QUARTERLY VIEW, Q4 2021
MACRO & TAA
DANSKE BANK ASSET MANAGEMENT

Europe is the place to be right now

The growth slowdown of recent months is over, in our view, and we expect stable to slightly higher growth going forward to year-end. Given our current expectations for growth and monetary policy, we see the greatest potential in European equities and bonds.

Danske Bank

The crisis at Chinese property developer Evergrande has sent shockwaves through the Chinese property sector and the financial markets. Here, pedestrians at a housing complex in Beijing built by Evergrande.

THE PAST QUARTER

Delta-variant and China steal the headlines

Just as the reopening of the US economy was gathering pace, the highly contagious Delta variant of Covid-19 emerged to cast a shadow over the summer. A new wave of infections rolled in across the US, hitting states with low vaccination rates particularly hard. While the health service came under pressure in certain states, there was no need – or political will – for renewed restrictions.

Nevertheless, the outbreak had consequences for economic activity, as many people again became cautious, which hit the service sector. At the same time, fiscal policy stimulus turned from a boost to growth to a drag, while parts of the manufacturing sector remained under considerable supply chain pressures. The overall result was markedly lower economic growth in the US over the summer compared with the heights reached in the spring.

That being said, the economy continued to grow and the US central bank, the Federal Reserve – or Fed, signalled at its September meeting that tapering (reduction in asset purchases) was just around the corner. This is primarily due to the labour market improving considerably in 2021 – and while inflation has been on the high side of expectations, the Fed stressed it expected substantially lower inflation in 2022.

Xi Jinping tightens the screws in China

The Delta variant also emerged in China, where the authorities have had a zero-tolerance policy to Covid-19 since the start of the pandemic. The summer saw the most significant restrictions since the initial outbreak in early ▸▸

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2020, which hit the economy hard in August, when growth fell sharply. However, the outbreak was quickly contained, and China was already easing restrictions in September, to the benefit of the service sector in particular.

Yet, the biggest news out of China was political. In July, the private education sector was eviscerated by new rules that essentially banned the profit-driven teaching of children outside the traditional school system. Several companies' share prices collapsed from one day to the next. Then came the continuing focus on China's tech giants, where data protection, monopolistic behaviour and foreign access to capital came under the spotlight. As the quarter drew to a close, the impending collapse of Evergrande, one of the country's largest property companies with a vast web of other businesses, hit headlines around the world. Shockwaves spread through both the Chinese property sector and the broader Asian corporate bond market, where Evergrande is one of the largest issuers.

European progress overshadowed by news from China and the US

While Europe also suffered an outbreak of the Delta variant in July, infection rates fell quickly – in part due to a successful vaccine rollout. So, although growth here also slowed from the highs of late spring and early summer, it remained decent.

The German election on 26 September was the most notable political event of the quarter, though it unfortunately did not produce a clear result. For economists, however, the key event was the ECB announcing the result of its strategic review in July. The ECB now assures us that its primary target for inflation will henceforth not be "below, but close to, 2%", but rather "2% on average".

While the ECB did not go as far as the US Fed did last year, the ECB is now saying it will tighten monetary policy later than has so far been the case to ensure the inflation target can be achieved. Despite the market's pricing of future inflation moving higher since the announcement in July and thus in the ECB's favour, it remains below the central bank's long-term target.

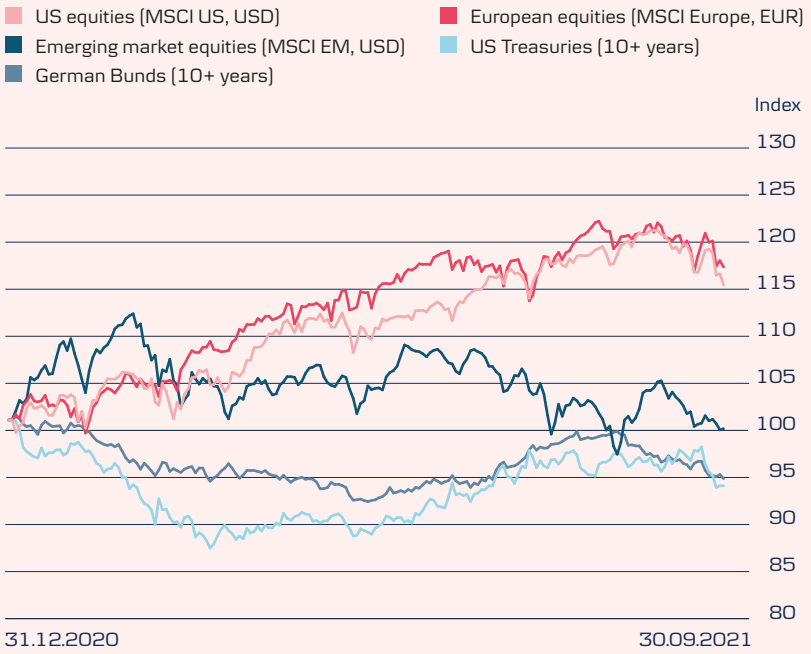
The ECB announcement comes after nearly a decade of the ECB failing to deliver inflation on target. Despite recent progress, this has lodged in the expectations of companies, consumers and financial markets, all of which reckon on lower future inflation than the ECB's target. In essence, the ECB has a credibility issue. Hence, the ECB can look forward to a protracted and tough battle to try to convince us that it now means what it says.

Financial market developments

The picture emerging for Q3 is thus of a global economy where growth slowed sharply, led by the US and China. Slower growth and nascent signs that inflation had peaked resulted in a significant decline in yields in July and August, especially in Germany. As the infection outbreak began to recede, particularly in the US, and the Fed signalled a winding down of bond purchases by summer 2022, short- and medium-term yields rose towards the end of the quarter.

Continuing economic growth and lower interest rates helped global equities reach new highs. Progress was paused in July due to the news out of China, but equities quickly recovered from that brief ripple and set new records in both Europe and the US, while emerging market equities were hit hard, especially in China. News from China again put global equities under pressure in September. Overall, global equities ended the quarter down slightly from Q221, with US & European equities yielding most positive returns, while EM equities were down about 8% for the quarter.

Total return so far this year



Source: MSCI, Bloomberg and Danske Bank Asset Management. Data as of 30.09.2021.

Shopping at the Lego store on 5th Avenue in New York. A spending boom has pushed total consumption in the US above pre-corona levels and helped the economy recover.

THE TIME AHEAD – MACROECONOMY

Global upswing still on track

At the start of the summer, we expected a gradual slowdown in global growth that would last into 2022. Instead, the picture emerging is of a global economy which, led by the US and China, has lost momentum much more quickly and earlier than we expected. Our assessment is therefore that the global growth slowdown is now over, and we expect stable to slightly accelerating growth going forward to year-end.

The main risk to this optimistic scenario remains Covid-19 and potential mutations of the virus that reduce the effectiveness of the vaccines against serious illness. At the time of writing, we expect that booster shots will be necessary as autumn turns to winter, as research shows that the effectiveness of the vaccines fades over time. Fortunately, research also indicates the vaccines remain effective against serious illness – including illness due to the Delta variant. Our expectations being realised depend on this continuing to hold true.

CHINA:
Growth picking up

While data for September remain thin on the ground for now, we estimate China experienced a marked improvement in economic activity, as the restrictions imposed in August have already been removed.

Taking a broader perspective, we assess Chinese economic policy to have been unusually tight ahead of the summer, with the clear aim of getting the property sector, in particular, to shift down a gear. Hence, domestic credit growth year-to-date has been the lowest in many years – and it has worked. Home sales have fallen by around 25% from their peak earlier this year and are now back at the pre-2020 level. ▸▸

> *The tightening of economic policy in China is over, and the authorities are taking their foot off the brake – though without pushing down on the accelerator.*

Lending to the property sector is low, and construction has fallen into line. Car sales are also down, though partly due to supply chain challenges, while private consumption growth has slowed considerably. In our view, the authorities have achieved what they set out to do.

While we do not expect any significant easing of credit policy and continue to foresee considerable challenges, especially in the property sector, we believe the tightening of economic policy is over for now and that the authorities will take their foot off the brake – though without pushing down on the accelerator. We therefore expect growth to be around trend going forward to the end of the year. That would represent a modest improvement compared to most of 2021 and constitute positive news given the significant worries about the property sector, in particular, right now.

USA:
Stable growth ahead

The slowdown in the US unfolded much faster than we had anticipated. We assess growth in August to have been particularly low – perhaps even below the long-term potential. In our view, this was due to fiscal policy losing its impact more quickly than expected and consumers retreating somewhat again, especially from contact-intensive sectors. The service sector has been hit hard and is the only broad sector that has not yet fully recovered from the corona crisis. Of the close to 5 million jobs still missing in the private sector, the service sector accounts for almost 4 million. On top of this comes a slowdown in the housing market after the steamy days in spring this year.

As infection rates retreat again and supply chain challenges, especially in the manufacturing sector, slowly ease, we expect stable to perhaps even slightly increasing growth in the short term. While growth could potentially slow a little again after year-end, our assessment is that the bulk of the growth slowdown is behind us.

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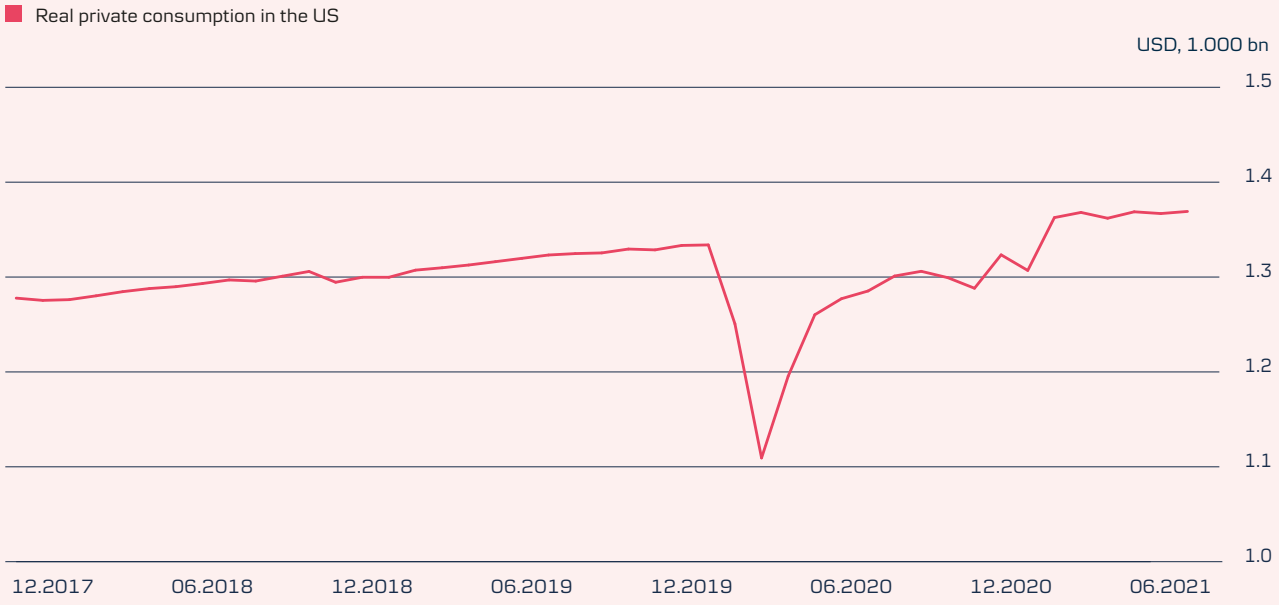
If our expectations pan out, the Federal Reserve will begin tapering in November and end asset purchases ▸▸

Strong comeback for consumption in the US

US private consumption is now above pre-corona levels, in part helped by economic assistance packages.



Source: Danske Bank Asset Management

in June/July 2022. We then expect 3-4 rate hikes in 2023. That is a tad below current market expectations.

EUROPE:
Solid growth to continue

Europe was slower to reopen, which is why growth peaked a little later here. We estimate growth was highest in May/June, when the pace and scale of restriction easing was at its height. As the speed of reopening has slowed, so growth has also eased. Given that few restrictions remain in place, our assessment is that growth has slowed significantly and that most of the slowdown is now behind us. Another factor behind the slowdown is of course the ravages of the Delta variant in July and August. However, as infection rates are now under control, the economy can continue to recover the last bit of, albeit limited, lost ground. Unlike the US, which had already achieved pre-corona levels of economic activity in Q2 2021, Europe still has a little catching up to do.

However, the most pronounced difference between the two regions is that European fiscal policy will continue to have a positive impact on growth, especially in Spain and Italy, and to a certain extent France, in the coming quarters. For the first two countries, this is due to the European recovery fund (Next Generation EU) having a serious impact on these economies now and throughout 2022. Thus, while the best may be behind us growth-wise, we expect Euroland growth of 3-4 per cent annualised going forward to summer 2022. That is around twice as high as the economy's long-term potential.

Despite this strong upswing, however, economic activity will remain below long-term/potential levels for a few years yet. Hence, the ECB continues to have a significant challenge with pushing up and maintaining inflation at the target. Given the new tone from the ECB on how they will pursue monetary policy, our view remains that the first rate hike will not be on the cards until 2025. ▸▸

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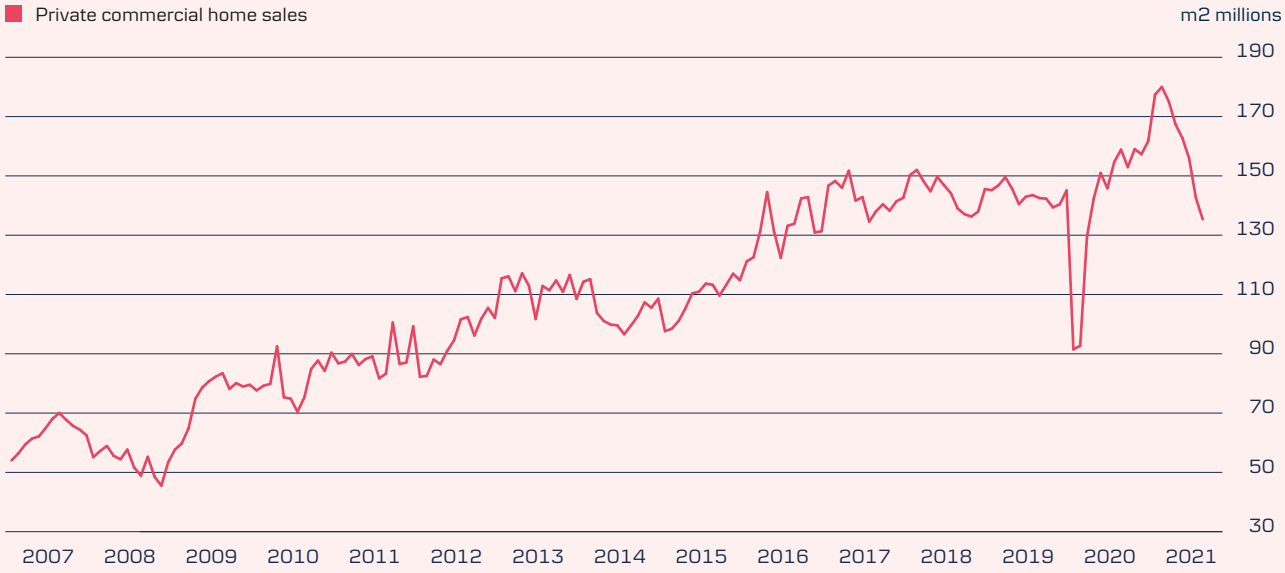
Chinese housing market has shifted down a gear

The Chinese authorities have pursued a tight economic policy with the aim, in our view, of getting the property sector in particular to shift down a gear – and they have succeeded.



Source: UBS and Danske Bank Asset Management. Note: Monthly seasonally adjusted sales.

The Arc de Triomphe in Paris wrapped in silvery blue material. Continental European equities – including French equities – are still priced on the cheap side and look the most attractive right now.

THE TIME AHEAD – THE FINANCIAL MARKETS

Equities to continue rising

EQUITIES:

Global equities have risen by more than 10 per cent YTD and performed considerably better through the summer's slowdown than we expected. Nevertheless, our view now is that the worst threat to global equity markets has passed – the growth slowdown is over for now. We therefore look forward to a modestly positive return on equities in the coming 12 months.

European equities have the brightest outlook in our opinion. We estimate the continental European equity market – in contrast to the US and emerging markets – is still priced on the cheap side. Hence, given our favourable growth expectations in a context of easing inflation and very accommodative monetary policy, we expect a return of 5-10 per cent in the coming year.

Emerging market equities have clearly been the poorest performers this year. In our view, this was partly due to the tight economic policy in China and the subsequent and significant growth slowdown. In addition, however, valuations were already high at the start of the year, and we estimated the broad market was priced up to 20 per cent too expensive. Hence, the news flow on regulatory tightening and concerns about the property sector hit hard. As the market has fallen, valuations have improved a little, though we still assess them to be 5-10 per cent too expensive. More crucial, however, is that our global, and especially our Chinese, growth expectations will now provide positive support for emerging markets going forward. We therefore expect a modestly positive return of around 5 per cent in the coming 12 months, which is a slight improvement on our expectations at the start of Q3 2021.

We still assess US equity market valuations to be unduly high – by around 5-10 per cent. However, we have not changed our view that solid growth, declining inflation and an accommodative monetary policy can support these relatively expensive valuations. Moreover, our growth expectations now point to stable to perhaps modestly better growth in the short term. We therefore continue to expect a return of 0-5 per cent from US equities in the coming 12 months, with the key change compared to the start of Q3 being that the growth slowdown is behind us. Hence, our worries about a correction of up to 10 ▸▸

per cent have eased, and we see a better, if still slightly unattractive, relationship between risk and potential return now than we did three months ago.

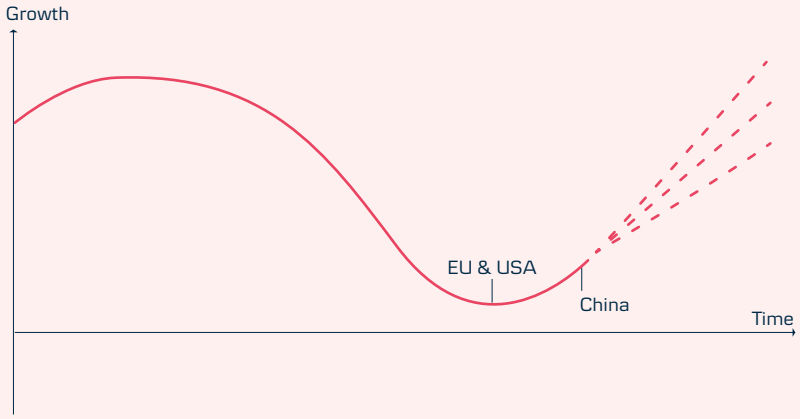
BONDS:
The decline in European yields, with Germany in the vanguard, came faster than we expected. Yields in the mid-maturity section of the German curve had already reached the level we expected sometime in 2022 by mid-August this year. Yields have increased again since then, and we are again looking for stable-to-slightly-declining yields in Europe in the coming months as inflation eases and the ECB continues its dovish rhetoric. We therefore have modestly positive return expectations for German Bunds and government bonds from other core European countries of 2-5 per cent for maturities of 10 years and more. Shorter yields should remain relatively unchanged.

US yields also fell towards the middle of the quarter by more than we expected three months ago, though they have since risen again. In our view, however, the most pronounced downward pressure on US yields – from the growth slowdown – is now behind us. Moreover, the Fed has clearly changed its tune and will now target normalising monetary policy. First, by tapering bond purchases and later via actual rate hikes. However, this has largely been priced into the market already, and we look for only modest increases in yields across the US curve going forward. We therefore expect returns of around 0 per cent for maturities up to 10 years, while the very long end may come under a little pressure.

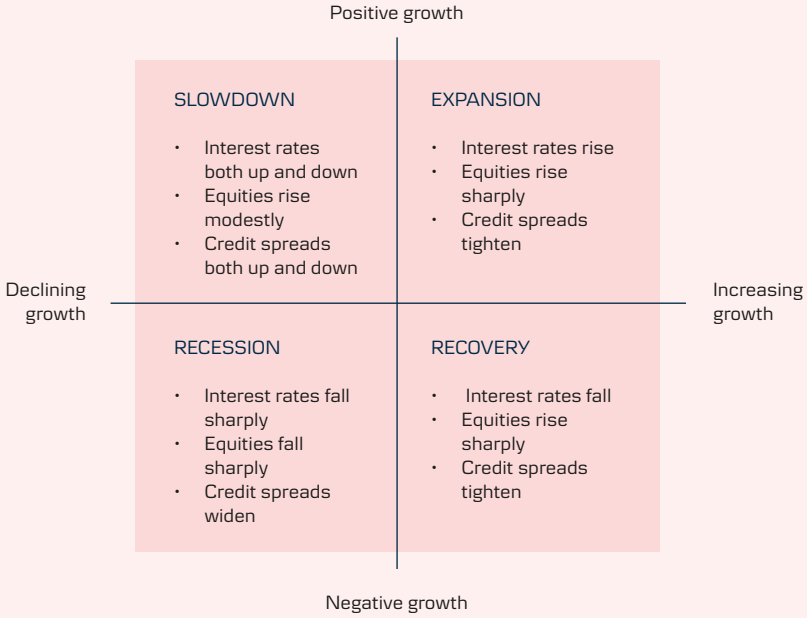
Overall, however, we would emphasise that the global growth slowdown is now over, in our opinion, which means the pronounced downward pressure on yields from this event is also a closed chapter. If the upswing continues in line with our expectations, then every day that passes would mean taking a step closer to a more normal monetary policy.

Macro barometer: USA and China have already peaked

CURRENT STATUS: There is greater potential for a further normalisation of the economy in Europe than in the US or China, whose post-corona economic recoveries are more advanced. This is one reason why we see the highest return potential in European equities in the coming 12 months.



ASSET CLASSES: Typical developments for various asset classes during the four phases of the economic cycle. While Europe is close to the top of the expansion phase, the US and China are in the slowdown phase.



Source: Danske Bank Asset Management

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