MACROECONOMIC REVIEW
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Sparinvest

Monthly comment by
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High growth in 2017

Positive markets in December

MSCI World (EUR) posted a return of 3.02% in December, and it seems that optimism regarding the US presidential election continues into the new year. The Volatility Index (VIX) generally remained under 14 throughout the month. Long-term interest rates rose slightly at the start of the month, but in the last half of December dropped again, especially in Europe.

The most positive symbol of optimism is probably the development in oil prices, which continues its upward trend after bottoming out in January-February 2016. At present, the price of oil (USD) has increased by approximately 87% since the beginning of 2016. This shows in part that the bottoming-out reflected an overreaction, and that growth expectations have risen significantly during the fourth quarter of 2016.

The Fed raises interest rates

At the monetary policy meeting on December 14th, the Fed decided, as expected, to raise interest rates from 0.5% to 0.75%. This brings US interest rates another step closer to normalisation, although one could argue that they need to rise another 2-3% for this to happen.

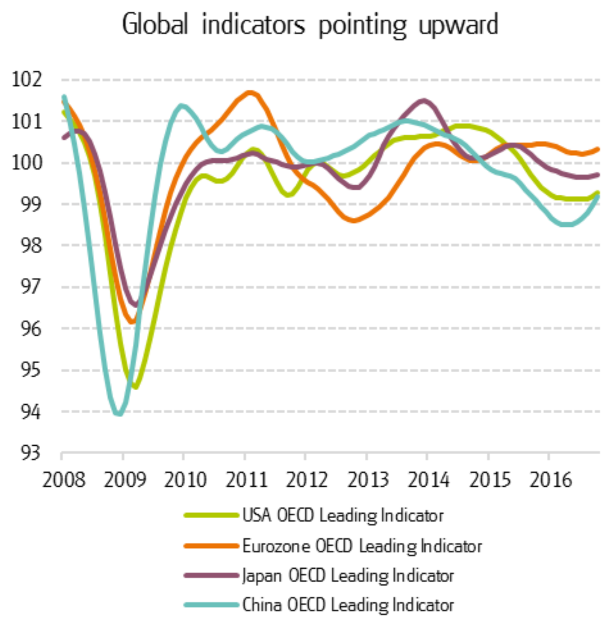
When commenting on the interest-rate change, the chair of the Federal Reserve, Janet Yellen, said that the labour market had improved considerably, and that salary advancement and inflation were on the road to normalisation.

The fixed income market responded quickly to the announcement by raising expectations for short-term rates, which have already been in a strong upward trend since the beginning of November.

> *At the monetary policy meeting on December 14th, the Fed decided to raise interest rates from 0.5% to 0.75%*

Updating the model predictions

If we look at our models of growth and leading indicators, it is not surprising that the markets are optimistic. Our models of leading indicators have long shown that markets ought to be improving in both Europe and the US. At present, it seems that indicators will improve over the coming months until the summer holidays, when they will subsequently fall slightly, but will remain in positive territory.



These models are supported by our models for industrial production, which indicate a strong growth acceleration through the summer of 2017 that will remain quite robust into the autumn, especially in the US. According to our models, the same holds true for Europe, but not quite to the same degree.

The growth seen in new manufacturing orders supports these model indications, especially in Europe. (See above image.)

Expectations for full-year growth

When we look at the year it seems likely the US will experience higher growth in 2017 than in 2016, when it was 2.1% to 2.3%. With a strong tailwind from both the fiscal policy of the upcoming Trump administration and the monetary policy, which will not fully neutralise the inflationary impact of the fiscal policy, the US GDP growth could sneak over 3% in 2017.

The euro zone will experience a GDP growth around the same level of 2016 – and maybe even a little higher if the above expectations for the US materialise. My expectation for euro zone GDP growth in 2017 is 2%, which is considerably higher than the rest of the analyst team, which expects European growth in the region of 1.4% in 2017.

> *My expectation for euro zone GDP growth in 2017 is 2%*

EU cooperation is in crisis, but the economy is OK

The terrorist attacks in Berlin and Istanbul were a disturbing way to end the year, but they serve, unfortunately, to illustrate a new normal way of European thinking. Some larger Danish media did not even cover the Istanbul attack. That may be because we have simply started to take regular terrorist attacks for granted, and that we have recognised that even horrific attacks that leave dozens dead have no real economic impact on the economy and the financial markets.

Unfortunately, the terrorist attacks on European soil also illustrate a division and perplexity in European cooperation, as I have previously written. Brexit and the momentum of several national, EU-critical movements and elections in 2017, which will help widen the cracks in European cooperation, will not improve conditions.

Although it is my expectation that the European economy will perform well in 2017, the market's perception of EU cooperation is now so battered that the euro may fall further against the US dollar. Partly because there seems to be no coordination in dealing with the refugee crisis, and partly because it still seems unlikely that European interest rates will rise significantly within the next three years. In fact, market expectations are that ECB rates will be negative until early 2020.

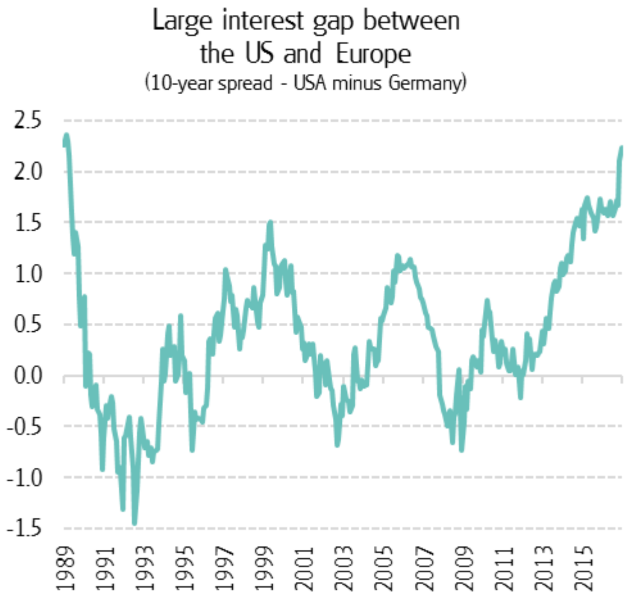
> *The market's perception of EU cooperation is now so battered that the euro may fall further against the US dollar*

In monthly reports over the past six months I have warned of higher long-term interest rates. I still expect higher interest rates, but now my expectation is that we are going to see an interim peak in the first quarter as bond markets will begin to decelerate in growth by the end of 2017. My expectations continue to be for positive growth (and higher inflation) at the end of the year, but it will probably be lower than in the first half of 2017.

Larger geographical tensions in the market

The rather large variety of interest-rate expectations and interest-rate levels between the United States and Europe will begin to influence the EUR/USD ratio, which threatens to break below parity (1.00) within a few days or weeks.

If we look at the spread between German and US interest rates on 10-year government bonds, it widened to 225 BPs, which has not been larger since 1989. The same trend can be seen in the 5-year yield spreads, and expectations of the Fed's and the ECB's interest rates over the following year.

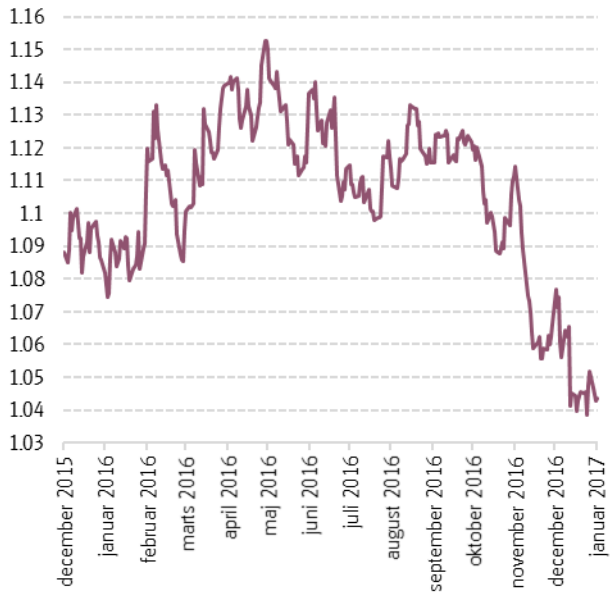


In my opinion, it is dangerous to expect such great differences between these two large regions, as it is difficult to imagine that European leaders at some point don't take action (as we are already seeing in Germany). It is also difficult to imagine a situation where it goes significantly better in the US economy, but the European economy does not improve.

Still, it is my expectation that the EUR/USD will remain under pressure over the coming six months, and that we won't see a stronger European coordination of emigration management in the EU until over the summer (before the German election).

Against this backdrop, I maintain, as in last month's report, that one should not have an underweight in the US. Exposure to US stocks could benefit from both higher equity markets in anticipation of the stimulus from the upcoming Trump administration, but also from a stronger dollar (and weaker EUR).

Euro weakened against the dollar



MomVol indicator

Our MomVol indicator assumed at the end of December a value of 0.73, which is a decrease from the end of November, but still firmly above the threshold of 0.6. Below this threshold, one should have an underweight in the stock market.

The indicator's signal is also supported by the fact that most of the OECD leading indicators are pointing upwards. An overweight to equities should therefore be retained in January.

Editorial deadline: January 6, 2017

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