Sparinvest

Monthly comment by
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Central bank response

At its monetary policy meeting in September when the European Central Bank (ECB) once again introduced new record levels of monetary easing, Mario Draghi, President of the ECB, criticised the politicians for not having done enough in terms of reforms. This time he went so far as to say that monetary policy cannot keep driving the economic expansion, as the negative side effects of the extremely accommodative monetary policy are becoming increasingly evident.

U.S. monetary policy was eased as well, with the FOMC cutting interest rates by 0.25 percentage points to 2.00 percent in mid-September as a response to the long-term inflation outlook, which had remained almost constant at below 2.0 percent in August. Consequently, the U.S. yield curve has moved a little further away from inversion, which has been a key theme for the most anxious market participants for quite a few months.

Mr Draghi's signalling that the ECB's monetary policy is now approaching impotence disappointed the European fixed income market, but the MSCI World (in euros) index was able to deliver a return of more than 3.0 percent in September. Overall, some risk appetite could be detected, as also credit spreads tightened. Despite massive attacks on Saudi facilities, oil prices actually dropped, ending the month virtually unchanged.

The euro continued declining in response to the prospect of continued negative interest rates in the eurozone. And probably also on account of a number of disappointing eurozone economic indicators – especially German industry is struggling with low order intake and a car industry crisis.

A hint of pessimism

A comparison of soft data (i.e. expectations and confidence indicators) and hard data (i.e. tangible data on actual input, order intakes etc.) shows that the over-optimistic sentiment in the eurozone has now turned into realism with a hint of pessimism. Trends are characterised by more or less unchanged hard data over the past year, while soft data have declined significantly, reflecting disappointment. This is probably one of the main reasons for the considerable yield declines, which culminated in August.

Retail trade growth across the OECD area has declined, but remains at a fairly decent level estimated at currently 1.7 percent – far from the disaster expected and priced into the market at this point. Especially the weak PMI manufacturing data have had an adverse impact on market sentiment, but according to our models, manufacturing in particular is headed for significant growth, accelerating over the next 12 months, at a rate probably not seen in the eurozone since 2013 –in terms of both actual output growth and order intake.

Light at the end of the data tunnel, but the Brexit train is approaching

It is not easy to have an entirely different opinion from the rest of the market, but in my view we are beginning to see light at the end of the tunnel in terms of 12-month growth. In the eurozone, monetary aggregates M2 and M3 saw the highest growth since 2009 in August.

At the same time, central banks all over the world have gone from a tight/neutral monetary policy stance to general easing, and in September the U.S. yield curve moved further away from inversion (as a result of, for instance, the interest rate cut in September). Also, the Eurocoin and Bloomberg real-time indicators of eurozone growth show stabilisation following a major decline since early 2018.

There is no doubt, however, that confidence in European industry is suffering from the lack of progress in the negotiations between the EU and the UK about the terms of the latter's exit from the EU. The prospect of a no-deal Brexit has made representatives of especially German industry warn strongly against such a scenario. At the beginning of October, UK Prime Minister Boris Johnson insisted that the UK will be leaving the EU on 31 October – despite the fact that the British Parliament has passed an act requiring that he request a delay if no deal is achieved. Mr Johnson is now attempting to have the act set aside by the Supreme Court or at least have the Court declare it illegal.

The rest of October (as a minimum) will therefore be characterised by volatility – especially in relation to European assets.

Which returns can be achieved in the equity market?

Even though the equities of developed markets are relatively expensive from a historical perspective, we are not on the edge of an abyss in terms of returns. The MSCI World index is currently trading at a price/earnings of 18.4, corresponding to an earnings yield of 5.4 percent. This means that at an earnings growth of zero, the world market should be able to deliver about 5.4 percent a year. However, the earnings growth is typically equal to GDP growth (or higher), so optimists may add a couple of per cent to the 5.4 percent.

There could be many reasons why long-term return expectations of 7.4 percent would be too high; the positioning of investors, investors' expectations and the real economy development could have a significant impact – especially in the short term. The proportion of investable funds currently allocated to equities is so high that historically, 10-year returns would only be around 5.0 percent.

The average earnings growth over the past 20 years has been 5.6 percent for companies included in the MSCI World index. This growth has been subject to quite considerable volatility, however; for instance, earnings dropped by 67 percent from 2007 to 2009. There is no doubt that the risk of a recession, and the impact of a recession on earnings, is haunting equity investors these months. The U.S. yield curve has already been inverted, and the eurozone yield curve is still relatively close to inverting.

U.S. election campaigns about to start in earnest

Equity investors therefore need some good news, but as usual, equity market trends are highly uncertain. U.S. election campaigns are approaching, and Donald Trump needs continued good news from the U.S. economy to stand a chance of re-election. As Mr Trump has defined S&P 500 returns as a measure of success, we can probably expect a number of equity-friendly measures from the White House over the next 12 months when election campaigns will be in full force.

There is probably no more convenient time for Mr Trump to conclude a trade agreement than in the next 2-5 months. A signed agreement with China would most likely cause immediate equity price rises of at least 0.5 percent.

According to PredictWise, which combines data from bookmakers, Elizabeth Warren is the favourite to become the Democratic Party's presidential candidate. The probability that Ms Warren will become the Democratic presidential candidate is 53 percent. The next candidate on the list is former Democratic Vice-President Joe Biden, whose chances of a candidature has been harmed by his involvement in a Ukrainian corruption scandal. His probability is currently 17 percent. Overall, odds from bookmakers indicate a 47 percent probability of a Republican president (Trump) after the election and a 53 percent probability of a Democratic president (probably Warren).

A Democratic candidate would traditionally pursue a more open trade policy than the one advocated by Mr Trump, and likewise, it is difficult to imagine that a Democratic president would be equally positive towards the equity market. The largest tech companies probably would not welcome Ms Warren as President, as she has urged the introduction of anti-trust measures to break their market dominance. These are not empty threats, as the U.S. has a long tradition of breaking up large companies, and Mark Zuckerberg has already announced that he sees Elizabeth Warren as a major threat to Facebook.

Equity allocation

The regional momentum and volatility indicators (MomVol) were still above the threshold value at the end of September, and we therefore – other things being equal – expect strong equity markets in October. 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 the leading indicator may bottom out over the next 2-3 months, which the equity market may try to price in. Against this background, I recommend investors to maintain a neutral equity allocation relative to their long-term target allocation.

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