The market and the economy in 2017

by Chief Investment Officer Finn Øystein Bergh

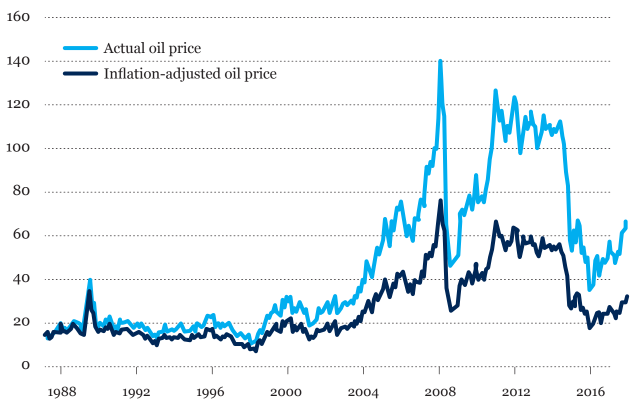
For much of 2017 the securities markets exhibited what seemed to be a stubborn sense of optimism. As has so often been the case in the past, the reasons for this became clearer as the year progressed.

In retrospect, 2017 seemed almost like a Kinder Surprise Egg: the oil price continued to rise, following a substantial increase on the low point reached in 2016. Market rates of interest remained more or less static in the wake of a modest rise before the year started and three increases in the US key rate. And stock markets worldwide surged, in some countries topping 20 per cent.

Not a return to the oil prices of yore, after all?

Brent Blend, price for immediate delivery in dollars per barrel.
Source: FactSet

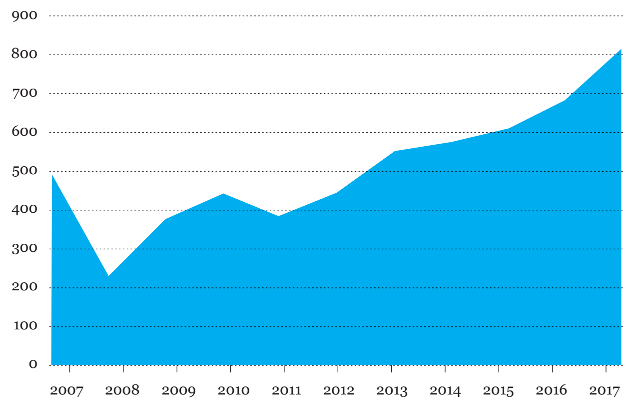
The true oil price remains moderate



Oil price (Brent Blend), price for immediate delivery adjusted for US inflation.
Source: FactSet, US Bureau of Labor Statistics, Pareto

Furthermore, the upturn was remarkably even. Whereas the preceding year had started with a major downturn, 2017 was mercifully free of substantial corrections. By the end of the year, the MSCI World index had been climbing continuously for 14 months. This had not been seen since the launch of the index on New Year's

What a recovery!

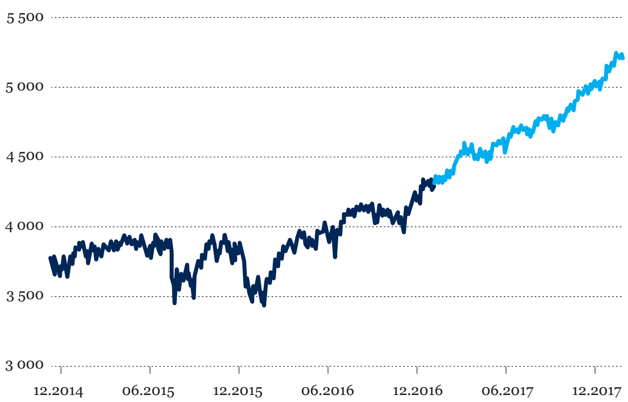


Oslo Børs Benchmark Index (OSEBX) listing at year end
Source: oslobors.no

Eve 1969.

Economic growth now also picked up globally. For the first time for many years we saw concurrent revivals in all the major economic areas of the world. But why was this happening now, after so many years of stimulatory measures in the wake of the financial crisis? And why had the stock market had so many prosperous and relatively

A remarkably steady rise



S&P 500 Total Return
Source: FactSet

stable years in the interim?

In fact, there is a logical connection here.

The interest rate nudge

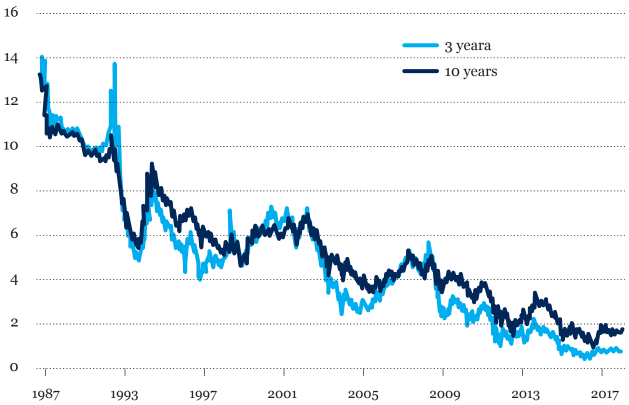
Let's start with a roundup of the last few years. The expansive monetary policy pursued in the aftermath of the financial crisis is a case for the history books. The central banks of the United States, Europe and Japan alone stockpiled securities, largely government bonds, to a value of over 10,000 billion dollars.

The US Federal Reserve ended its large-scale bond buying spree in the autumn of 2014, but thus far we have seen no significant reversal, beyond the absence of adjustment for redeemed bonds. And this was more than compensated for by the ECB and the Bank of Japan in further large-scale purchases.

The rationale may appear simple: the main impact of the key rates of central banks is on short-term interest rates, that is to say interest on papers with short durations. Purchasing bonds with long maturities also allows long-term interest rates to be influenced. This pushes prices upwards and the yield downwards.

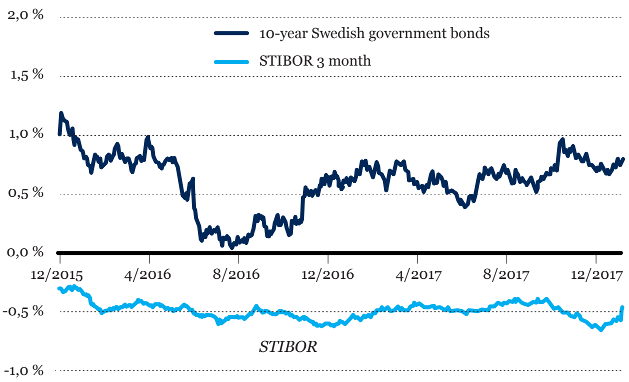
The United States, which was first out of the starting blocks, was able to get the 10-year bond yield down from around four per cent before the financial crisis to 1.4 per cent in the summer of 2016. In Europe, the starting point was higher still, and the lowest yield level was below zero. By the start of 2017, these rates had risen to approximately 2.4 per cent and 0.2 per cent. One year later, the US 10-year bond yield remained more or less unchanged, while the European 10-year bond

Hovering above the lowest point



Yield to maturity for different maturities of Norwegian government bonds, percentages
Source: Norges Bank

Money remains cheap in Sweden



Yield, percentages
Source: riksbanken.se

yield had inched upwards to 0.4 per cent.
This did not suffice, however. In the years following the financial crisis, in fact well into 2017, it was remarkable how slowly growth resumed. Certainly, the financial markets could be influenced, but the real economy responded abnormally sluggishly. Weak bank balances and recapitalisation requirements did not seem to provide a complete explanation.

Something was missing.

Spring awakening for risk capital

When in March 2016 the ECB announced that it intended to purchase corporate bonds, the measures began to approach the type of capital that means most to the investment decisions of companies: risk capital. The credit premium or spread, that is to say the interest-rate premium on corporate bonds over and above presumably safer government bonds, responded immediately.

After a nervous start to the year, the premium for Markit's European Crossover Index (combination of credit ratings), for example, had come within a whisker of 500 basis points, in other words five percentage points. February ended at 408 basis points, 2016 ended at 288 basis points and 2017 ended at just 232 basis points. Higher-risk bonds experienced an even steeper decline in credit premiums.

In other words, and this is an important point: during the course of a relatively short period of time, risk capital had become much cheaper. The price had been falling up until 2014 and then increasing up until the turning point in the spring of 2016, but already at the start of 2017 the credit premium was at its lowest level since the financial crisis. It continued to fall throughout the year.

While prices in the secondary market react instantly, it takes time for the primary market to respond. In 2017, however, the primary market loosened up in a big way.

The Nordic market for high-yield bonds set a new record with issues of new bonds to a value of over NOK 120 billion, and the biggest US corporations broke all previous issue records.

In the case of the Nordic countries, some of this growth can undoubtedly be attributed to the development of the market, but the response must be said to have followed the economic laws of gravity: when risk capital gets much cheaper, companies want to find more.

Cautiousness on the stock market

The picture would not be complete without adding that some central banks also purchased shares. Volumes were modest, however. For the stock market, the low interest rates were far and away the most important factor.

This because, obviously, lower interest rates played a part in the higher pricing of shares, as they also did in the case of real property. The fact is, however, that the stock market hesitated in following up the interest-rate reduction. Lower interest rates provide scope for pricing shares higher, but the market failed to fill the entire gap created by the reduction in interest rates. This was at least the case at the outset of 2017, and it is likely to have been the case at the end of 2017. As usual, the best statistics come from the United States, where the earnings yield long went hand in hand with long-term interest rates: earnings relative to share values rose and fell in line with long-term interest rates, typically with a slight lead (six weeks). This means that profits yielded returns on share values in more or less the same way as the effective rate of interest yielded returns on long government bonds.

In the 2000s they parted company. The stock market no longer had the courage to follow the same path as the fixed-income market, giving rise to a special share premium. This peaked four years after the collapse of Lehman Brothers at just under six percentage points. Something similar happened here in Norway. Prior to the financial crisis this share premium amounted to some four percentage points. In the years since, the average has been six percentage points. In other words, investors in equities have been somewhat uncertain and have put in place a larger safety margin. They have perceived interest rates to be artificially low, or at least have acted accordingly.

In 2017, we saw this margin shrink slightly, both here in Norway and abroad. In part, this was due to higher growth, globally and, not least, in Europe. In part, the stock market undoubtedly struggled to resist the gravitational force of record low rates of interest, given the difficulty of finding satisfactory returns elsewhere when interest rates are this low.

Nevertheless, measured in this way the share premium is well above its historical average level. This is an incomplete but nevertheless important explanation of why the market has exhibited so little volatility in recent years. The safety margin has quite simply been fairly wide relative to fixed-income investments.

It might perhaps be more correct to say that too many analyses have compared key figures such as P/E today with P/E in the past (and from this perspective the market has appeared to be more expensive). In practice, investors are more likely to compare share investments today with alternative forms of investment today. This comparison has favoured shares – by a comfortable margin.

This at least is the way things have been until now.

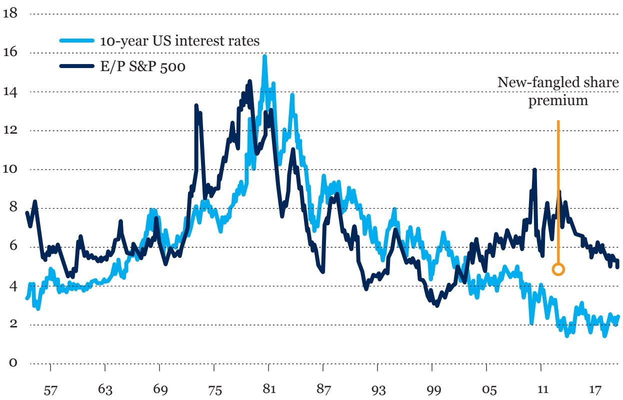
Lower cost of equity

Note the way in which this chain of effects demonstrates the limitations of monetary policy. Low key interest rates meant low rates of interest at the short end. Large-scale bond purchases brought about low interest rates at the long end. But in the case of shares, which, in technical terms, are securities with even longer durations than the longest bonds, the story was not quite so simple.

Put slightly differently: a substantial reduction in the price of debt capital was achieved, at least as far as debt capital with a modest credit risk was concerned. It took far longer to get the price of equity down – which is in reality a function of the pricing of the shares on the stock market, where the authorities have limited influence.

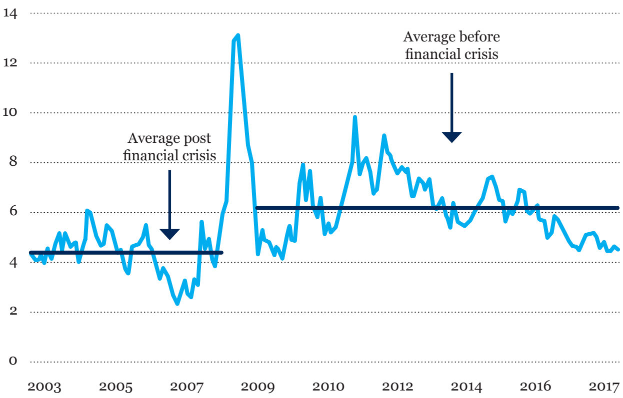
Similarly – and this is not unrelated to developments on the stock market – it took time to reduce the price of debt capital with a higher credit risk. Here too monetary policy proved less effective.
In 2017, we finally saw promising movement on both fronts. At the

Mind the gap!



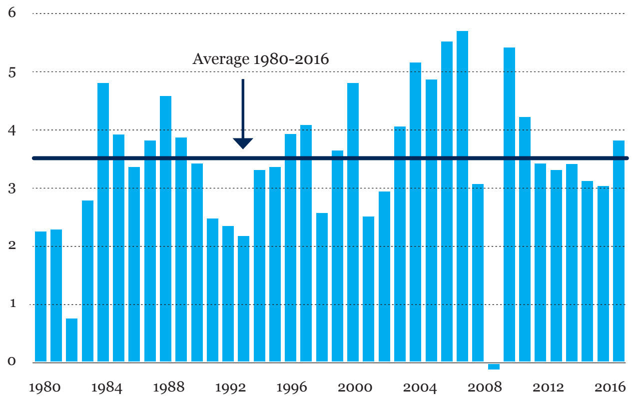
Yield on 10-year US government bonds and earnings yield on S&P 500.
Source: FactSet, Pareto Asset Management

Safety margin on Norwegian shares



Difference in percentage points between the forward earnings yield on the stock market and the yield on 10-year government bonds. Source: FactSet, Norges Bank.

At last, higher global growth



Percentage growth in global GDP
Source: IMF

same time, we witnessed increasing and unusually synchronised economic growth. For the first time in several years the International Monetary Fund adjusted its growth forecast upwards. The IMF now estimates that the world economy grew by 3.7 per cent in 2017, compared to the 3.4 per cent forecast just over one year earlier.

Estimates for 2018, a healthy 3.9 per cent, have also been impacted by the decision to cut taxes in the US, although the decision came too late to have had a marked effect on the real economy in 2017.

Monetary policy hits the spot

The transmission mechanism explains how monetary policy is affecting aggregate demand in the economy and, accordingly, growth. Normally, the thinking is that lower interest rates work by stimulating higher investment and reduced levels of savings. In the individual country, there may also be an indirect effect in the form of a weakening of the local currency.

Less attention has been devoted to the prices of risk capital, not least equity capital. There has been no clear acknowledgement of the fact that, in reality, the stock market defines the price of the equity capital.

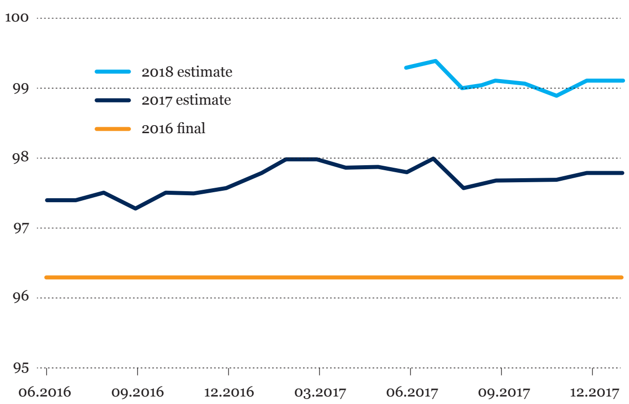
But perhaps developments in 2017 could do something about that? This year, the stimuli reached further out along the risk scale, thereby giving economic growth a small boost.

Two statistics from the IMF provide an illustration of this: In April 2016, immediately after the ECB announced that it too would be purchasing corporate bonds, the IMF forecast that investments in 2017 would constitute less than 20 per cent of GDP in the euro zone. By October 2017, investments had been adjusted upwards to over 20.6 (of a slightly higher GDP). This has provided a healthy stimulus to growth. Add the multiplier effect and it becomes clear that the price of risk capital – both shares and corporate bonds – might be just as interesting as the price of government bonds.

The oil price is high, notwithstanding elastic supply

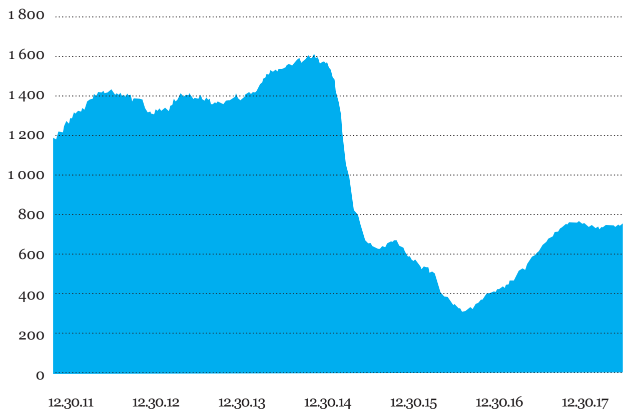
This price rise stands out even more clearly as a sign of strength when the speed with which oil output in the US now responds to higher

Stagnating oil optimism



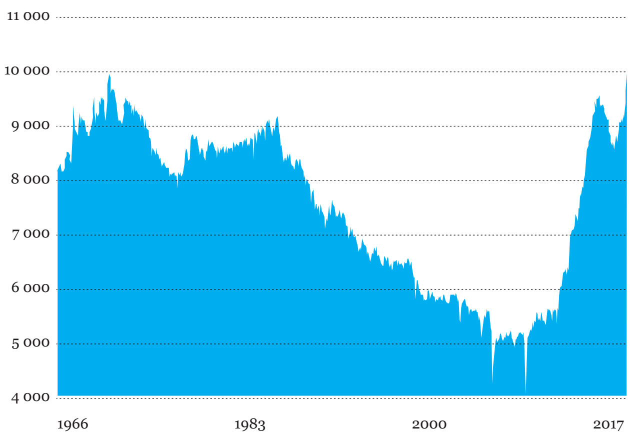
Global demand for oil in millions of barrels per day, estimates at various times.
Source: IEA

Reaction to the oil price



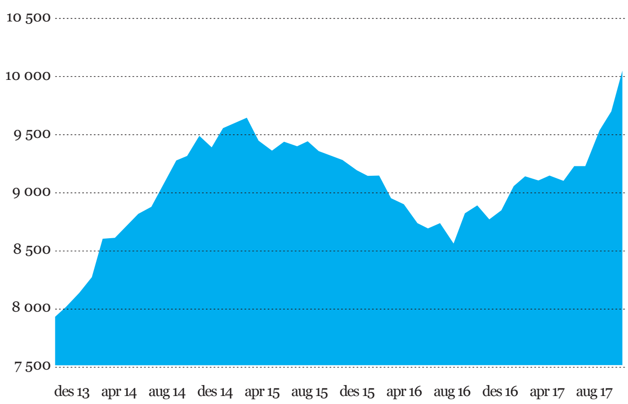
Active oil rigs in the US according to the Baker Hughes rig count

A return to the peaks of yore ...



US oil production in thousands of barrels per day
Source: US Energy Information Administration

... after a temporary dip



US oil production in thousands of barrels per day
Source: US Energy Information Administration

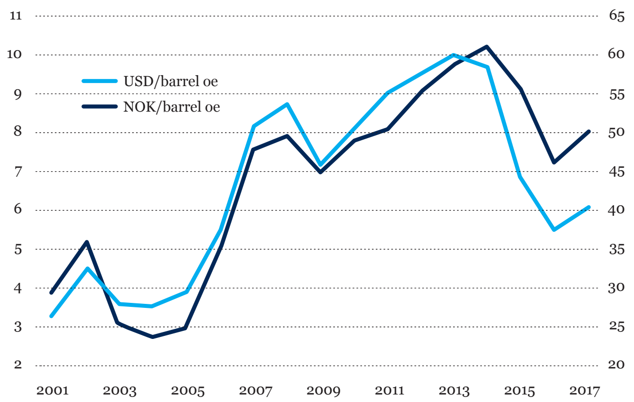
prices is taken into account. Many smaller shale oil fields come on stream rapidly when the oil price so permits and regular rig counts show that supply is clearly elastic.

Note that current oil prices do not necessarily reflect the prices provided for in the contracts of the petroleum companies. In Statoil's case, the average price in 2017 was approximately 54 dollars a barrel. Even so, the company was able to triple its adjusted operating profit, which tells us two things: that over the last few years Statoil has managed to cut costs dramatically and that profits are in any event extremely sensitive to the oil price.

Prices halved

For Statoil's subcontractors, the road back to profitability has been longer. While the cost cuts in our domestic petroleum giant worked their way through the system, the suppliers bore the burden of

The end of deflation on the Continental Shelf?



Statoil's operating costs (including sales and admin. expenses) per barrel of oil equivalents. Source: Pareto Securities

In the recovery position

Oslo Børs Oil Service Index remained more or less flat during a year in which the stock market generally climbed. Source: oslobors.no

compensating for the stringent price cuts.
This situation has been apparent on the stock market ever since the oil price started to slide in 2014. It has taken substantially longer for the situation to manifest itself in the national accounts, however. Nor is it visible at first glance.
If you search the website of Statistics Norway for the gross product for "service activities incidental to oil and gas", you might easily come to the conclusion that 2017 was an unproblematical year. Admittedly, the gross product of the industry continued to decline, but this drop was down from 15.1 per cent in 2016 to a more modest 5.5 per cent in 2017.

In this case, however, it is entirely accurate to say that the statistics are lying. When Statistics Norway calculates the "true" development in gross product, it adjusts for price growth. Or, in this case, price reduction. And the reduction has been dramatic – the 2017 statistics conceal a price drop of 49.9 per cent! In other words, the invoiced amounts have been more than halved – half price at a lower volume.

This adjustment reflects the price of delivered contracts. In the case of agreements entered into, the price reduction obviously occurred earlier, and would be discounted on the stock exchange as soon as it becomes known – or expected. This is why the full extent of the gravity of the situation for the industry is only now becoming apparent. If, that is, the situation can be said to have become apparent given that the price reduction does not show up in the usual GDP figures.

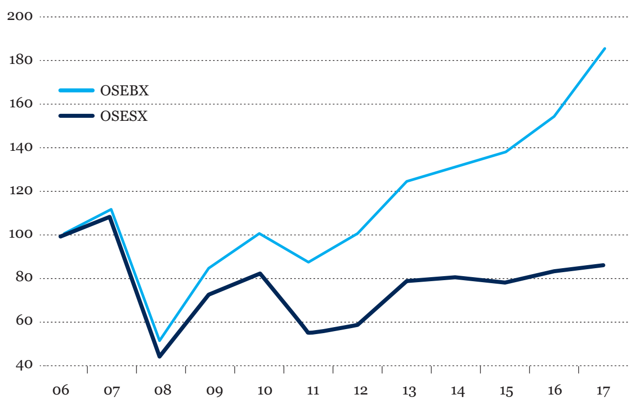
With numbers like this it is perhaps hardly surprising that the Oslo Børs Oil Service Index struggled to keep pace with an otherwise lively stock market. Or that smaller shares generally struggled to keep up. Some smaller oil service companies, at least, struggled badly.

In any event, the worst part should be behind us now.

The NOK remains weak

The oil price rise notwithstanding, the NOK exchange rate remained consistently low. Part of the reason was in all likelihood that house prices started to fail. The reduction was modest and largely confined to the Oslo area, but when Statistics Norway, for example, reports

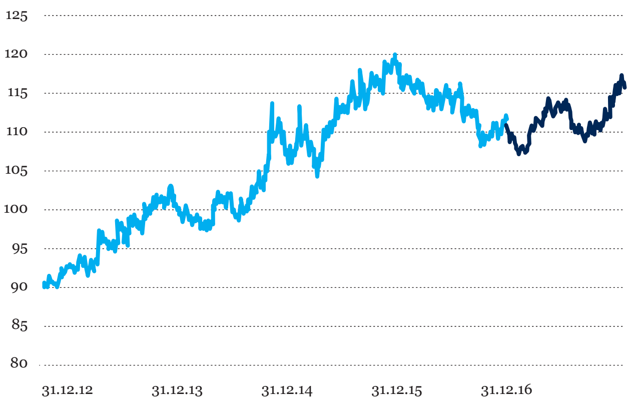
A tale of two stock markets



Dramatic underperformance by SMBs on Oslo Børs (OSESX) Source: oslobors.no

a downturn in prices in the region between the second and third quarters of 3.6 per cent, the psychology of the market is affected. Suddenly, the imminent collapse of the housing market seemed much more likely. And, with that, many players started to adjust their

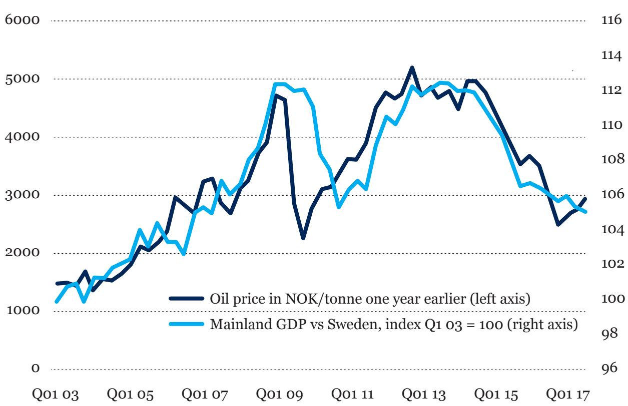
Further weakening



Trade-weighted exchange rate. Higher figures indicate weaker NOK.
Source: Norges Bank

expectations of the interest rate curve, downwards.
In all probability, the downward movement of the housing market was partially occasioned by new mortgage regulations introduced at the start of 2017. They imposed stricter requirements on the collateral required, not least in the case of secondary housing – in other words, buy-to-let properties. And the primary target of the legislation was the area around the capital city, precisely the part of Norway in which housing prices had increased most. Seen from this perspective, the legislation was both well targeted and effective.

Oil-fired heating on the mainland



Sources: Pareto, SCB, Statistics Norway

For the Norwegian economy, the weak krone proved to be helpful in a situation in which housing investments seemed less likely to replace oil investment as the engine of the economy. Provisional figures show a growth in GDP of 1.8 per cent both in the mainland economy and in the country as a whole. This is satisfactory, but somewhat below the probable trend GDP growth.

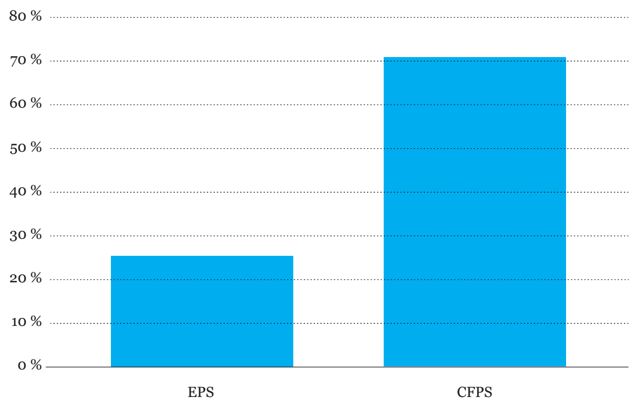
Our calculations show that the mainland economy is no less dependent upon the oil industry now than in the past. A comparison between the mainland economy and the Swedish economy reveals that the relative development continues to coincide with movements in the oil price. When the price of oil rises, the Norwegian mainland economy performs better relative to the Swedish economy, and vice versa – even if, as noted above, the oil sector is not included.

Statistics Norway does not as yet present figures for "exports" from the mainland economy to the oil sector. Nevertheless, our figures show clearly how the rest of the Norwegian economy too is influenced by what, in economic terms, is our most important industry.

The ghost train in the tunnel

At the outset of 2018 concerns are concentrated on two related factors: will a higher rate of inflation force interest rates upwards?

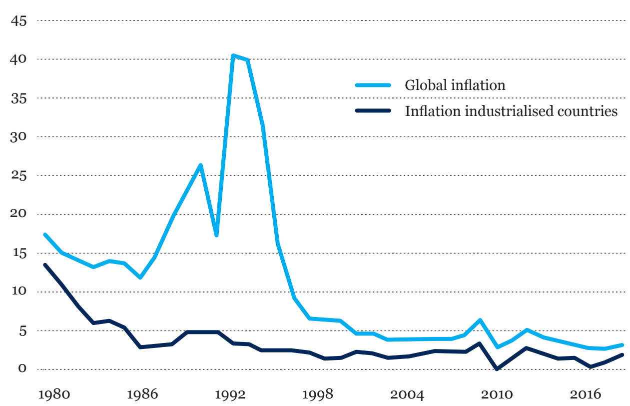
It generates more cash



Increase 2007-2017 in earnings per share and cash flow per share on the OSEBX.
Source: FactSet, Pareto Asset Management

And is the stock market becoming overpriced?
Both causes for concern are understandable. Nominally, shares are priced higher than in the past, and the healthy safety margins of the last few years have become narrower. Were interest rates to rise by more than a symbolic amount, the remaining safety margin might well be eroded fairly quickly. After all, a high growth rate in a situation of high capacity utilisation, in other words low unemployment, is

Inflation on the rise?



Source: IMF

traditionally associated with a tendency towards rising prices. This is not an arena for forecasts. Even so, it does afford an opportunity to remind ourselves that, viewed in isolation, key figures never provide the entire answer. If, for example, the rise in P/E on Oslo Børs is a cause for concern, it might be useful to bear in mind that cash flow per share has increased faster than earnings. Or that the P/B ratio, share price relative to book equity per share, is still well below the levels that in the past have signalled a downturn.

Likewise, there are many arguments in favour of the view that lower unemployment is no longer as inflationary as in the past, ranging from technological development to the globalisation of skills. A banal but illustrative example is the ease with which technical drawings in pdf-files can be exchanged and discussed by e-mail. Moreover, many years of low inflation have left an imprint on the way in which inflation expectations are formed and incorporated.

It is difficult to visualise a reversal that does not originate in the stock market or is also triggered there, and by this I mean a major reversal. Assessed rationally, the margin of safety afforded by shares is still so high, and the opportunity cost so low, that the likelihood of a reversal of this order seems modest.

On the other hand, the risk picture has changed. If the margin of safety has also provided a buffer against volatility, it must be noted that this buffer is smaller than it has been over the last six or seven years. And even though uncertainty attaches to the amount by which interest rates will or can be changed, at the outset of 2018 it seems likely that the direction is obvious: the interest rate curve is pointing upwards. This suggests that the market is now more vulnerable to corrections and higher volatility. We may have to prepare ourselves for more turbulence.

That being sad, restless markets are virtually the norm. The last few years have been abnormally stable and sound. Greater unrest would actually be in the nature of the market – and offers rewards. In the longer term, that reward is usually bountiful.

2017 in a nutshell

OSEBX	+19.1%
S&P 500 return	+21.8%
MSCI World net (USD)	+22.4%
3-month NIBOR	from 1.17 to 0.81%
3-month STIBOR	from -0.59 to -0.47%
10-year Norwegian Treasury	from 1.70 to 1.65%
10-year Swedish Treasury	from 0.55 to 0.78%
10-year US Treasury	from 2.44 to 2.41%
Brent Blend	from USD 56.82 to USD 66.87
USD/NOK	from 8.62 to 8.21
EUR/NOK	from 9.09 to 9.84
GDP growth, global	3.7%
GDP growth, Norway	1.8%
GDP growth Sweden	2.4%
GDP growth, Mainland Norway	1.8%

Sources: Oslo Børs, S&P Dow Jones Indices, MSCI, Norges Bank, FactSet, IMF, Statistics Norway, SCB, Riksbanken, Pareto.