Macroeconomic review, July 2022
Monthly comment for June

Sparinvest

INFLATION FEARS OVERSHADOWED BY GROWTH FEARS IN JUNE – RISK AVERSION DOMINATED

The financial markets shifted focus in June. Inflation fears dominated at first, but were overshadowed by growth fears towards the end of the period. This shift was reflected in government bond returns; the Danish 10Y government bond yield rose from 1.5% at the beginning of June to 2.1% on 21 June and then dropped to 1.7% at the end of June.

Growth fears put risky assets under strong pressure. Global equities lost 7.4% according to MSCI ACWI stated in local currencies. Translated into DKK, this was a decline of 6.3% in June. The generally pessimistic sentiment affected sector returns. Defensive sectors outperformed cyclical sectors. The highest returns were achieved within Health Care, Consumer Staples and Telecoms, while the lowest returns were achieved within Semiconductors, Materials, Energy and Banks. According to Bloomberg Industrial Metals Index, industrial metals were down by just over 14% in June.

Just like the equity market, the credit market was under pressure in June. OAS spreads (ie the yield pick-up on investment in a corporate bond relative to a government bond) of European investment grade and high-yield (HY) bonds widened by 55bp and 164bp, respectively. This resulted in excess returns of -260bp and -620bp, respectively, for the two asset classes relative to the returns on comparable government bonds in June.

Widespread order vacuum and general loss of economic momentum in June

Economic indicators bear witness to a significant loss of growth momentum in the OECD area in June. This is evident from the order components in recently published business confidence indicators. According to data from S&P Global, order indices of the US, the EU and Japan fell below index 50 in June. This development was subsequently confirmed by ISM data from the US. The order component shrunk from 51.1 in May to 49.2 in June. By comparison, the ISM order index came to 66.4 in June 2021. The widespread vacuum in the order intake once again coincides with signs of inventory build-up. The balance between the order indices and inventory indices has not been this low since November 2001 – with the exception of the extraordinarily heavy chocks experienced during the financial crisis and the covid-19 crisis.

On balance, the development has driven the composite leading indicator (CLI) for the OECD area into the recession phase. Developments in the order intake and inventory build-up may indicate the risk that the current growth slowdown in the OECD area may become even more pronounced than during the "mini cycles" in 11/12 and 15/16, when a moderate growth slowdown was replaced by a moderate growth upturn. However, it should be emphasised that China is currently experiencing renewed growth momentum. This development is mainly attributable to less restrictive covid-19 measures in China, which is phasing out partial lockdowns in Shanghai, Shenzhen and Beijing.

Investment conclusions and asset allocation

Changes in CLI that cause the indicator to enter into a recession phase always attract attention. This has first and foremost to do with signals of future growth paths below the historical trend level. Growth rates that low make economies extra vulnerable and extra dependent of changes in the economic policy, which may recreate higher growth momentum. Such political intervention is not deemed to be imminent at this early stage of the contraction cycle. This boils the scenario down to a recession phase, which, this time around, is likely to cause a trend turning point in key strategic areas, such as the job market and the housing market. It is in phases like these that losses of risky assets often increase. In times following a period of great unrest across all asset classes, it is of course particularly difficult to determine to which extent the above scenario has been factored in. Three aspects should be emphasised in such a determination:

- OAS spreads of US HY bonds have increased from a level of 300bp to 587bp since April 2022. This increase seems to be adequately proportionate to the development of the US CLI; however, the risk premium is deemed to be modest in a scenario that may become tougher than the aforementioned "mini cycles", during which OAS spreads rose to the level of 900bp in 11/12 and 15/16.
- Equity returns relative to bond returns have begun factoring in the HY-OAS spread widening. Prospects of higher risk premiums on HY bonds seem to suggest lower equity returns relative to bond returns.
- US government bonds again once again have a positive real rate following two years with a negative real rate. Today, 10Y government bonds have a YTM of 0.6% (BEI deflated) compared with -1% at the beginning of 2022, see the publication (*in Danish*): "Hvorfor så negative?"

In March 2022, the tactical risk level was reduced by overweighting the Minimum Volatility segment within the equity spectrum, see publication. This strategy is maintained. On the backdrop of the scenario outlined, the risk level is further reduced by establishing a tactical underweight of equities and corporate bonds relative to government bonds/covered bonds. The risk of the strategies derives from several factors, relating in part to the economic area, if growth momentum is restored and accelerates in the near future, and in part to the political area, if the current contraction cycle is suddenly replaced by an expansion cycle. The probability of these potential outcomes is, however, deemed to be low as both areas are at an early stage of the developments expected in the coming quarters. For further details, see the publication (*in Danish*): "Takis risikoniveau sænkes".

Editorial deadline: July 12, 2022