Sparinvest

Monthly comment by Chief Strategist, David Bakkegaard Karsbøl

November 2013

Strong but interesting markets

We are nearing the end of one of the strongest years in the market in recent times. Stock markets, in particular, have served investors well, and we finally see the market breaking higher from the range seen from 2000 to 2007. Even though many of the biggest stocks, especially US large caps, look expensive, we still see interesting opportunities – particularly in industrial stocks. Similarly, the decline in emerging-market assets over the summer left a lot of good investments in those countries that were most affected by it.

Appointment of Yellen

With the appointment of Janet Yellen as Fed Chairman (assuming office in January) the market can, in our opinion, expect the loose monetary policy to continue for some time to come. Yellen is probably the most activist choice as Chairman, and her academic credentials and affiliations indicate great faith in the power of monetary policy. Moreover, her academic work has revolved around the labour market and, in the current environment; it is the labour market that lags most noticeably when compared with past recoveries in the US. Therefore, in the Fed's transition from Greenspan to Bernanke and now to Yellen, it is likely that Yellen will represent a new extreme in activism. This means that we expect the 'unconventional' monetary policy to continue – e.g. in the form of more asset-purchase programmes, special loan facilities to financial (or other) businesses etc.

Tapering postponed

Tapering (i.e. the reduction of government and mortgage bond purchases) from the current monthly level of 85bn dollars is again on the Fed's agenda, but in our view, tapering will be very modest at first, and it may take up to a year before the current level of purchases will be reduced significantly. Moreover, it is likely that a Fed headed by Yellen will accept a rather high inflation rate – maybe even as high as 4% - for a relatively long period of time (in their eyes) to ensure that the economy will be boosted.

The ECB has lowered its key interest rate to 0.25%, and the Bank of England and the Bank of Japan will also keep interest rates low well into 2015, and here asset purchases will definitely continue too. The market sometimes says: 'Don't fight the Fed!' In other words, if the central banks want higher asset prices, it is not the time to sell or reduce your positions. If the proverb holds, it must apply in equal measure to the four major central banks which have - all at the same time - committed to expansive / unconventional monetary policy , and more or less explicitly stated that they are looking at asset price development and higher inflation as criteria for success.

Momentum in the real economy or driven by financial stimulus?

A considerable - and growing - problem with the monetary policy is that the market needs higher and higher doses of it to maintain momentum. Alternatively, the global economy needs to pick up, with improvements in demand and earnings over the coming years. This scenario probably also lies ahead of us, but developments remain uncertain. The central banks are hoping for a 'wealth effect' as a result of their loose monetary policy leading to higher asset prices. In other words, as consumers and developers see their financial holdings or home equity positions growing in value, they should increase spending and initiate new projects, thereby increasing the number of jobs and, through positive reinforcement, a virtuous spiral will result.

So far the central banks have not managed to create this positive spiral and this is probably due to the so-called 'Ricardo-Barro Effect', which describes a situation in which investors and consumers are cautious with their spending activities because they expect high government current account deficits and debt levels will result in higher future taxes. Japan is a good example of this.

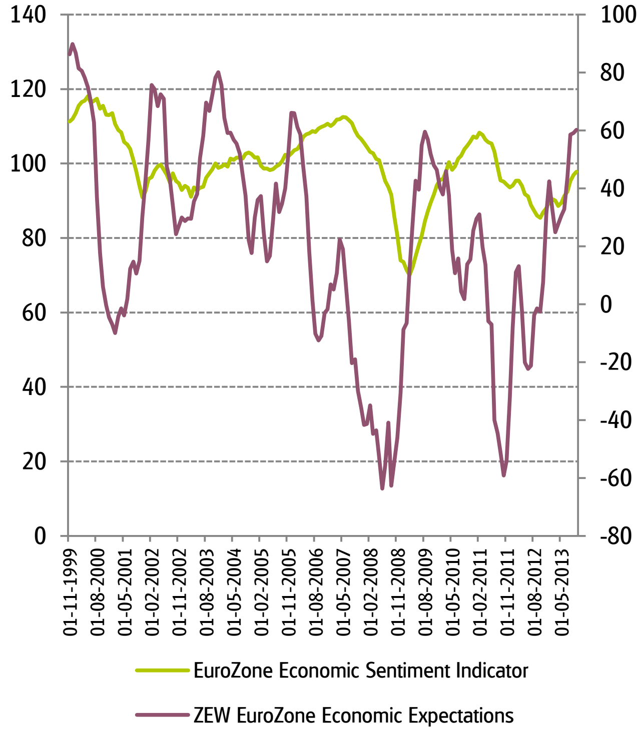
The Bank of Japan has kept interest rates exceptionally low for the past 20 years and the country has been running major budget deficits over the same period. Hence, consumers have been reluctant to spend in anticipation of higher taxes, and companies have reduced debt. The consequence of low Japanese domestic demand has been low inflation - or even deflation - for a number of years. It seems that under 'Abenomics', the Bank of Japan is determined in its efforts to create inflation in order to stimulate domestic demand and devalue the yen, thereby boosting the competitiveness of Japanese businesses. So far, the efforts have weakened the yen and strengthened stock markets, but domestic demand is yet to respond significantly to the changes in monetary policy.

The bottom has been reached in Europe

If we look at the activity in the economy in isolation, it is fair to conclude that things can hardly get any worse – especially in Europe. However, we see budding optimism, manifesting itself in the stock markets. The upswing since 2009 has been unusually fragile and slow from a historic perspective, and a number of factors indicate that the growth pendulum will finally swing towards better times:

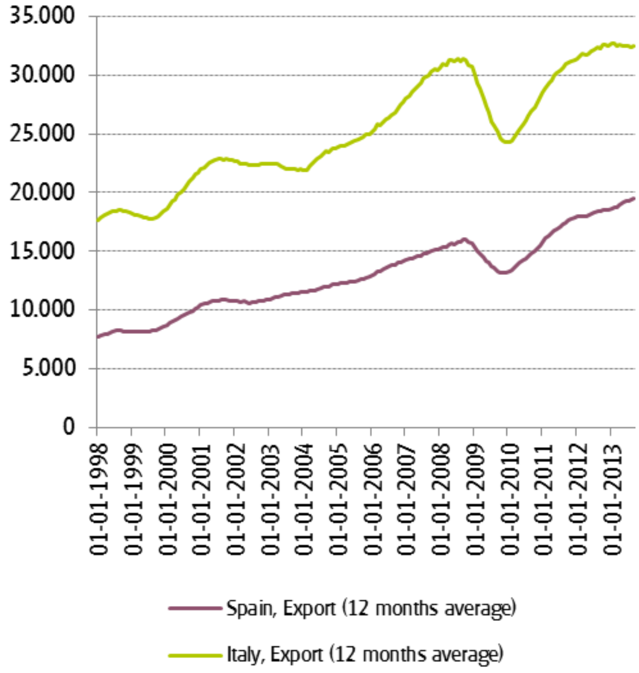
1. The number of Spanish properties with new loans has dropped to about 10% of the level of 2006-2007
2. Across the EU, building activity has dropped by 25%, reaching 1994-levels
3. Industry output is at the same level as 2000-2003, but now picking up
4. Unemployment in the Eurozone has reached 12.2%, but is not rising further
5. Pan-European sentiment is improving from a rather low level in 2012, which typically indicates increasing asset prices
6. Exports from PIIGS countries are growing remarkably, and it appears that business has been strengthened by the harsh reforms launched in Spain, Portugal and Ireland in particular.

Figure 1 – Sentiment indicator



There are still problems in Europe. First and foremost, public debt is a serious threat to long-term and sustainable growth, and it seems that the market is too laid back about the potential risk in relation to southern European government bonds. In our view, the macroeconomic risk in southern European government debt is priced way too cheaply. Therefore, any bigger crisis in the future will probably arise at the intersection between southern European banks and southern European governments. Consequently, we keep a close eye on the credit spread between German bunds and PIIGS bonds, but we do not find it problematic to buy European assets.

Figure 2 – export, million Euro



AQR and stress tests

In the coming 12 months, the ECB will run an Asset Quality Review and stress test of European banks. This will most likely force southern European banks to reduce balance sheets further, causing lending in southern Europe in particular to be flat or negative. This is already causing European inflation to be low, with some southern European countries actually experiencing deflation. The consensus is that this is a negative spiral for these countries, and even though they may not exactly have a good time down there, we see it as a natural and necessary step in order for them to improve competitiveness. Southern European stock markets currently thrive under cheap financing from a willing bond market and low(er) unit costs. Southern European stocks have long been marked by the negativity attaching to Europe, but during the autumn the market has increasingly recognized that there are convincing cases too among southern European stocks with a global exposure.

Reforms rub off well on markets

It is positive that big reforms of labour markets and social systems have been carried out in recent years, which will increase the number of qualified and motivated workers per labour unit cost, especially in Southern Europe. Spain, in particular, has succeeded in boosting exports considerably and, in broad terms, Spain's success will either inspire or force labour associations and voters to accept a 'Germanification' of the remaining European social states. Even though high debt levels in Europe are a worry, the outlook is, therefore, not bad for European stocks.

Emerging Markets – fragile five

India, Indonesia, Brazil, Turkey and South Africa have all seen big drops in their currencies over the past months. The worries stem from the fact that these countries have rather large trade deficits, salary inflation and stagnating growth. Since these countries make up around 7% of the global economy and an even bigger proportion of the Emerging Markets universe, the capital outflow has naturally impacted Emerging Markets as an asset class. However, empirical research shows that stock markets in countries with a depreciating currency will ride on a delayed wave of growth, arising from the boost that devaluation gives to competitiveness.

Large caps are expensive

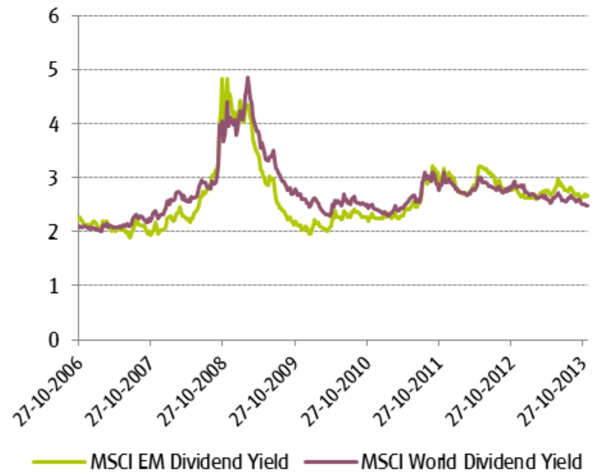
Stock markets are enjoying strong momentum, and, from a pure value investing perspective, there could be an argument for reduction in exposure, since markets in general – in very broad terms - seem expensive when measured on classic value criteria such as Price/Book, Price/Earnings, Shiller P/E, Market Cap/GDP, Tobin's Q, Buy-Out Valuation levels and earnings growth. This is especially the case for US stocks. Moreover, sentiment is very bullish, which is a typical sign of over-optimism. Our assessment is, however, that the current momentum can continue into the New Year, allowing investors to enjoy the January effect (January is statistically the strongest month of the year) before the current strong momentum may slow down.

However, if we look in more detail at equities, we see that US large caps in particular appear expensive, while European industrial stocks look attractive. Moreover, the current optimism that we see in larger European stocks is not reflected in the European micro-cap stocks. Emerging market stocks seem a bit more speculative, and many have not yet fully rebounded from the drop of the autumn. Therefore, we find many interesting cases here (see figures 3, 4 and 5).

Figure 3 - MSCI EM vs. MSCI World – Price/Book

Figure 4 - MSCI EM vs. MSCI World – Price/Earnings

Figure 5 -MSCI EM vs. MSCI World – Dividend Yield



Corporate bonds also strengthened by QE programme

There is no doubt that the corporate bond market has benefitted from the various QE programmes. The total outstanding amount of corporate bonds in the US is now bigger than the mortgage credit market for the first time, and strong demand has resulted in record issuance. The credit quality of the average issue is, however, decreasing and we increasingly see that investors are willing to lower their covenant requirements, which is worrying from a financial stability perspective. Historically, periods with loose covenant demands and large-scale issuing activity have resulted in increased volatility and more defaults.

If we take a look at EM corporate bonds, we find interesting possibilities especially in the investment grade segment, which currently trades at significantly higher premiums compared with bonds of a similar rating from developed markets. Moreover, the spread between high yield and investment grade is getting rather tight.

We continue to see good opportunities in corporate bonds with an energy exposure, with pledges in assets and short time to maturity, because we know that the demand for oil and gas will continue over the next three to five years.

As is the case for stock markets, it is, however, not the time to reduce the exposure to corporate bonds, and it would also be wrong to conclude that we lack interesting investment cases - even though the number has decreased since the mini crisis of 2011. We expect the current cycle to be further strengthened, which will rub off well on corporate bonds. In other words, the momentum in this asset class may very well continue into 2014.

Government bonds

As mentioned above, the spread between PIIGS countries and German bonds has tightened somewhat, and even negative news about slow reform momentum does not seem to affect the spread very much. In our opinion, this indicates that the market is too easy-going and willing to rely on the ECB to come to the rescue should even the smallest problem arise. Even though the ECB – if it sees signs of poor liquidity in the bond markets in the coming months - may make a move to turn deposit rates negative and introduce new LTRO programs, the market's faith in the Central Banks's capabilities in the event of a new sovereign debt crisis is far too optimistic.

In general, government bonds are currently trading at such low levels of return that they do not constitute an attractive investment, when you take into account the implied interest rate risk. However, government bonds issued by strong debtors like Germany, Holland, Finland and Denmark form a necessary element in portfolios in which the overall risk needs to be kept in check.

Figure 6 - 10-year government bond spread