Sparinvest

Monthly comment by
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A synchronised global

The OECD leading indicators (CLI) for the USA, the Eurozone and Japan all point towards a synchronised global recovery. In other words, we are still in an expansion scenario where risk-heavy asset classes typically deliver the best returns, inflation is rising and growth is high. Emerging Markets stocks and commodities also perform best in this scenario.

Additional leading indicators from the Conference Board, DZ Bank and others also point upwards for China, Australia and the BRIC countries as a whole. According to the Conference Board, only the United Kingdom looks challenged. In all probability, this is due to the uncertainty connected with the Brexit negotiations.

Best outlook for EM stocks

Although in the short term, stocks look like they will continue to give attractive returns (see the final paragraph), they are in many cases – and particularly in the USA – priced so highly that the wrinkles on the foreheads of long-term investors must run particularly deep.

EM stocks will lead the pack

US stocks	4
European stocks	6
Emerging Markets stocks	8
Global stocks (developed markets)	5

Long-term investors cannot expect much more than a 4% annualised return over the coming 10 years from US stocks. Investors in European stocks can expect around 6%, while EM investors can expect about 8%. The difference in pricing between developed markets in particular and EM stocks is historically large in favour of EM stocks, and as discussed above, these are favoured by the macroeconomic situation.

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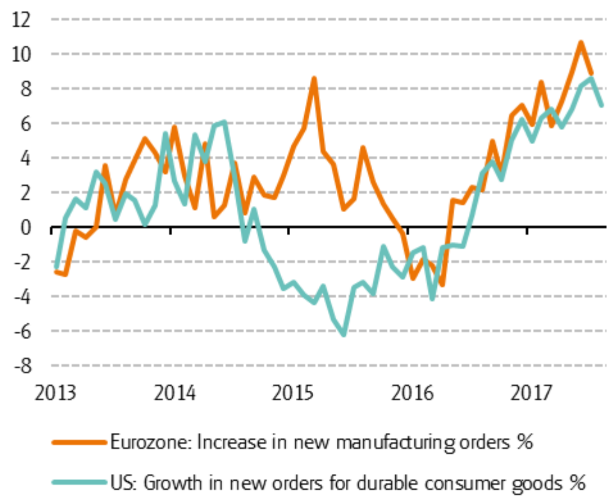
Long-term investors should therefore have an overweight to EM stocks, while bearing in mind that over time these have a tendency to show higher fluctuations in returns.

Falling order levels in sight

The manufacturing industry in both the Eurozone and the USA is experiencing a very pronounced increase in new orders in these months. In both regions, orders are growing by nearly 9%. This is considerably faster than growth in retail trade, which in this context serves as a proxy for demand. On the basis of this, estimates from our models show that orders will decelerate significantly over the coming 12 months, and that this deceleration will be most powerful at the end of 2018. The outlook is bleakest for the Eurozone, where order intake at the end of 2018 will be more or less zero. The picture is slightly better for the USA.

Strong increase in orders in the Eurozone og US



Growth in industrial productivity will be more moderate (and generally less volatile) in both the Eurozone and the USA. On the basis of the models, I predict that the current growth of around 3-4% in both regions will fall to around zero at the end of 2018.

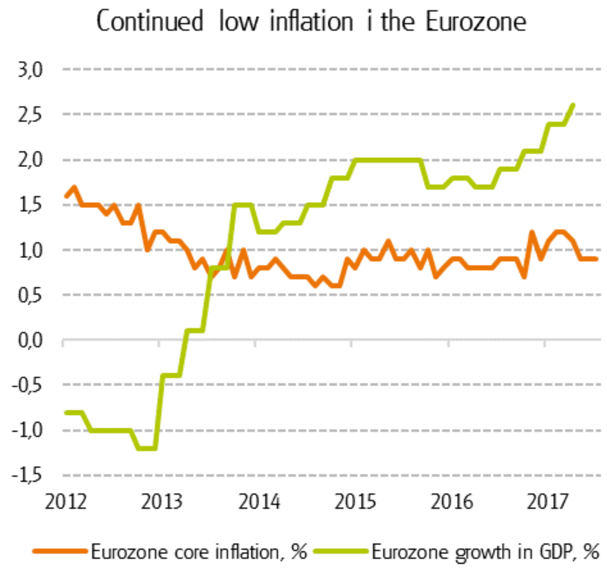
According to our models for the OECD leading indicators, the rise in these figures will peak within the coming 2-4 months and be replaced by a long decelerating tendency over the summer. The USA in particular looks like it will be hit, but as mentioned earlier, the models do not take into account the recently approved USA tax reform, which has the potential to extend the current upswing by many months or quarters.

The Euro: onwards and upwards

Despite low inflation figures from the Eurozone, the euro continues to rise. At the start of January, EUR/USD closed at its highest level since the start of 2015. Stricter rhetoric from the ECB and higher long-term inflation expectations (the so-called 5Y5Y inflation swaps) have led to expectations that the ECB, despite the current low inflation, will gradually wind down the QE acquisition programme that has already been reduced to €30 billion per month.

In my assessment, we will have to wait a further year or two before we get near the ECB's goal of a core inflation level of "just under 2%"

Several EU countries are still having to live with quite high – though falling – unemployment, where wage pressures are therefore not nearly as pronounced in southern Europe. In addition, core inflation is still at under 1%. Energy prices have risen significantly over the past months, but core inflation has a more decisive influence on the ECB in its decision making.



In my assessment, we will have to wait a further year or two before we get near the ECB's goal of a core inflation level of "just under 2%". Unemployment is still too high and core inflation too low.

Nevertheless, the ECB can feel obliged to wind up the QE acquisition programme over the course of 2018, and this can of course impact the European interest rates. This kind of activity is foreseen by the currency market, which means that the euro can easily continue to rise against the dollar.

Danish mortgage bonds defy rising interest rates in Europe

Improved economic conditions in the Eurozone have already resulted in gradually higher long-term inflation expectations, together with a general rise in long-term interest rates since mid-2016. In the short term, they also increased during the second half of December, but long-term Danish mortgage bonds have largely been isolated from this movement.

It is highly likely that large foreign interest in long-term Danish convertible bonds has supported the market in December. The reason is probably that Danish mortgage bonds still offer investors a better return than other secure European bonds with similar maturities.

At the moment, the spread between mortgage bonds and interest rates on Danish government bonds is exceptionally low. Even though this has been clear for several months, the spread is now so small that it begs the question as to whether all mortgage bonds investors have fully understood the risk involved.

Over the last few months, our own bond team has gradually reduced its exposure to this segment. In many ways, it seems like Danish mortgage bonds are traded in a kind of parallel universe relative to the rest of the European bond market.

Goldilocks scenario for the European economy and stocks

With a combination of continued modest inflation and what has become relatively strong growth in the Eurozone, the macroeconomic situation in the region can be characterised as a so-called "Goldilocks scenario". In the story of Goldilocks and the three bears, Goldilocks chooses the porridge that is just the right temperature. In the same way, investors in risk-heavy assets can hardly find a macroeconomic situation that could better live up to their wishes: strong growth combined with extremely lenient monetary policy.

Growth is stronger than it has been for many years – and it looks to continue for a while yet. In my view, a deceleration after summer 2018 should be seen as a temporary pause in a perennial expansion after a perennial slump that was particularly present in southern Europe.

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Analysts now expect a 2.1% growth in the Eurozone in 2018. In my opinion, we can easily come to see a growth of over 2.4%. With such a high rate of growth, we should not be surprised to see that other European companies will experience continued strong growth in income. Since the middle of 2016, this growth, when annualised, has been over 40%. My assessment is that we can easily come to see an income growth of over 20% again.

With continued low interest rates, European stocks can be expected to perform excellently in the new year.

The MomVol indicator

Our MomVol indicator assumed a value of 0.88 at the end of December, which is unchanged in relation to the previous month, but still solidly above the threshold of 0.6, under which one ought to be underweight the stock market.

As mentioned above, the leading indicators show continued wgrowth, which further supports my assessment that one should continue to maintain an overweight to shares.

Editorial deadline: January 10, 2018