Sparinvest

Monthly comment by Chief Strategist, David Bakkegaard Karsbøl

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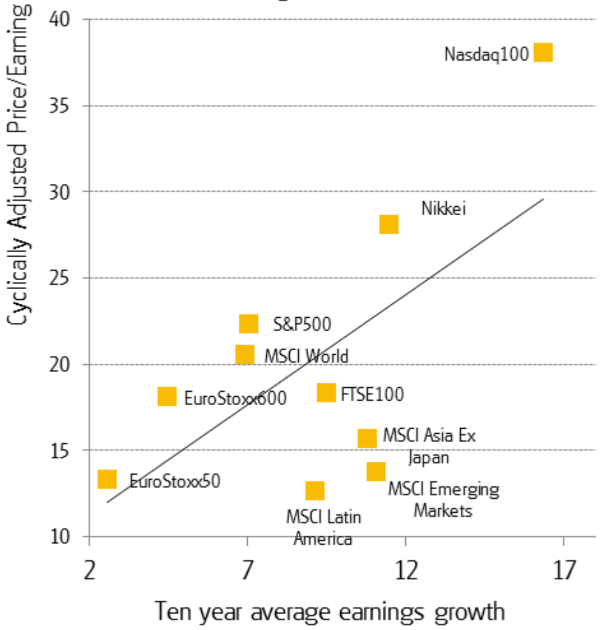
January Cleared the Air

After an Autumn marked by euphoria in the stock market, some skepticism crept in towards the New Year, and one can safely say that the traditional January effect is absent. (January tends to be the strongest for the stock market.) The reasons are said to be nerves about China's growth and the ability of the 'Fragile Five' countries (Turkey, India, Brazil, Indonesia and South Africa) to fund their balance of payments. Moreover, there is the gradual normalization of U.S. monetary policy, which some analysts expect could aggravate capital flows and thus the conditions for the emerging-market countries that are most dependent on foreign funding.

The MSCI World (developed markets) has declined by about 6% from early January to early February, while the MSCI Emerging Markets has fallen by around 9% over the same period. During the same period, the wider, European stock index, EuroSTOXX600, fell by less than 4%. This is interesting in itself - one would expect that a minor crisis in the stock market, caused by unfulfilled expectations for China and Fragile Five, would result in more significant differences in the relative returns picture.

In our view, this indicates two things: 1) This mini-crisis may have a different cause and 2) EM equities have become so cheap that events had already been priced into emerging-market equities. Let's delve a little deeper into these issues (figure 1).

Figure 1 - Relationship Between CAPE and Earnings Growth

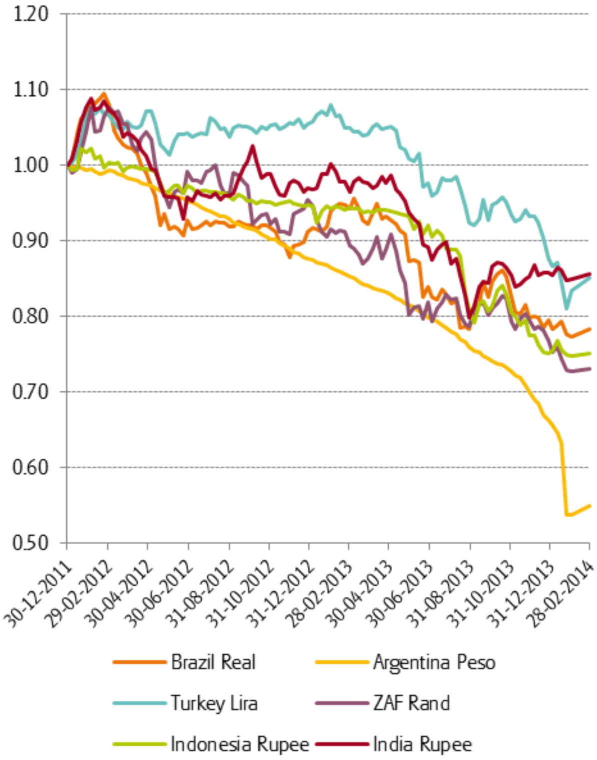


Another reason for the mini-crisis

As we have discussed in the last two monthly reports, the benchmark for the U.S. stock market (S&P 500) has become very expensive in comparison to the fundamentals. From a Value-investment perspective, it had become decidedly unattractive. Expectations were too rosy, and investors needed to come back down to earth. With EPS growth in the S&P 500 at about 6% over the last year and a rise in the index of just under 27%, the fundamentals have simply not kept pace with prices. Thus, it seems likely that the decline in global equity markets is, in part, due to over-optimism about the U.S. economy and the U.S. stock market. As so often before, you might ask: 'When so many investors are optimistic, where does the next buyer when come from?'

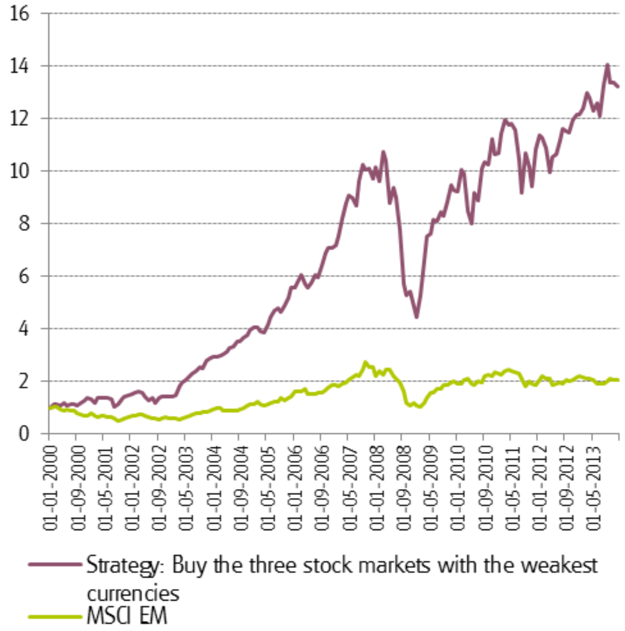
If we look, however, at the emerging markets, the situation was almost the opposite: It is rare that such a large proportion of professional analysts should be so pessimistic about Emerging Markets, and this is at a time when both EM equities and EM currencies have taken quite large dive (figure 2).

Figure 2 - EM Currencies Weakened Against USD



The detailed picture also shows that it is the Latin American and Eastern European equities and currencies in particular that have seen the largest declines because these countries also have larger gaps in their funding from abroad. The fact that these currencies have fallen quite significantly will, in future, enhance their business competitiveness significantly (figure 3). It is also true that a number of central banks in the Fragile Five countries have stepped in to defend their currencies by raising interest rates. This will help to attract capital back and stop the volatility of emerging-market assets even if – all else being equal – the move will be a burden for their most indebted companies.

Figure 3 - The effect of weakening currencies



China's figures show weakening of growth prospects

PMI data from the Chinese service sector indicates that the country's economic activity has fallen sharply since the fourth quarter of 2013. Corresponding figures from manufacturing industries confirm that picture. Analysts still expect that the country's growth will be 7.4% in 2014 but, in our view, there is reason to expect slower growth while the country's transition from an investment-driven to a more consumption-driven growth model is taking shape. This transition will – in itself – reduce growth, with China's funding problems reducing it still further.

The problems in China's interbank market will, by all accounts, not disappear during the year. The Banking Authority, the PBOC, is aware that credit expansion has been dangerously high and fast, but the authorities insist that the market be able to cope with the excesses on its own. Thus on 8 February, a report from the PBOC stated that: "the market must accept reasonable changes in interest rates, so interest rates may be used to help to allocate resources efficiently." In other words, the relatively high volatility in the Chinese interbank market interest rates that we have seen over the last six months is likely to continue and the rough ride will help to discipline the most daring market participants.

In our view, the Chinese authorities are acting wisely. They are willing to pay a price in terms of high, short-term interest rate volatility to ensure an even higher level of long-term stability. In the short term, this means that the market will continue to have to live with stories of indebted Chinese companies that can no longer meet their obligations. The shadow banking system will continue to be under pressure, and even though Chinese stocks are historically cheap, we should not expect significant returns from them this year.

Monetary policy: Relative tightening in the U.S. compared to Europe

The Federal Reserve has now got a new boss. Janet Yellen will, in all probability, maintain the same monetary policy stance as that taken by Ben Bernanke. So far, we can expect that 'tapering' will continue steadily over the next year so that for each monetary policy meeting, the monthly purchases of government and mortgage bonds will be reduced by USD 10 billion. By all accounts, therefore, the acquisition programme will be completed at the end of the year. U.S. core inflation rate is currently about 1.7%, and unemployment rate is steadily recovering. Thus, there is a general tightening of monetary policy in comparison with what we can expect for Europe. The ECB is struggling with inflation in the Eurozone, which is significantly lower than their long-term target of 2%. The general inflation rate for the euro zone is currently at 0.7 % per year, while core inflation is at 0.8%. Part of the reason is falling input prices, given that European industrial input prices have been declining since mid- 2013.

With an inflation rate that is so low, the Bundesbank seem ready to give ground in the monetary policy battle which they would have fought so hard against in recent years. In the ECB's view, the risk skewed. In relation to their long-term mandate, it would be far more dangerous for Eurozone inflation to fall further than for it to increase again. Therefore, there is an increasing likelihood that the ECB will embark on a similar 'unconventional monetary policy', to that seen in the U.S. since the crisis began.

The battle for OMT

One particularly important issue that should be mentioned is the pending case between the Bundesbank and the ECB on the legality of OMT (Outright Monetary Transactions). OMT was announced by Mario Draghi in September 2012 and was intended to stabilize the Euro and restore the market's belief in Eurozone government bonds and financial institutions. So far, OMT has not been used, but it may well come into play if inflation falls further, or if volatility rises again in the EUR market . The purpose of OMT is to narrow the spread of European sovereign debt (particularly for German government bonds) by buying Treasury notes with a maturity of 1-3 years. In doing so, it helps the individual states that would find it difficult to finance themselves at moderate rates.

The ECB could make some demands on the issuer in connection with the OMT, and it is clear that OMT would be 'fully sterilized ', i.e. that there would not be any increased liquidity compared to the market in the USA. In other words, OMT is not the same as Quantitative Easing, but a method to reduce the financing costs of the riskiest states at the expense of the least risky states. While this immediately sounds like a zero sum game, there is, in our view, a mechanism here that can help reduce the overall risk and volatility of the Eurozone. It is worth noting that the program would be 'unlimited' in its scale.

The German Constitutional Court, which usually takes a very restrictive/defensive view in its role of assessing whether the adoption of EU treaties conflicts with German law, has, for the first time in history, asked the European Court of Justice for a ruling on this matter. Thus, although OMT 's legality is technically still in doubt, it is our opinion that the OMT will be approved by the European Court of Justice, which has generally ruled in favour of further European integration.

Will Europe take over the monetary sweet spot?

Over the last three years, U.S. stocks and bonds have had significant support from monetary policy in the form of central bank asset purchases, making these assets some of the most expensive in the world – some US equities are trading at some of the highest Price/Earnings ratios (see graph) and U.S. government bonds are trading at some of the lowest expected real interest rates.

With the relative monetary tightening that we can expect from the United States, and the relative loosening that can be expected for the Eurozone, it is our expectation that European assets are about to take over the 'sweet spot' that until now has been firmly occupied by U.S. assets. This means that the performance-related 'gap' between European and U.S. stocks will probably tighten over the coming quarters. Whether the same is true for European bonds is difficult to say because the picture here is nuanced by the variety of issuers in Europe and the fact that the ECB is expected to have access to complete OMT if needed in future.

Listed European equities have so far only delivered moderate earnings growth, but this will most likely change in line with the fact that labour market and consumption figures have improved in the Eurozone. The unemployment rate is going down, although still high, and the structural reforms implemented in particular southern European countries has led to the bond markets having significantly greater confidence in the States funding situation.

In addition, we attach great importance to smaller (unlisted) companies in the Eurozone doing much better than a year ago. Over the past year, the total profit in the Eurozone (i.e. in both listed and unlisted companies) improved by about 12%. Listed companies have delivered only of half this earnings improvement. History shows a strong, long-term correlation between listed and unlisted companies' profits, and it can be seen also from other countries that the earnings of small businesses tend to predict the business cycle more closely than those of large companies. These considerations therefore point in the direction of a general European recovery of the stock market.