Sparinvest

Monthly comment for February

Equity index at all-time high – but has since been pressured by rising interest rates

The benchmark equity index hit an all-time high in mid-February but then fell towards end-February due to rising interest rates.
Global equities gained 2.4% in local currencies and 2.7% translated into DKK according to MSCI ACWI. In February the increases were led by MSCI DM, up by 2.6%, while MSCI EM rose by 1% in local currencies. The rising interest rates created large differences in return across sectors. Equities relating to Energy/Materials and Financials/Insurance obtained the highest return, while equities relating to Utilities, Technology and Health generated the lowest returns.

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 5bp and 29bp, respectively. This led to excess returns of 0.3% and 1.2%, respectively, on the two asset classes relative to comparable government bonds. The Danish 10Y government bond yield rose from -0.4% to -0.1% last month. This yielded a negative return of 2.4% in February.

Dropping virus curve – but economic indicators still without information value

In 2021, so far the virus curve has been sharply decelerating in the U.S., Europe and parts of Asia; a trend congruent with the expected pattern given the lockdowns of socio-economic activity. For a while now, the mechanical spread of virus has removed the information value from short-term economic data. The service sector is still generally hit harder than manufacturing by lockdowns.

Not surprisingly, the falling virus curve has triggered yet another reopening process, just like in the early stages of corona when the virus reproduction rate was dropping. This should benefit the hardest-hit sectors in the coming period.

From an economic viewpoint, the significantly upward revised growth outlook for this year has been the most remarkable in 2021. The optimistic outlook succeed recent months' vaccine breakthroughs in addition to the prospects of an American Rescue Plan, these weeks undergoing final political negotiations in the U.S. This trend holds potential to fuel a strong pent-up demand (rapid increase in demand) in the OECD area, once mass vaccination allows for a wider and more permanent reopening of socio-economic activity. In the U.S. alone such potential is assessed at a gross value in excess of 20% of GDP calculated before any countercyclical effects.

Investment conclusions and asset allocation

For the first time during the coronavirus crisis, nominal government bond yields in the U.S and partly in Europe are uptrending and reflect high inflation expectations expressed by BEI, which has increased with rises in CLI (Composite Leading Indicator, the OECD's cyclical indicator, which is an overall signal for global economic growth). This year, this has generated negative returns on the majority of U.S. and European government bonds and investment grade bonds. Any real monetary tightening resulting from the yield rises are probably limited. The 10Y real rate was up only marginally to -0.7% and has not significantly exceeded the particularly low real rates applicable since before the summer of 2020. In Germany the situation is even more extreme with the current 10Y real rate at -1.4%. 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?”.

The current rates are extremely favourable for risk premiums – possibly too favourable. The first adjustment could potentially put an end to the previously mentioned negative real rates. Historically, interest rate rises have been mostly positive for the returns of risky assets, and the development in risk premiums – when triggered by higher growth outlook rather than hawkish signals from central banks. This is currently the case.

We are seeing the contours of another acceleration in momentum during summer – set to additionally ripen economic growth. This process is expected to bring CLI from recovery to expansion. This is typically positive for the return ratio between risky and risk-free assets but with an impetus that is more moderate than in the recovery phase. The allocation overweight of equities vs government bonds and covered bonds is maintained.

Over the past few months, this allocation has been expanded with equity strategies, partly underpinned by the expected CLI process but also with sensitivity to higher interest rates. In the past year, the CLI process has fed through to the returns of cyclical and defensive sectors. In H1/2020 the robustness of EPS (earnings per share) benefitted the defensive sectors, but the CLI turnaround has since then granted preference in the cyclical sectors' favour. This scenario is expected to expand during 2021 as CLI moves through the expansion phase. In terms of allocation, Financials is overweighted in the U.S. and Europe, while Health and Utilities are underweighted in Europe – relative to the respective market indices.

Editorial deadline: March 16, 2021