Monthly comment by
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Time to lower exposure to shares

The release of the OECD's leading indicators at the start of March showed that they had already peaked at the end of 2017. The publication led to a revision of previous values, which is why the peak can only be seen now.

This means we are now moving from the expansion phase (where the leading indicators are high and rising) to the deceleration phase (where the leading indicators are high and decreasing) in the business cycle. The shift has significant implications for the returns we can expect in the various asset classes.

The stock market has already reacted to the bad news by falling sharply since January. MSCI World (EUR) has fallen by 6.3% since the end of January. The bond markets are also marked by a greater fear of the future, and the sharp rise in interest rates in early February has now been replaced by a fall in interest rates.

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The above development is a textbook case of what happens when the leading indicators have peaked. The development is also further supported by Trump's trade policy initiatives.

Fears for a trade war or a recession?

For the moment, fears for a trade war are based on shaky ground. It is estimated that Trump's trade policy initiatives will result in a 25% duty on Chinese exports to the value of around USD 50-60 billion, or approximately 2.5% of Chinese exports to the USA.

So far, the Chinese counter-measure has been a Chinese duty on goods produced in the American heartlands that voted for Trump. But these initiatives are few and small, and completely meaningless in the bigger picture. Both Trump and the Chinese administration can say to their people that they have "done something", so nobody loses face.

If Trump's initiatives start to destabilise trade, one can imagine that Congress would block them

No-one – and least of all the Chinese, who have a huge trade surplus in relation to the USA – is interested in a trade war. Even Trump's advisors oppose more and similar initiatives. Broadly speaking, by far the majority of politicians in the US Congress support free trade. If Trump's initiatives start to destabilise trade, one can imagine that Congress would block them.

Even though it is customary today for the President to almost single-handedly dictate trade policy, Congress could take this power back if it so desired. This is of course particularly true if the Democrats were to win the coming mid-term elections this autumn and wanted to cause Trump the most possible amount of trouble.

The stock market's very negative reaction since the end of January (measured in euros, MSCI World has fallen around 5% from the end of January to the end of March) is therefore probably more likely due to fears of a recession at some point in time over the course of the coming years.

The macroeconomic key figures have been declining in both the Eurozone and the USA, but particularly in the Eurozone. The Citygroup Economic Surprise Index for the Eurozone, which measures how much better or worse key economic figures are in relation to the analysts' expectations, show a steep deceleration throughout March especially.

The major concern in March has therefore been – or at any rate, should have been – that the US central bank would raise interest rates too quickly

The same does not apply to the United States. There, as expected, the economic ratios generally remain at a healthy level, but the yield curve has become considerably flatter due to expectations of a tighter monetary policy – in other words, expectations that the US Central Bank will continue to raise interest rates.

The major concern in March has therefore been – or at any rate, should have been – that the US central bank would raise interest rates too quickly. In connection with this, long-term investors should now also worry about being overweight in proportion to their long-term allocations.

The reason is that when the yield curve is inverted – when the short-term interest rates become higher than the long-term interest rates – the stock market has only delivered a satisfactory return a handful of times. With the difference between 2-year and 10-year interest rates in the United States now at around 50 basis points, we have got dangerously close to a reversal of the yield curve. In other words, we have here the bond market's warning that if the US central bank continues to raise interest rates (in addition to the current planned interest rate hikes of around 50 bps. over the next year), it will hurt growth and inflation in the longer term.

We last saw an inverted American yield curve in early 2006. It remained inverted for about a year. The stock market reaction in 2008-9 is well known, but this was also a historically fierce reaction that I do not expect repeated within the next many years. However, it is still worth keeping an eye on the interest rate market anyway.

Extra returns from FAANG shares are dwindling

In many ways, one can compare the current structure of the stock market with its structure in 2000 when the IT bubble burst. In both instances we have a segment of the stock market that is exceptionally expensive, and both instances involve technology shares. So-called FAANG shares (Facebook, Apple, Amazon, Netflix and Google/Alphabet) have delivered phenomenal returns to their investors, but these returns have come about because of extremely high valuations of the companies.

The value investors won out in the end, and I also expect them to do the same this time

In fact, FAANG shares are so expensive that they now make up 10% of the market value of all US-listed companies. As they are also included with considerable weight in the market-weighted stock indexes such as MSCI USA or the S&P500, these indexes in themselves have become relatively expensive in relation to their historical pricing.

The way FAANG shares have developed is relevant for investors who are concerned about the pricing of US shares. When US shares are expensive, it is due in no small part to the fact that FAANG shares are expensive. Investors with a value approach have a very hard time justifying investing in FAANG shares, which is the same as what happened during the development of the IT bubble from 1995-2002. The value investors won out in the end, and I expect them to do the same this time.

The fact that FAANG returns in relation to the S&P500 have been low over the last weeks can be the first signs that the FAANG fan base is diminishing. More and more are joining the growing band of sceptics with regard to Facebook and its data processing. Similarly, one cannot expect Walmart to sit around doing nothing while Amazon is busy planning to take over almost all global distribution and internet trade.

The MomVol indicator and share allocation

Our MomVol indicator showed a value of 0.62 at the end of February, which is noticeably lower than the previous month's value. It is still above the 0.6 threshold under which one should be underweight the stock market. In other words, the MomVol indicator is very close to a sale signal.

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Due to the fact that the leading indicators have peaked and we are now in a deceleration phase, investors should reduce their exposure to shares. As the MomVol indicator is still over 0.6, it is my assessment that for the first time in many months, investors should reduce their exposure to "neutral". At the same time, investors should also prepare to be clearly underweight if the MomVol indicator has fallen below 0.6 by the end of April.

Editorial deadline: April 10, 2018