QUARTERLY VIEW Q1 2022
MACRO & TAA
DANSKE BANK ASSET MANAGEMENT

Equities to continue rising in 2022

Despite significant uncertainty in the short term due to the Omicron variant, we expect global economic growth above the long-term potential and a positive return from equities in 2022, while yields appear set to increase.

Covid-19 numbers are soaring in the US at the moment, driven by the Omicron variant. Here, motorists receive home test kits in Broward County, Florida.

THE PAST QUARTER

US economy surges as Omicron overtakes Delta

After slowing substantially in the summer, the US economy again rolled up its sleeves in the autumn, with economic growth accelerating from 2-3% in Q3 to more than 6% in Q4 2021. Compare this with the economy's long-term growth potential of a little under 2%. Growth was broadly based across sectors and most apparent in the labour market, where unemployment fell sharply.

Inflation also took off in Q4 as first commodity prices and later supply chain bottlenecks caused consumer price growth to accelerate again and lift traditional annual inflation rates to levels not seen in 30 years.

Strong growth and high inflation wrong-footed the US central bank. The Federal Reserve had barely announced (in November) that bond purchases (QE) would be tapered and later cease in summer 2022 before it just six weeks later, at the December meeting, announced purchases would end in March 2022. At the same time, the central bank signalled the most likely scenario was three rate hikes in 2022 compared to a single hike in its September forecast.

The new Covid-19 variant, Omicron, did not manage to spoil the upbeat mood of the quarter as a whole, but US infection rates soaring again by the end of December cast a shadow over the opening months of 2022.

First Delta, then Omicron – Europe hit hardest

Europe was already suffering a wave of Delta infections before Omicron even emerged in South Africa. German infection rates, for example, hit levels in November that were twice as high as last winter's peak, which triggered renewed restrictions. Meanwhile, Omicron gained a firm foothold in Europe in the final weeks of the year and lifted infection rates here to completely new ▸▸

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highs. However, the incidence of severe cases was considerably lower, which meant the number of hospitalisations at the end of the quarter was still below the peaks of previous outbreaks.

The virus overshadowed what was otherwise a decent quarter in Europe from an economic perspective. Growth was positive, if considerably lower than the very high levels seen in the summer, while inflation also delivered an upside surprise, just like in the US. All in all, this cocktail was strong enough to convince the European Central Bank (ECB) the time was ripe to end pandemic-related bond purchases. Hence, the ECB will scale back purchases in 2022, though unlike the Fed the ECB has signalled it will maintain a modest level of net asset purchases until shortly before raising policy rates for the first time – something the ECB does not expect to happen for the next couple of years.

The Chinese authorities pursued an extraordinarily tight economic policy throughout 2021 that caused a notable slowdown in growth. On top of this came its zero-tolerance policy to Covid-19 infections, which prompted local restrictions and lockdowns.

China changes course

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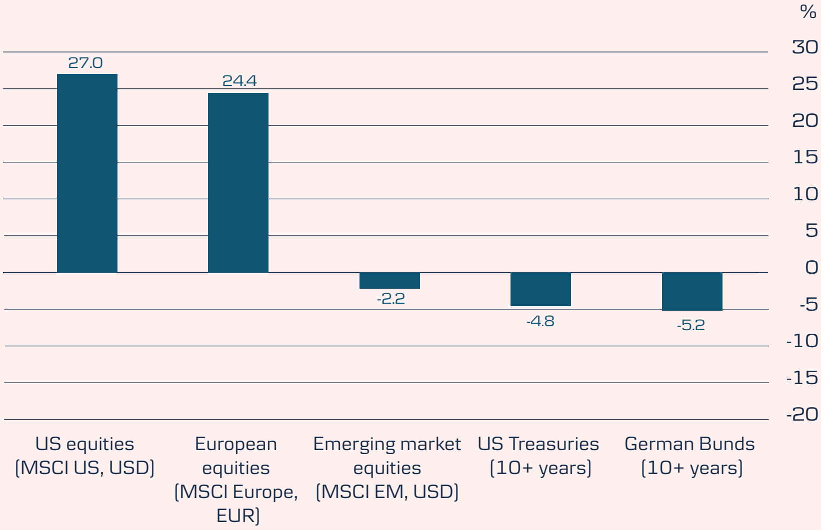
Total return in 2021

Historical return is not a reliable indicator of future return, which can also be negative.



5 years' accumulated return

Source: MSCI, Bloomberg and Danske Bank Asset Management.

notable slowdown in growth. On top of this came its zero-tolerance policy to Covid-19 infections, which prompted local restrictions and lockdowns. However, in the final quarter of the year, the authorities lifted their foot off the brake, as overall growth had fallen sharply and the property sector was on its knees.

The total credit flow for the fourth quarter as a whole hit its highest level since 2020, with even the hard-hit housing market showing signs of stabilising. Home sales rose from October to November – the first month-on-month increase after continually falling since February. China's exports also took off, and we estimate that Chinese growth has picked up to around trend (4-5%). Unfortunately, Covid-19 also cast a shadow over China, with an entire city of more than 10 million inhabitants forced into lockdown in the closing days of the year.

Financial market developments

Led by the US and China, global economic growth picked up after a sluggish summer and lifted global equities to new highs by mid-November. However, as news of the Omicron variant broke in late November, global equity markets initially tumbled – before rising again, with the US showing the way. Global equities thus rose by around 7% for the quarter as a whole.

Yields, too, initially rose on the back of accelerating growth, high inflation and the Fed hurrying to exit from an exceptionally accommodative monetary policy. However, Omicron, among other things, caused yields to decline again, and long yields in the US and Germany ended the quarter largely unchanged overall. In contrast, short rates and yields increased, particularly in the US, as the market discounted earlier and more rate hikes from the Federal Reserve.

Although we expect inflation in the US to ease from its current historical highs, it will likely remain above 2% throughout 2022. Given declining unemployment, we therefore expect the Fed to hike interest rates three times in 2022 and a further 3-4 times in 2023.

US unemployment soon back at pre-pandemic levels

Source: Macrobond.

Construction activity in Qingzhou, China. After a tough year for the Chinese property sector, a recovery is getting underway.

THE TIME AHEAD – MACROECONOMY

Omicron mars otherwise solid year for the global economy

For 2022 as a whole, we expect growth levels above the long-term potential for the US as well as for Europe and China. The driving forces remain normalisation after the recession in 2020, accommodative monetary policy (and fiscal policy in Euroland) and a less tight policy in China. However, this positive outlook will be marred by Omicron in the short term.

Omicron set to hit growth in Europe and the US – short-term pain, long-term solution?

Omicron is clearly very infectious. We currently estimate the variant is considerably more transmissible than Delta, which was already more than twice as infectious as the original variant. The world is in a wave of infections of hitherto unseen proportions. Yet, to our surprise, very few economists and central banks have so far been willing to incorporate the impact of Omicron into their forecasts for 2022. The Federal Reserve even raised its forecast for US growth in 2022 from 3.8% in September to 4% in December – although well aware that Omicron had already landed in the US. By comparison, we expect less than 3% growth in 2022, due in particular to a weak Q1. The Fed – and others – are using the excuse that uncertainty remains too high to say anything sensible about the economic impact of Omicron.

We completely agree that the uncertainty surrounding Omicron is still high – and would stress that our own forecasts and thus tactical risk taking are very sensitive to our assumptions. Nevertheless, we have had to reduce our growth expectations for 2022 due to Omicron. Naturally, this is because of the high transmissibility of the virus, which means the need for restrictions in the opening months of the year is considerably higher than with Delta. We have also assumed a certain risk of the virus mutating again, thus reducing the efficacy of vaccines and increasing the need for restrictions later on (for example, winter 2022/23).

Our scenario takes into account that Omicron is seemingly much milder than previous variants and we also reckon on an accelerating uptake of booster shots. We thus assume that Omicron will necessitate around one third of the hospitalisations of Delta. We also ▸▸

presume the authorities will react to an even greater extent to pressures on the health service in terms of introducing new restrictions, rather than just reacting to infection levels.

Nevertheless, Omicron's high transmissibility means the number of infected will offset the lower hospitalisation rate. We therefore expect to see a general need for restrictions in the opening months of the year, which means the global economy right now faces (and is in the midst of) a growth slowdown – a slowdown that could be somewhat more severe than many others expect if our assumptions largely pan out. The joker in the pack is of course consumer behaviour – soaring infection rates could cause consumers to step back, which could both hit growth and potentially also the supply of labour.

We therefore expect modest growth in Euroland and the US in Q1 which constitutes a significant slowdown from strong growth at the end of 2021. Should we be proved correct, many forecasters will have to revise down their growth forecast in the coming months. However, we would again emphasise that we are very sensitive to the news flow at the moment, so we may very well adjust our expectations either up or down in the first few weeks of the year.

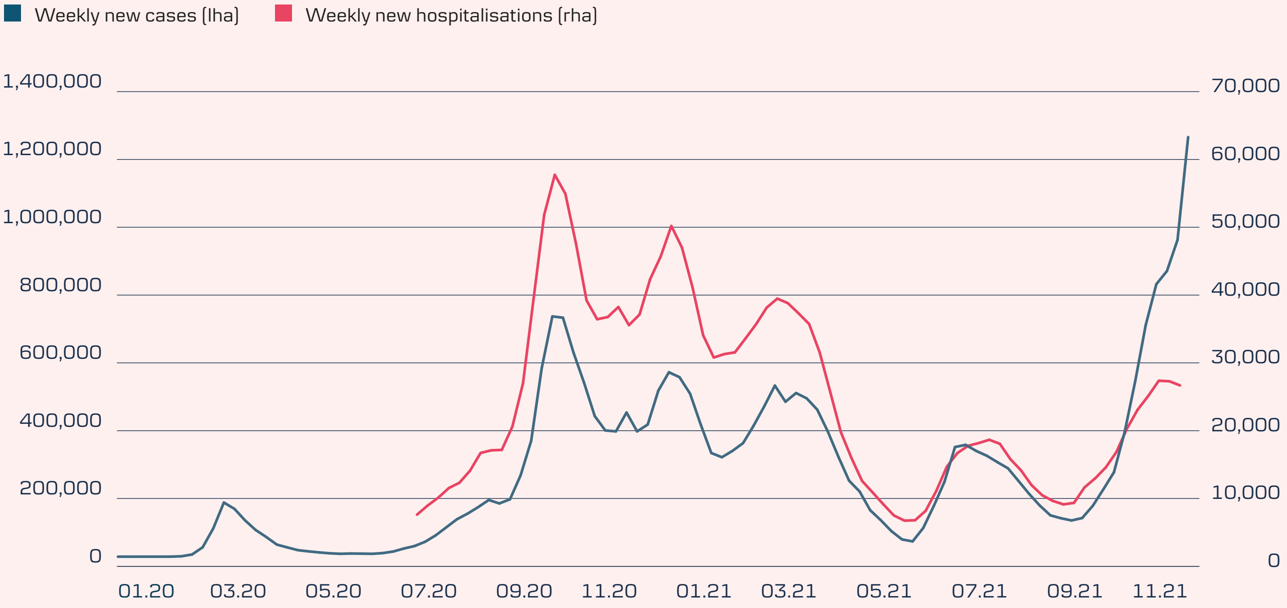
That being said, there is also a light at the end of the tunnel – and potentially a very strong one. Just as in the past two years, the end of winter will likely reduce infection rates again. That should trigger a powerful acceleration in growth as we head for the summer – similar to 2021. Moreover, should there be a need for them, we will of course see new and improved vaccines that can put a damper on Omicron later in 2022.

However, even more critical is whether Omicron marks the beginning of the end of the pandemic – i.e., will Omicron prove so mild that it more resembles a normal flu. Naturally, that would be very positive for the global economy, and we are certainly not ruling out the possibility at the moment.

The authorities in China have clearly shifted focus – economic growth is the goal in 2022. The key to this is generally less tight credit conditions and, in particular, a more accommodative policy for the struggling housing market.

Surge in number infected with Covid-19 in Europe, but not in hospitalisations

Data for Covid-19 for Germany, France, Spain and Italy.



Source: Macrobond.

Growth-wise, our key message is that both the US and Europe face several difficult weeks in early 2022. When infection rates are brought under control, booster shots rolled out and spring replaces winter, growth should pick up again. As well as the uncertainty in the very short term, we would stress our other important message – that 2022 will again be a strong year for the global economy overall.

Federal Reserve and ECB on divergent paths

The US in particular has progressed sufficiently for monetary policy to be normalised. While Omicron may provide some upsets in the very short term, the Federal Reserve appears keen to end bond purchases as quickly as possible. We expect this to happen in mid-March, which opens the door to rate hikes as early as the March meeting. Although we expect inflation to ease from its current historical highs, it will likely remain above 2% throughout 2022. Given declining unemployment, we therefore expect the Fed to hike interest rates three times in 2022 and a further 3-4 times in 2023. The central bank will also probably let its bond holdings shrink as they begin to mature later in the year.

This is in stark contrast to our forecast for the ECB. While the ECB is also set to scale back bond purchases, they will nevertheless carry on at a modest level. The ECB's total holding of bonds will therefore continue to increase in both 2022 and 2023, with rate hikes on the cards for end-2023, start-2024 at the earliest, in our view. This is because we expect inflation in Euroland, in contrast to the US, to fall to significantly below 2% in the course of 2022 and remain there until towards the end of 2023. Hence, the divergence in monetary policy between the two regions will be considerable.

China: Stable growth with the prospect of Omicron disruptions

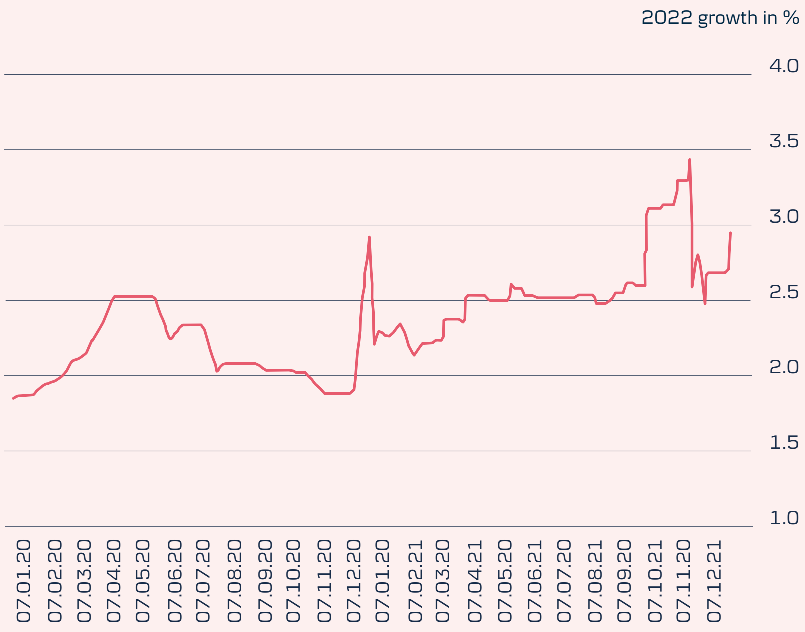
In contrast to the widespread infections in the US and Euroland, China looks set to continue its zero-tolerance policy for Covid-19 outbreaks against a backdrop of both the highly infectious Omicron variant and less effective vaccines, which means the authorities will be forced to repeatedly implement lockdowns. We therefore expect brief growth shocks stemming from Covid-19 in 2022.

Much more important for us, however, is the shift in economic policy. We have long focused on tight economic policy being the main reason for the Chinese economy not living up to expectations in 2021. Hence, it is crucial to our forecast that the authorities have now clearly shifted focus – economic growth is the goal in 2022. The key to this is generally less tight credit conditions and, in particular, a more accommodative policy for the struggling housing market. Fortunately, we are already seeing signs of this, and we expect more of the same in the coming months. Given the continuing strength of the booming export sector, Chinese growth should remain around its long-term potential, i.e., around 5%, though with brief, Covid-19-driven disruptions. ▸▸

> *We expect a return from US equities of around 5% for 2022 as a whole and a bit above 5% from European equities.*

Developments in our forecast for US growth in 2022

The emergence of the Omicron variant of Covid-19 has caused us to cut our growth expectations.



Source: Danske Bank Asset Management.

US central bank chair Jerome Powell will be a focal figure in 2022. The market is expecting to see considerable monetary policy tightening – but how fast and how far will the Fed hike?

THE TIME AHEAD – THE FINANCIAL MARKETS

Short-term uncertainty, but equities set to continue rising

EQUITIES:

Uncertainty is high in the very short term, as there are still many things we and others have yet to learn about Omicron. If our assumptions pan out, the market will have to adjust growth expectations for the near future, which may produce modest and short-lived falls in equity markets.

However, we would reiterate that the weakness in growth should be temporary and replaced by further strong growth as we head into spring & summer. While monetary policy in the US, in particular, is taking nascent steps towards normalisation, policy will remain accommodative and not in itself constitute a threat to the equity market.

We therefore expect a modest positive return on equities going forward to the summer and also a positive return for 2022 as a whole.

The biggest threat to these optimistic expectations is the still expensive valuations on US equities. We estimate US equities to be 5-10% overvalued – which could drag retuns down. Nevertheless, 2021 also illustrated that as long as the overall macroeconomic environment is favourable, particularly with regard to economic growth, then high valuations are not in themselves a problem – in a nutshell, equities can become even more expensive.

In contrast to the US, we still estimate European equities to be slightly cheap. The combination of our valuation estimates and our forecasts for ▸▸

Given their very disappointing return in 2021, emerging market equity valuations are now considerably less expensive than in the spring. Nonetheless, they are still around 5% too expensive, in our view.

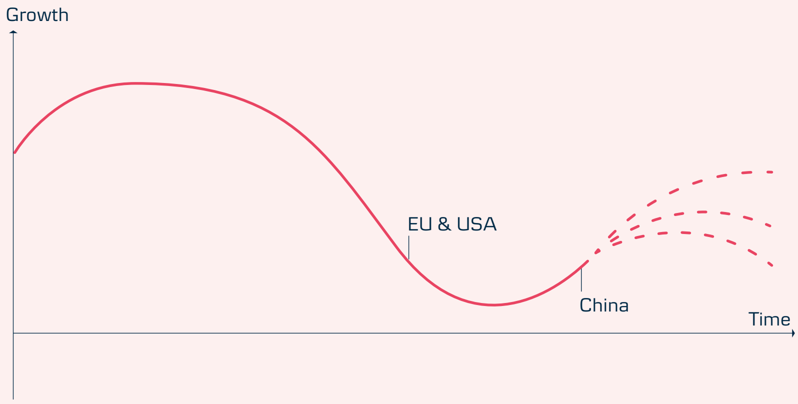
growth, inflation and monetary policy lead us to expect a return from US equities of around 5% for 2022 as a whole and a bit above 5% from European equities.

The biggest joker in the pack is emerging markets. Given their very disappointing return in 2021, emerging market equity valuations are now considerably less expensive than in the spring. Nonetheless, they are still around 5% too expensive, in our view. However, if our global and especially our Chinese forecasts prove correct, emerging market equities could deliver a positive return of around 5%.

BONDS:
Given the decline in yields, especially in November, we no longer view German fixed income instruments as attractive. Together with the significant revisions to our US monetary policy expectations, our view now is that long- and medium-term government yields in both Germany and the US are set to increase in the coming 12 months. More specifically, we expect US 10Y Treasury yields will rise to just shy of 2% from their current level of around 1.6%, while German yields will rise to around 0% from their current roughly -0.15%. In the US, especially rate hikes from the Federal Reserve will tend to push the short end of the yield curve considerably higher.

Macro barometer: Greatest potential in European equities

CURRENT STATUS: We expect the European and US economies to slow in the time ahead before growth picks up in spring/summer – and subsequently decelerates again. China is beginning to shift up a gear following disappointing growth in 2021. Valuations and the economic outlook make European equities the most attractive, in our view.



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.

Positive growth

Declining growth		Increasing 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	
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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