Sparinvest

Monthly comment by
Chief Strategist, David Bakkegaard Karsbøl

After Brexit – low interest rates in Europe

July has been in the sign of the central banks, with statements from the Bank of England, European Central Bank, the American Fed and the Bank of Japan. (The Bank of England waited to the start of August before lowering the interest rate to 0.25%). The market was expecting the Bank of England and the Bank of Japan to lower key interest rates so it was a surprise that all four central banks chose to keep their key interest rates unchanged.

Viewed separately, the absence of interest rate reductions puts a slight upwards pressure on short-term rates in both Europe and Denmark. The market now only expects the Bank of England, the European Central Bank and the Bank of Japan to ease their monetary policy at the next interest rate meetings, either through rate reductions or with further quantitative easing in the form of bond purchases.

The market continues to expect that the Fed will be the next to raise interest rates but there is a great of uncertainty about the timing and it cannot be excluded that the raise will first take place at the start of 2017. Expectations regarding the four central banks must be seen in the light of global growth once again being downgraded by the International Monetary Fund (IMF), this time by 0.1% for both 2016 and 2017. Also, real growth in the US for the second quarter of 2016 was 1.2%, which was disappointing in relation to its expected 2.6%.

Viewed separately, the absence of interest rate reductions puts a slight upwards pressure on short-term rates in both Europe and Denmark.

In addition, oil prices have fallen 15% over July. Viewed separately, this may keep market inflation expectations – and therefore interest rates – down. However, all things being equal the high base effect in calculating annual changes in energy prices throughout autumn will contribute to driving overall inflation figures higher over the next few months.

Strong July for the stock market

July was a strong month for shares after the great anxiety generated by the Brexit referendum. MSCI World (EUR) delivered a total return of 3.5%. After a series of strong American figures from the work market American shares delivered the biggest returns but most regions delivered solid returns in July.

The Small Cap factor worked particularly well in July and Value also delivered solid returns. For the first time in many months the MinVol factor delivered a disappointing return. This indicates that we may be in the first stages of a significant transformation of the stock market, where defensive stocks such as MinVol become both more expensive and less attractive in a cyclical perspective.

Similarly, the fact that higher interest rates in the USA are now being actively considered may be good news for Value investors. As I have written in previous monthly reports, the American labour market is tight and there is a risk of wage inflation by continued expansionary monetary policy.

With regard to the the stock market, it is slightly surprising to see how well especially American equities have managed in an environment of rising interest rate expectations in the US. Over the past many years we have been accustomed to seeing how lower interest rate expectations led to (or were correlated with) higher stocks, rather than the other way around.

The fact that higher interest rates in the USA are now being actively considered may be good news for Value investors.

Good macroeconomic data from the US – more expected

Another reason to be wary of data – particularly American data – that may give grounds for expectations for higher interest rates and inflation is that our growth models for industrial production indicate a massive acceleration over the coming months. The models predict an increase in growth from -0.7% to over 5% in March.

Furthermore, our model for orders for durable goods (excluding forms of transport) show that growth here will also increase considerably over the same time period. The Fed's arguments for continued low interest rates is likely to crumble over the coming months, and this can even occur at a time where inflation figures will also rise significantly.

It is likely that the American dollar will be further strengthened

A change in key market trends?

With higher interest rates and interest rate expectations in the USA together with further positive surprises for orders of durable goods and an acceleration in industrial production, it is likely that the American dollar will be further strengthened.

In addition, the Fed has been trendsetting for many months. The world is watching Yellen (and before her, Bernanke). It can be argued that broadly speaking the world's other central banks have a tendency to copy American monetary policy, typically between 3-24 months later. The lag is due to the American economy having a tendency to turn before the rest of the world's economies, although in recent years the consequences of globalisation have reduced the delay.

Beware of inflation in a few months – part 4

It is not just interest rates that tend to follow this dynamic. It is my assessment that inflation and inflation expectations are to a certain extent subject to the same pattern. As discussed in previous monthly reports, core inflation in the US is already at 2.3% and headline inflation (including energy and raw materials) will converge towards it in the long run. Assuming energy prices are unchanged, this effect will be dramatically enhanced over the coming months and culminate in January-February 2017.

It is possible that both interest rate expectations and inflation expectations in the eurozone are low and will remain relatively low in relation to the USA over the coming year but it is my assessment that the market may find itself very surprised about how quickly US interest rates and inflation – and the expectations thereof – can rise over the next six months.

For beleaguered Value investors such a scenario can come like manna from heaven. Large and expensive growth stocks (which now have assumed a significant role in the market value-weighted index) are vulnerable to this scenario, so in my opinion Value investors can look forward to solid returns in the coming months and years.

In my opinion, Value investors can look forward to solid returns in the coming months and years.

Emerging markets. Negative focus shifts to Europe – part 2

July was once again positive for Emerging Markets. EM equities rose and measured in US dollars they have now yielded 9% more than MSCI World during the year. The shift in focus is further illustrated by fresh figures from the EPFR Global indicator showing that we have seen a record inflow for EU bond funds over the past four weeks. Price rises in commodities and energy have without doubt helped to strengthen this development.

It looks like August will be a good month for the stock market

The momentum indicator says "buy"

Our MomVol indicator, which gives values between 0 and 1 where values over 0.6 are signals to buy, continues to indicate a value of 1 in the market. Historically, such a high value means there are good prospects for returns in the stock market in the coming month, (in other words, August). Since 1970, statistics show that returns in the month following a MomVol indicator value of between 0.9 and 1 have averaged 2.4% in terms of US dollars. 77% of the moths have given a positive return. It therefore looks like August will be a good month for the stock market.

Editorial deadline: August 9, 2016