Sparinvest

Monthly comment by
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# Optimism is spreading

Equity markets reached new highs in October – driven by good news and a surge of expectations among investors. October saw a broad-based hope that the U.S. and China would actually be able to conclude a so-called phase one trade deal despite the cancellation of the APEC meeting in Chile, where this deal was supposed to be concluded, because of the social turmoil in the country.

China appears to be willing to lower tariffs on part of the U.S. agricultural products, but a subsequent phase one trade deal cannot be expected to contain any notable measures such as a roll-back of existing trade barriers or tariffs. Most commentators merely consider a so-called phase one agreement a halt to the current, protracted escalation of the conflict between especially China and the U.S.

Apart from the prospects of a phase one trade deal, U.S. equity investors have benefitted from a so-called "mid-cycle" interest rate cut. The Federal Reserve opted to lower the Fed Funds Rate to only 1.75 percent at the end of October. This is remarkable as the U.S. economy may well have lost momentum over the past year, but the unemployment rate is still very low – albeit the unemployment rates of several states have started to pick up – and the inflation outlook is still relatively close to the targeted 2 percent.

We might therefore be allowed to take a slightly ironic view of the term "mid-cycle", which may rather suggest that the Fed fears that the U.S. economy cannot even cope with an interest rate at 2 percent despite being one of the strongest economies among the developed countries.

## Trend reversal in interest rates, factors and economic indicators

Optimism has also manifested itself in the fixed income market where long-term yields have gone up since mid-August. The sensational Austrian 100-year bond maturing in 2117 has dropped by more than 20 percent since mid-August, as the yield of the bond has gone up from around 0.6 percent to 1 percent.

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The interest rate cut and the higher U.S. yields have inherently led to a much steeper yield curve, and for the first time since May spreads between 3M and 10Y rates have become firmly positive, meaning that the dreaded inverted yield curve has been pushed much further away. As mentioned before the yield curve is usually perceived as one of the most reliable indicators of a future recession. The steepening is therefore good news, meaning that most analysts will interpret this as a somewhat lower probability of recession in the U.S. in the near future.

Germany has seen a steeper yield curve over the recent months, although the trend has not been nearly as pronounced. At the same time yield spreads between Germany and Southern Europe have tightened as a result of expectations of fiscal policy stabilisation in Italy but also because of less apparent market scepticism. A third reason is that especially Germany is affected by a marked deceleration in industrial output as the German auto industry, which is suffering as a result of Brexit uncertainty, the transition to electric cars and possibly gigantic fines for cheating on emissions testing.

In the factors universe we also detect some stabilisation. Defensive equity styles, such as the Minimum Volatility factor, has underperformed the general market significantly since August, while a more aggressive equity style, such as Small Cap equities, has started to rebound after prolonged poor performance.

## Clarity about Brexit in sight

In the UK, Boris Johnson has now called an election to be held on December 12. Although his conservative party holds a strong position according to the polls, there is no sure outcome because of the structure of the UK electoral system, which means that the candidates with the most votes in each constituency are elected to the House of Commons. As Nigel

Farage's Brexit Party has gained much support in recent months, the Conservative Party fears that the Brexit Party might win constituencies due to the large number of unhappy conservative voters. The Conservative Party would therefore only be able to set up a minority government or may even lose the election to Labour, which is otherwise quite weak according to polls.

There have been speculations as to the probability of such a scenario. Mr Farage himself says that he captured voters from particularly Labour in the last election, and that there is no reason to fear that Labour will win the election because of the success of the Brexit Party.

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In any case, I have noted that the GBP has strengthened in recent months as clarity about the UK's future relationship with the EU is drawing nearer, and that there are many indications that this clarity will take the form of a Brexit in the near future. In my opinion, clarification about the UK's relationship with the EU will be one of the biggest positive news in the UK for several years. The UK's leading indicator has been constantly on the decline since mid-2017, and house price growth has been declining since 2016.

Clarification – even a Brexit – will probably be good news to the depressed European auto industry, which is suffering as a result of the expectation of large fines as mentioned above.

## Model update

As far as car sales are concerned, our models show that the deceleration should have ended both in the U.S. and the eurozone, and that the next 12 months should see growth - other things being equal. The same applies to industrial output as mentioned above. A reversal has already set in, as expected, seeing that the deceleration has started to decline. Although it seems that our model expectations have been slightly more positive than the actual development in industrial output, there is still no doubt that particularly Germany will experience quite a significant recovery in manufacturing, including in the depressed auto industry, over the next 12 months.

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The same applies to the entire eurozone, which will also see a marked improvement in manufacturing order intake. In the U.S. growth in industrial output and in the order intake of durable consumer goods has also declined, albeit not to the same extent. The U.S. therefore has a stronger foundation, and it will not see recovery to the same extent in the next 12 months.

The impact from an equity market rebound, a steeper yield curve and (expectedly) strong acceleration in industrial output on leading indicators should be positive in coming months. This confirms our assumption that reversal in leading indicators is within reach, which will have a major impact on the performance of different asset classes.

## Performance outlook

Long-term returns in equity markets are still under pressure due to a stretched pricing. Investors should currently not expect annual returns of more than 4-5 percent in U.S. equities, 5-6 percent in global equities, 6 percent in European equities and 7 percent in emerging markets equities.

*High-risk asset classes have already priced in an economic rebound*

In the short term, however, equity returns are highly dominated by leading indicators, and if these bottom out and rebound, equities may deliver high annualised returns in the subsequent months. With an already high valuation in equity markets and tight credit spreads in the corporate bond markets, it appears that high-risk asset classes have already priced in an economic rebound.

The market where such rebound appears to be least expected is the market for secure assets and particularly top-rated government bonds (German, Dutch, Danish). As especially Germany has seen falling yields as a result of the sharp drop in auto/industrial production, I expect that particularly German government bonds are overpriced. However, we must assume that a shock in the form of rising German yields will feed through to Danish government and covered bonds.

# Equity allocation

Regional momentum and volatility indicators have gone up and have therefore passed the threshold value of 0.6 at end-October, for which reason we expect robust equity markets in November, 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 chance that the leading indicator may bottom out over the next 2-3 months – something which the equity market is trying to price in. Against this background, I recommend investors to maintain a neutral equity allocation relative to their long-term target allocation but with an uptrend in high-risk assets and downtrend in secure assets.

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