Sparinvest

Monthly comment by
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Weak but persistent recovery driven by caution

The optimism continued in April where MSCI World (in euros) delivered a return of just under 4.0 percent, while long interest rates rose as a consequence of slightly higher inflation expectations. The so-called 5Y5Y inflation swaps that indicate the market's inflation expectations from in five years' time and five years forward from then, rose in both the Eurozone and the USA.

During the course of the month, we saw a series of key Eurozone figures that showed a consolidatory trend. Despite the fact that the OECD's leading indicators for the Eurozone are still showing a declining trend, it is a clear sign that the Eurozone's immediate future looks brighter than first feared.

Even though the OECD's leading indicators for the entire OECD region are still showing a declining trend, the decline is easing off and it therefore seems probable that a bottom will be reached within the next 2-5 months. The bonds market also looks to be recognising this possibility, as the inversion (the difference between 2-year and 1-year government bonds) is moving further away in the USA. In the Eurozone, the short interest rates continue to be so low and negative that we are a long way from an inverted interest rate curve.

The labour market in the USA continues to look strong, even though one would have thought that the length of the recovery and low unemployment would soon start to be a problem. The fact that this is not yet the case is due to far more careful behaviour among households and banks in recent years.

Why economic imbalances can be serious

Over recent months the length of the recovery and the interest rate curve's inversion has given rise to many discussions and expectations of a coming recession. It is my clear impression that there are many reasons for a recession, and two recessions in a row will almost always have completely different causes. Despite everything, the players in the market will have the first recession fresh in their memories.

The 2001-2002 recession was primarily caused by the IT bubble bursting. Although this bubble was considerable, it was more of a threat to IT investors than players in the broader economic spectrum. The only worrying trend before, during and after the IT bubble was actually the fact that U.S. and European household debt levels grew faster than both the economy and their own income.

As an answer to the IT bubble's recession, the U.S. Central Bank reduced the short rate to what was at that time an unheard-of low of 1.0 percent. This contributed to creating a comprehensive speculation in property-related and credit-related financial instruments, as well as an intense acceleration in household loans and consumption.

We all know how that ended. However, households have subsequently dramatically changed their behaviour so their consumption, savings and levels of debt are considerably more conservative now than they have been for many years. At the same time, disposable nominal income in Danish households, for example, has risen by 37 percent since the end of 2008. U.S. income in the same time period has risen by 32 percent. Very low levels of interest has meant that the costs of servicing these debts has fallen dramatically over recent years.

The next recession's epicenter

It is therefore unlikely that a future recession will come about as a result of a shock from households that suddenly want to dramatically reduce their consumption, as we saw in 2008. In addition, the banking system is much better capitalised than in 2007 and the regulation of the financial sector has gradually been tightened to a much more significant level. In many ways, one can say that these constraints have been procyclical and have therefore contributed to making the current recovery weaker than it otherwise would have been.

However, at the same time, it can be part of the explanation that the recovery has also lasted longer than the historic norm.

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If we are to go looking for the most likely cause of the next recession, it will probably be found in the market for corporate bonds, which has pushed the problem over to the business sector instead of private households and banks. Today, many businesses are deeply dependent on continuing low interest rates and big risk appetites among investors.

This has resulted in their effective interest payments and credit spreads being at rock bottom. In addition, covenants (financial limitations for bond issuers) on a large part of the market are now worryingly relaxed, which historically has been a good indicator of when the market has been too optimistic and greedy.

Added to this, the financial regulations mentioned previously have contributed to the banks' brokerages' exposure to corporate bonds – and their self-holdings of them – being only a fraction of what it was just 6-7 years ago. For the same reason, market depth and potential liquidity have deteriorated dramatically, which unfortunately will be reflected in a general 'risk-off' scenario, where many investors are looking to sell at the same time.

The next recession – reasons and effects

In my opinion, the willingness of the central banks to tighten monetary policy from here will be the deciding factor in when the above-mentioned 'risk-off' scenario will arise. Unemployment in the major regions is falling significantly and is now quite low, but we have yet to see any inflation worth the name. In fact, we have not seen any at all.

In all probability, the central banks will be very reluctant to tighten monetary policy due to their fears of deflation – and this has already proved to be the case. The ECB's deposit rate has been zero or negative for the past seven years. I do not expect any significant monetary policy tightening in either the USA or Europe over the next year, but unemployment levels can fall so low that they feel forced to start raising short interest rates.

This means it is probably still a while before it starts to have a noticeable effect on the market for corporate bonds, even though the changes in monetary policy can naturally have greater influence on confidence among investors at that time. The global benchmark for investment grade corporate bonds (USD) now has an effective interest rate of under 2.9 percent. With a 2.5 percent short rate in the USA, there is a very limited credit spread and accompanying interest reward, which in my opinion does not match the risk of monetary policy tightening within the coming two years.

A greater effect will probably also be felt by the stock market, both through the fact that companies' funding interest rates will rise, but also that all things being equal their share issues will be reduced. In the USA particularly, issues through extensive buyback programmes have gone to support share prices. We cannot look to this supporting factor in the coming years when monetary policy is tightened.

Bright spots in Europe

That's enough about long-term flies in the ointment. Instead, let's look at the short-term bright spots. When we look at the Eurozone, there continues to be more indications that the next half year can deliver some positive surprises. First and foremost, the gap between soft (expectations-based) data and hard (directly measurable) data has now shrunk to zero. In other words, there is now no longer any reason to believe that the Eurozone's market players will be systematically disappointed over the coming months. A greater risk for European shares has therefore now been taken off the table.

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In my opinion, this would mean that from now on we can come to see a greater rise in long interest rates in the Eurozone.

Neutral allocation

The regional momentum and volatility indicators (MomVol) have further increased at the end of April and now have a value of 0.94, which is reasonably over the threshold that determines whether one can expect strong or weak stock markets in the subsequent month. All the regional stock markets had quite high MomVol indicator values at the end of April, which suggests an increased probability for further healthy returns in the stock market in April.

On the other hand, the OECD's leading indicators for the entire OECD region are continuing to fall, which is why for the immediate future I recommend a neutral share allocation in relation to long-term target allocation.

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