Sparinvest

Monthly comment by Chief Strategist, David Bakkegaard Karsbøl

January 2015

The ECB delivers the goods

At its press conference on January 22, the ECB delivered the main details of the purchase program which has been anticipated by the market to a greater and greater extent in recent months - as inflation has continuously declined and turned into deflation.

In short, we got more than we had hoped for, and more than had been priced into the market. The response was a rapid rise in both equities and bonds, combined with an increase in long-term inflation expectations, which the ECB hopes to raise to around 2% again.

The program will include purchases of covered bonds from corporate issuers and euro government bonds at a rate of initially around EUR 1,100 billion. ECB chief Mario Draghi let it be known the ECB would be willing to extend and enlarge the program, should it be needed. The acquisitions will take place from March 2014 to September 2016 and will be valued at about EUR 60 bn. per month.

The Bundesbank - which would otherwise have been the leading foot-dragging party – accepted the programs, despite the usual German resistance to anything that could lead to inflation. This was largely because of the set up whereby 80% of the credit risk of the acquisitions will be segregated, divided amongst the central banks of the individual euro countries. Nevertheless, the remaining 20% of the purchases represents an exposure to so-called "loss-sharing" – i.e. joint exposure to losses in the event that a country has to go bankrupt.

This is more of a cosmetic or symbolic representation because through the so-called TARGET2 system (which makes inter-European payments and capital flows) the Northern European countries - particularly Germany - have already advanced enormous sums to the Southern European countries. (Apparently not something that intrigues commentators and analysts.) In other words, credit risk has not been eliminated in reality - only on paper.

In my assessment, the ECB's QE program is unlikely to have any significant economic impact in itself, and the ECB would probably agree, having seen the experience of Japan. The Bank of Japan's QE program (which is significantly higher relative to Japan's GDP) has not had any noticeable effect – beyond weakening the yen.

However, where there may still be some effect from the program is on public perception. In my opinion, the formation of expectations is clearly influenced by the program - otherwise equities, bonds and expectations regarding inflation would not have risen on the back of its publication.

A lower euro will make European companies more competitive at the expense of European citizens' international consumption. At the same time, the expectations of ECB's program alone have led to considerably lower yield curves, which serve as benchmarks for investment. In other words, more investment pays off when the yield curve has been under downward pressure.

Economic upturn in store

As discussed in previous monthly reports, I expect - independently of the ECB's decision to expand its QE program - an improvement of the business cycle in Europe towards the summer. There are several reasons why we should expect such a development during the next year and possibly all the way into 2016.

Firstly, industrial production will improve as pessimism decreases. (There has been too little production, relative to demand, particularly in Europe). Secondly, the euro has weakened significantly over the past nine months, which further improves the competitiveness of European companies. Third, energy prices in many cases have almost halved over the same period, which is extremely important for Europe because as a region we import a relatively large amount of energy compared to our total production. Fourthly, interest rates have generally declined significantly to the point where they represent historical lows in most European countries. This last effect is instrumental in creating more growth, but it is probably also the weakest of the effects listed.

Figure 1 - Two factors supporting European growth

Looking at the above four factors, there is reason to expect higher growth in the Eurozone. According to Bloomberg, the majority of analysts expect a growth of around 1.1% for 2015 and 1.55% for 2016. I am considerably more optimistic, because for both years would not be surprised by a 2% growth in GDP.

American over-optimism and pessimism about Europe - but what about the EUR / USD exchange rate?

In 2014, the asset class that gave the absolute best risk-adjusted return - from a euro-denominated investor's eyes - was US equities. US equities – with dividends reinvested - rose by almost 40% since the beginning of 2014. By contrast, the return of European equities was around 6%.

A significant part of the explanation for this large difference lies in the fact that the EUR / USD has fallen by almost 20% over the period in question.

With the ECB's new QE program, the outstanding amount of government bonds will be reduced, and the current owners of government bonds will have to reinvest the proceeds. Part of the proceeds will, in all likelihood, be invested outside the EU, leading to a net sale of the euro. A contributory factor to the sharp decline in EUR / USD has therefore been the anticipation for this net sale of the euro which, in my opinion, now seems to be fully priced into the market.

As described above, I expect a recovery in the relative relationship in the economic developments in the US and Europe in favour of the latter. Moreover, the decline in EUR / USD is historically extreme. At the current price of 1.1280, the annual change in the exchange rate has only rarely been as strongly negative (-17%) as now. Only in 1985 and 1993 did the EUR / USD fall by more than 20% in one year, and in both cases, it was only by a little more and only briefly. By historical standards alone therefore, it should not be possible for the EUR / USD to fall more than 5-7% from the current level.

Greece - not what the doctor ordered!

Elections in Greece are now over and the dreaded shift to the far-left party, Syriza, materialized in abundance. The party was only two members of parliament short of obtaining an absolute majority in parliament. Fortunately, the Syriza decided to enter into a coalition with a centrist party, which is also sceptical of the EU. The two parties disagree on many issues, but are united in their criticism of the 'Troika' and its requirement for continued reforms in Greece.

Syriza's President, Alexis Tsipras, went to the polls on a number of promises that he will find it extremely difficult to keep. The promises both of higher minimum wages and higher pensions will be extremely expensive to implement, and a higher minimum wage will also be poison to an already terminally ill labour market.

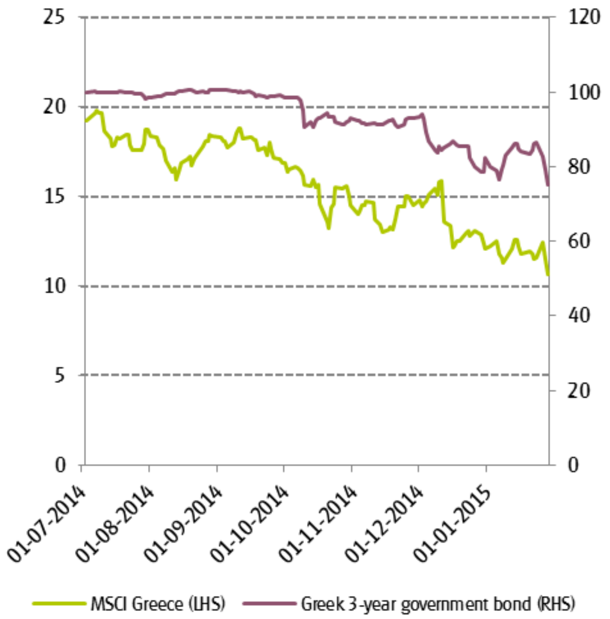
Already, the new government coalition seems to be having a hard time agreeing on anything other than stopping cuts in public spending and condemning the unyielding mentality of the Germans. The two parties simply disagree on too many things, and the coalition looks fragile.

A majority of Greeks want to remain in the euro, so Syriza will probably have to navigate away from this stated desire.

However it has already stated a desire to renegotiate the terms of repayment of the national debt. Germany's finance minister, Wolfgang Schäuble, has already flatly rejected any restructuring, but senior officials and politicians in the EU have already aired the possibility of an extension of the repayment period and a relaxation of interest rate conditions.

The market has also reacted much more calmly to Syriza's election victory than might have been feared. Investors have had time to consider the consequences of a Greek tragedy and realised that the true horror scenario is not so much the Greek tragedy in isolation as the possibility that disgruntled movements in other southern European countries will draw inspiration from Syriza's victory and any results it may obtain in the renegotiation of loan conditions with Troika.

Figure 2 - Syriza was not what the market had hoped for



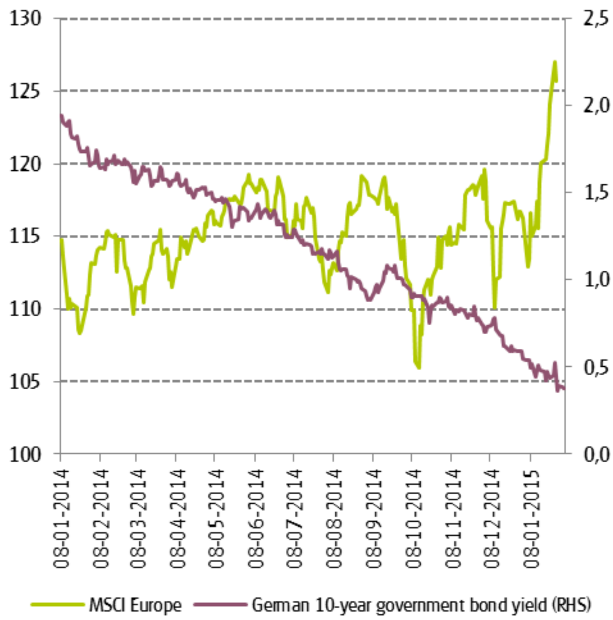
Regardless of what happens in the negotiations with the Troika, the domestic political picture is not encouraging for Greek investors. Deposits in Greek banks have fallen somewhat since 2009 and in fact have shown a slightly rising trend since 2012 where, after a decline of almost 40%, they apparently stabilised at around EUR 157 billion.

True, there is no doubt that tax collection in Greece is now much more efficient and tough than it has been in many decades (if not ever), but the many and expensive promises made in the election campaign and the threat of a return to the drachma and / or state bankruptcy with potentially catastrophic consequences for the Greek banking system, indicate that Greek savers are naive. The events in Cyprus in July 2013 threaten to be the inspiration for a solution for Greek and/or European policy makers, if a battle of wills emerges in negotiations with the Troika.

European equities ahead again

So far, the New Year has been merciful for European equities. While US indices are generally flat, the European index has risen by 5-9%. It is my opinion that 2015 will show a continuation of this trend - partly due to the relative improvement in the European economy (which apparently is not expected by the majority of analysts) and partly due to the fact that European equities are significantly more conservatively priced due to the extensive scepticism that is prevalent in European markets.

Figure 3 - Strong performance in European equities



In addition, there is a tendency for European equities to be considered more cyclical than for example the US, and they therefore should be prone to give higher returns as we see a stronger recovery in the world economy. With house prices everywhere rebounding, labour markets tightening, and both real consumption and real income growing globally at the highest rate since 2006-7, it looks more and more likely that European equities will prove to be an attractive exposure in 2015-6 – if only for their cyclical qualities.