Monthly comment by
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Best outlook for European shares

Spain - the Catalan independence question

The non-binding referendum on Catalonia's relationship to the rest of Spain generated a lot of headlines in September. The referendum was not sanctioned by the central government in Madrid and was therefore non-binding. In fact, according to the Spanish authorities it was illegal and the police were sent in to prevent the poll taking place.

Most people have probably seen the dramatic images of fully equipped riot police attempting to prevent Catalonians from voting, and the illegality of the referendum also led to it being boycotted by opponents of Catalan independence.

The result of the referendum has no real meaning, and it will have no immediate consequences. I say that because the referendum has in fact had an effect on Spain's sovereign debt, which has been subjected to a minor spread extension in relation to German government bonds.

However, the bonds market still regards the risk of independence as being very small, even though the Spanish CDS (the premium for insurance against national bankruptcy) has risen from 63 bps to around 77 bps.

Catalonian independence will have significant consequences for Spain, as Catalonia is one of the richest regions in the country and has the highest economic growth rate. Without Catalonia, there will be fewer – and relatively poorer – regions to maintain Spain's sovereign debt.

A new head of the USA central bank?

Janet Yellen's mandate as head of the American central bank is about to expire and there is a general consensus of opinion that Donald Trump will not extend her term of office. According to Trump himself, a new boss will be announced in the second half of October. There is currently speculation about a handful of candidates, who according to observers are Yellen's most probable successors.

Trump is known to have had talks with Kevin Warsh, Gary Cohn and Jerome Powell about the position, but otherwise there is just the usual speculation and rumours. In my opinion, Gary Cohn is probably the most interesting choice as he is regarded as relatively conservative. The other candidates are perhaps more "business as usual" (like Yellen) – in other words, a continued cautious monetary policy that will only be normalised slowly, and over the space of many years.

A Goldilocks scenario supports risk-heavy assets

September saw a flurry of healthy key figures from most regions. In the USA, the ISM (purchasing managers) for the manufacturing industry hit 60.8, which is the highest since 2004. There were also very high levels for building permits, new industrial orders, BNP growth (3.1% and the highest for two years), new job positions (the highest since records began in 2001) and NFIB Small Business.

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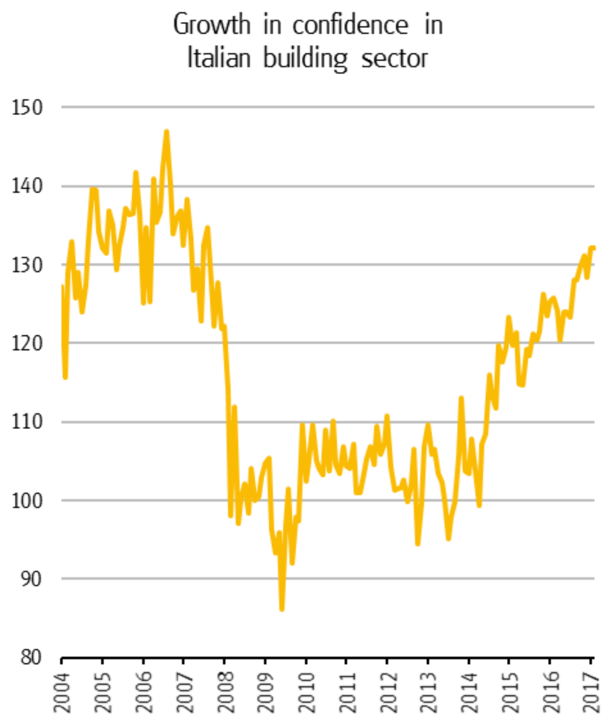
Europe also produced a flurry of good figures. Consumer confidence, money supply, the German ZEW and IFO expectation index figures, construction activity, industrial production, employment growth, BNP growth (2.3% - the highest since 2011) were all solid.

At the same time, there continues to be no inflation. In fact, when we look at the so-called core inflation, which excludes the most volatile elements like foodstuffs and energy, inflation is actually falling. The central banks would dearly love to normalise monetary policy (in other words, raise interest rates) but as long as inflation remains as low as it is, they simply do not have the arguments to do it.

There is therefore no doubt that we rule out the possibility of a recession in the near future. Both the European and the American economies will perform excellently in the coming months, but in my opinion we will see a gradually lower rate of growth in the USA that will be clearly visible in the spring of 2018.

Italy's secret recovery

The European economic recovery and the ECB's expansive monetary policy has slowly taken root in the southern European economies that have been most in need of it. Italy in particular looks to have had something of a secret come-back.



After a large and constant fall in house prices since the financial crisis, Italian house prices are now on the rise again. The OECD's leading indicator for Italy has been high since 2013 and is now on the rise again after a fall from the beginning of 2016.

Confidence in the Italian building and construction industry is now at its highest since 2008 and loans to households have risen by 50% in two years. Unemployment is still high (11.2%) but it is now falling rapidly.

Core inflation is rising in Italy after having hovered around the 0.5% mark between 2014-2016. Italian interest rates are therefore also rising, and this time it is not just an expression of the Italian state's increased credit risk relative to countries like Germany.

Higher interest rates are good for the Value factor

September's rising interest rates (particularly in the USA) have, like so many times before, had a significant positive effect on the Value factor (in other words, the relative yield between the shares that are cheap in relation to earnings and equity, and the broader market). The SmallCap factor has also performed well. Both Value and SmallCap perform well in an environment with rising leading indicators and rising interest rates.

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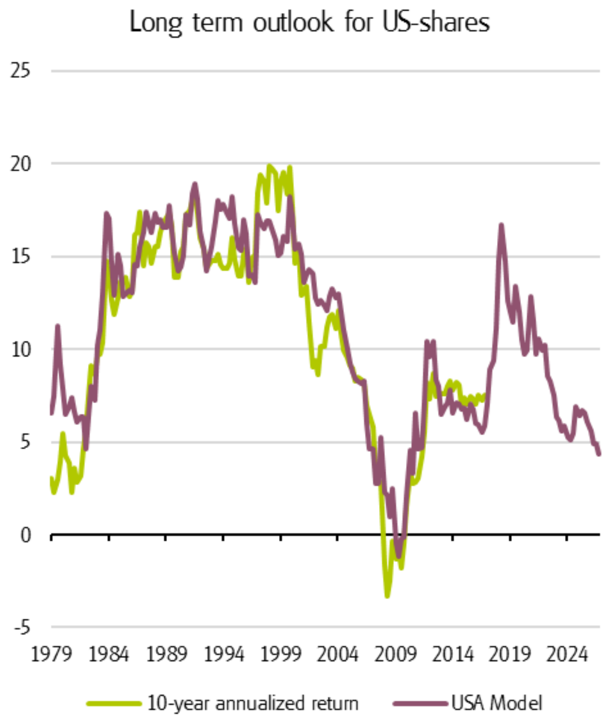
The Momentum factor has also performed well, which is probably due to limited market volatility. On the other hand, the Minimum Volatility factor and the Quality factor have performed rather poorly. At the present time, on a yearly basis they are behind in relation to the MSCI World with 6.3% and 1.9% respectively.

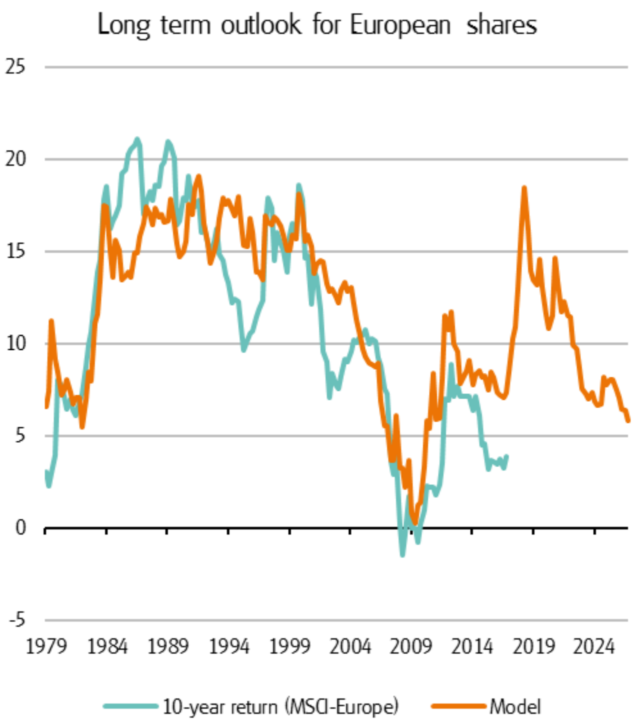
Generally speaking, it looks like we are about to see a repeat of the factor picture we saw at the end of 2016, where Value and SmallCap delivered solid returns.

Minimum Volatility and Quality shares began 2017 with quite high absolute and relative pricing. Historically, maintaining this performance has required macro-economic development to be uninspired and characterised by continued low interest rates and sluggish leading indicators. We have now got the opposite, and in my opinion it is quite probable that we will see a continuation of the present trend for at least another six months.

Long-term share expectations

After having updated our long-term (10-year) expectation models for shares at the start of October, a picture is emerging of further strained pricing in the stock market. This is particularly true of American shares, where our models indicate an annualised nominal return of just 4.3% measured in dollars. Unfortunately, periods with poor expectations are typically associated with higher volatility. For the moment, the VIX – the so-called fear index – is at a historic low, which indicates that poor returns can be postponed for a while. However, it is clear that risk-adjusted returns on American shares will continue to be rather disappointing.





The risk-adjusted returns in European shares over the coming year will be considerably better than in American shares

There is a rosier picture for European shares, where we can expect 5.8% in annualised nominal returns measured in euros. Even though this is higher, it is not impressive. European-based investors can, however, avoid the volatility that the indirect exposure to the euro/dollar exchange rate will cause in American shares.

Overall, it looks like the risk-adjusted returns in European shares over the coming year will be considerably better than in American shares.

A catalyst for the materialisation of these differences could easily be that the European economy in a cyclical sense is about two years behind in relation to the USA, which in all probability is experiencing so-called full employment at the present time. We are already seeing that the growth in earnings in European and Japanese companies is growing significantly faster than in American companies, and in my opinion this will be the start of a trend where investors will increasingly favour investing in Europe at the expense of the USA in particular.

MomVol Indicator

At the end of September, our MomVol indicator showed a value of 0.88, which is lower than the previous month but still solidly over the 0.6 threshold under which one should be underweight the share market.

As mentioned above, the leading CLI indicators from the OECD have not yet shifted phase, which was discussed in last month's report. This supports my assessment that one should continue to be overweight shares.

Editorial deadline: October 9, 2017