Sparinvest

Monthly comment by
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# The return of risk tolerance

The postponement of American import duties for Eurozone countries in particular has contributed to supporting a more risk-tolerant climate in the stock market throughout April. This trade risk, together with the friendlier relationship on the Korean peninsula, can contribute to supporting risky asset classes for another month or so.

After a turbulent start to the year, risk tolerance is slowly starting to return to the market. The stock markets have performed well in April and long-term interest rates have risen slightly. At the same time, the VIX index has fallen from 25 to around 16 and the price of crude oil has risen to USD 67 per barrel, which is its highest since 2014. Uncertainty about the stability of Iranian supplies have also contributed to pushing up prices.

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Risk tolerance is supported by strong earnings growth, geopolitical stability and cessation of confrontational trade politics. MSCI World earnings growth in April was around 23%, which of course is solid. However, the growth covers relatively large regional variations, as earnings growth for European shares are currently at an impressive 46% while earnings growth for Japanese and particularly American shares, while still good, are significantly lower.

## Breakthrough on the Korean peninsula

After so many years of meeting fire with fire on the Korean peninsula, there now seems to be an initial breakthrough in relations between the North Korean dictator Kim Jung-Un and the South Korean president Moon Jae-In. At the end of April, TV stations all over the world showed how the two leaders, full of smiles, met in the demilitarised zone, shook each other's hand and symbolically acknowledged an agreement on a nuclear-free zone on the peninsula.

Although there are important details to be ironed out before the agreement can become a reality, it is undeniably a major step in the right direction for both parties. The Nobel Peace Prize has been awarded for far, far less than this.

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A final peace agreement has enormous potential for both countries. Initially, both countries will be able to significantly reduce their defence costs, and if proper trade is built up, the population of both countries will benefit greatly. First and foremost, North Korea has no capital or know-how, but there is a large workforce that has survived at existence level for the past many years.

South Korea has a much higher level of capital per worker, and at the same time (due to demographic developments), a limited growth in the workforce. If future South Korean investment in North Korea is accepted, it will transform North Korean living standards in a short space of time. South Korean production costs will be significantly reduced and the country's competitiveness will be greatly strengthened.

## Trade war postponed or cancelled

It is no longer particularly surprising when President Trump drops his own suggestions. This is also the case in trade policy, where his proposal to impose a 25% duty on steel imports in particular is now postponed with regard to the European countries. For now, the proposal has been postponed for a month, but it looks like the market almost appreciates that it will subsequently be postponed again or completely dropped for the Eurozone.

The pattern that the market is becoming accustomed to is that Trump loudly proposes something or other that is meaningless in the economic sense yet leads his supporters to believe that he is "doing something", and that his actions are in their interests.

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There are few factors in economic theory that there is such universal agreement on than the factor that free trade benefits all the countries involved. But there are also few factors that the public misunderstands so greatly. It is this schism that Trump plays on, and it could easily be that the feared trade war turns into a symbolic water pistol battle between the combatants.

In any case, the postponement of the duty for the Eurozone countries in particular has contributed to supporting a more risk tolerant climate in the stock market throughout April. It is my assessment that this trade risk, together with the friendlier relationship on the Korean peninsula can contribute to supporting the risky asset classes for another month or more.

## Monetary policy tighter than expected in the Eurozone

Just how tight is European monetary policy? Judging by interest rates, it is historically loose. Judging by the ECB's acquisition programme, it is close to being historically loose. The acquisition programme has already been reduced and is approaching probable closure by the end of 2018.05.06

However, if we look at the euro's real and trade-weighted value, this has risen by 7% in a year and by 11% since the bottom of 2015. This hits European businesses, who are finding it harder to compete. Real unit costs relating to the labour force have risen by over 8% over the past year as a result of the strong euro.

In addition, nominal growth in gross domestic product (i.e. total production) in the Eurozone, has problems staying at over 2 per cent due to low inflation. Because the Eurozone is so burdened with debt, it is worrying that the nominal growth in production is not so strong. The burden of debt lessens when inflation and production increase rapidly.

*If money supply growth continues to fall, there may be a cause for concern*

While the Eurozone M1 money supply continues to grow healthily, we have seen a sharp decline in M2 growth and especially the M3 money supply – the broadest target for money – in recent months. This has not yet manifested itself in significant changes in the so-called Financial Stress Indicator for the Eurozone (which is a proxy for risk tolerance in the financial system), but if money supply growth continues to decline, this may be a cause of concern because such periods are typically followed by longer periods of greater falls in interest rates.

## The MomVol indicator and share allocation

Our MomVol indicator showed a value of 0.62 at the end of February, which is unchanged in relation to 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. But the fact that risk tolerance is also on its way shows that we are unsure of how to proceed with regard to shares.

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