Sparinvest

Monthly comment by Chief Strategist, David Bakkegaard Karsbøl

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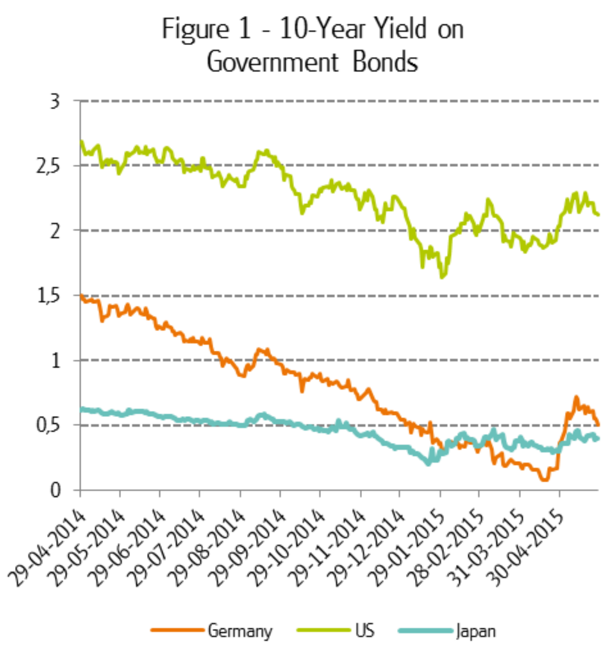
Sharp rise in European interest rates

In the latest monthly report (April, 2015) I warned that we were probably close to the bottom in the development of long term interest rates in Europe. This turned out to be unusually fortunate timing, since interest rates have risen sharply during the first half of May. For Germany, the 10-year interest rate on government bonds rose from around 10 basis points in mid-April to about 75 basis points in mid-May. In recent days they have fallen back slightly, but there is probably no doubt that the situation at the end of April was unsustainable.

During the past six years I have tried to describe and justify my positive expectations for the Euro zone's growth prospects. The basic thesis is that over the last two or three years we have slowly been turning a negative spiral into a positive spiral, where the generation of income, prices, labor, banking and government spending all more or less reversed in favor of European growth.

The thesis was that – as a result of a relatively deep recession – investors in Europe have been too pessimistic, and that in reality it would not take much to surprise them positively and consistently over time. This makes the expected development relevant for financial markets as a whole, as these too are primarily driven by surprises.

I see no reason to depart from this thesis. On the contrary, I expect the scenario to materialize as expected over the coming months, as the European economy gradually picks up momentum as we get closer to the end of the year and well into 2016. Part of the reason for the rise in European interest rates may be attributed to the fact that long-term inflation expectations have begun to creep higher (as a result of better growth prospects). Again we must say that the long-term European inflation expectations (here measured by the so-called 5Y5Y-inflation swap EUR) was exceptionally and unsustainably low in the first months of the year. From the end of April to mid-May it rose by almost 20 basis points.

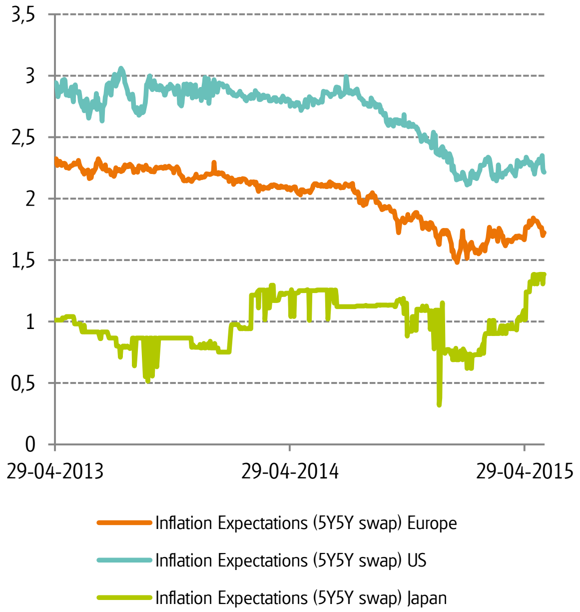


Loose Monetary Policies set the Direction

One of the reasons why inflation expectations were unsustainably low in the first few months of the year is that the European money supply (M2) has been growing again. This has not been dramatic as yet, with annual growth rates of around 4.5%, which is, in fact, close to the ECB's own long-term target for monetary growth.

However, since inflation in the Euro zone remains relatively low (0.0%), the real growth in the money supply is above the average for the past 10 years. This is usually a good leading indicator for higher growth and strong financial performance in the coming months.

Figure 2 - Inflation Expectations



A second, related indicator that is pointing in the same direction, is the so-called MFI (Monetary Financial Institutions) lending to both households and non-financial companies (real economy). For the former, they have increased slightly in the past year and for the latter they have been increasing slightly in the past six years. Over the same six years, the largest European banks have seen a significant increase in expected demand for loans from both businesses and households.

The interest rate market currently expects the ECB to have raised short-term rates above 1% for the first time in mid-June, 2020 - so even if the acquisitions programs will stop in September 2016 (as advertised), monetary policy in the market looks set to continue being highly expansionary for many years.

Against this background, European assets (equities) will be supported for quite some time yet. Even if growth should be stronger than anticipated by the market, the unemployment rate in the Euro zone is high enough that corporate margins are not in danger as a result of wage pressures. Earnings growth is thus reasonably safe.

PODEMOS are Noisy in Spain

Despite the clear economic recovery in Spain, there is still high unemployment accompanied by high levels of frustration. The anti-austerity movement, PODEMOS has strong support in certain parts of the country. In the recent local elections, the movement made gains along with a number of small, new parties and protest parties. The regional constituencies of both Madrid and Barcelona now look set to be dominated by PODEMOS or similar movements.

So far, there is no evidence of major concern to be seen - either in the fixed income market or the CDS (Credit Default Swaps) market where investors can insure themselves against the possibility that the Spanish government goes into receivership. Nevertheless, investors should be aware of developments in Spain. It is my assessment that time is working for the government since the reforms already implemented have moved the economy in the right direction (although it could go faster), but since parliamentary elections are scheduled for December 2015 or before, a good part of the frustration must also be defused if Spanish growth is to be ensured after the election.

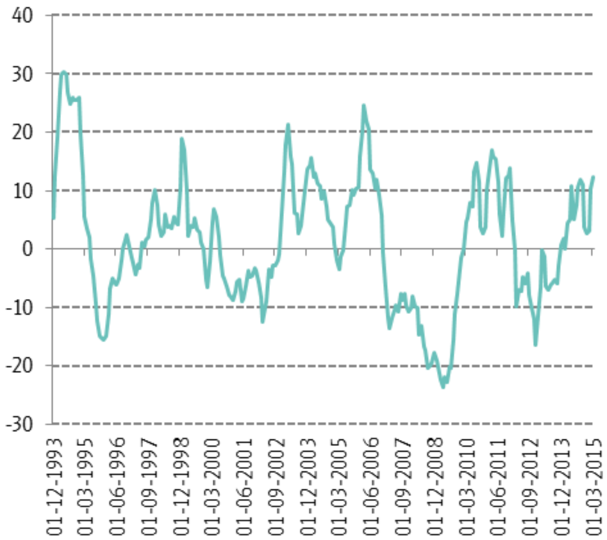
The polls indicate that support for PODEMOS has been declining, but a potential big vote winner (and a significant and troublesome factor in the future) will be ERC, a leftist, Catalan nationalist party that fights for Catalan independence. While ERC is the only party that has gained momentum since the beginning of the year, it can be an obstructive force for the old parties to deal with.

Since I expect relatively strong economic growth in the Euro zone for the rest of the year, it is my preliminary view that time is working in favour of Spain's old parties, and that support for protest parties will shrink, as unemployment falls. However, it is a development that we should keep an eye on as it has the potential to destroy the rosy recovery picture postcard of the PIIGS countries.

Election on the Cards in Denmark

It can hardly have escaped the attention of Danish readers of this Monthly Economic Report that we have elections in Denmark on 18 June. The polls point to a new government that will increasingly keep public spending in check and reduce taxes marginally. Overall, there will be no significant difference in the policies, and the choice will hardly have a major impact on the Danish economy, which essentially relies on international / regional business cycles.

Figure 3 - Eurozone Residential Building Permits, Growth YoY, %



As shown in the graph, (the ratio of Denmark's GDP in real terms divided by Eurozone GDP in real terms), the Danish economy's sensitivity to international / regional trends is high. This is particularly evident from the years 2003-2006 with strong European growth, where Danish GDP grew significantly faster than the Euro zone. It does not seem, however, that the Danish economy was able to exploit the return of growth in the years 2009-2010 to the full before the euro crisis occurred in 2011. With the relatively positive outlook for the European economy, however, we would easily be able to experience strong growth in the Danish economy in 2015-16.w

Light at the End of the American Tunnel

As anticipated in previous monthly reports – we have seen US data disappoint in recent months, but manufacturing now seems to light a candle at the end of the US tunnel. Most of the disappointing survey figures have probably been due to the over-optimism in manufacturing, but the other American figures have remained at relatively good levels in parallel with the weakening in the manufacturing industry, since it is specifically this sector that is most exposed to the strong USD.

The US labor market, the service sector and the construction industry are still doing fine, and now the models for manufacturing show that this will also come back strongly in the new year – despite the increasingly strong USD. The US housing market is still growing strongly, and the number of new buildings has recovered nicely. In the coming years we will see further growth of this industry, which also serves as a leading indicator for the rest of the economy.

EUR/USD - a Bottom?

If I start to see an end to the weakness in the US manufacturing, the rest of the market will probably also see this within very foreseeable future. For several months I have been writing that I thought we were close to the bottom in EUR/USD. Now the USD has strengthened again (since mid-May) and it is primarily due to changes in market's expectations for US rate hikes.

Market expectations for ECB's management of interest rates (as discussed above) are as much as the eye can see. At the same time the risk increases every day that Janet Yellen will tighten US monetary policy faster than anticipated. Yellen had three arguments for continuing to postpone the unpopular rate hikes: 1) the already strong USD, 2) historically low inflation and 3) weakness in US manufacturing. Now it seems that 3) is no longer relevant, and with respect to 2) long-term inflation expectations (5Y5Y inflation swaps) have quietly crept higher over the past two months.

Thus there may be a reason for the currency market to send EUR/USD down and test the bottom at 1.05 again. However it seems unlikely that we will test even lower levels, because in my view, the market has not yet realized the full power of the unfolding, European recovery.

After a period when the European economy has been stagnating for several years, it is swept up in a positive spiral of: lower unemployment, rising house prices and home equity, higher incomes, stronger consumption and consumer confidence as well as increasing demand for loans and willingness to lend. Thus we may find that it suddenly goes uphill fast for both the EUR and European equities.