



QUARTERLY VIEW Q2 2022
MACRO & TAA
DANSKE BANK ASSET MANAGEMENT

Interest rates set to rise further, equities to recoup losses

The normalisation of monetary policy continues and is putting upward pressure on global interest rates. Despite the uncertainty around the war in Ukraine, global growth should be strong enough for global equities to recoup their losses and rise to new heights.



Rising energy prices have contributed to a negative shock to the US and European economies, but we nevertheless still expect to see solid growth.

THE PAST QUARTER

War and inflation overshadow Omicron

When the first quarter of the year kicked off, the main focus was on the Omicron wave of Covid-19. The new variant lifted infection rates to hitherto unseen levels and put pressure on both the European and US economies. Growth declined while inflation increased further and created an unpalatable cocktail of weak growth and high inflation.

However, infection rates subsided almost as quickly as they had risen – especially in the US, where the labour market also proved particularly strong and was almost untouched by Omicron. Focus therefore quickly shifted away from Omicron and onto the central banks.

The US Federal Reserve was the first to step forward at the end of

January and unequivocally state that inflation was too high and that the normalisation of monetary policy should be accelerated.

The ECB followed suit in early February when ECB president Christine Lagarde basically refused to repeat the words that had almost become a mantra in late 2021, namely that the ECB raising the policy rate in 2022 was “highly unlikely”. Hence, both the ECB and the Federal Reserve contributed to putting upward pressure on yields.

These surprises had barely subsided before the drums of war began to beat in Ukraine and Russia launched its invasion at the end of February. The most extensive war in Europe since World War 2 had begun, sending shock waves through financial markets. The



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most obvious impact was the dramatic rise in commodity prices, especially natural gas – though oil prices also rose significantly. Naturally, this was a negative shock to global and especially European growth.

Unfortunately, the bad news did ►►

not stop there. The war caused huge challenges for global supply chains, particularly in the already hard hit car sector. The overall outcome was thus additional inflationary pressure at a time when inflation is already very high.

Monetary policy has to be normalised

While the war and its horrors continued undiminished throughout March, initial economic data indicated that the US had come through the immediate consequences relatively unscathed. This was one reason why the Federal Reserve at its interest rate meeting in mid-March again emphasised that monetary



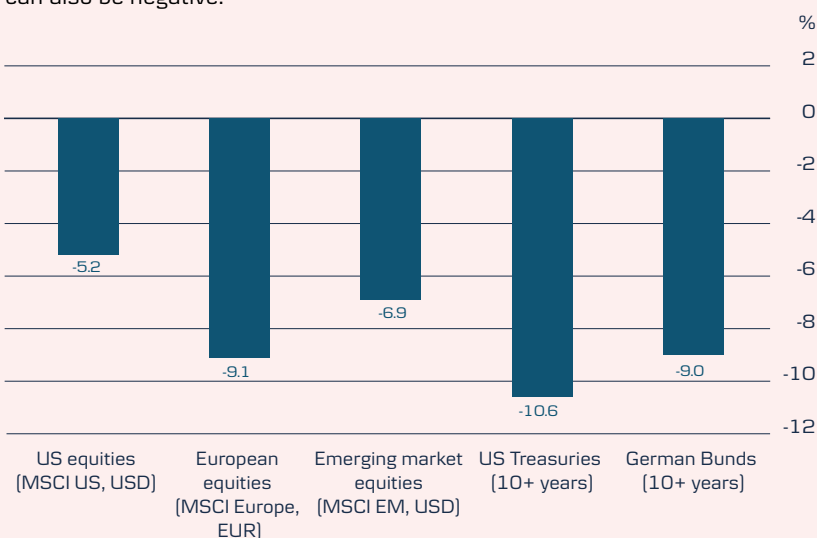
For the quarter as a whole, interest rates have risen strongly in both the US and Europe, creating the worst start to a year for bonds in a long time.

policy needed to be normalised quickly. Hence, bond purchases have now stopped and the key policy rate raised by 0.25% – and with its updated projection, the Federal Reserve is signalling at least seven rate hikes of 0.25% this year alongside a plan to soon begin runoff of its its bond holdings.

In contrast, Europe, as expected, appears to be harder hit by the effects of the war – mainly due to strongly increasing commodity prices and supply chain challenges. On top of this comes the impact on business and consumer confidence and the subsequent potential negative effects on investment and consumption. The good news is that growth appears to have been reasonable in March, albeit lower than the ▶▶

Total return Q1 2022

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.

high level in February. This is because the negative effects of the war are being countered by the ongoing reopening after Covid-19.

Despite the high level of uncertainty and the negative impact on growth from the war, the ECB signalled at its March meeting that underlying inflationary pressures had increased in the euro area, which is why the normalisation of monetary policy has to be speeded up here too. The ECB’s main scenario is that growth will remain above potential in 2022 and so continue to absorb the economy’s spare resources. This is why the ECB signalled that bond purchases under the Asset Purchase Programme are expected to cease in Q3, and that the first rate hike will come “sometime after”. Lagarde made clear at the press conference that the latter could be

as soon as a few weeks or also up to several months. Ultimately, that will depend on the data and therefore also on the war.

China hit by Omicron

While inflation, growth concerns and war affected developments in the US and Europe, the Chinese economy came strongly through the first two months of the year. Data indicated that the hard-pressed housing market improved further, while the industrial sector also generally delivered decent growth. This came on the back of a modest easing of economic policy in the final months of 2021.

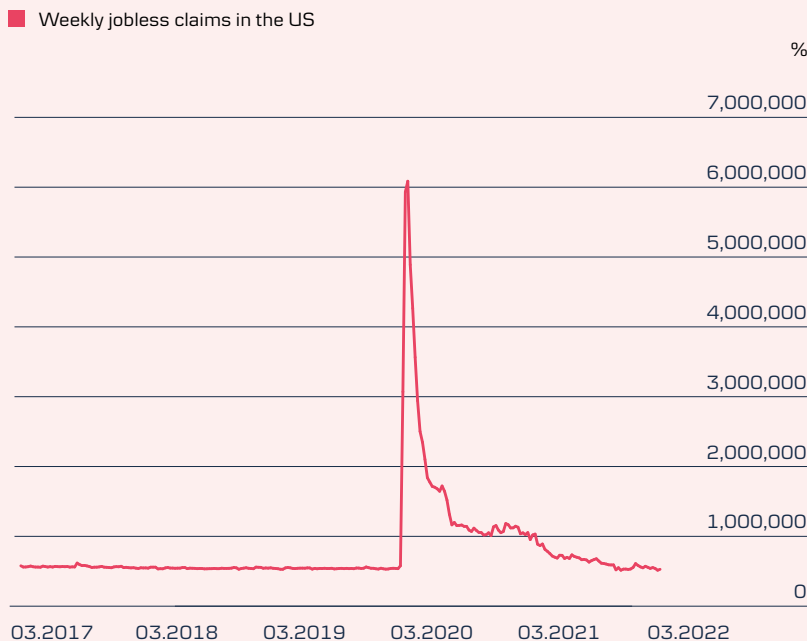
However, this positive trend was overshadowed first by dramatic price falls across the Chinese equity market and then the biggest wave of Covid-19

infections that China has experienced since the initial outbreak in early 2020. The authorities were forced to put several cities and districts into lockdown and high frequency data throughout March showed declining activity in those areas where lockdowns were most severe. Growth therefore fell sharply at the end of the quarter.

Combined with the steep falls in the equity market, this pressured the authorities into making a very clear announcement that they would ensure decent growth in 2022 and provide clarity on the regulation of the tech sector. Markets interpreted this as an unequivocal signal that the authorities would do what was necessary to ensure economic stability, although concrete initiatives were not elaborated on. Here, at the end of the quarter, China therefore still faces the considerable challenge of containing the outbreak without unduly damaging the economy.

Few jobless claims in the US

The number of weekly jobless claims exploded at the beginning of the pandemic in the US, but has since declined to a more than 50-year low.



Source: Macrobond.

Financial market developments

Weak growth and high inflation dealt a blow to equities in January, while interest rates rose. As the Omicron outbreak eased, equity markets stabilised at the end of January. However, the ECB and the Federal Reserve sent interest rates further up in February with their surprisingly hawkish announcements on monetary policy going forward and fuelled renewed pressure on equities.

The outbreak of war hit equities hard, though strong US growth and Chinese announcements helped stabilise equity markets. For the quarter as a whole, global equities fell c. 5%, though they were down c. 12.5% when things were at their worst – and have risen c. 4.5% since the day before the invasion of Ukraine was launched.

Interest rates, on the other hand, have essentially only moved one way – up. Short-lived concerns about the war caused both German and US interest rates to decline, but they rose quickly again. Hence, for the quarter as a whole, interest rates have risen strongly in both the US and Europe, creating the worst start to a year for bonds in a long time.





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THE TIME AHEAD – MACROECONOMY

Solid global growth in the shadow of war

At the start of the year we expected growth to be above the long-term potential in the world's three most important economies – the US, Europe and China – and we still do. However, we have of course reduced our growth expectations significantly as a result of the war in Ukraine, especially for Europe. We have also increased our expectations for inflation. Nevertheless, the war is unlikely to send the US or Europe into recession, and Omicron will not put China on the ropes. The key factor, however, will be how the war develops.

Where is the war leading us?

Let us be perfectly clear – should Putin press the nuclear button, or should Russia directly attack a NATO country, our forecast will not hold. In that situa-

tion, the global economy would likely be thrown into the worst crisis since World War 2. While we do our best to track developments and have included the impact of the war in our forecasts, they are subject to a high degree of uncertainty until Russia's ultimate intentions and the outcome of the war become clearer. The risk of an escalation is naturally not zero, which is why we would emphasise that a global recession would result if hostilities developed into a continental European conflict with a war between Russia and the West.

If the war is contained, European growth will continue at a solid pace

Given that we see the war remaining a conflict between Russia and Ukraine as the most likely outcome, however, we

currently expect that the US, Europe and China will continue to grow at a decent pace.

The impact of the war is most marked in Europe due to its closer connections to Russia, especially in terms of energy supplies. Because of the war, we have reduced our growth expectations for the euro area from around 3.4% for 2022 to around 2%. This reflects negative shocks to the economy from commodities and energy, including supply chain challenges, reduced trade with Russia in particular, less consumption and investment due to general uncertainty and tighter financial conditions, including higher interest rates. On the positive side, we have fiscal policy initiatives, including relief packages to mitigate price



increases, particularly on energy, and increased government consumption and investment in energy supplies and defence. However, these positive inputs to the economy unfortunately far from offset the negative shocks.

Nevertheless, we are still expecting solid growth over the year as a whole and – if we are proved correct – at above the economy’s long-term potential. This means the economy will continue to absorb the spare capacity remaining after the Covid-19 recession, which it is currently doing rather quickly. Hence, unemployment fell to 6.8% in February, the lowest in the history of the euro area, and the labour market appears to have continued to improve in March.

Not only had inflation risen more than expected before the war broke out – it is now increasing even more and appears to be better anchored around the ECB’s target in the coming years. We have thus revised our inflation expectations higher to far above the ECB’s target this year and to around

2% for 2023 and 2024. We therefore now expect the ECB will cease purchasing bonds in Q3 and raise interest rates either once or twice this year by 0.25%. Whether the ECB manages to hike twice this year will largely depend on developments in the war. However, more important is that we expect up to six rate hikes of 0.25% in 2023 as the clearest sign that monetary policy is heading towards a normalisation.

US “powers” ahead – the Federal Reserve wants to cool off the economy

In the words of the chair of the US central bank, Jerome Powell, the US has “powered through” the Omicron wave. While growth was probably very low due to Omicron for a brief period, infection rates have subsided and the reopening is in full swing again. This is most obvious in the labour market, where job creation has been incredibly strong and unemployment has continued to fall, with weekly jobless claims



Given current interest rate levels and the size of the balance sheet, the Federal Reserve is stimulating final demand at a point when it does not need stimulation – to put it mildly. The goal of the Federal Reserve is therefore to get monetary policy back to neutral as quickly as possible.

hitting a 50-year low in March. Again in Powell’s own words: “The economy is strong and the labour market very tight”. This is also reflected in wage growth, which has reached nominal levels not seen for more than 20 years.

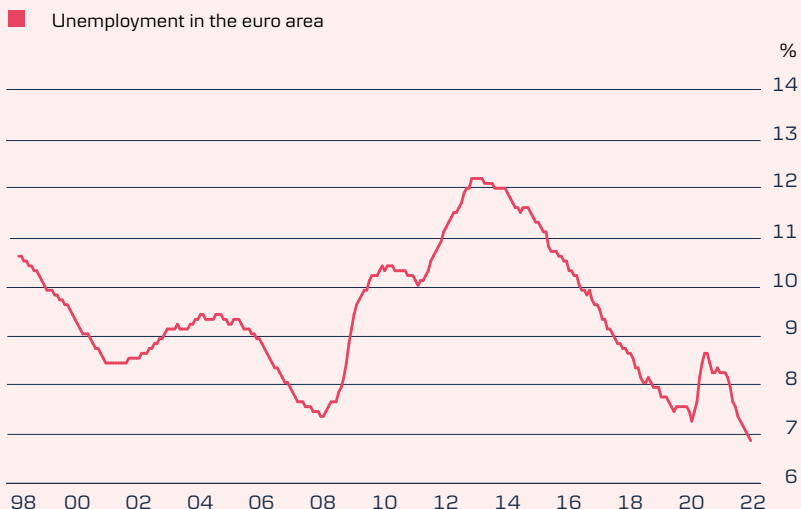
We expect growth of around 2.5% this year, i.e. significantly above potential. We have only made a modest negative adjustment due to the war in Ukraine, driven by rising oil prices. The US is much less economically dependent on Russia, which is why the war will not have a major impact here so long as it is geographically limited to Ukraine.

The strong economy is putting upward pressure on inflation. As inflation is already far too high and will only – if we are correct – decline to 2-2.5% in the coming years, the Federal Reserve must normalise monetary policy as soon as possible. Given current interest rate levels and the size of the balance sheet, the Federal Reserve is stimulating final demand at a point when it does not need stimulation – to put it mildly. The goal of the Federal Reserve is therefore to get monetary policy back to neutral as quickly as possible and probably also a little tight to cool strong demand and therefore also the labour market.



Record-low unemployment in the euro area

In February, unemployment fell to the lowest level in the history of the euro area, and the labour market appears to have improved further in March.



Source: Macrobond.

Fortunately, the economy is not fundamentally imbalanced via excessive investment in, for example, construction and/or private consumption, which is why the economy can, in our view, cope with the speedy normalisation of monetary policy. We therefore now expect the Federal Reserve to raise interest rates to 2% or more this year followed by further rate hikes next year to more than 2.5%. Growth looks set to ease in the course of H2 2022 and into



The big question is whether China can contain Omicron without the need for further and potentially far more extensive restrictions than those already implemented – we believe China can.

2023 and thus will slightly, but far from completely, ease inflationary pressures. Nevertheless, we expect the expansion to continue into 2023 and the famous soft landing to be achieved, so the Federal Reserve is not forced to send the economy into recession in order to sufficiently reduce inflation.

China will struggle with Omicron, but the battle is not lost

China’s solid start to 2022 is overshadowed by the Omicron outbreak. In the very near term that means lockdowns and restrictions that have already significantly reduced growth. However, the big question is whether China can contain Omicron without the need for further and potentially far more extensive restrictions than those already implemented – we believe China can.

The coming year will be an ongoing

battle between Omicron on the one hand and the will and ability of the authorities to contain the virus more effectively on the other. We would stress that China will never accept letting the virus spread as in Europe and the US, for the simple reason the health service would collapse if that happened. Hence, the battle will continue to rage until China either develops its own more effective vaccine or copies one of the successful vaccines from the West. Better treatment for the disease would help, but is not the long-term solution. However, we would maintain that China can keep Omicron under control via relatively modest and more targeted restrictions, which is why the economic damage from the disease will be limited in 2022.

However, the most important factor in our view is that the relatively strong

data of recent months confirms the economy is basically doing well, and that the primary reason for the weak growth last year was the continuous and at times significant tightening of economic policy. Precisely because China has now achieved its goal of getting the economy and the housing market to shift down a gear, the authorities can better stimulate the economy if and when there is a need. We therefore continue to paint a picture of China in 2022 that is markedly different to 2021 – the authorities will support the economy and the housing market if and when needed. We therefore maintain our expectation of solid growth of 4-5% this year. If we are right, that implies a significant acceleration in growth in the short term after restrictions are curtailed, as growth is currently very low.



USA: Expectations for growth, inflation and interest rates

| | 2021 | 2022 | 2023 | 2024 |
|-----------------------------------|-------|-------|-------|-------|
| Expected growth | 5.53% | 2.60% | 1.28% | 1.84% |
| Long-term growth potential | 1.86% | 1.87% | 1.88% | 1.88% |
| Core inflation (PCE) | 4.85% | 3.92% | 2.42% | 2.21% |
| Fed rate hikes | 0.00 | 7.92 | 2.29 | -0.62 |

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 |
|-----------------------------------|-------|-------|-------|-------|
| Expected growth | 4.64% | 2.09% | 2.43% | 1.39% |
| Long-term growth potential | 1.39% | 1.39% | 1.39% | 1.39% |
| Core inflation (PCE) | 2.23% | 2.62% | 1.97% | 1.96% |
| ECB rate hikes | 0.00 | 1.50 | 5.73 | -0.43 |

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





ECB president Christine Lagarde has clearly signalled that monetary policy tightening is coming to Europe, and in our view, the full increase in interest rates has not yet been priced into the market.

THE TIME AHEAD - THE FINANCIAL MARKETS

Interest rates to increase further, equities to recoup losses



EQUITIES:

Needless to say, the war in Ukraine is the most important uncertainty factor in the very near term. As mentioned earlier, a war with NATO or a nuclear escalation would obviously mean drastic price falls for equities. However, we reckon it most likely that the war will remain a conflict between Russia and Ukraine. The war is a human and social catastrophe, but as markets get used to it, the war will have negative but manageable effects from an economic and financial perspective.

If we are proved correct in our expectation of continued solid global economic growth led by the US and

China, equities will recoup their losses – and more. Despite major regional and sectoral differences, the war will not result in a global recession. That means further earnings growth and a macroeconomic environment where risk premiums on equities can be maintained at current levels.

We assess US and European equities to once again be valued slightly expensive, but view these valuations as sustainable if our expectations for the global economy are met. We therefore expect a return on US and European equities of 5-10% over the coming 12 months.



BONDS:

Our expectations include further upward pressure on interest rates – primarily in Europe. The normalisation of US monetary policy is up and running and will continue at a relatively swift pace in the coming quarters. However, following the latest increases in interest rates, major changes to monetary policy have already been priced in – in the short term, actually a little more than we currently expect. We therefore foresee only modest upward pressure on US interest rates going forward. We thus expect 10-year US Treasury yields to increase by 0.1 to 0.2 percentage points over the coming 12 months, ►►

which should be consistent with zero to modestly positive returns on US Treasuries in the coming 12 months.

Things look different in the euro area. Following the latest developments in inflation, we have seriously upped our expectations for rate hikes from the ECB. We now expect the ECB to raise its benchmark rate by 175 to 200bps going forward to the end of 2023 from the current -0.5% to around or just below 1.5%. This is more than the market is currently pricing in. At the same time, we view term premia across the German yield curve as too low, i.e. bonds are expensive. We therefore expect yields to increase further in Germany. We expect a roughly 0.5 percentage point increase in the 10-year Bund yield to a little above 1% in 12 months. In contrast to the US, we therefore have significant negative return expectations across the entire German yield curve.

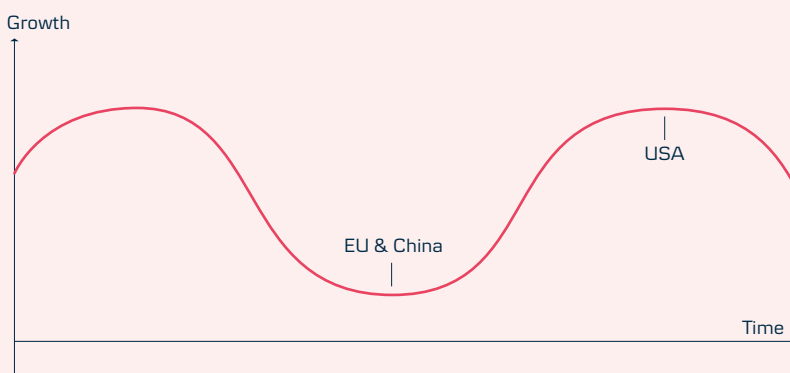


EMERGING MARKETS:

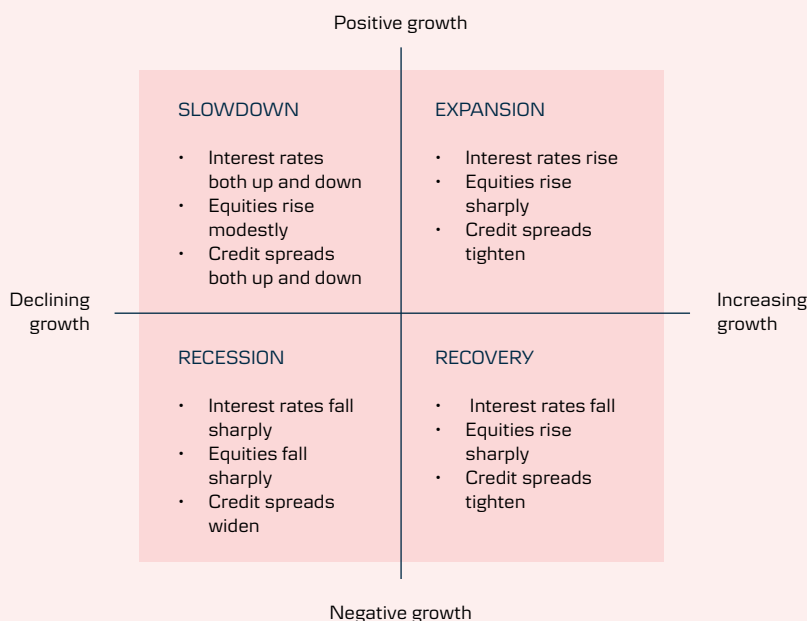
Our expectations for monetary policy and yields would normally constitute a challenge for emerging market equities. However, in contrast to the US and Europe, we now view emerging market equities as moderately undervalued. Hence, these markets have a little support from valuations, while valuations are a slight headwind in the US and Europe. Moreover, if our expectations for the Chinese economy pan out, including a significant acceleration in growth as we head for the summer, emerging market equities should be able to deliver decent positive returns in the coming quarters and for the year as a whole. This would be in contrast to last year, when emerging market equities delivered a return of close to zero.

*Macro barometer:
Most attractive prospects in emerging markets*

CURRENT STATUS: China is being hit by an Omicron outbreak right now, while the war in Ukraine is fuelling uncertainty about growth in the EU. We expect growth to pick up as the virus outbreak in China is brought under control and Europe continues to reopen. The US is powering ahead as its economy normalises after Omicron, after which we expect growth to slow. We see valuations and the economic outlook as being most attractive for equities in emerging markets.



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.



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