Sparinvest

Monthly comment by
Chief Strategist, David Bakkegaard Karsbøl

Danger signals point to underweight in shares

Over the course of May there were a series of danger signals that all point towards the same conclusion: for the first time in more than a year, readers of the monthly report are advised to be underweight shares in relation to their long-term target allocations.

In short, the story is that during the month we came even closer to seeing an inverted interest curve in the USA, where short-term interest rates rise higher than long-term interest rates, the leading indicators for the OECD region have peaked and now threaten to drop and cross 100, oil prices are falling and the general raw material index (Thomson /Reuter) is falling. In addition, the Italian problem is growing larger after the recent election and subsequent government that includes both the Five Star Movement and the Liga. This is presumably also the reason that European investor confidence (Sentix) has fallen more than expected in May.

In all probability, we will therefore also see that the current fairly strong growth in stock market earnings will abate somewhat

Our models for industrial production in the different regions also show that we can expect a relatively strong and synchronous deceleration across all regions over the next six months. Generally, this deceleration is likely to be so high that in terms of industrial output growth we will approach zero at the beginning of 2019. In all probability, we will therefore also see that the current fairly strong growth in stock market earnings will abate somewhat.

Can the market cope with the Italian problem?

At the start of March 2017 I wrote that the Italian banks' problems with bad debt, together with the big Italian state debt, were not solved and neither was there any immediate sign that they would be. My point then was that even though the problems were unsolved, it would still not have a negative effect on the market as long as the growth trends in the business cycle continued to be healthy. I estimated that it would only become a problem "in one to two years".

Now we're in trouble, and the reason is largely attributed to the attempt to create an Italian government on the basis of the Five Star Movement and the Liga, which are both anti-elite and EU-sceptic parties. By buying up special Italian government bonds, the ECB's extremely lenient monetary policy has saved the Italian state's finances from the market's scepticism – and potentially much higher interest rates.

The real reason why Italy is once again making headlines in the financial media is that the business cycle is starting to turn. The leading indicators, which have a tendency to signal changes in BNP growth, are pointing downwards for Europe and growth has already fallen. In my opinion, we will come close to zero growth in Europe in 2019 and it is precisely in this zero-growth scenario that the market will have difficulty coping with Italy's problems.

Even though Italy's national debt has climbed beyond 130% of BNP and BNP growth has been anaemic even in these times of upturn, the Italian government has managed to finance negative interest rates for short-term issues – until the middle of May, where interest on two-year bonds almost exploded. But what actually is the problem?

First and foremost, it's about being in the euro, which has made devaluations impossible. In the time of the lira, devaluations could continuously restore Italy's competitiveness when pay rises and costs became too big. Due to the inflexible Italian labour market, the Italian economy is simply not geared to a fixed currency rate through participation in the euro.

Secondly, against this background, so-called unit costs in Italian industry have risen far too much relative to their neighbours' costs, especially in Germany and Eastern Europe. Where Italian unit costs have increased by 37% since 1998, German unit costs have fallen by 9% over the same period due to the Hartz IV reform and extensive automation in German industry.

The largest part of this increase occurred in the bubble years of 1998-2008. However, since the Italian housing market rose sharply and household borrowing exploded, debt-driven growth was high enough for nobody to notice the danger signals.

Thirdly, the Five Star Movement and the Liga have presented a joint programme that in crucial areas will pose a challenge for the current interpretations of the rules covering the common currency. In the eyes of the two parties, the rules have constituted a significant barrier to growth in Italy's GDP. There is agreement on the fact that the burden of government debt must be got under control, but where previous attempts have been made to prevent debt growth by reducing public spending – and therefore also the constant budget deficit – instead, the two parties are pointing to solutions that aim to stimulate the country's unimpressive growth.

According to the two parties, the joint programme concentrates on recreating domestic demand, which has been in heavy decline since 2008 and has undeniably contributed to weak growth. If implemented, the proposed massive personal tax cuts can potentially increase growth, but they will probably increase the budget deficit so much that public debt will rise again. In other words, debt will rise faster than BNP.

The ECB will be forced to postpone the planned normalisation of monetary policy

My assessment is that the problems with Italy have always existed. Italian politicians have not been able to reform fast enough, which is why they have not been able to restore Italian competitiveness. Therefore, we will see major challenges for the EU co-operation over the coming quarters and the ECB will be forced to postpone the planned normalisation of monetary policy.

Cheap European stocks can get cheaper

Even though European stocks look cheap compared to US stocks, they can become even cheaper. Trump's trade policy (trade war), together with the no-confidence vote against Mariano Rajoy in Spain (and the return of the socialists), won't help either. My assessment is that it will not be as bad as the 2011-2014 European debt crisis but we will see some repercussions from it.

Long-term investors should still have an overweight of European and Emerging Market shares

Long-term investors should still have an overweight of European and Emerging Market shares because these (especially the latter) remain significantly cheaper than American shares. However, this kind of overweight can be challenged in the short-term by the turmoil in the Eurozone.

Say goodbye to the Goldilocks scenario

In the middle of 2017 we saw a tendency towards a US slowdown in the leading indicators. My assessment was that Trump's programme (deregulation, tax reforms and an infrastructure programme) would be able to create enough optimism to replace the slowdown with an extension of the expansion. This has actually occurred to such an extent that the US economy, because of its size, is the only one among the major OECD regions to still have an increasing CLI (leading indicator).

When Trump was elected, long-term US interest rates rose in anticipation of higher inflation and growth as a result of the implementation of an expansionary fiscal election programme. In my opinion, we have now got the best out of these expectations and it will be difficult for the US economy to deliver results that will match expectations.

I find myself worrying about what the effect will eventually be in the financial *markets when the US central bank continues to raise interest rates*

This is probably also the assessment of the bond market, as we are getting ever closer to an inversion of the US interest rate curve. If the current US recovery was regarded as being solid for many quarters ahead, we would not yet see trends towards a reversal of the yield curve.

Both the Eurozone and Japan have falling leading indicators. Even though US labour force figures and the like remain strong, I find myself worrying about what the effect will eventually be in the financial markets when the US central bank continues to raise interest rates.

Underweight to shares

For the first time in two years, our MomVol indicator now shows that it's time to exit the stock market. The indicator value fell from 0.62 at the end of April to 0.48 at the end of May. The threshold value is 0.6. In addition, the CLI or the OECD area as a whole is falling to such an extent that it is threatening to go under 100 at the next data point in the middle of June. All in all, this leads me to recommend investors to provisionally have a share allocation that is lower than the allocation for long-term goals.

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