Macroeconomic review, October 2021
Monthly comment for September

Sparinvest

EQUITIES UP, INTEREST RATES DOWN AND CREDIT SPREADS UNCHANGED IN SEPTEMBER

September saw unusual return patterns in the financial market. The month was characterised by increasing risk aversion, and yet without spurring any particular investor appetite for the most risk-free assets. On balance, this resulted in declining returns on equities and government bonds, while corporate bond credit spreads were left largely unchanged.

Global equities lost 3.4% according to MSCI ACWI stated in local currencies. Translated into DKK, this was a loss of 2.2% last month. This development took MSCI ACWI back to the end-June level. The decrease was driven by the US equity indices led by the tech sector, with Nasdaq dropping 5.3%. Up 4.3% in September, MSCI Japan showed positive performance. Risk premiums on European corporate bonds did not change much. Last month credit spreads (i.e. the yield pick-up on investment in a corporate bond relative to a government bond) of investment grade bonds tightened by 1 basis points and remained unchanged for high-yield bonds, resulting in excess returns of 15 basis points and 40 basis points, respectively, for the two asset classes relative to the return on comparable government bonds.

Industrial production hit by energy supply problems

Recently, leading indicators have more unambiguously shown that the economic momentum has peaked for now. However, this development still does not seem to be in line with general expectation formation. The so-called Economic Surprise Indices, published by Citi, are down from record-high 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. Here, it should be added that the development in the U.S and Europe in terms of growth-related economic indicators mostly predicate a moderate downturn, driving down momentum from high growth levels in the spring.

According to "Genåbningstoppen" (in Danish), this has largely been the scenario outlined since spring. Recent weeks' price increases and supply problems, especially in the energy area, are deemed to affect the growth scenario negatively. Imbalances in the energy area have over a few weeks reached dimensions that are detrimental to economic activity. Power shortages force the Chinese to prioritise between supplies to households or the corporate sector. Chinese authorities have within recent weeks recommended that energy-intensive businesses reduce or discontinue their production activities, primarily in the sectors of steel, cement and chemicals.

Supply problems in a key input area such as electricity may potentially bring very negative surprises and strike in times of global supply chain bottlenecks. A network in which Chinese industrial production plays a key role. Supply problems will have severe consequences for everything from earnings to price development – not only in China but across the globe. To much concern, China has seen negative economic momentum over the summer. Debt problems in the real estate market put a damper on general business confidence. Selective lockdowns of society due to power shortages have sent Chinese growth prospects on a more serious downtrend, see "Mørk tid i Kina" (in Danish).

Investment conclusions and asset allocation

Recent weeks' development bears witness of the complexity of the financial market' tactical environment. If the supply side cannot solve imbalances in the energy area relatively fast by way of increased energy production, equilibrium must be restored on the demand side, meaning lower economic momentum.

Two elements in particular have been deemed as essential to the financial market since spring. Both elements are rooted in the loss of momentum following in the wake of the explosive reopening of economy activity in Q2.

- Maximum economic momentum: indicators in the OECD area signal sustained solid economic activity, albeit at levels inferior to spring levels. The development in China described above and impacts on global industrial production are deemed to have slowed down the approaching growth momentum even further.

- Maximum excess liquidity: reopening of economic activity automatically takes a larger toll on liquidity. Interpretation has it that the Fed has recently advanced the quantitative easing (QE) tapering deadline. Combined, this will appear to be a tightening of liquidity conditions in the financial market.

The above does not indicate substantial concern about the current activity or liquidity levels, it only underlines the importance of how the areas mentioned will change. Under conditions where these areas lose momentum, the return ratios between risk-free and risky assets become more aligned. In periods like that, 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: October 12, 2021