Sparinvest

Monthly comment by Chief Strategist, David Bakkegaard Karsbøl

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Stock Markets hit new highs

At the time of writing in May, the S&P500 has already hit an historic new high. The same applies to virtually all major European indices, and we are now beginning to see - as predicted in previous monthly reports - emerging markets delivering higher returns relative to the MSCI World, which consists primarily of U.S. and European equities.

There is still a great deal of momentum in the stock markets - but it is weaker compared with March and April. Tactical investors should, in our view, still maintain a high equities stake in their portfolios, although the long-term (10-year) returns can be expected to be very modest compared to the previous five years.

The reason that Developed Market shares continue to do well, despite the relatively high levels, and that Emerging Market equities are once again delivering excess returns is that the global economy is still recovering. Although all is not rosy in the garden, and you should still fear a hard landing China, there is increased economic activity across the board.

In this respect it is interesting that our momentum indicators suggest that EM equities, including Latin America, which has been under pressure in recent months, are now is back with a momentum as strong as the global stock market's.

Poker-face Putin has a good hand

A cause of wonder to the outside observer is Russia's rising stock market. Is Russia not involved a local, cold war against the European countries, with the United States on the other side?

This may be the case, but if your cards are good enough, you can still play poker against all Western nations. As mentioned in an earlier monthly report, only about 30 percent of European gas imports are supplied from outside Russia.

Gas dependency is also concentrated in the eastern countries of the EU, which, fearing for their energy supply, will strongly oppose harsh sanctions against Russia. For this reason alone it must be expected that European countries will proceed with cautiously against Russia – indeed they may not be able to block Putin's intervention (both direct using the military and indirect using other means) in eastern Ukraine.

In early May, the discussion also arose as to whether it was morally defensible for France to conduct a major arms trade with Russia by selling two helicopter carriers worth €1.2 billion. Without taking a position on the morality of the issue, it must be noted that France has a huge economic interest in maintaining good relations with Russia. According to a Deutsche Bank report, the value of receivables in Russian companies owned by French banks totals approximately €50 billion.

In many cases, Putin has the final say over Russian companies' ability/desire to service their debt, putting him in a position where he could undermine the equivalent to a quarter of all French banks' Tier 1 capital. German, Dutch and Italian banks together have about €60 billion in exposure to Russian companies - and in addition, a significant proportion of their gas supply can be held hostage.

All things considered, in the light of the above, it is fair to say that Putin has the best hand, and that the European countries, along with the United States, cannot credibly threaten Putin with unpleasantness. Therefore, the market has also continued to price shares in anticipation of a (largely) globally peaceful outcome - but with the possibility of local unrest in Ukraine.

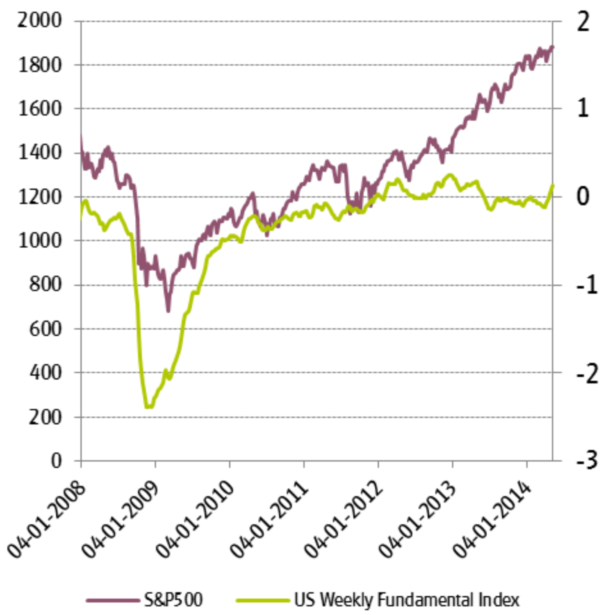
Good news from the U.S.

Aside from surprisingly poor GDP growth in the first quarter of 2014, the positive figures for the U.S. economy were stacked high in April and May. Consumer spending is growing strong job creation (Non-farm Payroll) is reasonable, and the European Credit Research Institute's leading indicators for the US are pointing in the right direction.

In addition, growth in lending by U.S. banks is rising again after a weak 2013, Wells Fargo's important 'Small Business Confidence' measure is at its highest level since 2008 and Gallup's 'Job Creation Index' likewise.

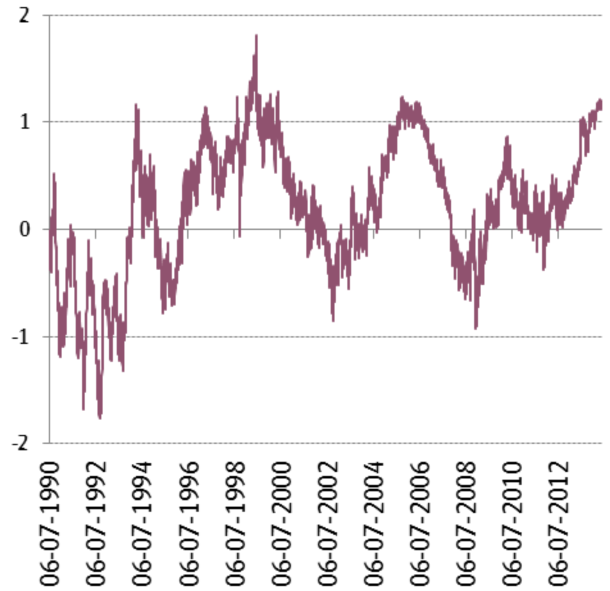
One of the most important leading indicators, however, is the number of building permits issued. Although still lower than in the period 1993-2008, these are soaring – a fact which will contribute further to the improvement of the U.S. labour market, which has been hit hard by construction workers' idleness.

Figure 1 - Improvement in weekly US macroeconomics data



As a result of the generally good numbers, one would have expected higher interest rates in the U.S., but the 10-year yield has actually fallen by 20 basis points since the end of April. It is probably due to the fact that U.S. and German yields tend to behave similarly (and the spread between these is already historically high at almost 120 basis points) that when Europe as a whole finds itself on the brink of deflation (and inflation expectations have declined significantly since April), the US interest rates reluctantly follow the European interest rates lower.

Figure 2 - 10-Year Interest Rate Spread: US-Germany



It is also possible that worries about a global slowdown in China and nervousness for southern European sovereign debt in an otherwise upbeat market may be the reason for the falling interest rates.

Problems in China main concern

In last month's report, I raised concerns about China which unfortunately have turned out to be justified. Macroeconomic data from China are notoriously unreliable. Regional GDP figures for instance, do not add up to the national figure (which logically they should), and lots of other time series contain unexplained volatility and outright holes. Therefore, whilst making appropriate allowances for the poor quality of data, one must also note that the data as a whole point towards a significant slowdown in the Chinese economy. Over recent years, there have certainly been some major imbalances created as a result of fast-paced investment in property and infrastructure - the big question is just how big these are.

By Western standards some of the imbalances are huge and there are signs of unhealthy, short-sighted and ill-considered speculation – particularly in the real estate market. The housing market in China's east coast is reportedly now as expensive as Manhattan in several places with apartments costing so many times more than an average Chinese annual salary that the bubbles in the United States, Britain and Spain pale in comparison.

These issues are not new. What is new, and what the market should focus on, is that Chinese property investors' behavior and expectations have gradually changed over the past few months. Whereas before we have seen periods of economic deterioration (also within the economic activity related to the real estate market), there was a constant expectation of rising - or at least stable - property prices. Every drop in property prices was treated as an opportunity to put more money in real estate - even though many buildings are empty and unused.

Most property indicators have continuously weakened since mid-2013, and the number of homes for sale in Beijing has gone from responding to 7 months of demand to responding to 12 months of demand. In April alone the transaction volume decreased by 18 per cent. Although these figures are also subject to considerable uncertainty, there is no doubt that the real estate market is cooling down or entering outright decline. Many stories (not reflected in the official statistics) indicate a steep decline in real estate with great discounts from cash-pressed developers desperate to sell finished projects. The problem is that these days, potential buyers, in anticipation of lower prices, are no longer accepting these discounts – the volume of unsold properties builds and increases the problem further for developers and sellers alike.

Just as the market can see a good spiral in good times, whereby developers and sellers get a good return, and they then plough this into the further expansion of their business volume, the 'bad' spiral of recession leads to the opposite scenario.

Once the housing market finds itself in this condition, international experience indicates that the 'bad' spiral will continue for several quarters - or years. China's problem is that so few Chinese have known a down market, unemployment and economic stagnation. Many have probably not considered the possibility that you could experience this in China. But China has not changed the laws of economics - just as Japan didn't change them in the 1980s or the U.S. in the noughties.

As China's growth has to a very large extent been related to fixed capital expenditures (including property), we expect that the related supply industries will see difficult times over the coming quarters. Chinese shares have already priced many problems in and they will, at some, point become a generation's most attractive buying opportunity. But it will be some time before this happens, because the realization of China's problems is only just beginning.

ECB - hoping for higher inflation

In response to the decline in inflation in the Eurozone, the ECB has thus far followed a conventional monetary policy – i.e. maintaining low interest rates. The result has been an appreciating euro and lower and lower inflation expectations due to weak demand, especially in southern European countries.

On 8th May, however, the ECB chief, Mario Draghi, signalled that at its next meeting, on 5th June, the ECB's management would be responding to the low level of inflation. The overwhelming majority of majority of analysts and market commentators currently anticipate some form of relief in the ECB's monetary policy at this meeting.

Change has so far been delayed in the hope that higher inflation would make further concessions (which the Germans generally opposed) irrelevant. But even the Germans given in and now recognize the need for relief. The euro fell on Draghi's comments, and we expect further deterioration in the coming months as the U.S. economy shifts into a higher gear.

Credit and EM also favourable

It's hard to find a murmur in the credit market these days. Most credit spreads continue to decline, and lending surveys from both the Federal Reserve and the European Central Bank show an increase in the desire from the banking system to lend to both small- and large-cap companies. In addition, these surveys report sharply falling margins on loans.

All this, together with a liberal American and European monetary policy is helping to prop up the credit market and we expect this will continue in the coming months. If we look at EM equities and emerging market bonds, the positive trend from last month (March-April) continues. This is probably because investors have now become very aware of how cheaply EM equities are priced and the fact that we can expect pretty strong industrial production from these countries over the next six months.

Figure 3 - Relationship Between Cape and Earnings Growth