Sparinvest

Monthly comment by Chief Strategist, David Bakkegaard Karsbøl

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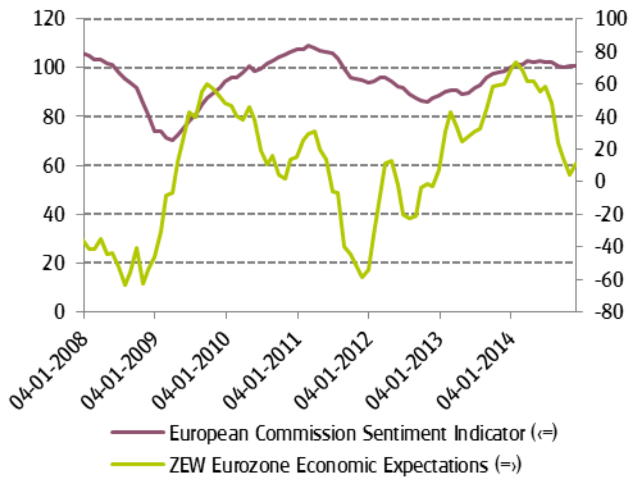
Prospect of stagnation ahead

If we look at industrial production (which is a high frequency target for economic development) and various surveys from the business community, the situation has not changed significantly from last month.

In Europe, France still lags behind, but Germany now looks to be benefitting from the weaker euro. In any case, we can now see stronger IFO and ZEW data from Germany. The overall picture is still that the Eurozone can expect something resembling economic inactivity over the coming months.

As previously discussed in the monthly report, the decline in growth is the result of over-optimism, especially in Germany, which, had produced too much over the summer in relation to demand. When reality intrudes, the result is declining production now, which also reflects in the IFO and ZEW figures for both Germany and the Eurozone as a whole.

Figure 1 – European sentiment surveys



Although we can look forward to, what resembles inactivity over the coming months, I do not expect a recession. The reason is that European companies are beginning to benefit from the weakened euro, and that the labour market is still improving. In addition, energy prices have fallen by about 30%, which is also a significant growth-supporting factor.

Deflation vs. inflation in the Eurozone

An essential factor in the development of European inflation is import prices in the manufacturing industry. These prices have fallen, especially in 2014 (by over 2%) and this has helped to drag overall inflation at European level down to the current 0.4%. Because of the weakened euro, import prices within the manufacturing industry are no longer falling so sharply, and all else being equal, this will contribute to higher inflation in the Eurozone going forward.

In addition, the money supply in the Eurozone is actually growing quite nicely. M1 money supply is now growing by 6.0% and M2 money supply by 2.7%. In fact, it is actually not that far from the ECB's long-term target of 4.5%. The ECB's big problem, of course, is that they also want an inflation rate of about 2%, which we are far from. Meanwhile, interest-rate market derived expectations suggest that inflation will remain low for several years.

These conditions may be a political problem for the ECB, but in my opinion, it is far from certain that they pose a problem for growth in Europe. The worst thing that could happen is actually that we get inflation without wage increases (ie real wage decline), as we see in Japan currently. Several leading members of the ECB have recently also pointed out that the aggressive monetary policy of the Bank of Japan only served to increase inequality by raising asset/share prices and causing the widespread erosion of Japanese real wages, while the effect on economic growth, at best, has been uncertain.

When supporters of a more aggressive monetary policy by the ECB point to the US as a good example it is, in my opinion, misleading. Monetary policy in the US has been extremely aggressive, but the fact that the economy is surging ahead (at least compared to Europe), is more due to the aggressive recapitalization of the US banking system through the Troubled Assets Relief Program and other utilities. Thus they also largely avoided the unpleasant combination of banking and sovereign debt crisis that Europe experienced in 2011-12.

When Europe therefore at present is particularly exposed to deflationary pressure, it is especially due to the fact that European banks are in the process of reducing their balance sheets to meet new regulatory requirements of Basel III agreement - including new and stricter requirements on solvency and liquidity. In other words, lending is still falling - even if the decline is slower and slower.

Moreover, one can point out that demographic developments in the Eurozone have actually peaked. Thus, seen from a consumer perspective, they are hardly going to look as good this year, as in the years leading up to the crisis of 2008-9. As the population of Europe is aging, and the proportion of people of working age in relation to 65-year-old falls, one can well imagine that the debt reduction, which started with the financial crisis, will continue for many more years. All else being equal, this will serve to dampen consumption growth and thus also inflation.

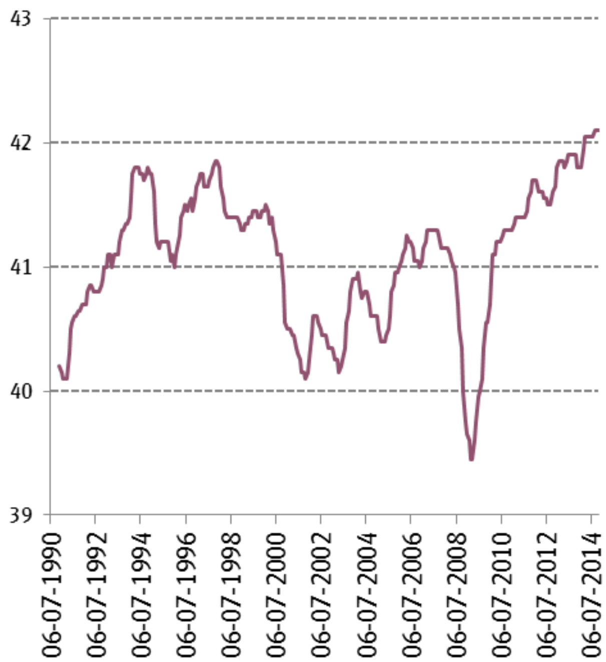
USA – looks like gradual "overheating"

If we look at the US, the situation is quite different. The difference in economic growth between the US and Europe has seldom been greater than in the period 2012-13 - and the current difference of 1.6% is also at the high end historically.

In short, things are actually going well in the United States, and one could argue that what we are seeing is, in some respects, reminiscent of an "overheating" of the US economy. I use quotation marks because the phrase in my opinion is poorly defined and misleading. If we disregard the fact that inflation is not dangerously high, there are a number of signs that the economy as a whole is characterized by strong optimism bordering on the unrealistic.

The average of working hours in the manufacturing industry has never been higher. In 2014, for the first time, they exceeded 42 hours. In addition, the average working time across all sectors is also reaching new heights. This is one of the most significant, leading indicators for the economy and the labour market, since employers receiving increased orders and feeling renewed optimism start by asking existing employees to work longer hours before they hire new ones. In addition, the number of first-time unemployed is at its lowest since a brief period in 2000.

Figure 2 – US – Average working hours in the production industry



If we look at the housing market, there are some signs of weakness (the lowest level of newly issued mortgage bonds since 2000), but if we look at the National Association of Home Builders (NAHB) expectations index, it is now at 58 - indicating a solid expansion of activities. The number of building permits granted supports these expectations.

The US economy's weakness may well prove to be the strong dollar, which makes it more difficult to sell goods - especially in Europe. The rather strong expectations in the ISM figures (several of them close to 60) will therefore probably fall closer to 50-55 (50 indicates expansion) in the coming months.

Stock markets - still showing strong momentum

The month of November has once again shown a strong momentum in the stock market. The Volatility Index (VIX) is back at around 12, and the S&P 500 has again been trading at historically high levels.

If the developed countries' markets, taken as a whole, look expensive, this is because the most expensive shares have become historically expensive, compared to the cheapest shares. If we look at the so-called 'Fama-French' data (available only for the US) and compare the average Price/Book (3.71) for the most expensive third of the market with the average Price/Book (1.09) for the cheapest third of the market, the difference quite simply has never been greater.

Although we do not have data for the rest of the developed markets, the same probably applies. Long-term investors should definitely keep this in mind. Further widening of the relative valuation gap (whether based on Price/Book, Price/capital or Price/Cash flow) will be extreme in an historical context (since 1926) and unprecedented.

Skeptics question the fact that, against the backdrop of economic inactivity in Europe in the coming months, stock markets across the board continue to rise. That is understandable, but history shows that in the short term (under 36 months) there is no correlation between GDP growth and stock market returns. In fact, there is strong evidence that high unemployment often supports equity market returns, because companies have access to abundant and cheap labour.

In the short run, the stock market is not necessarily overbought, but for long-term investors it is undoubtedly expensive. The exception may be Emerging Markets, which, as followers of my monthly report will know, I view positively. In addition, of course to value stocks, as mentioned above.

High-Yield - Looking interesting again

Back in the monthly report from June, I warned against the long-term prospects for investors in the High-Yield market. Looking at these again, they seem to have recovered. The so-called Option-Adjusted Spread between high-yield securities and government bonds has risen by 120 basis points since June.

Furthermore, both the Lending Surveys from the ECB and from the Federal Reserve show that the largest banks expect to increase lending to businesses. This will happen in competition with investors in corporate bonds, which is why the market for these bonds will be supported in the coming months.