Monthly comment by Chief Strategist, David Bakkegaard Karsbøl

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A dull autumn in store

In recent monthly reports, I have described how we could expect generally favorable growth figures particularly for industrial production over the summer months and then slower numbers towards the year-end. Now, these expectations are proving to be correct.

Germany, usually considered the growth engine in Europe, can look forward to a weak autumn. This is due to German companies having been overly optimistic at the start of the year and embarking on large-scale industrial production relative to demand (OECD retail sales). In addition, German production levels and expectations have also been affected by the sanctions against Russia in connection with the conflict in Ukraine.

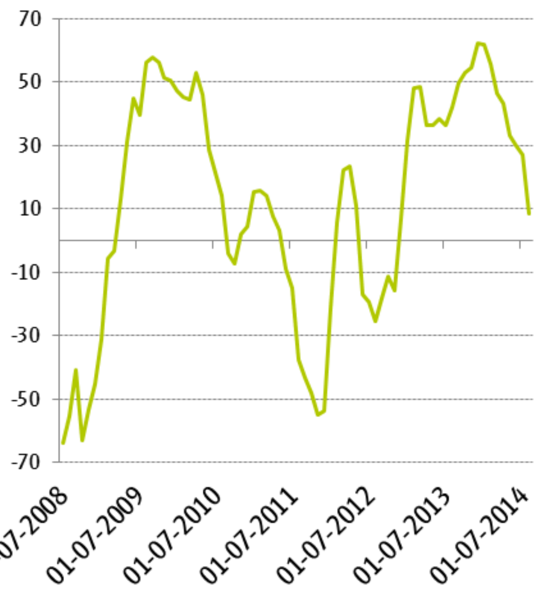
Similar trends can be seen in other European countries, but here it is less pronounced than in Germany, where expectations were already relatively high.

France is often mentioned as the new European problem child. The reason is that the Hollande government has so far shelved any proposals for much needed reforms in the country. In Italy we have a similar problem. In both countries, however, it appears that governments have realized that they will inevitably require reforms and (further) austerity in the public sectors. This should be visible in the short-term GDP figures, but it will in turn help to create a stronger foundation for future growth.

Overall, we therefore expect slower growth – especially in Europe – over the coming months with economic activity expected to bottom out around November-December 2014.

German forecasts (especially for economic growth) from the German sentiment indicators ZEW and IFO have already fallen from their relatively high levels at the turn of the year, and it is my expectation that they will continue to fall for one or two more months before we see a stabilization. See figure 1.

Figure 1 – ZEW research – German economic growth expectations



This stabilization will probably happen as a result of improvement in the European labour market, so that falling unemployment will continue to buoy consumption and thus earnings in European companies.

European shares

European shares are quite cheap compared to all other stock markets (with the exception of EM equities), but their earnings growth has been flat over the past decade (though with considerable volatility), and for that reason, a realization of their potential requires a continued European recovery.

The assessment that European equities are cheap is based on several factors that exert influence over the asset class's long-term returns. First and foremost European dividend payments are low compared to what they have historically been. This is particularly true for the PIIGS countries. Secondly, the CAPE (cyclically adjusted price/earnings) and Price/Book of European equities is significantly lower than other markets (except EM).

The chance of European equities to reach their true potential, however, depends on the prospects for a stronger and more stable European turnaround. The upswing of the last few months seems to have been hesitant and uncertain, meaning that European equities have not performed well in comparison to their American counterparts. Despite the fact that US equities are now amongst the most expensive in the world, the prospects for the American economy look much more convincing than those of Europe in the coming months.

ECB Lending Survey - a basis for recovery in 2015

The important quarterly 'Lending Survey' for European Banks was published in July. It did not contain many surprises but rather the consolidation of recent data showed a relatively broad-based improvement in European banks' funding positions.

In addition, the Lending Survey shows that European banks have eased and will continue to ease the tight credit squeeze that has hampered the small and mid-cap segment in particular among European equities in recent quarters.

Together these two trends are an important basis for the continued stabilization of the European economy and combined with the slow and gradual stabilization of the European labour market they indicate that the growth downturn expected in the coming months will not be serious.

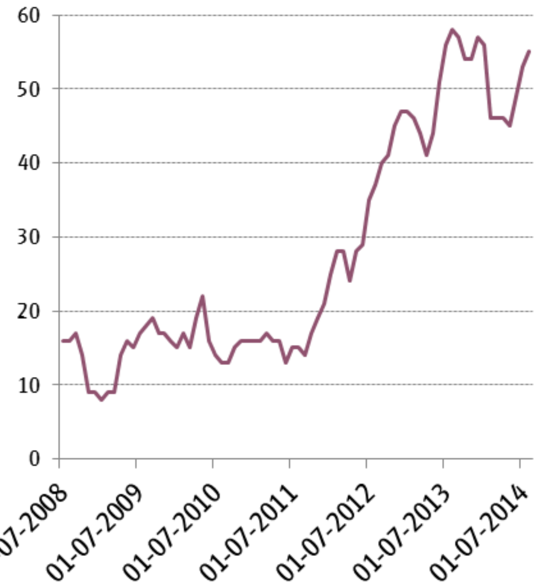
The American real estate market was a positive surprise

Construction activity is a very significant and leading indicator of future economic activity. The reason is that the construction sector is heavily cyclical, it can often suck in the unemployed and even the unskilled labour force in good times. This creates greater income to spend on consumption and lowers public spending on unemployment benefits. Increased construction activity also has great effect on other sectors – primarily through increased demand for materials and upward pressure on wages.

During the years 2003-2007, most countries experienced a very strong construction activity, and often too many homes were built in the face of demographic development, household formation and income levels. When the bubble burst in 2008, a historically high number of construction workers suddenly became unemployed, and it has taken several years to get these reallocated to other industries.

Now, however, it appears that construction activity - aided by rising incomes and low interest rates - is returning to the United States. Admittedly this is happening from a very low base, but there are several indications that this is an economically sustainable development.

Figure 2 – Market sentiment in the US construction industry



Firstly the proportion of vacant rental accommodation in the market gradually returned to a normal 7-8%, from its peak of over 11% in 2010 after the property bubble burst. Second, tenants' expenses (including of course rent) have been increasing significantly faster than overall prices in the United States, and this helps to make it more attractive to build rather than rent. Thirdly, the proportion of those who own their own homes has fallen back to below 65% from the peak in 2006 of over 69% (corresponding to the average for the period 1980 to 1998 - before the bubble).

Seeing Investment Grade and High Yield with fresh eyes

In the past two months I have pointed to the low yields and deterioration of covenant quality (restrictions on how the issuer must behave financially in different situations) in the high yield market as worrying. We will probably see the deterioration of the covenants of new issues in High Yield market emerging over the next several months or quarters, but the fall in the high-yield segment has led to a somewhat higher required rate of return for the asset class, which leaves hope for the future return.

In addition, I would add that our fund strategy of going "off-benchmark" and seeking exposure to smaller issuers with strong assets and good covenants on the issues will still be able to create attractive returns going forward. The effective interest rates on our funds' portfolios are significantly higher than the benchmark, but without any indication that defaults should be systematically higher than the benchmark.

Looking at Investment Grade bonds as an alternative to High Yield, one must say that the difference between the two asset classes in terms of yields and volatility favors High Yield going forward. Investors seeking greater certainty should, in the short term, consider a combination of government bonds and high-yield.

Emerging Markets

Again, we note that EM equities are doing fine despite the recent volatility in developed markets equities. Investors are really starting to wake up to the fact that EM equities are historically cheap - both in comparison with developed countries' shares and in comparison with their own history in terms of price/book, price/earnings, CAPE and dividend payments.

In addition, EM equities should be more immune to the weak industrial production that the developed countries are going to experience in the last few months of the year. This is because six months ago, the EM industries remained very conservative/sceptic about the increased demand growth in OECD countries. Therefore whilst developed countries therefore produced too much, EM countries produced too little.

Industrial production in emerging markets will therefore almost certainly remain at a reasonable level in the coming months, thereby supporting EM equities earnings and growth.

Even China, where I have noted my concerns in previous reports, seems to have recovered slightly. Chinese PMI data for new orders, the manufacturing industry and the service sector has recovered, pointing to renewed optimism. Although growth will be low by Chinese standards, it will still be 'all guns blazing' by Western standards.

Long bonds

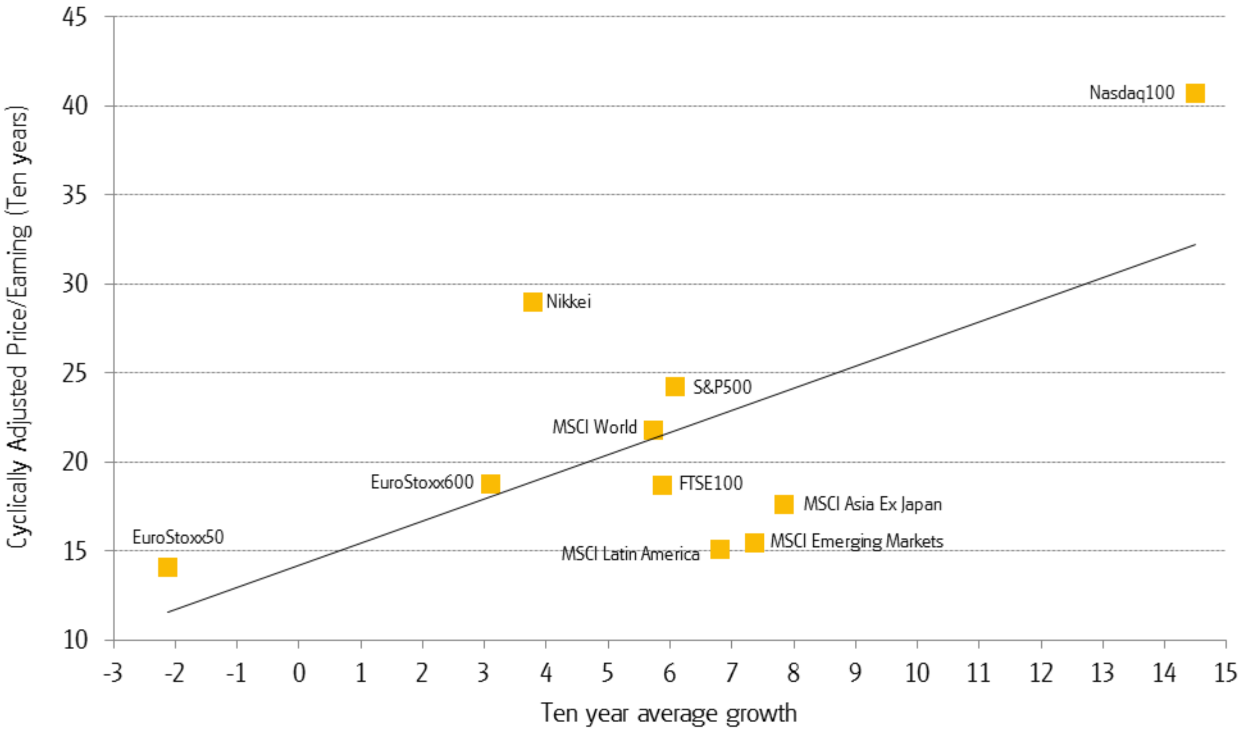
The return on the German Government's 10 year bond is now less than 1%, due to the previously mentioned downturn and the prospect of disappointing industrial production in the coming months. Since I expect that there will be several disappointments from Germany over the coming months to November to December, it will be natural to see a further slight decline in interest rates.

However, in my opinion, this will be a historic bottom, which you should use if you want long-term financing. The reason is that the American economy is now in strong recovery mode that the Fed is getting closer and closer to a point where it becomes irresponsible to continue with such low rates of interest rates as we have now.

Inflation is currently low in the Eurozone (0.4%), but the European labour market is improving, and it will not be many months before we, like the United States, experience a growing upward pressure on wages.

Editing completed on August 26th 2014.

Figur 3 - Relationship Between Cape and Earnings Growth



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