

FROM RISK AVERSION TO RISK APPETITE IN OCTOBER

October was characterised by risk asset growth, while risk-free assets were more challenged. Currently, more than half of the S&P 500 companies have presented their Q3/2022 Interim Reports, and "only" 71% of them beat their own EPS estimates, which are at the lowest level since Q1/2020. 24% of the companies did not beat their own EPS estimates, which are a good deal more than the historical average of 19%. These top-down results are particularly driven by the more cyclical sectors, which makes sense in light of the economic slowdown. In Europe, as expected, the ECB raised interest rates by 75bp because of the persistent inflationary pressure. In Denmark, the DKK has performed strongly vs the EUR for a good while. As a result, Denmark's Nationalbank intervened in the FX market, buying foreign currency worth DKK 23bn in September. Against this backdrop, the central bank decided to raise the monetary policy rates by "only" 60bp, which widens the monetary policy spread vs the Eurozone and mitigates some of the DKK strengthening vis-à-vis the EUR.

According to MSCI ACWI, global equities gained 5.1% in October, stated in local currencies, or 4.2% in DKK. At sector level, the returns were positive for all sectors except Real Estate, Consumer Discretionary and Communications. The returns were highest for Energy and Industrials. In October, the risk premium of European corporate bonds declined. Yield spreads (i.e. the yield pick-up on investment in a corporate bond relative to a government bond) of European Investment Grade and High Yield bonds decreased by 5bp and 36bp, respectively. This resulted in excess returns of 44bp and 164bp, respectively, for the two asset classes relative to the returns on comparable government bonds. The interest rate of Danish 10Y government bonds was 2.5% at end-October, unchanged from end-September.

Negative economic indicators in the U.S., Europe and China, but more mixed signals in Japan

Confidence indicators related to the manufacturing sector continued to drop in October in the U.S., Europe and Japan according to the Flash PMIs from S&P. The same trend was seen in the service sector in the U.S. and Europe, while Japan recorded growth. At end-October, the four indicators for the U.S. and Europe had dropped below index 50, while Japan's indicators are within the range of 51-53. This points to a business sector in the OECD area with negative or almost flat growth rates.

In China, signals are negative in light of stricter covid-19 control and prolonged drop in house prices. Official Chinese PMI figures were disappointing, both within the manufacturing and the service sector. Both now have a reading below 50, which indicates economic contraction. The fiscal and monetary policies are consequently still lenient.

Investment conclusions and asset allocation

In recent months, the financial market has continued its zigzag path in terms of returns of risk vs risk-free assets. Thus far, this return pattern most resembles the mini cycles of 2011/12 and 2015/16 when periods of moderate loss of economic growth momentum led to periods of converging returns across the risk spectrum. However, the economic and political environment is very different from the aforementioned mini cycles, which has mainly to do with the current synchronised monetary tightening cycle in the OECD area and parts of Asia, which aims to dampen growth and with that the price development. The FOMC Minutes conveyed the following message from the U.S. monetary policy members: "Participants noted that a period of below-trend real GDP growth would help reduce inflationary pressures and set the stage for the

sustained achievement of the Committee's objectives of maximum employment and price stability". The monetary tightening cycle has a significant, two-pronged impact on the macroeconomic environment expected to play out in coming quarters:

1. The short-term tactical momentum will remain weak, and tightening is likely to rule out a significant, sustained increase in the Composite Leading Indicator (the OECD's growth indicator).
2. This time around, low growth momentum will last for so long that it may potentially trigger turnarounds in strategic areas, such as job markets and housing markets.

These negative signals on inflation expectations given by leading central banks have once again sent real rates up – after a sharp drop in July. Viewed in isolation, this development is expected to curb the possibility of premiums on risk assets again returning to the low levels seen at the onset of 2022. In this environment, positive returns of equities will be even more dependent on the development in EPS continuing its upward trend. Here, it is worth emphasising that, in recent months, earnings expectations for 2022 and 2023 of S&P500 companies have changed from a positive to a negative trend. 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 tightening cycle is suddenly replaced by an expansion cycle. However, the likeliness of such an outcome is deemed small, especially in the light of recent monetary policy signals that reach into the next couple of months.

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