Sparinvest

Monthly comment by
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Indicators points towards overweight in equities – for now

Brexit vote creates nervousness

The British referendum on June 23rd on continued membership of the EU is playing an important factor in June. Some opinion polls have given the "Leave" faction a slim majority but most still predict a win for the "Stay" faction. If we look at the so-called prediction markets – i.e. bookmakers – who have traditionally provided the most accurate predictions about such events, the odds are a solid 73% for staying against 27% for leaving.

Even though it looks like the referendum will result in a "no" to leaving the EU, the opinion polls are still too close for the markets to relax. The voting results open up for too many questions: the nature of the EU partnership, new demands from Britain and concessions from the EU in the case of Britain staying, the value of the Pound sterling, Ireland and Scotland's position in the event of a "yes" vote to leave the EU.

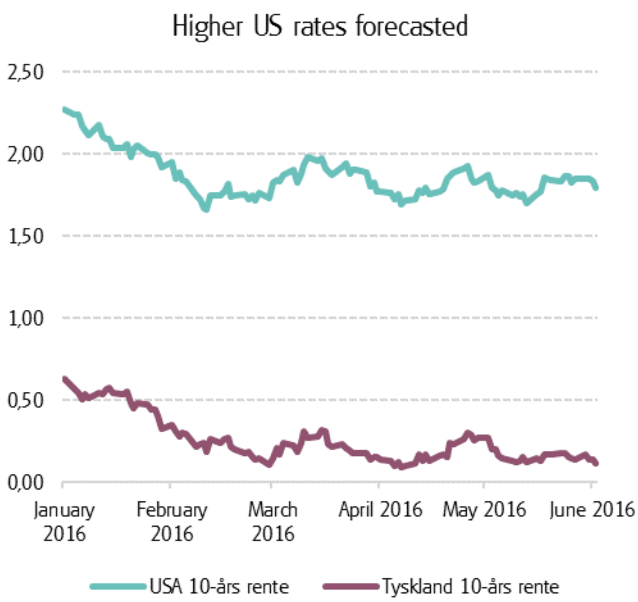
The implied volatility of the pound (i.e. currency options market) indicates record-high expectations of fluctuations in sterling. Similarly, there is evidence of a tendency for risk aversion in British Treasury notes, where the 10-year interest rate has fallen below 1.4%.

> *No Sparinvest funds are significantly exposed to the outcome of the British referendum*

None of Sparinvest funds are significantly exposed to the outcome of the British referendum. Our equity funds are broadly underweight to UK equities relative to their benchmarks, and our bond funds are on the same level as the benchmarks.

Stronger US dollar and higher interest rate expectations

In last month's report I wrote that the tight US labour market, together with higher inflationary pressure, would lead to higher interest rate expectations for the Federal Reserve as well as a new round of a stronger USD. It now looks like this is happening. In May the USD increased by 3% against the euro and the December 2017 forecast for US 3-month interest rates increased by 11.5 bps. My assessment is that these trends will continue in June. Higher interest rate expectations are in line with current developments in the US labour market, and the European economy looks like it will perform badly relative to the US over the summer (see below).

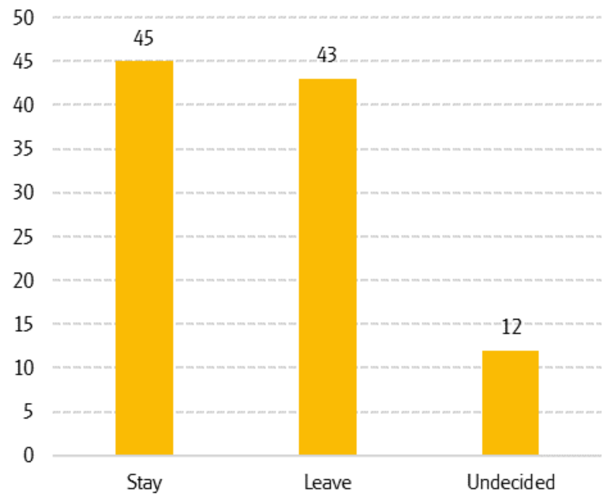


The already challenged US companies will be further troubled by the fact that the US dollar is once again stronger, which will adversely affect their competitiveness. According to the US Bureau of Economic Analysis, non-financial US company profits fell by 5.6% from March 2015 to March 2016.

Current developments in the US labour market make it natural to expect higher interest rates

Europe – fear of stagnation and Brexit

Currently, European policymakers are primarily occupied with the forthcoming negotiations with Britain (whether they vote yes or no to EU membership) and the refugee crisis, which is still far from being under control. Next on the agenda is a focus on reforms, which has particularly significance in France. The French government has adopted necessary but unpopular labour reforms, which are intended to thaw out somewhat inflexible French labour market.



The above issues are of course also relevant to investors in eurozone assets. Long-term yields fell dramatically in the beginning of the year but have not recovered in line with the stock market regaining its ground lost since the fall in January and February.

My assessment is that the European economy will suffer from a lack of confidence over the summer. This will partly be due to the Brexit referendum, partly because of the US economy's expected upswing after the summer, and finally due to further weakening of the euro against the USD. Generally speaking, European economic indicators have righted themselves from February's low point but I expect the US data to improve more than Europe's in the coming months.

Japan – will we have to rewrite the textbooks?

The bumblebee shouldn't be able to fly – and Japan's debt burden should stop it from financing itself in the bond market. Wisdom or old wives tales? Japan is calm, thanks to Abe and Kuroda's reform programme and an extremely expansive monetary policy that has gone from a macro-economic "basket-case" to moving towards the group of countries with far more moderate macroeconomic risks. A significant reason for this is the Bank of Japan's quantitative easing (bond purchase programmes), which in effect meant that the Bank of Japan's share of the total outstanding Japanese government bonds has risen from 12% in early 2013 to over a third today. For a country where government debt amounts to about 225% of GDP this can significantly reduce macroeconomic risk, because if the Bank of Japan owns a third of the public debt, it can in reality be cancelled.

The long-term investor should consider having overweight in Japanese equities

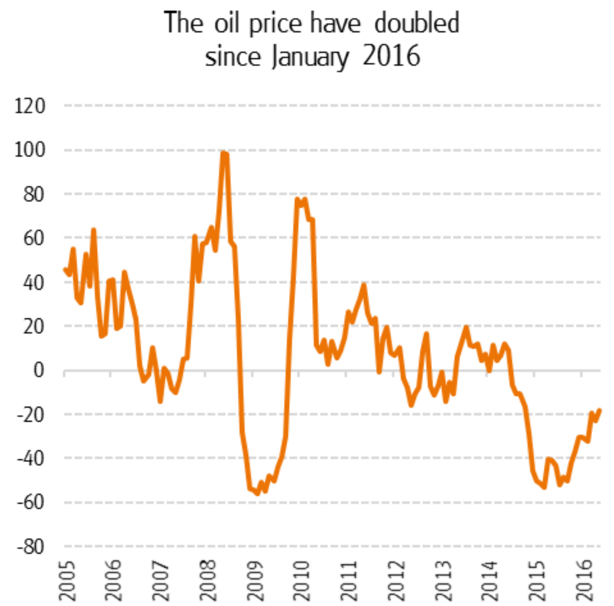
The acquisitions have obviously taken place with freshly printed money, but where economic textbooks state that an increase in money supply will eventually lead to an equal increase in prices in the community (in other words, changes in the money supply have no real effect), prices in Japan have hardly reacted to a rise in the Japanese money supply (base money) of not less than 179% since the beginning of 2013. Where the economic textbooks prescribe higher prices together with monetary expansion, prices have also risen in Japan. It is simply that the price of financial assets (especially bonds) has risen much more than ordinary consumer prices.

The market has gradually responded by letting the Japanese yen rise in value over the past two years. Government interest rates have of course also dropped dramatically, but with so massive a purchasing programme they are not a meaningful indicator of the market's perception of risk. On the other hand, one can say that when the macroeconomic risk has been reduced significantly, it should also have an impact on the stock market.

It will probably be a source of surprise that Japanese equities are trading at much lower multiples than US and European equities (the exact opposite of the normal state of affairs over past two decades). Only their dividend yield makes them look marginally more expensive. The long-term investor should consider having an overweight in Japanese equities.

Beware of inflation in a few months – part 2

As highlighted in previous monthly reports, I repeat my warning against rising interest rates and interest rate expectations. As mentioned above, it is only in America that long-term rates rose slightly after the fall of the first months of the year. But with oil prices doubling since February, there are not many months to go before the year-on-year rate of change in energy prices is positive and therefore a net contribution to inflation figures. My best guess is that it will happen in July or August.



Another reason to still expect rising interest rates and inflation expectations is that our indicators point to a significant improvement in the US economy and emerging markets in the second half of the year.

I still am more optimistic about the European economy than the majority of analysts

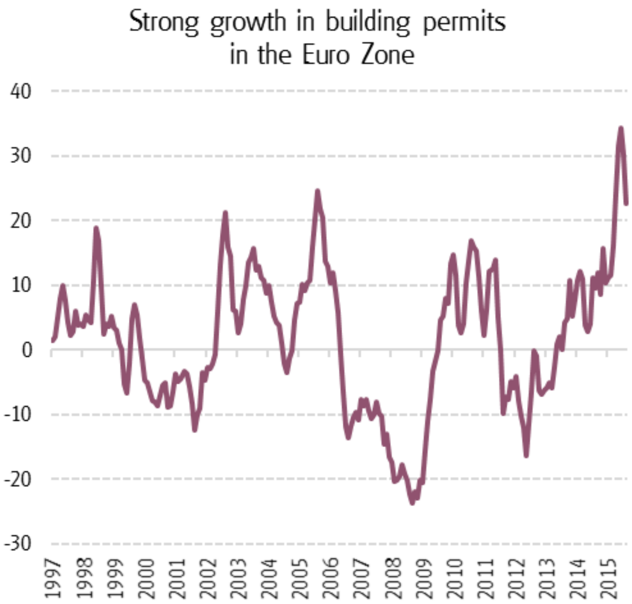
Update on indicators

The deceleration in US industrial production has now ended, and according to our models we are likely to be facing the greatest improvement in the growth of US industrial production for several years in the second half of 2016. The models' prognosis for Europe's development is significantly more subdued. On this basis we must expect that concerns about the European growth crisis will continue into 2016, although I am still more optimistic about the European economy than the majority of analysts.

For the United States, our 3-year model for growth in construction of residential buildings (an important leading indicator) shows there is still reason to be optimistic on the longer term. According to the model, growth rates will be approximately 20% per year, which is much higher than the historical average of 6%.

If we look at car sales, there is already a tendency to a slowdown in the US, which, according to our models, will escalate into a regular fall over the next 12 months. This seems likely, as US manufacturers have been exceptionally aggressive in recent years with regard to offering cheap financing deals that accelerated total consumption.

It actually looks more positive for Europe, where – according to the models – we can expect approximately 3-4% growth over the next 12 months. Another reason to not get too depressed on Europe's behalf is that building permits in the Eurozone are increasing rapidly. In the first months, growth here stayed at 22-34% compared to last year. Consumption in the Eurozone is also still strong, with a real growth of 2.1%. With (growing) growth in consumer loans of 5.3% in the Eurozone, there is no reason to believe that consumption growth will decline significantly from current levels.



If we look at our models of leading indicators, we still expect a gradual recovery of global growth in the rest of the year and into the first months of 2017. In particular, the US leading indicator should start to rise as it is here that the gap between the actual figures for the OECD Leading Indicator and the model's 12-month prediction is highest.

Momentum indicator says buy

Our MomVol indicator (which can assume values between 0 and 1, where values above 0.6 represents a "buy signal") is now back in the market, showing a value of 0.77 – up from last month's 0.44. The reason the indicator has risen so much in a month is because it screens global equity markets in local currencies, and these have risen significantly over the month. Many of these markets have been close to giving individual buying signals last month and have now crossed the "buy signal" threshold.

If we compare the MomVol indicator signal with the fact that our indicators of leading indicators are pointing upwards for the rest of the year, we should have a potent buy signal for stocks. In other words, there is a provisional basis for overweight over the summer.

Editorial deadline: June 6 2016