Sparinvest

Monthly comment by Chief Strategist, David Bakkegaard Karsbøl

January 2016

Poor US macroeconomic end to 2015

December was not a pleasant month for equity investors, and January continues to be uncomfortable.

In the United States, macroeconomic figures for December were weak and disappointing across the board - up to the FOMC's decision to raise interest rates on 16th December. Only housing market-related numbers looked strong, but these are also important indicators for future growth. At the end of the month we saw slightly better figures - from the housing market and also from consumption patterns (data on income and consumption as well as durable goods and consumer confidence). PMI data from the US, which is still quite weak - especially for the manufacturing industry, is still suffering from the strong USD. And in addition, the "Prices Paid" Survey from ISM also came in extremely low (at 33.5 it's the lowest since 2009), which signals continuing weak inflation expectations in the manufacturing industry.

It is particularly worrying that inventories in the manufacturing industry are so large that the great achievements of the US labour market now appear to be diminishing (though there is still progress). With an unemployment rate that has halved from 10% to 5% in six years, the probability of upwards pressure on wages increases. Thus, with the dollar continuing strong and expectations of price trends in the industry low, US companies could feel an uncomfortable pressure on their margins in the coming quarters.

However, it should be mentioned that our model of leading indicators for the US economy shows that the leading indicators should have begun strengthening a few months ago, and that they can now be expected to recover quite nicely over the next 12 months. In addition, there appears to be at an excess pessimism (beyond what is justified by the large inventories and stronger US dollar) in the manufacturing industry in the United States. Thus, our models for US industrial production growth say that it should increase sharply over the next 12 months - starting now.

For the abovementioned reasons, the weakness in US equities should therefore be over by now - unless serious wage inflation could put US corporate margins under additional pressure. This, in my opinion, however, not likely begin to appear about 12-24 months.

Eurozone still small steps toward normalization

In the Eurozone, the macroeconomic figures have been reasonably encouraging. Growth in industrial production surprised on the upside, and the number of full-time employees is now at its highest level since the euro crisis began. The European PMI data was nice (about 54) while ZEW expectations for the Eurozone recovered significantly from November.

Looking at Eurozone growth in lending, we see what looks more and more like a real normalization. This could bring us back to the 2% growth per year, 2% inflation and 2% increase in home prices - dream scenario after so many slack years. Lending to non-financial companies has increased by 0.8% compared to last year, and the loans to households over the same period increased by a full 1.9%. Lending to household consumption increased by 3.5% (and shows no signs of stopping), suggesting a stable and even stronger consumption growth in the Eurozone in the 2016.

Our models for growth in industrial production show that we can expect a steady but moderate improvement over the coming months in the largest European countries. The models for the leading indicators for the Eurozone show that we can expect further improvements in the region over the next 10-12 months (see graphs on page 3 and 4).

Yet, to the ECB's great regret, we have still not seen the full normalization of inflation expectations in the Eurozone. This could explain the weak equity markets in December in conjunction with impotent rhetoric from the ECB that signalled a continuation of monetary policy – possibly along with even more powerful stimuli. Unlike in previous months when such rhetoric has served to fuel further expectations for the stock market, this time around investors have not been impressed. One explanation for this is probably the continued weakening of the Chinese economy, examined below.

Tough start to the New Year in China

After a relatively strong autumn, Chinese equities started 2016 with a decline of about 7% in a single day. The reason is presumably a combination of the following factors: 1) The Chinese PMI report for the manufacturing industry disappointed - despite expectations that both fiscal and monetary stimulus would have supported it. 2) Restrictions that had been put in place in the autumn to prevent large investors from selling their positions were lifted on 8th January (and probably "front-run"). 3) The ongoing devaluation of the Chinese currency, the Renminbi has probably scared investors away.

Not everything in China is as bad as Chinese equity performance suggests. Bloomberg's monthly indicator of China's GDP seems to have reversed now and we can expect the indicator to show around 6.85% growth when we get the actual figures for Q4 2015.

In addition, the real appreciation (strengthening) of the Chinese currency has stopped. In a nominal sense, we have seen rising USD/RMB, but as Chinese inflation is significantly higher than China's trading partners, the real importance of this is not so great. Chinese industry needs a real (i.e. inflation adjusted) devaluation to restore competitiveness, which has been eroded away through a real appreciation of 72% in 10 years. It is an important first step that the continuous appreciation at least has stopped.

High Yield market begins to look attractive

The huge drops in commodity and energy prices have resulted in large increases in yield spreads for high-yield corporate bonds related to these sectors. On top of that, sectors not related to the commodity and energy markets have also seen spread-widening. Long-term investors should consider whether the market's reaction to the very large and unexpected falls in commodity and energy prices has gone from rational fear and discomfort to outright hysteria around the entire asset class.

In my opinion, it is too early to buy heavily into high-yield bonds, but long-term investors should begin to look at the asset class, which since mid-2014 has seen almost a doubling of the OAS (Options Adjusted Spread) against the equivalent duration in US government bonds. This also applies to the segments of the high yield market, which are unrelated to the commodity and energy markets.

The most sensible approach to the asset class, given current pricing and perspective, is probably to increase exposure gradually over the next 3-4 months.

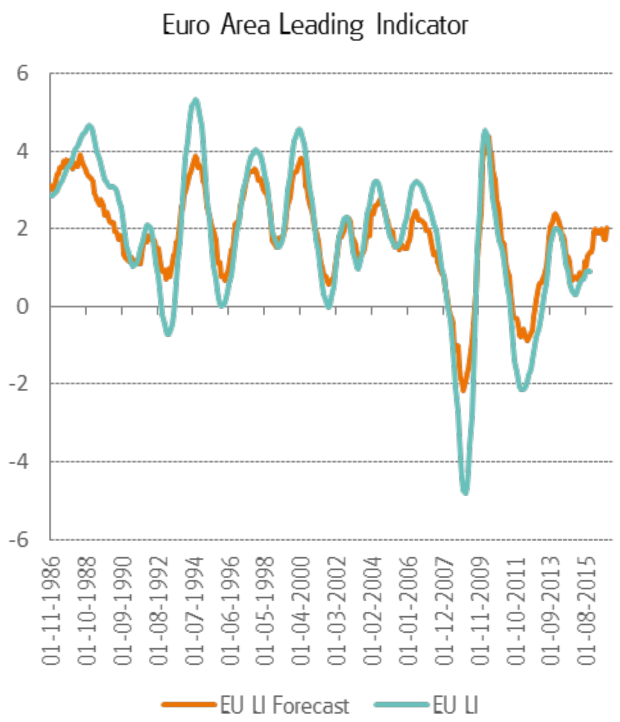
EM equities at bargain prices

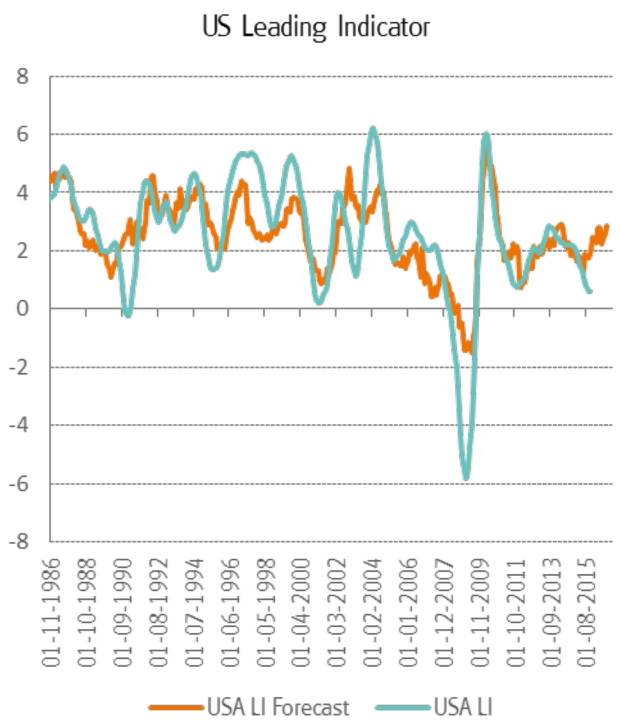
Once again, in this month's report, I will fly the flag for EM equities, which would appear to have been priced in a different universe to the rest of the market. Russian shares have obviously been affected by lower energy prices, but since the rouble also fell, company margins are actually not as much under pressure as one might think. Brent Crude oil fell only about 19% during 2015, while the US dollar fell twice as much. MSCI Russia is now trading at a CAPE (P/E calculated using average earnings over the last 10 years) of 4.6.

The story regarding Chinese stocks is somewhat different. These have not been overly influenced by commodity and energy prices. Their development is more the result of a combination of government stimulus programmes and highly speculative behaviour among Chinese investors. MSCI China trades at a CAPE of 12.4.

Brazilian shares have also become fiercely cheap after an almost endless parade of scandals, political incompetence, corruption and bureaucratic chaos. One hopes that the changing political winds in Venezuela and Argentina will inspire Brazil, which could also benefit from a similar breeze. If nothing else a CAPE-level of only 7.4 in the MSCI Brazil could secure a return for long-term investors, although this valuation also relies heavily on the large price drop in commodity and energy markets.

As mentioned in previous monthly reports, our models show that growth in industrial production in emerging markets should be sharply accelerating, in contrast to the pessimism that we actually see in manufacturing. Part of this pessimism is probably justified because of the drop in export prices for commodity-exporting countries, but other emerging-market countries can actually benefit from these lower prices, so overall, I maintain that EM equities are attractive for long-term investors.





Tensions between Iran and Saudi Arabia

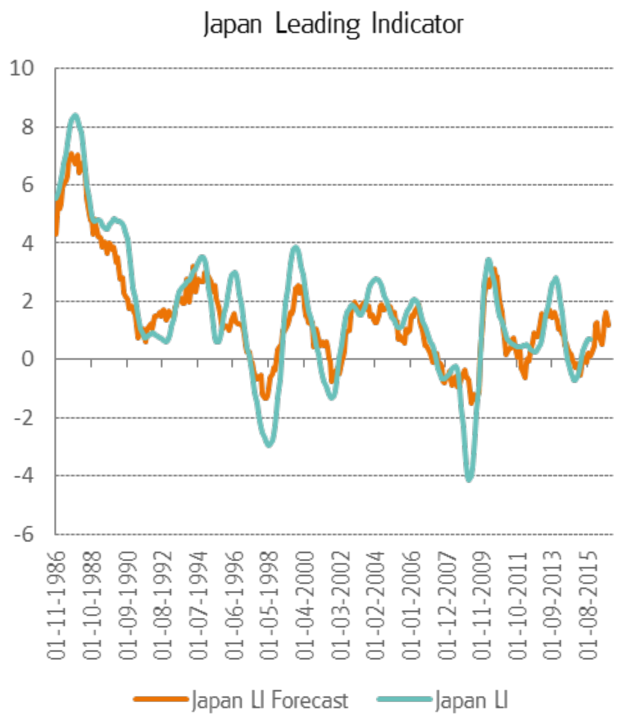
After the execution of a Shiite imam in the Sunni Muslim Saudi Arabia, angry Shia protesters in Iran reacted by burning the Saudi embassy. Saudi Arabia has now released all Iranian diplomats and cut off all diplomatic relations with Iran. The two countries have had a strained relationship for decades, and since the Syrian civil war broke out, they have been fighting a war by proxy. Saudi Arabia has supported the Sunni Islamic insurgent groups against the Assad regime, while Iran has supported the Assad regime and participated in the civil war through Hezbollah and other Shiite militias or conventional Iranian military units.

One might fear that it would result in a more open confrontation, and that the two leading countries in the Middle East would go from a "cold war" into a "hot war". Saudi Arabia and Iran are traditionally the two biggest oil producers in the Middle East but, in recent years, sanctions against Iran have reduced their production and sales. With the recently concluded nuclear deal (designed to ensure that nuclear technology is not used militarily by Iran) it is expected that Iran will increase production considerably.

So why has this nervousness in the oil market as a result of tensions between Iran and Saudi Arabia not yet translated into rising oil prices? This is probably because the United States, and other countries, have increased the production of energy through shale gas extraction and that OPEC have increased production despite the already low prices.

Momentum indicator again out of the market

Our MomVol indicator is again out of the market with a value of 0.19 at the end of December. The threshold value is 0.6, which suggests that the indicator will continue to prefer to be out of the market in the month ahead.


Japan Leading Indicator
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Japan LI Forecast
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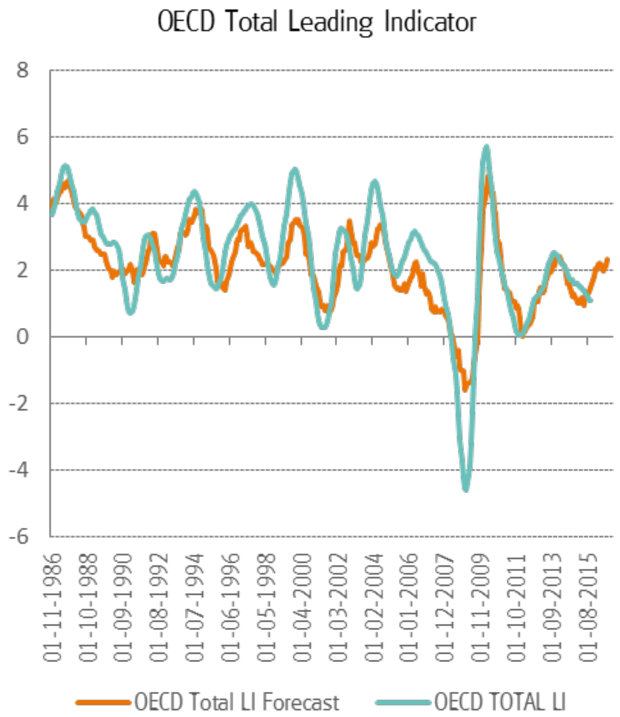
OECD Total Leading Indicator
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OECD Total LI Forecast
OECD TOTAL LI