Photo: Spencer Platt/AFP/Ritzau Scanpix

QUARTERLY VIEW Q3 2023
MACRO & TAA
DANSKE BANK ASSET MANAGEMENT
03.07.2023

Interest rates close to peaking, could equities spike?

OUR CURRENT EXPECTATIONS: The global expansion is set to continue, though growth will be relatively slow in the near term, particularly in the US. Inflation should decline in the US and the eurozone but remain above central bank targets and thus require tight monetary policy for an extended period. Yields are close to the peak and equities should rise a bit more. Question is – could equities go ballistic?

Danske Bank

An expanding service sector has been particularly supportive of economic growth - and as the sector is labour-intensive, unemployment remains very low in both Europe and the US.

THE PAST QUARTER

Global expansion still alive and kicking

Silicon Valley Bank and Credit Suisse collapsing in March meant the banking crisis was still a key theme as Q2 2023 kicked off. Three months later and the US has again wrong-footed most pundits by avoiding the recession a majority of economists have been predicting for close to a year now. Similarly, the European labour market remains in rude good health despite the energy crisis and substantial uncertainty. China has been the big disappointment this year after strong growth in early 2023 quickly petered out.

The banking crisis erupted...and disappeared again
The dust settled relatively quickly after the banking crisis, leaving us with a still surprisingly strong US economy and labour market – job creation continued unabated in Q2, unemployment remained record low and wage growth was solid. Most surprising perhaps was the housing market showing signs of having bottomed out despite higher interest rates. This picture was in stark contrast to most economists' expectation of an imminent recession. Nevertheless, consensus among economists is still that the recession is not cancelled but merely postponed – in other words, the long-expected weakness in the labour market is just a matter of time, they say.

The bad news in Q2 was a stagnating manufacturing sector and – even more important – consumer price inflation that stubbornly refused to ease as much as we all hoped. With this in mind, the US central bank raised interest rates again in May by 0.25 percentage points to 5.25%, and while the Federal Reserve skipped a rate hike in June, they clearly signalled that the normalisation of inflation was taking too long and that further rate hikes were probably necessary.

Bo Bejstrup Christensen
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One million new jobs in the eurozone!
In Europe, the European Central Bank, ECB, raised interest rates by 0.25 percentage points in both May and June, taking the ECB's deposit rate to a 20-year high of 3.5%. Inflation has been running too high for too long, and with new forecasts at hand ECB President Christine Lagarde all but promised at least one more rate hike. The new forecasts continue to show inflation above the central bank's target all the way out to 2025 – and even revised inflation higher. Finally, Lagarde articulated

how the rock-solid labour market would be a key driver of inflation going forward as accelerating wage growth comes on the heels of almost inconceivable job creation in Q1 this year. Employment rose by close to 1 million in Q1 – a figure that Lagarde at her press conference in June said well-illustrated how the labour market had performed much better than expected since the anxiety of winter.

China quickly ran out of steam

The second quarter of the year was not all good news, however – and the greatest disappointment was China. China's reopening sparked a near bombastic start to the year, with activity levels soaring. Yet growth soon slowed almost as quickly as it had accelerated. The hard-hit housing market was the reason, as momentum was soon lost despite early signs of a normalisation. That in turn fuelled speculation on renewed stimulation for both the housing market and the wider economy. However, such thinking proved overly optimistic, and the quarter drew to a close with even greater pessimism about China's prospects for growth.

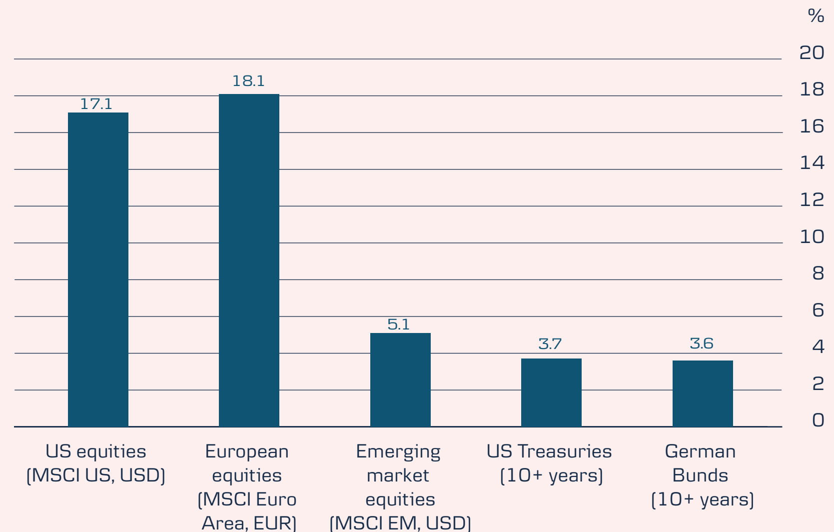
Financial market developments – renewed optimism

Despite the still high level of inflation, generally positive growth surprises from the US and Europe again gave a boost to global equity markets. June was a particularly strong month for US equities, which lifted the global MSCI equity index by 6.7% for the quarter. Year-to-date, the global index is up 14.4% in local currency.

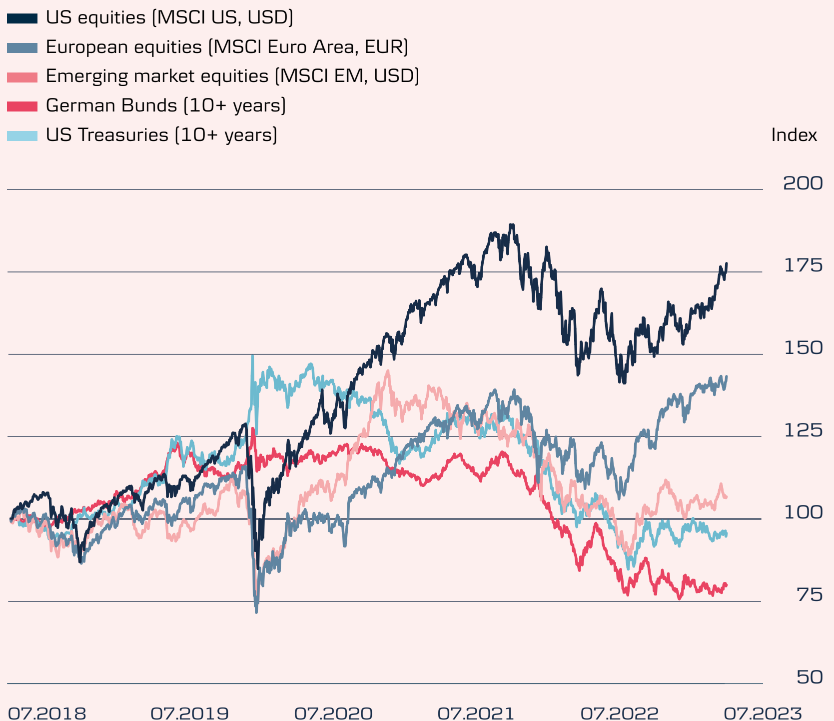
Meanwhile, short end bond yields rose on expectations of an increased and extended need for monetary policy tightening. In contrast, medium and long bond yields remained relatively stable, which also lent a helping hand to global equity markets, particularly the tech sector.

Total return H1 2022

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 30.06.2023

The long-predicted recession in the US has still not materialised, and we see a reasonable probably that it never will.

EXPECTATIONS GOING FORWARD – MACROECONOMY

Are labour markets unbreakable?

The simple answer to the above question is “no”. If the Federal Reserve had, for example, raised its benchmark rate to 10% and the ECB to 7.5%, both the US and the eurozone would of course tip into recession and unemployment consequently increase significantly. That would eventually tame inflation and the central banks would be able to cut rates again. This was a real risk last autumn, and in principle it still is.

However, we see the risk of this scenario unfolding as diminished, as both the Federal Reserve and the ECB have “shown their hand”. At least for now. Instead of tightening until something really breaks, both central banks have so far opted for a strategy that essentially aims to 1) tighten monetary policy to an extent that it is most likely very tight but without acting too aggressively, and 2) keep monetary policy tight long enough for inflation to slowly but surely drop down towards the target of approximately 2%.

The Federal Reserve has been relatively transparent about its strategy, namely that it is keen to see an extended period of below-potential growth in order to ease the pressure on the labour market and on prices generally. Were the ECB to communicate in the same way as the Federal Reserve, we would humbly suggest it would say more or less the same.

While we can only speculate on their rationale, part of the explanation is likely to be that a recession often has unintended consequences. As long as inflation does not continue to accelerate (as it did last year), central banks can instead buy a little wait-and-see time with the above strategy.

And several factors are working in their favour right now – at least in the short term. Supply chains are clearly improving, which should help ease abnormally high inflation in, for example, goods. Global commodity prices are trending down for the first time in a couple of years, and companies appear less aggressive with respect to their expectations for future price increases. Housing market activity has slowed as a direct consequence of the marked increases in interest rates, and both US and European banks are currently tightening credit conditions, which tends to dampen growth.

Some of these factors are of course temporary, but at least they are working in the right direction at the moment, which will ease the pressure on central banks. The question then remains of whether this is enough to push inflation all the way down to target.

US recession – it is now or never

Ever since recession fears ramped up last summer, we have consistently taken a contrarian view against this being the most likely scenario to play out. Naturally, we acknowledged the risk, but our assessment was that an extraordinary shock to the economy would be needed to trigger a recession – basically because the US economy is not fundamentally imbalanced. Households ▸▸

Hence, the second half of 2023 is probably crunch time. If the recession does not materialise now, it is likely that it will not happen for the foreseeable future, unless the Federal Reserve feels the need to force it.

and corporates have neither spent nor invested too much (borrowed) money, which makes it less sensitive to credit and monetary policy shocks.

And this remains our main argument for why the economy, despite the historical tightening of monetary policy and stricter credit conditions, will not tip into recession. The housing market is – and has been all along – a key factor in our considerations. It is normally a key driver of recessions, as tighter monetary policy and stricter lending practices usually cause construction activity to dip. Construction activity has indeed fallen this time too, but only modestly, and the slowdown is already showing signs of being over despite the highest mortgage rates in 15 years. Our view is that construction activity has been subdued for a long time pre the pandemic, so the supply of homes is record-low. This will ensure construction activity does not collapse and puts a bottom under house prices, which in turn helps both households and bank balance sheets.

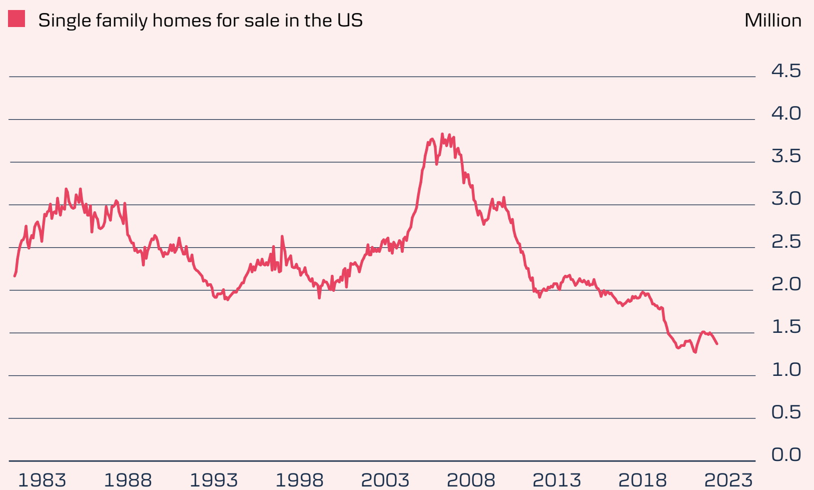
Another example is inventory investments. A traditional recession typically involves a significant downturn in inventory investments. If demand unexpectedly falls – for example, due to tight monetary policy or credit restrictions – companies are left with unduly large inventories and excessive levels of production. The reaction is to cut production levels, and not just down to the new level of demand, but even further down (temporarily) to reduce inventory levels.

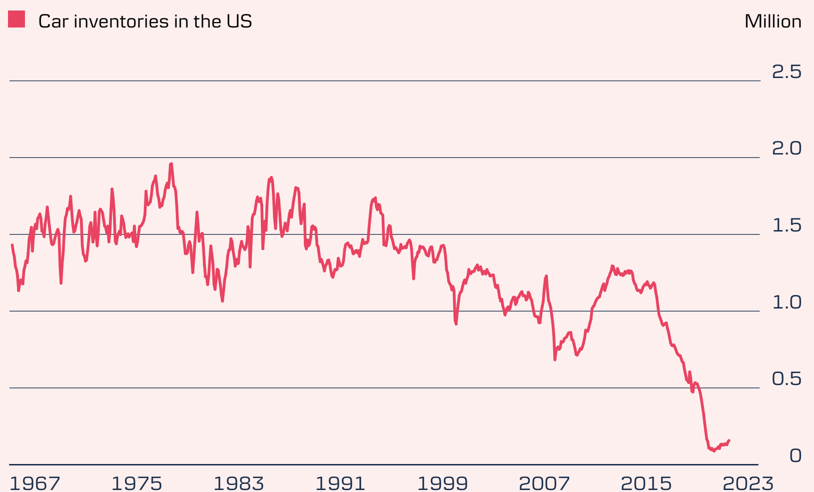
However, the current expansion has not been characterised by excessive inventory investments over an extended period. On the contrary, inventory investments have been modest, and while assessing the appropriateness of the actual inventory level is always difficult, we estimate that inventories are at the very least not abnormally high. An extreme example here is the car industry, which during the pandemic faced a tricky cocktail of solid demand and a dearth of microchips – the latter putting a cap on car production. This, coupled with robust demand, gutted car inventories to extremely low levels, which have only just begun to grow again.

We would stress that the housing and auto markets are two extreme examples underpinning our main argument – for while they are indeed unbalanced, the imbalance is leaning in the opposite direction compared to the situation ahead of previous recessions. Nevertheless, both sectors have ▸▸

No recession signals from housing or car markets in the US

Imbalances in the housing and car markets have historically played a key role in forcing the wider economy into recession, but there are currently no signals of an imminent recession from that front. The supply of homes for sale is extremely low, and ditto US car inventories.





Source: Macrobond.

historically played a key role in forcing the wider economy into recession, and we estimate that in the current situation they will most likely not do that this time.

But if we are wrong, the recession is likely imminent. We estimate that the impact of tighter monetary policy and credit restrictions will peak this year. Moreover, this coincides with the reopening impulse fading and additional household savings from the massive fiscal easing during the pandemic slowly but surely being run down. Hence, the second half of 2023 is probably crunch time. If the recession does not materialise now, it is likely that it will not happen for the foreseeable future, unless the Federal Reserve feels the need to force it.

And here we would maintain that inflation is not so deeply entrenched that the Federal Reserve has to tighten drastically and basically break the labour market in order to tame inflation. We estimate underlying inflation to be around 2.25%. If we are correct, the temporary factors we discussed above will help dampen inflation substantially over the next 12-18 months. In short, the Federal Reserve can look forward to a period where inflation moves in the right direction and the labour market – finally – experiences a modest slowdown as a result of tight monetary policy and tighter credit conditions. Hence, we expect a significant slowing of job growth and a modest increase in unemployment to around 4.25% from below 4% at present. This is the core argument underpinning our view that the Federal Reserve should very soon be able to pause its hiking cycle.

However, given that we do not expect a recession and thus a significant weakening of the labour market, inflation will not decline to 2% before 2025 at the earliest. We therefore still expect the Federal Reserve to keep monetary policy tight for quite some time in order to ensure disinflationary pressures are maintained – especially when the temporary factors normalise and there is no further disinflationary pressure to be had from here.

Summarising, we would argue the Federal Reserve will be successful in its strategy and achieve a relatively soft landing, though with the caveat that inflation will remain too high for a long time yet, leaving the Federal Reserve no opportunity for even modest easing before H2 2024 at the earliest.

ECB also close to peaking

The eurozone created close to 1.5 million jobs, in all, over the final quarter of 2022 and the first quarter of 2023. That equates to annualised employment growth of almost 2% in an economy where trend growth (including productivity growth) is barely 1.5%. That performance was strong enough to reduce unemployment despite an increase in the labour market participation rate.

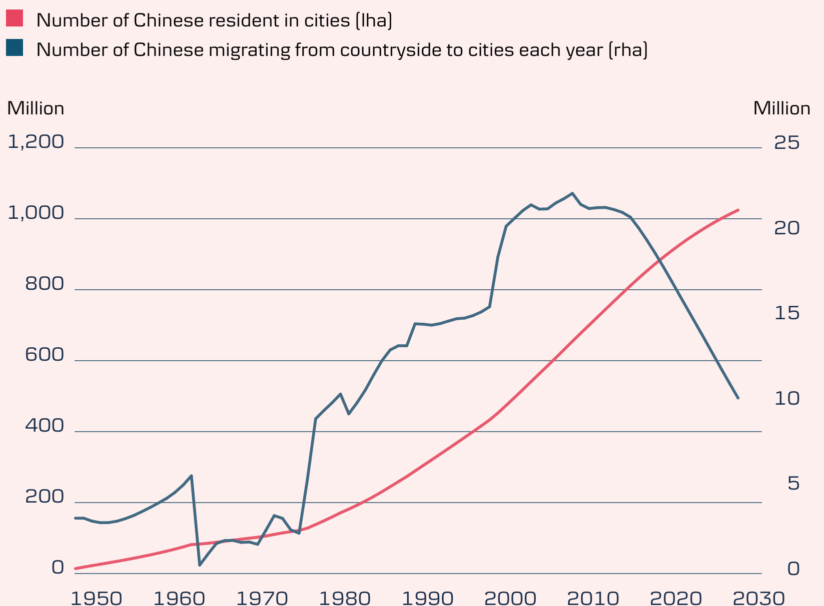
This figure alone underlines why the eurozone emerged from the winter in much better shape than expected and feared when the energy crisis was at its height. It also highlights why the ECB sees getting inflation down to 2% as a major challenge.

As with the US, we estimate underlying inflation to be modestly above the ECB's long-term target – so again we see no need to force a recession. Nevertheless, underlying inflation has taken hold above the target, which is why the ECB has to tighten further and keep monetary policy tight for longer. We thus expect the ECB to hike the deposit rate to 4% and keep it there far into 2024.

Hence, the ECB, too, needs the labour market to slow and thus ▸▸

China's construction boom fades

Booming construction activity in recent decades has been a key driver of China's high level of growth. However, we estimate construction activity in China has peaked, structurally speaking, and will decline significantly in the next 10-15 years. This is very much due to fewer migrating from the countryside to the cities in recent years – and we expect this trend to continue going forward.



Source: Macrobond.

ensure that inflation lands around target in the longer term. We therefore also expect growth here to be below potential in the coming quarters, and if we are wrong in our estimate of 'true' underlying inflationary pressure, we would again stress that the ECB could well end up hiking to above 4%.

Has China's growth model collapsed?

Our most important mistake this year was our forecast for China. Initially, we had a clear expectation that China's reopening would prove faster and stronger than most other economists anticipated. That expectation was met. We then expected growth to be maintained at high levels in Q2, as the stalled housing market had one final arrow in its quiver due to the artificially low demand during the pandemic. This proved completely wide of the mark. Instead, home sales have largely collapsed once more, and overall growth has tumbled just as quickly as it rose. Financial markets are almost screaming for further stimulus, but none is in sight at the time of writing.

We see our error as being rooted in very pronounced uncertainty around the long-term development of the housing market. Tough restrictions during lockdown naturally had an impact on demand, but prior to that the authorities were pursuing a strict policy towards construction companies, as they were concerned about the long-term viability of the housing market. The combination of weak demand and tight credit and financing policies has felled the one indebted constructor after the other.

USA: Expectations for growth, inflation and interest rates

	2022	2023	2024	2024
Expected growth	0.96%	1.04%	1.14%	1.80%
Long-term growth potential	1.87%	1.88%	1.88%	1.88%
Core inflation (PCE)	4.72%	3.69%	2.40%	2.21%
Federal funds rate	4.38%	5.35%	4.70%	3.88%

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	1.84%	0.13%	0.86%	1.13%
Long-term growth potential	1.07%	1.23%	1.36%	1.36%
Core inflation (HICP)	4.97%	3.75%	2.43%	2.26%
ECB depo rate	2.00%	3.92%	3.32%	2.75%

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 30.3.2023.

This seems to have caused widespread scepticism and concern among potential homebuyers.

Only a marked easing of housing market policy and/or an extended period of stability are likely capable of altering this. With respect to the former – i.e. stimulus – our opinion remains that the authorities have neither the interest nor the will to stimulate a sector that faces major long-term challenges. Hence, we assess construction activity to have peaked in China from a structural perspective and see it falling significantly over the coming 10-15 years. This is not only due to the population shrinking slightly, but even more so to the fact that although the urbanisation process has not yet ended, the number of people migrating to the cities is falling sharply, which puts a sustained downward pressure on construction activity. We have long held this opinion, but as mentioned above, we assessed that demand during the pandemic had fallen too far for even this slightly pessimistic view. This assessment proved to be wrong.

We have therefore revisited our short-term expectations for Chinese growth. While the housing market could still pick up a little, we are expecting growth around the economy's long-term potential, which is roughly 4-5%. Hence, the good news is that the worst is behind us, growth has fallen to low levels – the bad news is that what lies ahead does not look particularly attractive.

Looking even further into the future, we note that China not only faces a structural decline in construction activity but also a more challenging export environment. For, while China captured a greater share of global export markets during the pandemic, China losing these market shares again seems a reasonable assumption, and this will put pressure on exports in the near term. Longer term, the geopolitical situation puts China's export machine in a difficult spot. All in all, the above serves to underline why China more than ever needs domestic innovation and increased productivity in order to sustain growth of around 4-5%.

Underlying inflation in the eurozone has taken hold above the target, which is why the European Central Bank has to both tighten further and keep monetary policy tight for longer.

EXPECTATIONS GOING FORWARD – THE FINANCIAL MARKETS

Yields peaking, equities should rise moderately

As Q2 kicked off, we were expecting both short yields and equity prices to rise. This more or less panned out. But what happens now?

Overall, our main message is that the global expansion remains intact. We expect growth to continue at a slow but positive pace in the coming quarters and inflation to ease but remain above central bank targets. If this holds, global equities should be capable of rising a further 5-10% over the coming 6-12 months. Yield levels now seem more reasonable in our opinion – but given that we expect monetary policy will have to remain tight for quite some time, we see no real potential for any significant easing and therefore do not expect yields to decline much going forward.

EQUITIES:

Following the latest price rises, we now assess US equity valuations in particular to be expensive. We estimate US and emerging market equities to be 10% overvalued, while major equities in the eurozone are overvalued by 5-8%. Naturally, this tends to curtail future return potential. However, in light of our moderately optimistic expectations for global growth, we estimate these expensive valuations can be sustained and risk premiums on equities fall a tad more. This explains why our expected returns for global equities come in at 5-10% for the next 6-12 months.

However, given the high valuations, a recession could potentially trigger a significant increase in equity risk premiums and put equities on the ropes. Thus, if we are wrong, especially in our assessment of the short-term outlook for US growth, equities could fall 10-20%.

Conversely, we would stress there is a considerable probability that equity risk premiums could fall further and thus send global equities into even more overvalued territory. This scenario could materialise if we are right about expecting low but positive growth in the coming quarters, followed by a modest acceleration in growth in H1 2024. If inflation also fell significantly, the Federal Reserve and the ECB could potentially begin to air the possibility of modest monetary policy easing later in 2024 or 2025. This scenario unfolding could cause euphoria in global equity markets and thus a situation were equity risk premiums basically collapse.

A narrowing of our estimated equity risk premiums to 2021 levels – in other words, prior to inflation fears sending serious shock waves through the markets – implies an increase in US equity prices of more than 10%. Should risk premia fall further – in a way similar to previous, bubble-like situations – global equities could potentially rise by up to 20% over the coming year. As mentioned, this is not our main scenario but nevertheless a scenario we would recommend taking very serious – especially in light of the widespread scepticism about US growth.

BONDS:

With the latest increases in bond yields in mind, market pricing of short bond yields now makes more sense to us. We remain at odds with the market on the potential for both the Federal Reserve and the ECB to cut rates noticeably from H2 2024 onwards, but our distance from each other is much less pronounced now compared to earlier. Meanwhile, we continue to view long yields in particular as fair. We therefore estimate that bond yields overall are now at an appropriate level, and we expect stable to slightly declining bond yields on a 6-12-month horizon.

Should inflation prove more sticky than we estimate, the need for monetary policy tightening would increase – and the Federal Reserve and the ECB would doubtless deliver, as they have clearly communicated they must rein in inflation again. Such actions would likely push short yields further up, but long yields would remain stable in this scenario, in our opinion, as inflation risk premiums would probably fall, and ▸▸

the market would price in monetary policy easing further out in the future.

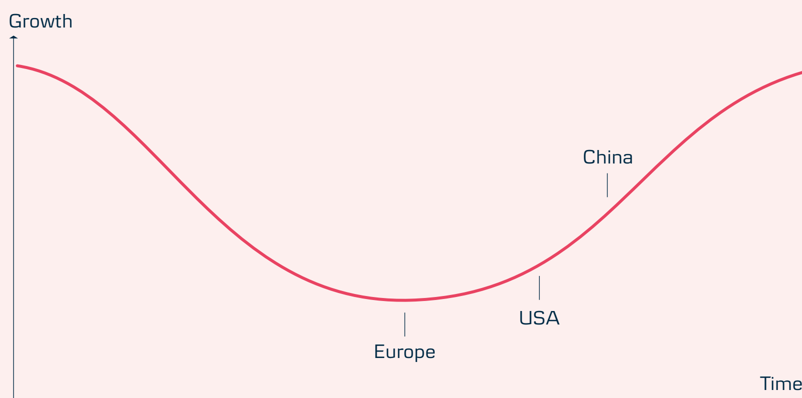
The most troublesome risk scenario for our take on bonds is the "productivity story". Right now, stories about the impact of artificial intelligence (AI) are flourishing. If AI proves capable of boosting the long-term growth potential of global benchmark economies, we will have to reassess our long-term expectations for neutral monetary policy. So far, we have only raised our expectations slightly. We estimate the neutral, nominal short-term rate in the US to be around 2.6% and around 1.8% in the eurozone. Should this prove unduly pessimistic, both the ECB and the Federal Reserve could hike interest rates more than we currently estimate, while rates would on average be higher over the long term. In essence, that would mean even higher short and long yields than we currently expect.

EMERGING MARKETS: Disappointment about China's economy floundering in Q2 hit Chinese equities hard, which in turn pulled the broader emerging markets index lower. However, as we have written, we expect the worst is behind us. Not only should Chinese growth stabilise in the coming quarters, but stability and later a modest acceleration in US and European growth should also assist China and the broader emerging markets index – especially if inflation eases and monetary policy tightening is soon a closed chapter. We therefore expect emerging market equity prices to increase 5-10% over the coming 6-12 months as well as favourable conditions for bonds issued by emerging market countries.

In addition to the obvious risks, such as a US recession and the potential need for even tighter monetary policy, the long-term geopolitical situation of course casts a shadow over Chinese equities in particular. This could hamper how expensive the market is capable of pricing equity risk, even in the global scenario outlined above with US euphoria.

Makrobarometer: Reasonable growth outlook

US growth remains low but positive. We expect this to continue in H2 2023 and for growth to then accelerate back to trend in the course of 2024 if a recession is avoided. Tight monetary policy and future fiscal policy tightening will also keep growth in Europe subdued, though the fading energy crisis should help somewhat. We expect growth in China to pick up slightly, as it has unexpectedly fallen sharply in recent months. Our main point, however, is that growth should hover around the economy's long-term potential and remain relatively stable after a short period of improvement.



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

Positive growth

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

Negative growth

Source: Danske Bank Asset Management

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