16 August 2020

Harr's View

Vaccine and the Fed to drive risk premiums and returns

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Good evening all

Today, I discuss forward-looking market measures, in combination with future macro and policy drivers, to access expected return across financial markets. This week, the reflation theme broadened with nominal government bond yields and swap rates rising, while curves steepened. July inflation data surprised on the upside in Scandinavia and the US partly due to supply-driven factors (see *here* and *here*). The NOK outperformed, supported by higher domestic interest rates and equities, while global growth data in general surprised to the upside. Last Sunday, I argued that there is no disconnect between markets and fundamentals, but is the recent financial performance as good as it gets, and how do future risks compare with current market pricing and thereby expected return?

To access future expected return, I first analyse forward-looking ex-ante risk premiums. To measure the equity risk premium, I look at the spread between equity markets forward-looking E/P and 10Y government bond yields (see Chart 1). We may think of this measure as a relative value indicator between equities and government bonds. In my view, the equity premium exists because investors are structurally long non-diversifiable equity risk. US equities have cheapened versus government bonds compared to pre-COVID-19, which reflects the sharp drop in US yields. This is in contrast to Germany. **Equity risk premiums are now below the average over the last 10 years, but above the average since the late 1980s. Hence, based on this simple measure, equities do not look expensive.**

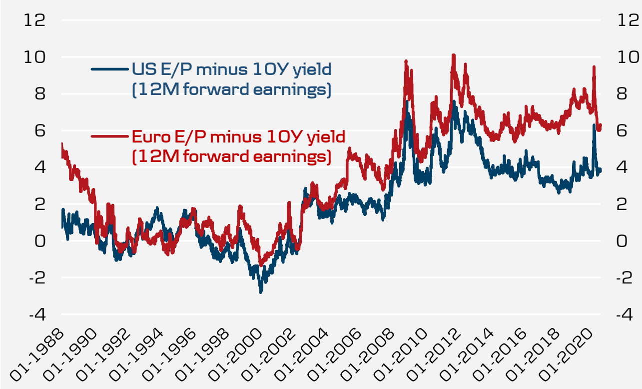
To analyse the bond risk premium, I look at the term premium (see Chart 2). Since GFC, there has been a very close link between term premium and curve steepness, particularly in Germany as the ECB anchors the short end, while realized and expected inflation is the key macro driver of term premiums. In recent years, term premiums have turned negative in the US and Germany. They have risen in the US during the crisis, while they have been flat in Germany. To provide an indication of the credit risk premium, I calculate the implied probability of default from Europe HY CDS (see Chart 3). S&P forecasts an 8.5% default rate for speculative-grade European bonds, which is not directly comparable to the 4.3% implied default rate I have calculated. However, S&P has argued that spreads do not adequately price risk (see *here*). To measure FX risk premiums, I use the 25-delta risk reversal (see Chart 4). **Interestingly, based on option pricing, the SEK is not cheap any longer against the USD, which is in contrast to mid-May (see *here*).**

What are then the global macro drivers and policies, which together with the current risk premiums will drive expected returns in the fall? I will rank a) COVID-19 vaccine, b) Fed policy, c) US-China tensions and d) US election. Last Sunday, I argued that the prospects for a COVID-19 vaccine will be key to 2021 growth expectations, and thereby to equity and credit markets in the fall. Medical experts predict that we will have a COVID-19 vaccine next year, but it is uncertain how effective it will be, and for how long a time it will create immunity. Countries are likely to continue to take precautionary health measures in 2021, while the bar for new broad lockdowns are high. The strong rally in European credit since the crisis peak reflects the extraordinary policy measures, and expectations of a sharp economic recovery next year. **There is enormous uncertainty about next year's growth with risks skewed slightly to the downside. Given how depressed credit risk premiums have become, I believe European credit will now tread water.**

We believe the Fed in September will introduce some kind of average inflation targeting. I believe it will be explicit in its forward guidance and allowing inflation to overshoot linked to its long-run policy framework review. I expect we will learn more from the July FOMC minutes on Wednesday. **If we are right, and the Fed is successful in convincing the market it is serious about targeting higher inflation, the US curve may steepen further, and the term premium turn less negative.** I see more room for the US curve to steepen than in the Eurozone where the ECB would surely step in if rates were to increase. However, our view on the Fed is consensus, and there is room for disappointment with broad-based implications for US real and nominal rates and the USD.

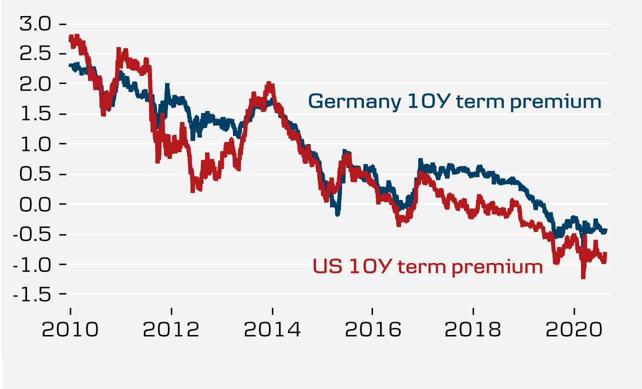
The cold war between the US and China is turning from bad to worse (see *here*). For financial markets, the tensions may not have a big impact unless we see serious disruptions in terms of trade wars or material escalation in the conflicts around the South China Sea and Taiwan. The survival of the phase one trade deal will be the most important factor in the short term. No matter who wins the US election, they will be tough on China. From an economic and market point of view, the focus in the election would be on the implications for fiscal policy, which would depend both on the president, but also the composition of Congress. A Biden win together with a Democratic-dominant Congress may be the fiscally most expansionary outcome, while a Trump win with a Democratic House may end up being the least expansionary. On a final note, I will be live on CNBC on Tuesday at 10am CEST discussing some of these topics. 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: Equities are not looking expensive relatively to government bonds



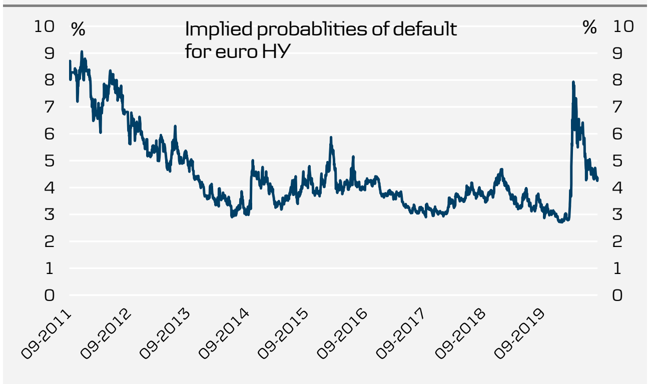
Note: Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index. *Using MSCIs and 10Y Germany government bond yield for euro.
Source: Bloomberg, Danske Bank

Chart 2: Term premiums are particularly negative in the US – room for the curve to steepen



Note: Past performance is not a reliable indicator of current or future results. Method used by Adrian et. Al. in 'Pricing the term structure with linear regressions'. Source: Bloomberg, Danske Bank

Chart 3: The market is now pricing low probabilities of default



*Note: Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index. *Estimated from Markit iTraxx Europe Crossover index. Assuming a flat default rate over the lifetime of the index and a fixed recovery rate of 30%. Source: Bloomberg, Danske Bank*

Chart 4: The SEK is not cheap against the USD any longer

3M 25D absolute risk reversal implied FX risk premiums vs EUR. Percentile of latest

... Own history			... Across currencies	
PLN	15		JPY	6
HUF	45		CHF	18
RUB	55		TWD	34
TWD	56	Expensive	SGD	39
SEK	57		SEK	40
ZAR	58		USD	45
GBP	68		PLN	52
JPY	68		GBP	56
KRW	71		CAD	59
NZD	76		CNH	61
AUD	76		INR	61
NOK	80		CZK	62
INR	81		HUF	63
CNH	85		NOK	64
BRL	86		NZD	64
CAD	88		AUD	67
SGD	90	Cheap	KRW	72
MXN	90		IDR	89
CZK	92		ZAR	89
IDR	95		RUB	93
TRY	97		BRL	95
CHF	100		MXN	95
USD	100		TRY	100

Note: Past performance is not a reliable indicator of current or future results. 25D absolute risk reversal implied FX premiums versus EUR. Percentile of latest observation with 5Y history versus.... Note that a value of 50 is the median in the 5Y history. Source: Bloomberg, Danske Bank

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Report completed: 16 August 2020, 19:10 CEST

Report first disseminated: 16 August 2020, 20:00 CEST