



QUARTERLY VIEW Q3 2022  
MACRO & TAA  
DANSKE BANK ASSET MANAGEMENT

## *Stable bond yields and higher equity markets ahead*

Central banks will push short rates up, but the bulk of the increase in long bond yields is behind us. We expect moderate economic growth, which should send equities higher despite the uncertainty fanned by inflation and war.



Central bank heads Christine Lagarde (ECB) and Jerome Powell (Fed) have signalled that inflation must be tamed – almost at any price. Central bank monetary policy tightening could, at worst, tip the economy into recession, but that is not our main scenario at Danske Bank Asset Management.



THE PAST QUARTER

# Central banks declare war on inflation

Financial markets had achieved a degree of stability as Q2 22 kicked off. Global equities had shrugged off the shock of the war in Ukraine, global growth looked solid and yields had already risen considerably on expectations of a normalisation of monetary policy in both the US and Europe. However, this stability proved short-lived.

Growth in the US and Europe initially seemed decent, led by strong labour markets, but inflation was higher than expected. This, together with still rising commodity prices, fuelled renewed fears of a stagflation scenario – in other words, a period of high inflation and low growth. Meanwhile, focus shifted to the European Central Bank (ECB), which had surprisingly signalled in Q1

that rate hikes could be on the cards as early as 2022.

This proved an understated comment. Inflation gathered pace and the rhetoric of leading ECB members turned increasingly hawkish. The market responded by pricing in additional interest rate hikes as early as H2 22 and sending European bond yields significantly higher.

ECB president Christine Lagarde even wrote a blog on the ECB’s website at the end of May, basically announcing that the benchmark monetary policy rate would be raised by at least 0.5 percentage points in Q3 – a highly unusual step for the ECB. But the culmination came in June.

At the ECB’s scheduled meeting in June, the central bank released a



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forecast that showed inflation above target all the way out to 2024. The forecast was accompanied by rhetoric indicating rate hikes of 0.5 percentage points could be on the cards as the ECB endeavoured to normalise monetary policy. Finally, the ECB provided no details on how it proposed to



protect potentially vulnerable countries, like Italy, if the normalisation process put pressure on bond markets in these countries. In short, a historic ECB meeting that was followed by another shortly afterwards.

Markets reacted strongly to these signals from the ECB, sending Italian bond yields, in particular, higher. The ECB felt forced to convene an emergency meeting and released a statement saying it would use existing tools to ensure stability, while also declaring it would accelerate the development of new tools to ensure stability going forward. This induced a degree of calm again. Nevertheless, a dramatic shift in ECB monetary policy was clearly underway - and the ECB has only just begun. The shift is happening despite clear signs that European economic growth has slowed substantially and that the risk of a recession has increased.

**Federal Reserve still stole the headlines in the end**

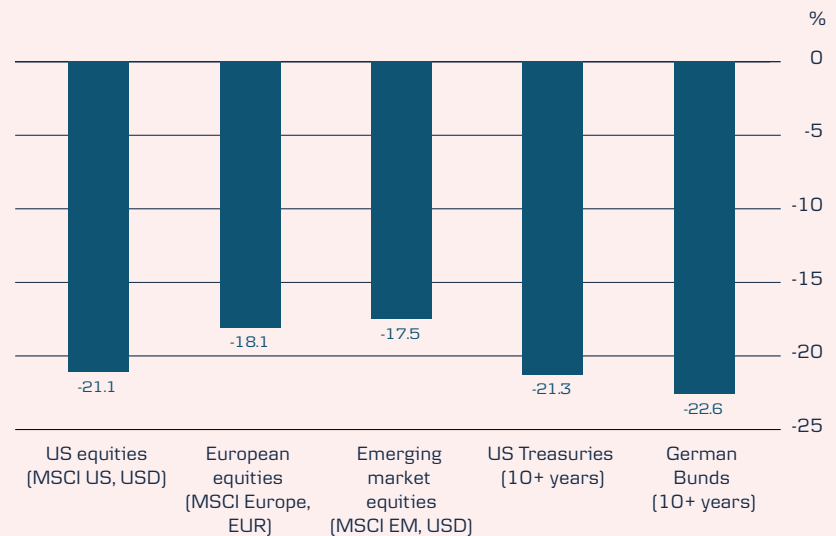
In contrast to German bond yields, a certain calm descended on the US after the first policy rate hike in March. Even a further 0.5 percentage point rate increase in May had no particular impact on long bond yields, as the hike was already largely priced in - the real surprise came in June.

The first inflation report with data for May arrived on Friday 10 June. Inflation was considerably higher than expected and subcomponents showed high levels of inflation in those categories where inflation tends to persist and is difficult to reduce. A benchmark consumer confidence report arrived later the same afternoon, showing the highest long-term inflation expectations for around 15 years. Both sets of data sent shock waves through the financial markets.

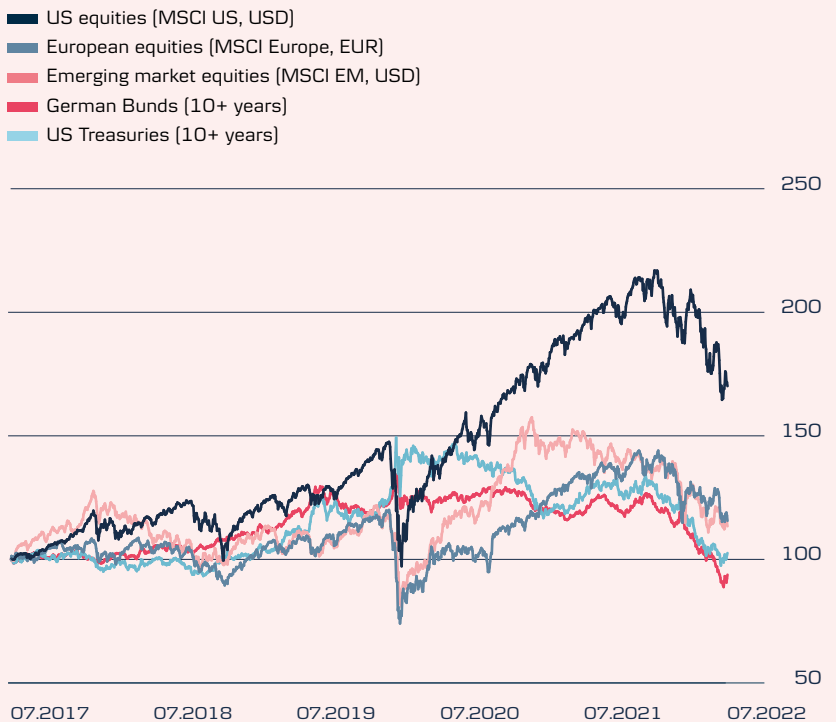
On Monday 13 June, the day before the Federal Reserve's June meeting was scheduled to start, a leading newspaper published an article suggesting a rate hike of 0.75 percentage points was on the table at the upcoming meeting. This was contrary not only to the signals the central bank itself had sent, but also to the message the same ▶▶

*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.

newspaper had published just one day before. Yet another bombshell rocked financial markets.

When the meeting concluded the next day and Fed chair Jerome Powell appeared on our screens, he had two things to say. First, interest rates would be raised by a historic 0.75 percentage points and further increases on that scale were also possible. Second, and much more important, Powell stressed that the Federal Reserve would now do everything in its power to lower inflation – cost what it may. In other words, even if the pronounced tightening of monetary policy causes a recession, that is the price that has to be paid to get inflation under control. Not only did inflation fears rise, so too did fears of a recession.

Hence, the Fed meeting marked the culmination of an exceptional quarter where the world’s leading central banks firmly nailed their colours to the mast: inflation has been too high for too long. There is now a significant risk

of inflation expectations rising further, and central banks cannot and will not accept this. Monetary policy therefore has to be tightened both quickly and significantly. Should a recession consequently unfold, that is the price that has to be paid.

**China crawls out of recession**

Omicron and the accompanying restrictions had already tipped China into recession in March. Data for April showed the recession continued and deepened. Car sales, for example, fell 45% between February and April, while housing sales collapsed by close to 40% over the same period. The biggest falls occurred from March to April, when up to 25% of the Chinese economy was under lockdown.

However, lockdown restrictions started to be relaxed towards the end of April as the wave of Omicron infections was brought under control again, and the economy was already beginning to normalise in May. Hence, car sales



*Rising rates and yields, uncertainty and recession fears proved a poisonous cocktail for risk assets, particularly equities.*

surged in May to March levels, though the normalisation of the housing market is taking somewhat longer. Initial data for June indicated the economy was continuing to shift up in gear and that growth was solid.

**Financial market developments – a historically difficult quarter**

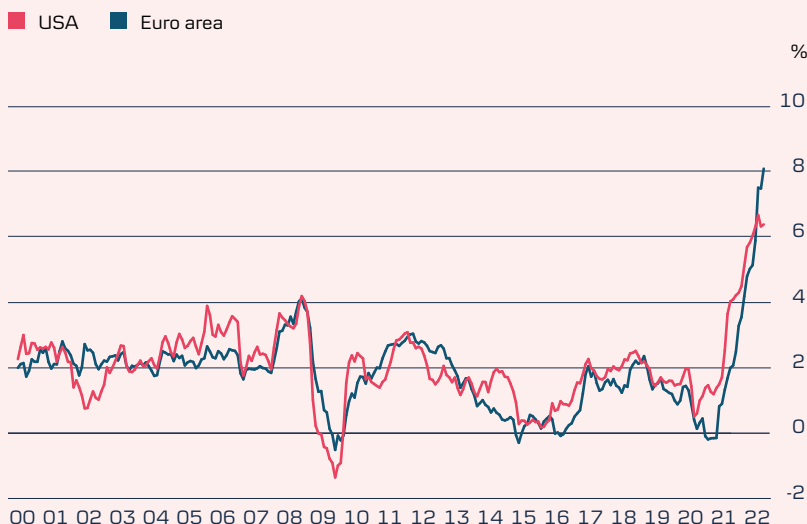
High inflation was the all-dominating theme for the financial markets in both Q2 and the first half of 2022 overall. Pedal to the metal on monetary policy normalisation triggered a surge in interest rates, while uncertainty on the future trajectory of inflation and tough talk from the central banks stoked rampant financial market volatility that caused risk premiums to increase significantly. The result was soaring yields across both the US and German government curves and – for the half-year as a whole – the largest losses on bonds in more than 30 years.

Rising rates and yields, uncertainty and recession fears as a result of significant monetary policy tightening proved a poisonous cocktail for risk assets, particularly equities. US equities were on the ropes in June, tumbling to new lows almost 24% from their earlier peak before markets rose slightly towards the end of the quarter.

The past half-year has proved one of the most troublesome in the last 40 years. Both global equities and bonds have fallen, and day-to-day and week-to-week volatility has been on a par with or higher than during some of the previous crises we have experienced. ▶▶

*Inflation hits new highs*

Rising energy and food prices as a result of the war in Ukraine have further boosted consumer price inflation.



Source: Macrobond.





*The war in Ukraine is creating great uncertainty on Russian gas supplies to Europe. Spearheaded by Germany, several European countries have therefore announced they will ramp up energy production from coal-fired power plants, which were otherwise set to be phased out. Here, coal at a coal-fired power plant in Mehrum, Germany.*

## THE TIME AHEAD - MACROECONOMY

# We are not pencilling in a recession, but uncertainty is high

As Q2 started, we were expecting growth to pick up in China and the euro area but to slow in the US. Here, on the cusp of Q3, China appears to have bounced back after Omicron, while growth in the euro area seems to have slowed further. However, the key question is whether the US faces a recession, as growth has clearly slowed and the Federal Reserve is tightening monetary policy at pace.

### Are we on the threshold of a US recession?

US economic data have been something of a paradox in H1 22. On the one hand, the national accounts showed negative growth in Q1, while estimates for Q2 indicate growth was not particu-

larly high, though nonetheless positive. On the other hand, the labour market has proved extremely robust and job creation very high.

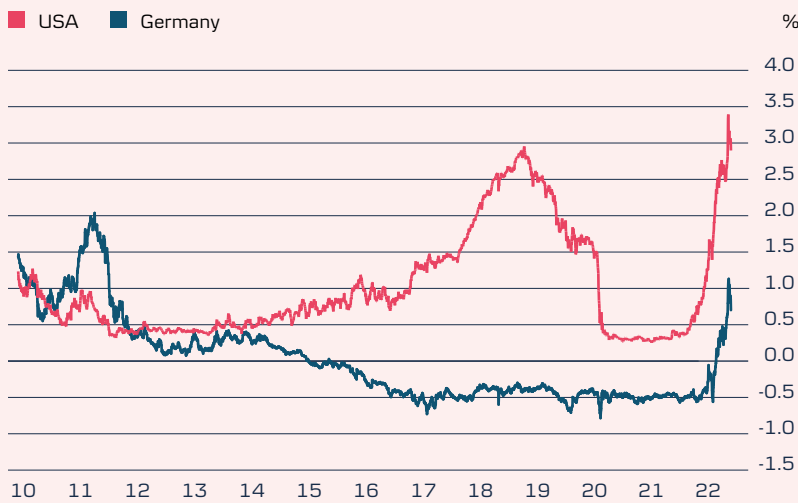
We have been swayed by the labour market and estimate the US has, initially at least, emerged strongly from the negative shocks emanating from the war in Ukraine. Essentially, this was due to the tailwinds provided by the latter stages of the reopening post-pandemic. Unfortunately, these tailwinds are now history and, as we did last quarter, we would stress that growth going forward will be much lower; not only is the reopening a closed chapter, fiscal policy is no longer making a positive contribution to growth, and we now face the knock-on effects of a tightening monetary policy.

However, at this moment, we do not expect a recession. Rather, we expect growth of 1-1.5% over the coming 2-4 quarters – in other words, growth below the economy's long-term potential. If our expectations are proved correct, some of the pressure will be taken off the labour market and thus also the Federal Reserve.

There are essentially three crucial aspects to this forecast. First, we estimate that current inflation is far above the underlying trend, which we assess to be a little above 2%. If we are correct in our assessment, the Federal Reserve will not have to send the economy into recession to get inflation under control. On the contrary, inflation should begin to decline in ▶▶

### Dramatic increase in yields this year

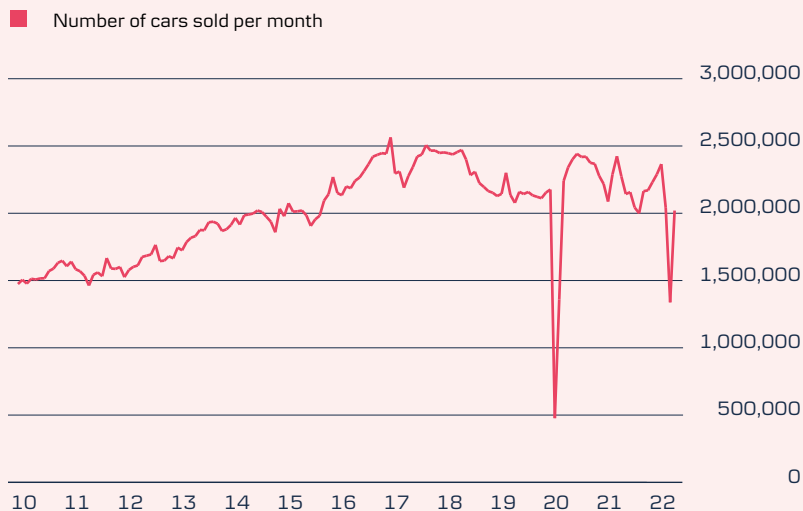
2Y government bond yields in the US and Germany, which have risen much faster than expected at the start of the year.



Source: Macrobond.

### Car sales plummet and then bounce back in China

Lockdowns due to Omicron caused a severe recession in the Chinese economy in the spring, as exemplified by car sales, which plummeted but then bounced back again.



Source: Macrobond.

the coming 6-9 months. This, together with clear signals from the Federal Reserve, should put a lid on inflation expectations.

The second crucial factor is our expectation of a further pick-up in labour market participation rates. Many people have not returned to the labour market after the pandemic, probably for several reasons, including fear of infection, high unemployment benefits and a loose fiscal policy. The latter two in particular no longer apply, which is why we are expecting a certain, though not full, normalisation of labour supply. If our assumption is correct, it should ease some of the pressure on the labour market - and therefore on wages.

If the above pans out as we expect, the Federal Reserve should at the very least be in a position to push the pause button on rate hikes when the fed funds rate reaches 3-3.5% sometime in H1 next year. Such a tightening of monetary policy will of course result in lower growth, but is not in itself enough to tip the economy into recession. Ultimately, that is because of our third and final point - the US economy is not fundamentally imbalanced via unduly high levels of investment, overconsumption or debt.

We would emphasise, however, that the level of uncertainty is high. As we write, the data points to growth having fallen - perhaps even substantially. That means the economy is more vulnerable to unforeseen shocks, such as a further escalation of the war in Ukraine in the shape of a direct confrontation with NATO. We estimate growth has already fallen from above 4% earlier this year to below 2% now. This lower level of growth means a higher probability that a negative shock could be sufficient to push the economy into recession. Finally, if we are wrong on inflation, we are also wrong on the Federal Reserve. Should inflation not decline, the Fed will tighten more than we expect and force a recession. No-one should be in any doubt about this after the past six months.





**Eurozone growth more dependent on the course of the war**

Growth has slowed in the eurozone as well. Manufacturing has long been weak - squeezed by high materials prices and supply chain challenges. Up to now, however, the service sector has had a tailwind from the reopening, which is why the broader economy has been growing strongly, as symbolised by still high employment growth. But that is history now.



*China has proved that a modest reopening is possible with frequent testing and rapid lockdowns as the key intervention measures. At the same time, the government is still enacting initiatives that can support the economy.*

Reopening is close to complete in the eurozone. While there is still a little catching up to do in the most travel- and tourism-dependent countries, that will not save countries like France and Germany. Then of course there is the negative impact from monetary policy being tightened. However, in contrast to the US, fiscal policy is still expansive in the eurozone - especially in the more vulnerable countries. Moreover, the region is not experiencing excessive investment or consumption. We therefore still expect decent growth here. Nevertheless, we also continue to foresee high inflation as the ECB carries on normalising monetary policy, and we expect the benchmark interest rate to hit 1.5-2% in H2 23.

While we again do not expect an actual recession here, we would

emphasise that the eurozone is more vulnerable to unforeseen shocks. The war in Ukraine and the broader conflict with Russia is clearly the key risk here. Should Russia shut down gas supplies, or the region decide to end energy imports from Russia faster than we are counting on, growth will slide into negative territory. This is more likely to happen as winter draws closer and could potentially mean the ECB having to stop hiking interest rates earlier than we expect.

**China has Omicron under control as normalisation continues**

We would maintain that China still faces a tough battle with Omicron, as the Middle Kingdom is not yet ready to abandon its zero-covid policy. This is still because too large a share of the elderly and vulnerable are not fully

vaccinated, as well as the fact that the Chinese vaccine is not as effective as those developed in the West. We therefore continue to expect sporadic and targeted restrictions that from time to time will create headlines and have a negative impact on the economy.

Nevertheless, China has proved that a modest reopening is possible with frequent testing and rapid lockdowns as the key intervention measures. At the same time, the government is still enacting initiatives that can support the economy. While we do not expect major easing on a par with previous stimulation, this is still a moderately positive factor. We therefore expect growth over the summer to be a little above the economy's long-term potential as the normalisation process unfolds followed by lower but still decent growth as we head towards the end of the year. ▶▶



**USA: Expectations for growth, inflation and interest rates**

	2021	2022	2023	2024
<b>Expected growth</b>	5.53%	0.58%	1.42%	1.84%
<b>Long-term growth potential</b>	1.86%	1.87%	1.88%	1.88%
<b>Core inflation (PCE)</b>	4.85%	4.21%	2.56%	2.27%
<b>Fed rate hikes</b>	0.00	12.32	0.40	-1.38

*Note: Growth and inflation forecasts are changes from Q4 in the previous year to Q4 in the indicated year (Q4/Q4). Inflation forecast is from December in the previous year to December in the indicated year. Number of rate hikes is the number of 25bps changes to the Federal Funds rate for the relevant year.*  
 Source: Danske Bank Asset Management



**Euro area: Expectations for growth, inflation and interest rates**

	2021	2022	2023	2024
<b>Expected growth</b>	4.66%	1.25%	1.46%	1.39%
<b>Long-term growth potential</b>	1.39%	1.39%	1.39%	1.39%
<b>Core inflation (PCE)</b>	2.23%	3.53%	2.35%	2.15%
<b>Fed rate hikes</b>	0.00	5.27	4.43	-0.04

*Note: Growth and inflation forecasts are changes from Q4 in the previous year to Q4 in the indicated year (Q4/Q4). Inflation forecast is from December in the previous year to December in the indicated year. Number of rate hikes is the number of 25bps changes to the ECB's deposit facility rate.*  
 Source: Danske Bank Asset Management



*While soaring inflation has eroded consumer purchasing power globally, US consumers have so far been bolstered by impressive employment growth and relatively high wage increases. Overall, this has prevented a decline in real consumption despite high inflation.*

## THE TIME AHEAD - THE FINANCIAL MARKETS

# Bond yields stabilising and equities set to rise

Our biggest forecasting error this year has been our inflation outlook. While we viewed German and US government bonds as expensive at the start of the year and regularly revised our yield expectations higher, yields have risen by more than we anticipated just 3-6 months ago. These increases in yields and the high level of volatility accompanying them have, together with the Chinese recession and now a significant tightening of monetary policy, sent risk premiums on equities higher and thus equity prices lower.

We would stress that the greatest risks to our expectations remain inflation and the war. If we are again wrong-footed on inflation, central banks will tighten further and probably cause

a recession. This will presumably send yields even higher and equities further south, especially in the very short term. The war in Ukraine also remains an uncertainty factor.

That being said, our key message is that we argue the worst is now behind us.



### EQUITIES:

At the end of last year, we assessed the risk premium on US equities to be too low, meaning the US equity market was overvalued to the tune of about 15%. However, as this year kicked off, we expected that solid growth and declining

inflation would keep the risk premium at this low level. We were wrong.

We now estimate the risk premium on US equities to be a little above the long-term fair level, which means we view US equities as being priced slightly cheap – by around 5%. If our expectations pan out, i.e. the US economy avoids a recession and the bulk of the growth slowdown is now behind us, a degree of calm should descend on markets. If we are also right about the Federal Reserve pushing the pause button in H1 23, the risk premium should even fall a little. We therefore expect that US equities could rise by around 10% in the coming 12 months. This unfolding as we anticipate would also boost global equities to a similar extent. ►►



We would again emphasise, however, that uncertainty is high, and that the markets are particularly sensitive to unforeseen shocks, such as a jump in oil prices. Unfortunately, there is no help to be had from the central banks, who are fully focused on lowering inflation and so will not be addressing weak growth as they have done previously.



**BONDS: :**

The Federal Reserve and the ECB are set to send short benchmark rates considerably higher in the coming 3-12 months. Only an abrupt fall in inflation or a relatively pronounced recession can halt this in the near term. This will put a floor under yields and prevent them from declining much.

On the other hand, we now assess risk premiums across the US Treasury curve to be attractive. Relatively low growth and declining inflation should curb the upward pressure on yields. Our view, therefore, is that US Treasury yields are close to a temporary peak, and we estimate the US 10Y Treasury yield will hover around current levels of about 3% in 12 months, with the risk being tilted slightly to the downside.

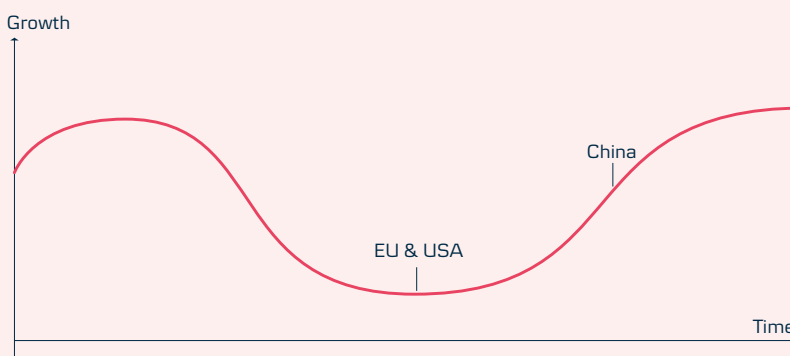
Turning to Europe, for the first time in more than six months we assess me-



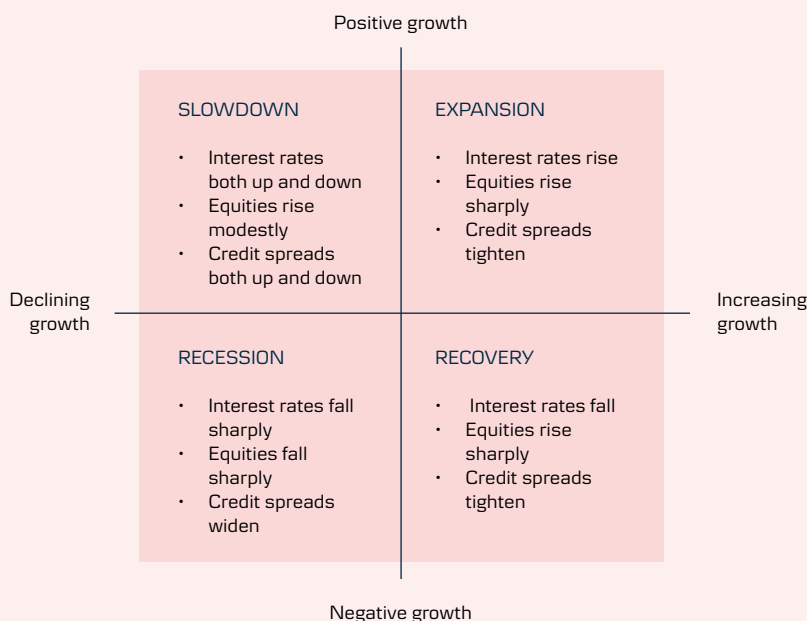
*Turning to Europe, for the first time in more than six months we assess medium to long end yields in Germany as reasonably priced. In contrast to the US, however, levels are not overly attractive.*

## Macro barometer: Outlook is for low but stable to slightly higher growth

**CURRENT STATUS:** Growth in the US has slowed due to the end of the reopening, monetary policy tightening, the loss of fiscal policy stimulation and high inflation. We look for low growth below trend in the coming 12 months, though growth should be stable and pick up slightly. Growth in the eurozone has also declined, but if energy supplies from Russia are not cut off, the region should avoid a recession and experience low but modestly increasing growth. China's reopening is not finished yet, so grow here could pick up a little further.



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



*Government employees in protective suits prepare to set up an isolation zone after new Covid-19 cases were found in Shanghai. China faces a tough struggle with Omicron, as the authorities are not yet ready to drop their zero-Covid policy. Nevertheless, the Chinese have managed to get this spring's wave of infections under control and the economy moving again.*



dium to long end yields in Germany as reasonably priced. In contrast to the US, however, levels are not overly attractive. This is due, in particular, to our relatively aggressive expectations for the ECB, which will push short yields higher. However, we expect most of the yield increases are behind us further out on the curve, and we look for only modest additional increases in the German 10Y Bund yield. Hence, we expect considerably more stable fixed income markets in the coming 6-12 months compared to the dramatic half-year we are now leaving behind.

Q2 were due, in particular, to Chinese equities performing very well at the same time as the situation in the US and Europe was most challenging. We continue to assess the risk premium, especially on Chinese equities, as higher than normal, and view the Chinese equity market as the cheapest of the major broader indexes - undervalued by 10% to 15%. Should our expectations for solid growth in China over the summer and calmer global financial markets materialise, equities in emerging markets, spearheaded by China, should deliver decent positive returns in H2 22 - perhaps even above the returns we expect in the US and Europe.



#### EMERGING MARKETS:

While emerging market equities also declined in Q2, they outperformed the US and Europe. This was in glaring contrast to March, when China tipped into recession and Chinese equities in particular fell sharply - and to 2021 as a whole, when equities in the emerging markets and specifically in China substantially underperformed the rest of the world.

Relatively sound developments in



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