Sparinvest

Monthly comment for May

# Positive returns on equities in May, yet signs of flattening since mid-April

This spring has seen a flattening and sideways trend in the financial market. This applies to a broad spectrum of areas, including credit spreads (ie the yield pick-up on investment in a corporate bond relative to a government bond) of corporate bonds, the VIX index, U.S. government bond yields, benchmark equity indices and cyclical versus defensive equity sectors. The initial reactions of "max momentum" in growth-related economic indicators, again coinciding with confidence indicators, have recently shown high investor optimism.

Global equities gained 1.1% in May according to MSCI ACWI (in local currencies) and -0.1% (in DKK). Credit spreads of European investment grade bonds widened by 2bp, generating a return matching that of comparable government bonds. Credit spreads of European high yield bonds were unchanged in May, resulting in an excess return of 0.3% compared with the return on government bonds. The Danish 10Y government bond yield increased marginally in the period by 5bp to 0.1% at end-May.

"Max momentum" is starting to feed through to economic indicators

As described in recent publications, growth-related economic indicators increased this spring to levels typically characterised as peaking economic momentum (see "Tættere på maks. momentum" (In Danish). The high-frequency data series, Weekly Economic Index, published by the Federal Reserve, almost shot straight up until mid-April in connection with the U.S. reopening society. Since mid-April, the index has been drifting sideways. Largely the same conclusions can be drawn from the ISM business reports on the U.S. manufacturing and service sectors. The above-mentioned trend is reflected in market expectations for the growth profile of U.S. GDP in the coming quarters. According to Bloomberg, growth is expected to peak this quarter at a level exceeding 8% in annualised terms. The markets are expecting growth to decelerate but still high in Q3, with growth rates in the subsequent quarters contracting up to end-2022.

The most recent business confidence indicators for Asia show a similar picture of growth momentum nearing a peak. This is reflected in falling PMIs in South Korea, Taiwan, and a mixed trend from Chinese indicators. In Europe, however, the generally positive trend continued in May, among other things, prompted by the development in the corona crisis – in Europe lagging behind compared with the U.S. and Asia. Similarly, European growth indicators have already reached levels, which historically have coincided with the momentum peak.

## Investment conclusions and asset allocation

Since early 2020 the economic cycle has been remarkable. The economic downturn in 2020 was extreme yet short-lived, as the adverse growth momentum lasted only two months in March and April. Likewise, certain leading indicators now suggest that the current positive momentum is conducted at a pace, indicating that the development probably will be brief. As mentioned, the extraordinary growth outlook in Q2 and Q3/2021 can be summarised as "max momentum", which is deemed to have the following overall economic consequences and impacts on the financial market:

- Max momentum = approaching economic phase shift
- Max momentum = minimum risk premiums
- Max momentum = optimistic investor sentiment
- Max momentum = signals of economic tightening rather than easing

It is essential that a phase shift in the wake of "max momentum" reflect some 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 the lowest degree of accuracy. The tactical asset allocations has recently begun preparing for the outlined trend. The overweight of equities and the underweight of government bonds/covered bonds bonds were at end-April neutralised to benchmark (see "Taktisk risikoniveau sænkes"). As usual, "max momentum" left risk premiums at low levels. For example, credit spreads of global HY bonds have again reached the lowest levels since the financial crisis. Similarly, the current income-related pricing of global equities has not been higher since the financial crisis. The low risk premiums again coincide with generally high investor optimism and high allocation to risky assets. This fits well with the behaviour typically seen after the economic momentum.

So far the tactical strategies within the equity spectrum are unchanged, ie overweight of Financials in the U.S. and Europe and underweight of Healthcare 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 U.S. government bond, in particular, is still considered extraordinarily negative, and this could trigger an upward pressure on yields for a period, even under conditions where growth momentum has peaked.

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