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Harr's View

Why markets are not disconnected from fundamentals

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Good evening all

Today, I discuss whether financial markets' performance during the COVID-19 crisis is in accordance with fundamentals and policy responses. Next Sunday, I plan to discuss forward-looking market measures, in combination with future macro and policy drivers to access expected return. Chart 1 shows that the S&P 500 is nearly back to its pre-crisis historical peak, in contrast with Eurozone stocks where banks remain the laggards. Norwegian stocks have underperformed Scandi markets with Danish stocks shining, while Scandinavian banks have outperformed their Eurozone peers. European credit has, after a solid run over the summer, recovered more than stocks, and Italian-German spreads are close to pre-crisis levels (Chart 2). Swedish mortgage bonds have almost fully recovered, whereas Danish flex bonds are lagging modestly. Real interest rates have collapsed in the US as well as in Norway, which is in contrast to Sweden (Chart 3). Oil prices have recovered, but only slightly more than 50%. The USD has weakened significantly, the EUR has rallied, while gold has reached a record high (Chart 4). The SEK is stronger than pre-crisis levels, while the NOK is weaker.

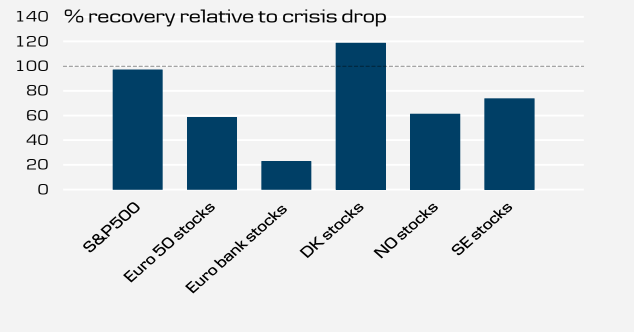
The financial markets' performance during a crisis depends on fundamentals, the policy response and confidence. I recall the framework, which I have previously introduced to analyse FX markets (see *here*). I find it useful to divide countries into two groups: the 'centre' and the 'periphery'. The US, China and the Eurozone belong to the centre and any other economy belongs to the 'periphery'. Changes in the centre's growth expectations, monetary conditions and investment trends drive growth, capital flows and financial market performance in the periphery economies, but not the other way around. The level of and changes of relative 1) growth, 2) real policy rates and 3) policies discriminate between periphery economies and markets. How can we use this framework to compare financial markets' performance in the COVID-19 crisis with previous global crises? A crisis is marked by defining moments such as the Fed's decision to buy US treasuries in March 2009 and Draghi's 'whatever it takes' in July 2012. In previous crises, equities and credit markets weakened before the recession began, but recovered before the recession ended (see Chart 5). The USD strengthened and EUR/USD fell during the recessions, but the trends reversed late in the recession or at the early stage of recovery.

This time there was no pre-recession period as no one predicted the COVID-19 crisis. The Chinese economy was in free fall during late January-February and Europe/US in March-April. For markets, the game changer was in late March when the ECB's PEPP and the Fed's open-ended/unlimited QE, together with signs that COVID-19 was peaking (see *here*), supported confidence and eased global monetary conditions. This immediately spread to global and Nordic markets. The surprisingly strong EU response to the crisis further supported European markets. Equities, credit spreads and the USD turned in March, oil prices in April, while US 10Y yield may not have bottomed. The fall in the USD is in line with the dynamics in 2009 (see Chart 6), and the debasing of the greenback has triggered a gold rush, exactly as it did during 2009-2011. **Historically, it is not unusual that risky assets turned before data rebounded. However, what is unusual is the speed of the recovery in US equities. But this is also a very different crisis.** It is not a balance sheet crisis, nor triggered by policy tightening. The economic rebound has been extraordinarily fast due to the nature of the crisis and the massive policy stimulus. The US has recorded positive labour market growth during May-July after recording the largest layoffs on record in April, and the PMIs are firmly north of 50. This is a much faster rebound than during previous crises.

Theoretically and empirically, rising expected future growth rates will lead to stronger equities and tighter credit spreads today. Consensus forecasts of 2021 were revised sharply upwards during April/May, both in the large economies, and in the Nordics (See Chart 7). **The lack of an effect on US stocks of the second wave of the virus reflects that it has not influenced 2021 growth expectations** (of course, the massive Q2 earnings surprises have also helped). Current news flows on the second wave of the virus in the US and Europe should not impact equity and credit markets. Neither should current economic data. Instead, news regarding the prospects of a COVID-19 vaccine will be key to 2021 growth expectations, and thereby to equity and credit markets in the fall.

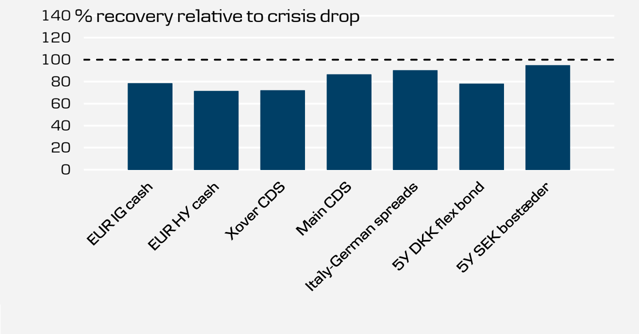
We have argued that the Nordic economies will outperform, as the countries did not close down production and construction. The latest data confirms this view (see Chart 8). The easing of global monetary conditions and the improvements in growth expectations have supported Nordic markets. However, the US-led global reflation has only helped the NOK to a limited extent as oil and gas prices are still much lower than pre-crisis levels. This has weighed on Norwegian stocks relative to Swedish stocks. **The underperformance of the NOK vs. the SEK during the crisis is influenced by the relative developments in real interest rates and stock markets in the two countries.** The Riksbank's forceful buying of Swedish mortgage bonds remains the key driver of the outperformance of bostäder. That is all for today's comment. On that note, I wish you a great Sunday night and coming week. Best regards Thomas

Chart 1: DK and US stocks have outperformed; NO stocks and in particular euro banks have underperformed



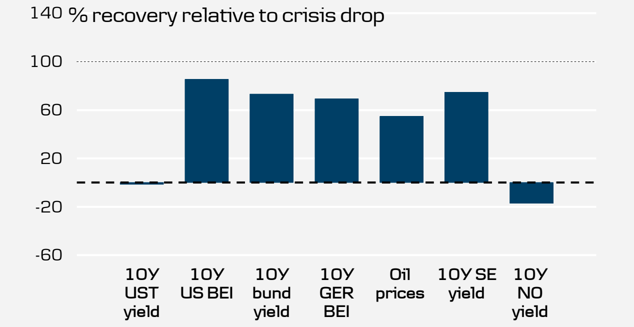
Note: Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index. Source: Bloomberg, Danske Bank

Chart 2: Bostäder and Italian bonds have outperformed*



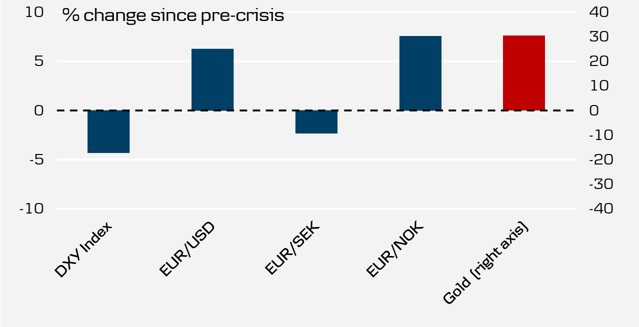
*Note: Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index. *5Y flex and 5Y bostäder ASW vs. 6M. Source: Bloomberg, Danske Bank*

Chart 3: Real yields have collapsed in the US and Norway, but not in Sweden*



*Note: Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index. *10Y UST and 10Y NO yield relatively to the lowest during the peak of the crisis, oil price relatively to 20 January, Source: Bloomberg, Danske Bank*

Chart 4: The USD has fallen sharply with the gold rush while NOK/SEK have weakened*



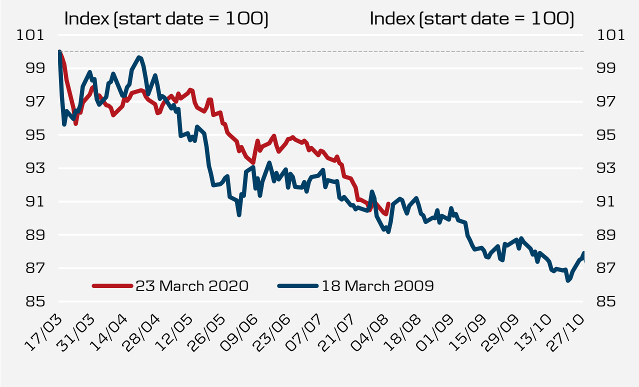
*Note: Past performance is not a reliable indicator of current or future results. *relatively to 20 January, Source: Bloomberg, Danske Bank*

Chart 5: Market reaction similar to previous recessions, but just much faster which is due to the nature of the crisis

	Dot-com Mar 01-Nov 01 (US)	GFC Dec 07-Jun 09 (US), Apr 08-Apr 09 (Euro)	Euro debt Oct 11-Jan 13 (euro)	Covid-19 Feb 2020-
S&P 500	Sep-01 (new low again in Oct-02)**	mar-09		mar-20
10Y UST	nov-01	dec-08		?
Oil	nov-01	dec-08		apr-20
USD	jan-02	mar-09		mar-20
US ISM	nov-01	jan-09		maj-20
NFP	nov-01	apr-09		maj-20
Fed		mar-09		mar-20
Euro stocks		mar-09	sep-11	mar-20
Euro HY, IG		mar-09	Oct-11	mar-20
10Y bund yield		jan-09	May-13 (repeated lows thereafter)	mar-20
EUR/USD		nov-08	July-12	mar-20
OECD leading, euro		mar-09	dec-12	apr-20
ECB			jul-12	mar-20
China cycle		dec-08		mar-20
China policy		nov-08		

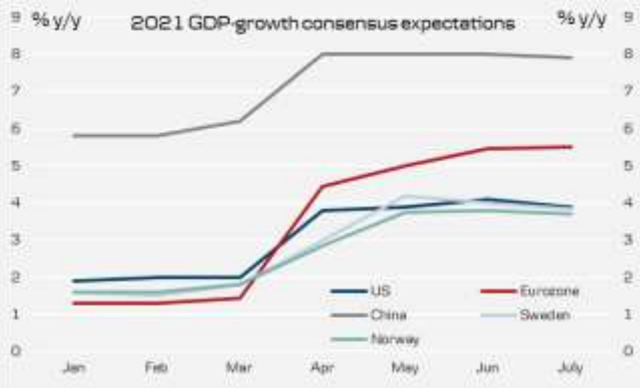
*Note: Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index. *NBER US recessions, CEPR Euro recession, Source: Bloomberg, Danske Bank*

Chart 6: The USD has weakened in line with 2009 fuelled by Fed's QE policies



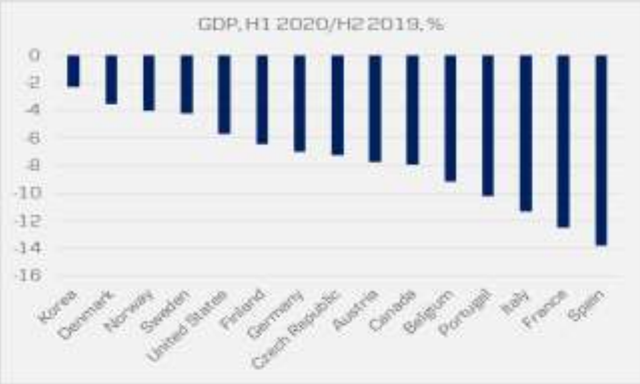
Note: Past performance is not a reliable indicator of current or future results. Source: Bloomberg

Chart 7: Growth expectations were revised up during April-May, and they have not been revised down again



Source: Bloomberg, Danske Bank

Chart 8: The Nordics are among the world's best so far*



**Note: Includes all OECD countries that have published Q2 data, plus the Nordics. Danske Bank estimates used for Q2 in the Nordics Source: Bloomberg, Danske Bank*

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