Photo: JAnthony Behar/SIPA/Ritzau Scanpix.

Let the good times roll?

OUR CURRENT EXPECTATIONS: We continue to expect solid growth in the US and remain more positive than most – and even though inflation has been elevated recently, the downward trend remains intact, which should motivate moderate monetary policy easing going into 2025. This cocktail should send equities further up, while bonds again offer decent value – and 60/40 might finally be back. For good.

Quarterly View Q2 2024
Macro & TAA
Danske Bank Asset Management
02.04.2024

Danske Bank

ECB president Christine Lagarde has made clear that rate cuts will not happen until the data supports it – and that is not yet the case.

Photo: Imago/Ritzau Scanpix.

THE PAST QUARTER

Data not instilling enough confidence to cut

When 2024 kicked off, financial markets had priced in a pronounced and impending easing of monetary policy in both the US and the eurozone. Rate cut speculation was prompted by low inflation numbers at the end of 2023 and ongoing concerns about the durability of the US recovery.

> Jerome Powell explained how the data had not yet given the leading members sufficient confidence to start cutting rates. Nevertheless, they still expected that confidence would come later in the year.

However, the market was soon forced to revise its expectations as the US labour market surprised yet again with exceptionally strong job creation in January and the first inflation report of the year proved grim reading – inflation was markedly higher than expected. US growth data generally continued to show strength, and while the inflation report for February was a tad better than January's, inflation remained higher than anticipated and incompatible with swift rate cuts.

US central bank chair Jerome Powell thus spoke on 20 March on the back of new forecasts from the leading members of the Federal Reserve that showed considerably higher growth and moderately higher inflation in 2024 than in their forecast from December 2023. Powell also explained how the data had not yet given the leading members sufficient confidence to start cutting rates. Nevertheless, they still expected that confidence would come later in the year and that they would cut rates three

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times in 2024 and further in 2025. In other words – stronger growth, slightly higher inflation in 2024, but not particularly in 2025 and 2026, so it was still appropriate for the Federal Reserve to begin normalising monetary policy later this year.

ECB is data-dependent – and the data is not yet ripe

The European Central Bank, ECB, made clear in December that they were done with tightening monetary policy and that their future path would depend on the data. If the data met their expectations of

When the first two inflation reports of the year also surprised to the upside, it soon became clear that the ECB would not be cutting rates anytime soon.

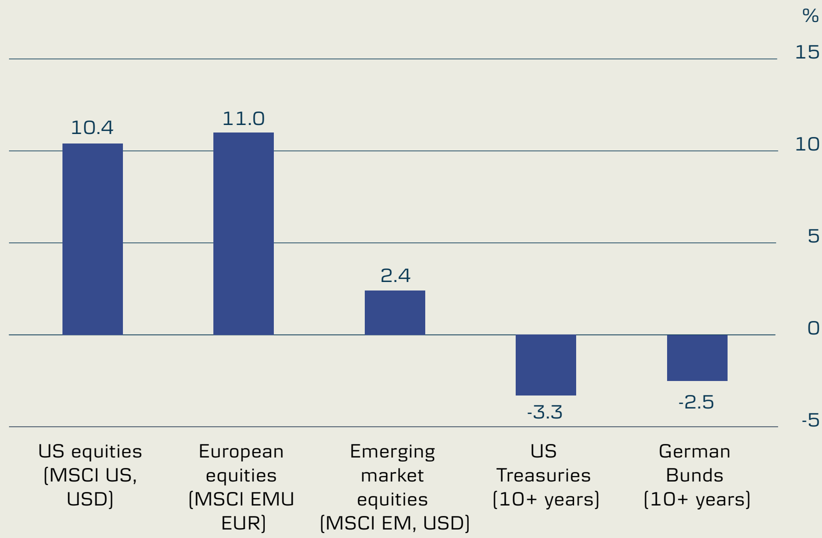
further improvements in inflation, a rate cut would be the next step. Markets interpreted this as a sign that the first rate cut could come as early as the ECB's March meeting.

However, the ECB also stressed that the key factor in the short term would be how the labour market developed. Indeed, the ECB estimated that domestically generated inflation, which very much depends on the tightness of the labour market and wage growth, remained too high to sufficiently ensure that consumer price inflation would decline to 2% in the medium term. And while wage growth is now showing signs of slowing, it remains relatively high. Moreover, unemployment hit a new record low in January, and when the first two inflation reports of the year also surprised to the upside, it soon became clear that the ECB would not be cutting rates anytime soon.

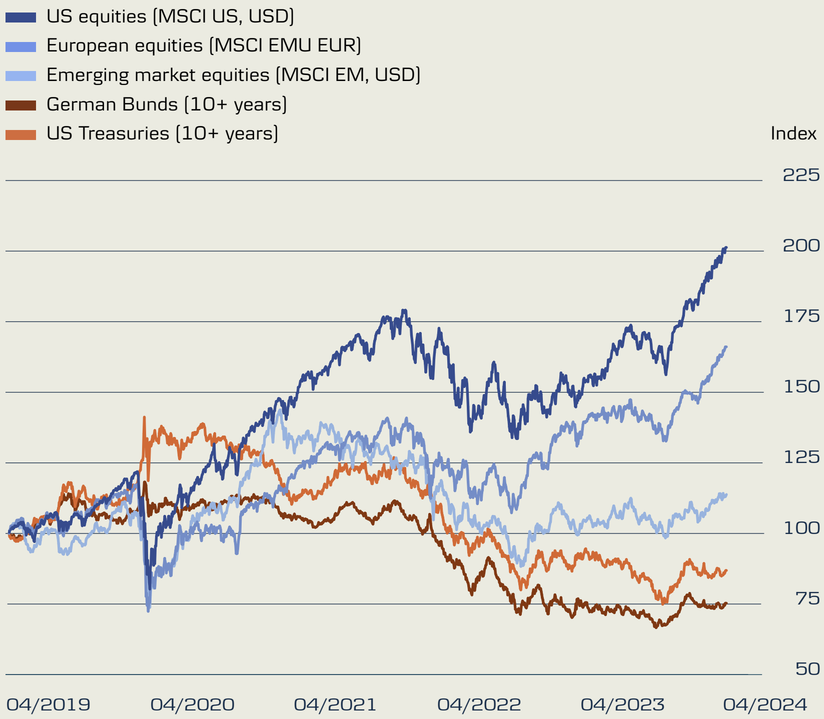
ECB president Christine Lagarde could therefore step up to the lectern in March with a new set of forecasts which, while they showed inflation approaching target in 2025 and 2026, nevertheless prompted her to stress that the central bank was awaiting more data, particularly in relation to wage growth, before they could be sufficiently confident that easing monetary policy was appropriate. When growth data at the same time showed nascent signs of a turn back towards positive territory from the now extended period of stagnation, the market also significantly pushed back their expectations of rate cuts from the ECB. Hence, while the quarter started with the market pricing around 6 rate cuts of 0.25% for 2024, the quarter is

Total return Q1 2024

Historical return is not a reliable indicator of future return, which can also be negative.



5 years' accumulated return



Source: Macrobond, Bloomberg and Danske Bank Asset Management as per 31.03.2024 ending with less than 4 rate cuts priced in. Furthermore, the expected monetary policy rate at the end of 2025 has risen from just below 2% to around 2.5%.

China's tricky balancing act
China's property crisis seems to be without end, and sections of the property market are now in free fall with record-low sales and new home starts. Nevertheless, the government is continuing to pull out all the stops to prevent the crisis from rippling through the economy via a banking crisis by ensuring financial stability and easing economic policy where necessary. The Chinese authorities are thus attempting to strike a difficult balance between supporting the economy sufficiently to deliver decent levels of growth while not offering excessive support that might risk fuelling new imbalances in other areas of the economy. So far, the balancing act has been progressing reasonably well, given that we estimate growth hovering around long-term potential of 4-5% in the first quarter of 2024.

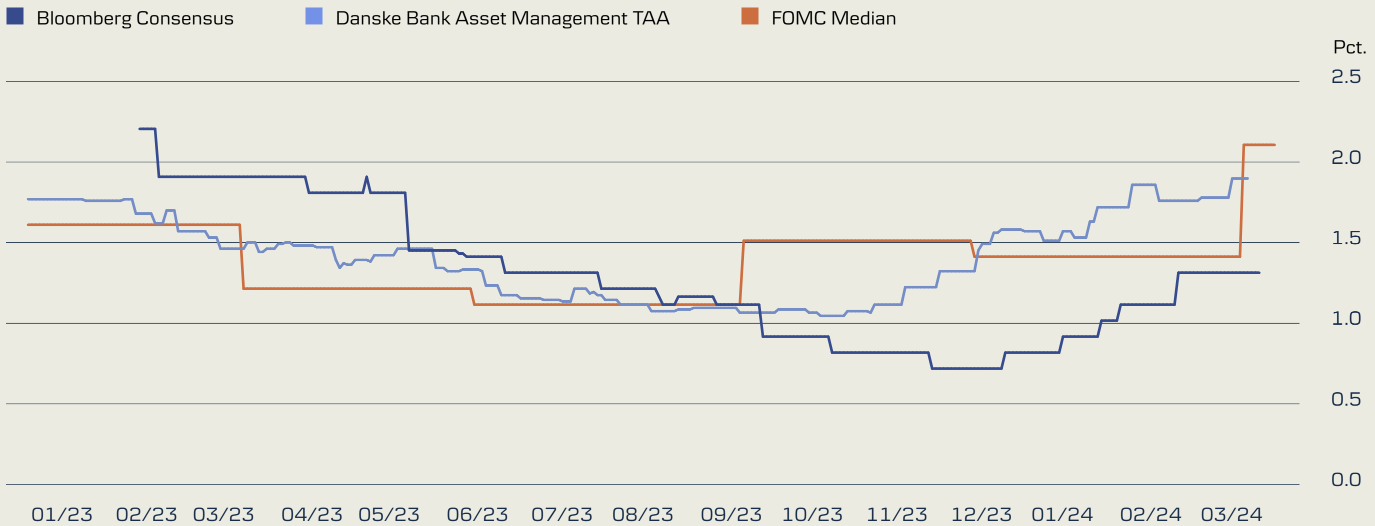
Financial market performance – equity breakout
Last year was an excellent year for equities, and 2024 has brought more of the same. Global equities were up almost 10% in Q1 this year, led by Japan, the US and Europe. Meanwhile, volatility across global equity markets has been exceptionally low, which is why risk-adjusted returns here were far above the norm. As in 2023, the driving force was surprisingly strong US growth data and still solid earnings growth. Since the start of the year, consensus has upped 2024 growth expectations for the US by close to 0.5 percentage points, a remarkably high revision over such a short space of time. European equities, too, were no laggards, rising by just as much as their near-fabled US counterparts.

Meanwhile, strong growth and high inflation pushed both short and long bond yields higher. Equities nonetheless rising was remarkable, perhaps indicating more normal times are on cards for the financial markets, with equities and bonds better diversifying each other again. The reason for this is that inflation, despite everything, has in fact declined markedly, so markets can currently focus solely on debating when rate cuts might materialise and not, for now, on whether interest rates should be set even higher to tame inflation.

> China's property crisis seems to be without end, and sections of the property market are now in free fall with record-low sales and new home starts.

Growth forecast for USA

Ongoing real-time growth forecasts for US growth from Q4 2023 to Q4 2024, where Danske Bank Asset Management currently expects somewhat higher growth than market consensus.



Source: Bloomberg and Danske Bank Asset Management.

The US labour market is screaming for workers, and in recent years immigration has been crucial to creating an approximate balance in the labour market and avoiding unduly excessive wage pressures.

Photo: Justin Sullivan/AFP/Ritzau Scanpix.

EXPECTATIONS GOING FORWARD – MACROECONOMY

Expansion set to continue – and strengthen

At the start of 2024, we wrote that we expected significantly higher growth in the US in 2024 than consensus estimated and was priced into equity markets at the time. We also expected less monetary policy easing in 2024 and 2025 than the market was indicating.

Growth data has positively surprised us since then, and we have revised our expectations for how quickly the banking system will normalise after the bank crisis in spring 2023. This is because both general financial conditions have eased, but also because the tightening of bank credit standards seems to be ending faster than we anticipated. We have therefore revised our growth expectations even higher. And while consensus and the market have shifted, we are still relatively more positive on the growth outlook for 2024 and into 2025. In other words, we expect a further acceleration in US growth as we approach summer and growth for the year as a whole to print close to 2%.

> In our view, the high level of new arrivals is part of the reason why we are seeing a more balanced US labour market, as the supply of labour has increased. That is good news for the inflation outlook.

Furthermore, while we have increased our inflation forecast for this year, like the Federal Reserve we consider most of the inflation disappointments so far this year to have been driven by temporary factors, which is why we have not significantly revised our inflation forecasts for 2025 and 2026. We therefore continue to expect the Federal Reserve can initiate a modest easing of monetary policy via interest rate cuts this summer. We now find ourselves in a situation where we assess the market to be a tad too sceptical on the potential for future rate cuts, and we expect a benchmark rate of around 3.75% by the end of 2025 compared to the market's pricing of around 4%.

Hence, we are also maintaining our long-term analysis – the US will achieve a soft landing and the upswing will continue into the second half of this decade. The quarter also brought a few surprises for us, however. The Congressional Budget Office released new estimates for immigration to the US that showed the number of new arrivals last year was markedly higher than its previous estimates. Crucially, its forecast shows that immigration will continue at these exceptionally high levels until 2026. The CBO has therefore raised its estimate for potential growth significantly both for last year and for the next couple of years.

In our view, the high level of new arrivals is part of the reason why we are seeing a more balanced US labour market, as the supply of labour has increased. That is good news for the inflation outlook, because the Federal Reserve will have to do less in the way of tightening monetary policy and reducing the demand for labour. On the other hand, it also means the economy can tolerate higher interest rates for longer than previously assumed.

Given the above, we have revised up our estimates for potential growth in 2024 and forward to 2026 while at the same time raising our growth forecast for 2024 in particular. However, despite the CBO's marked adjustments we would urge a degree of caution on this otherwise positive news – for there is of course great uncertainty on both how many newcomers will arrive and on their productivity. So, we have started off slowly here but expect that this theme will attract a good deal of attention in the coming quarters.

Nevertheless, the good news is that the US upswing is intact – and with more momentum than we expected just a few months ago. If we are correct, further positive growth surprises are on the cards. And while inflation will be a little higher than we previously estimated, it is still slowly but surely heading down towards target, which means the Federal Reserve can commence cutting later this year and reduce the benchmark rate to around 3.75% by the end of 2025.

ECB warming up for a rate cut in June – growth to accelerate further

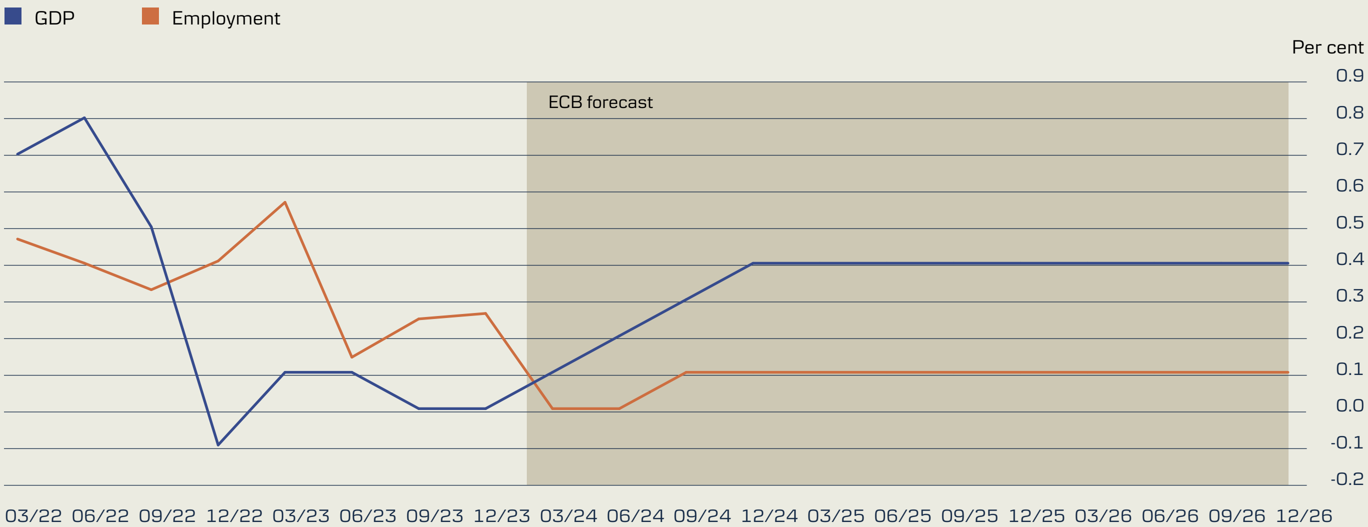
High frequency data indicates growth in the eurozone has begun to accelerate, and we expect growth to pick up further in the coming months as the negative effects from tight monetary and fiscal policy, the banks' tightening of credit terms, the energy crisis and inventory drawdown begin to ease.

The key question is therefore what will happen to the rock-solid labour market when overall growth picks up. The ECB expects employment growth to remain relatively low because, roughly speaking, they assume that businesses have hoarded labour over the past year when general economic growth has been low. However, the ECB has consistently underestimated the strength of the labour market in recent quarters, as employment growth has been stronger than expected. The labour market has mainly achieved a better balance due to the supply of labour also increasing significantly in the eurozone, primarily driven by higher participation rates. Hen-

> The ECB has consistently underestimated the strength of the labour market in recent quarters, as employment growth has been stronger than expected. The labour market has mainly achieved a better balance due to the supply of labour also increasing significantly in the eurozone.

Eurozone – quarterly realised growth and ECB forecast

The past year has been a very atypical period for the European economy, with employment growth outpacing economic growth, which has hovered around zero. The ECB expects economic growth to normalise while employment growth is expected to remain low.



Kilde: ECB og Danske Bank Asset Management.

China cannot continue with its current accommodative economic policy indefinitely. So, towards the middle of the next decade, the choice will be between considerably lower growth or a significant weakening of the yuan (CNY).

ce, there remains a risk that employment growth could pick up along with overall economic growth. If that happens, the ECB risks ending up in a situation where the labour market essentially does not allow for significant monetary policy easing.

Our view therefore remains that the ECB will attempt to strike a balance. On the one hand, further improvements in inflation could be on the cards, as we continue to estimate that the true underlying inflation rate (corrected for supply chain stress, the reopening, etc.) is just marginally above 2%. This suggests that the ECB need not keep monetary policy as tight as at present. On the other hand, the ECB must ensure that the demand for labour does not increase and put additional pressure on an already tight labour market. If correct, striking this balance will mean the ECB commencing modest rate cuts later this year, but that they will reduce interest rates by less over the coming 18-24 months than is priced by the market.

China has lost its sparkle – but there is enough to keep sentiment buoyant

In our view, growth in China has been surprisingly stable around its long-term potential of 3-5% since summer last year. Hence, the fluctuations in the Chinese growth cycle have become a dull story both in historical terms and relative to, for example, the surprisingly strong growth in the US and the now accelerating growth in the eurozone.

We continue to expect more of the same – the authorities are fighting a brave fight to stabilise the crisis-hit housing market, which is now so deep in the doldrums that any further deterioration would require a massive negative shock. The authorities are supporting the financial system and ensuring financial stability so that sectors in crisis do not fall further and the rest of the economy can develop positively. The overall result is reasonable but not sparkling growth, and we expect growth to remain relatively stable in the coming quarters. That should be sufficient to ensure an improved sentiment around China, simply because China yet again will avoid the apocalyptic scenarios that many continue to fret about.

Nevertheless, we would stress, as we have done for some time, that China faces considerable challenges in the long term. As outlined in previous editions of this publication, China cannot continue with its current accommodative economic policy indefinitely. So, towards the middle of the next decade, the choice will be between considerably lower growth (than the current 4-5%) or a significant weakening of the yuan (CNY). However, the Chinese authorities need not make this decision for at least a few years yet, so in our view they will continue to focus on ensuring that the long-term adjustment of the housing market to sharply lower levels of activity happens without causing a financial crisis. And they can do so, because China has never been dependent on outside capital, which is why managing China's long-term challenges is a matter for China alone.

USA: Expectations for growth. inflation and interest rates

	2023	2024	2025	2026
Expected growth	3.11%	1.89%	1.96%	1.90%
Long-term growth potential	2.08%	2.04%	1.96%	1.90%
Unemployment rate	3.77%	3.89%	3.91%	3.91%
Core inflation (PCE)	3.15%	2.57%	2.10%	2.05%
Federal funds rate	5.38%	4.72%	3.81%	3.55%

NOTE: Projections of growth and inflation are percent changes from the fourth quarter of the previous year to the fourth quarter of the year indicated. Our forecast for the federal funds rate is the expected level of the effective federal funds rate at the end of that particular year.

Euro area: Expectations for growth. inflation and interest rates

	2023	2024	2025	2026
Expected growth	0.07%	0.69%	1.00%	1.19%
Long-term growth potential	1.27%	1.31%	1.29%	1.29%
Core inflation (HICP)	3.38%	2.60%	2.16%	2.11%
ECB depo rate	4.00%	3.33%	2.73%	2.35%

NOTE: Projections of growth are percent changes from the fourth quarter of the previous year to the fourth quarter of the year indicated. Projections of inflation are percent changes from the last month of the previous year to the last month of the year indicated. The ECB depo rate is the expected level for the rate on the ECB's deposit facility at the end of the indicated year.
Source: Danske Bank Asset Management as per 31.03.2024.

Construction in Beijing. Despite major structural problems for the property sector that are challenging the Chinese economy, we see a decent return potential in emerging market equities in the coming year.

Photo: Johannes Neudecker/DPA/Ritzau Scanpix.

EXPECTATIONS GOING FORWARD – THE FINACIAL MARKETS

Rate cuts approaching, equities to rise further

At the start of 2024, we wrote that the markets had priced in slightly too much monetary policy easing in the near term, which was why short yields had fallen too far, while medium- to long-term yields were roughly fair or a tad too high, which would mean declining yields at this end of the curve going forward to 2025 and equities rising further. Our call proved more or less correct, although long US yields in particular clearly rose more than we expected in Q1 2024.

We have for quite some time been focused on just how expensive the market would be capable of pricing equity risk if our expectations of a soft landing and the prospect of economic growth going forward to the second half of this decade panned out. But equities have again outperformed our expectations, which begs the question – can this really continue?

EQUITIES:

Our reply is yes, but at a slower pace. We assess the driving factor behind the impressive rise in equities and the low level of volatility to be the market's ongoing upward revisions to growth expectations, especially for the US. As we continue to see decent growth both this year and next and in fact remain more positive on the US growth outlook than Consensus, this trend should continue. And given accelerating growth in the eurozone, stability in China, lower inflation and the start of modest monetary policy easing, equities in the rest of the world should also perform reasonably.

Clearly, the upcoming presidential election in the US is an uncertainty factor and will stoke volatility across financial markets as the election campaigns ramp up. But neither of the candidates will do serious damage to the US economy, so any tumult in the equity market should be temporary as long as our economic forecasts are more or less met.

As we write, we are expecting a return of 6-9% on US equities over the next 12 months and 10-12% in the eurozone.

BONDS:

The market is now pricing a more realistic path for monetary policy in 2024 in both the US and the eurozone than it did at the start of the year. However, for 2025 and beyond we now assess the market to be slightly sceptical in terms of how far the Federal Reserve may cut interest rates. And given that strong growth data and the latest inflation figures have sent medium- and long-term bond yields further up, for the first time in a long time we now see decent value across most of the US yield curve. We therefore expect significant declines in both short and long bond yields in the US over the next 6-12 months, driven in particular by rate cuts kicking off.

In contrast, we are still of the opinion that the market is pricing in too much easing from the ECB going forward to 2025 and 2026, which is why very short bond yields do not look particularly attractive in our view. However, the rest of the eurozone curve is more sensibly priced, and we are also expecting modest declines in yields here as actual rate cuts approach in the second half of 2024.

Hence, we are now in a situation where bonds offer decent value, while equities and bonds are beginning to diversify each other better. With even lower inflation ahead, the market's ability to price significant rate cuts in the event of unexpected negative shocks to the economy should increase. Thus, recent market developments and our forward-looking macro forecasts are now compatible with stronger risk adjusted performance for the classic balanced portfolio, where diversification between equity & bond duration risk generates improved risk adjusted returns and bond duration provides solid protection against left tail outcomes in the equity space.

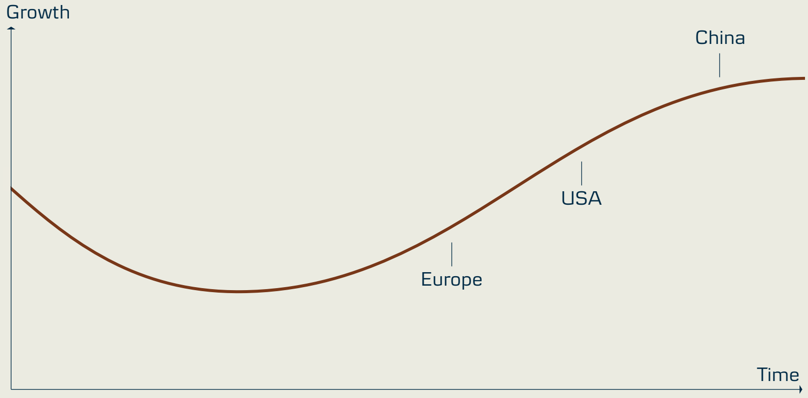
EMERGING MARKETS:

As usual, we would emphasise the significant difference in asset classes within emerging markets. Lower global inflation and more accommodative monetary policy in the US and Europe should support bonds issued by emerging markets in both local and hard currency.

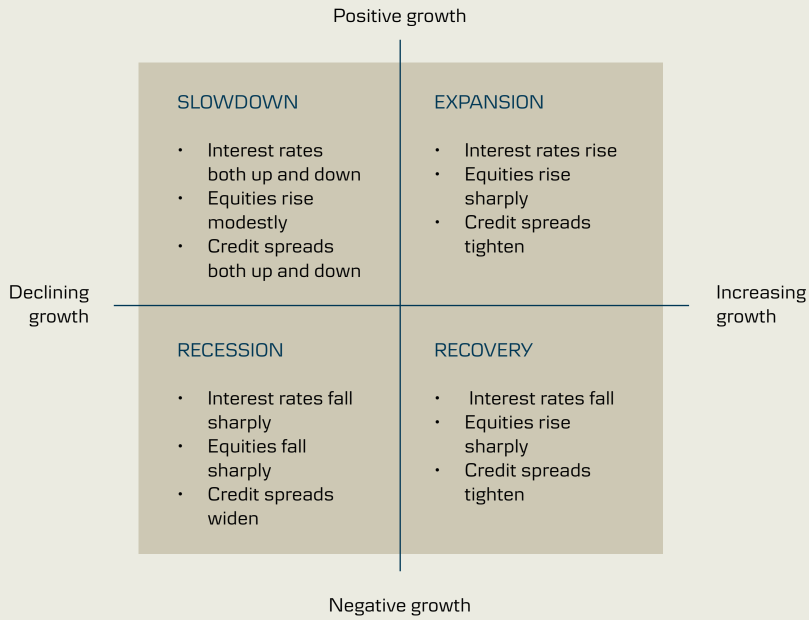
In terms of emerging market equities, we would continue to stress the long-term challenges in China as a hindrance for the market. In the short term, however, our positive global growth expectations, lower inflation and more accommodative monetary policy should support emerging market equities, and we expect a return on the broad emerging markets index of around 10-12% in the coming 12 months.

Macro barometer: Prospect of higher growth

Growth in the eurozone is finally improving and beginning to accelerate from around 0%. We expect a further pickup towards trend as the negative shocks from tighter monetary policy and bank credit policies as well as the energy crisis ease. US growth has increased from relatively low levels at the end of 2023 to slightly below trend. We expect a further modest acceleration to and thereafter stability around 2%. Growth in China has risen to around 5% on the back of the authorities' more accommodative economic policy and nascent stability in the housing market. Going forward, we expect stable growth of around 4-5%.



ASSET CLASSES: Typical developments for various asset classes during the four phases of the economic cycle.



Source: Danske Bank Asset Management

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