Sparinvest

Monthly comment for January

Volatility shock triggered switch from risk-on to risk-off in January

Several benchmark equity indices hit new all-time highs in the first half of January. The positive performance of high-risk assets came to an abrupt halt at the end of the month, however. In a single day, volatility determined using the VIX index increased from 23% to 37%; the third-largest surge on record measured relative to starting point. The financial shock was partly triggered by extraordinarily large price movements and high trading activity in the most heavily shorted companies in the equity market.

According to MSCI ACWI global equities went down by 0.2% in local currencies but gained 0.25% in DKK. Particularly the returns on the major U.S. banks lagged behind the returns on other DM equities. MSCI EM rose by 3.8% in local currencies in January. Overall, there were no major movements in indices for European corporate bonds. In January, credit spreads of European investment grade widened by 1bp but tightened by 6bp for European high-yield bonds. As a result, investment grade bonds performed on a par with comparable government bonds, while high-yield bonds produced an excess return of 0.5%. The Danish 10Y government bond yield rose by a modest 4bp to -0.4% at end-January.

Mixed economic indicators following new lockdowns

The coronavirus pandemic has made forecasts of short-term economic momentum increasingly futile. The persevering coronavirus has triggered an almost mechanical cycle based on the following parameters in this order:
Virus curve ➡ virus measures ➡ economic indicators

During the corona crisis, focus has naturally been on the virus curve, which has defined the direction of subsequent societal restrictions and thus economic momentum. Growth-related economic indicators have become a function of the virus curve. In the negative version, the current lockdowns will weaken economic indicators in the coming months. In the positive version, the measures will start taking effect. The virus curves are reversing in the U.S., most of Europe and Japan. The cycle is largely intact resulting in low news and information value.

Naturally, the mixed picture applies to business as well as consumer confidence indicators. With yet another period of lockdowns in the OECD area, there are widespread expectations that the economy will lose momentum in Q1/2021.

Investment conclusions and asset allocation

The corona crisis has delivered many surprises, in terms of both health and economic effects. With the recent approvals of covid-19 vaccines in the U.S. and Europe, it is now even more likely that the course of the corona crisis may be described in these three headlines:

- Lockdown/reopening (short term)
- Covid-19 vaccines
- Recovery/normalisation (long term)

This is, of course, a highly simplified description. The point is that covid-19 vaccines will be the means to ensure long-term recovery and normalisation of the global economy. The news flow of the recent period in this area is therefore of decisive importance. Test results from vaccines developed by JNJ and Novavax were published in January. These vaccines appear to have efficacy and side effect rates, which means that they could be approved for mass rollout in the near future. However, this does not change the fact that widespread lockdowns are likely to be maintained until infection rates fall further and vaccines are administered on a large scale.

Recent months' high returns on risky assets per se have weakened the tactical risk/reward relationship. Some investor reports also show a strong preference for risky assets and high allocation to corporate bonds/equities. The most recent financial policy news flow still suggests a strong determination to support the economies. This applies not only to the current lockdown period but also in the following period allowing higher economic activity. Until now, this strategy has not seemed to prompt more market-based tightening measures, such as higher real rates, but is kept afloat by the recent monetary policy announcements from leading central banks.

This is reflected in the generally favourable climate for pricing and risk premiums, see the publication "Hvorfor så negativ?" Overall, this favours maintaining the tactical overweight of equities vs government bonds/covered bonds. Over the past few months, this overall allocation strategy has been expanded with equity strategies. Most recently, a strategy of underweighting EU Health Care versus EU Market has been opened, as this sector has more defensive characteristics with respect to their earnings and return patterns in relative terms.

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