FOTO: Impa/IPA/Ritzau Scanpix

Danske Bank Asset Management
Quarterly House View Spring 2020
INSTITUTIONAL

Potential in equities despite coronavirus fears

The coronavirus is adding volatility to the financial markets at the moment, but under the troubled surface we expect the economy to stabilise further once the uncertainty fades, and we still expect a reasonable return from equities in 2020.

Danske Bank

UK citizens will now have a new blue passport instead of their burgundy EU passport. Even though the UK has left the EU, the Brexit drama could quickly flare up again when the terms and conditions of the future relationship between the EU and the UK have to be negotiated.

FOTO:© No10 Crown Copyright/Ritzau Scanpix

Time for cautious optimism

A modest overweight of equities in our portfolios is, in our view, the correct, balanced approach to equity markets at present. While we see a number of positive driving forces for the economy and equities, we also acknowledge there are substantial risks.

By Danske Bank's chief strategist Henrik Drusebjerg

Fears of further outbreaks of the coronavirus outside China have triggered a great deal of volatility in equity markets recently, but up to then the equity and bond markets each had their own story to tell so far this year:

Equity prices had risen to new record-highs, supported by signs of the global economy stabilising and a number of upside surprises in the latest reporting season. Equities enjoyed further tailwinds from declining political risk after the US and China signed a so-called phase 1 trade agreement and the UK left the EU in an orderly fashion. Even the coronavirus outbreak had so far only triggered brief setbacks, as investors expected the Chinese economy would quickly regain its strength once the outbreak had been contained.

In contrast, bond markets have told a less positive story in recent months. Here, yields have fallen on, for example, German and US government bonds, which typically act as safe havens during periods of turmoil and concern about economic growth, just as a fall in yields also reflects increased expectations that central banks will ease monetary policy further to support the economy. This expectation has, incidentally, also been an additional positive factor for equities.

Whereas equity market trends ▸▸

> *Even the coronavirus outbreak had so far only triggered brief setbacks, as investors expected the Chinese economy would quickly regain its strength once the outbreak had been contained.*

Expected return from global equities of

4-8%

over the coming 12 months in local currency.

↑ **Overweight in equities**

↓ **Underweight in bonds**

until recently had signalled significant optimism and faith in the future, the trends apparent in bond markets had signalled a degree of scepticism as regards the strength of the global economy. So which story should investors buy into?

In our opinion, investors should focus on the sum of the two stories. Yes, many indicators point in the right direction for the economy and the financial markets, but no, investors should not get carried away, as there are also significant risks. So while we have an overweight in equities – in other words, a higher share of equities in our portfolios than we expect to have in the long term – it is a modest overweight. This is a time for cautious optimism as an investor, not greed.

Positive factors

Let us first consider why we still see a foundation for optimism on equity markets:

Looking at economic indicators, we had until the coronavirus stole the picture seen further signs of growth stabilisation following a period of weak indicators and outright recession fears during 2019. One of the underlying factors here has been diminishing concern about an escalation in the trade war, which has previously weighed heavily on business confidence.

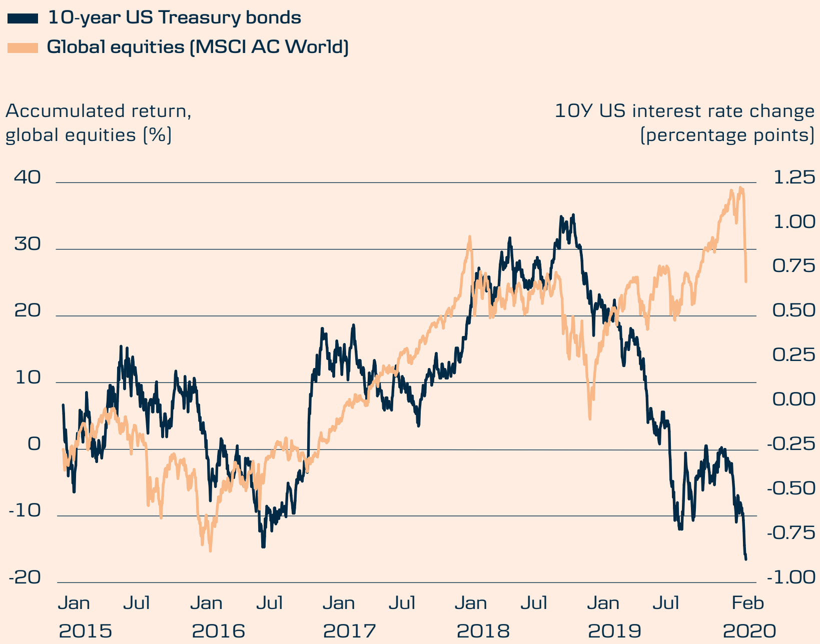
In addition, strong labour markets, rising wages and low interest rates – and thus low housing costs – continue to ensure solid private consumption remains a key driving force for the economy. In recent months consumers have even benefited from falling oil prices, meaning less pain at the pump.

Limited inflation and moderate economic growth continue to provide central banks with the leeway to support the economy through accommodative monetary policy.

Other important factors are limited inflation and moderate economic growth. These factors continue to provide central banks with the leeway to support the economy through accommodative monetary policy – i.e. low interest rates and bond purchases – without fear of economic overheating or runaway inflation. This is why we expect central banks will continue to play a key role for the economy and equity markets going forward.

Equities and yields sent mixed signals

While equity markets until recently had signalled optimism and faith in the future with rising prices in 2020, falling yields have signalled increased scepticism on economic growth. The trend was a continuation of the pattern we saw in parts of 2019. Historical return is not a reliable indicator of future return.



Source: Macrobond, 01.01.2015-27.02.2020.

Key risks

We nevertheless urge caution due to a number of reasons:

STABILISATION – BUT NO ACCELERATION: While we have seen signs of economic growth stabilising, that should not be confused with acceleration, which we find hard to imagine at the moment. Furthermore, uncertainty on the coronavirus may have an impact during a period with disappointing ▸▸

FOTO: Kimimasa Mayama/EPA/Ritzau Scanpix

Concerns about the negative impact of the coronavirus on the global economy have triggered pronounced price falls across equity markets recently. However, we expect the negative effects will be temporary and that we will subsequently see a robust recovery in economic activity.

economic data, which could increase investor concerns on whether the stabilisation of the economy is on the right path.

POLITICAL RISK COULD FLARE UP AGAIN: Diminishing political risk may have limited durability. Despite the phase 1 trade agreement between the US and China, there is still a long way to go to reach a more comprehensive trade deal between the two countries, just as a hard Brexit remains a real possibility. The UK and the EU still have to agree the terms and conditions of their future relationship when the current transition period expires at the end of the year, so we expect the

> *Should the negative effects of the virus prove greater or more long-lasting than expected, the stabilisation of the global economy could be threatened.*

Brexit drama to intensify again at some point. In the Middle East, tensions between Iran and the US could quickly flare up again and affect the oil price, while a further political uncertainty factor is the presidential election in the US. We could risk Trump ramping up the rhetoric on US trading partners in the heat of the election battle and for example fanning the flames of a trade conflict with Europe. In Germany, focus may increase on the fragile coalition government and also on who will head up the CDU after Angela Merkel.

CORONAVIRUS OUTBREAK MAY LAST SOME TIME: We expect the negative impact of the coronavirus to be temporary, while we at the same time expect the Chinese authorities will do their bit to stimulate the Chinese economy so it remains afloat.

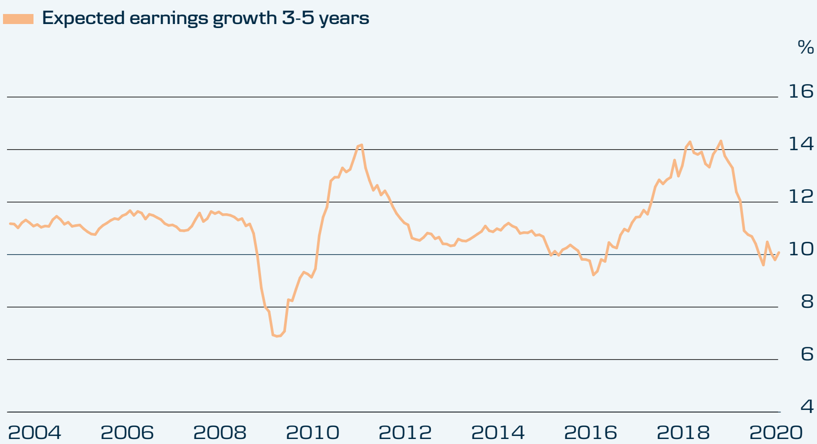
Equities remain the best alternative

Despite recent price falls, equities are not particularly cheap in P/E terms – in other words, the price investors pay per unit of earnings in the companies. However, equity valuations look more attractive than prior to the recent price falls and overall we still assess equities to be the best alternative for investors in the current low interest rate environment. That is why we continue to expect a solid underlying demand for equities despite the current turbulence.

In the shorter term, uncertainty on the coronavirus may result in further price falls, though historically speaking major corrections in equity valuations have typically been triggered by recessions or the high risk of a recession, but we continue to expect a further stabilisation in economic growth once we are through the current turmoil prompted by the coronavirus.

Low expectations for long-term earnings

Analyst expectations for corporate earnings in the next 3-5 years are currently at a low level historically. Long-term earnings expectations are often a key factor for determining equity valuations, and here we see a potential for upside surprises if the economy continues to stabilise.



Source: Macrobond, based on MSCI AC World Long-Term EPS Growth Rate.

> *While the accommodative monetary policies of central banks are supporting equity markets, expectations can run too high and result in a backlash.*

However, should the negative effects of the virus prove greater or more long-lasting than expected, the stabilisation of the global economy could be threatened. Recent outbreaks of the virus in South Korea, Iran and Italy, etc. have increased the risk of a more extended downturn than previously expected before we see a recovery in economic activity and corporate earnings. Indeed the uncertainty alone on the consequences of the virus could potentially increase volatility going forward.

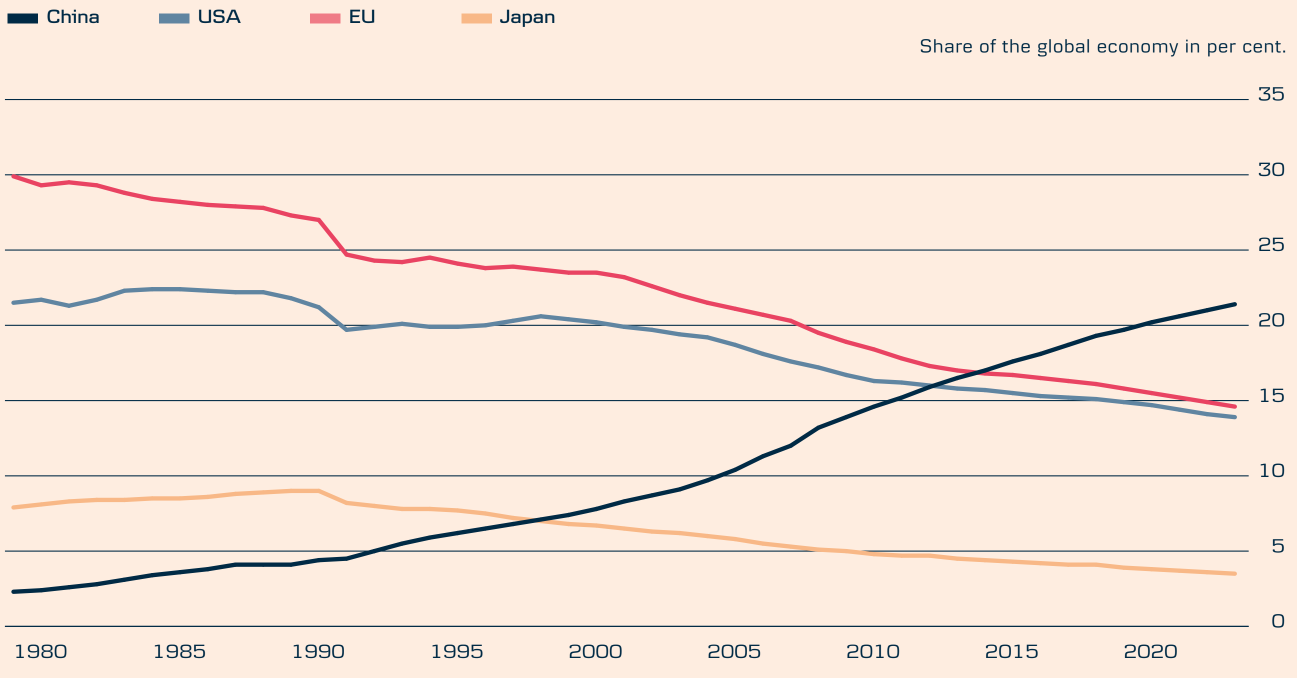
SHATTERED EXPECTATIONS ON CENTRAL BANK ACTION: While the accommodative monetary policies of central banks are supporting equity markets, expectations can run too high and result in a backlash. Investors have of late been increasingly expecting further monetary policy easing, and the rhetoric and actions of the central banks in the US and Europe failing to match these expectations could have a negative impact on the financial markets.

OTHER FACTORS: With regard to equity markets, analyst expectations for corporate earnings in 2020 certainly look optimistic. In addition, economic data could surprise on the downside, as we recently experienced with the figures for European industrial production.

Hence, investors should not be ▸▸

China's increasing significance for the global economy

The coronavirus outbreak in China is a greater threat to the global economy than the SARS virus in 2002-2003, for the simple reason that the Chinese economy currently accounts for twice as large a share of the global economy as back then.



Source: Macrobond, based on data for global GDP (PPP).

March will be the decisive month in the race to become the Democrats' presidential candidate, who will go on to face Donald Trump at the election in November.

FOTO: Jonathan Ernst/Reuters/Ritzau Scanpix

surprised if they encounter periods of uncertainty and market volatility in the coming months.

The right balance in the portfolio
Nevertheless, despite the series of potential uncertainty factors, we estimate that cautious optimism is the correct, balanced approach to equity markets at the moment. Our main scenario of economic stabilisation and accommodative central banks continuing is, all else being equal, favourable for equities and other risk assets. However, by having just a modest 5% overweight in equities we are also acknowledging the current risk factors.

An important aspect of the overall picture is naturally also that bonds still offer very low interest rates, and while we do not expect any significant yield increases in the immediate future, continued economic stabilisation over the coming 12 months could boost yields and thus push bond prices lower. This would then further dilute the return potential from bonds.

Overall, we therefore still consider equities the most attractive asset class and going forward expect to see the necessary demand for equities. However, given the short-term uncertainties and the political risks in the slightly longer term – combined with the modest rate of economic growth – our return expectations are no more than moderate. More specifically, we envisage a return potential in equities of 4-8% over the coming 12 months.

Given the short-term uncertainties and the political risks in the slightly longer term – combined with the modest rate of economic growth – our return expectations are no more than moderate.

Topical figures:

1.90%

We at Danske Bank expect US 10-year Treasury yields to rise to 1.90% in 12 months, whereas they are currently hovering around 1.30%. We also expect to see rising long yields in Europe – on both German and Nordic government bonds. As rising yields are synonymous with declining bond prices, this will place further pressure on bond returns. However, in the coming months we expect yields to remain at current levels due to uncertainty on the coronavirus, among other things.

1990

The US presidential election is one of the year's most important events for the financial markets, with the Democrats currently in the process of determining who will take the fight to Donald Trump. To win the nomination, the Democratic presidential candidate has to win 1990 out of 3779 delegates. The key decision day is Super Tuesday on 3 March, when there will be caucuses and primaries in a great number of states and a total of 1344 delegates at stake. Other important dates are 17 March and 28 April, when 577 and 663 delegates, respectively, will be at stake.

Always remember your risk as an investor:
This publication is based on Danske Bank's macroeconomic and financial market expectations. Deviations from our expectations could potentially affect the return on any investments negatively and result in a loss.

Danske Bank has prepared this material for information purposes only, and it does not constitute investment advice.

Always speak to an advisor if you are considering making an investment based on this material to establish whether a particular investment suits your investment profile, including your risk appetite, investment horizon and ability to absorb a loss.

Danske Bank A/S
Holmens Kanal 2-12
1092 Copenhagen K

Phone +45 33 44 00 00
CVR no. 61 12 62 28
danskebank.com