Sparinvest

Monthly comment for December

Risk appetite maintained in December

Towards end-2020 risk appetite still dominated financial markets. The deteriorating virus curves in the U.S. and Europe were weighed against positive news in the areas of vaccines, relief packages and Brexit.

Global equities gained 3.8% in local currencies, according to MSCI ACWI. Translated into DKK, this was an increase of 2.3%. The development was driven by emerging markets, which were up 5% measured in DKK. These favourable trends were also observed in credit markets. Credit spreads (i.e. the yield pick-up on investment in a corporate bond relative to a government bond) of European investment grade and high-yield bonds tightened by 2 basis points and 13 basis points, respectively, in December. This led to excess returns of 0.3% and 0.9%, respectively, on the two categories relative to returns on comparable bonds. The Danish 10Y government bond yield remained unchanged at -0.5% last month.

Price rises also characterised large parts of the commodity market. Oil and copper prices were up 8.8% and 2.9%, respectively, in December.

Mixed economic indicators following new lockdowns

The coronavirus pandemic has made forecasts of short-term economic momentum increasingly futile. The persevering coronavirus has triggered an almost mechanical cycle based on the following parameters in this order:

Virus curve ➡ virus measures ➡ economic indicators

During the corona crisis, focus has naturally been on the virus curve, which has defined the direction of subsequent societal restrictions and thus economic momentum. Growth-related economic indicators have become a function of the virus curve. In the negative version, the current lockdowns will weaken economic indicators in the coming months. In the positive version, the measures will start taking effect. The virus curves seem to have peaked in Europe and the U.S. – albeit with an upward trend in infection rates in the past few weeks of 2020. The cycle is intact with high predictability and low information value.

The mixed economic indicators are reflected in the weekly economic activity indices. In Germany, the index has been falling since mid-September. In the U.S., however, the index has been on the rise since May. Business confidence indicators are also beginning to show a more mixed picture, as new societal restrictions will inevitably reduce economic momentum.

Investment conclusions and asset allocation

The corona crisis has delivered many surprises, in terms of both health and economic effects. With the recent approvals of covid-19 vaccines in the U.S. and Europe, it is now even more likely that the course of the corona crisis may be described in these three headlines:

- Lockdown/reopening (short term)
- Covid-19 vaccines
- Recovery/normalisation (long term)

This is, of course, a highly simplified description. The point is that covid-19 vaccines will be the means to ensure long-term recovery and normalisation of the global economy. The news flow of recent weeks in this area is therefore of decisive importance. Vaccines from Pfizer/BioNTech and Moderna have been granted emergency use authorisations. A vaccine from AstraZeneca is under review. This supports the probability that these three vaccines, at a minimum, will be the standard vaccines applied in the OECD area in the near term.

In spring, the corona crisis made the economy shift from a late-cycle to an early-cycle position. During normal economic cycles, such movements usually take several years – but with the corona crisis, they took only a few months. Early-cycle positions are typically characterised by high idle production capacity. Against this background, the coming years are likely to be characterised by low investment activity and modest wage growth. Because of these factors, economic policy is expected to remain lenient in the years to come. Early-cycle positions, expressed as turning points in the job market, have historically prompted a positive earnings trend and important return patterns in financial markets. First, returns on high-risk asset returns have trended above returns on risk-free assets when unemployment has been on the decline. Second, equities have on average yielded positive returns in downturn phases of the CLI (the OECD's Composite Leading Indicator – an aggregate measure of global economic growth) when these phases have occurred in periods of strengthening job markets. For further details, please refer to the publication "Fra 'late cycle' til 'early cycle'" (From late cycle to early cycle). Overall, this favours maintaining the tactical overweight of equities vs government/covered bonds. Over the past few months, this overall allocation strategy has been expanded with equity strategies. Most recently, a strategy of underweighting EU Health Care versus EU Market has been opened, as this sector has more defensive characteristics with respect to their earnings and return patterns in relative terms.

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