Sparinvest

Monthly comment for March

Returns on risky assets take the lead in March

Several benchmark equity indices reached record-high levels in late March as increases in government bond yields began to flatten.

Global equities gained 3.5% in local currencies and 5.6% translated into DKK according to MSCI ACWI. In March the increases were, once again, led by MSCI DM, up by 4.2%, while MSCI EM fell by 0.9% in local currencies. Despite the strong risk appetite, the returns pattern was somewhat more blurred across equity sectors. In March, returns were led by the Utilities and Consumer Staples sectors, while Technology and Consumer Discretionary generated the lowest returns.

In the preceding month, credit spreads (ie the yield pick-up on investment in a credit bond relative to a government bond) of European investment grade bonds widened by 1bp, which led to a return matching that of comparable government bonds. OAS spreads of European high yield bonds fell by 9bp, resulting in an excess return of 0.4% relative to comparable government bonds. The Danish 10Y government bond yield rose marginally from -0.1% to 0% in March.

Growth-related U.S. fundamentals are exploding

In recent weeks, especially the growth-related fundamentals have exploded in the economies whose vaccination rollouts against corona are most advanced. A case in point is business confidence among U.S. companies. According to the ISM, optimism in the U.S. manufacturing sector is at the highest level since 1983. An equivalent report for the service sector shows that business confidence is at the highest level since the data series began in 1997. This reflects several factors:

- Firstly, part of the strong momentum can be seen as a mechanical phenomenon that automatically sets in when activity in society can take place in a less restricted environment.
- Secondly, this development can be seen as the initial realisation of the enormous pent-up demand potential stemming from the most recent economic recovery packages and the associated savings surplus in the household sector. In the U.S., this amounts to almost USD 4,500bn – corresponding to more than 20% of GDP.

The above factors contain key input for considerations about developments in the tactical indicators in the coming months. With the current record-high confidence levels, there can no longer be any doubt that "max optimism" is already materialising – so that assessments of the future tactical environment to a much larger extent boil down to how long these particularly high confidence levels will persist.

Investment conclusions and asset allocation

For the first time during the corona crisis, the bond market has begun to factor in a more optimistic scenario for the economy. This has especially led to heavy losses in parts of the U.S. bond market. In mid-March, the drawdown of U.S. 30Y government bonds had reached a level of around 25%. However, it is more doubtful whether the yield rises have led to actual tightening in the monetary environment. The U.S. 10Y real rate has risen only marginally to -0.6% and has not significantly exceeded the particularly low real rates applicable since the early summer of 2020. In Germany, the situation is now more extreme in the form of a 10Y real rate of -1.7%. Negative real rates are a relatively rare phenomenon in the U.S. In the past 20 years, real rates have been positive for 18 years and negative for just 2 years, see the publication *(in Danish)* "Hvorfor så negativ?".

Hence, the interest rate environment remains favourable for risk premiums – presumably too favourable. Historically, interest rate rises have been mostly positive for the returns of risky assets and the development in risk premiums – when triggered by a higher growth outlook rather than hawkish signals from central banks. This is currently the case.

There are no indications of monetary policy tightening in the OECD area over the summer. In Europe, the ECB has recently announced that bond purchases under the PEPP will be increased until end-Q2. This should be seen as a step to counter the rise in interest rates seen in recent months. In the U.S., the Fed has set high ambitions for job market recovery, namely *"Achieving and sustaining maximum employment"*.

Tactical indicators close to "max optimism" should always give rise to considerations about a possible imminent phase shift in economic momentum. At present, mass vaccination and the resultant reopening in the OECD area are deemed to be in the initial phase – which can ensure near-maximum economic momentum for some time yet. This is typically positive for the return ratio between risky and risk-free assets, but the impetus will presumably be more moderate in the coming period. The allocation overweight of equities vs government bonds and covered bonds is maintained. In recent months, the overall tactical allocation has regularly been extended with strategies in the equity spectrum; strategies that are supported by the expected trend in the CLI (Composite Leading Indicator – the OECD's measure of overall growth in the global economy) but also sensitive to higher interest rates. This means that Financials is overweighted in the U.S. and Europe, while Health and Utilities are underweighted in Europe – relative to the respective market indices. See the publication *(in Danish)* "CLI og indtjeningsvendingen" for an elaboration on and status of these equity strategies.

Editorial deadline: April 13, 2021