Danske Bank
Quarterly House View Winter 2020
INSTITUTIONAL

Light at the end of the tunnel

After a tough year in the shadow of the coronavirus, we see several grounds for optimism on both the global economy and investments in 2021.

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The outcome of the US presidential election was well received by the financial markets. Joe Biden's win should reduce the risk of an escalation in the trade war, among other things.

Grounds for degree of optimism in 2021

Despite continuing uncertainty on the coronavirus and economic growth, we see 2021 as having the potential to be a good year for risk assets such as equities.

By chief strategist Henrik Drusebjerg

Both Europe and the US are currently being slammed by the coronavirus, yet US equities are at historical highs and European equities are at post-crisis peaks after the huge dip in the spring.

While seemingly contradictory, there is a certain logic, as the financial markets are almost always a step ahead of the current reality. Professional investors are more inclined to consider how the world may look in six months' or a year's time – and if we lift our gaze from the high infection rates and renewed lockdowns in Europe, there is good reason for a degree of optimism on equities and other risk assets, even if periodic relapses are almost inevitable.

What's driving equities higher?
Let's take a look at the main reasons for our optimism:

US ELECTION RESULT: First up is the US presidential election, where the outcome was positive for investors. Joe Biden in the White House means greater predictability and less risk of an escalation in the trade war with China, etc., plus there is the prospect of a split Congress, with Democrats and Republicans having a majority in each of their chambers – respectively, the House of Representatives and the Senate. This makes it extremely difficult for ▸▸

As vaccines continue to be developed, produced and distributed, we expect they can further boost market sentiment and the prospects for economic growth.

Expected return from global equities for the coming 12 months, in euro:

3-8%

Modest overweight in equities

Modest underweight in bonds

US equities have been amongst this year's winners. On Tuesday 24 November, the Dow Jones index passed 30,000 for the first time ever.

Joe Biden and the Democrats to push through their agenda of higher taxes and increased regulation of the energy and health sectors along with the tech giants, etc. – a win-win situation for investors.

While there are still two runoffs to be held in the state of Georgia before we know the final composition of the Senate, and even though a split Congress means the Democrats cannot realise their massive corona fiscal relief package, the election result has nevertheless been positively received by the financial markets.

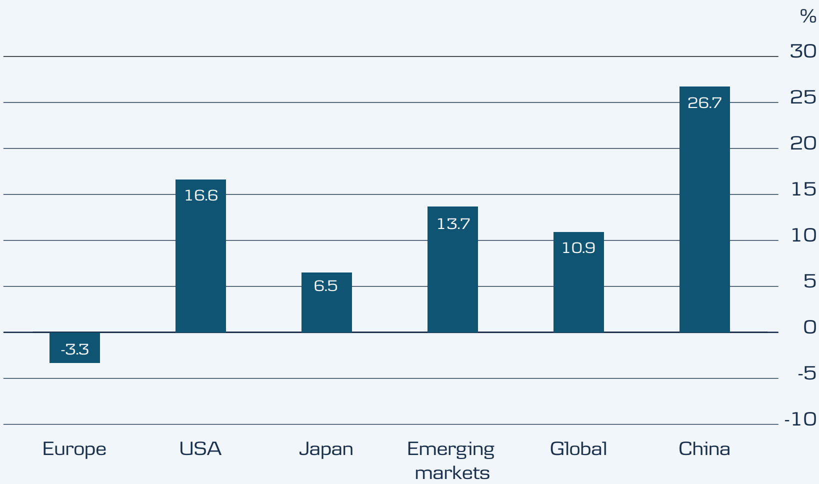
THE ECONOMY: While we have experienced both positive and negative surprises in the macroeconomic data, the overall trend has been pointing in the right direction for confidence indicators, consumer data, the job market in the US and economic growth as a whole. Progress on the macroeconomic front has provided a buffer against major equity price falls during periods of investor concern about the resurgent coronavirus or disappointment over politicians in the US failing to agree a new fiscal relief package.

Economic trends will continue to be a crucial factor for market developments, and despite the new corona-related restrictions and lockdowns, we expect to avoid a global recession like the one in the spring – in fact, we see the economic upswing gaining traction in the course of 2021. In the shorter term, however, the new wave of COVID-19 infections will likely put a brake on much of the economic data and figures, just as we expect more subdued growth in China following a rapid acceleration in economic activity.

CORPORATE EARNINGS: The Q3 reporting season surprised positively, as a great many companies beat analyst expectations on earnings. Nevertheless, market reaction was limited, so one could argue that a good deal of ▸▸

Return on equities so far this year

Return in local currency since 1 January 2020.



Accumulated return over past 5 years

Source: Macrobond, data for MSCI Index, total return in local currency. Calculated: 26.11.2020
Historical return is no reliable indicator of future return.

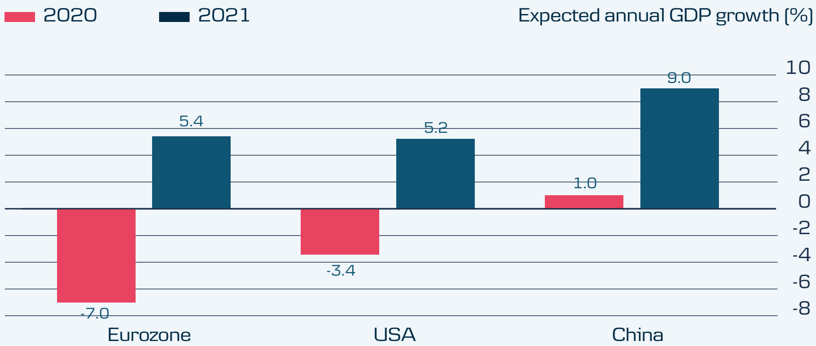
While London is decorating for Christmas, the Christmas spirit is absent. Brexit remains unresolved, and the UK Chancellor recently announced expected negative growth of 11.3% in 2020 – which if it pans out would be the largest fall in more than 300 years.

positivity had already been priced into equities. On the other hand, the solid earnings reports confirmed what we can see in the macroeconomic data; namely that the recovery in the global economy is on track. Had earnings not met expectations, we would presumably have experienced significantly greater uncertainty and more volatility across equity markets. So, while earnings reports did not drive prices higher, they have lent support to equities.

VACCINE DEVELOPMENT: Topping it all off, fully developed vaccines to fight the coronavirus seem to be just around the corner. Pharmaceutical companies Pfizer and Moderna were the first to produce robust test data, which was – as expected – warmly welcomed by the financial markets. For investors, this good news is a light at the end of the tunnel, and a signal that we could well be entering the concluding phase of the global battle against the coronavirus. That is not to say that the virus will disappear from the face of the earth, but effective vaccines are crucial to a full reopening and recovery of the global economy.

Expected growth in 2021

Danske Bank expects an economic upswing next year, though the numbers are subject to significant uncertainty and depend on how the coronavirus develops, among other things.



Source: Danske Bank.

Vaccines are the key

Effective vaccines will be the key factor for getting the global economy back to pre-corona levels. For, while we have seen great progress since the spring, the jobs market, consumption and corporate investment appetite are all still suffering due to the coronavirus. As long as restrictions and lockdowns persist, there will be a limit to how far economic activity can be ramped up.

Investors have already priced in some of the promise of the upcoming vaccines, but as vaccines continue to be developed, produced and distributed, we expect they can further boost market sentiment and the prospects for economic growth.

In the shorter term, however, the coronavirus still has the potential to severely dent the mood of the financial markets if restrictions and lockdowns are tightened or extended, if the rollout of vaccines does not proceed as quickly and smoothly as hoped, or the economic recovery shows signs of stalling. Hence, we are still in the embrace

Brexit uncertainty continues

The EU and the UK have still not reached an agreement on the future terms of their relationship once the British leave the EU as planned at the end of the year. Hence, a hard Brexit remains a real risk. We still expect that a hard Brexit can be avoided – potentially via a partial deal before the end of the year that could form the basis for further negotiations. However, a deal failing to materialise could have negative consequences for the European economy and equities.

Hence, Brexit remains an uncertainty factor, particularly for Europe. However, we would expect the equity market's reaction to a hard Brexit to be relatively short-lived, as the risk of a hard Brexit has presumably been priced into European equity prices to some extent. Moreover, simply achieving a resolution may provide some relief after several years of uncertainty. Nevertheless, no matter how you look at it, a hard Brexit would ultimately be very negative.

The IT sector has been this year's runaway bright spot in equity markets, driven forward by tech giants like Apple and Microsoft. The sector is benefiting from structural growth – in other words, underlying growth independent of the economic cycle.

of a period with a heightened risk of volatility and relapse.

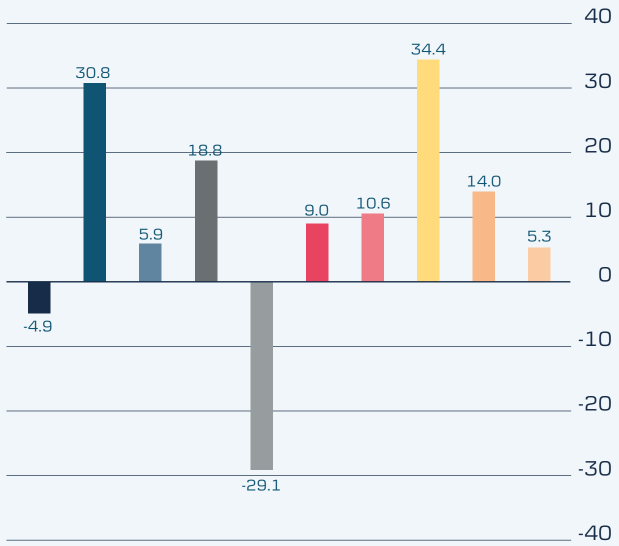
Nevertheless, the extremely accommodative monetary policies of the central banks, with very low interest rates and massive bond purchases, will continue to be an important prop for global markets, and given the low level of inflation and still high level of unemployment, there is, in our opinion, little prospect of monetary policy being tightened anytime soon. On the contrary, the European Central Bank has signalled further easing in December.

Top- and bottom-ranked equity sectors

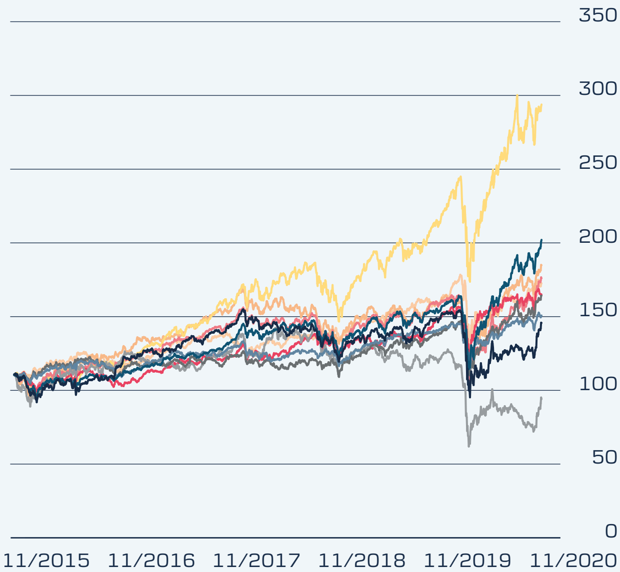
This year's equity market winners have generally been sectors and companies with solid structural growth – in other words, underlying growth independent of the economic cycle. During this period of great uncertainty on economic growth, investors have naturally sought out companies that can deliver good growth and earnings, even in challenging times. This has particularly been the case with the IT sector, though healthcare, communication services and e-commerce companies have also performed well, which has helped boost US and Danish equities this year.

On the bottom rung of the ladder this year we find cyclical sectors like energy and financials, which typically perform best during economic expansions. Lately, though, we have seen some sector rotation, with investors increasingly turning to cyclical equities and beginning to position for better times in 2021 with higher growth and less uncertainty. However, given the continuing uncertainty on global growth and the duration of restrictions and lockdowns, we assess the timing to be too early to focus solely on cyclical equities. We therefore currently favour the best of both worlds.

Return by equity sector so far this year



Accumulated return over past 5 years



Financials | Consumer discretionary | Consumer stables | Communication services
Energy | Healthcare | Industrials | IT
Materials | Utilities

Source: Macrobond, data for Global MSCI Index, total return in USD. Calculated: 26.11.2020
Historical return is no reliable indicator of future return.

The US state of Georgia still has to hold a runoff on two Senate seats, with the outcome deciding whether the Democrats or the Republicans gain control of the Senate. Read more on this page.

US elections not over yet

On 5 January 2021, voters in Georgia have to elect two senators to represent the state in Congress in Washington.

Republicans are expected to win the two seats in Georgia, but if the Democrats win both seats, they will control both chambers in Congress – the Senate and the House of Representatives. That would allow Joe Biden and the Democrats to pass an extensive fiscal relief package to boost the US economy, which would generally be positive for equity markets. On the negative side, however, it would increase the likelihood of higher taxes and increased regulation.

The financial markets would presumably prefer to maintain a split Congress, with the Democrats and Republicans each controlling one chamber, thus limiting how many changes the Democrats can push through in the economic area. However, we would not rule out the parties potentially agreeing a more limited fiscal relief package – not least if the US economy moves in the wrong direction.

Central banks still an important component

We have previously experienced how positive economic news can ultimately have a negative effect on the financial markets because economic growth has triggered investor fears that the central banks will tighten monetary policy. However, in the shorter term at least, we see only a limited risk of this dynamic gaining traction in the financial markets. There are several reasons for this:

- First, the US central bank, the Fed, altered its strategy earlier this year, so it now navigates 'to achieve an average inflation target of 2%, where the word average is what has changed from earlier. Going forward, this means the Fed will allow periods with inflation above 2%, and so will not be so fast to tighten monetary policy when unemployment falls or inflation crawls higher. Even if the economic recovery in the US progresses faster than anticipated, we expect the Fed will turn a blind eye to this for a while.
- Second, the central banks have indicated that they do not necessarily consider corona vaccines a game changer for a game changer for the economy – and that could have a major impact, as it may stop investors from speculating that the development and distribution of vaccines will automatically go hand in hand with monetary policy tightening.

All in all, this increases the likelihood that good news on corona vaccines will remain good news for the financial markets and not turn sour.

If expectations pan out …

Given the prospect of near imminent corona vaccines and further growth in the global economy, we expect corporate earnings to experience a marked uplift in 2021, with our expectations further reinforced by companies having been good at reducing costs during the corona crisis. In fact, corporate earnings not rising significantly in the coming year would be a marked disappointment. That would tend to indicate that equities are simply too expensive at the moment in P/E terms, which expresses the price investors pay for one unit (USD, DKK, etc.) of company earnings.

However, if our expectations for 2021 pan out, investors can look forward to a decent return from equities in the range 3-8% (return expectation in euro). Another important point to remember is that the very low or negative yields on many bonds offer limited alternatives to equities, and we expect this will help support equity markets. At Danske Bank, we are therefore maintaining an overweight of equities in our portfolios and an underweight in bonds. However, despite our positive expectations for global growth and risk assets in the coming year, our overweight in equities is modest, as we acknowledge that global growth will still be subject to significant uncertainty in 2021, plus the coronavirus has not yet been conquered and the short-term picture could turn worse before it gets better.

We also expect the combination of low/negative yields and higher growth in the coming year to be supportive of other risk assets, with investors able to earn a higher return than on the most secure bond types. This applies, not least, to emerging market bonds.

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