Sparinvest

Monthly comment for October

Risk appetite turned into risk aversion amid rising infection rates in October

The rise in registered coronavirus cases continued into October. This prompted lower risk appetite to return to the financial markets after MSCI ACWI touched an all-time high in mid-October. MSCI ACWI was down by 2.5% in local currencies and 1.8% in DKK. The negative performance was driven by developed markets headed by the European markets. MSCI EM rose, however, by 1.5% in October, despite USD strengthening.

Credit spreads (i.e. the yield pick-up from investing in a corporate bond relative to a government bond) of European corporate bonds went up in the second half of October, but the month ended at largely unchanged levels. Credit spreads of investment grade bonds dropped by 2 basis points, while credit spreads of high-yield bonds increased by 3 basis points in October, prompting an excess return of 0.3% on investment grade bonds relative to comparable government bonds. High-yield bonds generated a return in line with comparable government bonds. The Danish 10Y government bond yield fell by 10 basis points to -0.5% in October.

New measures to fight coronavirus will once again feed through to economic indicators

As mentioned, the number of registered coronavirus cases is surging in Europe as well as in the U.S. This obviously extends the period in which the virus will be determining the course of economic indicators. During a prolonged health crisis, expectations for/forecasts of economic momentum make increasingly less sense. In Western economies, infection rates tend to hinge on activity in society, and politicians'/authorities' response patterns tend to mechanically follow the infection rates. In previous commentaries, we have referred to the current pattern of shifts between deterioration and improvement as the new normal. In the coming period coronavirus is once again expected to impact the healthcare measures taken by the authorities and consequently the real economic momentum.

This is why even the most recent indicators do not offer great value, despite being classified as leading indicators. But currently the selective measures against coronavirus have not resulted in a decline in manufacturing business confidence. Recent data show rising order components from the U.S., the eurozone and Japan in October. The largest negative effects are so far attributable to the service sector in Europe. China has maintained the low number of virus cases from spring, and economic recovery is gaining ground. Manufacturing data are strong. According to the reliable Chinese media Caixin, at the end of October the ratio between orders and inventories had climbed to a record high since early 2011. Thanks to the Chinese credit policy, the economic impulse is still trending up. Viewed in isolation, this setting is favourable for continued positive momentum in China in the quarters ahead.

Investment conclusions and asset allocation

The corona crisis has wreaked havoc for nine months. The actual virus development measured by the infection rate seems to follow a pattern of rising when the levels of activity in society increase and declining when the levels of activity in society decrease. This infection pattern is characteristic of most viruses. But exactly this pattern is the reason why expectations for/forecasts of economic momentum make increasingly less sense, as the outcome primarily depends on authorities' expected virus response. This infection pattern and response pattern have become the new normal and will most likely continue until a vaccine permanently brings the pandemic to an end. The coming months may simply be characterised as an in-between period between the following:

1: The rising coronavirus cases in Europe and the U.S. have brought and will bring about new restrictive measures until the curve has been reversed once again. Soft lockdowns will only selectively cause economic momentum to wane, while hard lockdowns will lead to sharp declines in economic activity.
2: The first phase III clinical trial results for a coronavirus vaccine will most likely be published within the coming months.

From a tactical perspective, this in-between period is complex. Stage **1** implies that the economic outcome space in the short term remains big. Stage **2** may, on the other hand, mark the beginning of a transitional period in which vaccines become the remedy to ultimately eliminate coronavirus. A pivotal medical breakthrough could, at best, lie just ahead of us.

Recent developments indicate that the virus curves particularly in Ireland and the northern regions of the UK have started to top out, following so-called Level 5 and Tier 3 lockdowns of the two areas. A positive aspect of these observations is obviously that lockdowns once again prove their ability to reverse the curves. A negative aspect is that the same trend in the virus curve for Continental Europe may require even stricter lockdowns than the current ones. The general view is that, compared with spring, Western authorities are now better prepared for handling higher infection rates, which so far have not fed through to similar increases in virus-related hospitalisations or deaths. This calls for selective measures rather than widespread hard lockdowns. The tactical overweight of equities vs government bonds and covered bonds is maintained. In early June, this allocation was expanded by a tactical preference for European banks. Historically, the sector has yielded the highest return when the OECD's Composite Leading Indicators (CLI's) rise from low levels, see the publication 'Overvægt EU-banker versus EU-marked'.

Editorial deadline: November 10, 2020