Sparinvest

Monthly comment by Chief Strategist, David Bakkegaard Karsbøl

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Weaker growth until Q1 2015 - but no disaster

Over the past months, numerous articles have debated whether Germany is heading into recession. Recently, both the monthly IFO and ZEW surveys have been somewhat more negative for Germany than for the other countries of Europe taken as a whole.

Certainly, Germany has been hit hard by the EUR/JPY exchange rate which has increased by about 40% since 2012 and within Europe it is chiefly German companies that produce the capital goods that place them in direct competition with Japanese companies. Thus when the JPY weakens against the euro, Japanese companies get a major competitive advantage over German ones. This is possibly one of the reasons why German companies have experienced weak exports in recent months.

France also looks to be having a difficult time, judging from the most recent PMI for the manufacturing industry. But overall it is not a disaster scenario. Keeping focus on a pan-European level, these disappointments are offset by pretty strong figures from Spain, Ireland, Poland and the UK.

It would appear that the IFO and ZEW figures for Germany are attracting too much attention in the context of the overall growth perspective for Europe. Sure enough, we expect that growth will slow but it should still be positive over the New Year and into the first quarter of 2015.

It is likely - as I have written – that we can expect signs of further risk reduction until 2015, meaning that the volatility of October may well be repeated in November and December.

US indicators conflict with low inflation expectations

At its meeting of October 29, the Federal Reserve announced the completion of 'the full taper' – i.e. it has gradually reduced its monthly purchases of mortgage and government bonds to zero.

This is possibly one of the reasons why the market has experienced increased volatility during the month of October, and that the VIX (implied volatility index based on option prices on the S&P 500) briefly rose above 30.

But there is no longer any doubt that acquisition programs are at an end, what is less certain is whether the Fed will immediately begin to raise interest rates, currently at 0.25%. As a result of the turmoil in early October, market expectations of interest rates were lowered, so that the derived market expectation (i.e. when we look at the futures market for interest rate derivatives) is at a level of 0.75% at end-2015, 1.3% at the end of 2016 and at the end of 2017 the expected interest rate is 2.4%.

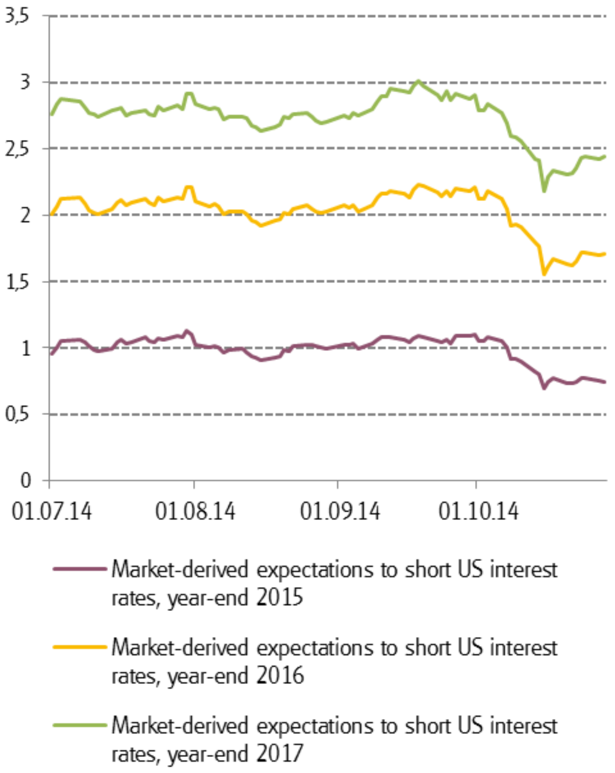
In other words, the market still firmly expects a mild incline in interest rates over the next three years. This scenario now looks to be a bit of a paradox, when compared with developments in the US labour market. The number of people who register as unemployed for the first time has never been lower (with the exception of a short period in a booming labour market in 2000). The average number of working hours for private sector employees is again in line with the pre-crisis levels of 2008, and the unemployment rate has now fallen to only 5.9%.

Perhaps the only remaining justification for keeping interest rates at such a low level is that inflation expectations are relatively low, if not declining, even in the United States.

Since this summer, the expectation for the average inflation figure over the next five years decreased from over 2% to 1.5%, which is clearly inconsistent with the Fed's inflation target of about 2%.

This trend is supported by a soaring US dollar, which, via lower import prices, helps to keep inflation low. One of the main catalysts for inflation is wage increases which, until now, have not risen significantly. The reason is that many of the jobs that were abolished after the crisis paid higher salaries than the jobs which have subsequently been created. However, it is difficult to imagine that the labour market in the United States can continue to evolve at such a fast pace without seeing higher pay rises.

From this perspective, the low inflation expectations can be seen as something temporary, and probably an over-reaction created by the still quite skeptical investment climate that has prevailed since 2009. My assessment is that within the next 12 months we will see headlines in the US that challenge the current very low expectations for inflation. The labour market is very 'tight' and both PMI and ISM numbers could hardly be better in the United States. At the same time some of the most important leading indicators for house building are definitely on the right track.



Asset Quality Review Test from ECB

The long-awaited results of the ECB's Asset Quality Review (AQR) have now been published. The market did not react significantly to these - with the exception of a handful of Italian banks which were highlighted as being thin on capital.

The test is based on a number of scenarios that would provide a revenue problem for banks - including slow growth or outright recession. Although the conclusion of AQR is probably true based on the scenarios tested, the test as a whole has been rightly criticized for not including a deflationary scenario, which would provide a fairly difficult earnings environment for the banks covered by the test.

That omission is particularly glaring when the test scenarios are compared with the actual developments in European inflation and the ECB's own inflation expectations. Firstly, 8 out of 28 EU countries are already experiencing outright deflation (falling prices) - including large countries like Spain and Italy. Secondly, the Eurozone inflation rate is now only 0.3% - very close to deflation. Third, the ECB's ability to predict the evolution of inflation has been particularly called into question by what has happened in reality where we see the development of much stronger disinflationary and/or deflationary trends than the ECB had predicted. Given that the stress tests were supposed to be especially challenging, showing what might happen in the 'worst-case' scenario of low inflation and given that this 'worst case' scenario has already been overtaken by the actual development in Eurozone rates, one must of course question the test's overall validity.

Eurozone in 2015

Nevertheless, there is no doubt that the Eurozone banks today are much better capitalized than they were in 2009. Furthermore, it is good to note that growth in loans to Eurozone non-financial companies appears to be stabilizing. They are still falling but at a slower rate. At the same time, the European unemployment figures are also moving slowly in the right direction. The unemployment rate has fallen from 12% in the first half of 2013 to 11.5% in 2015 and will dip below 11% (still high by historical standards), so the economic situation in the Eurozone has actually improved.

When the labour market also tightens in the Eurozone, it will support general economic activity and the investment climate. Growth in lending to non-financial corporations in the Eurozone is likely to be positive in mid-2015 - for the first time since 2011-12. Despite the slow pace of reform in Southern Europe and France – the tide could still turn from a downward spiral into a positive spiral. And although we envisage low growth in Europe (and the developed markets) with declining growth in industrial production until the first quarter of 2015, the indicators suggest that we will subsequently see stabilization.

Deflation in Europe - a growing problem?

The Swedish Riksbank has just lowered interest rates to zero. The reason is that over the past 18 months, Sweden has had more or less constant deflation. As mentioned above, 8 out of 28 EU countries are currently experiencing deflation, and significantly more countries are on the brink of deflation.

Is that a problem? The central banks' eyes, yes, because they want a stable inflation rate of about 2%. In consumers' eyes, it is not at all a problem. Lower prices result in greater purchasing power, and it will help sustain consumption. The traditional argument against deflation is that consumers postpone their consumption in anticipation of even lower prices. This may be true in an environment of very strong deflation which, theoretically, could be caused by a collapse in purchasing power (as a result of increase in unemployment and decline in production)

However, a period of low and stable deflation in Europe is not necessarily something to fear. Under the classical gold standard (where most European currencies were redeemable in gold), we saw just that, and this period (about 1870-1914) is generally characterized as a golden era resulting in increased prosperity across Western countries.

By the same token, over the past decade, all consumers will have realized that the price of, for example, a flat-screen TV has been falling, but this price trend has not stood in the way of a fairly large volume of sales being achieved in this market.

Part of the reason for deflation in the Eurozone is that the euro has been quite strong in recent years. Therefore, we have seen a decline in import prices. In the past two years, import prices in the Eurozone fell by 1.5-3.5% per year, which of course has helped to keep the overall price level stable or slightly declining.

If the countries of Southern Europe are more prone to deflation than those of Northern Europe, it is because these countries (especially Spain) in the period 2002-2007 saw an unsustainable boom in construction activity, which accounted for a large proportion of the total growth in gross domestic product. So great was the up-swing, and so many resources - including labour - were drawn into it from other, more sustainable sectors of the economy, that these countries must go through a painful adjustment to regain competitiveness relative to the rest of the EU.

In reality, this means that wages must be considerably reduced to reflect the lower labour productivity in Southern Europe, and the general price level must also come down to reflect the lower purchasing power (and higher debt ratios) compared to Northern Europe. Therefore, we expect that for several years in the future, there will be a relatively large difference between the inflation we are experiencing in Northern Europe and the threat/experience of deflation in Southern Europe.

Falling energy prices and Russia

The decline in energy prices is also helping to keep prices down in the Eurozone, as well as elsewhere. This is probably due to the close alliance between the United States and Saudi Arabia. In order to erode the Russian economy, which is largely based on energy from fossil fuels, Saudi Arabia has agreed to maintain a high level of production of oil and natural gas. As a result, prices fall, and this - together with the other sanctions against Russia – is helping to undermine Russian growth and its government's budget.

We already see that the Russian foreign reserves have fallen by an annualized rate of up to 17% - and this figure increases, as the capital gushes out of the country. The White House hopes that this will help to soften Russia in the Ukrainian question, but it would probably be naive to expect that the Russians react within a few months as a result of lower energy prices alone.

Brazil - the charade continues

Readers of my monthly reports should have noticed that I'm quite positive towards EM equities - which is probably the one and only share class – apart from (southern) European shares, that has a rather speculative touch to it. My EM-optimism is still intact, and it is due to EM equities still being very cheap on the basis of CAPE, P/B, P/E, Dividend Yield and EPS growth, as well as the fact that they face relatively strong industrial production in comparison with the developed markets and emerging market currencies now are historically cheap.

However, I must comment specifically on Brazilian equities. These have taken a big dive as a result of the presidential election (which unfortunately resulted in the re-election of Dilma Rousseff). Brazilian shares are now trading at a CAPE around 10 – and are among the cheapest in the world. Virtually only Russian and Greek equities are more undervalued - and in both cases they must be viewed as significantly more speculative.

Although Brazil will now, by all accounts, have to wait another half a decade for meaningful and much-needed reforms, the country's shares are so cheap that they may well accommodate such uncertainty. Elections in Brazil should not deter one from having a large exposure to EM equities.

Corporate bonds

Volatility in October also hit corporate bonds and although I outlined that the macroeconomic factors support the market (especially the 'financing gap' and the US Senior Officers Loan Survey), we can expect continued volatility in this market.

The ML Global High Yield Index is now trading at a yield to maturity of 6.3%, which is significantly higher than in June, when I warned about the potential of the high-yield market for long-term investors. At this somewhat higher required rate of return, the market now offers better prospects for long-term investors, but with the caution that they should still be able to withstand volatility.

	CAPE
MSCI GREECE	4,2
MSCI RUSSIA	5,1
MSCI EM EASTERN EUROPE	5,9
MSCI PORTUGAL	8,7
MSCI EMEA	9,4
MSCI IRELAND	9,9
MSCI BRAZIL	10,4
MSCI SPAIN	11,7
MSCI ITALY	11,7
MSCI NORWAY	12,7
MSCI EM LATIN AMERICA	13
MSCI VIETNAM	13,8
MSCI EM	13,8
MSCI CHINA	14,5
MSCI FRANCE	14,9
MSCI EFM AFRICA	15,5
MSCI UK	16,4
MSCI EUROPE	16,5
MSCI GERMANY	16,7
MSCI FRONTIER MARKETS	17,3
MSCI AUSTRALIA	17,6
MSCI SWEDEN	17,9
MSCI THAILAND	18,3

MSCI ACWI	19,5
MSCI CANADA	19,8
MSCI WORLD	20,2
MSCI SWITZERLAND	20,7
MSCI JAPAN	22,0
MSCI MEXICO	22,2
MSCI SOUTH AFRICA	22,5
MSCI USA	23,1
MSCI INDONESIA	25,1
MSCI INDIA	27,9
MSCI DENMARK	30,2

	CAPE
MSCI EUR BARRA MOMENTUM	12,6
MSCI WORLD HI DVD YIELD	15,9
S&P SUPERCOM HME BLD IDX	16,2
MSCI WORLD VALUE INDEX	16,5
MSCI USA BARRA LOW VOLATILITY	18,2
MSCI WORLD GROWTH INDEX	24,7
MSCI WORLD SMALL CAP	41,7
MSCI US REIT INDEX	65,1

	CAPE
MSCI EUR/ENERGY	9,4
MSCI EUR/FINANCE	9,9
MSCI EUR/UTILITY	12,7
MSCI EUR/MATERIAL	16,1
MSCI EUR/TEL SVC	17,3
MSCI EUR/CONS DIS	19,5
MSCI EUR/INDUSTRL	20,0
MSCI EUR/CON STPL	24,3
MSCI EUR/HLTH CARE	26,9
MSCI EUR/INF TECH	28,8

	CAPE
MSCI WORLD/ENERGY	13,2
MSCI WORLD/FINANCE	13,3
MSCI WORLD/MATERIAL	16,8
MSCI WORLD/UTILITY	16,8
MSCI WORLD/TEL SVC	18,6
MSCI WORLD/INDUSTRL	20,8
MSCI WORLD/CON STPL	24,8
MSCI WORLD/HLTH CARE	26,5
MSCI WORLD/CONS DIS	27,2
MSCI WORLD/INF TECH	28,0