Monthly comment by
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Major fissures appear in the European collaboration

The euro is under pressure and has fallen by around 7% over the past few months. In 2017, the euro was able to defy the headwind caused by the yield spread and stand strong to the USA because of a surprisingly healthy economic development. However, the OECD's leading indicator (CLI) has now turned downwards for the Eurozone and points towards a continued rapid deceleration towards the end of the year.

Another reason for the weakening of the European position is probably due to the fissures in the European collaboration becoming bigger after the election of the new Italian government, which is challenging the accepted methods and ideas of the EU elite alliance of France and Germany on a number of crucial issues.

Germany and France are now challenged both with regard to the question of immigration, where Italy and Austria have now in reality joined the four Visgrad countries (Hungary, Slovakia, Poland and the Czech Republic), and also on the basic understanding of the fundamental rules of the European collaboration. Italy in particular will be a major irritant for Germany when it comes to future compliance with Maastricht's criteria for budget deficits.

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With the current initiatives in Italy, it is only a question of a few months before we will in all probability see a clear breach of the 3% maximum budget deficit stipulated in the Maastricht Treaty. It will be exciting to see how Germany's decision makers will react – particularly because Italy's economy is much greater than that of Greece so they cannot simply be bullied back into line in the same way.

In addition, the Italian government is also challenging the usual perception of rational economic policy. The modest reforms that previous Italian governments have been able to push through in order to increase dynamics and reduce the country's enormous unemployment now look like they will be rolled back. In early July, the Minister of Labour, Luigi Di Maio, announced an intervention short-term employment contracts.

Cracks have also appeared in Germany. A conflict between the two conservative sister parties, CSU and CDU, centering on the handling of migrants to Germany, broke out into the open at the end of June. Here, the CSU leader and Minister of the Interior, Horst Seehofer, threatened to leave the government and pull the carpet from under Chancellor Merkel's feet if Germany did not in future reject migrants who had already passed through other safe European countries. The conflict was apparently defused at the start of July with the creation of transit camps on the Austrian border, but this simply challenges the relationship with Austria, who also denies the existence of any agreement between the two countries.

The U.S. yield spread is a problem for the euro

The EU collaboration's political problems mentioned above can, in themselves, be a problem for the value of the euro, but as the difference between American and European interest rates has also expanded to the biggest spread in many years – and according to the American Central Bank - Fed - they will be expanded even more over the next few years – it is no surprise that the USD is rising in relation to the euro.

The current difference between 2-year rates between U.S. and German government bonds is 3.2%, which is the highest it has been since 1997. The difference in 10-year rates is 2.57%.

According to the U.S. Central Bank, we can expect at least four interest hikes of 25 basis points over the course of the next 12-18 months. At the end of 2019 this will leave us with a short U.S. interest rate of 3%. The interest market is not quite as optimistic as the American Central Bank and expects rates of only 2.5 – 2.75% at that time.

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It is my assessment that the interest market is – as usual – more accurate in its prognosis than the American Central Bank. Right now, American growth is strong and the leading indicators continue to rise. But the rate of increase is slowing down and it seems probable that it will peak over the next two to three months. If this is the case, the American leading indicators will, like Europe's and Japan's, point downwards. My assessment is not just that the interest market is correct in its distrust of the American Central Bank's prognoses ("Fed dots"), but also that we might see lower interest rates than the current rates due to a decline in growth at the end of 2018.

The prospects for U.S. interest rates are a problem for risky assets

If the US Central Bank carries on raising interest rates throughout the rest of 2018, the unchanged long-term interest rates will experience a so-called inverted interest rate curve, which has always been an early sign of an approaching recession (typically 12-18 months after the short rates started to be higher than the long rates).

A 3% rate would mean that investors could place their money in corporate bonds with a short maturity of around 4% against accepting a modest credit risk. There is a fairly broad consensus that U.S. shares will be able to deliver a return of 5% or an absolute maximum of 6% over a longer term due to their high value ratings – but this would be at a much higher risk.

In other words, due to the promised tightening of U.S. monetary policy, investors face major changes in expected risk-adjusted returns (between shares and short positions in corporate bonds, for example), and this has great significance with regard to allocation. This is presumably also the reason why investors in shares have experienced moderate returns and greater volatility in recent months.

EM hit by higher interest rates and a trade war

Few segments of the market feel the expectation of higher interest rates as much as EM bonds, shares and currencies. In many EM countries, both companies and states are having trouble finding investors for issues of debts in their own currency due to poor, opaque legislation and property rights.

This is why EM countries are often dependent on being able to issue loans in USD or other hard currencies. This also means that when the USD and American rates rise, these countries are hit hard. The bigger the portion of the loan that is issued in hard currency, the harder they are hit. Turkey, Argentina and similar countries with big balance of payments deficits are hit very hard.

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In addition, China and Mexico are exposed to the possible escalation of President Trump's trade war. The current rhetoric is hard and intractable but Trump himself has put forward a proposal that indicates he is, in principle, an advocate of free trade across the entire G7 region.

Although the proposal also contains views that import prices should be adjusted for social dumping (low wages), which clearly contradicts the concept of free trade, in relation to the current system of customs barriers and technical barriers to trade between the regions, his proposal might actually be a step in the right direction after all.

In my opinion, we will have to live with the uncertainty surrounding trade policy for another few months. Like so much other negative news, the market's ability to cope will depend on the state of the global economy. In other words, trade policy with be a millstone around the neck of the stock market's returns until we see a bottom line in the leading indicators.

Continued underweight to shares

As in last month, our MomVol indicator signals an exit from the share market. The indicator value fell from 0.48 from the end of May to 0.40 at the end of June, where the threshold value is 0.6. In addition, the CLI for the OECD region as a whole is falling and under 100, which increases the probability of a recession and poor returns in risky assets in the coming months. Overall, this leads me to recommend investors to provisionally have a share allocation lower than in their long-term target allocation.

Editorial deadline: July 4, 2018