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TECH DOMINANCE IN MAY OVER-SHADOWED FLAT RETURNS ON MOST ASSET CLASSES

The tech sector dominated global equity markets in May. Investors have shifted their focus to artificial intelligence, which lifted the Info Tech sector by 8% last month. This overshadows a general negative return development in most other parts of the equity market. The Energy and Materials sectors were at the bottom of the return hierarchy with returns of -9% and -7%, respectively. Overall, MSCI ACWI decreased by 0.3% measured in local currencies, while the index increased by 2.5% measured in DKK.

At index level, the European corporate bond market was characterised by minor fluctuations in May. Changes in credit spreads were modest. The spread of investment-grade bonds went up by 8bp to 175bp, while the spread of 494bp of high-yield bonds remained unchanged from the previous month. This meant that investment grade bonds yielded an excess return of -15bp compared with comparable government bonds. The excess return on high-yield bonds amounted to 49bp in May. The Danish 10Y government bond yield fell by a modest 3bp to 2.6% at the end of May.

Broad-based downturn in manufacturing momentum

Recent business confidence indicators in manufacturing once again signal a loss of momentum. Declines are broad-based, as PMIs according to S&P Global show a downturn in Europe, the US and the UK. For all data series, PMIs have again dropped below index 50, which signals a decline in manufacturing output. Recent data from China are mixed. The confidence indicators from NBS and Caixin, respectively, fluctuate around index 50, which can be interpreted as a broadly flat development in manufacturing output at the moment. Japan is the only positive exception among the major economies. The latest business confidence indicators in the services industry indicate that economic momentum has started to peak at relatively solid growth levels. The gap in current economic momentum between the services and the manufacturing sector in the leading economies has not been bigger since 2009, measured by the confidence indicators mentioned above.

Recent inflation data have generally confirmed the tendency for inflation to decline mainly on account of developments in cyclical components, including food and energy prices. Core inflation, on the other hand, appears to remain sticky. Core inflation in the US and Europe is at 5-5.5%, while it has risen to just under 7% in the UK. These inflation levels are still extremely far from central bank targets.

Investment conclusions and asset allocation

Stability on the surface seems to characterise the situation in financial markets these weeks. This implies modest risk premiums on corporate bonds and on equities in particular. Implied volatility on equities has stabilised again at extremely low levels.

Financial markets increasingly expect the US central bank, Federal Reserve, to lower its policy rate by around 0.75 percentage point relative to the current level of 5.25% over the coming year. This is diametrically opposed to the market conditions in 2022, when expectations signalled strong rate hikes from the Federal Reserve. The prospect of an imminent turning point in the monetary policy cycle apparently leaves investors with a high degree of comfort and correspondingly low requirements for risk premiums.

The economic development in the OECD area has moved in "slow motion" in recent quarters. The slow pace has probably contributed to the widespread expectation that economies are heading for a soft landing – despite the strongest monetary policy tightening cycle for 40 years. However, we rarely see soft landings. The current extraordinarily tight job market in the US and partly in Europe suggests that a soft landing will not be sufficient to curb the exceptionally high wage inflation. Central banks will ensure more capacity in the job markets by maintaining a restrictive monetary environment. Terminal rates in the US and Europe have started to head higher again in recent weeks now that the turmoil in the banking sector is fading away.

The tactical asset allocation stems from expectations of short-term economic momentum – but the prospect of an imminent turning point in the job market means that for the first time in around 15 years, the strategic environment provides a strategically negative backdrop for risky assets. The US job market has reached its maximum. Job openings have decreased by 16% since their peak in June 2022. Since then, earnings among US companies have been in recession. Forward EPS for the companies in the S&P 500 and Russell 2000, respectively, are down by 4% and 20% from their respective peaks. The negative earnings trend is expected to continue as the job market eases. This strategic path provides poor conditions for a possible tactical recovery of a more sustained nature. The current low risk premiums on both equities and corporate bonds do not suggest that pricing levels factor in such an economic outlook. Overall, a defensive asset allocation is preferred. Equities and corporate bonds are underweighted relative to government bonds/mortgage bonds. In the equity universe, we overweight the Minimum Volatility segment.

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