Pareto

The market and the economy in 2013

Globally, growth estimates were adjusted downwards. In Norway, warnings that the good times were over became increasingly more urgent. All the while the stock market rose to new all-time highs. In other words, 2013 was just another normal year.

There will always be something to worry about. A recurring concern this year was the fear of weaker global growth, generally accompanied by references to higher property prices and speculative lending in China. When the IMF presented its usual autumn World Economic Outlook in October, the estimates for 2013 were adjusted downwards for the sixth time running – accompanied by warnings about the many things that could go wrong. The estimates for 2014 were also adjusted downwards, for the third time out of a total of three.

In the meantime, the MSCI World Index rose to new all-time highs. Measured in local currency, the index recorded a return of almost 30 per cent, its best performance since 1986.

Here in Norway concern about the growth of the Norwegian economy was increasing. Not only was it becoming increasingly more obvious that growth in the mainland economy would suffer as a consequence of weaker impulses from the petroleum sector; it was also very apparent that the wage costs shouldered by Norwegian business and industry had raced past the levels borne by our trading partners. Nor could any help be expected from housing investments, quite the contrary. During the course of the year, the forecasts for the Norwegian economy were adjusted downwards by a significant amount.

In the meantime, the Oslo Børs benchmark index hit an all-time high for the first time in over six years. Not unexpectedly, the new record – which lasted for exactly 24 hours – attracted much attention.

Increasing optimism ...

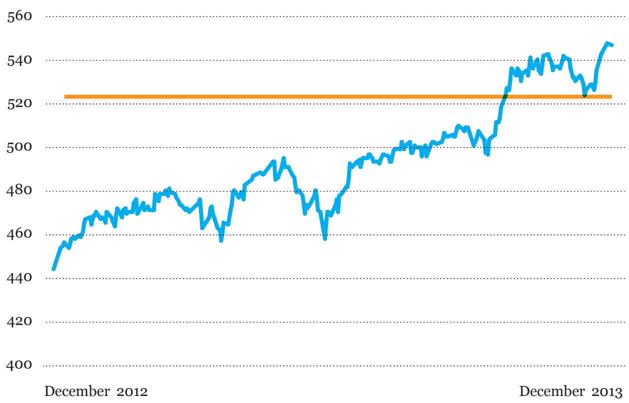
The attention focused on new all-time highs is as understandable as it is misunderstood. The market is destined to hit new peaks at regular intervals, quite simply because the listed companies normally operate at a profit. In fact, in aggregate, the constituent companies in the US S&P 500 index have never operated at a loss. Had it not been for fluctuations in price, the stock market would hit an all-time high every single day – in the same way that an ordinary savings account does.

That the new all-time high coincided with a rising torrent of negative signals is also entirely explicable. Three factors stand out as especially important.

Firstly, an increasing number of signals were received of new or increasing growth in countries that had long battled against stagnation or even recession, particularly European countries with absolutely no scope for fiscally stimulating their economies. Many key figures outstripped the predictions of the forecasters. The market became more confident in its belief in better times.

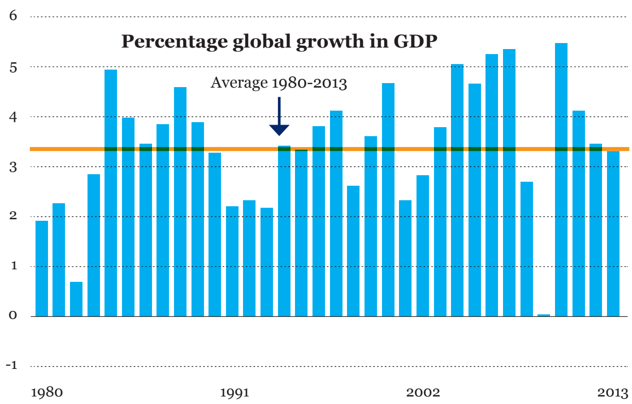
This might appear paradoxical, considering that a number of macroeconomic observers were adjusting their estimates for both the global economy and the Norwegian economy downwards. Nor do

The last peak is finally surmounted



The Oslo Børs benchmark index. Source: Oslo Børs

Slightly below average



Source: IMF

provisional figures suggest that growth was especially strong in the year in question.

However, external studies as well as Pareto's own calculations show that there is no statistical connection between price changes and economic growth in the same year. On the other hand, however, there is a very clear connection between price movements in one year and economic growth in the *following year*.

From this perspective, the price rise foretold a far more optimistic outlook for 2014 than the estimates produced by various macro-economic observers, for example, Statistics Norway, which at the time of writing is expecting GDP growth in Norway of 0.6 per cent. (Memo: Provisional accounts for 2014 is expecting 2.2 per cent.)

Should we believe this more optimistic forecast? In purely statistical terms at least, there are grounds for doing so. Last year, Pareto documented that the World Index has been a far more accurate indicator of future growth than have the estimates produced by the IMF – even though in a number of circles the latter in many ways sets the tone. The strong link between developments in price and future growth has also been documented in other studies.

We know from past experience that there are many who find this surprising. They should not be surprised, however. After all, the stock market reflects the average of all active predictions about the future, or more precisely: all forecasts that are followed up by actual investment decisions. Accordingly, the market will normally be some way ahead of the real economy.

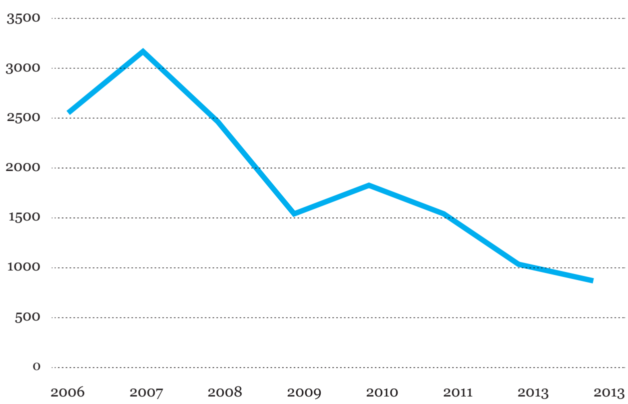
... higher pricing...

Secondly, increasing confidence and less uncertainty meant that investors reduced their risk aversion, and pricing rose. At the end of 2013 US stocks were priced at almost 2.7 times book equity, according to FactSet, while at just below 1.6 Norwegian stocks were significantly more reasonable in price. Even so, the latter represented an upturn of close to 20 per cent. Measured against earnings, pricing increased by over 30 per cent, regardless of whether the comparison is with actual or estimated results.

Admittedly, 2013 ended with lower turnover of shares on Oslo Børs, as has now been the tendency over a number of years. Even so, the turnover for the year as a whole conceals the fact that month by month liquidity increased. At the start of the year, turnover was approximately half of what it had been at the same time in the preceding year. Towards the end of the year, turnover was substantially higher than in the corresponding period in 2012.

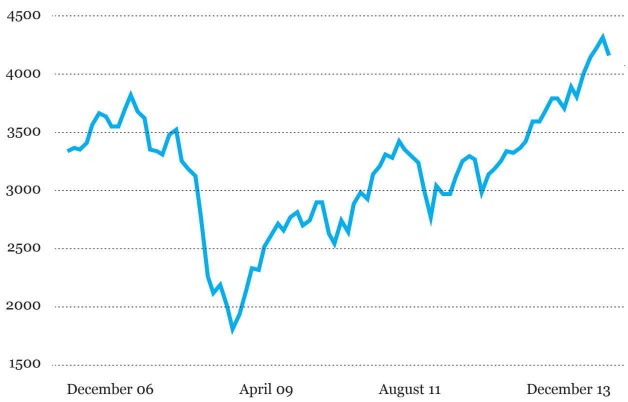
A similar pattern can be identified in asset management. For example, the month of December alone accounted for more than half

The drought continues



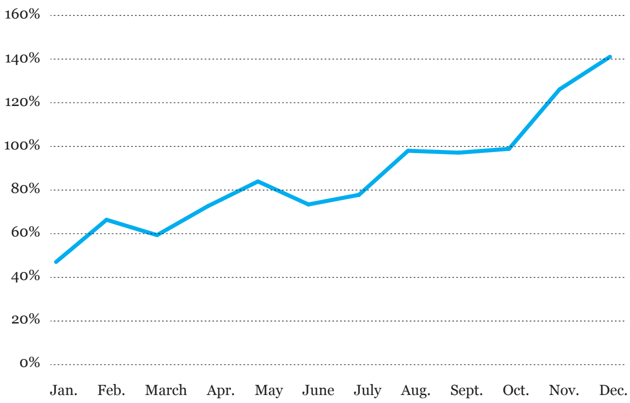
Total turnover of shares, equity certificates and ETFs on Oslo Børs in NOK billion. Source: Oslo Børs

Towards new peaks



MSCI World net (excluding withholding tax), total return in US dollars. Source: MSCI

The return of the much-missed willingness to invest



Total turnover of shares, equity certificates and ETFs on Oslo Børs, 2013 as a percentage of 2012, two months' moving average. Source: Oslo Børs.

of net subscriptions for mutual funds for the entire year as a whole, according to the Norwegian Fund and Asset Management Association. The pattern isn't usually as sharply delineated as this, although December is normally a good month for funds.

... and very few tempting alternatives

And thirdly, the main alternative to equities did not look especially tempting. After interest rates had continued to fall for years in a row, in both nominal and real terms, the low rate of return on bank deposits and short-term fixed-income papers was not the only problem. The potential for further interest rate reductions, and with this an increase in the price of longer bonds, was clearly limited. As Norwegian central bank governor Øystein Olsen put it in his annual address in February 2014: "... But today there is no longer room for a considerable fall in interest rates."

Ice-skating legend Hjalmar Andersen, who as it happens died this year, once laconically remarked on the subject of the increasingly lower world speed-skating records that "they'll never get it down to zero". The central banks in a number of countries have demonstrated that key rates of interest are by no means governed by the same logic. The US target rate remains unchanged in the range 0-0.25 per cent (the actual rate is close to zero), while in Japan it remains at 0.1 per cent. Following two reductions during the course of the last year, the European key rate has now been reduced to 0.25 per cent. In Norway, the key rate has remained at an all-time low of 1.5 per cent.

One further effect of this has been lower money market rates here in Norway, with three month NIBOR having fallen from 1.832 to 1.69 per cent during the course of 2013.

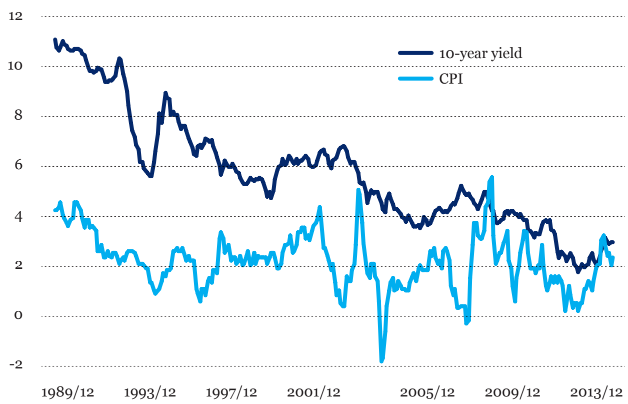
Globally, not least in the United States, we have also seen that the move towards fixed-income funds has decreased or reversed. Here in Norway, net subscriptions for fixed-income funds totalled NOK 9.3 billion in 2013, down from NOK 32.3 billion the year before. However, at the same time these figures provide an excellent example of the way in which statistics can distort reality.

High on high-yield

In actual fact, the market for corporate bonds was in sterling health in 2013. Risk premiums contracted, which resulted in a very satisfactory increase in the price of many corporate bonds, and the volume of issues scaled new peaks. In total, subscriptions for corporate bonds exceeded NOK 104 billion, of which a shade over NOK 61 billion in high-yield bonds.

In addition, we are seeing the emergence of a Nordic market for corporate bonds, which is attracting a great deal of interest not least from both issuers and investors in Sweden. The establishment of part-Norwegian-owned Swedish Trustee and a trustee services scheme based on the Norwegian model has created a relatively standardised institutional framework and provides improved scope for investors in both countries to diversify their portfolios of corporate bonds.

Shrinking potential



Yield to redemption 10-year government bonds and rolling 12-month changes in consumer price index. Source Norges Bank, Statistics Norway

Up from the yield trough

Yield to redemption 10-year government bonds during 2013. Source: Norges Bank

That short-term interest rates could continue to fall in such a lively market was due to the simple fact that the short end of the yield curve is not controlled by the market. The heftiest influence is wielded by central banks and politicians.

Long interest rates, however, are fairly freely fixed by the market. And, in fact, in this market, too, there were signs of an upturn. In Norway the yield to redemption on 10-year government bonds rose from 2.04 to 3.04 per cent – an increase of almost 50 per cent.

Thus during the course of 2013 the yield curve became much steeper. This is normally a sign of better times to come. So it would seem that both the stock market and the fixed-income market gave off the same signals about the future in 2013: clear signs of better times ahead.

Saved by the fall of the kroner

One obvious question, however, is where times will get better. Whereas in recent years the Norwegian economy has surfed smoothly past the waves of concern that have washed over most other European countries, in 2013 we saw a combination of cautious optimism abroad and shrinking growth in the Norwegian economy. During the course of just a single year Statistics Norway downgraded its estimates of GDP growth for this year from 2.8 to 0.7 per cent, and from 2.9 to 1.8 per cent for the mainland economy.

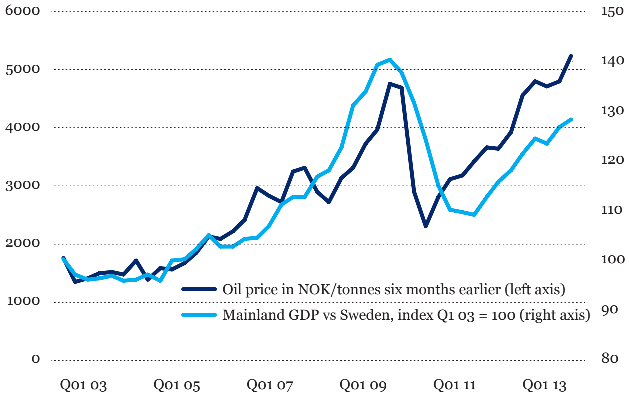
In last year's annual report we presented the conclusions drawn in an analysis showing how mainland Norway too had become dependent on oil. According to Pareto's calculations, "exports" from the mainland economy to the petroleum sector had reached a level of almost 10 per cent of mainland GDP, more than three times the total exports of goods and services to the entire Nordic region.

Much of this can be ascribed to the fact that producing oil had become more costly; more kroner per barrel accrued to subcontractors on the mainland. Measured in terms of funds not channelled to the Government Pension Fund Global this represented a total stimulus of the order of NOK 500 billion. The discussion about the expenditure of what is termed oil money – a few billion more or less in the national budget – paled by comparison.

In our assessment, this is one of the key reasons for why wage costs have also skyrocketed in other industries on the mainland. The Norwegian Technical Calculation Committee for Wage Settlements now estimates that average hourly wage costs for Norwegian industry in 2013 were a hefty 55 per cent higher than the rates borne by our trading partners in the European Union. Admittedly, after adjustments have been made for new basic data this corresponds to a reduction of two percentage points on the preceding year, but this reduction is due to a significant drop in the strength of the kroner.

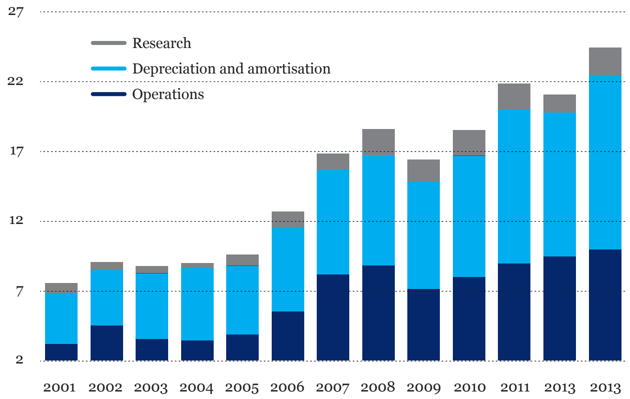
The drop in the value of the krone undoubtedly came as a surprise in many quarters. On the other hand, there can be no doubt that it arrived at a convenient time. Many exporters seem to have

Oil-fired heating on the mainland



Sources: Pareto, SCB, Statistics Norway

Costs continue to rise in the North Sea



Statoil's costs in Norway, US dollars per barrel. Source: Pareto Securities rescued their otherwise failing margins in this way, at least in the short-term.

A uniquely Norwegian rise in expenses

The question is whether we are also in the process of throttling the growth rate of the Norwegian business and industry by other means. Oil is not the only factor contributing to the one-sidedness of the Norwegian economy. In Norway public expenditure has reached a level that has a major effect on the national economy, without necessarily making it more robust.

Public expenditure as a percentage of GDP – be it the mainland economy or adjusted for the economic rent of the petroleum industry – provides an interesting, albeit limited, picture of this effect. In all likelihood, the petroleum industry has had long-term knock-on effects that go far beyond the annual economic rent. Without this stimulation of the Norwegian economy, public expenditure at the current level would have made up an even greater proportion of the economy.

Moreover, for obvious reasons, the public sector's own operations are concentrated around activities with limited scope for productivity increases. Washing and caring for senior citizens cannot be automated in the same way as can the production of cars and mobile telephones.

Many items of public expenditure undoubtedly have beneficial ripple effects (externalities) that might easily be underestimated, typical examples being education and infrastructure. The question is just how great a proportion of the funds are used on items of this nature, and, not least, how efficiently the expenditure increase is channelled.

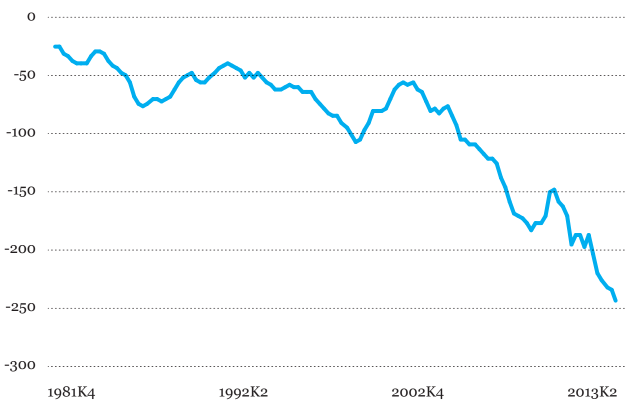
So far in this century public sector expenditure has increased by 141 per cent here in Norway. To the east of the Norwegian border, the increase has been 49 per cent, or 56 per cent if we adjust for changes

2013 in a nutshell

OSEBX	+23.6%
S&P 500 return	+32.4%
MSCI World net	+26.7%
3-month NIBOR	from 1.83% to 1.69%
10 year Norwegian Treasury	from 2.04% to 3.04%
Share turnover Oslo Børs (value)	-16.4%
Brent Blend	from USD 111.11 to USD 110.80
USD/NOK	from 5.57 to 6.08
EUR/NOK	from 7.34 to 8.38
GDP growth, global	3.3%
GDP growth, Norway	1.0%
GDP growth, Mainland Norway	2.3%

Sources: *Oslo Børs, S&P Dow Jones Indices, MSCI, Norges Bank, FactSet, IMF, Statistics Norway, Pareto. GDP growth is updated with revised estimates after the respective Pareto annual reports were published.*

Drama on the mainland?



Rolling four quarters' mainland balance of trade (excluding exports of crude oil and natural gas). Sources: Statistics Norway, Pareto

Or business as usual?

Mainland balance of trade as a percentage of mainland GDP. Source: Statistics Norway, Pareto in the exchange rate. And these are just the current expenses. In addition, future expenses have increased significantly more in Norway, in part through the commitments that follow from current expenditure items, in part as a result of the very much stronger increase in the pension debt.

Since 2001, the Norwegian public sector pension debt has almost kept up with the explosive increase in the value of the Government Pension Fund Global. Whereas the fund has increased in value by NOK 4,100 billion during the intervening period, the pension debt has grown by NOK 3,700 billion. In other words, the actual coverage of the debt is not much better than it was, notwithstanding the reports of how much richer each and every Norwegian has become.

Compared with other countries, however, we should be able to afford to pay people to stop working.

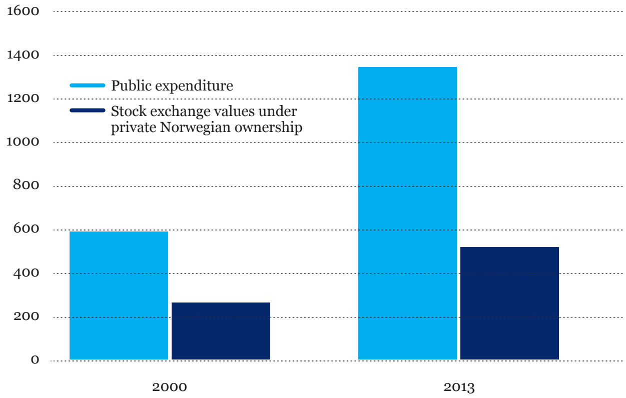
Where are the end customers?

Although there may be grounds for scepticism about developments in the Norwegian economy, it should also be noted that business and industry in Norway are becoming ever less dependent on developments in the domestic economy. The apparently fairly stable level of exports may give a slightly misleading picture, since many companies with domestic customers are subcontractors to exporters – oil service companies being a prime example.

In other words, regardless of the problems in the domestic economy we will receive regular top-ups of new, vigorous companies with end customers in other countries and with exposure to entirely different factors than the Norwegian national accounts.

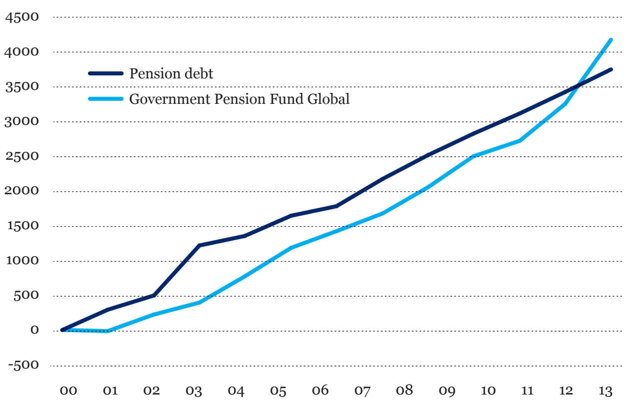
We can find sound investors for these companies, and we can find sound companies for them to invest in. These processes continue and give Pareto excellent opportunities for continued growth. The point is simply that an oil-fuelled increase in both costs and public expenditure has given business and industry a hefty burden to carry. In which case it is no bad idea to have some notion of the true weight.

More politics, less stock market



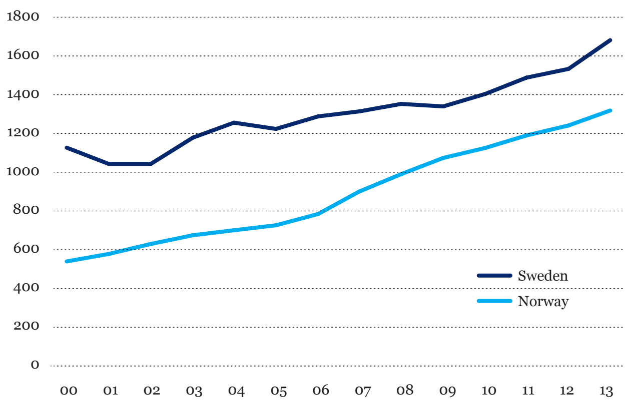
NOK billion. Source: Ministry of Finance, Oslo Børs

The pension race



Aggregate changes since 2001 in NOK billion. Source: FI/NBIM

From 50% of Sweden to 80%



Total public expenditure in NOK billion. Source: Statistics Norway/FI/SCB