Sparinvest

Monthly comment by Chief Strategist, David Bakkegaard Karsbøl

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PMI now reacting negatively

In recent monthly reports, I have described how I expected the industrial production in particular EU countries to slacken somewhat as we approach New Year. This is about to happen, and we now see the PMI index reflecting a perceived lack of domestic demand. PMI data is based on a survey among the employees of companies that are responsible for purchasing. The sluggish autumn is due to the fact that, about six months ago, industrial production became too high compared to overall retail sales, thereby filling stock levels.

As the OECD countries' overall retail sales have held up well, with annual growth rates of around 1.6% in the past six months, I see the weakness in industrial production to be of a temporary nature. Thus, it is still my opinion that whilst we will see weaker industrial production growth in the coming three months, this will bottom out around the turn of the year. Although where the euro area is concerned, I would not be surprised to see positive (though only just) growth figures - also in the last months of the current year

If we look at the United States, we see that the economic recovery seems to be quite firm - with a current growth rate in industrial production of over 4%. This will remain strong in the last few months of the year and whilst – at first glance – it may appear weaker in the first quarter of 2015, it will probably even then be quite decent in comparison with figures from the euro zone. PMI data from the United States is obviously very strong - and that goes for both the manufacturing and service industries.

Emerging markets (ex China)

In emerging markets, there are no immediate signs of economic weakness, when we look at industrial production. Some commentators have begun talking about the possibility of a Fragile Five crisis 2.0 and fear that a potential tightening of monetary policy by the United States will result in less demand for riskier assets in the emerging market universe.

Since the balance of payments problems have improved somewhat in the original Fragile Five countries (India, Indonesia, South Africa, Brazil and Turkey) – especially in India and Turkey and to some extent in Indonesia (while they are virtually unchanged in South Africa and Brazil) – some of the risk has been reduced.

In addition, industrial production seems to remain at a reasonable level. Even though we see a tendency of disappointing production in some countries - including China, South Africa and Turkey, the emerging market countries are still performing well compared to developed countries.

Another reason that the risk associated with emerging market exposure (both stocks and bonds) has decreased is that emerging market currencies are already significantly cheaper than two or three years ago. There is no guarantee that they will not become cheaper, but current levels are a much better starting point for investing in emerging market assets than when currencies were higher.

China disappoints

The main danger for the markets right now seems to be a further deterioration of the situation in China. This is a fear that I have previously aired in the monthly report and, due to

China's size and importance to the world economy, there is unfortunately still cause for concern.

The monthly GDP indicator (which is designed to predict the development of GDP - see figure 1) now shows that we can expect real growth in China of around 6.3%. Although it sounds high from a European perspective, it is quite disappointing compared to the usual Chinese standard. Only in 2009, have we seen lower growth in China.

Figure 1 - GDP outlook China

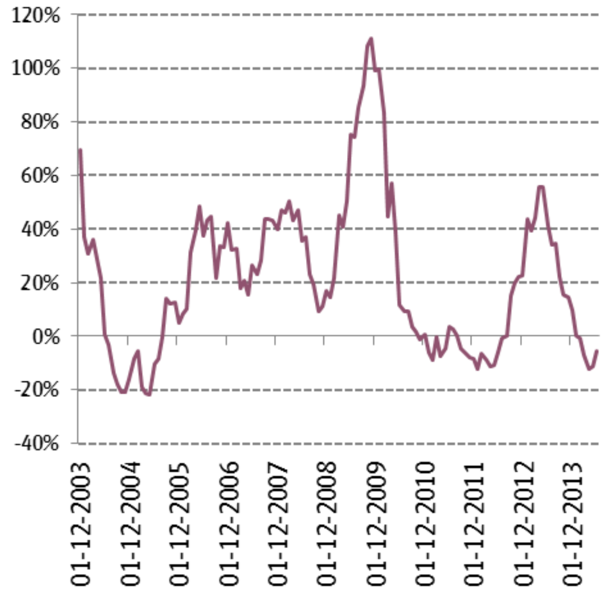
An already very expensive, Chinese housing market is now declining on a monthly basis - even during the seasonally "good" months where one would normally expect to see price hikes. Home sales disappoint too, and the value of total property transactions is declining. Thus we could - barring further stimulus from the Chinese State - very well be at the end of the road of a stimulus-induced tour-de-force of epic proportions.

Until now, Chinese authorities have been able to create a growth of (minimum) 7.5% which, so far, seems to have been the lowest, politically acceptable figure. This is done through very large stimulus programs and the provision of liquidity to a stressed Chinese banking system.

As in so many other economic contexts, however, it appears that the efficiency of the governmental monetary and fiscal stimulus programs has been declining. In other words, it has taken more and more stimulus to get an extra percent of growth in GDP.

After the last major stimulus in 2013, when the total annual credit growth reached 56%, credit creation has now fallen dramatically, and growth has actually been negative (figure 2).

Figure 2 - China: Total Social Financing YoY %



A series of stories about the so-called shadow banking in China illustrates the lack of reliable credit standards, business models and problems with the quality of investment in China. Negative growth in credit creation (as in Europe) therefore comes as no surprise. In fact, there is a need for more subdued development and stronger discipline in the financial sector (including the unregulated part of it) to create a more sustainable economic growth.

China's situation is worrying because it is experiencing high wage inflation. Due to the Chinese currency being pegged against the USD, there is in fact an ongoing erosion of the country's competitiveness because Chinese wages have risen so much in recent years. Although the Chinese currency has declined in nominal terms, this has not been the case in real terms if you adjust the exchange rate for wage increases.

Some considerations about currencies

Since the first quarter of this year, I have repeatedly mentioned that, due to very low inflation and very large differences in economic development between the United States and Europe, I expected the EUR to drop against the dollar. I still expect this, but the positioning in the market (i.e. 'speculative short positions' in EUR) has become so extreme that one should not be surprised to see further EUR strengthening in the short term.

Another important trend in the foreign exchange market is again the falling yen. The Japanese economy has not responded as desired to the Abenomics programme's 'three arrows' (monetary expansion, fiscal stimulus and structural reforms). On the contrary, both industrial production and consumer spending have taken a big dive over the last six months, and the easing of monetary policy (the largest of its kind in relation to the size of the economy) will in all probability continue. With that, a greater and more prolonged decline in the value of JPY may well be set in motion.

The yen has traditionally been a favoured haven within the foreign exchange market when there were signs of risk aversion. This is because Japan has usually had surpluses both on current account and trade balance. In fact, both are now in the red and, as mentioned, the expansionary monetary policy seems to continue. It is therefore my opinion that the yen will weaken further, and this can potentially be a very large and persistent decline.

It is therefore essential for the world to be ready for a major weakening of the yen. If this scenario unfolds then China and Germany in particular could have major challenges. Chinese industry will suffer - both as a competitor and a subcontractor for Japan – if the yen weakens. If China's economy continues to be challenged by weak growth and the JPY drops, the Chinese authorities may be forced to allow the Renminbi to follow JPY lower in order to respond to the competitive situation in Japan and to maintain China's role as the world's "Production Hub".

Germany's position as a manufacturer of capital goods will also be challenged significantly by a further weakening of the yen - and this is happening at a time when most people consider Germany as close to being economically 'foolproof' (as one of the few countries that came through the crisis unscathed). Such hubris could prove dangerous for investors with German exposure.

Raw materials and inflation

Weaker growth – especially China's – has already rubbed off on the whole commodity complex, affected by weaker demand and a strong U.S. dollar. Since virtually all commodities are quoted in U.S. dollars, a stronger dollar therefore means that the prices of raw materials will – ceteris paribus – fall.

Over the past three months, oil prices have fallen by 15%, the CRB commodity index fell by 11% and the price of iron ore decreased by 20%. The price of copper, known to be a leading indicator because of the large copper content in many industrial products, fell by 7%.

If the weak Chinese growth and a relatively strong dollar continue, we will see a continued decline in commodity prices, and this will lead to lower inflationary pressures in many countries already flirting with deflation.

Weakened Chinese demand for commodities will particularly impact on the raw material-producing countries such as Brazil and Australia. This is obviously worth keeping an eye on - not least because Australia is struggling with a very expensive housing market (it has risen by 26% since the end of 2007).

The stock market

As mentioned about European stocks in last month's report, we could easily see signs of risk reduction in the coming months, with industrial production growth likely to be declining (although probably still positive). While this is probably mostly applicable to Europe, European shares are currently enjoying being supported by the very weak euro, which improves their competitiveness. In local currency, European shares have outperformed American equities in September.

Nevertheless, it is still my opinion that the stock market may be more than usually volatile towards the turn of the year, after which industrial production figures will probably begin to strengthen again.

Japanese stocks are already benefiting from the weaker yen, but it is my opinion that the full value of their increased competitiveness has not yet been priced into them. Our studies show that this typically takes a long time (months or quarters), and Japanese stocks therefore contain a return potential at current prices.

The same holds true for Chinese stocks, which have already done well this year. There is, however, no harm in repeating it: there is no correlation between GDP growth and local stock market returns. In fact it appears that weak GDP growth in many cases leads to a stronger stock market. This is probably due to improved margins in businesses and expectations of (or realized) stimulus from monetary policy, which helps to push stock market multiples higher.

Bonds

In the bond market conditions are becoming more and more absurd and intolerable for long-term investors. In Germany, all government bonds with maturities of less than 4 years now have a negative yield-to-maturity. 5-year government bonds have traded at a yield of 6 miserable basis points.

Many proprietary institutional investors, and those acting on mandate instructions, are forced to buy government bonds of a certain minimum quality and with specific maturities and, in that sense, the progress towards absurdity has been self-reinforcing. Investors in guaranteed pension funds in particular suffer from this unfortunate dynamic. One is therefore forced to take on additional credit risk and interest rate risk and even then, in many cases, one is unable to count on a positive return from a portfolio.

Although the situation is absurd, there is unfortunately no immediate prospect that this will change for the better (ie with a return to higher interest rates). Central Bank buying programs (either directly or through the banking system) suck up the supply of quality bonds, reinforcing their price development and exacerbating the liquidity of the market for these bonds.

Investors who simply want diversification (and return), and who are not bound by orders and regulation, buy corporate bonds – a fact that also forces investors to take more risk than normal. So far, the macroeconomic developments and monetary policy have supported this development. But the Federal Reserve has now moved closer to the normalization of interest rates, which is a potential risk in this segment. However, in a macro perspective we continue to see the so-called American 'funding gap' and the American 'lending survey' as being supportive of corporate bonds as an asset class. The recent sell-off therefore seems to be a result of over-positioning to the asset class rather than driven by macro factors.

Editing completed on September 30th 2014.

Figure 3 - Relationship Between Cape and Earnings Growth