Sparinvest

Monthly comment by
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Negative headlines weigh heavy on Emerging Markets

August was dominated by negative news from the developing countries, or Emerging Markets. The news was particularly bad from Turkey, South Africa and Argentina. Common to all these countries is their large foreign debt in hard currency, together with large ongoing budget deficits and balance of trade deficits (with the exception of Turkey). As the U.S. Dollar has shown an upward tendency for most of the year, the national debt of these countries has steadily become more difficult to service.

The development is being made worse by political leaders, who in all three countries have blamed more or less everyone else but themselves. Turkey has been hardest hit so far with a fall in the Turkish Lira of approximately 50 percent since the start of 2016. The Turkish Lira is falling generally in relation to most currencies from developing countries due to the high Turkish inflation rates, but the fall was particularly abrupt in August and CDS prices (the price of insurance against bankruptcy) for Turkish banks rose significantly.

Developments in the EM countries' debt markets do not yet seem to have any significant effect on the developing markets

As resistance to reform in Argentina has turned the country into an almost permanent bankruptcy speculator, it comes as no surprise that the Argentinian Peso has fallen and their interest rates have risen sharply in parallel with the Turkish crisis. To cap it all, rumour has it that President Maurico Macri will introduce even more taxes on grain exports at the start of September, which is almost the worst possible time to do so.

In recent years, confidence in the South African economy has gradually been undermined by rampant corruption and a balance of payments deficit that seems to be out of control. In recent weeks, the government has been talking openly about amending the Constitution so that land belonging to white farmers can be confiscated by the state without compensation and redistributed to the black population, who, 24 years after the fall of apartheid, still only own a smaller share of the land. Discussions like these spread like rings in the water in the investment community, where respect for private property is probably the most important prerequisite for a desire to invest in a particular country. CDS prices are also rising here, and at the start of September they closed at their highest level since 2016.

Developments in the EM countries' debt markets do not yet seem to have any significant effect on the developing markets. Apart from a handful of primarily Southern European banks and property developers with exposure in Turkey, a deterioration of Turkey's problems will probably not lead to a spill over into other markets.

Emerging Markets – have they become cheap?

The market for Emerging Markets government bonds often uses a JP Morgan benchmark (EMBI Global Diversified). A Bank of America Merrill Lynch benchmark (Global High Yield Index) is used for high-interest corporate bonds. For the first time in the history of these two indexes, and over a wide range, EM government bonds have a higher spread (more interest) on government bonds than the high-interest market. This is obviously linked to the sharp fall in EM government bonds over the past three months and could indicate that EM government bonds have become cheap.

In my opinion it can be advantageous to start a gradual restructuring and increase allocation to EM government bonds

Although long-term investors ought to start showing more of an interest in this active class, as the momentum is still extremely negative it is probably too early to buy. In my opinion it can be advantageous to start a gradual restructuring and increase allocation to EM government bonds. However, the lion's share of the investment should take place when the market is no longer falling on an almost daily basis.

'Cacophony a la Romana'

In Italy there is a cacophony from the bond markets, where the yield spread on German government bonds with the same duration has expanded considerably over recent weeks. First and foremost this is due to the desire of the coalition government to introduce large-scale fiscal easing. The 5-Star movement want a form of citizen's salary and Lega want massive tax cuts. As Italy has not had a balance of payments surplus in decades and the 2017 deficit is 2.3 percent of their GDP, these two actions alone can potentially push the deficit to over three percent of the GDP that Maastricht's criteria states is the limit for EU member states.

Understandably, the market's reaction is higher interest rates, and until we have examined the details it is hard to believe Finance Minister Giovanni Tria's claim that the market will be able to relax more when the finished draft of the bill is presented.

It is, however, interesting to note that the Ita-Coin indicator, which is a leading indicator for Italian growth, increased in August after falling for five consecutive months. In my view, the presentation of the coalition government's proposals will probably collide with Maastricht's criteria and therefore create friction in the EU collaboration, but not enough to do any real damage. I also expect the market to react favourably when the full details become known.

At the start of September, Lega's leader Matteo Salvini assured the market that "all the rules" will be adhered to, which caused interest rates to fall. Before we see the full details of the new Finance Act it would be wise to be sceptical of this statement.

The leading indicators continue to fall

If we look at the leading indicators from the OECD, there is still a declining trend across all the major regions. Only China looks like it is moving forward but the development in Chinese credit markets are pulling in the other direction, as the so-called credit impulse is very weak.

The OECD region's overall leading indicator is low (under 100) and falling. We call this phase a recession because it is typically associated with a greater fall in growth that will occur within six to nine months. Seen in isolation, this is a potential problem for the stock market, which empirically has had difficulty in creating solid returns in such a phase. In fact, since the 1950s, some of the greatest falls in the stock market have occurred in precisely this phase.

Unless the leading indicators soon bottom out it will be difficult to retain the stock market's current momentum

The stock markets have, however, received several helping hands in the form of quite a strong earnings growth, Trump's tax reform and deregulation, together with a solid momentum and low volatility. However, in my view, many of these helping hands will disappear as we enter 2019, and unless the leading indicators soon bottom out it will be difficult to retain the stock market's current momentum.

Share allocation

The stock market had a good August and at the end of the month our MomVol indicator showed a value of 0.75. That keeps it over the threshold of 0.6, over which – according to the indicator – one ought to invest in the stock market.

On the other hand, the overall leading indicator (CLI) for the OECD region continues to fall, which when seen in isolation means that one should stay away from shares.

Against this background, it is therefore still my opinion that we have a strong stock market momentum in a decelerating global economy, and that one therefore ought to have a neutral share allocation in relation to long-term target allocation.

Editorial deadline: September 7, 2018