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Sparinvest

Monthly comment by
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The Fed protects shares

In November, we once again saw considerable volatility in the stock market. After an increase at the start of the month, the stock market declined because of concerns about excessive tightening of monetary policy in the U.S. At the same time, there was a visible declining trend in long-term inflation expectations. The so-called 5Y5Y inflation swaps fell from around 2.45 at the end of September to around 2.27 in mid-November.

The head of the Fed, Jerome Powell, had previously stuck to the line that short-term interest rates in the U.S. were "well below" the natural interest rate that characterizes a neutral monetary policy. Due to sharply declining inflation expectations, Powell changed his rhetoric to short-term interest rates being "just below" the natural rate. This caused investors to breathe a sigh of relief and sent stocks up sharply in the last days of the month.

Generally speaking, the volatility index (VIX) is staying high. In the first days of December, we saw the VIX bounce back to over 25. Overall, one can say that the idea of Fed issuing a put option for share investors, which protects them from falling markets, can be supported by Powell's actions. Where it used to be Greenspan, Bernanke and Yellen who had to put their names to an imaginary put-option like this, now it is Powell.

The inverted interest rate curve moves closer

The reason for the nervousness in the stock market is that after three painful experiences with inverted curves (i.e. short-term interest rates become higher than long-term interest rates) in 1989, 2000 and 2006-7, equity investors are looking at the gap between 2-year and 10-year interest rates on U.S. government bonds with growing concern.

This difference narrowed again in November, so the spread is now down to 12 bps, or 0.12 percentage points. In fact, if we look at the 2-year and 5-year interest rates the yield curve has already been inverted in the U.S. This indicates that the bonds market is beginning to be skeptical about the strength and development of the U.S. economy over the next two to three years.

Many analysts have already expressed an expectation that there will be a recession in 2020. In many ways, this also more or less fits with my own models and expectations. My only concern with this is when so many share the same opinion and expect the same thing, the likelihood of it occurring decreases.

Trade war – and an arrest

One of the reasons why the stock market rose relatively sharply (+4.0 percent) in the space of a few days at the end of November was the expectation of an easing up of trade policy tensions between the U.S. and China. Therefore, when the news broke that Huawei's CFO, Wanzhou Meng, had been arrested in Canada and was about to being handed over to the United States because of an alleged breach of U.S. sanctions against Iran, it provoked a strong reaction from the Chinese authorities.

The arrest of Meng, the daughter of the founder of Huawei and one of the most important Chinese business figures, has naturally thrown sand in the negotiation machinery

The arrest of Meng, the daughter of the founder of Huawei and one of the most important Chinese business figures, has naturally thrown sand in the negotiation machinery. However, it cannot be discounted that a subsequent release can work as a kind of trade policy lubricant for Trump, making it easier for him to establish a new trade agreement.

Trump has indicated that he wants an agreement within 90 days or else he will impose a 25 percent duty on Chinese imports into the United States. Although still high, Chinese growth already seems to be falling slightly to around 6.5 percent in the fourth quarter, but the great asymmetry of trade between the two countries means China has quite a bit more to lose than the United States in a protracted trade war.

High Yield and EM bonds – now with new and larger spans

Risk-heavy bonds have also been hit in recent months. Global High Yield bonds have lost 2.4 percent (in USD) since the start of the year, and OAS (credit spreads) have now been pushed to 465 basis points compared to U.S. government bonds with the same duration. The effective interest rate has risen from about 5.0 percent in mid-2017 to 7.0 percent. Corresponding developments can be seen for Emerging Market government bonds, where both effective interest rates and OAS in relation to U.S. government bonds have expanded substantially.

For both corporate bonds and emerging market government bonds, the net falling energy prices are a negative effect for the asset class

For both corporate bonds and emerging market government bonds, the net falling energy prices are a negative effect for the asset class. A fall in the price of oil by about $25 per barrel (in other words, by about a third) since the start of October has had a destabilizing effect on these markets.

The return of Value and Momentum

November turned out to be almost the culmination of the perfect factor storm in the stock market. Factors are investment strategies that are exposed to a particular segment of the market. Value means when you buy cheaper shares where you gain ownership of more registered equity capital or earnings per dollar invested than in other shares. Momentum is an expression for buying shares that have delivered a better yield than the rest of the market. Small Cap means buying smaller businesses. Minimum volatility is buying shares that have less price fluctuations because of lower gearing or safer business models.

In Sparinvest, we have typically implemented one or more of the above factors in our funds. In the balanced funds, which contain both stocks and bonds, we have exposure to all factors (excluding Minimum Volatility). In addition, we are seeking to implement a so-called double sorting on Value and Momentum, so we buy the segment of the stock market that is both cheaper and stronger than the rest of the market.

The market will start to see a greater yield from the combination of Value and Momentum again in a few months

Unfortunately, the second half of 2018 in particular has seen some historically poor months for precisely this segment, and the Small Cap factor has experienced strong headwinds. The only factor that has worked this year is Minimum volatility, but we have not implemented it in the balanced funds' stock exposure.

The fact that these factors have performed so historically badly leads us to believe that it is a passing phenomenon, and the market will start to see a greater yield from the combination of Value and Momentum again in a few months.

France – the rotten apple

"The yellow vests" are blocking the roads into Paris and demonstrating their dissatisfaction with President Macron's reforms and/or lack of the same on an almost daily basis. The 'yellow vest' protest movement seems to have neither leaders, policies nor coherent views. One of the few things that unites them is the opposition to higher fuel taxes.

The country's economy is clogged up with decades of regulations that raise the cost of living and keep hopeful people out of the labor market

In addition, they are dissatisfied with high unemployment, lower speed limits on country roads and tax cuts for 'the rich'. They also feel that Macron has become too elite. The lower-middle class seem to be a common element in the movement: people in work and with a clean criminal record that have just become tired of the endless struggle to make ends meet. The country's economy is clogged up with decades of regulations that raise the cost of living and keep hopeful people out of the labor market.

Nevertheless, there is no clear desire to deregulate the French economy. It seems almost ironic that the movement is on the streets almost the same week that France takes over from Denmark as having the dubious honor of being the hardest taxed country in the world.

French government debt is trading at significantly lower interest rates than Italian government debt on the financial markets, but this is increasingly looking like a misunderstanding. By the end of 2017, although Italy's debt ratio was 131 percent against France's 97 percent, Italy had a lower budget deficit and the country's leading indicator (from the OECD) fell slower than the French.

Added to this is the fact that the French burden of taxation has been constantly rising since 2009, while in Italy it has been falling since 2012. The Commission's economic confidence indicator is also falling faster for France than for Italy. If we fast-forward a few months, I think it is most likely that that the interest rate spread between France and Italy will narrow and the market will be surprised more often by negative news from France and some positive news from Italy, who has more market-friendly reforms on the table.

Macron's reaction to the demonstrators reeks of desperation. Raising the minimum wage by €100 is guaranteed to create even more unemployment and scrapping the tax on certain pension payments will create an even bigger hole in public funds without increasing the number of available jobs. He is also reducing tax on overtime in order to push job availability in the right direction, but this will also contribute to worsening public finances. Macron's actions draw a picture of a country that is about to overtake Italy with regard to budget deficits and problems in complying with the Maastricht criteria.

Share allocation

The regional Momentum and Volatility Indicators (MomVol) show a modest increase by the end of November for all regions except Europe. American shares still have significantly stronger momentum than the rest of the world. European shares have replaced EM shares at the bottom of the table.

One ought to keep a neutral share allocation in relation to long-term target allocation

The overall MomVol indicator showed a value of 0.71 at the end of November, which was higher than at the end of October (0.67). Despite the fall at the start of December, it still looks like there is a fairly strong momentum in the stock market in December.

On the other hand, the OECD's leading indicator for the entire OECD region still shows a declining trend, which suggests an ever more consistent decelerating trend in the economies.

Against this background, I am maintaining my recommendation from the previous months, which is to maintain a neutral share allocation in relation to long-term target allocation.

Editorial deadline: December 11, 2018