

RENEWED RISK APPETITE IN JANUARY – ONCE AGAIN IN THE WAKE OF YIELD DECLINES

Risk appetite of finance investors surged in January following a period in December dominated by risk aversion (investors' reluctance to assume risk without being rewarded). We have seen shifts between risk appetite and risk aversion since the beginning of 2022. Such shifts are characteristic of the times of change following monetary tightening. Once again, risk assets generated high returns in periods of relatively large declines in US government bond yields.

Global equities returned 6.5% in January according to MSCI ACWI in local currencies. The return corresponded to 5.7% in DKK. January was characterised by major sector rotation. Sectors with the lowest and highest returns in 2022 achieved the highest and lowest, respectively, returns in January 2023. Companies within the sectors Semiconductors, Media and Consumer Discretionary generated the highest returns, while the returns of companies within Health Care, Utilities and Consumer Staples were the lowest.

In January 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 declined by 17bp and 56bp, respectively. This resulted in excess returns of 101bp and 253bp, respectively, for the two asset classes relative to the returns on comparable government bonds. The Danish 10Y government bond yield declined from 2.8% to 2.5% last month.

Slight changes in prospects for order books – Europe stands out

Recent confidence indicators in manufacturing suggest that the order intake is stabilising. According to S&P PMI flash data, marginal increases in the order

components in the US, China and Japan provide index readings at 44, 49 and 46, respectively. In Europe the rise was more substantial with the order component jumping from 43 to 45. On the threshold to 2023, global manufacturing remains on a relatively feeble footing and is characterised by low new orders and high inventories. In Europe, prices of natural gas and electricity have dropped to levels below the levels before the outbreak of the Ukraine/Russia conflict. This is obviously positive for the European economy, viewed in isolation, and the latest improvements in the European key figures should be interpreted in that context.

China has recently abandoned its zero-tolerance corona approach with extensive restrictions and has today cancelled virtually all restrictions in society, irrespective of corona developments. In China, corona has primarily dampened activity in the services sector rather than in manufacturing. So, the coming period will mainly see normalisation of the domestic Chinese economy and secondarily foreign growth impacts on the other Asian economies.

Investment conclusions and asset allocation

As mentioned above, economies and financial markets are undergoing times of change. This has given a volatile return pattern across the risk spectrum, but so far also a converging return pattern between equities and bonds. The return on equities still seems to cling to the yield development. Times of change brought about by monetary tightening are challenging environments. Monetary tightening is a relatively rare phenomenon and has occurred just eight times in the US over the past 50 years. When monetary tightening is finally initiated, there is a *lag* in the effects on the real economy. In periods of monetary tightening, there

is room for highly diverging scenarios. And exactly such diverging scenarios are currently reflected in the expectations of financial markets:

- Hard landing: In the bond market, the federal funds rate in the US is expected to peak at 4.9% in June, after which the US Federal Reserve will initiate a new expansion cycle. Market expectations are pencilling in a decline in the federal funds rate to 4.5% towards the end of 2023 and yet another drop to 3% at end-2024.
- Soft landing: According to Jerome Powell, Chair of the US Federal Reserve, *"no participants anticipated that it would be appropriate to begin reducing the federal funds rate target in 2023"*.
- No landing: Equity market expectations are that the earnings capacity is strong and prospects are quite favourable. S&P EPS will continue to rise in the coming 12-18 months.

This leaves a large outcome space, but outcomes are also mutually contradictory. Not all outcomes can thus materialise. All the above makes for a challenging environment.

The past 12 months have shown that economic growth is slowing down at a moderate pace, see the publication "[Slow motion](#)". This means that the most likely scenario is a continuation of the synchronous tightening cycle in 2023. Such scenario will prevent the monetary policy pivot as mentioned above, where the tightening cycle swiftly changes to an expansion cycle.

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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