Sparinvest

Monthly comment by Chief Strategist, David Bakkegaard Karsbøl

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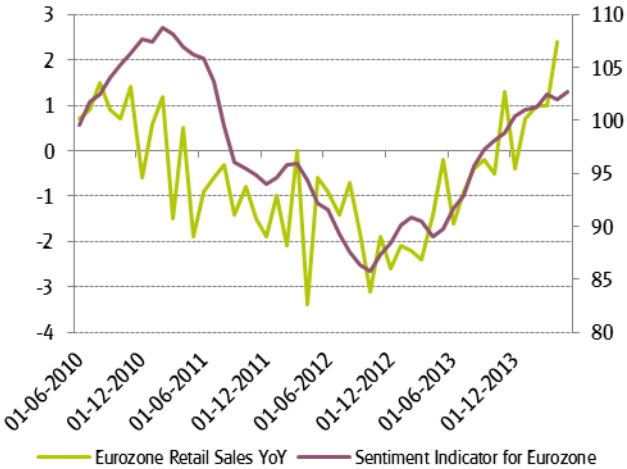
The recovery is a reality

In past monthly comments, I have done a lot to describe how the economy has been developing in the right direction - albeit at a slow pace – and how it would continue to improve over the summer months.

It is with some satisfaction that I can report that economic recovery now appears to be firmly underway. Trust and expectation surveys (PMI, ISM, ZEW IFO etc.) all bear witness to the major improvements that have been seen over the last two months, with figures for private consumption in the euro zone showing the strongest annual increase since 2007. The same applies to the euro zone construction industry, which, after years of negligible growth is now growing at 8% - the strongest since 2007.

The figures are also strong due to an improvement in the European labour market, where the unemployment rate is finally pointing consistently in a downward direction.

Figure 1 - Retail sales and consumer confidence in euro zone



Strong momentum in shares

Again we have seen a strong month for equities. The strength is widely distributed geographically, and now that the market is no longer burdened by bad news stories about Fragile Five countries etc., interest in EM equities is now truly awakened. Although developments in China may yet give cause for concern (see last month's comment), it is apparently not something the market is fiercely devoted to thinking about.

The period from March to May was relatively weak for equity markets, as investors doubted whether the strongly supportive monetary policy from the ECB and the Federal Reserve would continue. The stock market has regained confidence in the central bank's monetary policy over the coming quarters, believing that it will not stifle the recovery and thus the stock market.

The stock market itself – despite expensive multiples – finds itself in one of the best scenarios: solid economic growth combined with supportive monetary policy.

In addition, judging from credit spreads and risk premiums in general the corporate bond market seems unconcerned, verging on easy-going. However, there is nothing to suggest that we will see a significant change for the worse over the coming months.

Dove-like cooing from Yellen

At the FOMC meeting on 17-18 June the Fed, as expected, reduced the monthly purchases of government and mortgage bonds to a total of USD 35 billion. The decision was accompanied by a statement from Yellen that whilst the Fed sees a general economic recovery, the housing market is still relatively weak. Similarly, she expressed concern about the recumbent state of the market. Specifically, she mentioned the implied lack of stock market volatility (low VIX) and the fact that various credit spreads have narrowed very considerably and in many cases are now lower than before the financial crisis.

Ironically, the market reaction was to send VIX and credit spreads down even further. This is because it is the Federal Reserve's own continued expansionary monetary policy which is the primary reason for investors' willingness to take risks in the listed markets. So, when Yellen continues to promise an expansive and strongly supportive monetary policy, her words serve to amplify the trends in the market that she simultaneously expresses concern about.

Yellen has made herself a spokeswoman for greater transparency and better 'guidance' (ie instruction manual) about future monetary policy. The various members of the FOMC, which is the governing body of the U.S. Federal Reserve, have filed their own expectations for short-term rates at various future horizons.

It is a cause for concern that the FOMC members expect significantly higher short-term rates than the expectations that are currently priced into the market for short-term interest rate futures. In other words, the market is not buying the story that the FOMC will tighten monetary policy as much as the various members say they will.

We have had this situation before - that the market has anticipated lower rates of interest from the central bank than the bank itself expected, and so far the market has been right. But if inflation increases, and the labour market is tightening faster than expected, the market may end up disappointed and this may affect investors' willingness to take future risks.

El Nino and Iraq - a boost to inflation?

Break-even inflation expectations - ie. expectations derived from the market for ordinary government bonds and inflation-linked bonds shows that market expectations of inflation have risen relatively sharply over the past month. The expectation of 2-6-year inflation in particular has increased greatly, and the Federal Reserve therefore risks not living up to its goal of price stability.

This trend is reinforced by an improvement in the U.S. labour market, where the unemployment rate is now down to 6.3% - ie. lower than the 6.5% threshold previously set by the bank as that below which you would see actual rate hikes.

In addition, we have a deteriorating security situation in Iraq, where the terrorist group ISIL has set itself up in the significant cities in the eastern part of the country and some areas of Baghdad. This gives ISIL the ability to influence oil production in the country and we have already seen that several companies have evacuated their staff for fear of further escalation of the situation. Oil prices have already responded by rising sharply and we can easily expect further rises.

Another development that could undermine the Fed's price stability objective is El Nino. Already the National Oceanic and Atmospheric Administration (NOAA) reports that at a global level, this May has been the warmest ever recorded in their data. The probability that we are about to go into a severe El Nino over the summer and the rest of the year, is soaring.

The result could easily be more cases of droughts, storms and floods, which together could cause very large compensation sums and sharply increased prices for agricultural products.

In our opinion, these factors, taken as a whole, represent an asymmetric risk of price increases - especially the so-called 'headline inflation' rate, which is the broadest measure of consumer prices.

Negative deposit rates at the ECB

The ECB would view higher consumer prices as manna from heaven - especially in southern Europe which, until now, has been teetering on the brink of deflation. At the last meeting, the ECB felt under pressure to respond to the persistent low inflation in the euro zone by lowering both the refinancing rate and custody rate in the banking system transactions with the ECB.

In addition, the ECB introduced LTRO's long-awaited successor TLTRO (Targeted Long Term Refinance Operation). As outlined, this will reward the banking system for providing loans to non-financial corporations and households (except for loans related to house purchase) on highly concessional terms.

These decisions will, all things being equal, punish banks' deposits with the ECB and reward their lending to businesses and households in the euro zone, and this happens at a time when the economy is starting to recover significantly across the euro zone (with the possible exception of France).

This is good news for European companies - especially the smaller ones which, until now, have had considerable difficulties in obtaining financing. The ECB's own Lending Survey among euro zone banks indicates that there is a great demand for bank loans, so it seems likely that the ECB's recent actions may have a significant and positive effect on economic activity in the euro zone.

Mixed figures from China

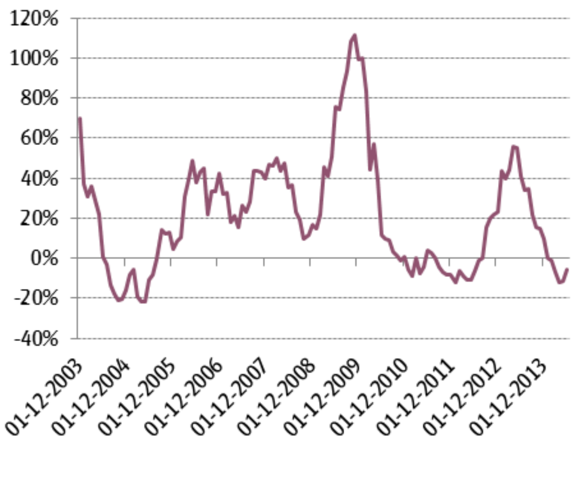
The Chinese authorities have managed to get the banking system to reign in its financing of the real-estate sector, and the Party Congress resolutions are gradually being translated into the larger, planned transition in which prices (ie market) should increasingly determine the allocation of resources to the various sectors.

The Yuan has apparently stabilized after a historic decline against the U.S. dollar during February to March, when a barrage of negative news from China hit the financial markets.

Even though the news flow is still negative for the Chinese real estate market, the recent PMI figures for Chinese production have been surprisingly good. A stronger manufacturing sector in China can generally help to stabilize the Chinese economy, which is suffering from a forced transition from being driven by infrastructure and real estate investments towards a greater dependence on consumer spending.

The total, aggregated loans are no longer growing in China (see figure 2), and this will probably help reduce growth further from the current about 7.4% to just under 7% in the coming quarters. It does not sound like much in a Chinese context, but it will be enough to keep the labour market intact and contribute significantly to world economic growth.

Figure 2 - China: Total Social Financing YoY



Still, there are reasons to worry about the large imbalances in China. The global recovery over the summer months will, by all accounts, mitigate the negative impact of over-investment in infrastructure and real estate and the financial excesses in these sectors. Nevertheless, Chinese growth over the coming years, in my opinion, still be challenged - especially if the global recovery over the summer gradually runs out and no longer can support the Chinese manufacturing industry.

High-yield products

Both EM-related and DM-related high-yield bonds (and both from government and private issuers) are expensive relative to their own history. Well, inflation is low - especially in the euro zone - but their yield-to-maturity is also now at very low levels, and this must provide long-term investors an opportunity for reflection.

The question must inevitably be: what alternative investment choices are available at a time when the higher prices of many assets are pushing their future returns lower and lower? The U.S. so-called 'funding gap' (i.e. the difference between non-financial firms funding needs and domestic savings) is still negative, which is a good sign for the high-yield market over the coming months. Furthermore, both the ECB and the Fed's lending surveys suggest that banks are increasingly willing to lend money.

With the current monetary policy from the Federal Reserve and the ECB (and the Bank of Japan), it is still too early to expect the worst calamities from the high-yield market. Our expectation is - again, that despite the low yield on these bonds - they can do well over the summer and into the autumn. However, we keep a close eye on lending surveys and financing gap in the U.S. to evaluate this exposure.

Figure 3 - Relationship Between Cape and Earnings Growth