Sparinvest

DECEMBER SAW NEGATIVE RETURNS ACROSS THE RISK SPECTRUM

The negative sentiment returned to the financial markets in December. The development led to relatively large and broad-based losses on both risk-free and risk assets.

According to MSCI ACWI, global equities lost 4.7% stated in local currencies. Translated into DKK, this was a decrease of 7.5%. The negative returns were driven mainly by developments in MSCI World, which fell by 5.1% stated in local currencies, while MSCI EM fell by 2.0% in December. The negative environment also affected the return hierarchy stated at sector level. The largest falls were seen in cyclical sectors such as Info Tech and Consumer Discretionary. The smallest falls were seen in defensive sectors such as Utilities and Health Care.

The return on European corporate bonds were relatively strong compared with those of other asset classes. 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 tightened by 13bp and 8.0bp, respectively, last month, resulting in excess returns of just over 0.7pp for the two asset classes relative to the return on comparable government bonds. The Danish 10Y government bond yield rose from 2.1% to 2.7% in December.

Global business confidence declined further

Confidence indicators across the OECD area showed a diverse pattern in December. Within manufacturing, business confidence declined further in the US and Japan, while it rose from low levels in Europe. At the aggregated level, business confidence still shows a downward trend. JPM Global Manufacturing PMI (Purchasing Managers Index) peaked at 56 in May 2021. The declining trend since this peak meant that the index was at 48.8 at end-November 2022. An index below 50 typically indicates shrinking global industrial output. The current level mostly points to a moderate decrease rather than an abrupt downturn for the global industrial sector. The current index level matches the levels at which the PMI bottomed out during the three “mini-cycles” in 2011-12, 2015-16 and 2018-19, which then characterised periods of moderate economic slowdown in the OECD area. The Chinese authorities have finally taken a new approach to corona. The shift is extreme. China has gone directly from a zero-tolerance approach with extensive restrictions to cancelling virtually all restrictions in society, irrespective of corona developments. This radical shift will result in heightened uncertainty for a while – and there are indications that in some areas economic activity has declined further due to cautious behaviour among the population. The information value of Chinese economic indicators will be low in the near term.

Investment conclusions and asset allocation

In recent quarters, economies and financial markets have been in the process of shifting to a contractive (restrictive) economic policy in order to curb demand and slow down growth. Growth has so far slowed down at a moderate pace, see the publication “Slow motion”. There are incipient signs of a slowdown in the job markets and housing markets in the OECD area, but impacts remain limited. This has given rise to exceptionally volatile return patterns, both for risk and risk-free assets, reflected in high-frequency fluctuations between risk aversion and risk appetite. This is characteristic of a time of crisis.

The synchronised tightening cycle has gathered further speed in recent weeks. As regards Europe, the ECB has indicated that ".. substantial further hikes are still needed to get rates into sufficiently restrictive territory". According to market expectations, this will mean raising the key policy rate from currently 2% to a level of 3.5% by Q3/2023. The ECB's clear message about a tighter environment is bad news for economic momentum in Europe, see the publication (in Danish) "Hellere for meget end for lidt ..". As regards Japan, the BoJ will in future allow the target 10Y government bond yield of around 0% to fluctuate within the interval +/-0.5% rather than +/-0.25%. Following that announcement, the yield immediately moved to the top of the new interval.

Federal Reserve chair Jerome Powell has recently stressed: "So, from a risk management standpoint, we want to be sure that we don't make the mistake of either failing to tighten enough, or loosening policy too soon". If the Fed opts to follow this message in its future monetary policy intervention measures, the implications will be two-fold: Firstly, the key policy rate will continue up in 2023. Secondly, monetary tightening will not immediately make way for monetary easing. This is in stark contrast to a financial market that is factoring in the beginning of a new monetary easing cycle in H2/2023. A Fed pivot has not previously been a signal that led to impending turning points in risk premiums. Following Fed pivots in 2001 and 2007, the OAS spreads of global high-yield bonds did not peak until 15-18 months later, see the publication (in Danish) "Fed pivot og kreditspænd".

Given the prospect of a weak tactical environment, a turning point in the strategic environment and generally reduced liquidity due to quantitative tightening, a defensive allocation of assets is preferred. Both equities and corporate bonds are underweight relative to government bonds/mortgage bonds. In the equity universe, the Minimum Volatility segment is overweight.

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