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INTERVENTION IN BANKING SECTORS STABILISED FINANCIAL MARKETS IN MARCH

Banking turmoil affected the financial markets in March, leading to large yield declines on government bonds. This put risky assets under pressure until the US and European authorities set up lending facilities and loss guarantees. Intervention led to renewed risk appetite at the end of the month.

According to MSCI ACWI, global equities gained 2.4% stated in local currencies. Converted into DKK, the rise was 0.7%. March saw high diversification at sector level with an underlying defensive trend. Finance, Energy and Real Estate had the highest negative returns; Tech, Communication Services and Utilities had the highest positive returns.

The banking turmoil put risk premiums on corporate bonds under pressure. 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 widened by 22bp and 55bp, respectively. As a result, the two asset classes yielded excess returns of -88bp and -180bp, respectively, relative to returns on comparable government bonds. The yield on Danish 5Y government bonds fell from 2.9% to 2.6% in March, resulting in a 1.8% return for the period.

Core inflation is a bigger problem than growth

Growth-related economic indicators have, for an extended period, been sending out signals, which can be summarised in two general conclusions. First, the service sector in general is experiencing solid growth compared with the manufacturing sector, which is seeing stagnating growth. This applies to the OECD area and China. Secondly, the manufacturing sector currently has relatively high inventories and low order intake, which is an imbalance that puts industrial production under pressure. Overall, the economy is characterised by some degree of setback, showing also a fragmented trend of continued high labour demand, especially in the service sector.

So far, the abovementioned growth has been sufficient to maintain job market growth. As a result, the current inflationary situation is considered a bigger problem than the growth trend. The most recent inflation data from the US and Europe suggest so-called sticky core inflation. The US Core PCE index (ex housing) continues to rise by 5% annually, thus holding the trend level since May 2021. European core inflation was up 5.7% in March with no signs of a slowdown. Naturally, this has caused concern for the Federal Reserve as well as the ECB.

Investment conclusions and asset allocation

The events of recent weeks in the US and European banking sectors are yet another sign that the economies and financial markets are undergoing times of change. This leaves a challenging environment brought about by monetary tightening. Of course, the systemic scope is being discussed. The problem is that since spring of 2022, both large and small US banks have lost historically large deposits. This is probably due to more attractive alternatives to bank deposits – both with regard to return and security. The steps taken by the US government in recent weeks have not had a fundamental effect on this. The higher premiums on interbank loans and commercial papers have stabilised but have yet to reach the low levels at the beginning of March. This is a simple indication of how mistrust in the banking sector in no time spreads to lending conditions in other areas of the economy. Such development must be quickly stifled, see the publication "Credit crunch".

The banking sector turmoil is bound to disturb the monetary tightening cycle of the leading central banks. The Federal Reserve has had to launch the Bank Term Funding Program (BTFP), which can be equated with the ECB's Transmission Protection Instrument (TPI). Both facilities aim at ring-fencing "weak-link" banks in the US and in European buffer states. With that, central banks will be ready to continue the tightening cycle using traditional instruments. Neither the Federal Reserve nor the ECB have slackened their efforts to bring down inflation in recent weeks. The programme for the economic process in the coming quarters remains in tune with the conclusions made by Jerome Powell, who, after the FOMC meeting in early February, said:

> *"... you will not have a sustainable return to 2% inflation in that (core services ex-shelter) sector without a better balance in the labour market".*

For this reason, the OECD area is experiencing a monetary tightening cycle that is the fastest and strongest to set in for more than 40 years. Under such circumstances, traditional collaterals lose value. A problem which is not limited to the banking sector. Several episodes are likely caused by credit crunches in the coming period and serve merely as a reminder of the difficulty of establishing the "soft landing" which central banks believe to be possible this time. Viewed in isolation, such circumstances call for higher risk premiums. Given the 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. Equities and corporate bonds are underweighted relative to government bonds/mortgage bonds. In the equity universe, the Minimum Volatility segment is overweighted.

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