Monthly comment by Chief Strategist, David Bakkegaard Karsbøl

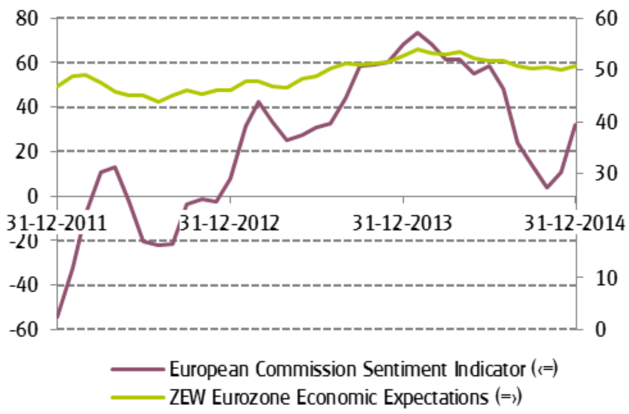
December 2014

Europe is now close to the bottom

The expected deceleration in the growth of industrial production, which has been a regular feature in recent monthly reports, is now nearing completion. In all probability, the decline in growth will be at its worst (compared to 12 months previously) around January or February, and production managers should begin to see that they have adjusted it too far down. Therefore, it is not a surprise that the European expectation-surveys have begun to improve.

The important ZEW and IFO figures for expected future growth in the Eurozone positively surprised the majority of analysts in December and I expect that the figures in the coming months will also show improvements. Over the past 12 months, the unemployment rate of the 27 EU countries decreased by 0.7 percentage points to 10%. This is still high in a historical context, but the direction is right, and I expect a similar decline over the next 12 months, which could have significant impact on consumer confidence and consumption patterns in the Eurozone and the surrounding countries.

Figure 1 – European sentiment surveys



If we look at the most recently published ECB Lending Survey, it indicates that the largest European banks expect to relax lending standards again – both to households and to non-financial companies – over the next three months. After three years of consolidation of balance sheets and solvency, it now appears that the banking system again has the appetite and ability to comply with the private sector's demand for credit.

These loans are actually still falling, but by less and less, and it is my expectation that by the middle of 2015, we will see increased lending to those non-financial companies that are particularly important for job creation and growth in Europe. The fact that the euro has weakened since 2013 helps to support this development. Through a combination of lower currency and lower prices, European companies have been increasing their competitiveness especially against US companies.

Worrying developments in Russia and Greece

A combination of sharply falling energy prices and sanctions initiated by the US and the EU has now led to a serious destabilization of the Russian economy, which, to a large extent, relies on the production and export of energy.

The majority of analysts now expect a mild recession in Russia in 2015 (with -0.2% growth for the year as a whole). Capital has been gushing out of the country and as a result, Russian currency reserves have reduced by 19% in the last 11 months. In addition, the ruble fell by around 40% against the euro in 2014, and inflation seems to be rising sharply (although we have not yet seen the results of this in terms of soaring import prices). The central bank has responded to the collapse of the ruble by raising short-term rates to 17%. This led to a strong backlash but it is not yet possible to assess whether we have now seen the bottom in the value of the ruble, after some highly volatile months.

As the Russian economy worsens, however, the fear is that Vladimir Putin may find it attractive to further increase tensions in foreign policy to distract attention away from domestic political problems and onto something more likely to cause the nation to rally behind his leadership. A leadership, by the way, that still enjoys great support among ordinary Russians.

Turning our attention to Greece, here one can also fear developments in the political situation after a series of opinion polls showed strong support for the far-left party, Syriza. The polls revealed that up to a third of the discontented and reform-shocked Greek voters would vote for the party. Broadly speaking, Syriza is promising to roll back a significant part of the extensive Greek structural reforms and threatens to refuse meeting the economic conditions laid down for Greece by the EU and IMF as a precondition for loans.

Following the publication of these opinion polls, Greek 3-year yields increased from about 6.5% to about 11%. In other words, the market perceived a significant risk that Syriza would come to power in the upcoming election. This is, in many ways, a particularly regrettable development. First, because Greece has already gone a long way towards meeting EU and IMF requirements by implementing the necessary reforms since the euro crisis was at its peak in 2011. Greece has seen radical improvement in international measurements such as: how easy and fast it is to start a business, investor protection, transparency of bankruptcy legislation etc. From its former position on the absolute European bottom rung in several of these measurements, Greece has now moved several steps forward to be above the average of other European countries. It is my assessment that Greece – if it is able to stick to current reforms and perhaps even continue in the reform track – could develop, in economic terms, into the absolute darling of the Eurozone. After some very difficult years - 2012-2013 - Greece has now surplus in its primary balance (ie excluding interest owed abroad), and growth has returned strongly. These are the significant areas of progress that risk being reversed in the event that Syriza gains power.

American over-optimism?

Whilst Europe, as previously mentioned, can anticipate better times ahead from January or February, the American business cycle is starting to approach more mature levels. First, various ISM and PMI surveys have been quite high for a long time, and the dollar's strength has made American companies less competitive.

Secondly, a sharp decline in unemployment has led to an increased risk of wage inflation, which may contribute to a weakening of margins for US companies and require faster-than-expected interest rate hikes.

Thirdly, at the recent FOMC meeting, the Fed indicated a change in monetary policy by changing the wording of its expectations. Specifically Janet Yellen kept former promises to keep interest rates very low for "a considerable time" (contrary to expectations) but added that the central bank has "patience" in efforts to normalize monetary policy.

At a subsequent press conference, Yellen indicated that interest rates would not be tampered with in the first quarter of 2015 and that normalization might only be expected in 2017. On the whole, the US fixed income market has not moved as a result of the recent FOMC meeting. In other words, the overall scenario that the FOMC and Janet Yellen were trying to convey, was already priced into the market.

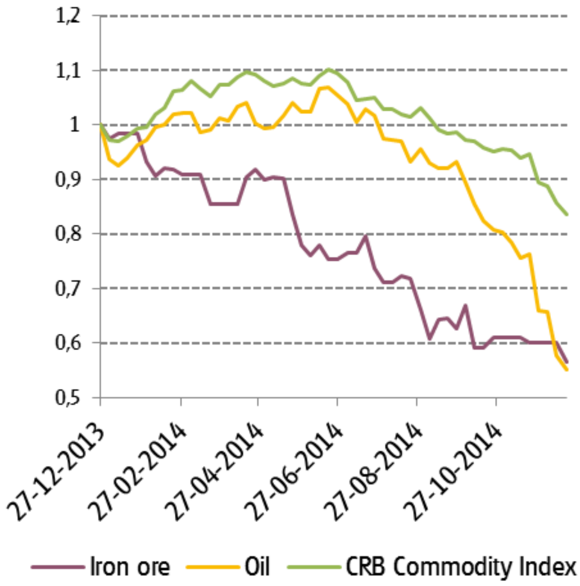
All in all, it therefore seems that the economic situation in the US is moving into somewhat more normal territory. And, with the rather large price increases we have seen in the US housing market (and thus the improvement of household equity), it appears that growth in consumption can still be expected in some quarters to come. The annual growth in the US retail sector has dropped to about 2% per year, but in 2015 we will probably see increasing growth in this figure. This will further assist Europe.

High Yield hit hard by fall in commodity prices

In last month's letter, I wrote that macroeconomic factors continued to support corporate bonds - including the high yield market. So far, this is still the case because 1) both the American and the European Central Bank lending surveys indicate relaxed lending standards during the three months ahead, 2) government interest rates are still exceptionally low and 3) the so-called US financing gap is extreme.

One factor that nonetheless made it painful to be a high yield investor was the slump in commodity prices which had a major impact on companies in the materials sector. The prices of both iron ore and oil have seen extraordinarily steep falls over recent months. This has made numerous companies involved with raw material extraction unprofitable or, at the very least, put them under great financial strain.

Figure 2 – Iron ore, oil and commodity prices



It would be pointless to try to predict how commodity prices will evolve over the next few months, where virtually anything could happen. However, our models' predictions of increased industrial production for both the Eurozone and Emerging Markets give hope of a stabilization over the next six months. Higher industrial production and higher numbers of PMI, ZEW and IFO etc, will help to stabilize the situation for both commodities and high-yield bonds.

A look back at 2014

2014 has been an eventful year - especially since the end of the summer. Until mid-December, the stock market (MSCI All Countries) delivered a return of over 9%. US stocks in particular lifted the return while European equities delivered about 5%.

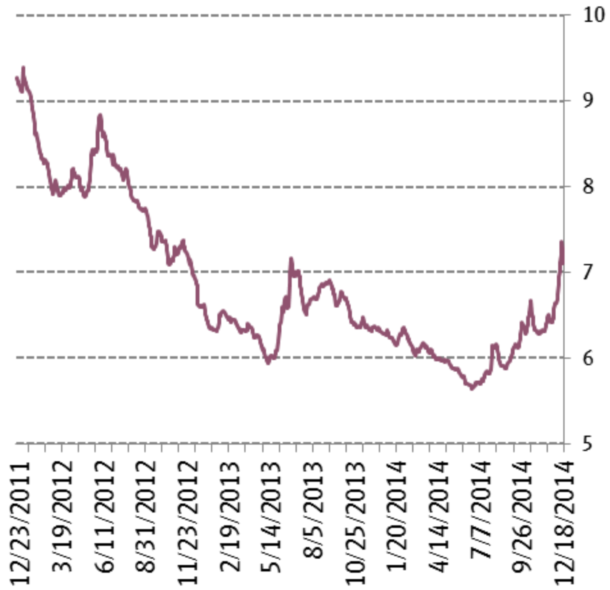
The US dollar strengthened significantly in the second half. Since May, the EUR/USD dropped by about 12%. Over the same period, USD/JPY increased by almost 18%. Dollar strength, coupled with lower growth in China, has been a major reason for the fact that commodity prices have fallen significantly.

The price of iron ore almost halved during the year, whilst a similar reduction in the price of oil happened in just six months.

Global industrial production has generally remained at a growth level of over 3% throughout the year, and it is Europe in particular which has experienced a decline during the late autumn. However – for the reasons given above – this appears to be temporary.

The high-yield market has been hit hard, especially in the late autumn. Commodity producers have seen lower commodity prices marked to market and there has been a general increased in volatility and risk aversion during October and December. In December alone, the yield-to-maturity on the Merrill Lynch Global High Yield Index increased from approximately 6.5% to 7.3%. Investment Grade has, on the whole, performed brilliantly throughout the year and appear almost to behave as substitutes for government bonds.

Figure 3 – Yield to maturity, Merrill Lynch Global High Yield Index



If we look at government bonds, analysts' expectations for both long and medium-term interest by the end of 2013 were uniquely uniform. Of the nearly 100 analysts, who submitted their predictions to Bloomberg, none expected that interest rates would fall. As is so often the case, it would therefore have paid to be contrarian. After all, where would the next bonds sale come from when everyone expected that interest rates were set to rise? In fact, interest rates in almost all countries have fallen significantly from what were already low levels at the start of 2014. In Germany, it is now completely impossible to get a positive yield to maturity from even four-year government bonds.

The geopolitical year has also been eventful. Few would have expected that the Islamic State in Syria and Iraq would come to fill as much of the media, or that they would come to control such large and important areas of land as is the case. Moreover, Russia's annexation of the Crimean peninsula and involvement in eastern Ukraine has also drawn headlines. The fall of the ruble and significant sanctions against Russia have also had some impact –especially on European companies.