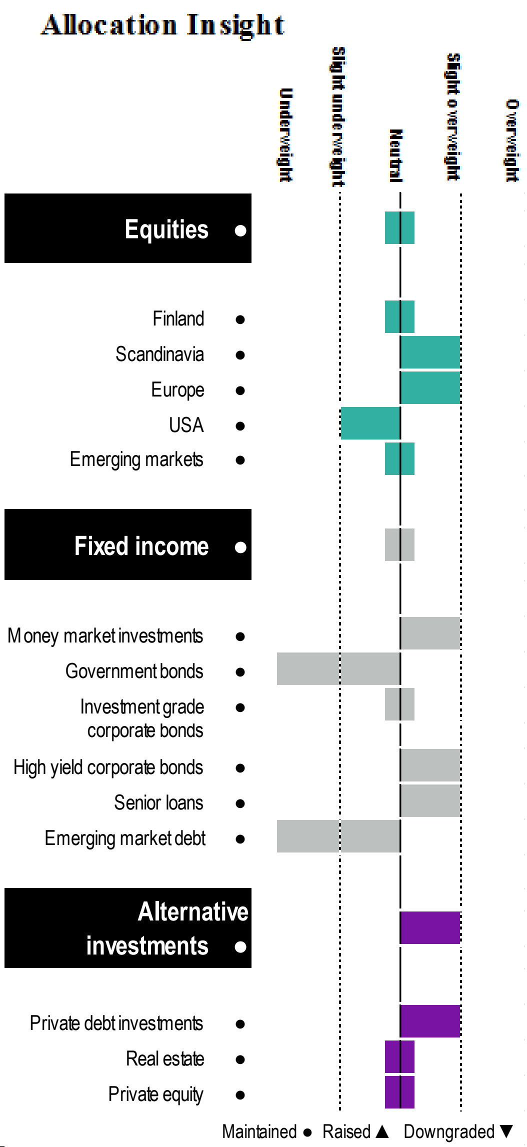
Allocation Insight

9.4.2018

Keep calm and carry on

The market volatility stemming from the interest rate environment and trade policies at the start of the year has raised questions about the duration of the economic cycle. We are thus looking into what economic theory says about economic cycles and their phases, and how the US fixed income market is currently factoring in the likelihood of a downturn. In our January Allocation Insight, we listed three market themes that we believed would significantly impact the current year's investment environment. These were 1) a rise in interest rates driven by inflation expectations, 2) the role of technology equities as a factor explaining the total return on the equity markets and 3) the very unanimous view of market parties on this year's market performance. In this review, we will return to these themes and, in light of them, analyse the first few months of the year.



Hyman Minsky is one of the most well-known researchers of economic cycles. Minsky explains the birth of an economic cycle, not based on the cyclicity of the economy, but rather on the change in the amount of debt. He describes how the change in the demand for and availability of debt enhances the cyclicity of the economy. As the economy grows, consumers and investors become more optimistic, their expectations concerning the return on projects and investments improve and they thus become more willing to increase their loan burden. At the same time, the risk assessments of lenders improve and they are ready to issue more loans, also to projects and investments which earlier would not have passed a risk analysis. Similarly, when economic growth slows down, the situation is reversed.

As the economy grows, consumers and investors become more optimistic

In his research, Minsky focused particularly on the behaviour of parties that had accumulated a large amount of debt and especially those whose debt stemmed from seeking out short-term returns. Their motive was, above all, to target the rise in investments' valuation levels (not so much cash flow) in the hopes that the escalation in value would exceed the costs paid on the debt. When debt management costs exceed the return on investments, these parties will be forced to sell. According to Minsky, this behaviour is the main reason for the birth of major economic cycles and for the fragility of the economy when growth slows down. The development path described by Minsky is important to keep in mind and helps to roughly judge whereabouts we are in the economic cycle. It does not, however, tell us at which point in the cycle the turning point will take place. To answer this question, we must look to the fixed income market.

One of the most quoted academic methods for assessing economic cycle turning points is based on the differential between long and short rates. A zero or sub-zero interest rate differential has been found, in an empirical study based on US research data, to be one of the most precise indicators of a looming downturn. In 2006, a study was published by the Fed examining interest-rate-differential-based methods and their ability to assess the likelihood of a downturn occurring over the next 12 months. The study found that using the current interest rate level as a control parameter would increase the accuracy of the predictive model based on the interest rate differential. Using the combination of these two interest rate differentials, we can see (Figure 1) that although the likelihood of a downturn in the US has risen slightly over the past year, the likelihood of a downturn is still very low. According to the model, the rising of the likelihood of a downturn over the next 12 months to more than 50% would require a significantly flatter yield curve and/or considerably tighter interest rate environment. It is, however, good to remember that the model is a simplified picture of reality.

Review of 2018 market themes

In January, we highlighted three market themes for 2018. Below is a review of how closely development corresponds with our expectations, how we have reacted to the development and an assessment of how relevant the themes will be from this point on:

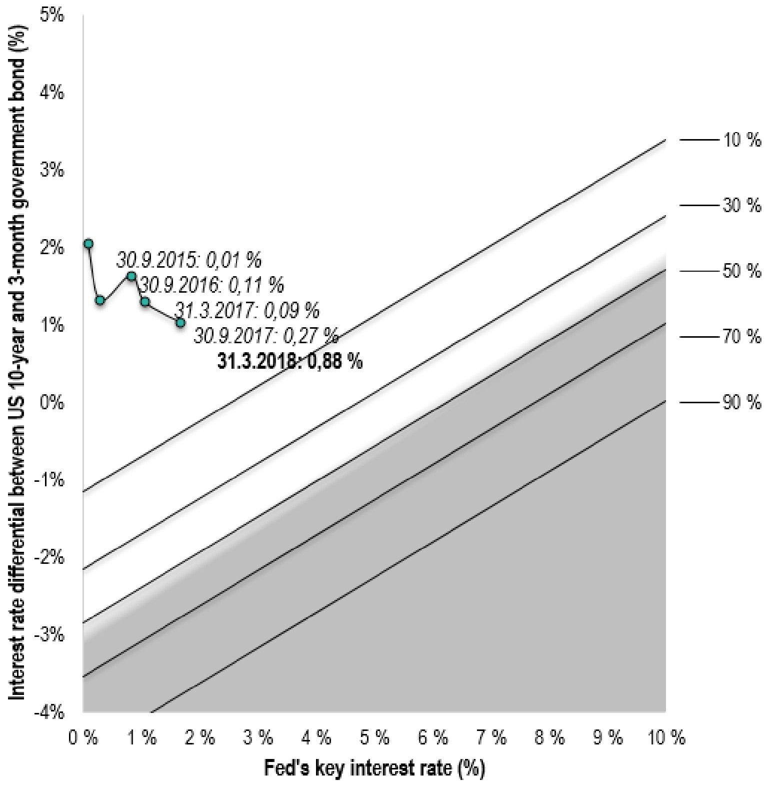


Figure 1. Likelihood of a downturn in the US over the next 12 months.

Source: Bloomberg.

1) Escalation of inflation and its impacts on the interest rate level and different asset classes.

Real inflation has remained moderate but rising inflation expectations caused market rates to rise in January-February with the US 10-year government bond peaking at 2.95%. Also in Germany, the interest rate of the 10-year bond rose, at its highest, to around 0.76%. The rise in interest rates with real inflation remaining moderate meant a rise in the real interest rate, setting off a repricing of equities in late January, which was presumably strengthened by a sales wave of various strategies based on the momentum effect. Although inflation has not accelerated to any great extent, rising inflation expectations have had similar ripple effects on the equity markets, for instance.

With real inflation remaining moderate, the markets' assessment of the timing of the tightening of central banks' monetary policies has become somewhat more cautious. Thus, February's and March's inflation expectations, and thus also the interest rate level in both the US and Europe, have fallen somewhat, partly impacted by increased uncertainty in trade politics and thus in the continuation of global economic growth.

The duration of our allocation solutions' fixed income investments is more moderate than the market index and the focus is on Nordic corporate bonds. With the interest rate level still facing moderate upward pressure, also the alternative investment asset class appears attractive. In the longer run, the expected return on fixed income investments is low, which is why we are overweighting alternatives at the cost of fixed income investments. Within alternatives, we have weighted alternative fixed income investments and real estate development projects, and made capital investments selectively.

2) Technology sector growth and earnings development.

In 2017, the stock prices of technology sector companies rose dramatically, which was responsible for most of the return on the general indices in both the US and the emerging markets. Within the technology sector, the stock price surge was driven by companies whose business models are built around the internet, such as Amazon and Netflix. The stock price surge was, however, faster than companies' earnings growth, which raised the valuation level.

This year, the strong forward momentum of technology companies seemed set to continue, but due to Facebook's data leak scandal, uncertainty increased, depressing stock prices in March (Figure 2). The markets' fear is the restriction of the use of consumer data through legislative means, which could cause difficulties for companies' current business models. Amazon faced an attack by President Trump, at least on Twitter, although, according to the White House, there are no actual plans underway to regulate the company's operations. From the start of the year, technology sector returns are just slightly higher than those of the market as a whole. The valuation levels of internet companies are still considerably high. At the same time, market uncertainty has grown over the past few months. For these reasons, among others, we have kept these companies at underweight in our allocation solutions and further reduced their share in March. The tech sector overall is, however, slightly overweight in relation to the market index.

Despite the price volatility caused by technology shares, the still relatively attractive return expectation, particularly when compared with fixed income investments, speaks in favour of making equity investments, but the valuation level of the shares is slightly above the historical average. In March, we have slightly reduced the market sensitivity of equity investments, retaining a neutral weight, however.

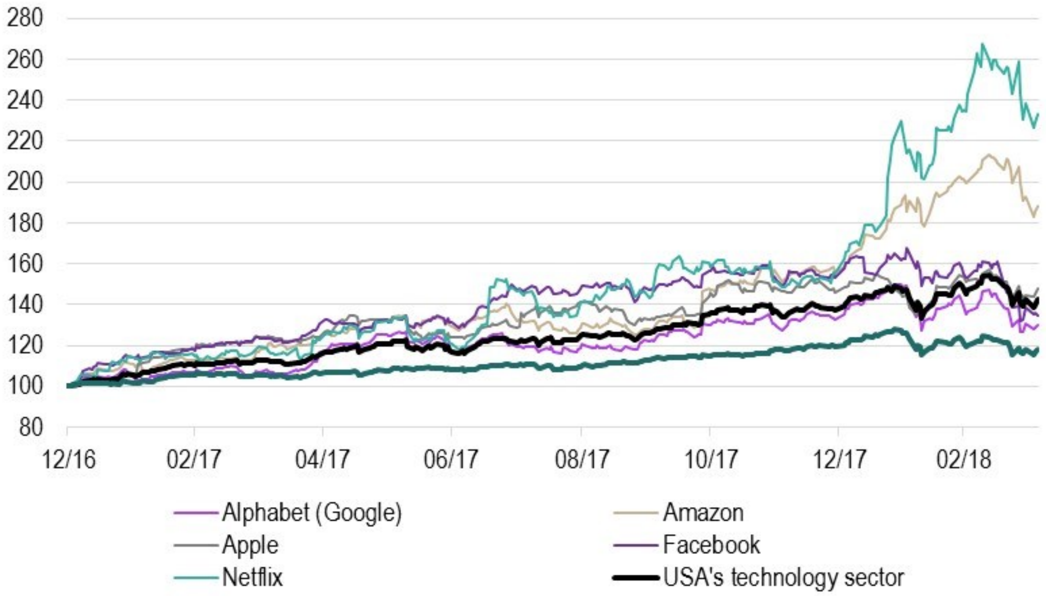


Figure 2. Performance of the general index for US technology companies and the equity market 30 Dec 2016–4 April 2018. Source: Bloomberg.

3) Investors clearly unanimous about future market development.

At the start of the year, global economic growth was expected to remain stable, the interest rate level to maintain its moderate upward trend and companies to have positive earnings growth, driven by rising net sales. As often before, unanimity has been followed by a more unstable period. Economic growth expectations remain positive but the interest rate level has seesawed more strongly than anticipated, which has affected other asset classes as well. After a few calmer years, price volatility has normalised to the long-term level, which will probably be the case for the rest of the year. Volatility on its own is not enough to explain equity returns; in the long run, changes in companies' ability to bring in earnings determine the return expectation of equities. Following the tax reform in the US, companies' earnings growth forecasts have even been raised, but after the one-time growth spurt offered by the tax reform, continuous good economic growth will be needed to maintain the earnings growth rate in the long term. The volatile market environment will require patience from investors.

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