RETURNS ON RISKY ASSETS TAKE THE LEAD IN AUGUST

Risky asset returns predominantly took the lead in August – driven by equities and high-yield bonds.

According to MSCI ACWI, global equities gained 2.6% in local currencies, or 2.9% in DKK last month. The gains were led by the tech sector, triggering a 4% rise on Nasdaq in August. Likewise, companies in Banking and Insurance generated the highest returns, underpinned by slightly increasing government bond yields in the period. The credit spreads of European investment grade bonds widened by 1bp in August. This resulted in an excess return of 2bp relative to the return of comparable government bonds. Conversely, the credit spread of European high-yield bonds dropped by 10bp, yielding an excess return of 64bp relative to the return of comparable government bonds.

Growth-related economic indicators surprised more unanimously on the downside

Following the development in August, growth-related economic indicators are starting to draw a more consistent picture of dwindling momentum. In recent month, business confidence in manufacturing further declined in leading OECD economies. The equivalent indicator for China released by the National Bureau of Statistics (NBS) reveals a decline for the fifth consecutive month. The order index, nearly at 54 in March, had dropped below 50 at the end of August.

The development described above does not seem to be in line with general expectation formation. The so-called Economic Surprise Indices, published by Citi, are down from record levels in mid-2020 to negative levels in the U.S., Europe and China today, reflecting that the outcomes of a broad-based basket of economic indicators in the said economies do not live up to market expectations at this point. It is acknowledged that a higher virus reproduction rate of more infectious corona strains has added to the aforementioned loss of economic momentum. The main reason is, however, deemed to be a consequence of explosive growth momentum sparked in the first half of 2021 in the wake of mass vaccinations. Growth at this level may only be maintained for a limited period of time. However, abating growth momentum reaches beyond the trajectory seen in the wake of the reopening peak. Credit and liquidity indicators have for some time signalled that the otherwise quite favourable effects from these areas would become more contractive (tighter) in 2021 in China and the U.S. Again, this bears witness of the fact that changes to rather than levels of economic policy variables play the most significant role in driving economic momentum.

Investment conclusions and asset allocation

By now, the reopening trajectory of global economies has come to a stage where tactical surroundings are turning more complex. The complexity consists of a shift in the trend of the two factors outlined below, which, as usual, are expected to affect performance in financial markets in the period to come.

- Maximum economic momentum

As mentioned above, the leading indicators send more uniform signals that economic growth has peaked in the OECD area as well as in China. A shift is underway, which will generally cause the economic cycle to change phase from expansion to slowdown. Consequently, market forecasts of GDP growth in leading economies will gradually become dominated by downward revisions.

- Maximum excess liquidity

The rollout of corona vaccines has reached a stage where the most material virus-related restrictions have been phased out. Societies are moving closer to a full normalisation. Thus, this development is increasingly 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. From here it is mostly a question of time before these QE programmes are tapered. Excess liquidity, expressed as the relationship between growth in the money supply and economic growth, has already maxed out in the U.S. The same is the case for the credit area in China, which has moved in a more contractive direction since the turn of the year.

The two factors outlined above are expected to be key parameters in financial markets in the time to come. Firstly, a shift in phase from expansion to slowdown will typically result in risk premiums that bottom out. The shift in the economic cycle is likely to be reflected in more modest EPS expectations – with downward revisions of earnings estimates exceeding upward revisions for some time. Slowdown phases bring return ratios between risk-free and risky assets more in alignment. Secondly, the shrinking excess liquidity will impair otherwise favourable conditions for investors' risk appetite and allocation of capital to riskier assets. Under such circumstances, tactical asset allocation is characterised by the lowest degree of accuracy and the highest degree of uncertainty. For those reasons, we prefer a neutral-weight allocation between equities and bonds.

Editorial deadline: September 7, 2021