Nordic Investment Partners

Update June 2018

2018 half year pit stop

2 July 2018

Protectionism takes the scene

The bull run stopped

- Stocks declined in June as fears of a trade war rattled financial markets. Global markets declined 0.7% in $. For 2018 to date markets are mixed with US up 4% in DKK and Europe down 2% in DKK

Do not let the Smoot-Hawley ghost out

- History and protectionism is scary reading. The Smoot-Hawley Trade Act in US from June 1930 is widely credited for triggering the Great Depression. If large economies move into a trade war it would be a serious and bad diversion on the financial market roadmap

2Q 2018 reports will be good, but look for softness in forward statements

- Underlying earnings are growing nicely driven by solid economic expansion and tax reductions in US. In the upcoming 2Q reports US earnings are expected to show 18% growth and Europe to show 4% growth. If economic pace to do not change materially then 2H 2018 earnings growth in US is expected to be 16-18% and Europe at 15% growth. At 16.8x and 14.1x respective multiples valuation is neutral to modest attractive.

Slower economic pace ahead…..

- However, the risk of slower economic pace has increased. The latest PMI and ifo indicators for forward economic activity points toward 1.5-1.8% GDP growth and not 2.0% pace that is currently the consensus for Europe. And fears of a trade war will not change the mood in a positive direction

…when you look at sector moves

- Message from the market is very clear; automotive were down 10% in June as cars have been picked out in the trade war narrative. Defensive sectors such as health care and food/beverage performed well as investors shift exposures to safe heavens
- The model portfolio is up 8.2% year to date and MSCI World is up 3.0% in DKK. The June performance of -2% was impacted by automotive exposures

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The Smoot-Hawley ghost should be busted

Smoot-Hawley focused on local interests despite plead of global industrialist to avoid that path

Very few normal people know what Smoot-Hawley Tariff Act is, but most have heard of the Great Depression in 1930'ies. In 1927 the League of Nations (today's UN) stated that trade tariffs should be abolished in order for war debt and reparations to be repaid in an orderly way. Goods were the main method of repayment, but national pride and tariffs to protects own interest made protectionism was rampant. Smoot-Hawley introduced import taxes in 1930 on more than 20.000 items and in hindsight this added to the depth of the Great Depression.
https://www.britannica.com/topic/Smoot-Hawley-Tariff-Act

Good lessons from past productivity leaps

In 1920'ies tractors, trucks and automobiles replaced horses and mules and freed up 25% of US farmland previously devoted to horse and mule feed. Automation provided an enormous productivity gain but the additional agricultural production exceeded consumption which caused agricultural prices to plummet as US farmers exported their production. Back then farming was a big contribution to economic activity so the importers of cheap agricultural products reacted to protect their own farmers. And with glacial speed a global trade war developed into something we should try to avoid by all costs.

Globalization cannot be stopped without pain

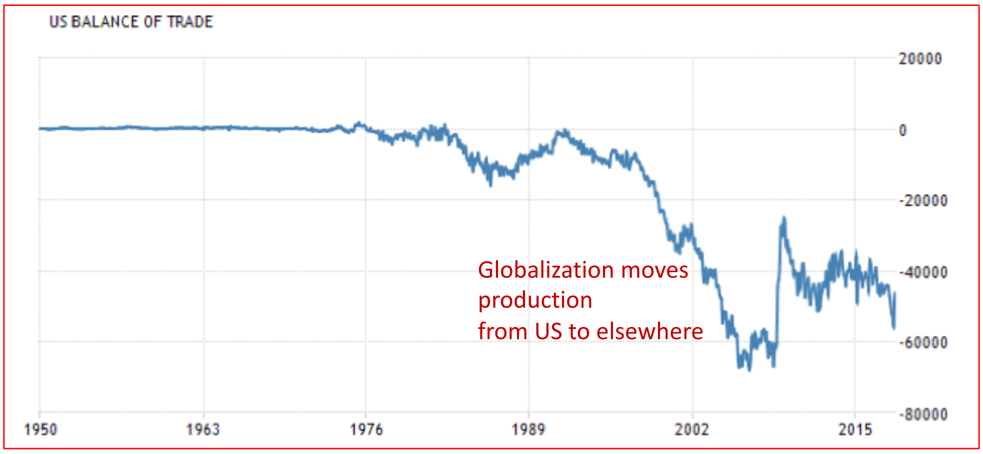
Globalization has increased productivity

Fast forward to 2010'ies and foreign trade constitute 15% of US economy vs 5% in 1930. US has been running a trade deficit for decades as US businesses moved production outside US borders (like Mexico, Japan and China) when trade barriers were removed via WTO and GATT agreements. Global value chains have revolutionized world trade, improved productivity and created a better platform for affluence for developing economies. However, the majority of the US inhabitants have been left behind measured in real disposable income. In 1975 US worker pay was 46.000 $ (inflation adjusted) and in 2016 it was 53.000 $. US is still the largest economy in the world, but vast parts of the US has been left behind – the infrastructure is crumpling and anyone using US airport infrastructure knows what it looks like. The US airport status become especially visible when you compare with regional airports in China or the airports in the Middle East.

US runs an unsustainable government budget deficit as I've mentioned before, but if you think you can fix the imbalances by import tariffs you should read the history books.

US trade deficit developed while US businesses moved production to cheaper production regions and imported their goods back into US

US trade deficit – million US$ per month



The productive road forward would be paved with measures that make US competitive again i.e. making it attractive to manufacture in US rather than in low cost regions. There are several hurdles on that road however such as US consumers want cheap goods and next generation manufacturing is automated and hence brings fewer jobs. Consequently, a more competitive US will take time to build and a quick fix with trade barriers is not the road forward.

Trade war increase risk of recession

A full blown global trade war would likely shave 0.5-2.0% of global economic activity and make many products much more expensive. This would force consumers and businesses to seriously consider their spending and likely reduce the total flow of goods. Some industries such as tech and automotive would face troubling disruption to their 'just in time' production platforms, which could cause shortage of goods and much higher prices for smartphones and cars.

EM manufacturing hubs are discounting trouble ahead

Emerging market stocks are down 5% in 2018 and China is down 20% from the peak in January 2018, so financial markets have started to discount a trade war. It's difficult to quantify how much a trade war would impact stocks, however in periods of turmoil stocks decline 10-20% from peak and in worst cases they slump 50%. So summer 2018 will be following the news flow and hope politicians are rational people.

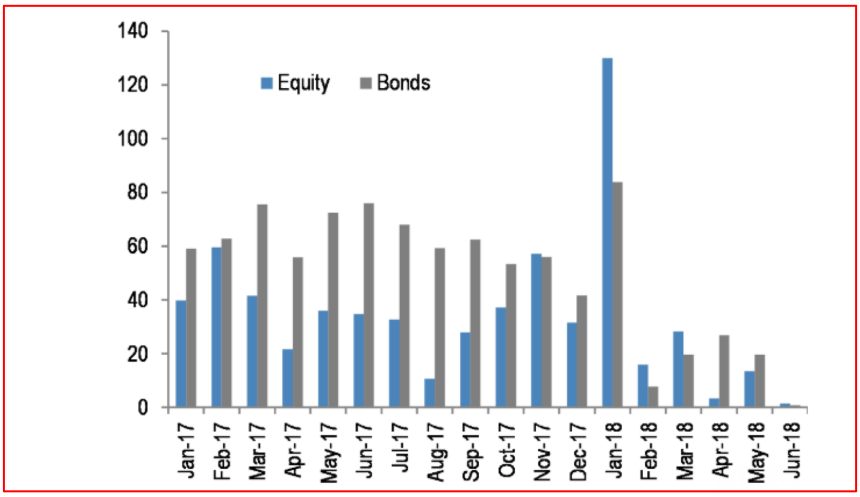
Trade war is a really bad cocktail, which Smoot-Hawley clearly showed

Flow of investment money – keeping the powder dry

After a strong January 2018 markets ran into higher volatility driven by higher interest rates in US. That experience has caused investors to step to the sidelines as seen in the chart below. The amount of cash on the sidelines put a firm holding hand below current markets if and when the trade war issue is sorted out.

Flow on investment capital per month in US$

Capital is being parked on the sidelines



Pit-stop and checking the main drivers

GDP growth and inflation on track

When I outlined my roadmap for 2018 it was for 3-4% global GDP growth, modest inflation, higher interest rates and energy prices. That mixture would translate into 10% higher earnings and consequently a decent 10% return for equities.

Almost half way in 2018 its clear that GDP growth and inflation goes as forecasted and the same for interest rates in US and energy prices have been strong. Higher European rates is forecasted from September 2018 when ECB scales down its quantitative easing program.

Earnings are up nicely in 2018, but stock have returned zero

So, you can say from the macro factor perspective the roadmap works as planned. Earnings have been better than expected and mainly driven by lower corporate taxes in US. Given that fact it’s interesting to note that stock market returns are around zero in board terms. China is down 20% from 2018 peak and US is up 2% and for sectors Energy has been strong, while automotive and banks have been weak

My interpretation of the moves are simply that investors have become more cautious due to the volatile political narrative as well as the surprising negative moves in February and March 2018.

July is 2Q 2018 reporting month for a lot of companies and hence we will have more evidence of the real drivers for stocks in the coming weeks. US should show 18% growth and Europe 4% growth, but the words about the coming quarters will be weighed and analyzed to detect weakness or confirmation of slower economic activity.

Stay tuned !

Performance, earnings growth and P/E 2018

Sector performances (local currency)						
		2018	Last month	3 year growth rate	P/E18	PEG ratio
	Auto	-4,5%	-2,7%	5%	7,7	154
	Banks	-4,0%	-3,0%	7%	12,0	171
	Food/beverage	-6,0%	4,4%	8%	17,1	214
	Healthcare	2,3%	0,4%	10%	15,3	151
	Oil/gas	6,0%	0,1%	25%	17,9	72
	Retail (incl Amazon)	18,3%	4,0%	11%	21,2	193
	Tech	9,7%	-2,9%	11%	18,3	166
	S&P500	1,7%	-0,6%	8%	16,8	210
	Auto	-10,9%	-9,9%	5%	7,1	142
	Banks	-10,0%	-2,6%	7%	9,9	141
	Food/beverage	-2,7%	1,2%	6%	18,8	313
	Healthcare	-0,7%	-0,4%	5%	15,9	318
	Oil/gas	9,9%	-0,8%	14%	12,4	89
	Retail	6,9%	1,5%	4%	18,0	450
	Tech	6,8%	-0,9%	9%	23,7	263
	Stoxx 600	-2,4%	-1,8%	6%	14,1	235