Danske Bank
Quarterly House View Q2 2019

Strategist: Equities reward the fearless

While a number of uncertainties continue to create concern about the financial markets, equities offer the most attractive return potential, according to senior strategist Lars Skovgaard Andersen. He explains why and explores the investment areas of greatest interest in this latest edition of Quarterly House View.

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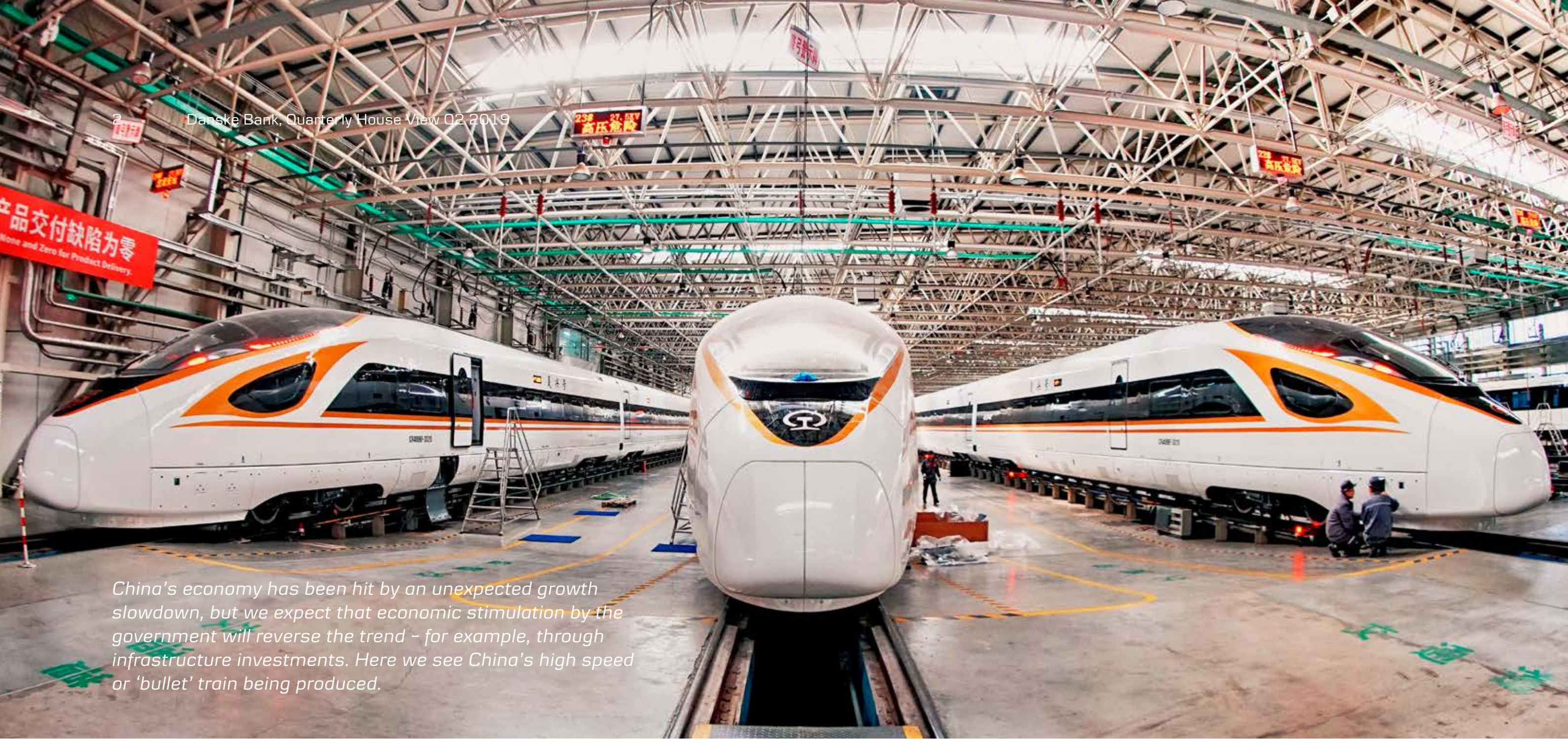


China's economy has been hit by an unexpected growth slowdown, but we expect that economic stimulation by the government will reverse the trend – for example, through infrastructure investments. Here we see China's high speed or 'bullet' train being produced.

Are equity markets running on empty?

Following a strong start to 2019, equity markets have recouped much of their end of year losses, but are they running on empty? We consider where the next uplift to equities might come from.

"Buy the dip" is a classic equity market saying that suggests price falls should be viewed as an opportunity to buy up stocks. The expression has proved its worth many times over the years – most recently following the market decline in late 2018, as the solid start to 2019 means equities have recouped much of their losses.

However, we are now fast approaching the point where there is no more dip left to buy – and equity prices rising further from here will require a new source of fuel. That being said, we expect macroeconomic and political developments to support equities for the rest of 2019, so equity markets still hold potential for investors.

> *Prices have now reached a level where equities are no longer oversold and looking like a steal, as they did in late December.*

Why did the markets turn so quickly?

January this year was the best January for US equities (S&P 500) since 1987, and came on the heels of the worst December since 1931. The sharp turnaround underlines just how quickly investor sentiment can shift, with the brighter mood in no small way due to an easing of several major uncertainties that had plagued investors towards the end of 2018.

- The US central bank, the Fed, switched off its autopilot and convinced markets it would not continue to crank up interest rates regardless. Investors had feared the Fed might choke the economic upswing by hiking interest rates too far and too fast, but instead the central bank has signalled it will be keeping

By Lars Skovgaard Andersen, senior strategist at Danske Bank.

Expected return from global equities of

5-7%

over the coming 12 months in local currency.

↑ **Overweight in equities**

↓ **Underweight in bonds**

a watchful eye on economic and financial developments – which has calmed investor nerves.

- Meanwhile, a warmer tone between the US and China on trade signalled an easing of the dispute between the two countries that has proved a severe headache over the past year.
- Finally, the very substantial price falls simply seemed overdone when viewed against the positive outlook for economic growth and the attractive equity valuations.

What now for equities?

In our view, the equity price rises seen so far in 2019 have been fully justified. But on the other hand, prices have now reached a level where equities are no longer oversold and looking like a steal, as they did in late December. So what now for equities?

We expect the equity markets will continue to enjoy a tailwind from the factors that have driven price movements so far this year. More specifically this means:

- We expect economic growth to remain solid and see no real prospect of a recession this year.
- We expect the US and China to hammer out a deal that will end the trade dispute.
- We see only a low probability of a hard Brexit with no agreement on future trading terms between the UK and the EU.
- While we expect monetary policy to be tightened, central banks will, in our opinion, proceed with caution in both the US and Europe so they do not choke economic growth.
- Economic growth has disappointed in Europe and China in recent quarters. In China, the government has begun to stimulate the economy, while in Europe we expect to see a more supportive fiscal policy that will help to stabilise growth.
- Finally, corporate earnings expectations are not as high as last year, which makes it easier for companies to surprise positively.

Given our expectation of solid economic growth, we have difficulty envisaging lower yields in the time ahead, while monetary tightening should gradually push yields higher. We therefore expect just a modest return from government and mortgage bonds in the coming period, and so we continue to overweight equities and underweight bonds by an equivalent amount in our portfolios.

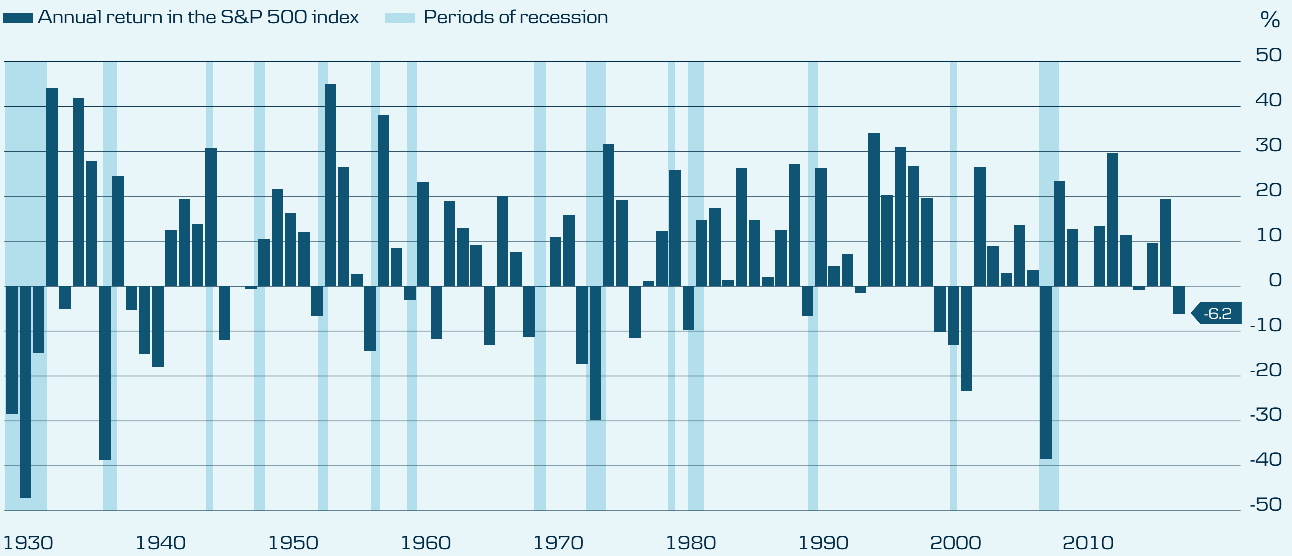
Uncertainty set to continue, so remember bonds

However, even the best plan can go off course, so bonds should always ▸▸

Price falls are usually one-offs

The US S&P 500 index has never experienced two consecutive years of negative equity returns if the economy has not been in recession – although historical return is no guarantee of future return.

Correlation between equity returns and recessions



Source: Macrobond, calculated in USD.

Fed chief Jerome Powell lifted investor faith in the future at the end of 2018 by announcing a more cautious approach to rate hikes – a welcome move in the wake of substantial equity prices falls.

make up a significant share of a balanced portfolio. Market movements in 2018 perfectly illustrate the value of holding bonds, as end of year equity market volatility and price falls prompted many investors to seek a safe haven in the more secure areas of the bond market, which in turn pushed bond prices higher and thus reduced losses in balanced portfolios containing both equities and bonds.

While we are generally positive on equity markets going forward, there are still substantial risks we need to take into account. For example, equity prices could suffer if, contrary to expectations, the trade dispute between China and the US does not ease further, the UK crashes out of the EU in a hard Brexit, or Donald Trump's threat of a trade war with Europe resurfaces. Central bank tightening could, furthermore, continue to create uncertainty and turbulence, while the expected stabilisation of the Chinese and European economies might take longer than expected.

We thus still see a risk of considerable market volatility. Nevertheless, the signs are positive overall, and below we explore in more depth some of the factors that could provide additional fuel for equity markets and ensure further growth in 2019:

Growth is the key factor

Economic growth is generally a prerequisite for rising stock prices. However, business confidence indicators have been hit by events such as the trade dispute, Brexit uncertainty, concerns about Chinese growth and the challenges facing the German car industry. Taken together, these factors have sown seeds of doubt about the sustainability of growth here in the latter stages of the economic upswing, but we must not forget consumers in our calculations. They also comprise a central pillar of the economy, and tighter labour markets in Europe and the US are helping wage growth, which in turn could boost consumption and the economy in general. Political uncertainty easing could also help lift confidence indicators and keep the economy on track.

The elephant in the room

The ongoing Sino-US trade dispute is the elephant in the room when it comes to the financial markets, but the Americans and Chinese are making progress towards a negotiated settlement, spurred on by the fact that both parties are suffering in the dispute. Politically, Donald Trump will likely also become keener to find a solution, as so far the two countries' mutually punitive tariffs have generally targeted goods that are not particularly visible to private consumers – and hence voters. But if the US enacts further tariffs, consumer goods will be next in line to become more expensive,

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Hence, both the latest news on the negotiations and the prevailing political incentives give us reason to assume the probability of a Sino-US deal on trade has increased. However, Donald Trump is not the most predictable of presidents and no deal has been signed yet, so future news on the dispute could still go either way and potentially trigger more equity market turmoil. On the other hand, any agreement that is hammered out could be received very positively by investors, even though some of the positive effect is already priced into equities.

Few want a hard Brexit

We are still very much in the dark about how the drama surrounding Brexit will end, when and if the UK exits the EU as planned on 29 March. Worst case is a hard Brexit with no agreement on future trading terms between the EU and the UK, which would hurt British companies in particular.

Expected economic growth in 2019

The considerable volatility seen in equity markets in 2018 was in part caused by fears of an imminent recession, but that is definitely not our main scenario at Danske Bank, where we expect further decent economic growth in 2019 and into 2020.

Eurozone	USA	China
1.5%	**2.7%**	**6.2%**
(2020: 1.5%)	(2020: 2.0%)	(2020: 6.2%)

Source: Danske Bank.

Despite the chaos, we ultimately expect a deal will be reached for an orderly Brexit with sensible terms governing trade – which in turn could erase some of the uncertainty in the financial markets and boost business confidence, especially in Europe. However, right now, our main scenario is that the British postpone the EU exit, so there is better time to agree on the framework for an orderly Brexit.

In the midst of this great upheaval we must remember that few want a hard Brexit, so we expect a better solution will be found. But of course nothing has been settled yet and things could still go either way, meaning Brexit could be a positive price trigger for equity markets or a serious downside risk.

Market-friendly policies in Europe and China

Europe is still benefiting from a very accommodative monetary policy with record-low interest rates, though we should expect the European Central Bank, the ECB, to gradually normalise rates, which could cause some market jitters. However, very modest inflation pressures mean we expect the ECB to proceed so slowly with tightening that any negative fallout will be minimal. Meanwhile, we foresee fiscal policy loosening, not least in Germany, which may help support and stabilise Europe's economy.

The Sino-US trade dispute has resulted in an unexpectedly sharp economic slowdown in China and widespread concern about emerging market growth generally. However, the Chinese government has responded with stimulatory measures including increased infrastructure investments, reduced taxes and charges for various types of companies and an easing of bank capital reserve requirements to increase lending. We expect the impact of these initiatives will begin to be reflected in economic indicators in Q2, and we have already seen how they have boosted emerging market equities. In the bigger picture, this may help lift global business confidence and, for example, have a positive knock-on effect on the export-dependent European economy.

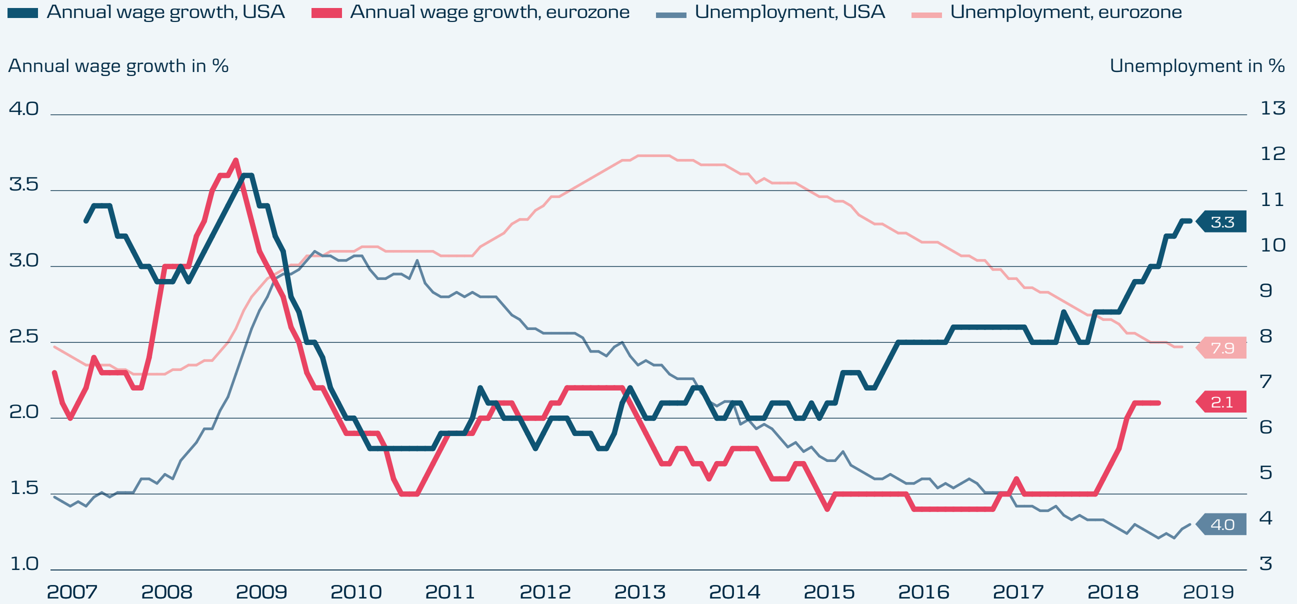
Lower expectations can actually be positive

While the outlook for corporate earnings growth remains solid for 2019, we have seen a wave of downward revisions to analyst expectations. Yet lower expectations are not necessarily bad news, as more modest forecasts mean a lower risk of disappointment – and more opportunity for upside surprises.

A number of large stock market listed companies were suffering ▸▸

Strong labour markets support consumption

Falling unemployment and rising wages support consumption, which is a central pillar of the economy.



Source: Macrobond.

from a mismatch between expectations and reality towards the end of 2018. Many investors were looking for a further steady stream of better-than-expected results, while companies, in contrast, were beginning to tone down their forward guidance. Lower guidance came on the back of the many uncertainties that have dominated recently and which caused markets to go off the boil, but this means we are now very probably at a more sustainable level, with a better match between investors' expectations and actual growth in company earnings in the coming quarters.

During the latest reporting season investors appear to have been satisfied with financial results that were unimpressive and simply ok, whereas last year this could have triggered very negative price reactions. This is a fine example of the wisdom contained in a classic quote from US investor Warren Buffet: The secret to happiness is having low expectations.

> *A number of large stock market listed companies were suffering from a mismatch between expectations and reality towards the end of 2018.*

Where we see greatest potential in equity markets

EMERGING MARKETS: Brighter prospects after a tough 2018

Emerging market equities had a tough 2018. The trade war has weighed heavily on emerging market economies, not least the Chinese, though economic stimuli in China and progress on trade talks between China and the US mean the region has begun to attract the interest of investors once more, and we expect investor interest will continue to grow.

Rising US interest rates and a stronger greenback have also buffeted emerging markets, though the impact of these factors has been muted by the Fed's more dovish rhetoric on rate hikes going forward. Furthermore, corporate earnings growth in emerging markets looks set to outpace earnings growth in the US as the effect of Donald Trump's tax reforms begin to fade.

These are some of the reasons why we now have an overweight of emerging market equities in our portfolios.

EUROPE: Negative factors taking too heavy a toll

Economic growth in Europe has essentially stalled in recent quarters, with European equities subsequently trailing global equities. However, we expect the economic data to bottom out in the coming months and then rebound – supported by a more accommodative fiscal policy, among other things. This is also why we are currently overweighting European equities in our portfolios. Furthermore, we see too much negativity priced into European equities, which now seem to be attractively priced, while low levels of unemployment and rising wages should support private consumption.

The Sino-US trade dispute has also affected the European economy, which is vulnerable to downturns in exports – and indeed many European exporters have been hit by lower demand from China, so a deal between the US and China would certainly be positive news for Europe.

QUALITY EQUITIES: A steadying hand in turbulent times

While we have seen equity prices rise in the opening months of 2019, we are still in choppy seas with the prospect of further price volatility. We would therefore recommend buying so-called quality equities at the moment, as these tend to be more robust in times of turmoil. Quality equities refers to companies with stable earnings growth, a high return on equity (ROE) and low financial leverage – in other words, a relatively limited level of debt. Such equities have tended to perform well during periods of turbulence, though this is no guarantee of future return.

Quality equities are usually less vulnerable to interest rate increases, they can obtain loans more cheaply than other companies and ultimately have the prerequisites for achieving a better bottom line than companies of lesser quality – all of which are attractive characteristics in volatile markets. Quality equities provide a steadying hand at the tiller.

Europe's economy has been under pressure in recent quarters, with Germany's car industry being particularly hard hit. In our view, however, a turning point is not far off.

Current allocations

Danske Bank expects that overweighted assets will outperform the market in general and that underweighted assets will underperform. With an overweight we therefore currently have a higher proportion of that asset in our portfolio than we expect to have over the long term, and with an underweight a lower proportion.

OVERALL ALLOCATION
Allocation by asset class

Equities	↑	Overweight
Bonds	↓	Underweight
Cash	→	Neutral weight

BONDS
Allocation within the asset class bonds

Local bonds	↓	Underweight
Investment grade	↑	Overweight
High yield	→	Neutral weight
Emerging market bonds	→	Neutral weight
Global government bonds	→	Neutral weight

EQUITIES - REGIONS
Regional allocation within the asset class equities

USA	↓	Underweight
Europe	↑	Overweight
Emerging markets	↑	Overweight
Japan	↓	Underweight
Denmark	→	Neutral weight

EQUITIES - EMERGING MARKETS
Country allocation within the emerging markets region

Brazil	↓	Underweight
India	↑	Overweight
Russia	↓	Underweight
China	↑	Overweight

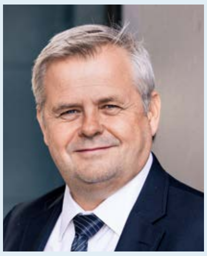
EQUITIES - SECTORS
Sector allocation within the asset class equities

Consumer discretionary	→	Neutral weight
Energy	↓	Underweight
Financials/Real estate	→	Neutral weight
Utilities	↓	Underweight
Industrials	↑	Overweight
IT	↑	Overweight
Materials	→	Neutral weight
Consumer staples	↓	Underweight
Healthcare	↑	Overweight
Telecoms	→	Neutral weight

Source: Danske Bank

Who are we?

Strategy & Macro | Danske Bank House View



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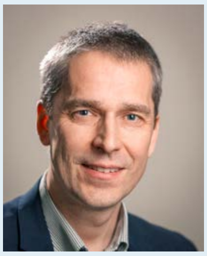

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Always remember your risk as an investor:
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