Sparinvest

Monthly comment by Chief Strategist, David Bakkegaard Karsbøl

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A maturing – but not euphoric – recovery

Again – as expected – July was a month that saw a general improvement in economic data. Both the short industrial production cycle and longer labour market cycle showed gradual improvements.

As I have described, we have reason to expect a general slowdown in the growth of industrial production during the autumn and into 2015 but we still don't see this as serious, and there are even signs that we might get another acceleration of industrial production growth in the spring of 2015. This cycle - driven by industrial production, consumption growth and stock trends - is relatively short and not of very high importance for long-term GDP growth. Here it is the development of 'slow' indicators such as unemployment, inflation and especially construction activity that is more crucial.

It is therefore important to distinguish between cycles and keep track of when they overlap and/or reinforce each other. In the next six months, industrial production will probably decelerate slightly, but the labour market will, in all probability, be further strengthened and it is this development which - along with stronger consumption growth and the real estate market - will contribute to the normalization of GDP growth.

We are also beginning to see that construction activity is starting to come back in several countries.

Geopolitical risk

Although there can be a long wait for any good news from Iraq and Syria these days, the market has not yet priced in a greater disruption of energy supplies from the region. The fact that ISIL/ISIS has taken power in eastern Syria and western Iraq can hardly be said to be conducive to equity and energy markets but, at the same time, we must also recognize that the areas now controlled by ISIL/ISIS have been of little economic importance.

Both West Texas Intermediate Crude Oil and Brent Crude Oil traded at relatively unchanged rates for the first half of the year.

Similarly, the already very low VIX (the options exchange market showing expectations of future volatility in the S & P 500 stock market index) is pretty much unchanged, continuing low. Credit spreads in the High Yield market also suggest that there aren't too many worries in the market.

The turmoil in Ukraine and the shooting of a Malaysian Air passenger plane has not had any noticeable influence on the market. However, both Russian equities and the ruble have taken a slight dip, not that this can actually be traced in price-graphs, unless one knows when it happened!

Emerging market shares - the only cheap asset class?

While equity markets in general have resulted in moderate and favorable results during the June-July months, investors have really become aware of how undervalued emerging market equities are. In late July, we have experienced strong increases in several emerging market countries' stock markets.

An expansionary monetary policy from the Fed, BoJ, BoE and ECB has generally helped all asset classes so that both developed market shares and corporate bonds generally traded at historically low returns. The same applies to sovereign bonds, which again in July hit new, low interest rate levels. German 10-year government bonds traded to a new record low interest rate of around 1.15%.

The only notable exception is in our view, emerging market equities. Despite recent increases, it is still our view that emerging market equities will provide a superior risk-adjusted long-term return compared to all other major asset classes. This is most likely to be a recurring theme for this month's commentary.

The reason is that emerging market equities are 'under-owned' by investors due to a great dislike for the asset class since 2011. Consequently, the rate of return requirements for many emerging market equities are still near the top of their historical range, while the required return on virtually all other asset classes is either at rock bottom or close to it.

At the time of writing, the MSCI Emerging Markets Index traded at a P/E of 13.7, a P/B of 1.61 and a CAPE (Cyclically adjusted price earnings) of 15.1. At the same time the long-term EPS growth in this index was almost incomparably greater than all other stock indices.

High yield and tapering

We mentioned in last month's comment that long-term investors would be looking with concern at the required return in the high yield market. The Monthly Report turned out to be exceptionally well-timed as the effective yield on BofA/ML High Yield 100 Index has since risen by over 50 basis points. The reasons for this increase in effective yield may be several but, in our opinion, it is most likely due to the fact that we are coming closer to a date for the closing of US Quantitative Easing. Already here in late July, it is expected that the monthly purchases of government and mortgage bonds from the Federal Reserve will be reduced to total 25 billion dollars.

It may be the end of the Fed's buying programs and the subsequent expected normalization of interest rates, which worries the market for corporate bonds. As long-term investors - despite the now slightly higher yield requirements for high-yield bonds - we still share these concerns.

Although we are still convinced by our STRATEGIC approach - with its emphasis on unrated, emerging market-related and off-benchmark bonds - we cannot ignore the fact that if our benchmark is hit by further concerns, our portfolios will also be affected.

Long-term bonds

In the year to date, the yield on 10-year German government bonds has fallen from 1.93% to 1.13%; a relatively large decrease from an already low level. The effective yield for European long government bonds is now so low that these are also very likely to be unattractive for the long-term investor.

The decrease is probably due to fact that the ECB has been so reluctant to ease monetary policy and therefore inflation in the euro zone has been allowed to remain exceptionally low - even with the prospect of months or years of low inflation.

However, interest rates in the United States also declined, and this can be seen as more surprising because inflation here is already 'normal' (around 2%), and the labour market recovering fast.

Since we anticipate a continued general improvement in the slightly longer, slower cyclical economic indicators such as global unemployment, construction activity and investments during 2014 and 2015, it will, in our view, not be attractive to be exposed to long government bonds.

Investors who want alternatives to the high yield market should therefore increasingly consider exposing themselves to a combination of emerging market equities (which stand to benefit greatly from a further strengthening of the global economy) and short government bonds, which can protect against rising interest rate risks.

Figure 3 - Relationship Between Cape and Earnings Growth