Sparinvest

Monthly comment by
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Sell in May and walk away?

MSCI World (in euros) lost 5.0 percent in May, so the old slogan of "sell in May and walk away" is actually quite fitting again this year. If the reason is not to be found in the slogan itself, it can probably be found in the fear that Trump's trade war with China looked like it was escalating in May. In addition, there is apparently a significant drop in growth expectations in the U.S. in particular, where long-term inflation expectations (5Y5Y) fell by 0.17 percent over the course of May. The PMI figures have plummeted across the major regions as companies have had to turn down their growth expectations as a result of weak demand.

American GDP growth is at 3.1 percent and there is a significant rise in the so-called NAHB index, which measures expected activity in the U.S. property market. In addition, there has been a significant rise in the Empire Manufacturing index over recent months. However, it looks like the market has suddenly noticed the weak PMI figures and the fact that the OECD's leading indicators for the USA have been falling for nearly a year. Conference Board's leading indicators for the USA are also at their weakest level since the start of 2016.

There has been a considerable amount of discussion surrounding the auto industry, which is looking at a fall in demand as well as huge fines for manipulating NOX emissions figures. My models show that the auto industry in general can expect a fall in sales of 3-4 percent over the coming year. So far, these reversals have been met with a series of mass redundancies from car manufacturers.

The bond market has answered by sending interest rate expectations crashing down, especially for short interest rates over the next couple of years. The 2-year rates in the USA have fallen so much that the interest curve has actually steepened, despite the unchanged 2.5 percent Fed Fund's Rate. The fall is so great that the fixed income market now expects two interest rate cuts of 0.25 percent this year.

Huge game of "chicken" in the fixed income market

The fixed income market has challenged the American Central Bank on its credibility and professionalism. The last rise in interest rates was in December 2018 and that was against a background of falling interest rate expectations that the stock market reacted to with a large drop in December.

The Central Bank's reaction to major changes in the market's expectations for interest rate developments will be the decisive factor for risky assets

Subsequently, further interest rate rises were shelved and the American Central bank must now suffer the indignity of almost being forced by the market to cut rates again – despite record low unemployment and very moderate inflation. Some analysts predict as many as three cuts over the rest of the year, although that might seem slightly hysterical.

The central banks' reaction to the major changes in market expectations on interest rate developments will be critical for risky assets, including the stock market. I expect that the American Central Bank in particular will recognize the potential weakening of the U.S. economy that the fixed income market has now priced in, but I also expect the Central Bank to be reluctant to actually do anything to ease monetary policy such a short time after raising interest rates – unless Trump's trade war really throws some sand in the growth engine.

The next six months – downturn in the USA

Even though I continue to believe that the American economy will lose momentum in the coming months, I also believe that we will see an acceleration again from the start of 2020. Trump and the Republicans will have a vested interest in supporting the U.S. economy in order to maximize the chance of re-election. Trump has repeatedly used the S&P500 performance as a benchmark for his own success, which increases the likelihood that he will support the stock market politically if it stagnates too much.

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Our models for industrial production and order intake for durable consumer goods in the U.S. shows that we can expect a general weakening approaching zero growth over the coming five to six months. However, they also show that especially order intake will pick up again from the start of 2020. In other words, the American Central Bank will have its monetary policy confirmed if it waits long enough (two to four months) but the fixed income market will have to recognize that it was overly pessimistic in its outlook for the U.S. economy.

Over-optimism has disappeared

The last remaining signs of over-optimism in the Eurozone have now disappeared. The scales have fallen from the eyes of players like European investors and economic agents, and it is now widely accepted that growth in the Eurozone is structurally challenged. This is both good and bad. It is good because it is now possible to be pleasantly surprised. It is bad because it shows that growth in the Eurozone is still lagging behind in relation to the rest of the world.

Both industrial production and order intake in the European manufacturing industry are looking miserable in current months

Both industrial production and order intake in the European manufacturing industry are looking miserable in current months, which is why the Eurozone's PMI figures are low, particularly for industry. But now it cannot actually get any worse. The European manufacturing industry's confidence will gradually return over the coming months and the start of 2020 in particular will see quite high order intakes as a result of the current over-reaction due to the weak development of retail business across the OECD countries.

Can Trump time the market?

As mentioned earlier, it is my belief that investors should not miss the possibility of Trump attempting to influence the market before his re-election campaign. If the stock market settles even more from here on in, he will be quick to accuse the Central Bank of destructive influencing. The next Presidential election is in November 2020 and it is therefore too early for Trump to pour petrol on the share bonfire if he wants a lovely upward trend to follow him to the end of his first presidential term.

At the start of 2020, I expect him to start mentioning some of the measures that will be able to prevent unemployment from rising and the stock market from falling. His untraditional and controversial manner more or less guarantees that we will be hearing more in this respect.

My biggest worry

We are currently seeing a general fall in growth that was also accurately predicted by the leading indicators, which have been falling across the major regions for about a year. At the moment, this development is expected and within the boundaries of what we would normally expect. The bank sector and households are well upholstered so potential problems will not arise from that department. I am more worried about the combination of companies that have large debts in relation to income, and business models that are dependent on continued low interest rates and a normal development of demand for their products. As mentioned before, we are already seeing a significant fall in the OECD's retail growth, which, however, is still positive. If for some reason global consumers become even more hesitant and consumer growth becomes negative, despite the current over-pessimism we have discussed above it can force them to further reduce production – and therefore also any plans for new hirings.

If we are going to have a negative spiral during the course of the coming year, I have difficulty seeing how it could arise in another way. However, I do not think it likely that it will happen now. Also, this must be considered in the context of developments in the leading indicators – see below.

Keep a neutral share allocation

The regional Momentum and Volatility indicators (MomVol) were still high at the end of May, which is why – all things being equal – we can expect a strong stock market in June. The OECD leading indicators for the entire OECD region are still falling even though it is happening in a somewhat slower tempo than before. There is a real possibility that we will see a bottoming out in the leading indicators within the coming two to three months, which the stock market will try to meet. Against this background, I recommend keeping a neutral share allocation in the near future in relation to long-term target allocation.

Editorial deadline: June 12, 2019