

RISK APPETITE TURNED TO RISK AVERSION IN AUGUST

In August, investor behaviour was characterised by risk appetite in the first half of the month, while renewed risk aversion dominated in the second half of the month. This development probably reflected a resumed uptrend in short-term U.S. government bond yields following a period of flatter yield trends in July. Towards the end of August, yield rises intensified against a backdrop of messages from both the Federal Reserve and the ECB reiterating the need for monetary tightening to curb inflation. Last month, global equities went down by 3% in local currencies, or 2.4% in DKK, according to MSCI ACWI. MSCI EM yielded an excess return in August of 1.2% relative to a return of -3.5% for MSCI World. Within MSCI World, returns were lowest in Europe, followed by the U.S. and Japan. As mentioned, yields increased in August. Danish 10Y government bond yields increased by 80bp to some 1.9%, touching the June level. Last month, risk premiums of European corporate bonds trended unusually when credit spreads (ie the yield pick-up on investment in a corporate bond relative to a government bond) of investment grade bonds widened by 13bp yet tightened by 32bp for high-yield bonds. As a result, the two asset classes generated excess returns of -50bp and 170bp, respectively, relative to the return on comparable government bonds.

Business confidence declines and consumer confidence stabilises

Business confidence indicators continued declining in August. This was the case in the U.S., Europe and Japan according to the so-called Flash PMIs from S&P. The adverse trends occurred in both the manufacturing sector and the service sector. At end-August, three of the mentioned six indicators dropped below index 50, and the remaining three indicators fell to 50-51. These points to a business sector in the OECD area with negative or almost flat growth rates. By contrast, last month, consumer confidence was up in the

U.S., Europe and Japan, albeit from extraordinarily low levels. Consumer confidence was likely impacted by the price decline of certain commodities, including petrol, over the summer. In China, the situation is deteriorating. Long-lasting problems in the Chinese housing market have an adverse impact on the economy and now on the Chinese banking sector and the ability of the authorities to sell land to raise funds for building projects. This development recently triggered a number of measures. The key policy rate has been lowered. Lending facilities, earmarked to finance the real estate sector, are provided to the banking sector. New infrastructure projects are being launched. Overall, these measures mainly aim to stabilise a stressed real estate sector rather than stimulate private demand. The measures are likely to play a limited role in restoring the confidence of the corporate and household sectors.

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 synchronised monetary tightening cycle, viewed separately, forms a basis for the tactical economic momentum to continue in the OECD – at the risk of leading to turnarounds in strategic areas, such as job and housing markets. This is the basic purpose of a monetary tightening and applies mainly in a time with an unusually tight job market and historically high wage inflation, particularly in the U.S. Relative to the financial markets, history shows that developments in the

mentioned tactical and strategic indicators are essential for return patterns. Return losses on risky assets relative to risk-free assets

- are at the *tactical* level highest in CLI downturn phases
- are further intensified when CLI downturn phases occur in periods with negative impact in *strategic* indicators

With the prospect of further declines in tactical as well as strategic indicators, financial markets may be more prone to begin pricing in the combination of declines in both indicators, leaving the typical return pattern to yield higher returns on risk-free assets relative to risky assets.

Earnings forecasts over the past few months have been adjusted downwards, particularly in U.S. companies. This could prompt a major and long-lasting turnaround. Despite the downwards adjustment, a 12% rise is still expected over the next 18 months. This increasingly contrasts with signals from the Conference Boards LEI, down over the past five months. The decline in LEI signals a turnaround, with earnings growth replacing earnings decrease. A defensive asset allocation is generally preferred. 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](#). 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.

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