

APPETITE FOR RISKY ASSETS IN APRIL – BUT DEFENSIVE SECTORS TOOK THE LEAD

In April, investors still digested the US and European banking sector turmoil, which hit the financial markets in mid-March. It should be noted that several market-specific signals indicating banking sector stress stabilised in April, interpreted in the short term to mean that related loan markets are fully functional.

The overall financial market trend in April showed renewed appetite for risky assets. Global equities gained 1.4% according to MSCI ACWI in local currencies. MSCI ACWI remained unchanged in April, in DKK. Generally higher equity indices were, however, led by defensive rather than cyclical sectors. High returns were generated by Consumer Staples/Health Care, while low returns were generated by Semiconductors/Consumer Discretionary. MSCI World Defensives yielded a return in April of 3.7%, outperforming MSCI World Cyclical at 1.0%.

European corporate bonds saw marginal changes in risk premiums in April. Credit spreads (i.e. the yield pick-up on investment in a corporate bond relative to a government bond) of investment grade bonds tightened by 7bp and remained largely unchanged for high-yield bonds. This resulted in excess returns of 52bp and 32bp, respectively, for the two asset classes relative to comparable government bonds. With Danish 10Y government bond yields at 2.6%, the level remained almost unchanged in April.

Unacceptably high core inflation in the US, Europe and the UK

April's growth-related indicators do not change the long-standing economic momentum trends. Signals may be summed up in two overall conclusions: Firstly, 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.

On the price side, April key figures confirmed the sticky wage and core inflation trends. In Q1/2023, U.S. payroll costs rose by 5% on an annual basis. The high level has characterised the last four quarters. As for consumer prices, core inflation in the U.S., the UK and Europe exceeds 5.5% on an annual basis. It goes without saying that central banks find these levels unacceptably high. Recent data cover March.

Investment conclusions and asset allocation

Banking sector turmoil has only lasted six weeks, and evidently, it is too early to measure real economic effects. However, experiences from the banking sector show that turmoil in that specific sector must be brought under control very quickly to avoid broad-based negative effects. Beginning of May, U.S. authorities again had to initiate a solution under which yet another regional bank facing bankruptcy (FRC) was taken over by another bank (JPM). This only serves as proof of the risk that problems in the sector carry certain systemic characteristics. Since spring of 2022, both large and small U.S. banks have lost historically large deposits. This is due to more attractive alternatives to bank deposits – both with regard to re-

turn and security. The steps taken by the U.S. government recently have not had a fundamental effect on this.

On the positive side, it should be emphasised that premiums on interbank loans have stabilised in recent weeks, again allowing the financial market to shift focus back to the balance between growth/inflation and the tightening cycle. In the same period, expectations for central bank terminal rates have started to head higher again, as a reflection of the perceived need for more doses of monetary tightening to dampen inflation and growth. The next Fed and ECB meetings will take place beginning of May, at which point, central banks only have limited data for assessing the real economic effects of the banking sector turmoil. The most likely scenario is for central banks to stick to their intentions of bringing down inflation. Therefore, 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".

Against this backdrop, the OECD area is experiencing a monetary tightening cycle that is the fastest and strongest to set in for more than 40 years, providing the right conditions for a fast-emerging credit crunch. A problem which is not limited to the banking sector. Several similar episodes are likely in the coming period and serve merely as a reminder of the difficulty of establishing the "soft landing" that 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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