MACROECONOMIC REVIEW

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Sparinvest

Monthly comment by
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Strongest quarter for shares in four years

Seen through the eyes of European investors, the first quarter of the year was the strongest in four years. MSCI World (in euros) delivered a return of 14.7 percent. March delivered a return of just under 3.0 percent. Risky asset classes like high-interest business bonds and Emerging Markets (EM) government bonds also delivered a very high yield. In addition to the strong momentum from the first months of the year, the main reason for the strong performance was probably that both the U.S. and European central banks reacted to sharply falling inflation expectations by more or less giving up their planned tightening of monetary policy.

With regard to shares, MSCI World is now dealing on a Cyclically Adjusted Price/Earning (CAPE, in other words the index price divided by average earnings over a 10-year period) of just under 23. Despite the strong returns this year, this is still lower than the 25 that the index was dealt at in 2018.

CAPE is often used as a long-term target for establishing the value of a share or a share index, as the average earning is more stable than the earnings of a single year. 2019 marked the 10-year anniversary of the stock market bottoming out in 2009, but it is also the 10th anniversary of earnings in the global stock market also bottoming out in its collapse in 2008-2009. So CAPE is a result of the poor earnings year of 2009 slipping out of the average but still contributing to a lower CAPE. When measured by CAPE, the global stock market will therefore appear cheaper as we pass through 2019. Assuming unchanged prices, my best take is that CAPE will fall by at least two to just under 21.

Even though the above-mentioned mechanism can hardly come as a surprise to fundamental long-term investors, it can also have been a contributory factor to the fact that investors are being persuaded to carry on buying shares in an environment with a continuing significant fall in interest rates on the safer asset classes.

Inverted interest curve

Despite the state of near euphoria among share investors in March, an event also occurred that had been feared by long-term investors – an inversion of the U.S. interest curve. An inversion is when the short-term interest rates becomes higher than the long-term rates. The reason for the rarity of an inverted interest curve is that investors in long-term bonds experience considerably more volatility because of the changes in expectations for both interest rates and inflation. This is normally compensated for in the form of higher rates.

The most often used reference for an inversion in the difference between 2-year rates and the 10-year rate in government bonds. On March 22nd, we saw for the first time since 2007 that the difference between the three-month rate in the U.S. was higher than the 10-year rate. Although the rates have now changed and there is no longer talk of an inversion, and there has not been talk of the yield spread that analysts often look at, this a worrying event because the inversion of the interest curve in recent times (since 1980) has often been an early warning of significant imbalances in monetary policy.

As long-term investor one should still have great respect for the signal that the interest curve is sending

Even though the interest curve was inverted for 12-24 months before the recessions of 1989-90, 2001-2002 and 2008-2009, one should bear in mind that the stock market delivered quite a high return (between 7.0 percent and 39 percent) from the moment the curve inverted until the market peaked in all three cases. The interest curve cannot give a precise signal about timing in the stock market other than it can be difficult and emotionally painful.

Having said that, as a long-term investor one should still have great respect for the signal that the interest curve is sending. Many excuses have been aired over the last three major recessions about why this time the interest curve will be misleading, such as the previous budget surplus in the U.S. or the savings surplus in EM could distort interest rates and therefore also the indications. But the recessions came one after another even though they were preceded by a roaring, euphoric upturn.

The leading indicators gets closer to rock bottom

The OECD leading indicators are continuing to fall in all regions, although the Eurozone seems to be falling more slowly than before. This often indicates that rock bottom is fast approaching, especially if there are no revisions to the data included in the Eurozone's leading indicators.

Our model for industrial production in Europe shows that we are facing accelerated growth in the coming 12 months

When I speculate that a bottoming out of the leading indicators for the Eurozone is getting closer, it is based on the observation that 1) the leading indicators in Europe have already fallen for 14 months in a row, and 2) that our models for industrial production in Europe show that we are facing accelerated growth in the coming 12 months. Although growth in European industrial production is currently negative, we should – all things being equal – expect faint positive growth rates at the start of 2012. Similarly, the models show that growth deceleration is worst in April-May. Leaders in the European manufacturing industry who have already seen the PMI figures (a leading questionnaire survey) far south, will in all probability sense a change for the better over the coming two to three months.

Trump wants a re-election – and returns on his shares

A third reason for believing that a bottoming out of the leading indicators might be close is that special investigator Robert Mueller has now cleared Trump of collaborating with the Russians in the 2016 election campaign. The acquittal has already improved Trump's chances for re-election in the betting markets, although his odds are still set at 43 percent. The odds on his coming Democratic opponent are at 57 percent.

In addition, the stock market performance of the Trump administration – and of Trump himself in particular – will be seen as a crucial factor in its chances for re-election

If the 2016 election campaign showed anything, it was that Trump is a fighter who was able to claw his way to the top from what was seen as a position as hopeless underdog. Now the mid-term elections are well over and the market has to look towards the Presidential election in 2012, the long-term investor has to factor in that the Trump administration has significantly distanced itself from previous administrations by owning significantly larger share positions, which means it has a much more sensitive finger on the pulse than the Obama administration, for example.

Therefore, the Trump administration's stock market performance – and Trump himself – will be seen as a decisive factor for its chances for re-election. The performance of the economy and the stock market will be particularly decisive with regard to pulling doubters – in other words, right-wing Democrats – across the middle ground.

Trade deal up the sleeve

Trump also has a card up his sleeve: his negotiations with the Chinese for a new trade deal between the two countries. Firstly, a new deal could be entered into more or less any time. The Chinese economy is in a downward trend, which means signatures for U.S.-sized trade deals are not hard to come by.

Secondly, a deal will probably boost the stock market and contribute to increasing economic activity in both the American and the Chinese economies. As there is still over 18 months to the election, my best take is that Trump will maximize the effect on the election by waiting to enter into a deal either until it is absolutely necessary or until around six months before the election.

Neutral share allocation

The regional Momentum and Volatility indicators (MomVol) have further increased since the end of March and now have a value of 0.86, which is some way over the threshold that indicates whether one can expect a strong or a weak stock market in the following month. At the end of March, all the regional stock markets have shown quite high MomVol indicator values, which means there is an increased probability for further healthy stock market returns in April.

On the other hand, the OECD leading indicators for the entire OECD region are continuing to fall and the interest curve has just inverted in the U.S. However, Trump has a trade deal up his sleeve and a strong personal interest in a rising stock market.

Against this background, my recommendation is to have a neutral share allocation in the near future in relation to long-term goal allocation.

Editorial deadline: April 4, 2019