Sparinvest

Monthly comment for May

High returns on risky assets in May – reopening priced in

Most western countries began reopening their societies in May. The financial markets reacted to the first positive momentum signals in the economic indicators, which led to high returns on risky assets.

Global equities gained 4.2% in May according to MSCI ACWI stated in local currencies. Translated into DKK, this was an increase of 2.7%. Risk premiums on corporate bonds decreased. The option-adjusted spreads of European Investment Grade bonds and High Yield bonds tightened by 17bp and 77bp, respectively, in May. This led to excess returns of 0.9% and 3.4%, respectively, relative to comparable government bonds in the previous month. The yield level of global government bonds remained low in May. The yield of 10Y Danish government bonds was -0.34% in early May and -0.28% at end-May.

Reopening creates positive momentum in economic indicators

The reopening of society in western economies is reflected in most of the economic indicators. For example, global business confidence in manufacturing rose from 39.6 in April to 42.4 in May, according to data from JPM Global PMI.

Business confidence remains extremely low but is – most importantly – heading towards a more optimistic level. Just like the transition from lockdown to reopening marks a turning point in the corona crisis, even a marginal increase in the confidence indicators constitutes an essential turnaround in expectations for the future.

It is still too soon to draw conclusions from the reopening of western economies. Experience gained from the Asian reopening has been mixed, having seen new partial lockdowns in China, Hong Kong, South Korea and Singapore. Therefore, it is only natural to expect new virus outbreaks in Europe and the U.S. as well, severe enough to spark new partial lockdowns. The precautionary principle appears to be one of the common features of the countries' approach to reopening. The emphasis on the precautionary principle may well reduce the largest risk of this scenario: a major corona virus resurgence causing, at worst, a new general lockdown.

In this particular context, the lockdown period has likely pushed the financial markets' general expectations for reopening towards taking a far more cautious position. A cautious reopening will probably be accepted if only the reopening keeps momentum. Overall, this corresponds to a development in CLI where free falling in Q1 and Q2 is followed by a certain degree of positive momentum during the summer.

Investment conclusions and asset allocation

In recent months, developments in the financial markets have again shown that *changes* to the economic momentum play a more important role than the *level* of economic activity when it comes to risk premiums and return patterns. The reopening of western economies is still in the initial phase. This means that the positive momentum in economic indicators may continue in the coming months as the reopening unfolds.

This scenario should underpin risky assets. Option-adjusted spreads of global high-yield bonds have tightened from 1,100bp during lockdown to currently 666bp in connection with the reopening. In this context, the credit market will again play a key role for the equity market. In the current environment, it is futile to estimate an "equilibrium premium"; one must simply refer to the fact that option-adjusted spreads have averaged well under 600bp since 1998. Of course, the corona crisis sets a limit for how much these risk premiums may and should fall. Reopening is not a normalisation. The tactical overweight of equities relative to government bonds/covered bonds is maintained, although much of the potential has already been realised as the lower credit spreads of corporate bonds have narrowed in recent weeks.

Naturally, the corona crisis has created great uncertainty about earnings capacity. Yet according to Citi's Earnings Revision Index, EPS downgrades peaked in mid-March in connection with the lockdown. Since then, the index has risen, probably because of the positive effects of the reopening. Generally, this development is a very positive factor for the equity market. The corona crisis resulted in historically large losses on risky assets up until mid-March. Clearly, this sparked a low risk appetite and high-risk aversion among investors. Most significantly, according to AAII Sentiment Survey and BofAML Fund Manager Survey, the risk appetite and risk aversion do not seem to have changed noticeably since then, despite the reopening and historically high returns on risky assets in recent weeks. This may indicate that the current positioning and expectations remain characterised by scepticism and caution.

The reopening process could very well trigger new virus outbreaks that could force authorities to renewed lockdown. This is considered the greatest risk in the time ahead. In the geopolitical arena, U.S./China tensions have re-escalated. This has increased the risk of restrictive measures from both parties – typically curbing the positive economic momentum and leading to higher risk premiums on financial assets.

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