NEGATIVE RETURN ON EQUITIES, CREDIT BONDS AND GOVERNMENT BONDS IN JANUARY

Financial markets were dominated by investors' risk aversion in January. This generally negative trend followed signals by the Federal Reserve of changes to the monetary policy path. The financial markets interpreted this important news, and investors have been wanting to reduce their share of risky assets exerting pressure on equity prices in particular – and this in a climate where government bond yields have generally been going up.

In January, MSCI ACWI fell by 4.6% and 3.4% measured in local currency and DKK, respectively. The declines were led by the US and Japan, whereas Europe and Emerging Markets saw relatively minor price drops. The month was characterised by very granular returns in terms of sector and factors. The largest increases were observed in Energy and Banks, and the largest declines were attributable to Tech and Consumer Discretionary. This January, Small Caps had a tendency to underperform Large Caps. The same applied to Growth vs Value.

In terms of European corporate bonds, credit spreads (i.e. the yield pick-up on investment in a corporate bond relative to a government bond) of investment grade and high-yield bonds widened by 9bp and 34bp, respectively, in January. This resulted in excess returns of -46bp and -82bp, respectively, for the two asset classes relative to the returns on comparable government bonds. The Danish 10Y government bond yield increased by 14bp in January to some 0.2%.

Loss of economic growth momentum in January

The most recent growth-related economic data keep showing a mixed picture – albeit with a continuously downward trend overall. As to manufacturing, most of the US business confidence indicators fell whereas Europe has seen signs of some stabilisation prompted by the recent development in German. The service component has been slightly more negative in January. The indicators dived sharply in the US and Europe. In January, American purchasing managers took a more negative view on US economic activity than the month before, measured by PMI (Purchasing Managers Index), down to 50.9 in January. Presumably, the high corona infection rates have had a particularly negative effect on the service sector up to and into the New Year.

China saw declining business confidence indicators in the manufacturing sector and the service sector in January. Manufacturing indices are at 50.1 according to NBS (National Bureau of Statistics) and 49.1 according to Caixin Media. These levels reflect a Chinese manufacturing sector currently recording zero growth. As is the case for the OECD area, it is likely that the development in China this month was also adversely affected by the coronavirus.

Investment conclusions and asset allocation

As mentioned, the US central bank has accelerated its plans for the coming monetary policy tightening, likely based on an off-the-mark economic analysis. The key policy rate is now expected to be raised in the near future, and reduction of the portfolio of interest-bearing assets will begin after the first interest rate hike, see the publication "Fra QE til QT" (In Danish).

The initial phases of monetary policy tightening usually do not trigger strategic turning points, nor job market turning points. This does not seem to be the case this time around. However, a less relaxed monetary policy triggers a less favourable climate for the financial markets and the economy. These factors

could make the main difference between 2021 and 2022. The above indicates that the Fed may find it hard to come up with a credible plan for monetary policy tightening. Generally, there is a record-high decoupling between monetary factors and the economy – at the risk of leaving the Fed "behind the curve" and with a monetary overdose. We thus expect more to the same effect in 2022 in respect of recent weeks' market turmoil. Moreover, the ECB is likely to go through the same cycle as the Fed.

Tighter financial/monetary climates are of course not positive factors for the economic momentum. However, so far the changes have been limited and primarily been related to higher short-term rates and thus a flatter yield curve. Real US 10Y government yields rose by around 50bp in January to -0.5%, which only brings the real yield level back to the March 2021 level. The economic rub-off is currently considered small-scale.

Again, the tactical picture can be boiled down to the interpretation of the economic momentum based on traditional data. In this respect, the overall picture still suggests a slowdown, led by the US and reflected in a once again falling CESI index (Citigroup Economic Surprise Index) where economic indicators generally do not meet market expectations. The declining momentum is gradually being reflected in earnings data. Since mid-2020 upward earnings revisions have dominated EPS (earnings per share) but have now been replaced by a more balanced relationship between upward and downward earnings revisions. This is typically an early warning of EPS growth headed in the same direction. Tactically this favours maintaining a neutral allocation between equities and bonds.

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