Sparinvest

Monthly comment by
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The worse the figures, the better

January was marked by a series of disappointing macroeconomic key figures from both the Eurozone, USA and Japan. Among the major countries, only Japan could come up with positive surprises and even these were moderate. For the Eurozone in particular, there was talk of quite strikingly disappointing PMI figures that are now hovering over the recession threshold of 50. As expected in previous monthly reports we are currently witnessing an extensive deceleration in industrial production, where European growth is now down 3.3 percent. The deceleration has also manifested itself in the EU commission's monthly confidence surveys, which despite a continuous fall since the start of 2018 are still too optimistic compared with both the leading indicators and the hard data for development in the Eurozone.

Despite January's disappointing macroeconomic key figures, the stock market had its best month for years. The MSCI World (in euros) rose by 7.4 percent, which is the biggest monthly return since October 2015. The developments in January have almost been characterized by the worse the figures, the better it was for the stock market. The underlying logic of this rather 'perverted'-sounding statement is founded in the fear of further tightening of monetary policy that culminated in the fourth quarter of 2018. The current market dynamic for shares is therefore marked by the fact that when macroeconomic figures indicate a slowdown in growth, it becomes less likely that we will see further tightening of monetary policy by central banks in the near future.

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The underlying premise here is that a tightening of monetary policy is worse for the stock market than a growth decline.

However, this premise is not entirely true. If the growth perspective is too gloomy and the recession moves too close it will dominate the overall picture, and not even more conciliatory tones from the central banks will be able to generate good returns for the stock market.

Was that a dead cat bounce?

As seen many times before, long-term interest rates fall on the back of bad news. So for the bond market, the growth perspective has clearly deteriorated. This is also happening at the same time as the long (5Y5Y) inflation expectations are falling sharply, which is another indication that despite historically low interest rates and the buy-back programme the central banks actually have a relatively tight monetary policy.

It worries me that European confidence survey numbers are still so high

Sometimes the stock market rises after a big fall even though the fundamental situation has not improved. In the United States, this is described as being like a cat that falls out of the window, hits the ground and then 'jumps' up again - the so-called 'dead cat bounce'. The question is whether we should see January's increase as an indication that the market is doing well again.

As mentioned above, it worries me that European confidence survey numbers are still so high. It does not seem as if there is a sufficiently realistic recognition of the coming downturn in the Eurozone and the political tensions - including Brexit - which the region is facing. With regard to the United States I am more concerned about the continued high pricing, which is likely to push long-term stock market returns down below five percent.

Comparing the above with the fact that the OECD leading indicators are still declining in both the USA and the Eurozone, and that despite a strong January, momentum in the stock market remains weak and exposed to great volatility, my best bet is that the cat is in pretty bad shape - if it is alive at all.

Expectations for interest rates and inflation

If we look at the interest rate futures market, expectations are now 10 basis points lower than Fed Funds Rate than the current one. In other words, almost 50 percent likelihood that the central bank will lower interest rates. It is not exactly big news that the futures market and the central bank have divergent views, but it has often been the rule in the current upswing that the futures market would price in further hikes 1-2 years ahead.

The current pricing, then, expresses a concern that we should not take lightly. For every passing month, the slope of the U.S. yield curve comes closer and closer to zero. In both December and January, differences in 2-year and 10-year rates have remained below 20 basis points. The last time we saw a similar difference was in 2007.

The increased volatility since October 2018 has left an impression of extremely diverging prospects for the U.S. and the Eurozone. Even after January's increase in risk appetite, interest rate expectations for the Eurozone have not materialised. They are still at the new lower levels caused by the risk aversion at the end of 2018.

The major – and expected – differences in the U.S. and Europe's monetary policies continue. The market considers Europe's situation to be increasingly hampered by structural and political problems. These are seen to be so extensive that even a very expansive monetary policy will not be able to change anything in the foreseeable future. At the same time, the spread between 'soft' and 'hard' data clearly shows that over-optimism is also greatest in Europe.

Ominous implications for the Eurozone

In my opinion, European shares will yield a slightly larger long-term return than U.S. shares due to significantly lower pricing. However, in the shorter term (1-2 years) my view is that the Eurozone's structural problems and the ECB's impotence with regard to monetary policy will be such prominent themes that both the euro and European shares will disappoint.

One of the reasons for this can still be Italy, which is now officially in recession. Both the third and fourth quarter of 2018 had negative GDP growth in the country. Although the spread between Italy and Germany's 10-year interest rates has narrowed somewhat since October-November, Italy's PMI figures are under 50. If the Italian government does not soon implement reforms that can support growth, it will be difficult to maintain any measure of optimism for Italy.

It is more likely that the biggest disappointments will come from Germany and France

Having said that, I do not think that Italy is the biggest problem for the Eurozone because its problems are both recognised and widely discussed. It is more likely that the biggest disappointments will come from Germany and France. Firstly, they are the two biggest countries in the Eurozone; and secondly, optimism continues to be greater for both of them. Bloomberg's high-frequency real time GDP growth indicator in Germany shows a very significant slowdown in growth over the past two months. The same is partly true in France, which has been hit by problems like the yellow vest demonstrations.

Brexit moves closer

Another uniquely European problem is Brexit, which will take place in one form or another when the Article 50 deadline expires at end of March. I will not even try to predict what will emerge from that chaotic process. I just expect the uncertainty surrounding Brexit might be a problem for the entire Eurozone until we get some clarification on Britain's relationship with the EU after March.

Share allocation

The regional Momentum and Volatility Indicators (MomVol) have recovered somewhat after the sharp decline in December. However, the overall indicator, which is a weighted version of the regional indicators, remains below the threshold of 0.6 that determines whether to expect strong or weak stock markets in the following month. American shares have even stronger momentum than the rest of the world.

As the OECD's leading indicator for the entire OECD area continue to decline, it is therefore still my assessment that there should be underweight shares and other risky asset classes in relation to long-term target allocation.

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