



QUARTERLY VIEW, Q3 2021
DANSKE BANK ASSET MANAGEMENT

Party not quite over

While the best is probably behind us in terms of both the economic boom and equity markets, we continue to see a certain return potential in the coming 12 months – primarily driven by European assets.



After 16 months, bars and nightclubs in Holland were recently able to reopen without any restrictions other than having a negative COVID-19 test, here in the town of Tilburg (also front-page picture). The many reopenings around the world have resulted in an economic boom.

THE PAST QUARTER

Reopening party really took off

Ever since the first positive vaccine results were reported in autumn 2020, expectations have been high for both economic growth and the markets.



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These expectations were realised in the past quarter.

The US was first out of the starting blocks, as its vaccine rollout was already under way just after New Year. Hence, pressure on the health service quickly eased and reopening could commence in Q1. This, combined with significant fiscal stimulus that fed through to the economy at the end of March, meant the US thundered into Q2 with high levels of private consumption, employment growth – and inflation.

The reopening thus led to extreme price pressures in certain sectors that faced shortages of goods, such as new and used cars. Increasing shortages of labour soon emerged too, as the continued closure of schools along with extended and increased unemployment benefits held back many people from



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participating in the rapidly improving labour market.

Europe a step behind

The overall picture painted by US economic data was thus a quarter of very high levels of growth and high inflation. This was also the situation in Europe, though the reopening here only ▶▶

really took off in Q2 due vaccine supply issues. By the middle of the quarter, however, the major European nations had overtaken the US in daily vaccination numbers, and by the end of Q2 Europe had more or less erased the US lead and vaccinated around 50 per cent of its population with at least one jab.

Growth in Europe greatly picked up between Q1, when growth was negative, and Q2. While inflation also rose here, the increase was not quite as pronounced as in the US - in part due to less fiscal stimulation.

More subdued growth in China

While the major economies in the developed world experienced an explosion in economic activity in Q2, developments in China were more lacklustre. China has long had the virus under control and its reopening is largely complete. Nevertheless, we estimate

that China's economy also expanded at a decent pace in Q2. Moreover, China significantly ramped up its vaccination drive in May and June with its own vaccine, immunising up to 1.5 per cent of the population on a daily basis.

Financial market developments

All in all then, Q2 saw a global economy with strong growth and high inflation, led by the US and Europe. This was also reflected in the markets, where global equities rose by around 7 per cent and yield spreads on credit bonds continued to tighten.

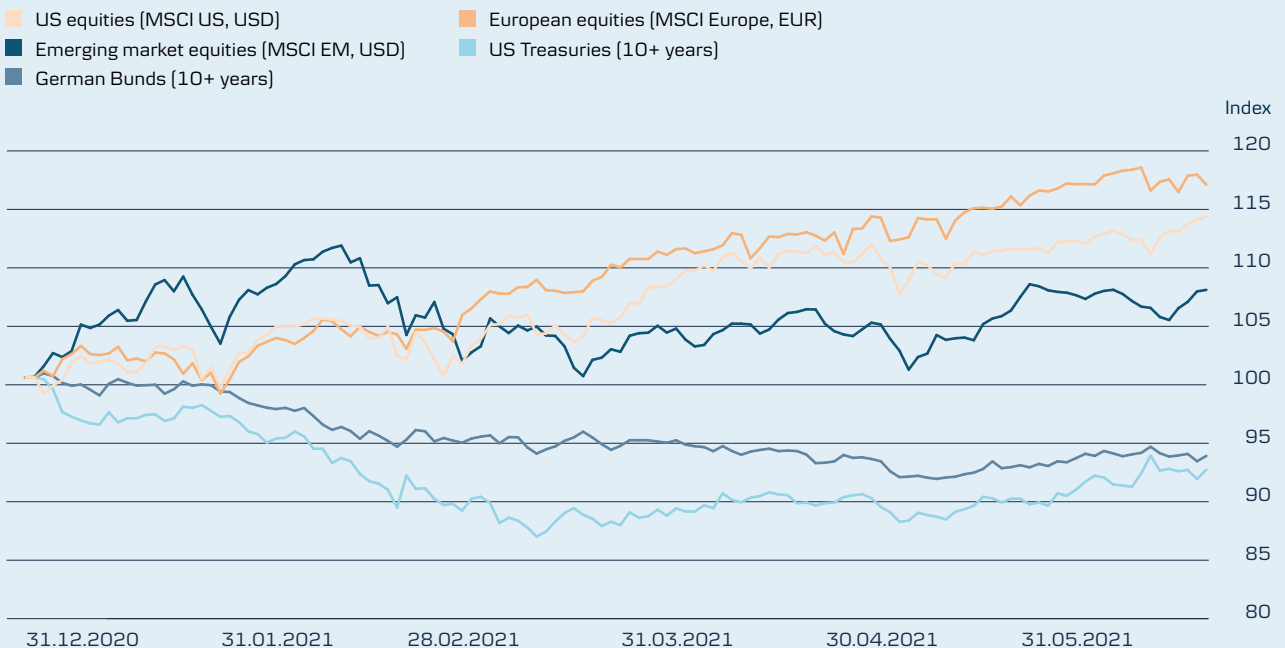
In contrast, yield levels on benchmark government bonds were largely unchanged after increasing significantly in Q1. Finally, the US dollar (USD) broadly strengthened on FX markets after the US central bank (the Federal Reserve, or 'Fed') signalled in June that it would soon discuss tapering bond



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purchases, while the European Central Bank (ECB) continued to signal it would maintain a very accommodative monetary policy. ▶▶

Total return so far this year



Source: MSCI, Bloomberg and Danske Bank Asset Management.



Strong demand and shortages of certain materials, components and products have caused inflation to soar in the US. Prices for new and used cars, among other things, have jumped.

THE TIME AHEAD: MACROECONOMY

Party to continue for a little while yet

We expect the high rate of growth in the global economy to continue over the summer and into early autumn. We assess there are still sectors in both the US and Europe that are not yet fully normalised, and some restrictions apply that still have to be removed. To this can be added accommodative fiscal and monetary policies.

The key, of course, is whether the virus can be kept under control and thus prevent pressure on the health service that would require new lockdowns in the autumn or winter. We would therefore stress that the greatest risk to both the global economy and the financial markets is virus mutations that render current vaccines significantly less effective.

Fortunately, the data currently indicates the major vaccines also provide

high levels of protection against the latest and very contagious Delta variant of the coronavirus. We therefore expect to see strong growth in both the US and Europe over the summer, while China is more likely to grow at a rate just slightly above its long-term trend.

Nevertheless, we would underline that there are significant differences between the largest economies.



USA:

Growth has already peaked, inflation is the joker in the pack

Our assessment is that US growth had already peaked by the end of Q1, as fiscal policy, reopening speed and normalisation after a tough winter coalesced to produce exceptionally strong

growth in private consumption, housing and manufacturing.

While we expect growth to slow in coming quarters as the economy fully reopens and fiscal stimulation fades, we would emphasise that we expect ►►



The US economy had probably already closed the gap created by lockdown by Q2.

growth to remain high in the US in the coming months. The labour market, in particular, has still not fully reacted to certain aspects of the reopening and the strong growth in private consumption, etc. Employment should rise significantly once the final, temporary obstacles, such as extended unemployment benefit, expire by September.

We thus estimate US GDP will grow by close to 8 per cent this year (from Q4 2020 to Q4 2021). The economy had probably already closed the gap created by lockdown by Q2, which means we are looking for a normalised labour market towards the end of this year or the start of next year.

The greatest uncertainty factor in our view is inflation. While clearly higher than expected in Q2, most of that inflation surprise stemmed from those parts of the economy hit hard by temporary issues, such as low car production. We therefore see inflation hovering around the Fed's target of approximately 2 per cent as the most likely scenario for next year. If we are right in our assumption, inflation, like

growth, will slow considerably in the second half of the year.

If our expectations pan out, central banks can gradually begin to normalise. We therefore expect the Fed will officially begin discussing over the summer and into the autumn how its asset purchase programme should be scaled back, or tapered. The plan will likely be presented at their December 2021 meeting, with the first tapering of purchases occurring in January. Purchases will then be gradually scaled back further and the programme wound up by the end of 2022. Hence, any potential rate hikes will not be on the cards until sometime in 2023, probably in H2.



EUROPE:

Growth set to steam ahead over the summer

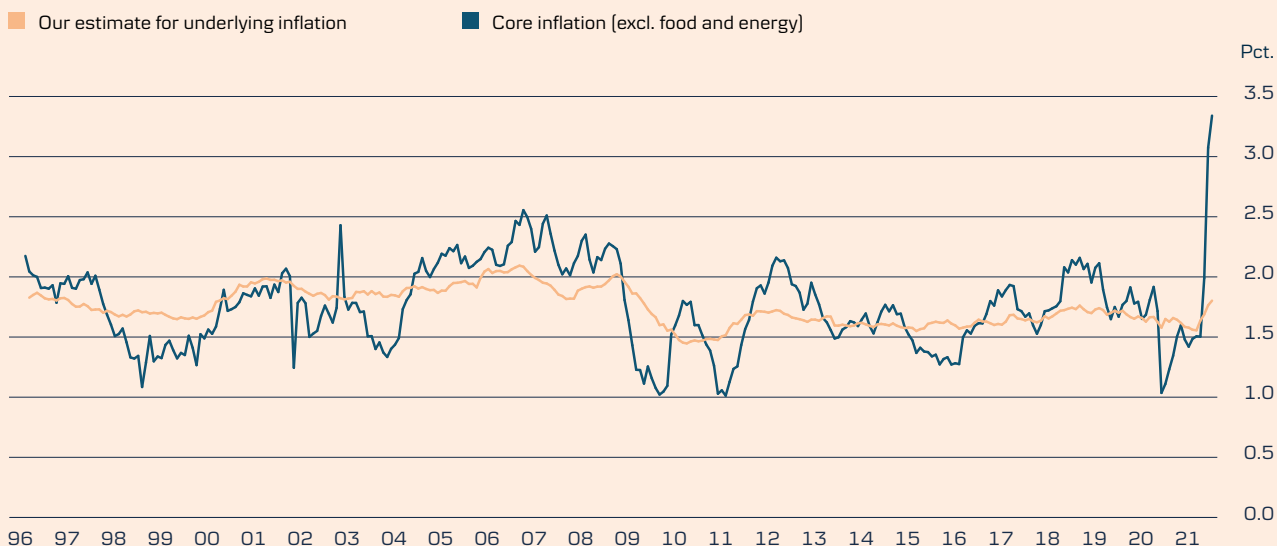
Given Europe's slightly delayed reopening and tougher restrictions over the winter, there is more potential for a further normalisation of the European economy than the US economy. We



Our position remains that the ECB is far from being able to normalise monetary policy and that bond buybacks will continue for quite some time yet.

therefore expect stronger growth in Europe over the summer than we do in the US. While our best estimate is that growth in Europe will peak in the early summer months, as the pace of reopening will be fastest here, growth should remain very high into early autumn. ▶▶

US consumer price inflation



Source: US Bureau of Economic Analysis and Danske Bank Asset Management

We thus expect that the Euro area will not close the gap in economic activity created during lockdown until Q3.

We therefore also expect the labour market will take considerably longer to heal in Europe than in the US. That is why we continue to assess the Euro area's economy to be deflationary and underlying inflationary pressures to be limited.

After 10 years of extremely low inflation, the ECB thus still faces a major problem without any significant end in sight. We anticipate the ECB will announce the results of its so-called strategy review in the early autumn. While we expect the ECB to specify their inflation target even more precisely in an attempt to raise inflation expectations, there is still a long way to go for the ECB to gain credibility with respect to its ability and determination to realise long-term inflation of just below 2 per cent.

Hence, our position remains that the ECB is far from being able to normalise monetary policy and that bond buy-backs will continue for quite some time yet. We do not expect the first rate hike this side of 2025.



CHINA:

Dull can be better in the longer term
China has long been dull compared to the US and Europe. Pretty much the entire economy has normalised and the most important impulse for growth remains exceptionally strong exports. However, that impulse too is also fading now as the rest of the world opens up and private consumption in China's key export markets migrates towards the service sectors. We therefore expect decent growth slightly above trend in China for the coming months.

Where China differs most, however, is on economic policy. China's credit

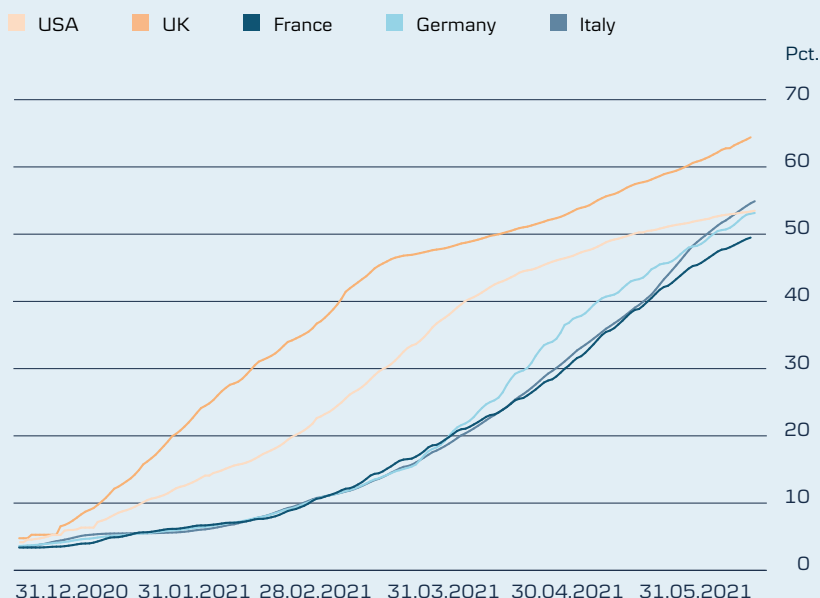


China's growth story is rather uninteresting in the short term – we expect growth around the long-term potential. On the other hand, this is very good news for China's long-term growth outlook.

and fiscal policies were unsustainable over the past decade. Local authorities in particular had a tendency to borrow too much money to unproductive projects, and lending to the housing market generally was too lax at times. The authorities acknowledged the situation in 2017 and began a major tightening and tidying up process in the financial sector. This was briefly put on hold in H1 2020 while the authorities tackled the corona crisis.

Since then, however, the expansive fiscal and credit policy has been rapidly normalised, and we assess that credit granting across the economy – including the excesses of the public and semi-public sectors – is now at a sustainable level. This stands in stark contrast to the US in particular, where fiscal policy will remain a key issue for a long time to come. China's growth story is thus rather uninteresting in the short term – we expect growth around the long-term potential. On the other hand, this is very good news for China's long-term growth outlook, as the economy is not accumulating imbalances over an extended period that risk ending in a major crisis. ▶▶

Share of population that has received at least one jab against the coronavirus.





We see the greatest return potential in European equities and bonds in the time ahead - in part, because we continue to expect that a tighter monetary policy from the European Central Bank headed by Christine Lagarde is still some way off.

THE TIME AHEAD: THE FINANCIAL MARKETS

The best is behind us, but the party is not quite over yet



EQUITIES:

Biggest potential in Europe

With returns well above 10 per cent in H1 2021, equity markets welcomed the reopening. In fact, so much so, that we now estimate US equities are 10-15 per cent overpriced. Naturally, this means the future potential is considerably less attractive.

Growth slowing, as we expect going forward to 2022, would also normally mean equities losing an important tailwind. However, still relatively high levels of growth should support US equities, and given that we expect the normalisation of monetary policy to be a very

gradual and measured process, nor do we expect any major shocks to equity markets from here.

All in all, we therefore expect modest positive return of around 0-5 per cent from US equities in the coming 12 months. We would stress, however, that the short-term risk of a price fall of 5-10 per cent is higher than normal, as growth could potentially fade faster than we expect at a time when valuations are on the expensive side. Nevertheless, should that happen, we estimate the market would quickly right itself again. In contrast, stronger-than-expected growth against a background of rapid normalisation and a decline in inflation would probably result in further strong

returns for US equities.

The story in Europe is a little different. We estimate the continental European equity market remains priced to the cheap side - around 5-10 per cent too low. In contrast to the US, the equity risk premium could thus be reduced a little more if our optimistic growth expectations are realised while the ECB at the same time maintains its accommodative approach. We therefore expect a return on equities of over 5 per cent in Europe in the coming 12 months.

Emerging market equity valuations are, in our opinion, the most expensive of the three major regions. We estimate the broad emerging market index is ►►

currently 15-20 per cent too expensive. Naturally, this limits future return potential. On the other hand, high rates of global growth and the slow normalisation of US monetary policy, in particular, mean valuations should be capable of being sustained at a relatively high level. We therefore expect emerging market equity returns to be on a par with the US - in other words, 0-5 per cent over the coming 12 months.



BONDS:

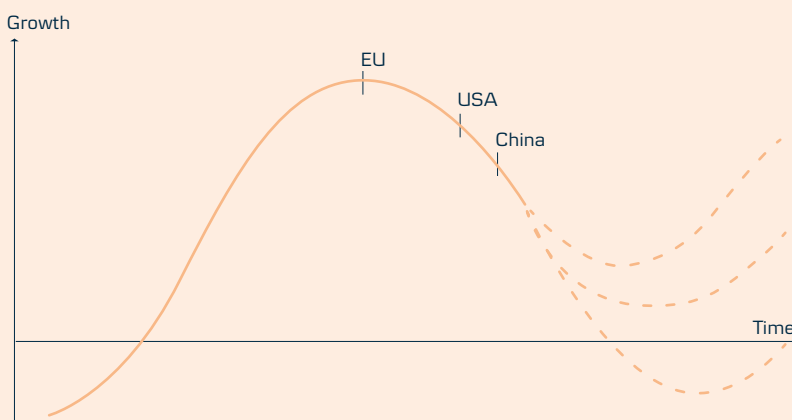
Expect a positive return in Europe
Turning to bond markets, we estimate the yield increases seen during Q1, in particular, were justified, although we had not anticipated them. A surprisingly strong US fiscal policy and the current high level of inflation mean that the US central bank can normalise monetary policy significantly earlier than we expected 3-6 months ago.

Nevertheless, we now assess US yields to be more or less fairly priced. We currently expect roughly two rate hikes from the Fed in 2023 followed by a further gradual normalisation of interest rates. The market is pricing in slightly more than we expect, so short rates and yields look marginally attractive, while long yields are roughly fair in our view. Our overall expectation is for a return of around 0 per cent in the coming 12 months across the US government yield curve.

The picture in Europe is somewhat different. Given the latest yield increases and our expectation of a very slow normalisation of monetary policy, we view the German yield curve as attractively priced. We therefore expect a decided fall in European yields over the next 12 months as growth slows in the autumn and it becomes clear that the ECB - in contrast to the Fed - is far from its inflation target. We therefore expect a positive return from core Euro area government bonds.

Macro barometer: USA and China have already peaked

CURRENT STATUS: There is greater potential for a further normalisation of the economy in Europe than in the US or China, whose post-corona economic recoveries are more advanced. This is one reason why we see the highest return potential in European equities in the coming 12 months.



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		
	SLOWDOWN	EXPANSION	
	<ul style="list-style-type: none"> • Interest rates both up and down • Equities rise modestly • Credit spreads both up and down 	<ul style="list-style-type: none"> • Interest rates rise • Equities rise sharply • Credit spreads tighten 	
Declining growth	RECESSION	RECOVERY	Increasing growth
	<ul style="list-style-type: none"> • Interest rates fall sharply • Equities fall sharply • Credit spreads widen 	<ul style="list-style-type: none"> • Interest rates fall • Equities rise sharply • Credit spreads tighten 	
	Negative growth		

Always remember your risk as an investor:

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Always speak to an advisor if you are considering making an investment based on this material to establish whether a particular investment suits your investment profile, including your risk appetite, investment horizon and ability to absorb a loss.

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