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EQUITIES, CREDIT SPREADS AND YIELDS UP IN OCTOBER

Risk appetite came back with a vengeance in October – not generally speaking, but specifically for equities. Equities yielded strong returns, staying resilient to increasing credit spreads on corporate bonds. According to MSCI ACWI, global equities went up 5% stated in local currencies. In DKK, the increase was 5.4% last month. Increases were led by the U.S., followed by Europe and Emerging Markets and with Japan in last place. Companies with ties to the Software, Semiconductors and Consumer Discretionary sectors stood out positively. Microsoft, Apple and Tesla alone contributed well over 1pp to the total return on MSCI ACWI in October.

Risk premiums on corporate bonds went up. Credit spreads (i.e. the yield pick-up on investment in a corporate bond relative to a government bond) of European investment grade and high-yield bonds widened by 3bp and 18bp, respectively, resulting in returns of -16bp and -12bp, respectively, relative to the return on comparable government bonds. The Danish 10Y government bond yield increased by 6bp to 0.15% at end-October.

Weakening order intake, but rising end price

The most recent set of leading growth indicators still show a momentum slowdown. For example, the most recent flash PMIs (Purchasing Managers' Index) from the U.S. and Europe reveal a continuing decline in the ratio between order intake and inventories. This probably means that the industrial output still needs to adjust to the lower activity level in the coming period. The most recent industrial output data covering Germany, Japan and South Korea show a decline of 4%, 5% and 1%, respectively, on the month before. It should be noted that the industrial sectors of these countries are closely related to the car industry. In China, NBS business confidence dropped to 49.2 in October, down from 49.6 in September. The new orders component slid to 48.8, having remained below the 50-index point benchmark for three consecutive months. On the positive side, Caixin PMI gained 0.6 index points, arriving at 50.6 in October, which reflected a more stable environment in terms of business confidence among small companies with a large export share.

Despite the prospect of weaker growth momentum in manufacturing, the most recent indicators point to even higher end prices. End prices thus continue to serve as a buffer despite several signs of lower activity, which is merely indicative of extraordinarily large imbalances in global manufacturing. This development is for a large part attributable to broken supply chains and bottlenecks built up in the wake of corona-related restrictions. The remaining part is attributable to strong demand across the board. At this point there are no signs of a real improvement of the current mismatch between supply and demand; see the publication "Problemer med balancen" (in Danish).

Particularly in China, the downward spiral has gained speed after the summer. China is currently facing power and energy supply problems of a magnitude exceeding that of periods with similar bottlenecks. This time, the supply problems occur outside the energy-intensive peak seasons of summer and winter. In several Chinese provinces, the authorities have recommended that energy-intensive companies discontinue or reduce their production activity. The consequences for economic momentum are unclear, but supply problems relating to a key input such as electricity hold a high potential for very negative surprises. This also reaches further than simply the direct consequences for economic momentum, seeing as the phenomenon puts areas such as price development and earnings capacity under pressure. For more details, read "Mørk tid i Kina" (in Danish). This comes on top of the now fairly long-term debt problems faced by the Chinese real estate sector. Data for September and October bear witness of somewhat lower activity in the Chinese housing market and a negative rub-off effect on the price development.

Investment conclusions and asset allocation

The situation outlined above means that the general tactical environment is currently characterised by the following adjustments to expectation formation:

- Lower economic growth
- Higher inflation
- Acceleration of monetary tightening

In terms of growth, the levels are not critical, but less positive momentum has suggested a certain slowdown in recent quarters. Compared with the general patterns of previous slowdown phases, the aforementioned composition of expectation formation is atypical as lower growth momentum has exceptionally led to expectations of higher inflation and accelerated monetary tightening.

Thus far, the current financial reporting season has shown solid financial results; However, this has not prevented additional reductions in ratio between earnings upgrades and earnings downgrades. This tells of the current dilemma. The notably higher input prices pressure companies to pass on these increases to end prices. On balance, this makes for a complex environment for the financial markets. The key parameter for an improvement of the tactical picture is an improvement of the economic momentum – which conflicts even more with supply chains that fail to keep up with and meet current demand. Neither the current economic phase nor higher inflation expectations suggest lower risk premiums. The neutral tactical allocation between equities and fixed income is maintained.

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