Sparinvest

Monthly comment by
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Support from the prospect of a trade agreement

The stock market continued its positive trend in February. A significant factor behind the rise in share prices has been a friendlier tone between President Donald Trump and president Xi Jinping. At the end of February, Donald Trump even cancelled a planned raise in customs duties on Chinese goods in the expectation that the trade deal negotiations could soon be satisfactorily (for him, anyway) concluded.

The stock market seems to have anticipated the benefits of less trade policy sabre-rattling but it is by no means certain that a deal can be landed. Trump is known for being unpredictable and has almost turned being unpredictable into a virtue in his negotiations. The Chinese are struggling with a weakened economy and a high debt factor. At the present time, they have absolutely no need for further punitive customs duties and more problems for their exports. Also, the size of their personal shareholdings means there are fewer people on earth – quite literally – that have a greater potential for reaping the benefits of a trade deal with Trump and his administration.

In my view, an end to the trade war between the USA and China will be announced within the next few months

Against this background, it is therefore my view that an end to the trade war between the USA and China will be announced within the next few months. For a great many, a conclusion of the trade war has already been priced in to the stock market. Clearly then, there is a risk that a deal cannot be made and the trade war actually escalates.

Weaker economies, stronger shares

January's theme continues into February. In other words, the poor macroeconomic key figures supported the stock markets as they implied that the central banks' normalization was postponed.

For the moment, one can say that the need for a postponement of the aforementioned normalization has also increased over the course of the past two months. In the Eurozone in particular, long-term inflation expectations have fallen significantly – also in February. The so-called 5Y5Y inflation swaps, which are an expression of the market's expected inflation in the Eurozone from in five years' time to ten years' time, are currently under 1.54 percent. This is far under the ECB's comfort zone and far under the level where the ECB ought to have dropped any ideas about an imminent normalization. In comparison, American 5Y5Y inflation swaps are at 2.2 percent, and these have even risen since the end of December.

The difference between inflation expectations in the USA and the Eurozone do not just cover major differences in the market's perception of the economic strength of the two regions. It also says something about the central banks' abilities to tackle the cyclical headwinds they are facing.

While the Fed has worked quite proactively throughout the whole crisis, and has tried to raise interest rates and unload the substantial bond holdings they had acquired over the following upturn, the ECB has responded reactively to developments almost as a matter of course. This has even occurred with a particularly unclear mandate – it was only Mario Draghi's statement that the ECB would do "whatever it takes" to save the euro and the EU's economic development.

Recession – yes or no?

It is crystal clear for most analysts that the Eurozone is heading for a recession. However, the ECB has only recently, and as a reaction to the rapidly falling inflation expectations, shelved plans for raising interest rates. In the short term, we have not yet seen the lowest point of economic activity, as the cycle of industrial production in both the Eurozone and the USA will probably first flatten out in a couple of months, or perhaps four. In other words, the macroeconomic data will probably continue to disappoint in the coming few months. After that, we can in fact expect a relatively rapid acceleration over the summer. This is particularly relevant for order intake for the manufacturing industry in the Eurozone and for durable consumer goods in the USA.

All in all, it does not look like we will have a recession in the near future

All in all, it does not look like we will have a recession in the near future. Although employment growth is slowing down, it is still so positive that it seems unrealistic that the European unemployment rate will start to rise significantly within the next six months. In addition, the European industrial cycle will turn and start to become a positive driver for growth over the summer of 2019, which will further strengthen the labor market.

Having said that, the confidence indicators (soft data) in the Eurozone are still too high in relation to actual development (hard data). The Eurozone's economic players are therefore going to be disappointed over the coming months, despite the industrial cycle being about to change and become a positive driver over the summer. As the disappointments pile up over the coming months, European shares can continue to limp behind the global market.

Share allocation

The regional Momentum and Volatility Indicators (MomVol) have bounced back a bit after December's strong fall in the stock market. However, the overarching indicators, which are a weighted version of the regional indicators, have risen to 0.65, which is over the threshold value that determines whether one can expect strong or weak stock markets in the following month. Only European shares had a lower score than the threshold value.

As the OECD's leading indicators for the entire OECD region continue to fall, it is still my assessment that one should be underweight shares and other risky asset classes in relation to long-term goal allocations.

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