



Monthly comment by Chief Strategist, David Bakkegaard Karsbøl

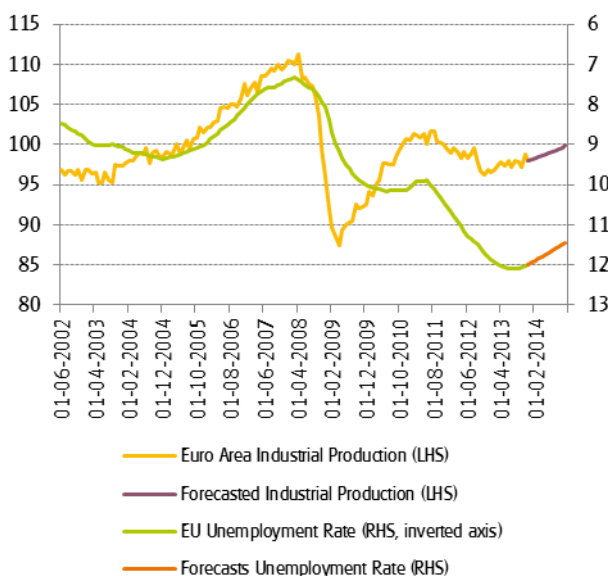
April 2014

Economy shows steady improvement

March and April have so far seen a steady consolidation - if not strengthening - of economic activity across the board. In other words, many indicators show a gradual and widespread improvement, as we discussed and anticipated in last month's report (March). The Purchasing Managers Index (PMI) for most countries has continued to grow during the past month, and labour markets are also improving. It was still slow in the Eurozone, where unemployment remains high (11.9%), but the unemployment rate has fallen and is thus back on track. We expect that unemployment will hit 11% in early 2015 and this will lead to a drastic change in consumer psychology from the current semi-depressive state to a gradual normalization.

In the U.S. and Japan, the labour markets are also improving. For the U.S., it is extremely important that monetary policy is both directly and indirectly a function of the labour market. In Japan, the unemployment rate has now actually fallen to its lowest level in many years. You could argue that many of the newly-created jobs in the U.S. are paid less than the jobs that were abolished in crisis, and you could argue that the improvement in Japanese unemployment is partly a result of continuing demand for labour and but with a lower supply (read: a reduced population that is of working age). However, the broad picture is still one of a gradual and steady improvement, and we expect that a strengthening of industrial production over the summer of 2014, will result in even more good news for the labour markets.

Forecast of Industrial Production and
Unemployment Rate



Spring atmosphere in the coming months

In view of the increasingly significant improvement in key economic indicators, we anticipate a gradual change in the tenor of the headlines and news coverage - particularly in the financial media - in the coming months. We find it likely that you will see such headlines as: 'the crisis is over' or 'the economy gathers momentum' over the summer. This positivity, along with the fact that the vast majority of national property markets have stopped falling - or are even rising in some cases - can be crucial in influencing patterns of consumption and investment levels in companies, many of which have endured tight capital discipline for several years.

Such businesses are likely to be able to boost investment in the coming months as a result of the more optimistic expectations for the future. The reason is, firstly, a stronger industrial production, but also the fact that, as a result of years of low investment levels, the average age of capital is almost historically low. The average age of permanent, privately-owned fixed assets in the United States has now risen to 16

years from around 14 years throughout the period 1980-2002. We must in fact go all the way back to 1965 to see an average age at its current level.

Another reason to expect increasing levels of investment in companies is that the CEO surveys in the U.S. show a strong improvement in CEO's expectations of their companies' earnings over the coming months. These expectations have historically been closely correlated to CAPEX ('Capital Expenditure') – i.e. capital investment.

Bank of America/ML has published a survey of investors' 'wish lists' for the managements of companies they have invested in. Of the three possible uses that money could be put to – i.e. 1.) strengthening balance sheets by paying off debts 2.) repaying earnings to investors as dividends or buy-back programmes and 3.) CAPEX – the percentage desiring CAPEX was the highest since the survey began in 2002. Therefore we can assume that CEO's are probably also experiencing pressure from their investors, pushing them towards higher CAPEX investment.

CAPEX investment is essential for future returns in the stock market, because revenue growth can only be ensured by continuous maintenance of capital equipment (i.e. machines and equipment). Capacity utilisation is rising across countries and industries, and increased CAPEX will be able to ensure that the companies' growth in production and earnings as a result of stronger demand will be stable and without inflationary pressure in the years ahead.

In addition, increased CAPEX levels have a major impact on the so-called sector-rotation between shares. We expect that European companies in particular, stand to benefit from increased CAPEX. European companies are among the most important producers of capital goods.

Pressure on the ECB for further easing

Bundesbank Chief, Jens Weidmann now no longer excludes the possibility of outright acquisition programmes, similar to those currently being wound down in the United States. Given that two heads of the Bundesbank had previously resigned over this issue and Weidmann himself has previously criticized QE programs in no uncertain terms, this is a remarkable turnabout, and thus it seems that, with the main obstacle apparently cleared out of the way, the ECB may also engage in more expansive monetary policy, as the ECB's Chief, Mario Draghi, has long desired.

The pressure on the ECB for further easing of monetary policy has increased in recent months as core inflation figures have

consolidated themselves at very low levels, and the euro has reached new heights against the dollar. Core inflation at a pan-European level has now fallen to only 0.5%, and the market-derived expectation lies between 1 and 1.5% for the next 5-10 years in France, Germany and Italy.

It is most notably the current low core inflation figure (stripped of volatile prices such as energy and food) as well as the relatively low market expectations, that force the ECB – including the Bundesbank – to revise its already accommodative monetary policy. The ECB has only one mandate: to achieve price stability. In other words, the expected 2% future inflation variance of an unchanged monetary policy is simply too great for doing nothing to be an option.

Another issue that must be managed by the ECB is the ongoing liquidation of its LTRO (Long Term Refinancing Operations) loans. These loans were granted to a number of European banks on a 36-month basis and on highly favourable terms – in order to ensure them sufficient liquidity preparedness. LTRO loans increased the European banking system's excess reserves of liquidity from almost zero in 2011 to 800 billion euro in 2012. Now, as a result of repayment of LTRO loans (after they reach their three-years maturity wall), excess reserves – and hence banks' liquidity – have been reduced to a critical level of around 125 billion euro.

Europe more interesting than U.S. – Has EUR/USD topped?

In the light of the above, we expect further easing in the ECB's monetary policy over the coming years – despite the recovery of the economy through increased production, consumption and investment. This will – as previously mentioned – particularly be beneficial for European shares which can take over the monetary policy 'sweetspot' that until now has been occupied by US equities.

A continuation and modification of the accommodative stance of monetary policy will also have a beneficial effect on European banks which, to a large extent, depend on the ECB's benevolence.

On the other hand, one must assume that the euro can only experience further difficulties when the ECB's monetary policy eases, relative to that of the U.S. central bank. In the past months, we have expressed the view that we have now seen the peak in EUR/USD, and we still hold to that view – despite the strengthening in April.

The stock market in consolidation – when good is bad and bad is good

Increasingly we hear daily reports about stock analysts and investors who believe that the US stock market has been overbought and is too expensive. A number of factors suggest that we could have seen a temporary top and that we are now entering a period of consolidation which could last over the coming months. Firstly there is the fact that the stock market has declined slightly year-to-date, indicating that the strong momentum from last year seems to have disappeared. Secondly, equities in the developed economies (especially in the United States) are expensive when measured on traditional value-criteria such as Price/Book, Price/Earnings, Price/cash flow etc. A third factor worth mentioning is that in the American Association of Individual Investors, the number of 'bullish' investors compared with the number of 'bearish' investors has, until recently, been very high. This, however, has changed over the last week or so as a result of the fall in the stock market at the beginning of April, when the 'bullish'/'bearish' relationship returned to normal.

A significant factor for stock market pricing is investors' long-term expectations for monetary policy. As described above, we are now about to come out of a period during which the stock markets have enjoyed a historical monetary policy stimulus. In this context, 'bad economic news' was – somewhat illogically – welcomed because it was interpreted as a signal that the monetary policy stimulus would continue even further – and thus further support the stock markets. The opposite was also true – that 'good economic news' was interpreted as being bad for the stock markets, because it meant that monetary policy would be tighter in the future.

Therefore over the next 4-6 months – during which we can look forward to higher growth in industrial production and stronger labour markets in both the United States and Europe – we should expect stock market consolidation, and investors must increasingly learn to accept the necessity of this: that the stock market must be able to stand unsupported, without crutches, and that interest rate levels must be normalized over the coming years.

As a result of this new 'normalization regime' in the stock market, we should probably expect higher volatility in the future. In the developed countries, broader stock markets delivered particularly strong results in 2013, and there was a tendency in the period 2011-2013, for investors to buy just about anything without taking a second look at the pricing. This explains how growth shares were able to give superior

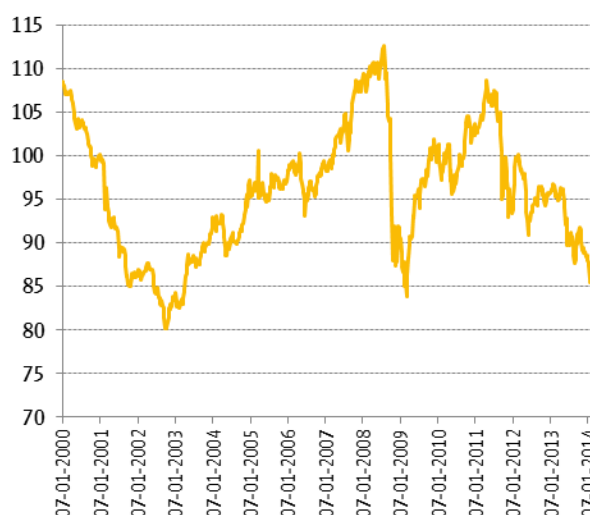
returns in relation to value shares during this period. Now that this situation is normalized and pricing is an issue again we see that value stocks are now giving surplus returns in relation to growth shares.

Emerging Markets Equities

A return to strong performance for value strategies in the market will, all else being equal, result in excess returns from EM equities, for the simple reason that they are (historically) cheaper than developed countries' markets. As previously mentioned in these monthly reports, it has historically been a source of surplus returns to buy the local equity markets whose currencies have fallen most against the USD. According to J.P. Morgan's EURO currency index EM currencies have rarely been as cheap relative to the USD as they are now (see graph).

Only in 2002 and 2009, have they been (marginally) weaker – and on both of these occasions it proved an extremely good time to buy EM-shares. This is because EM-countries' companies become more competitive when their currencies fall against USD and EUR, but the market tends to be slow in pricing in this increase in competitiveness. Against this background, it is still our view that investors should increase their exposure to EM equities in the coming months – both as a tactical and a strategic investment.

Figure 2 - JP Morgan Emerging Market
Currency Index



EM-bonds – a bubble in negativity

Since 2011, growth in global industrial production has been slowly falling, which has traditionally been bad for everything related to Emerging Markets and, in particular, for shares. As we have outlined above, this image is now about to turn around, since we can look forward to a significantly higher growth in industrial production, especially in EM countries, over the next 12 months.

Thus we can expect to see the period during which EM bonds have only delivered weak returns gradually coming to an end, and moving forward, the extremely negative karma currently associated with EM-bonds will prove to be unfounded. EM currencies have entirely bottomed and, as industrial production growth increases, it will very likely result in stronger EM currencies. Our (Denmark domiciled) fund with EM sovereign bonds in local currency thus appears to be an attractive alternative to bonds in developed countries, which are struggling with extremely low interest rates and little prospect of further increase in the currency exchange rates.

The Fund has recently increased exposure to high-interest countries such as Indonesia and Brazil. It has also increased the duration of the portfolio to get the benefit of a stabilization and/or improvement in interest rate developments in the EM countries.

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Figure 3 - Relationship Between Cape and Earnings Growth

