Macroeconomic review, April 2022
Monthly comment for March

Sparinvest

GEOPOLITICAL RISK PREMIUMS ELIMINATED IN MARCH

The military conflict between Russia and Ukraine continues to affect the financial markets. The initial phase of the conflict led to higher risk premiums until mid-March – after which the risk premiums were generally eliminated in the second half of the month. Broadly speaking, the returns pattern seen so far has matched those seen in connection with previous military conflicts.

According to MSCI ACWI, global equities gained 2.5% in March, stated in local currencies. Stated in DKK, the return was 3.3%. Equity returns in the US and Japan exceeded those in Europe last month. At the sector level, the highest price rises were seen in Energy, Insurance and Health Care, while Banks and Consumer Staples showed the strongest falls.

Lower risk premiums also characterised credit market developments in March. Credit spreads (ie the yield pick-up on investment in a corporate bond relative to a government bond) of European investment grade and high-yield bonds fell by 19bp and 42bp, respectively, resulting in excess returns of 78bp and 153bp, respectively, for these two asset classes relative to comparable government bonds. The Danish 10Y government bond yield rose from 0.4% to 0.8% in March. The upward trend in commodity prices continued in March. According to Bloomberg Commodity Index, the prices of industrial metals, agricultural produce and energy rose by 12%, 4% and 16%, respectively.

Geopolitical tensions eclipse key indicators

The conflict between Russia and Ukraine will for some time take focus away from traditional key indicators. Key indicators covering the period up to the outbreak of the conflict will be deemed worthless – and those covering the period immediately after the outbreak will be so strongly impacted by the conflict that a prudent interpretation is necessary.

As regarding confidence indicators in manufacturing, there was a general downside tendency in March. The loss of confidence was strongest in Europe, where eg the German IFO Expectations Index (of business confidence) dived from 98.4 to 85.1. Asian confidence indicators also declined in March. The fall was most pronounced for China, which is, once again, adversely affected by corona-related restrictions – but loss of momentum was also seen in South Korea and Taiwan. In the US, developments were on the positive side in March. According to Markit PMI Manufacturing, business confidence rose from 57.3 to 58.5. Overall, this points to declining growth momentum in March, which is also reflected in the continued negative tendency in the manufacturing orders-to-stocks ratio.

Investment conclusions and asset allocation

There are still many uncertainties linked to the conflict, which does not seem to be approaching its end. On the *positive* side, the parties have initiated negotiations at government level, and gas supplies from Russia to Europe have been exempted from sanctions. The tail scenario for the European economy and parts of the energy market has not materialised. On the *negative* side, the military conflict seems to be in a deadlock. Neither party is currently assessed to have achieved the superiority required to bring about surrender and pave the way for a peace agreement. With a military stalemate in Ukraine, it could take some before the conflict reaches its conclusion. This points to escalation of the sanctions against Russia. In response, Russia is gradually increasing its gas sanctions – most recently by decreeing settlement in RUB in future, not in EUR or USD as agreed under the original contractual terms. In general, the sanctions will lead to a selective fall in the supply of energy, metal and food commodities. Countries in Asia and Latin America have now introduced restrictions on exports of food in order to secure their supplies. More countries are likely to follow suit.

At present, the conflict has not derailed the central banks' plans to tighten monetary policy. Addressing the US Senate, the chairman of the Board of Governors of the Federal Reserve System, Jerome Powell, recently confirmed that the Fed is "*willing to do what it takes to protect price stability*". Paradoxically, the Fed's 25bp interest-rate hike in mid-March coincided with the downward adjustment of its US growth forecast from 4.0% to 2.8% and the upward adjustment of its core inflation forecast from 2.7% to 4.1% for 2022. For the Fed, price developments are now a higher priority than growth.

Although geopolitical conflicts have historically not had a permanent impact on risk aversion and returns, events in the near term will contribute to prolonging and amplifying the loss of economic momentum seen since mid-2021. This is beginning to affect the financial markets in terms of earnings expectations. The ratio of upward to downward adjustments has been falling for several quarters. However, in the last few weeks, there has been a tendency for the number of downward adjustments to exceed the number of upward adjustments, a situation not seen since September 2020. The neutral allocation between equities and bonds is maintained – but a tactical overweight of Minimum Volatility has been established relative to the market at the MSCI World level. Minimum Volatility tends to yield a positive excess return in periods of falling confidence indicators, lower economic momentum and a generally tighter financial environment, cf the publication "Overvægt Minimum Volatility".

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