Sparinvest

Monthly comment for July

Positive returns on risky assets in July – but weaker USD

The financial market trends in July were generally a repetition of Q2 trends. Risky assets again outperformed risk-free assets. However, the USD weakened by just under 5% vs DKK last month, which of course reduced the returns on U.S. assets translated into DKK. Global equities gained 4.0% in local currencies and 0.3% in DKK according to MSCI ACWI. The Emerging Markets and U.S. equity indices led the increases, which often gain on a lower USD. OAS spreads of corporate bonds were down 22bp and 37bp in European IG bonds and HY bonds, respectively. This led to excess returns of 1.3% and 1.6%, respectively, for the two asset classes relative to comparable government bonds. The Danish 10Y government bond yield fell marginally by 6bp in July to -0.4% at end-July.

Coronavirus remains essential to reopening process

The coronavirus continues to influence the reopening process and consequently economic growth. Hard-lockdown countries have generally been able to reopen without seeing a significant acceleration in corona cases. By contrast, countries with soft lockdowns and early reopening tend to see a renewed acceleration in corona cases.

For example, the U.S. reopening backfired due to the increasing number of cases from mid-June. In the past few weeks the U.S. has introduced new restrictions in the states hardest hit, primarily affecting activities involving large gatherings, including restaurants/entertainment. High-frequency data from the U.S. now suggest minor activity declines in restaurants/retail trade and stable industrial production in July. This past month, the reopening in other leading economies has been somewhat smoother compared with the U.S. As expected, we will see new coronavirus outbreaks in Asia and Europe, primarily in the form of cluster outbreaks, which countries are trying to contain through different interventions.

Against this background, the important industry life cycle continued growing in July – with increases in all benchmark economies. The increase was most significant in China where Caixin PMI was up 52.8 in July. This is the weakest level since the beginning of 2011. Globally, this indicates that the positive economic momentum continued into July albeit at a somewhat more moderate rate of increase compared with the strong turnaround in early May.

Investment conclusions and asset allocation

In recent months, developments in the financial markets have again shown that *changes* to the economic momentum play a more important role than the *level* of economic activity when it comes to risk premiums and return patterns. The reopening of western economies is still in the initial phase. This means that the positive momentum in economic indicators may continue in the coming months as the reopening of economies unfolds. Mainly the aforementioned virus spread in certain parts of the U.S has blurred visibility in financial markets going forward, particularly in the wake of lower risk premiums since March. However, in the past three weeks, the virus curve does appear to have been flattening again at aggregate level in the U.S. This flattening is driven by more positive trends in the hardest hit southern states of the U.S. The number of coronavirus deaths in the U.S. per day increased to just over 1,000 from about 600 in the weeks of June/July. This is still significantly lower, however, than the mid-April level of more than 2,500 deaths. The fatality rate has thus not kept pace with the higher infection rates. Similar diverging trends have been reported in other parts of the world. If this trend persists, new lockdown measuresmay be both of a smaller scale and less far-reaching than previously.

Current risk appetite and risk positioning do not seem to have changed noticeably since March, see for example the AAII Sentiment Survey and BofAML Fund Manager Survey. In the U.S, investments in money market funds are up just over USD 1,100bn since early March. A mere USD 300bn was invested in the period when S&P 500 fell, whereas USD 800bn was invested in the period when S&P 500 increased by about 40%, see the publication "(Mange) penge på siden". This trend has reversed in the past five weeks, however, after around USD 200bn has been withdrawn again from the money market funds. This substantiates the overall perception that the current expectations and positioning among investors remain characterised by scepticism and caution. The generally positive economic data remain reflected in the revisions of earnings estimates. According to Citi's Earnings Revision Index, the negative momentum in estimate revisions peaked in mid-March. In the past three months, the index has increased significantly in tandem with the CLI turnaround. Based on the above, the tactical overweight of equities vs government bonds/covered bonds is maintained. In early June, this allocation was highlighted by a tactical preference for European banks. Historically, the sector has yielded the highest return when CLIs rise from low levels; see the publication "Overvægt EU-banker versus EU-marked".

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