Macroeconomic review, August 2021
Monthly comment for July

Sparinvest

MIXED PERFORMANCE OF RISKY ASSETS AND YIELD DECLINES IN JULY

July saw mixed performance of risky assets with relatively large drops in yields of benchmark government bonds.

Last month, global equities gained 0.7% in local currencies and 0.6% in DKK according to MSCI ACWI; developments with relatively large variations in sub-indices. At country level, US equities rose by 2.3% while Japanese equities fell by 2.4% in local currencies. Developed Markets equities rose by 1.7% while Emerging Markets equities fell by 6.1% in local currencies. Credit bond yield spreads generally rose in July. Credit spreads (i.e. the yield pick-up on investment in a credit bond relative to a government bond) of European corporate bonds widened by 1bp and 15bp on investment grade bonds and high-yield bonds, respectively. This led to excess returns of 0.1% and -0.1% relative to returns on comparable government bonds. Last month, the Danish 10Y government bond yield fell by 22bp to -0.15%. Equivalent U.S. bonds fell by 25bp to 1.2%, which led to a 2% return in July.

The peak reopening is showing more generally in the economic indicators

In July, forward-looking indicators showed general signs of having peaked. Thus, the OECD growth indicators (Composite Leading Indicators) are currently moving from expansion to slowdown - starting first in China and the U.S. In the U.S., the ISM manufacturing index fell again from the peak level of 64.7 in March to 59.5 in July. The confidence levels remain high but it is more important to note that optimism is fading.

The development in confidence indicators mentioned above occurred even earlier in China and generally continued in July. The Chinese authorities already seem to be in a dilemma. At end-March, People's Bank of China recommended reducing new lending for the remainder of 2021. Since then, the credit impulse has weakened further. In early July, People's Bank of China suddenly reduced bank reserve requirements by 50bp – the first easing of this nature since March 2020. This suggests that the credit impulse once again is having a contractive impact on Chinese economic growth.

The European reopening is progressing more slowly because of the generally slow start to the vaccine rollout. However, the most recent development in European growth indicators suggests a strong reopening, largely driven by the same dynamics as in the U.S. The development in July's growth indicators show that a European peak reopening is also within reach.

Investment conclusions and asset allocation

The financial market trends in July are a testament to the more complex tactical conditions. Returns on risky asset relative to risk-free assets are no longer following the same clear pattern as in the previous quarters. This could indicate financial markets are preparing for a shift in expectations. The following conditions are considered important for the coming period:

- Maximum economic momentum
- Maximum excess liquidity

The complexity in the financial market reaches beyond expectations for the economic momentum. In the US 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 US and EUR 80bn in Europe. From here, it is mostly a question of time before these QE programmes are tapered. The current economic recovery will absorb liquidity and mechanically lead to a significant drop in excess liquidity in the next quarters. This will be perceived as tighter liquidity conditions in the financial market.

The financial markets may thus be characterised by two important factors going forward. First that the economic momentum will reach its maximum, led by the development in the US 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, which have perhaps started to show in the credit market. During such conditions, the current investor optimism also reaches its maximum. As a result, the tactical risk level has been more balanced over the past few months. Overall, this means that equities are neutrally weighted against bonds. Developments in the tactical risk level last month also integrated the equity strategies, eliminating the overweight of U.S. and European Financial Sector and the underweight of the European Health Care and Utilities sectors relative to the respective market indices.

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