Sparinvest

Monthly comment by
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Economic trends support stocks

Right now, the leading indicator for the OECD area continues to rise, and this generally applies across regions. Looking at OECD's leading indicator for the entire OECD area, it is now over 100, and it will most likely continue to rise soon, as there is typically some inertia in these movements. This means that we have moved into the expansion phase, where returns for the risky asset classes are quite good, but slightly less than in the swelling phase, which we just came from.

If we look across asset classes, it is remarkable that especially long-term bonds (and, in part, investment grade) have a lower return than their long-term trend in this phase. Also, government bonds in Emerging Markets may suffer from lower returns and increased volatility.

Because of this macroeconomic environment, one should keep a continued overweight of shares, which is supported by our MomVol indicator (see below).

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In macro-strategic contexts, it may be useful to operate with four phases of cyclical fluctuations based on the leading indicators from, for example, the OECD. If we assume the overall leading indicator across the OECD economies, this may be decreasing or rising, and may be high (over 100) or low (below 100).

This gives rise to four possible phases of business development, which we can call 'recovery' (low and rising), 'expansion' (high and rising), 'deceleration' and 'recession' (low and decreasing). There may be a very large difference in the return of active classes across the four phases of the business cycle. Typically, 'recovery' and 'expansion' give the best return on the risky asset classes (especially stocks, convertible bonds and high-yield corporate bonds), while in deceleration and especially 'recession' they experience bad or totally miserable returns.

Tailwind for convertible bonds and global equities

Monthly excess return compared to long-term return (since 1980)	Long Bonds	Short Bonds	IG Corporate Bonds	HY Corporate Bonds	Convertible Bonds	EM Govern-ment Bonds	Global Equities
Expansion (high / increasing)	-0.46	-0.20	-0.42	-0.30	0.47	-0.34	0.49
Recession (low / declining)	0.55	0.22	0.28	-0.10	-0.62	0.31	-0.91
Deceleration (high / declining)	0.14	0.02	-0.17	-0.69	-0.90	-0.31	-0.93
Recovery (low / increasing)	-0.11	0.02	0.34	1.10	0.90	0.50	1.31

Tabel 1

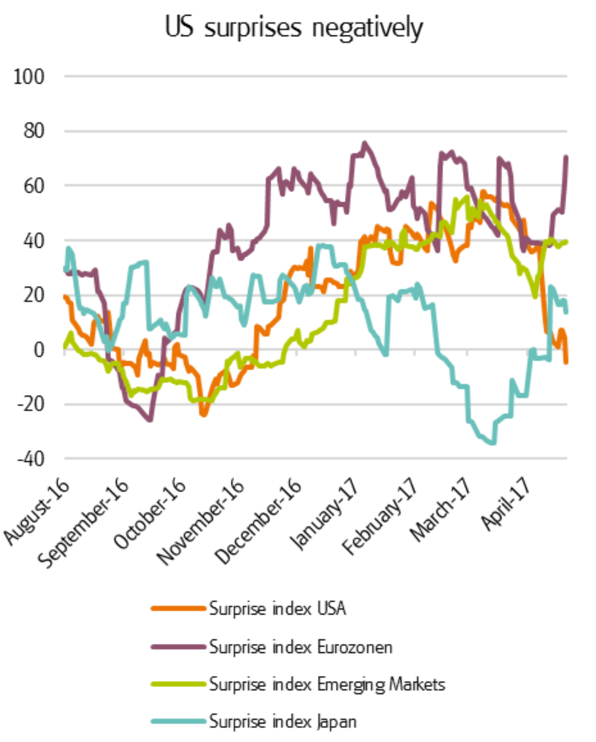
From rosy to optimistic

As described in the latest monthly reports, macroeconomic data in March became somewhat rosy or overoptimistic. My expectation was that expectation data would moderate over the coming months – but also that they would remain relatively high.

We now see the first tendencies. I do not want to take credit for predicting a decline in US growth (Q1), which disappointed the market by the end of April (0.7% annual growth against expected 1.0% in annual growth), but this could well serve as a symbol that expectations had shot a little too far ahead of reality.

It was especially the inflation-related surveys and figures that moderated in the past month. Although long-term inflation expectations in the United States remained largely unchanged, the gap between 2- and 10-year US government rates continued to narrow. The important US PCE core inflation index fell to 1.6% in March from 1.8% in February.

Perhaps it helps to illustrate how much the influence of the rise of energy prices since the beginning of 2016 has had on the inflation figures.

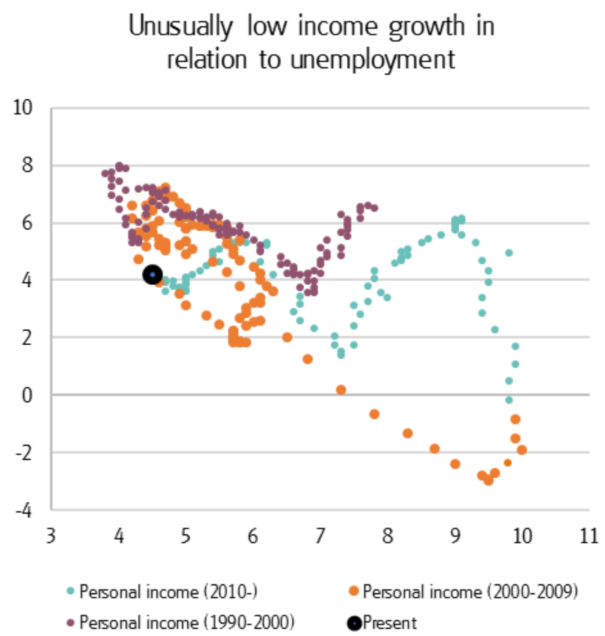


The so-called American 'surprise' index from Citigroup (see graph), in turn, brings together all the macroeconomic key figures realized in relation to their respective expectations from the analyst corps. This index fell throughout the spring from a high level to now being negative. For the Eurozone, the index is at a fairly nice level. For Emerging Markets as a whole, the index in question keeps up to quite high levels over the last five years, and it may be one of the explanations for the reasonable return in the group in recent months.

More interest-rate hikes in the US in 2017?

At present, the interest rate market almost precisely expects an interest rate hike from the US central bank for the rest of 2017, so we would end at 1.25%. The problem for the central bank is that inflation, as mentioned above, already appears to be moderating and, in any case, remains below the bank's long-term target of 2%.

This has already led to remarks that the central bank might completely cancel more interest rate hikes in 2017. However, as the US labour market is approaching a historically tight level, it is not necessary until we finally see the wage pressures that analysts have predicted for several years.



Looking at data since 1980, it has never happened that the current level of unemployment in the United States has resulted in lower growth in household income. Current growth in income is 4.2%, and the norm for the past decades, with current unemployment, would be 6-7% growth in income.

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In my view, the risk of wage pressures is still present. Given the level and direction of the leading indicators, it would be natural to assume that the labour market through increased output is further tapered and creates upward pressure on wages that would be natural at current unemployment.

Agreement with Greece

In recent monthly reports, I have written that EURUSD would affect parity in the coming months as higher US interest rates and unchanged European interest rates increased the interest-rate differential between the two regions – and because of the problems of EU cooperation.

However, the euro has risen to my expectation, and it is thanks to a few European elections, where critics of EU cooperation were somewhat quieted in public debates and affected election results less than feared.

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On top of that, the recent agreement between Greece and its creditors removes a lot of the uncertainty about the Greek economy, which has been hanging like a black cloud over the country since 2011.

Greek stocks have already risen almost 10% in April and the country's industrial output has risen from very high levels to rampant growth, with almost 11% growth in the beginning of 2017. In addition, there are also signs that the big run on the banks of the country has stopped, and bank deposits rose slightly during March.

Negotiations with Greece's creditors appear to result in further cuts in public expenditures, an increase in the retirement age and tax increases. In addition, the European countries (read: Germany) seem to be able to approve the agreement if the IMF is included in it. Greece will then be able to access another 7 billion euro to pay their creditors, and the country's debt can subsequently be reconstructed.

Considering how much the problems in Greece have filled the financial media in recent years, this should be received as positive news from a Europe that has otherwise not been able to move on. Against this background, it makes sense that the euro is strengthened.

Le Pen continued but lost momentum

The first round of the French presidential election is over, which resulted in Emmanuel Macron and Marine Le Pen moving on to the second round to be held on the 7th of May.

That Le Pen is against Macron means that her odds of winning are halved even though she has moved on to the second round. This is because Macron can appeal to both the right and left wing, where Francois Fillon or Jean-Luc Melenchon could only appeal to either the right or left.

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The fact that Macron is becoming a French president (and that the elections in the Netherlands are over) means that the risk of a collapse in EU cooperation has decreased significantly. European – and especially French – stocks have reacted with high increases, and long-term interest rates have also risen in response.

Stick with stocks

Our MomVol indicator assumed a value of 0.96 at the end of April. This is an increase from late March and still firmly above the threshold of 0.6, below which, you 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 in stocks should therefore be maintained in May.

Editorial deadlinwe: May 5 2017