Danske Bank Asset Management
House View Q2 2018
INSTITUTIONAL

End of an era – but equity upswing still in place

After a historically long period of declining interest rates, we will likely have to adjust to a new economic reality.

Danske Bank

Jerome Powell was sworn in as the new chair of the US central bank in February (front page photo). Donald Trump's chosen Fed chief will have the difficult job of navigating the US economy through a series of interest rate hikes.

New times for the global economy – but no reason to panic

Fears of higher inflation and interest rates are gaining traction in the financial markets. And while the outlook remains positive for equities, we see two potential scenarios playing out in the coming quarter – one positive, and one negative.

By Anders Svennesen,
CIO, Danske Bank Asset Management

After more than 30 years of declining interest rates there is much to suggest we will have to adjust to an economic regime change – and February's equity market correction probably marked the start of this new reality. In our view, the correction reflects investors beginning to prepare for a future investment environment in which we will move away from the ultra-accommodative monetary policy, historically low interest rates, ample global liquidity and non-existent inflationary pressures of recent years that added up to favourable conditions and low volatility for the equity market.

In our opinion, Q1 2018 will go down in the history books as the quarter when interest rates definitively turned after declining for decades, but that does not mean we should abandon the equity market in a panic. Interest rate hikes or not, we expect the global economic expansion to continue in 2018 and are therefore maintaining our overweight in equities while underweighting bonds. We still see the equity market as having the most attractive potential for return.

We should also remember that an economic and financial regime change does not happen from one day to the next, and nor will the changes occur in a straight line. It is a lengthy process that will shunt forwards and backwards, and just as we have been surprised that interest rates could continue to decline year after year, we may be equally surprised about how long the overall trend for interest rates will now ▸▸

But before we allow increasing inflation and rising interest rates to give us the frights, we should remember that modest inflationary pressure is in fact beneficial for everyone.

Expected return from global equities of

10-12%

over the coming 12 months in local currency.

↑ Overweight in equities

↓ Underweight in bonds

▸▸ be upward. However, this does not mean there will be a dramatic increase in interest rates from the one moment to the next.

Better a little inflation than none

US wage data was the spark that at the beginning of February ignited the equity correction. Wages rose more than expected and triggered fears that higher inflation expectations would prompt the US central bank, the Fed, to hike interest rates substantially faster and higher than expected – which could potentially hit econo- ▸▸

The world from a long-term investor's perspective

Growth and inflation are the two critical factors that determine the health of the financial markets

Growth and inflation together define our position in the economic cycle and which asset classes can be expected to perform best.

Recent decades have essentially been disinflationary; in other words, inflation has been declining or at times actually negative. Looking just at the past few years, we have been in a disinflationary boom (see figure below) of solid economic growth and low inflation – often termed a Goldilocks scenario – which typically provides attractive returns for investors.

However, you cannot put together investments based on growth and inflation data alone. Other factors, such as asset valuations, corporate earnings, liquidity, etc. also play a part.

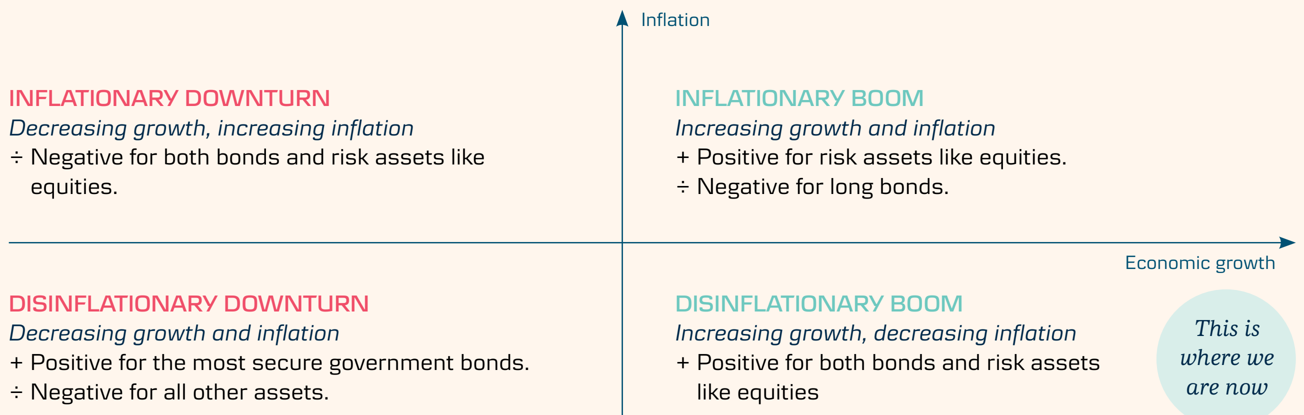
The big question is, of course, which phase are we now entering, given that interest rates look set to rise?

We expect the economic upswing to continue and inflation to rise just slightly or moderately. Hence, we do not expect any major inflationary pressures to build in the immediate future – and even increasing inflationary pressures would not necessarily be a problem for equities so long as growth remains high. Historically, if growth is high, inflation has only posed a problem for the equity market when it reaches 5-6%.

Overall, however, our estimate is that we are still far from the point where investors should begin to adjust their investments for low growth or high inflation. More specifically, we are maintaining our current overweight in equities, which at sector level is in IT, materials and healthcare.

1.82% was the level of core inflation in the US at the end of January 2018 – below the Fed's target of 2%.

Four phases of the economy



Source: Gavekal and Danske Bank.

The German economy has been a driving force for European economic growth in recent years, and the outlook for Europe remains an attractive combination of solid growth and low inflation – a so-called Goldilocks scenario – which is supportive of equities.

Although we have a positive outlook on the economy, the equity market could in the short term be driven more by market sentiment and tecǎical factors that are decoupled from economic fundamentals.

▸▸ mic growth and corporate earnings negatively.

But before we allow increasing inflation and rising interest rates to give us the frights, we should remember that modest inflationary pressure is in fact beneficial for everyone and that US inflation is simply developing in line with Fed projections. Deflation, in other words falling prices, has in fact been investors' most feared scenario in recent years, as deflation paralyses growth. Moreover, both the European Central Bank (ECB) and the Fed have at times struggled to reach their inflation target of around 2%.

We now expect US inflation will quietly and calmly crawl up towards the Fed's inflation target of 2%, while inflation in Europe will continue to be kept in check by the ample capacity for labour market growth that exists outside Germany before significant wage pressures take hold. Overall, we therefore expect that inflationary pressure will remain very modest and do not anticipate rising inflation and rate hikes derailing the economic upswing. We will continue to enjoy robust economic growth that supports corporate earnings.

Two potential scenarios for Q2

But while our view on economic growth over the coming 12-24 months is one thing, what happens in the next few months following February's equity correction is another. Although we have a positive outlook on the economy, the equity market could in the short term be driven more by market sentiment and technical factors that are decoupled from economic fundamentals. More specifically, we see two potential scenarios unfolding in Q2:

THE POSITIVE SCENARIO: US inflation figures behave as expected, including wage growth data included in the US jobs report on 9 March. The Fed, headed by new chair Jerome Powell, hikes rates as expected at the next rate setting meeting on 21 March and signals no change in the projected number of rate hikes for 2018 – in other words, the Fed continues to expect a total of three rate hikes this year. Calm returns to the equity market and the current bull run continues, albeit with slightly greater price volatility than in 2017.

THE NEGATIVE SCENARIO: Inflation and wage growth continue to deliver upside surprises in the US. As expected, the Fed hikes rates at the next rate setting meeting on 21 March, while increasing inflationary pressure causes the Fed to pencil in an extra rate hike in 2018 – in other words, four rate hikes this year instead of three. Uncertainty on rising inflation and interest rates and their impact on the real economy builds and further fuels the equity market correction, triggering a new wave of tumbling prices. ▸▸

Inflation vs. deflation: A difficult balancing act

Both high inflation and deflation (negative inflation) fuel uncertainty and are bad for economic growth.

Inflation is one of the main determining factors for monetary policy in the developed economies. Both the ECB and the Fed have an explicit goal that inflation should be around 2%, which is assessed to be a favourable level for long-term economic growth.

If inflation is too high, it creates uncertainty about the future value of your money and is detrimental to economic activity and growth in a society. High inflation will prompt creditors to demand high interest rates for lending, so they are compensated for inflation eroding the value of their money.

Deflation may make consumers reluctant to spend their money, as in principle their money will be worth more tomorrow than today and wages will fall. This can quickly push the economy into a downward spiral.

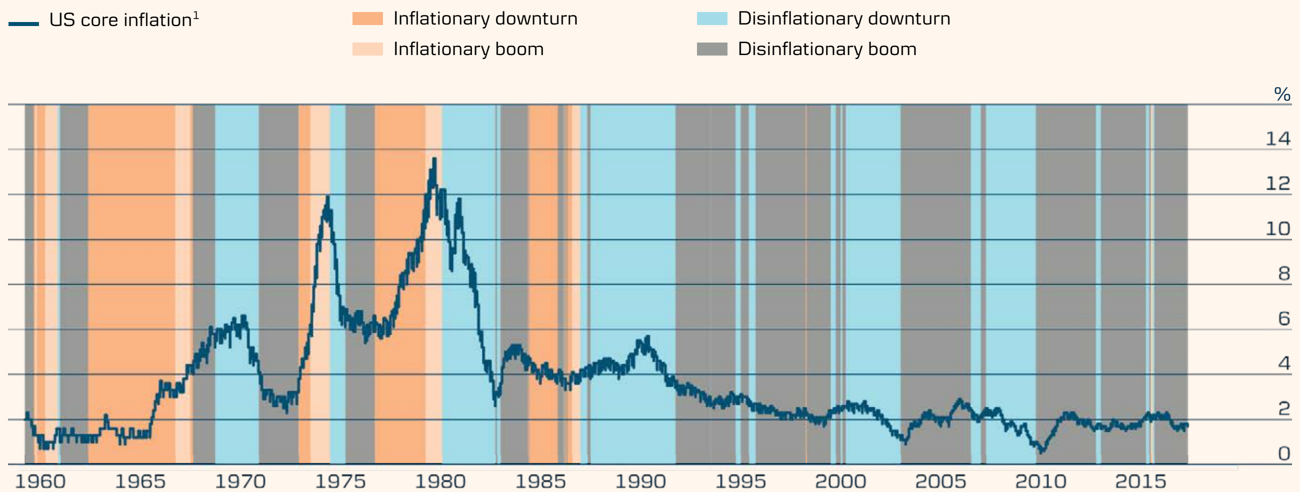
Interest rates are a fundamental monetary policy tool for the central banks to control inflation, and there is generally a close correlation between movements in inflation and interest rates.

Worst case is no disaster
We view the positive scenario as the most likely, but even if the negative scenario unfolds we currently see no sign of an economic recession being imminent. Even if economic confidence indicators dip, we do not expect developments in the financial markets to spill over negatively into the real economy. Strong labour markets, rising wages and the positive outlook for corporate earnings put a solid foundation under private consumption and corporate investment activity, in our opinion. Moreover, global monetary policy remains accommodative and supportive of the economy despite tightening.

In short, we expect that once the adjustment to these new times has run its course and investors have come to terms with the era of declining interest rates being over, then the focus of investors will again shift to the factors that plot the longer-term course for equities; the overall macroeconomic picture, corporate earnings and equity valuations. And here we estimate there is still more potential for equity investors.

Phases of the economy since 1960

Recent years have seen a disinflationary boom with high growth and low inflation – an attractive combination for investors. During the recessions of 2001 and 2008-09, when growth was negative, the economy was in a disinflationary downturn, which is poison for equity markets. The graph is based on the US economy and shows which phase the economy was in from 1960 until now (see description of phases on page 3).



Two economic eras in recent times

1960-1980: Inflation made life difficult for bonds
The years from 1960 to 1980 were for long periods characterised by an inflationary environment. Rising inflation gave rising interest rates, which caused long government bond prices to fall. With regards to equities, prices generally rose during periods when rising inflation went hand in hand with increasing economic growth, while the equity market declined when growth slowed.

1980-2018: Good times with setbacks along the way
Since 1980 we have generally been in a disinflationary environment with declining interest rates and rising bond prices, which has produced attractive returns from long government bonds. Equity prices have been hit by several recessions along the way, but long periods of solid economic growth and low inflation (the so-called Goldilocks scenario) have, on the other hand, generated high returns.

Source: Gavekal, based on data from 01.01.1960 to 31.01.2018.
[1]Inflation is just one of the variables when determining whether we are in an overall inflationary or disinflationary economic environment.

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