Sparinvest

Monthly comment for April

High risk appetite continued in April

In April several benchmark equity indices again reached record-high levels. This trend coincided with the implicit volatility measured by the VIX index (which indicates the degree of market concerns) last month falling below index 20, the lowest level since the corona pandemic outbreak.

In April global equities gained 3.7% in local currencies and 1.9% translated into DKK according to MSCI ACWI. The increases were again led by MSCI DM, up by 4%, while MSCI EM rose by 2.2% in local currencies.

The favourable return development was also seen for corporate bonds. Credit spreads (ie the yield pick-up on investment in a corporate bond relative to a government bond) of European investment grade and high-yield bonds tightened by 6bp and 11bp, respectively, in April. This led to excess returns of 0.4% and 0.9%, respectively, relative to comparable government bonds. Danish 10Y government bond yields rose marginally from 0% to 0.1% in the previous month.

Explosive economic growth in the US

The US handling of the vaccine roll-out in 2021 has been in stark contrast to its handling of the epidemic in 2020. This is reflected in Joe Biden upping his goal of reaching 100 million vaccinations in this first 100 days in office to now 200 million vaccinations. To this end, the US is well prepared for reopening society.

The past weeks' positive outlook is strongly impacting growth-related indicators. According to the ISM, optimism in the US manufacturing sector is at the highest level since 1983. In the service sector optimism is at its highest since the start of the data series in 1997. In H1/2020 the Weekly Economic Index from the Federal Reserve Bank of New York reflected the development in growth momentum in the period of lockdown and reopening, respectively, of the US society. In the past few weeks the activity index has exploded, thus suggesting record-high momentum in the real-economic activity at the moment.

The above-mentioned development is reflected in market expectations for the growth profile of US GDP in the coming quarters. According to Bloomberg growth is expected to peak this quarter to a level exceeding 8% in annualised terms. The markets are expecting growth to decelerate but remain high in Q3, with growth rates in the subsequent quarters contracting up to end-2022.

Investment conclusions and asset allocation

The current situation in the financial market reflects the very positive momentum signals in the typical manner:

- OAS spreads of US high-yield bonds are close to the record-low levels in 2017/2018.
- Several benchmark equity indices hit all-time highs.
- Confidence indicators largely express very high optimism among investors.
- Equity funds have attracted a record-high number of investors in the past months,, particularly in the US.

This trend is not problematic in itself. Typically, further expansion would require additional increases in growth indicators in the coming months from the currently very high levels. This is possible, but not particularly likely. The indicators trigger expectations that particularly job-related data in the coming period will be strong enough for the US central bank (the Fed) and subsequently other benchmark central banks to begin sending the first signals of a less lenient development in monetary policy conditions. The monetary policy trends are seen in China where People's Bank of China has recommended that banks reduce new lending for the remainder of 2021. This signal should not be overinterpreted as a major monetary tightening. But the credit impulse is likely to further decline in the coming quarters. A generally less favourable impulse from the monetary policy is expected to weaken the tactical momentum and reduce the currently particularly high risk appetite among investors.

As mentioned, the currently extraordinarily high growth momentum has a high probability of fading after Q2. If so, we expect cyclical movements which are likely to reflect a slowdown in economic growth. Slowdown movements are typically reflected in financial markets by more identical returns on equities and bonds, and here, tactical allocation strategies between the two asset classes are characterised by a low degree of accuracy. The tactical risk level relative to the asset allocations has begun preparing for the outlined trend. The overweight of equities and the underweight of government bonds and covered bonds have recently been neutralised to benchmark (see the publication "Taktisk risikoniveau sænkes"). So far the tactical strategies within the equity spectrum will be left unchanged, ie overweight of financial sector in the US and Europe and underweight of Health and Utilities in Europe relative to the respective market indices. The relative EPS development of the strategies is still favourable. The strategies generally have a high sensitivity to increasing interest rates. The real rate level of US government bond, in particular, is still considered extraordinarily negative, and this could trigger an upward pressure on interest rates for a period, even under conditions where growth momentum has peaked.

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