RISKY ASSETS GAINED IN JUNE COMBINED WITH CURVE FLATTENING AND SECTOR ROTATION

In June, financial markets were driven by positive returns on risky assets combined with a flatter yield curve resulting from higher short-term government bond yields and lower long-term government bond yields. The yield trend triggered sector rotation in the equity market. The flattening of credit spreads of corporate bonds and the VIX Index (measuring the market's projection of volatility), which began in mid-April, continued in June.

According to MSCI ACWI, global equities gained 2.1% in local currencies and 4.5% in DKK. Developed Markets relative to Emerging Markets drove the increases. Especially interest rate trends in June led to a rotation back to Tech companies, which thus generated the highest returns and rotation away from companies within Insurance/Banks, which generated the lowest returns in the sector. 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 3bp and 6bp, respectively, in June. This led to excess returns of 0.2% and 0.5% relative to returns on comparable government bonds. Danish 10Y government bond yields fell marginally by 6bp to -0.1% in June.

"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 NY Federal Reserve, almost shot straight up until mid-April in connection with the U.S. reopening. The index has lost its momentum since the beginning of May; a pattern expected to spread in general to U.S. manufacturing and service PMIs in the coming period. 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 in the second quarter at a level exceeding 9% 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.

The most recent business confidence indicators for Asia paint a similar picture of a growth momentum nearing its peak. This is reflected in the mostly negative trend in Chinese indicators. In Europe, however, the generally positive trend continued in June, among other things, prompted by the development in the corona crisis – in Europe lagging behind compared with the U.S. and Asia. However, European growth indicators have already reached levels, which historically have coincided with the momentum peak.

Investment conclusions and asset allocation

The financial market trends over the past few months are a testament to the more complex conditions. Returns on risky asset relative to risk-free assets this spring have not been following the same unique pattern as in the previous quarters. This could indicate an expected slowdown in economic momentum and a slower rate of expansion. See "Genåbningstoppen" (In Danish).

Yet the complexity reaches beyond expectations for the economic momentum. In the U.S. and Europe, for some time now, mass vaccinations have allowed for reopening of society and in time, this will lead to a normalisation of the economies. Thus, this development is more and more in conflict with maintaining the current monetary policy, which still includes monthly QE programmes of USD 120bn in the U.S. and EUR 80bn in Europe. The most recent FOMC meeting revealed that the central bank would again need to change its economic forecast to higher inflation in 2021 and a lower unemployment rate in 2022. At the meeting, several members expressed a wish to expedite a monetary policy tightening. The credibility of the monetary policy manuscript is shrinking, see "Fra sikker til skråsikker" (In Danish). The bond market immediately priced in the central bank's new signals concerning the key policy rate. However, the probability that short- and long-term interest rates move in opposite directions is considered limited this early in a tightening cycle where not even the first initiatives have been executed.

The financial markets may thus be characterised by two important factors going forward. First that the economic momentum will reach its maximum in Q2, led by the development in the U.S. and China followed by Europe. Second that the monetary environment faces a tightening course with unfavourable liquidity. This trend is generally expected to be reflected in more identical returns between risky assets and risk-free assets. Transitions to slowdown phases typically represent periods where risk premiums stop falling. The current investor optimism reaches its maximum. The tactical strategies within the equity spectrum are unchanged, i.e. overweight Financials in the U.S. and Europe and underweight 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 bonds, in particular, is still considered extraordinarily negative, and this could trigger an upward pressure on yields for a period, even under conditions where the growth momentum has peaked.

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