Photo: Graeme Sloan/SIPA/Ritzau Scanpix

QUARTERLY VIEW 04 2023
MACRO & TAA
DANSKE BANK ASSET MANAGEMENT
29.09.2023

Long end bond yields reach new highs – voodoo or common sense?

OUR CURRENT EXPECTATIONS: The global expansion remains intact, but with considerable regional variation. Strong labour markets and overly high inflation still require tighter-for-longer monetary policies and are keeping short yields, in particular, elevated. While the expansion supports equities, the key question in the short term is whether long yields can go even higher?

Danske Bank

New York skyline. Despite fears of a recession, the US economy continues to deliver upside surprises.

Photo: Abaca/Ritzau Scanpix.

THE PAST QUARTER

The American powerhouse

The central theme in 2023 has been the US economy and its apparent refusal to tip into the recession that a majority of economists have now been predicting for more than a year. On the contrary, growth appears to be solid and – on the surface at least – perhaps even decidedly strong despite the gargantuan efforts of the central bank to ensure a period of low growth that would dampen inflationary pressures. That being said, easing inflation contributed to signals from the US central bank, the Federal Reserve, that the rate hiking cycle was drawing to a close.

In the eurozone by contrast, growth appears to have weakened substantially, which was one reason why the European Central Bank (ECB) signalled in September that the hiking cycle has been paused, at least for now. China continued to struggle with a weak construction sector, though dig deeper and the authorities seem to be wary about loosening economic policy due to fears of stimulating a sector that is in structural decline.

Is there simply no stopping the US economy?

US labour market momentum has been maintained, allowing private consumption to stay strong. This perhaps sums up Q3 2023 at a time when classical national accounts data indicates growth in the US has been running above the economy's long-term potential despite the drastic tightening of monetary policy and increasingly stricter access to loans and credit from the banks. And while inflation is moving in the right direction, fully tamed it is not. The most important message of the quarter therefore came from Jerome Powell and his fellow central bankers at their rate meeting in September, when they kept the fed funds rate at 5.5% after the increase in July. Rate hikes being close to peaking was no real surprise. But what was surprising was the Fed not currently seeing the same potential as earlier for cutting rates again in 2024. Questioned at the press conference, Powell clearly stated that the motivator of this change in view was not the inflation news but rather surprisingly strong growth and the prospect of just a modest increase in unemployment. The message was unmistakable – the leading members of the Federal Reserve were signalling that monetary policy would in fact have to be very tight for a long time yet for inflation to fall to target.

ECB hits pause

In contrast to the Federal Reserve, the ECB decided to increase interest rates at both its meetings in Q3 2023 – putting the benchmark deposit rate at a roughly 20-year high of 4%. More important, however, was the ECB's unequivocal signal that it would now take a pause from hiking interest rates. Hence, on one level, the ECB can note it has tightened monetary policy at a record pace and that inflation is beginning to show signs of slowing, which buys the ECB some time. Digging deeper, part of the explanation also appears to be Q3 experiencing a significant slowdown in economic growth, with short-term growth prospects lower than the ECB had expected – and potentially even negative. Previously rock-solid, the service sector in particular appears to have lost steam, which of course is exactly what the ECB has to achieve to have a serious chance of getting inflation down. However, the loss of momentum is so significant – and to some extent so surprising – that the ECB will, for a while at least, wait and see before tinkering with monetary policy again.

Bo Bejstrup Christensen
Chief Portfolio Manager
Head of Macro & TAA
Danske Bank Asset Management

Is China actually tightening economic policy?

Chinese growth was surprisingly low in Q3 2023, even if there were nascent signs it had begun to stabilise. Nevertheless, low growth and huge challenges in the housing and construction sectors ensured the negative news bubbled to the surface, especially news related to the construction sector. That was the main reason why the authorities talked up the imminent loosening of economic policy and in both July and August announced new measures to halt the housing sector's apparent free fall. What is crucial here, however, is to distinguish between what the authorities say and what they do. Data for July and August showed that credit ▸▸

flows, which has traditionally been China's most important economic tool, in fact fell. Perhaps the results of the policy easing simply take time. Perhaps it reflects no-one wanting to borrow money anymore. And maybe it reflects the authorities losing their near legendary grip on the economy. And herein lies the key message – regardless of the reason, the last thing China currently needs is uncertainty.

Financial market developments – when good news is bad news

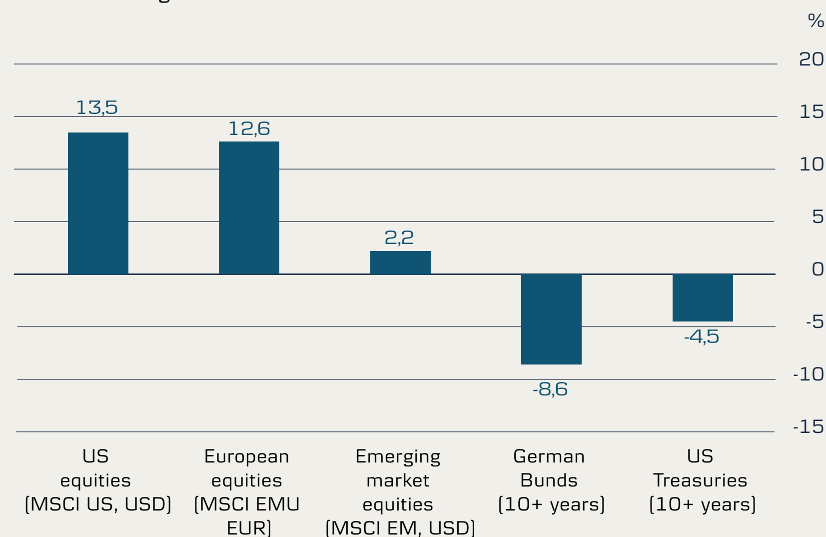
Rising – and decidedly strong – US growth is normally positive for risk assets, especially equities. But right now, that trend is poison, as it means the Federal Reserve must keep monetary policy tight for longer than expected to rein in inflation. Naturally, this pushes short bond yields higher. However, it also creates uncertainty on medium- and long-term yields and thus on the discounting of future corporate earnings. So, the question now is: does the economy's ability to withstand the historic tightening of monetary policy and the dramatic increase in interest rates over the past 18 months in reality mean that the long-term level for short yields should be considerably higher than most of us have been estimating for a long time?

This uncertainty and dynamic created significant problems for equities, which after rising nicely at the start of the quarter were floored in late July and early August – and again in September as a result of strong US data and the Fed's messaging. The global MSCI equity index was down 2.4% for the quarter, though year-to-date the global index is up 11.6% in local currencies.

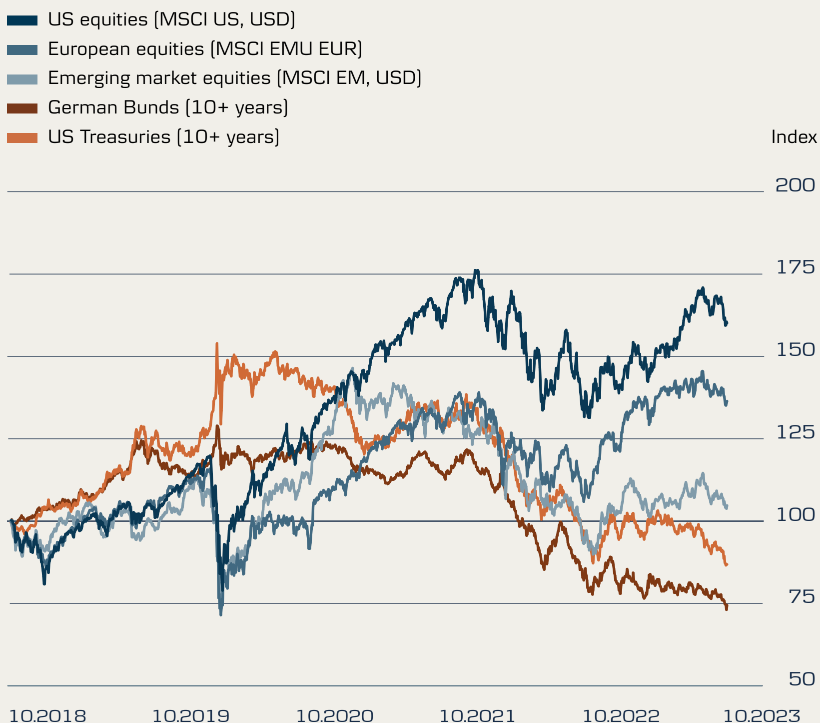
Meanwhile, short bond yields rose on expectations of an increased and extended need for monetary policy tightening. More importantly, medium- and long-term bond yields also rose significantly, especially in the US, as a reaction to the surprisingly strong US economy. European yields rose by less, but nevertheless reached some of the highest levels seen in 10-15 years.

Total return Q1-Q3 2023

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 29.09.2023

US auto workers are striking for higher pay – here with the support of Joe Biden – but the US labour market nevertheless remains extremely strong.

Photo: Jim Watson/AFP/Ritzau Scanpix

EXPECTATIONS GOING FORWARD – MACROECONOMY

Will US strength continue?

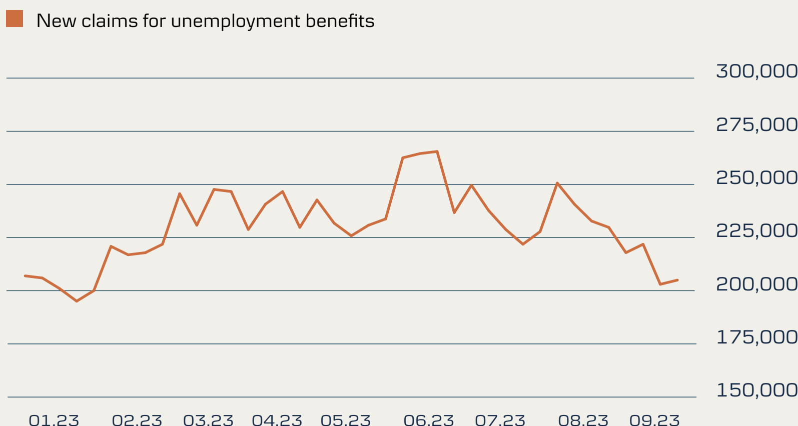
As we write, a number of well-known key figures indicate growth in the US running at above 4% in Q3 2023. That is more than double the economy's long-term potential and comes on the back of strong growth in private consumption, which is ultimately being driven by the still thriving labour market, as symbolised by historically low levels of unemployment, decent employment growth and solid wage growth. Meanwhile, the housing market is showing clear signs of having bottomed out despite 30-year mortgage rates topping 7%. These trends have surprised most observers and shifted consensus among economists away from the recession scenario most had pencilled in since summer last year. Consensus expectations are now for only a modest increase in unemployment and not for consecutive quarters of declining employment.

While we were never in the 'recession camp', the strength of the US economy has surprised us too. In our view, the main reason for our misjudgement is that the economy has proved even more resilient to tight monetary policy, interest rate hikes and tighter credit conditions than even we had assumed. Our analysis was that in the absence of normal imbalances, such as excessive private consumption and misplaced investments financed with borrowed funds, there was little chance of a 'normal' recession – but the economy delivering above-trend growth was a big surprise, also for us.

Hence, the question now is whether

US labour market delivers another upside surprise

Rising interest rates were expected to put a damper on the strong US labour market, but this is not reflected in the latest new claims data.



Source: Macrobond.

this show of strength can continue. Our response is 'probably not'. Dig below the surface and we can see signs that growth is lower than the headlines proclaim. In our view, the broader data picture indicates growth closer to 2% than 4%. And despite the fine figures from the labour market, employment growth is showing clear signs of slowing.

Looking ahead, the ongoing impact of higher interest rates and tighter credit conditions should still be sufficient to keep growth below its long-term potential. Despite recent strength, we therefore maintain our expectation of

Should growth prove stronger than expected, or inflation not decline fast enough, the ECB could well raise rates again – potentially several times.

a period of below-trend growth going forward to summer 2024 accompanied by a moderate increase in unemployment.

That being said, our most important expectation remains that the economic harm inflicted by the historic tightening of monetary policy will be relatively limited, so any spare capacity released into the economy will be insubstantial. Despite the recent tick-down in inflation and our expectation of more to come, we are therefore sticking to our mantra of a need for tighter-for-longer monetary policy, as symbolised by just modest rate cuts in late 2024 and in 2025. Hence, the new monetary policy views expressed by the leading members of the Fed are more on the ball in our eyes than they have been for a long time.

ECB hits pause – but likely means stop

Predicting whether the ECB would hike its benchmark rate to 3.75%, 4% or slightly higher has been a difficult exercise in recent months, as it ultimately came down to when the ECB Governing Council would agree that monetary policy was 'tight enough' coupled with data developments in the very near term. Going by the rhetoric of the September meeting, the ECB now appears to unanimously agree that monetary policy is tight enough for now. Naturally, this consensus was prompted by inflation trending lower, but perhaps even more so by the latest weakening of the economy that caught the ECB off guard (and to some extent us too). Hence, they have hit the pause button to assess what exactly is happening and whether the good inflation news will continue – which makes good sense, in our view.

With respect to inflation, the good news should continue for the next 6-12 months. Even if the late-summer jump in commodity prices creates challenges, they will by nature be temporary. A further unkinking of the supply chain, reopening effects in the service sector fading and a weakened housing market should send inflation further down.

Hence, the immediate uncertainty lies on the growth side. Growth has slowed more than we expected and will likely remain subdued in the short term. We assess that our misjudgement resides in the slowdown in credit growth, which has rapidly gone from relatively high to almost zero. Unless both the banks and consumers as well as businesses suffer a new shock, the negative impulse from here is probably behind us. Going forward, the key impulse will instead be fiscal policy. In contrast to the US, fiscal policy boosted eurozone growth in 2022 as a whole and over the winter in response to the energy crisis. This has now changed, with fiscal policy set to be either tightened or at least ▸▸

Eurozone service sector weakens

PMI confidence indicators for the eurozone service sector have dipped below 50 in recent months, indicating a downturn.

Source: Macrobond.

not loosened further, which will reduce growth for a while and in our view keep it below trend.

Low growth combined with a modestly slowing labour market and lower inflation should therefore mean that the ECB has hit peak policy rates and will remain there. Nevertheless, we recognise the small risk that the ECB could feel forced to raise interest rates further. And we would re-emphasise that should growth prove stronger than expected, or inflation not decline fast enough, the ECB could well raise rates again – potentially several times. Hence, our mantra remains that monetary policy needs to be tighter for longer – also in the eurozone.

Easing, what easing?

Markets remain very jittery on China, with the uncertainty primarily centred on the still very weak housing market. Growth printed lower than expected in Q3, though it appears to have stabilised at a low level. We remain rather pessimistic on China in the long term. As we outlined in the previous edition of Quarterly View, China's demographic trends and lost momentum in the urbanisation process mean the need for construction will be considerably lower in the future than during the past 5-10 years. This is unnerving the entire economy due to the significant knock-on effects the housing market brings with it. For example, building houses in China also means the building of critical infrastructure, the service sector expanding and private consumption getting a boost. This process is now stuck in reverse, which is why the long-term growth potential in China over the next 10 years is approaching a maximum of 3-4%.

Nevertheless, we estimate construction sector activity has now been fallen to a level that is below even our relatively pessimistic long-term forecasts. Hence, halting the decline and regaining some strength should be possible. The rhetoric certainly cannot be faulted, with the authorities vowing to ease over the summer and the first concrete initiatives materialising in late August/early September, including reduced down payment requirements and lower interest rates. This is why we expect the housing market to stabilise in the short term and strengthen slightly going forward, enabling overall growth momentum to pick up a bit. What has surprised us, however, is that economic policy up to late summer appears to have been decidedly tight. Credit flows fell at one point, whereas the general economy had a need for stimulation. We would sound a note of warning and acknowledge that something may be afoot that is very difficult to address – widespread caution among consumers and businesses given the long-term challenges and the authorities' at times abrupt shifts in both rhetoric and policy.

Despite the uncertainty, the most likely explanation in our opinion is that the authorities have absolutely no desire to overstimulate either the housing market or the economy generally. Historically, this is precisely what has happened, and it has brought significant problems – such as excessive debt among local authorities, etc. – which are essentially still being rectified. We therefore assume that any easing has been modest and will only now start to influence the economy and benefit growth. We therefore expect modestly increasing growth back to around 4-5%, after which growth rates will stabilise. That being said, our central point here remains that China faces major hurdles just to deliver even 4% growth, on average, for the remainder of this decade.

USA: Expectations for growth, inflation and interest rates

	2022	2023	2024	2025
Expected growth	0.88%	1.93%	1.05%	1.77%
Long-term growth potential	1.87%	1.88%	1.88%	1.88%
Unemployment rate	3.60%	3.77%	4.19%	4.24%
Core inflation (PCE)	4.72%	3.42%	2.37%	2.21%
Federal funds rate	4.38%	5.54%	5.11%	4.31%

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

	2022	2023	2024	2025
Expected growth	1.75%	0.15%	0.82%	1.26%
Long-term growth potential	1.07%	1.23%	1.36%	1.36%
Core inflation (HICP)	4.97%	3.87%	2.32%	2.18%
ECB depo rate	2.00%	4.05%	3.57%	2.85%

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 29.09.2023.

Deutsche Börse (stock exchange) in Frankfurt. We expect a reasonable return from equities in the coming 12 months, but that will require stability in long yields.

Photo: Boris Roessler/DPA/Ritzau Scanpix

EXPECTATIONS GOING FORWARD – THE FINANCIAL MARKETS

Long end bond yields hold the key to higher equities

As Q3 2023 kicked off, we were expecting further modest increases in equity prices and relatively stable bond yields. Hence, the rise in long US yields, in particular, wrong-footed us, and was our most important forecasting error over the summer.

Therefore, the question now is whether long end bond yields have in fact stabilised. If not, equities are likely to slide again in the short term, as markets are currently very sensitive to the uncertainty surrounding the discounting of future value, and especially the earnings of growth-oriented businesses. We therefore note that uncertainty has increased in the short term but nevertheless maintain our expectation that the global expansion will lend support to equities. Meanwhile, slightly lower growth in the US combined with significant risk premiums at the long end of the US yield curve should reduce the chances of further interest rate hikes.

EQUITIES:

Global equity valuations are still expensive in our estimation and currently do not offer the risk premiums they should for long-term investors. We regard the US equity market as around 10% overvalued right now, while European equity valuations are close to fair following recent weakness. If we are right in our assessment of an upcoming period of below-trend growth without any major harm inflicted on labour markets, equities should be capable of maintaining their valuations and – when long yields have calmed some more – of rising a little to reflect moderate earnings growth. We also still see a significant probability of equities becoming considerably more expensive if the US economy achieves the soft landing we have long argued for.

In the short term, however, we would stress the need for long bond yields to stabilise in order for equity markets to calm again. The crux of the matter here is whether the increase in yields is driven by higher long-term growth expectations (ultimately positive for equities) or rising forward term premiums (probably bad news for equities – particularly in the short term). All in all, we expect equities to rise by 5-10% over the coming 12 months, but we conclude that this requires greater stability in long yields in the near term.

BONDS:

Our assessment of the potential in short bonds in both the US and the eurozone has long been either negative or only modestly positive, as we have maintained that the market failed to price sufficient tightening of monetary policy this year and – especially in recent months – had priced in too many rate cuts in 2024 and 2025. Given recent monetary policy announcements from both the ECB and the Federal Reserve and the recent rise in short yields,

▸▸

we argue they are now at a reasonable level. We would stress, however, that the potential for yields to decline in this section of the yield curve is limited if our outlook for monetary policy proves accurate.

Our key focus – and our most obvious forecasting error in the past quarter – centres on long end bond yields, especially in the US. In short, our take has long been that the neutral nominal policy rate (i.e. the long-term equilibrium level for the key interest rate) in the US and the eurozone is slightly below 3% and 2%, respectively. Even with a few high estimates for fair risk premiums at, for example, the 20-year and 30-year points of the US yield curve, current mid- to long end yields of more than 4% would still be attractive. In Q3, however, our assessment clearly proved to be off the mark.

Explanations abound, of course, and some quickly become difficult to quantify and 'voodoo'-like. These arguments stretch from a lack of purchases (or even direct sales of bonds) by the central banks and China's reduced purchases of government bonds to supply and demand analyses and rising potential growth driven by technological advances (think artificial intelligence). Common to most of these explanations is that they are good and obvious stories, but often difficult to quantify.

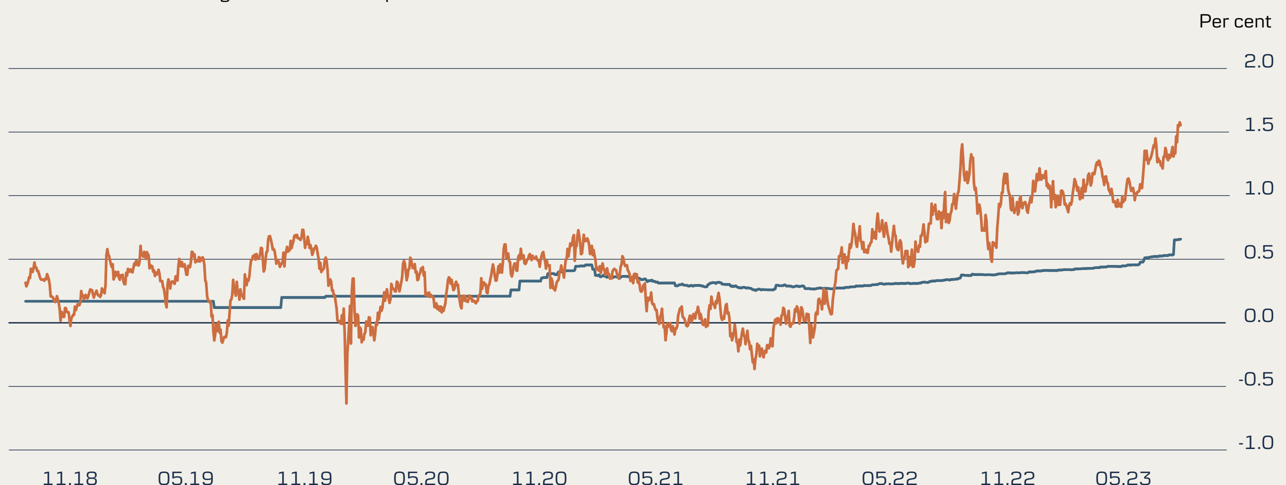
Calling them 'voodoo'-like is not reflective of a desire to neglect them. They all play an important role. Indeed, we have adjusted our own expectations for the US long-term nominal interest rate from around 2.5% in the spring to around 2.9% now. The driving forces have been ongoing new research that points in that direction as well as the fact that the economy has proved surprisingly resilient to the tightening of monetary policy.

However, interest rates are significantly higher right now, which therefore leaves risk premiums (e.g. term premiums) as the focus point. We have also adjusted our fair estimates slightly higher here – in part due to the continuing deterioration of US government finances and steadily rising debt-to-GDP ratio. But even including the total effect of the adjustments mentioned, we ▸▸

We are expecting a moderate decline in yields across the curve over the coming 6-12 months in both the US and the eurozone.

Long yields unduly high

At Danske Bank Asset Management (DBAM), we currently assess the 30Y zero-coupon forward premium to be significantly above the fair long-term level in the US.



Source: Macrobond.

are nowhere near quantifying a 30-year yield of 4.7% as approximately fair. Rather, our fair estimate is around 3.6%, which is why we continue to argue there is decent value in the medium-to-long end of the US yield curve in particular.

That being said, uncertainty has increased, and until we obtain greater clarity on whether our growth forecasts are completely wide of the mark (i.e. whether growth remains strong, or declines slightly, as we expect) we are being more cautious in our allocation. Nevertheless, we are expecting a moderate decline in yields across the curve over the coming 6-12 months in both the US and the eurozone as inflation slows further, labour market pressures ease and central banks can declare the current tightening cycle done and dusted, so we can look forward to modest rate cuts in late 2024 and into 2025.

EMERGING MARKETS:
China is still the key to emerging markets, even though there are many other important aspects to this asset class, especially with respect to bonds issued by emerging market nations in both hard and local currencies. Regarding equities, we assess Chinese equity valuations to be on the cheap side. More specifically, we estimate the Chinese equity market to be undervalued by 5-10%, so it offers a risk premium slightly above the fair long-term level. However, both such long-term considerations and the geopolitical outlook are subject to substantial uncertainty.

Conversely, we view certain other emerging market valuations as expensive. This, together with our limited optimism on China in the short term and our structural concerns for China's growth potential in the long term, means we see only a limited return potential in the broader emerging market equity indexes of 3-8% on a 12-month horizon. Once again, long US yields and the entire tight US monetary policy theme will continue to be key factors for a long time to come.

Macro barometer: Mixed picture

US growth picked up unexpectedly, driven by strong private consumption and a turnaround in the housing market. However, we expect growth to be slightly lower in the coming quarters due to a banking system that remains under pressure, the recent rise in long end bond yields and higher oil prices. Growth in the eurozone is accelerating modestly from a low level, driven by less negative impulses from the credit system and energy prices, while tighter fiscal policy is tending to pull growth lower. Moderate easing in China coupled with a more stable housing market should lift growth here to around the long-term potential.

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

Positive growth

	SLOWDOWN	EXPANSION	
Declining growth	• Interest rates both up and down • Equities rise modestly • Credit spreads both up and down	• Interest rates rise • Equities rise sharply • Credit spreads tighten	Increasing growth
	RECESSION	**RECOVERY**	
	• Interest rates fall sharply • Equities fall sharply • Credit spreads widen	• Interest rates fall • Equities rise sharply • Credit spreads tighten	

Negative growth

Source: Danske Bank Asset Management

This publication has been prepared as marketing communication by Danske Bank A/S ("Danske Bank"). Danske Bank is under supervision by the Danish Financial Supervisory Authority (Finanstilsynet).

This publication has been prepared for informational purposes only and it is not to be relied upon as investment, legal, tax, or financial advice. You must consult with your advisor as to the legal, tax, financial or other matters relevant to the suitability and appropriateness of a potential investment. The publication has been prepared for selected, potential, and current retail customers and professional investors.

Danske Bank may have financial interests in the distribution of this publication.

Prices, costs, and expenses quoted in this publication are indicative and may be subject to change and fluctuations due to ordinary market risks.

This publication is not an offer or solicitation of any offer to purchase or sell any financial instrument, this includes instruments distributed by third parties. Whilst reasonable care has been taken to ensure that the contents of this publication is fair, true, and not misleading, no guarantee is made as to its accuracy or completeness and no liability is accepted for any loss arising from reliance on it. Danske Bank accepts no responsibility for the accuracy and/or completeness of any third party information obtained from sources Danske Bank believes to be reliable but which have not been independently verified.

Performances presented in this publication are historical. Past performances are not indicative of future performances and investors may incur losses on their investments.

This publication nor any copy of it may be taken or transmitted into the United States of America, its territories or possessions (the 'United States') or distributed directly or indirectly in the United States or to any U.S. person (as defined in Regulation S under the U.S Securities Act of 1933, as amended), including any national or resident of the United States, or any corporation, partnership or other entity organised under the laws of the United States.

Any information or opinions contained in this publication are not intended for distribution to or use by any person in any jurisdiction or country where such distribution or use would be unlawful.

In Switzerland, this publication is intended exclusively for qualified investors pursuant to Art.10 Para.3, 3bis and 3ter of the Swiss Collective Investment Schemes Act (CISA) and independent asset managers as per Art. 3 Para.2 lit c CISA with country of residence in Switzerland. It is not intended for any investor who is not considered as a qualified investor and may not be made available or distributed publicly to non-qualified investors.

This publication is only for professional investors. It is not intended and not suitable for any retail investor and may, therefore, not be publicly distributed and not be forwarded or made available, directly or indirectly, to any investor which is not a professional investor.

Copyright © Danske Bank A/S. All rights reserved. This publication is protected by copyright and may not be reproduced in whole or in part without permission.

Danske Bank Asset Management
Danske Bank A/S
Holmens Kanal 2-12
DK-1091 Copenhagen, Denmark

Company reg. no.: 61 12 62 28
Tel. +45 45 13 96 00
Fax +45 45 14 98 03
danskebank.dk