Monthly comment by
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The Composite Leading Indicators (CLI) is now recovering

As anticipated in the last monthly commentary, the CLI for the OECD area is now recovering. The CLI is rising for the first time in almost two years. This usually has a substantial impact on the returns seen in various asset classes and for various investment strategies.

The main reasons for the recovery are a considerably steeper yield curve, especially in the US, and relatively strong growth in the number of building permits issued. The ISM and PMI indices (of activity and demand in the manufacturing sector) have also bottomed out and are now rising marginally – even for manufacturing, which has been severely affected by too large stocks in the last 12 months. Moreover, this is taking place against the background of fairly strong increases in M2 growth, both in the US and the eurozone, in the last couple of months.

When the CLI rises, the market usually adjusts to higher growth expectations over the subsequent 12 months. Hence, we will presumably see inflation expectations rise too, while long-term yields will rise further (despite central banks' asset purchase programmes), and equity markets will be well supported by the expansionary monetary policies of central banks.

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As regards investment strategies, a rising CLI typically means that the riskier strategies stand to gain. For equity investments, the aggressive factors Value, Momentum and Small Cap typically perform best in such periods, while defensive factors such as Minimum Volatility, Quality and Growth typically trail behind. As yet, there are no indications that Quality and Growth are performing below the market, but Minimum Volatility has lagged well behind the market in the last three months. Among the aggressive factors, we have not yet seen Value and Momentum recover, but Small Cap equities have bounced back since September.

Trade agreement and election

The equity market ended 2019 with a fine December result. MSCI World (EUR) achieved a full-year return of 30%, with December accounting for 1.2%. Part of the explanation is that the current equity market prices have already factored in an upswing. This also applies extensively to high-yield corporate bonds, for which credit spreads in the largest indices have narrowed substantially – a tendency already seen before the CLI recovery was confirmed.

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The optimism has to some extent been driven by expectations that President Trump would conclude a trade agreement with China, thereby reducing equity market stress before the 2020 election to allow him to present favourable S&P500 results to the voters when the time comes.

According to the White House, the President will sign a phase 1 agreement with China in mid-January and subsequently begin to negotiate a more extensive phase 2 agreement. In the phase 1 agreement, China will make a commitment to purchase more agricultural produce from the US and to respect intellectual property rights to a greater extent. In return, the US will roll back many of the customs tariffs on imports from China imposed by the Trump administration.

Finally, as part of the agreement, China aims to increase overall imports from the US by USD 200bn over the next two years. This process has presumably also been designed to buoy up US economic activity in the run-up to the presidential election.

More strife in the Middle East

In early January, President Trump chose to have Iran's second-in-command, Qassem Soleimani, killed by a drone in an airport in Baghdad. Soleimani's name was already on multiple lists of terrorists, and it had been established that he was responsible for a number of nasty attacks worldwide in the last decade.

With this killing, President Trump is playing for high stakes. On the one hand, a war with Iran is by no means a dream scenario for the equity market that the President has defined as an excellent success indicator. On the other hand, it is close to being rule no 1 for presidents seeking re-election to show decisiveness and try to bring together the nation against a common enemy.

In my assessment, President Trump is anticipating revenge attacks from Iran, but expects them to be few and small in an overall context as Iran is certainly not interested in a large-scale war with "the Great Satan". Instead, we are likely to see more provocations that will keep the pot boiling so that neither party is seen to have lost face.

The market response has also been relatively subdued, except for the oil price hike of just under 4% in the immediate aftermath of the killing. Equity markets have fallen by around 1% and long-term interest rates by 10bp in both Germany and the US. This is within the normal fluctuation range.

Attempt to impeach President Trump not likely to succeed

Although the Democrats' attempt at impeachment does not seem to affect the President, the process itself is presumably still an annoying burden for him. In the House of Representatives, where the Democrats have the majority, several months' hearings have now led to a vote in favour of impeaching President Trump, which is a political (not a legal) process that could lead to removal of the President from office.

However, the Senate, where the Republicans have the majority, ultimately decides whether to go ahead with the process, and despite headlines splashed across the media and political judgments etc, it is difficult to imagine a removal from office in the current situation.

In my assessment, the impeachment process should be seen as a way for the Democrats to put pressure on Republican candidates for the Senate in swing states, ie states that could go either way in the forthcoming election to the Senate. By forcing Republican senators to take a stand on impeachment of the President before the election, the Democrats are hoping that Trump-friendly senators in swing states will push centre voters into the Democratic camp.

It remains to be seen whether this strategy will work for the Democrats, who are fighting an uphill battle for the Senate. At present, the bookmakers operate with a probability of around 70% that the Senate will remain Republican. As regards the House of Representatives, the probability that it will remain Democratic is also assessed at around 70%. And as the impeachment hearings have become increasingly toothless, the presidential odds have swung in favour of Donald Trump, so that his chances of re-election are now approx 52%, or 5pp higher than before the hearings.

Impact of the US election on equities

The alternative to Donald Trump increasingly seems to be former Vice President in the Obama administration, Joe Biden, who is seen as a centre-oriented Democrat. The bookmakers rate his chances of becoming the Democratic candidate at 30%. He is followed by Bernie Sanders (24%), who is on the far left of the Democratic Party. Bernie Sanders would be a large spoke in the wheel for the equity market due to his ideas about higher taxes and more regulation, but in simplified terms we can estimate the probability of a market-friendly outcome at 52% (Trump) + 30% (Biden) = 82% in total. In fact, it is likely to be higher as there are also other market-friendly candidates among the Democrats.

Boris Johnson's victory paves the way for Brexit

Following Boris Johnson's election victory, Brexit is now a matter of course, and the only outstanding issue is which agreement Johnson can reach with the EU. The response from the notoriously EU positive Scots has been to initiate a process to clarify and legitimise a Scottish referendum on independence in relation to the UK (which many Scots wish to leave) and the EU (which many wish to remain a member of).

As I see it, the response of the GBP to the political events in the UK since 2016 has been most significant, as UK equities and bonds were only to a limited extent affected, except in the first few days. In contrast, there seems to have been a lasting effect on the GBP so the immediate response to the election outcome – strengthening despite the Scots' talk of independence – gives reason for optimism.

Equity allocation

Regional momentum and volatility indicators (MomVol) have risen slightly and remain very high and above the threshold value of 0.6 at end-December, for which reason we expect robust equity markets in January, other things being equal.

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The OECD leading indicator for the entire OECD area has now begun to rise after having fallen almost continuously for two years. Against this background, I recommend that investors hold an overweight of equities and risky assets relative to their long-term target allocation.

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