Allocation insight

7 November 2018

Navigating the headwind

The slight upward surge in the real interest rate in September triggered October's equity market movement, just as at the beginning of the year. Once again, the interest rate movement was founded on stronger-than-expected economic figures and fears of the US economy overheating. A differentiating factor from the January-February situation is that companies' earnings forecasts are being downgraded and economic activity is becoming more moderate globally. Early on in the year, the trend in the economy and earnings forecast was quite the opposite.

Signs of slowing economic activity

Economic figures released in Europe and China in October show signs of slowing economic activity. Part of the reason is trade policy uncertainty, part of it is how the side effects of China's already slowing economic growth are impacting the country's trade partners. The United States' year-old tax reform set off a consumption and investment frenzy, but the impacts are expected to die down little by little. Corporate and consumer confidence indicators are still at a high level but have declined from their early-year figures.

Trade policy uncertainty continues, although there have been weak signs of it easing up. The volatility of emerging market currencies has diminished and their depreciation has levelled out. In Brazil, the currency has appreciated dramatically due to the election of a new president. The dollar's advancement persists as the interest rate differential continues to grow between the US and Europe. The majority achieved by US Democrats in the House of Representatives in the US mid-term elections will make it difficult to pass any new economic stimulus policies.

Interest rate differential growing between US and Europe

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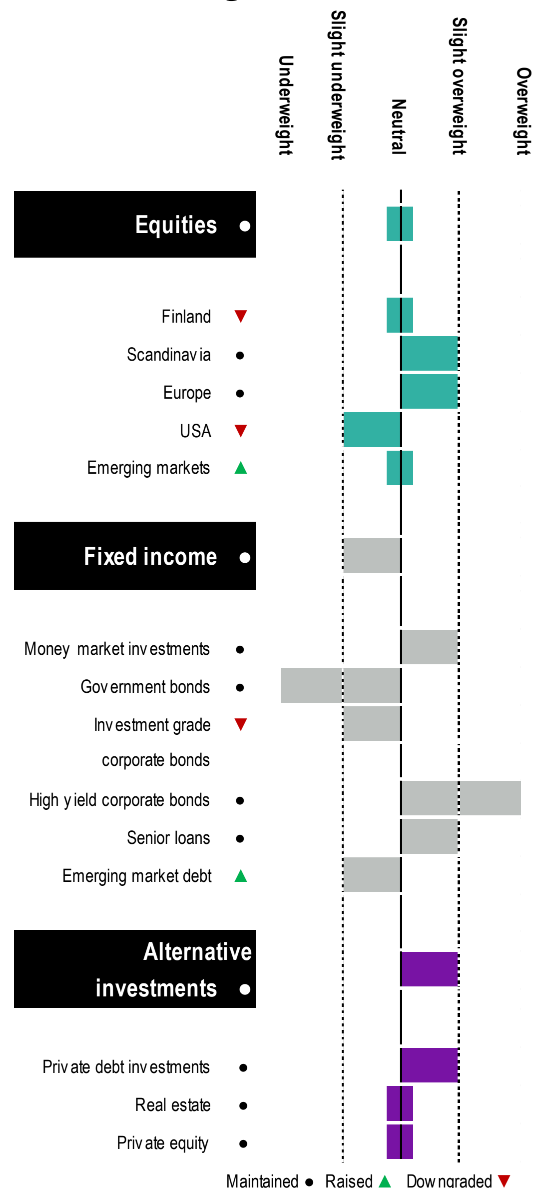

Central banks are expected to further tighten their monetary policies. In the US, labour market development is positive and pay inflation is accelerating. October's employment report provided further indications of this. The Fed is expected to implement a key interest rate hike of anywhere between 2.25 and 2.50 per cent in December, and three more in 2019. As we see it, the key investment environment risk is a too-fast tightening of the central banks' monetary policy or the wrong timing of the tightening measures. In Europe, the central bank will end its purchase programme at the turn of the year, but will maintain its current key interest rate at least until the summer of 2019. In Europe, pressure on interest rates to rise is alleviated by political uncertainty.

Real interest rate rising, continued adaptation of fixed income investments

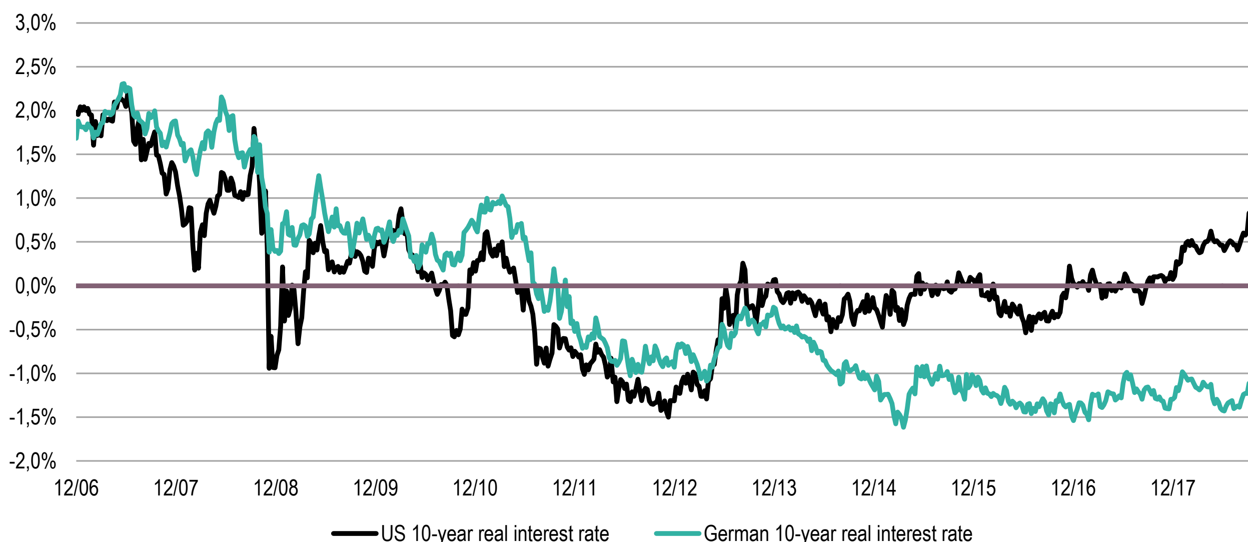

Figure 1. Development of US and German real interest rates 29 Dec. 2006–5 Nov. 2018. Source: Bloomberg.

The low or negative real interest rate encourages the use of loan money for the financing of, for example, consumption, business activities and investment operations. If the real interest rate rises, the situation is the opposite. Due to the early-year rise, the real interest rate has for the first time in seven years risen clearly above zero in the US. In September, another correction occurred (Figure 1), as a result of which liquid asset classes were re-priced. With the US continuing its monetary policy tightening, the current market movement is unlikely to remain the last one of its kind this cycle.

In October, the return on fixed income investments was in line with the market index. Additional investments made in emerging market debt during the month contributed to the positive performance. The open USD exposure of fixed income investments has been reduced further and was just under 10 per cent at the end of the month. In fixed income investments, the focus is on Nordic corporate bonds, which offer better return potential than continental Europe. The weight of higher risk high yield investments is neutral. We have been very selective in making new high yield investments. Due to the low return level, we underweight European government bonds. The interest rate risk of our fixed income investments, measured by duration, is more moderate than the market index, which we wish to use to prepare for a rise in interest rates due to a tightening central bank policy.

On the US equity market, the high index weight of the technology sector, the rising real interest rate and weakening forward-looking earnings growth encourage caution.

We continued to reduce US low-risk investment grade corporate bonds, which further reduces both the fixed income investments' foreign exchange risk and sensitivity to changes in the interest rate level. The rise in the dollar's hedging cost has clearly weakened dollar-denominated investments' attractiveness from the euro investor's perspective.

We have added some emerging market debt investments. Their return levels exceed the return levels on Western bonds. After the summer's emerging market currency turbulence, return levels have become decidedly more attractive from the euro investor's standpoint.

Falling earnings forecast trend increases uncertainty on equity markets

The Q3 earnings season exceeded expectations in both the US and Europe. Despite this, the forward-looking guidance given by companies provides a more uncertain outlook than expected for the business environment and next year's earnings power. The reasons mentioned for the fragility of the economic environment are slowing economic activity and trade policy issues. Earnings for 2019 are expected to grow but earnings growth levels will be revised downwards.

Highly-valued large technology companies have not been able to meet the high expectations. The stock prices of Apple, Amazon and Google have, like those of many other tech sector companies, fallen by an average of –15 per cent over the past month. On the emerging markets, the forward march of technology companies ended in early 2018. In the US, the technology sector has long been the driving force of the equity market, but this trend seems to be showing signs of turning (Figure 2). Although the valuation levels of technology companies and the entire equity market have become more moderate after October's market movement, the level remains higher than the historical average.

Figure 2. The price development of US technology sector companies 31 Jun 2016–5 Nov 2018 in relation to the broad S&P 500 market index. When the curve rises, technology sector companies are outperforming the market and correspondingly underperforming when it falls.
Source: Bloomberg.

The protective measure that we carried out on the US equity markets in early October using sales options was a success. Just as in our Group in general, we are taking a cautious approach to the US equity market. The high index weight of the technology sector, the rising real interest rate and weakening forward-looking earnings growth encourage caution. In October and November, we have continued to gradually reduce the share of US equities in our portfolios.

Similarly, we have increased the weight of emerging market equities in the portfolios within the limits of neutral weight. More moderate foreign exchange rate development and a low valuation level have raised the return expectations of emerging market equities to a level that is attractive, considering the risk. We have also slightly reduced the weight of Finnish equities in the portfolios. Finland's earnings season has also shown that the economic environment is more challenging than expected.

Alternative investments performed well in October

Building the portfolio has proceeded according to plan and in October the degree of investment rose as a result of capital calls. The degree of investment will rise as the existing investment commitments are called in. The value of alternative investments rose further in October, chiefly due to the positive value development of unlisted debt investments. In October, we made new commitments in the eEquity IV private equity fund and Baumont Real Estate One fund.

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