Sparinvest

Monthly comment by
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New records in the interest rates – again

Despite the summer holiday, there is more than enough to write about. The market has not been idle but it seems as if there's more of the same, just in a more extreme way.

Last month, Denmark became the first country in history where the entire treasury yield curve became negative. However, this was due to the fact that our longest issue is the 2039 loan – a 20-year bond. Now the entire German treasury yield curve has also become negative and their longest bond expires in 2048.

In Denmark, Jyske Bank has now opened a 10-year mortgage with negative interest and 30-year 1 percent interest-only loans are very close to price 100. In Italy, the 10-year interest on government bonds has fallen from over 3.5 percent in October to under 1.5 percent.

Fear or coercion?

Normally, when interest rates fall as dramatically as they have done recently, there is a particularly unpleasant reason for it. Over 2008, German 10-year bonds fell by 1.57 percent. Over the last 12 months up to the end of July, they have fallen by 0.88 percent. In other words a fall in interest rates that is the equivalent of more than half a financial crisis.

There can be both good and not-so-good macroeconomic reasons why interest rates are currently falling so much, but in my opinion it has at least as much to do with market dynamics that are driven by the central banks' purchasing programmes and expectations of the same.

The central banks' immense purchasing programmes have had a great impact on particularly the assets that were covered by the purchasing programmes dues to the demands of liquidity and credit worthiness. The US central bank's balance has been reduced since 2014 but is still the equivalent of 17.17 percent of GDP. The figure for the Bank of England is 22.6 percent of GDP; the ECB figure is 39.9 percent and the Bank of Japan (BoJ) is up at 102.7 percent of GDP.

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The way it appears is that the ECB and BoJ have had the greatest impact. In reality, the ECB has already vacuumed the market for high quality bonds for European issuers and pushed the price up so far on them that few investors will touch them as long-term investments unless for example pension funds are forced to buy them for hedging-related or regulatory reasons.

Expectations regarding further purchasing programmes mean the market expects that the ECB will have to buy bonds from investors, who despite the poor yield prospects are reluctant to part with them. These investors will therefore have to be further compensated for parting with the bonds, and that can only happen through even higher prices.

Although there may also be reasons – as we will see below – for seeing things through pessimistic, macroeconomic glasses, the sharp fall in interest rates is probably primarily due to the fact that it is the "forced" investors that the central banks must eventually persuade to sell their remaining holdings.

The macroeconomic picture for the next 12 months is actually not that bad

There have been quite a few negative headlines about the global economy over the past few months. These have been accompanied by the lowest PMI figures for many years, especially for the manufacturing industry. Regular readers of this monthly report ought therefore not to be surprised, as I have written about a significant weakening of growth in industrial production and order intake in the manufacturing industry for several months – and this should be culminating round about now. If we look at the acceleration in industrial production, we are actually already over the worst.

The most likely scenario for the Eurozone and Japan is a continued growth in the labour market in both regions

As we head towards the new year, my models indicate that we will see a significantly stronger growth in order intake than is currently the case, particularly in the Eurozone. With regard to industrial production, even both Japan and the Eurozone will look more solid at the end of the year. Although the USA's development looks like it will be less inspiring, it should be added that the USA is already experiencing noticeably higher growth rates than the Eurozone and Japan.

My assessment is that the most likely scenario for the Eurozone and Japan is a continued growth in the labour market in both regions in the form of falling unemployment, the start of wage inflation, together with a moderate rise in consumption. The USA is more cyclically challenged because its unemployment levels are already much lower and will therefore have difficulty falling as fast as unemployment levels in the Eurozone and Japan.

The trade war can cause a currency war and higher inflation

In July there were fears that a trade war between the USA and China would flare up again. A direct market reaction is therefore to buy safe shares, particularly US government bonds. To buy these, one must first buy US dollars, which caused an upward pressure on the currency. The Chinese allowed their currency to fall further, so the Renminbi is now at its lowest level since 2008.

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While Trump might stand to gain by increasing customs duties on Chinese imports, he can lose by China's weak currency winning back their competitiveness. The trade war's logic then becomes a currency war where the world's central banks and governments devalue their currency, further lower the short rates and re-start bond buying programmes to stimulate the economies even more.

With the low unemployment rates that we are already seeing now, it will not take much to re-create wage inflation and expectations of the same. This may very well be the reason for gold prices rising over 25 percent in a year. Since February, the notoriously volatile Bitcoins have risen by 250 percent.

A "blow-off" phase for bonds?

A number of factors indicate that right now, we are in some form or other of extreme ending to a bubble in the bond market. The fact that Danish homeowners can borrow over 30 years at 1 percent interest makes no sense in a risk perspective. Also, due to their length and an assumption of fairly normal interest rate fluctuations, long bonds are a ticking time bombs without any credibility and expected profit for investors.

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Well, interest rates can go even lower and perhaps even more negative, but we have long since crossed the line where one must emphasize that in order to generate a return from the current levels, you have to find an even bigger "fool" to buy the bonds.

The risk of a sudden return to higher inflation expectations is also clearly present when monetary growth in both the U.S. and the Eurozone is on the increase after a major fall in 2017-2018 and when important retail growth has almost only risen since its fall at the beginning of the year. Current levels of growth are 3.4 percent for the United States and 2.6 percent for the Eurozone. In addition, the banking systems in both regions still appear to have relaxed lending conditions and moderate to positive expectations for loan demand.

How expensive are the stock markets?

Now more than ever, it can be tempting to remember TINA – "there is no alternative". In other words, there is no alternative to shares and high-interest bonds if one needs a long-term yield when rates are so low. There is therefore no doubt that bonds have become unattractive to the long-term investor. But how expensive are the alternatives, really?

At the start of August, MSCI World is trading at price/earnings of around 17.8, while MSCI USA is at 19.3. MSCI Europe is trading at 17.6, while MSCI Emerging Markets is only trading at 13.1. All things being equal, this is the equivalent of a so-called earnings yield (a yield percent with unchanged income) of between 5.2 percent for the USA and 7.6 percent for EM. Under all circumstances a significantly higher return than the interest on any government or mortgage bond.

Neutral allocation

The regional Momentum and Volatility indicators (MomVol) were still high at the end of July, so all things being equal we can expect a strong stock market in August. The OECD leading indicators for the entire OECD region are still falling, although at a somewhat slower tempo than earlier. There is a real possibility that we have seen the bottom in the leading indicators for the coming two to three months, which the stock market will try to meet. Against this background I recommend a neutral share allocation in the near future in relation to long-term goal allocation.

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