Sparinvest

Monthly comment for June

Risky assets rallied in June

The financial market trends in June were generally a repetition of April and May trends. Risky assets outperformed risk-free assets. Return patterns reflected the positive momentum in the economic indicators in connection with the reopening of society. Global equities gained 2.9% in local currencies and 1.8% in DKK according to MSCI ACWI – a trend led by more cyclical regions. Emerging Market equities were up 6.6% compared with 2.3% for Developed Market equities. Risk premiums on corporate bonds declined further in June. The option-adjusted spreads of European Investment Grade bonds and High Yield bonds tightened by 16 basis points and 42 basis points, respectively, in the previous month. This led to excess returns of 1.1% and 1.8%, respectively, for the two types of assets relative to comparable government bonds. The Danish 10Y government bond yield fell marginally by five basis points to -0.3% at end-June.

Strong turnaround in economic indicators in the wake of reopening

The "February 2020 allocation overview" introduced the OECD's CLIs, which were expected to unfold in the first part of the corona crisis. The CLIs rested on two legs: First a period with a *negative* shock to the economy then (followed by) a period with a *positive* shock to the economy. The Asian economies reopened in March, and most western economies began reopening at the beginning of May, meaning that the reopening has currently lasted 2-4 months. This is reflected in a strong turnaround in some economic indicators. Generally, business and confidence indicators have regained most of the ground lost during lockdown. In terms of the reopening process, the Asian business sector has generally recovered ground more quickly than the households have, whereas the opposite has been true for large parts of the western economies. Albeit of a different nature, this has left potential/backlogs in both regions. Global business relations and supply chains should still be considered far from normal. Based on the current situation, the reopening is likely to span over the rest of 2020, depending of course on the spread of the coronavirus. This scenario suggests that the economic indicators could reinforce the strong turnaround from April/May, when Europe and the U.S. reopened. This will happen at a slower pace, which is the natural pattern when an upswing is replaced by a period of expansion.

Political intervention is expected to continue but, in future, compensation packages will be replaced by activity packages. The intervention mentioned have secured income formation during lockdown, whereas the latter intervention should increase demand after reopening. The activity packages being prepared/negotiated include the EU Recovery Fund worth EUR 750bn and possibly the USA Infrastructure Bill worth USD 1,000bn.

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 unfolds.

Obviously, the reopening process is associated with a risk of coronavirus resurgence. Experience from China and Europe suggests that the virus reproduction rate has remained at low levels. But recent weeks show an acceleration in total confirmed corona cases in the U.S., among other factors, due to relatively large outbreaks in Texas, California and Florida. New so-called hotspots are emerging, probably due to premature or rash reopening. By contrast, we are seeing a decline in corona cases in former hotspots, including in New York. Of course, this complicates things in the time ahead. The downturn in the U.S. is considered the first word of warning in the reopening process for the most important economies. However, the trend over the past few months has also shown that the financial markets are able to handle a corona crisis and a cautious reopening if the economic momentum picks up. Lockdown initiatives in the mentioned U.S. hotspots should not surpass the positive effects of reopening in the rest of the U.S., Asia and Europe.

The virus situation in certain parts of the U.S. has resulted in a more two-sided financial market, particularly in the wake of large declines in risk premiums since mid-March. 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 for the period when S&P 500 fell, whereas USD 800bn was invested for the period when S&P 500 increased by about 40%. This substantiates the overall perception that the current expectations and positioning among investors remain characterised by scepticism and caution. Overall, this favours maintaining the tactical overweight of equities vs government bonds/covered bonds. In early June, this allocation was highlighted by a tactical preference to European banks. Historically, the sector has yielded the highest return when CLIs rise from low levels.

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