Danske Bank Asset Management
Quarterly House View Q1 2019
INSTITUTIONAL

In 2019 we will finally put the financial crisis behind us

After close to 10 years of aftershocks from the financial crisis, the global economy is finally headed towards normality again, and we expect decent equity returns in the coming year, where recession fears are exaggerated. In contrast, the outlook for bonds is less encouraging.

Danske Bank

The trade war between China and the US has cost a little Chinese growth in 2018. However, we expect Chinese companies to experience a decent increase in earnings in 2019, while Chinese equity valuations are attractive following price falls in the past year.

Equities to recoup losses in 2019

The financial markets are behaving as if an economic recession is imminent, but we do not buy into the widespread scepticism and see an interesting potential in the equity market in 2019. We are particularly focused on Asia and quality equities.

By Anders Svennesen, CIO, Danske Bank Asset Management

When will the next recession come? That has been this year's most popular question – and judging by developments in the financial markets since early October, many investors are already beginning to position for a coming downturn.

So far this year, equity markets have delivered the weakest returns since the financial crisis ended, and the picture is not much brighter when we look at the various bond categories.

There are many good reasons why global equities currently give a negative return of around 2-3% for 2018; the new government in Italy and its budget challenges with the EU, uncertainty on Brexit, the US mid-term elections, the trade war between the US and China in particular and, not least, rising global interest rates spurred by the normalisation of US monetary policy.

The final item is probably also the reason why we experienced no less than two equity market corrections in 2018 with price falls in the order of 10%, which is definitely not normal. Historically, corrections on this scale occur once a year, while corrections of 5% are more normal, typically occurring three times a year.

However, I would like to stress that 2018 is perhaps not quite as abnormal as I suggest above. Prior to the correction in February, we had a full 572 days without a single 3% correction in the equity market – which is truly abnormal, as the equity market has a distinctive characteristic called mean revision. In other words, the equity market constantly tries to move towards its historical average return. So given this, two 10% corrections are largely to ▸▸

I simply cannot interpret current developments as indicating the next recession will strike in 2019.

Expected return from global equities of

7-9%

over the coming 12 months in local currency.

↑ Overweight in equities

↓ Underweight in bonds

be expected after such a long equity market upswing.

Overweight equities, underweight bonds

However, the most important conclusion to draw from equity markets at present is that this year's return signals recession-like circumstances at a time when we are definitely not in an economic recession. We therefore maintain our positive view on equities and recommend overweighting equities relative to bonds. That being said, we have revised down our return expectations slightly to 7-9% in local currency over the coming 12 months, which should be seen against our expectation of rising market volatility as global monetary policy becomes less and less accommodative.

In short, we expect 2019 to be more normal than 2018. The huge monetary policy experiment whereby central banks bought back enormous amounts of bonds is coming to an end. The US central bank, the Fed, is well under way with normalising monetary policy and by June 2019 we expect the policy rate to be neutral – in other words at 3% and neither stimulative nor contractive. As we approach that point, uncertainty on future Fed policy will grow, which in itself can increase the risk of financial market turmoil.

In Europe, we expect the European Central Bank, ECB, to follow suit. First, by ending bond buybacks at the end of the year, followed by the first rate hike since 2011 in the final quarter of 2019.

Bonds face a tough year

A changing monetary policy regime can certainly be expected to leave its mark on the financial markets – and investors will need to find their footing in the new reality. Major shifts in economic fundamentals never occur quietly, and in our view this is very much what ▸▸

2018 has been disappointing, but not exceptional

So far this year, global equities have generated a negative return of around 2-3%. While we have become used to better in recent years, this is not a return that should surprise equity investors. Looking at US equities (S&P 500), 30% of annual returns since 1928 have been within the range -10 to +10%. This is illustrated in the chart below, which shows the distribution of annual returns. 27% of annual returns have been negative.

Distribution of annual returns in the S&P 500 index

Returns post-2000 highlighted in bold

Over 40%	40-30%	30-20%	20-10%	10-0%	0 -10%	10-20%	20-30%	30-40%	Over 40%
						1942 19.2%			
						1944 19.0%			
						1972 18.8%			
						1979 18.5%			
					1993 10.0%	1986 18.5%	1938 29.3%		
					1992 7.5%	1949 18.3%	**2003 28.4%**		
					1956 7.4%	1952 18.2%	1998 28.3%		
				1939 -1.1%	1978 6.5%	1988 16.5%	1961 26.6%	1995 37.2%	
				1934 -1.2%	1984 6.1%	1964 16.4%	**2009 25.9%**	1975 37.0%	
				1953 -1.2%	1987 5.8%	**2012 15.9%**	1943 25.1%	1945 35.8%	
				1990 -3.1%	1948 5.7%	**2006 15.6%**	1976 23.8%	1997 33.1%	
				1981 -4.7%	**2007 5.5%**	**2010 14.8%**	1967 23.8%	1955 32.6%	
				1977 -7.0%	1947 5.2%	1971 14.2%	1951 23.7%	**2013 32.1%**	
			1966 -10.0%	1969 -8.2%	**2005 4.8%**	**2014 13.5%**	1996 22.7%	1936 31.9%	
			1957 -10.5%	1929 -8.3%	1970 3.6%	1965 12.4%	1963 22.6%	1980 31.7%	1954 52.6%
			1940 -10.7%	1946 -8.4%	2011 2.1%	1959 12.1%	1983 22.3%	1989 31.5%	1933 50.0%
		2002 -22.0%	**2001 -11.8%**	1932 -8.6%	**2015 1.4%**	**2016 11.8%**	**2017 21.6%**	1985 31.2%	1935 46.7%
	1937 -35.3%	1930 -25.1%	1941 -12.8%	1962 -8.8%	1994 1.3%	1968 10.8%	1999 20.9%	1950 30.8%	1928 43.8%
1931 -43.8%	**2008 -36.6%**	1974 -25.9%	1973 -14.3%	2000 -9.0%	1960 0.3%	2004 10.7%	1982 20.4%	1991 30.2%	1958 43.7%

Negative return | Positive return

Source: Annual returns from US equity index S&P 500 incl. reinvested dividends for the period end-1927 to end-2017. Data collected from New York University Stern School of Business.

The US economy is benefiting from a strong labour market with more job vacancies than unemployed. However, this is pushing wages higher.

has happened this year. After close to a decade of aftershocks from the financial crisis, the global economy is on the road to normalisation, and this reality is gradually sinking in.

The only path we can discern for yields in 2019 is up. This limits the return potential on government bonds, where we are unable to calculate our way to a positive expected return for the next 12 months. More specifically, we expect the 10Y US yield to climb to 3.5% in 2019. German yields are also expected to track higher to 0.9%, which will tend to pull Nordic yields up. All in all, we expect Nordic and European government bonds to generate a return of -2% to 0% over the coming 12 months. So even given our slightly lower expectations for equity returns compared to earlier, equities remain more attractive than bonds, in our view.

2019 will be two steps forward and one step back

Our positive stance on equities is based on our expectation that the global economic upswing will remain intact in 2019. While we acknowledge there are plenty of good reasons why markets have been under pressure this year, in our optic markets will continue to climb and at least recoup their losses, though like this year progress will be two steps forward and one step back.

No matter how you view them, the economic fundamentals remain solid and supportive: growth combined with historically low unemployment in the US, room for growth in Europe and still modest inflation – which admittedly is rising, but not at a pace that indicates negative surprises. In addition, the outlook is for corporate earnings and revenues to remain buoyant, plus valuations have also fallen recently, meaning US equities in particular are priced fair.

Remember, though, that everyone else can see this information – it is not unique. What makes the difference is how we interpret the information, and we simply cannot interpret current developments as indicating the next recession will strike in 2019. If a recession does hit us in the coming year, it will be unexpected and unpredictable – as recessions tend to be, we might add in brackets.

> *In our optic markets will continue to climb and at least recoup their losses, though like this year progress will be two steps forward and one step back.*

No to the cream cake

Yet, the experiences of the financial crisis probably still sit deep in many investors, making them more cautious and increasing their focus on capital preservation rather than return – which is perfectly understandable. It is a little like a delicious cream cake. We know it tastes good, but also that it is unhealthy. While we could not resist back in the 2000s, we are now in a situation where we dare not run the risk of the potential consequences – we investors fear losses more than we look forward to gains.

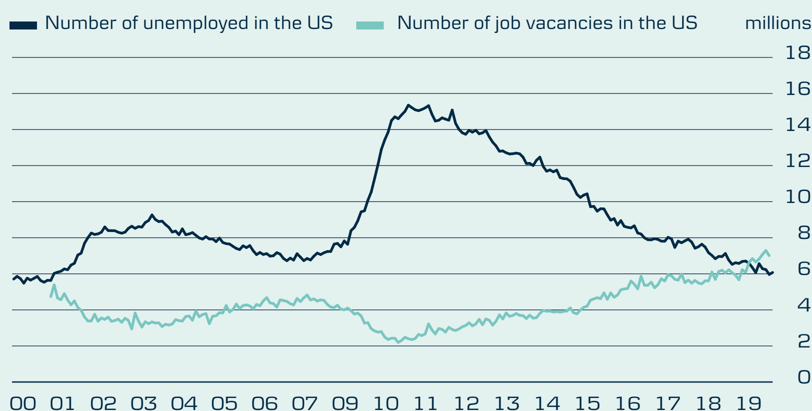
Nevertheless, from a more rational perspective this reluctance is a little hard to understand. Historically speaking, there are currently very few of the usual recession alarm bells ringing.

However, if economic growth has peaked and interest rates have bottomed out, it is entirely appropriate for investors to question equity valuations, which is what the latest correction reflects. That being said, overreacting is also a quite normal human

Historically strong US labour market

The number of job vacancies in the US now exceeds the number of unemployed, which is rather unusual. In other words, all Americans could find a job if they had the right qualifications.

Unemployment and job vacancies in the US



Source: Macrobond for period 01.01.2000-01.10.2018

response, and in our view the latest correction puts global equity markets in a better position than before to begin a new phase of the almost 10-year-long bull market.

Focus on Asia and quality equities

At Danske Bank, our overweight in equities remains rooted in an overweight of Asian equities, which have fallen sharply in 2018 and are priced cheap – particularly in relation to earnings expectations for 2019. The trade conflict between the US and China is the most obvious explanation for the substantial price falls, but fortunately tensions may soon be easing now that the respective governments have restarted their dialogue.

We see a real probability that China and the US will reach some form of agreement in 2019, though we have to remember that negotiations can take time. However, we should not neglect what drives Donald Trump. He is concerned about economic growth and equity prices, and so far his trade war has had a negative effect on both, in part because the trade war has resulted in weaker Chinese economic data. Hence, he could well soon demonstrate a greater willingness to negotiate – and a trade war truce might be enough for Asian markets to recoup their losses.

We have a particular focus on Asian consumers. The global middle class is expected to grow by around one billion people over the next decade, with close to 90% estimated to be in Asia. This megatrend will support the earnings potential of companies within the consumer discretionary, leisure, insurance and new tech sectors. Following this year's fall in valuations, we recommend that investors capitalise on the opportunity to acquire long-term exposure to Asia.

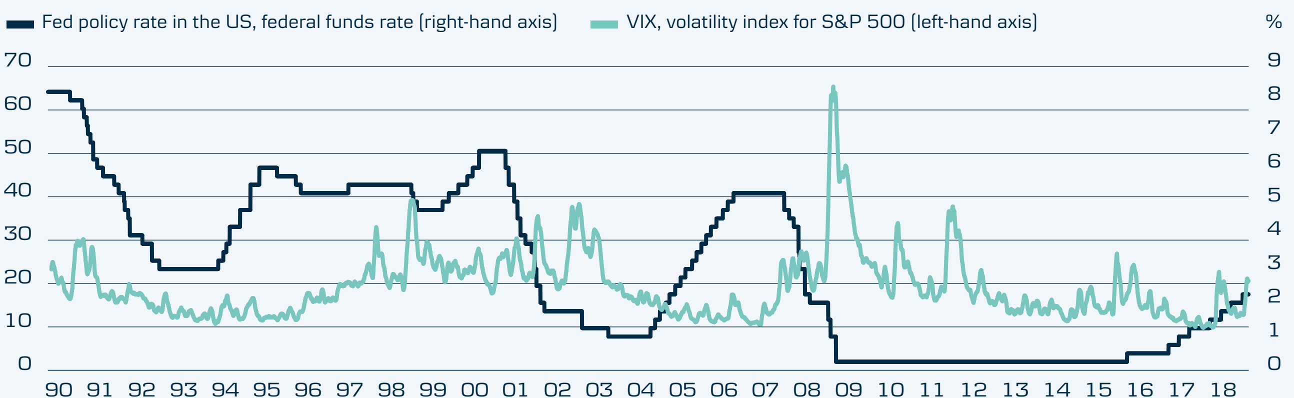
Given the outlook for rising volatility, we also recommend a more cautious approach to European equities – with a focus on quality, in contrast to our current, broader exposure to European equities. Quality equities include companies with stable earnings growth, a sensible debt mix and growing dividend payments – and such an exposure can be achieved without forsaking all the growth elements in the equity market. ▸▸

We experienced no less than two equity market corrections in 2018 with price falls in the order of 10%, which is definitely not normal.

Interest rate hikes could increase price volatility in 2019

Periods of interest rate hikes from the US central bank, the Fed, have historically resulted in greater equity market volatility, though typically with a delay as the impact of the rate hikes on the economy and corporate earnings becomes clear and gets priced into equities. The ongoing Fed rate hikes could potentially lead to greater volatility in the coming year.

Correlation between interest rates and volatility in the S&P 500



Source: Macrobond for period 01.01.1990-19.11.2018.

While consumers are helping support the economic upswing, it is not driven by private borrowing, as was the case during the financial crisis. Consumers in both Europe and the US are saving up.

9 reasons why we do not fear a recession in 2019

A number of variables normally provide the initial warning that a recession is in the making, but there are no blinking lights at the moment. That being said, there is no guarantee that historical patterns will be repeated in the future.

1. **The yield curve**, which shows the spread between short and long yields, always flattens ahead of a recession. However, the flattening can continue for an extended period, and it is only when the curve has inverted – in other words, short yields become higher than long yields – that a recession has occurred. The US yield curve still has a positive slope. The 2-10 year spread is currently 0.25 percentage points, and Danske Bank expects this to narrow to 0.1 percentage points over the coming 12 months: in other words, no inversion. Moreover, even when an inversion occurs, it typically still takes 10-12 months for the US S&P 500 index to peak.

2. **The US high-yield spread**, which shows the yield spread between Treasury bonds and high-yield bonds in the US, always widens significantly ahead of a recession. Historically, this spread has widened by between 2 and 5 percentage points and starts almost two years before the recession takes hold. Currently, this yield spread has widened by around 1 percentage point since the low prior to the turmoil in October. Understandably, this is one of the indicators that has concerned many investors, but we do not yet see any serious danger signals here.

3. **Real policy rates** are still much too low and inconsistent with a recession. Over the past 60 years, we have not had a single downturn with real policy rates below 1.8%. Short US real rates – ie short rates minus inflation – are currently still some way below 1%. That being said, there is no doubt monetary policy is being tightened and that the ending of major buyback programmes has had an effect on the markets.

4. **Consumers in both the US and Europe** are saving up. The upswing is not being driven by debt-financed private-consumption, which was very much the case in the US ahead of the financial crisis, and that is a signal the upswing could potentially surprise us all and continue for longer than predicted. The flipside of course is corporate debt levels, which have grown and now constitute an increasing risk in China, for example. Nevertheless, consumers' savings give the upswing a buffer against any downturn, which is unlikely to be as severe and deep as the financial crisis, when the debt house of cards collapsed. Consumer confidence also remains solid, and is closely correlated to labour market developments. In short, a very large upset would be required to undermine private consumption.

5. **Housing market activity** has begun to show signs of weakness in the US. As this is a very interest-rate-sensitive sector, the Fed's rate hikes should naturally have an effect. We are tracking developments closely, but also note that construction activity has to be viewed against labour shortages in the sector and tax reforms reducing the value of the interest rate deduction. House prices show no real sign of weakness, though price increases appear to be flattening out, which indicates the positive wealth effects from here are declining. House prices typically peak 15 months ahead of the S&P 500 peaking.

The alternatives to equities remain less attractive in terms of expected risk-adjusted return.

6. **The unemployment rate** has to bottom out and begin to rise before the S&P 500 peaks, says history. We see no sign of labour market growth having petered out. Job vacancies are currently record-high – in fact there are so many that all unemployed Americans could get a job if they had the right qualifications.

7. **Corporate earnings** typically peak when they exceed the long-term trend by around 30%. US earnings are currently 13% above the norm, or just 6% above if we deduct the effects of the tax reforms.

8. **Long yields are rising** for the right reasons and are starting to find a level commensurate with economic fundamentals after being held artificially low for a decade. Recent increases in US government yields come not on the back of inflation fears, but strong growth. The economy and equities typically have no problem absorbing rising long yields as long as the increases are due to solid growth prospects and not inflationary pressures that are starting to get out of control. However, when long yields surge over a very short time span, as in February and October, uncertainty and financial market turbulence are sure to follow, and we can certainly not rule out similar episodes going forward. Adjusting to a new regime is seldom a calm and measured process, while a significant risk of policy mistakes by central banks can cause investor jitters and thus considerable equity market volatility.

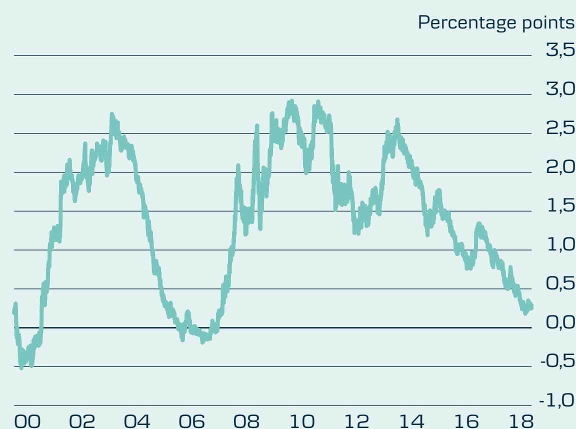
9. **Central banks** are often the reason for a downturn. Some 29 of the past 45 recessions in G7 countries coincide with monetary policy having been tightened. So no surprise the Fed's announcements of further rate hikes for some time yet are causing uncertainty. However, we are still some way off monetary policy being truly tight. The Fed views 3% as neutral for the economy – and as long as inflation remains well behaved we see no reason to position now for June next year, when the policy rate is set to hit 3% and the monetary policy outlook will likely become even more uncertain. As we noted, the equity market can certainly rise while the Fed is tightening. During the past seven tightening cycles (since 1980) the S&P 500 has generated an average return of 12% and not a single period saw a negative return.

CONCLUSION: Not being onboard can be expensive. All in all, we estimate the equity market has not yet peaked in this upswing. So long as the yield curve does not invert before late 2019, as we expect, then we see good reason to remain overweight in equities for the coming 12 months. Historically, the S&P 500 has risen 25% on average in the final 12 months of a bull market (though historical return is no guarantee of future return, which may also be negative). Even if we are proved correct and equities rise by a more modest 7-9%, the alternatives to equities remain less attractive in terms of expected risk-adjusted return. Cash generates zero return at present, while European government bonds at best give the same. We are thus willing to run the risk of being onboard in the final phase of the bull market, as the upside potential is much more attractive than what the alternatives offer, while the risk of a recession in 2019 is limited, in our view.

Yield spread forewarns of tougher times – but not yet

The 10-year yield in the US is still higher than the 2-year yield, though the spread is ever diminishing. Historically, a so-called inversion of the yield curve, where the 2-year yield exceeds the 10-year yield, has heralded an imminent economic recession. However, up to a year may pass from the yield curve inverting until equity prices have peaked.

Spread between 2-year and 10-year yields in the US



Source: Macrobond for period 01.01.2000-19.11.2018

Always remember your risk as an investor:
This publication is based on Danske Bank's macroeconomic and financial market expectations. Deviations from our expectations could potentially affect the return on any investments negatively and result in a loss.

Danske Bank has prepared this material for information purposes only, and it does not constitute investment advice.

Always speak to an advisor if you are considering making an investment based on this material to establish whether a particular investment suits your investment profile, including your risk appetite, investment horizon and ability to absorb a loss.

Danske Bank A/S
Holmens Kanal 2-12
1092 Copenhagen K

Phone +45 33 44 00 00
CVR no. 61 12 62 28
danskebank.com