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HIGH RETURNS ON BOTH RISK-FREE AND RISK ASSETS IN JULY

Almost all financial asset classes delivered high returns in July in the wake of the interest rate declines in the U.S. and Europe, starting in mid-June and continuing into July. In the financial market, this was probably considered a reverse interest rate shock, which helped slightly ease the tightening of the financial environment predominant in 2022.

Global equities gained 7.1% according to MSCI ACWI in local currencies. In DKK, the increase was 10.1% in July. This should be compared with returns of 2.9% and 4.3% on Danish 5-year government bonds and covered bonds, respectively. Credit spreads of European corporate bonds decreased by 29bp and 57bp for European Investment Grade bonds and High Yield bonds, respectively, in July. As a result, the two asset classes yielded excess returns of 191bp and 306bp, respectively, relative to comparable government bonds.

Business confidence indicators plunged in the U.S., Europe and China

The majority of the key indicators plunged in July – not only in manufacturing but also in the service sector. This was reflected in the Composite PMIs from S&P, which includes both these parts of the business sector. In the U.S., the index shrunk from 52.7 in June to 47.5 in July. In Europe, the corresponding index dropped from 52.0 in June to 49.4 in July. Both indices have now dropped below index level 50, which typically signals whether business activity is trending up or down. The reports also showed that the ratio between order intake and inventory build-up deteriorated further in July. This supports the reports from several companies of rising inventories following order cancellations. In China the trend is the same. Composite PMI from NBS decreased from DKK 54.1 to DKK 52.5, signalling a slowdown in domestic as well as foreign order components.

Recent data from the household sector suggest that consumer demand has dropped considerably within a short period. This indicates that the higher prices of goods now seem to feed into consumer behaviour. In the U.S., retail trade in the early summer was 3-4% lower than the same period in 2021 (in real terms). In terms of current prices, retail trade has risen by 8%. Recent data from Germany show the same trend. In June, retail trade dropped by 9% in volume and by 1% in current prices compared with the levels in 2021. In recent time, we have only seen negative consumer behaviour of this magnitude in connection with the financial crisis or the corona crisis. Overall, this suggests that the deteriorated growth outlook in the OECD area is now driven by demand and partly triggered by a relatively large decrease in real wages.

Investment conclusions and asset allocation

The economic outlook is extremely uncertain. Central banks have initiated a synchronised monetary tightening cycle at a time when the key indicators signal a growth slowdown in the OECD area. The current situation underlines the dilemma faced by the central banks with their ultra-lenient monetary policies triggered by the corona crisis. Inflation targets now have a much higher priority than growth targets. The current tightening cycle inevitably involves the global job market. In the U.S., the chair of the Federal Reserve described the job market situation as unhealthy due to the low unemployment. Wage inflation has risen to 5-6.5% annually, which is the highest wage inflation for more than 20 years. The Federal Reserve recently stated "The natural rate of unemployment – the rate consistent with stable prices – has moved up materially". This means that for the first time since the financial crisis, the job market is at a turning point towards higher unemployment, which is typically required for wage inflation to decline. The corona crisis also prompted a short-lived unemployment rise, but

this development was triggered by a mandatory lockdown and was not cyclical. In relation to the financial market, this provides a strategical background characterised by decline, which typically causes a long-term downward pressure on risk assets. The opposite applies when the strategic background is expansion.

In recent weeks, financial markets have started to price in a lower Federal Reserve key policy rate from mid-2023. Prevailing market expectations are now a swift change in Federal Reserve behaviour, transitioning directly from the current tightening cycle to an easing cycle. This contrasts with the central bank's own dot plot with expectations of higher key policy rates in 2023, which the Federal Reserve referred to after the recent interest rate meeting. At the meeting the Federal Reserve only signalled that the tightening pace would slow down, which is considered plausible following rate hikes of 2.25pp in total in less than five months. In the past few weeks, expectations and the risk-reward relationship have shifted towards a scenario, which will be difficult for the Federal Reserve to achieve.

The development in the tactical and strategic indicators is the main reason why a defensive asset allocation is preferred. The current financial reporting season has initiated a further decline in EPS revisions, driven by a negative trend in the U.S.: a typical warning of a lower future EPS level. This is in conflict with the current market expectations of EPS growth of 10% in 2022 and additional growth of 7% in 2023 determined on the basis of companies in MSCI ACWI. Both equities and corporate bonds are underweighted relative to government bonds and covered bonds, see the publication (in Danish): "Taktisk risikoniveau sænkes". The Minimum Volatility segment within the equity spectrum is overweighted, see publication.

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