manufacturing industry, both as a result of overoptimistically high production around 12 months ago together with a falling demand, has downwardly adjusted production so much that we can finally expect a significant rise as we approach the new year – and particularly afterwards.

Another factor that can contribute to confirming this picture is the continued fall of the OECD leading indicators, which are falling slower and slower. In the light of this, and unless we come to see a more significant revision of the already released data that is included in the indicators, it seem realistic that we will reach the bottom over the course of the next 2-4 months.

Landmark Danish interest rates

As previously mentioned, a wide range of interest rates continued to fall in June. This was partly due to continued falling inflation expectations, partly to expectations of a downturn in a year's time, and partly to the sudden fall in the PMI figures across all regions.

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The Danish bonds market stood out by the fact that in June, Denmark became the first country in the world where all issued government bonds were traded at such high prices that the interest rate curve was negative. There can be no doubt that thanks to our moderate national debt, Denmark is now considered to be one of the most financially secure countries in the world.

The mortgage market also reacted positively to the ECB's statements, and over the course of the month Danish home owners had the opportunity to take out a 30-year 1% loan with repayments almost at par.

Also Italy, southern Europe's problem country, benefitted from lower interest rates. The rate on their 2-year government bonds also became negative over the course of the month.

New Italian kettle of fish

Italian interest rates are falling so much because the Italian government has reduced its planned budget deficit from 2.4% to 2.04% in order to avoid potential fines from the EU. By doing this, the Lega's Salvini has covered his flank from the EU. This left him free to go on the offensive and set the agenda for negotiations on a number of top posts in the EU in collaboration with the Visegrad countries.

In the end game for top posts, the EU leaders reached an agreement to propose Christine Lagarde for the position of ECB Director Mario Draghi's successor and German defence minister Ursula von der Leyen as President of the Commission. The initial reaction of the EUR to this delayed negotiation result was a slight fall.

Expectations of better times maintained

Despite weak PMI figures, pessimism, uncertainty surrounding trade policy (also between the EU and the USA), and interest rates close to inversion (short rates are higher than long rates), in my view, investors should still prepare themselves for both the American and the European economies improving significantly over the coming 12 months. In other words, the recession has been delayed for the time being.

Neutral allocation

At the end of June, the regional Momentum and Volatility indicators (MomVol) were still high, which is why – all things being equal – we can expect a strong stock market in July. The OECD leading indicators for the entire OECD region are continuing to fall, even though this is happening at a considerably slower tempo than previously. There is a definite possibility that we will see the bottom of the leading indicators within the next two to three months, and the stock market will try to meet this. Against this background, I recommend a neutral share allocation in the near future in relation to long-term target allocation.

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