Sparinvest

Monthly comment by Chief Strategist, David Bakkegaard Karsbøl

December 2015

Draghi's foot on the accelerator

The ECB has long struggled to keep up both inflation and inflation expectations in the Euro Zone. Despite negative interest rates on deposits and a major acquisition program, the ECB has not yet succeeded in pushing inflation expectations beyond 1.8% for any length of time. Core inflation in the Euro Zone has increased from only about 0.7% at the beginning of the year to around 0.9% at the end of the year.

On this basis, the market anticipated that on Thursday, December 3, the ECB would lower the deposit interest rate further from the then -0.2%. In fact, they lowered it to -0.3%, which immediately led to a stronger Euro. Fixed income markets had apparently counted on an even lower interest rate in December, and European equities responded with a slight decline.

The main point is still that the ECB will maintain a strongly stimulating monetary policy for two to three years. Interest rates will probably remain negative until mid-2018, but then, only slowly, converge towards normalization. Risky assets (equities, HY and property) in the Euro Zone should therefore do well in the next few years.

Yellen's foot on the brake

The US central bank is facing a landmark decision. After reducing the monthly support purchases of government bonds to zero, the next step is to begin to raise interest rates in an effort to normalize monetary policy – after a period of almost seven years with an interest rate of 0.25%.

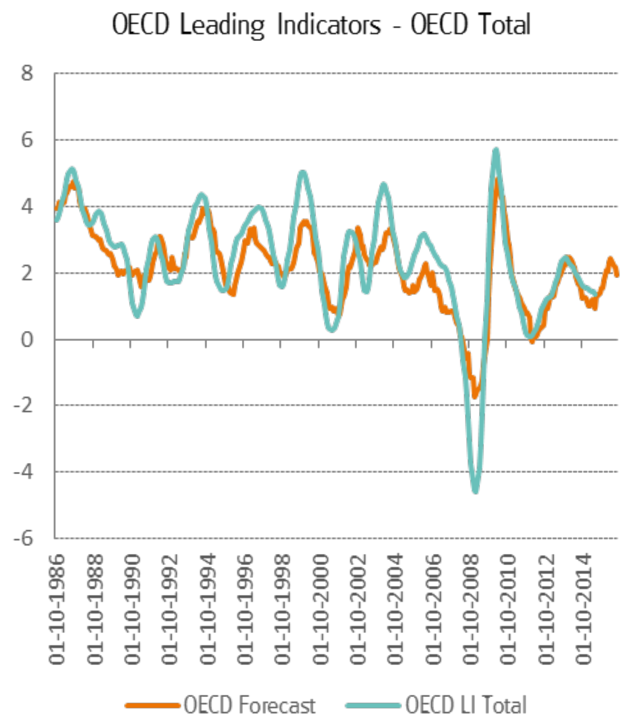
The interest rate market (STIR Futures) now puts the probability of a rate hike of 25 basis points at almost 90%. The likelihood has gradually increased as the US unemployment rate has improved further in the last two months, and now we also see the return of wage pressure. The growth in hourly wages in the United States has not exceeded 2.25% at any time since 2010, but now we have a growth rate of 2.5%. In addition, the long-term, market-derived inflation expectations (5Y/5Y inflation swaps) have tended to increase and now stand at around 2.2%, which is certainly acceptable in relation to the Fed's long-term goals.

Raised interest rates in the United States, as the futures market expects, means that in a year see we will a short interest rate of just over 1%. This fresh perspective may lead to a further strengthening of the US dollar, which has already been a millstone around the neck of American manufacturing. The dollar's strength is mentioned with increasing frequency as a concern in various reports from the Federal Reserve and various surveys.

The most likely economic development over the next 12 months (see the model of the OECD's leading indicator for the United States below) is a progressively stronger growth in the United States from the current semi slack situation. As in previous monthly reports, however, I maintain my expectation that the ISM and PMI surveys for the United States will bottom out around New Year and then will improve significantly. This is particularly true for manufacturing.

OECD countries in broad recovery

According to our models for the OECD leading indicators, all the major developed regions/countries (USD, Euro Zone and Japan), will experience increasing growth rates over the next 8-12 months (see OECD Total graph). The top of the current economic cycle is thus likely to be around May-June 2016, except for the United States, which currently is at its lowest (and early) point in the business cycle. The US is thus likely to experience a continuing strengthening of growth over the next 12 months, with the Euro Zone and Japan likely to experience a gradual weakening over the summer.



The fact that all three major regions will experience stronger growth at the same time over the next (minimum) 8 months is quite important in an active allocation perspective. Risky assets tend to be positively correlated with the OECD leading indicators.

A rather significant factor in the OECD's development is demand. If we use the retail trade as a proxy for demand, we see a steady improvement over the past year. Growth in OECD retailing is probably at around 2.6% right now (we don't have the actual numbers, but they can be estimated fairly reliably), and it is significantly better than the historical average of about 1.6%.

EM equities

Since the spring, EM equities been a long and dismal history. Both multiples and earnings for EM equities have declined, and investors have had to search long and hard for attractive stories. In particular, the BRIC countries and the commodity and energy producing countries all suffered from falling export prices and volume.

However, it is quite difficult to imagine a situation where growth in the retail sector across the OECD area remains well above the historical average of 1.6%; where the leading indicators are improving solidly and where EM countries fail to benefit from the situation.

Stronger demand in Western countries will lead to greater production in Emerging Markets, which have already been pessimistic due to their low growth in industrial production. According to our models for industrial production for EM countries, growth in industrial output should accelerate strongly (by approximately 5 percentage points) from the current 2.6% over the coming 12 months.

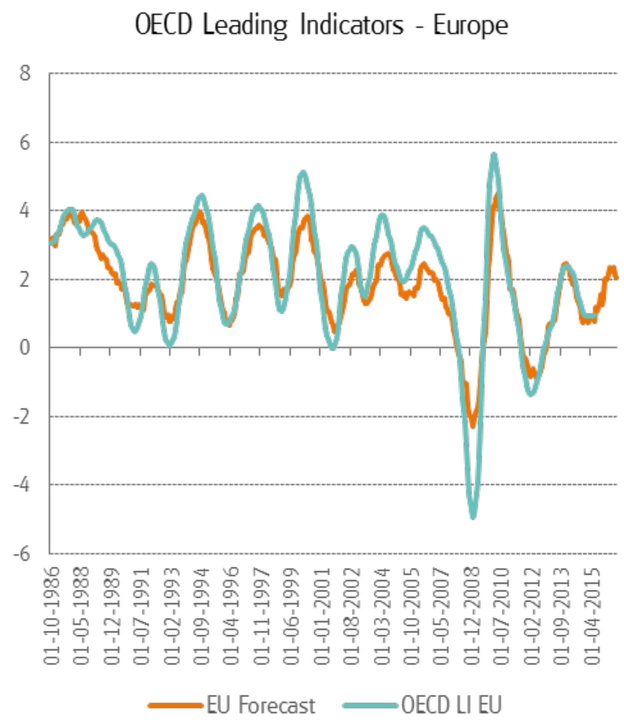
Momentum getting back in stocks

Our Momentum indicator is back in the market with a value of 0.67 for the month of December - the threshold value is 0.6. It also fits well with the ECB's actions (continued strong stimulus) and the macroeconomic input (see below). Back tests of our so-called MomVol indicator show that when the indicator is above 0.6 (it can assume values between 0 and 1), there is 66% probability that the return of the following month in the MSCI World is positive. In addition, the distribution of the subsequent month's return is also asymmetric - in the sense that there are fewer very negative returns when MomVol indicator is above 0.6.

Macro-economic momentum positive for risky assets

Following a major internal project for the modelling of the OECD leading indicators, we have prepared an active allocation model, based on which of the four macro-economic scenarios, the world economy is most likely to find itself in over the next three months.

At present, according to our models we are in scenario 1, which is the combination of high and rising growth in the leading indicators for the world economy. Optimizations since 1989 show that in this scenario, one should have an overweight to EM equities, Momentum stocks, European stocks and commodities. The latter is not directly available as a product on our shelves - but our High-Yield funds indirectly create exposure to commodity prices.


OECD Leading Indicators - Europe
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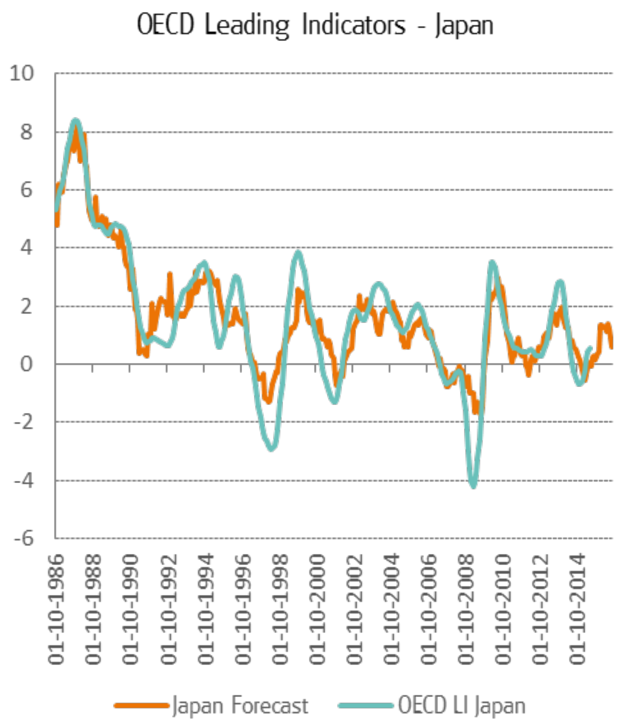
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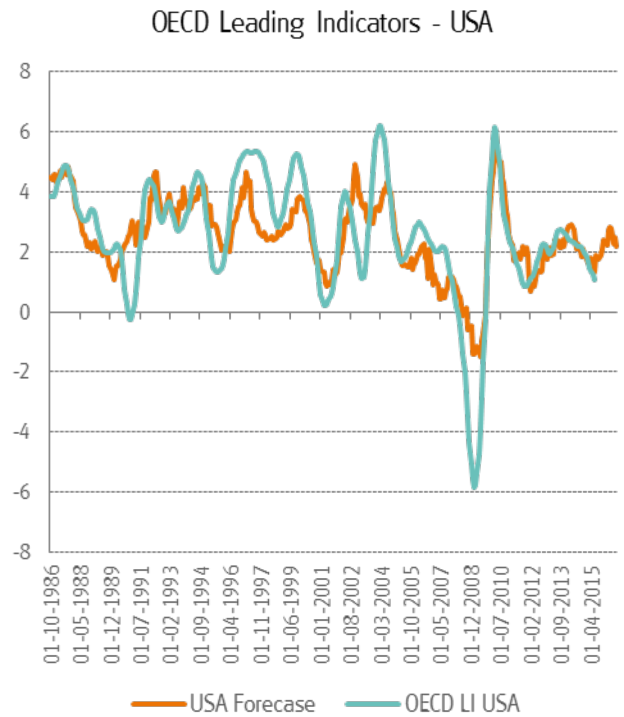
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