12 January 2018

Strategy

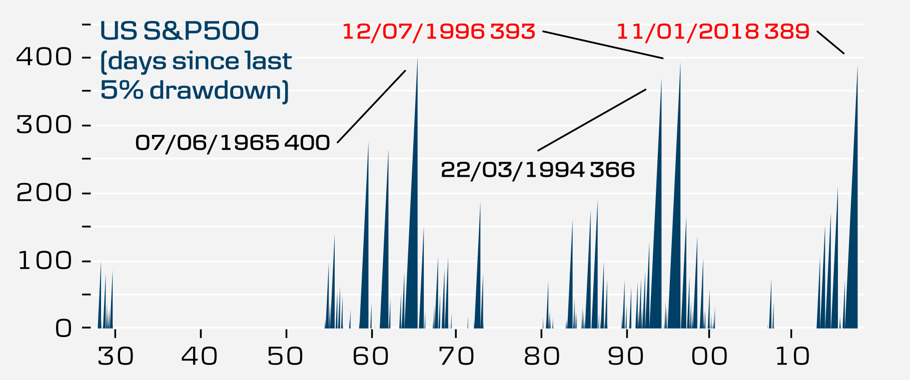
Strong start to 2018 amid increasing US-China tensions

Strong start to 2018 for equities

This year has started very strongly, as S&P 500 has risen 3.5% YTD. It is now 389 days since we had a 5% drawdown, which is close to the record from the 1990s of 393 days. **One reason is that economic data remain very strong**, not least in the euro area. Economic confidence in the euro area has been higher only in 2000 during the IT bubble, industrial production rose 1% in November and the unemployment rate has fallen to 8.7% (the lowest since the crisis). The combination of high consumer and business confidence in both the US and Europe means growth is likely to be more balanced between private consumption and business investments than in the past two to three years. **While we think the acceleration phase is over, we expect global growth to stabilise at a strong level, supporting our view that equity markets should do well in 2018 too.** In our view, the main downside risk is China due to a combination of credit tightening, renewed reform push and anti-pollution measures.

Despite the strong economic cycle, the missing link is still inflation, which we expect – as in recent years – to remain an important topic this year. Based on meeting minutes from both the ECB and Federal Reserve, the persistent low inflation is the biggest puzzle for central banks right now. Normal economic wisdom says inflation should move higher as the output gap closes but inflation remains low globally. Last week new data showed that euro area HICP inflation was lower than expected in December and wage growth remains modest in the US. With Brent oil trading just below USD70/bl, the reflation theme is slowly returning to markets and inflation expectations have risen in both Europe and the US. One reason for the higher inflation expectations is that central banks have been determined to stay on course and not turned too hawkish despite their inner eagerness to tighten monetary policy at this point in the cycle. **While the higher oil price puts upward pressure on overall inflation in the short term, we believe core inflation is likely to remain subdued in both the US and Europe**, as wage growth remains modest and inflation expectations, despite increases, remain below average.

Equities have had a good start to 2018 – it has been a while since we have had a large market correction

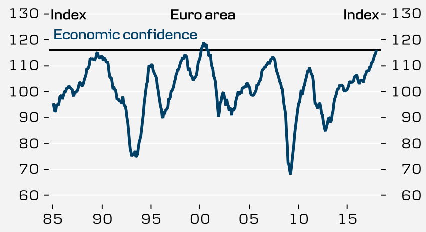


Source: Macrobond Financial

Today's key points

- We are still positive on equities, as global growth remains solid, although the acceleration phase is likely to be over soon.
- Inflation remains one of the most important topics this year. Despite higher oil prices, we expect core inflation to remain subdued.
- In our view, markets have priced the ECB too aggressively, as we expect the first ECB hike in Q2 19.
- Increasing tension between the US and China is a cause for concern.

Extremely high optimism in Europe



Source: DG ECFIN, Macrobond Financial

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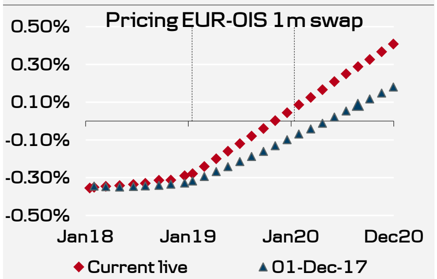
Markets have priced the ECB too aggressively – too early for EUR/USD to make the next level shift higher

Due to the strong economic data, the return of the reflation theme and a couple of hawkish comments from the ECB, we have seen a repricing of the front end of the EUR curve since December. Markets now price in the first 10bp ECB hike in early 2019 and are pricing in that the deposit rate will reach zero by the end of 2019. This is more aggressive than our own ECB forecast and we strongly doubt the ECB will be able to hike according to expectations. We expect the first ECB hike in Q2 19. Although the QE programme officially runs until September, the ECB has communicated that it does not want to make a sudden stop and we believe we are likely to see some sort of tapering in Q4 18. As the ECB forward guidance says rates will stay at present levels 'well past' the QE horizon, it simply seems to us too early for the ECB to hike in Q1 19.

We continue to expect a modestly steeper EUR yield curve for the 2Y10Y in 2018. The ECB maintains a tight grip on the short end of the curve. However, this is not the case for the 10Y segment of the curve, which we expect US yields and a smaller QE programme to push higher.

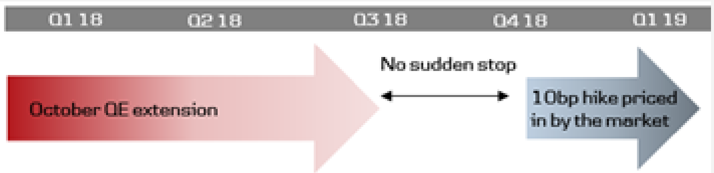
At the time of writing, EUR/USD is trading above 1.21, pushed up not only by hawkish ECB comments but also by the progress in the German coalition talks. **However, we do not buy into the 'reflation' story and hence still deem it too early for EUR/USD to make the next level shift higher.** For this to happen in Q1 would require a cyclical outperformance of the eurozone versus the US and/or upside wage/inflation surprises with neither being our base case.

First 10bp ECB hike priced for early 2019



Source: Danske Bank

ECB is priced too aggressively due to sequencing and 'well past'



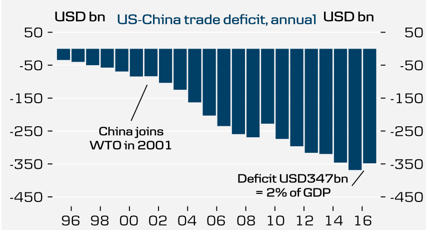
Source: Danske Bank illustration

US-China relations on a concerning path

With a strong economic cycle, high optimism, low yields, strong earnings and subdued inflation, it is natural to question what could possibly go wrong. While there are not many risk factors out there (in our view, even the Italian election has become less important, as anti-establishment parties such as the Five Star Movement have said they do not want to pull Italy out of the euro), there are still a few. We have been reminded of one this week, as US President Donald Trump seems to have shifted his focus to trade since his success in passing the tax reform. Trump wants to satisfy his voter base ahead of the mid-term elections by implementing protectionist measures against China (and possibly pulling out of NAFTA if negotiations turn out unsuccessfully) despite the push back from establishment and business organisations.

On Wednesday, there was a story suggesting China was considering reducing its purchases of US Treasuries quoting unnamed Chinese officials. The Chinese government denied the story the following day. While it is hard to say whether it was just a big mistake, we think China deliberately planted the story as a friendly reminder to the US that China will retaliate if Trump implements protectionist measures against China. China owns 10% of US marketable debt and 10Y US yields rose close to 5bp on the news. For more, see *Flash Comment – US-China relations on a concerning path – part 2*, 11 January.

Donald Trump wants to reduce US trade deficit with China



Source: Census Bureau, Macrobond Financial

Financial views

Asset class	Main factors
Equities	
Positive on 3-12 month horizon.	Strong business cycle and near double digit earnings growth in most major regions. Low rates and bond yields drive demand for risk assets.
Bond market	
German/Scandi yields – set to stay in recent range for now, higher on 12M horizon	Inflation set to stay subdued despite decent growth. Stronger euro keeps euro inflation outlook down. ECB to normalise gradually only, due to lack of wage pressure and stronger euro. ECB on hold for a long time.
EU curve – 2Y10Y set to steepen when long yields rise again. Flattening of US 2Y10Y curve to continue	The ECB keeps a tight leash on the short end of the curve. With 10Y yields stable, the curve should change little on a 3-6M horizon. Risk is skewed towards a steeper curve but that is a 6M to 12M forecast.
US-euro spread - set to widen marginally	The Fed's QT programme (balance sheet reduction) is set to happen at a very gradual pace and the effect on the Treasury market should be benign. Yet, market pricing for Fed hikes is still dovish for 2019 and yields should edge higher on a 12M horizon.
Peripheral spreads – tightening but still some factors to watch	We expect economic recovery, ECB stimuli, better fundamentals, particularly in Portugal and Spain, an improved political picture and rating upgrades to lead to further tightening despite the recent strong moves. Italy is the big risk factor but it is very expensive to be short Italian bonds.
FX	
EUR/USD – rangebound near term but upside risks in 2018	EUR/USD not yet ready to make the next level shift higher, but cross moving firmly into mid-1.20s on valuation and debt-flow reversal in H2.
EUR/GBP – in range near term but GBP to strengthen eventuall	We still see EUR/GBP within 0.8650-0.90 in coming months as the Brexit risk premium is likely to persist near term. Longer term, GBP should strengthen.
USD/JPY – gradually higher longer term but challenged near te	Focus on BoJ's quiet tapering and personnel changes to weigh on USD/JPY near term. Still supported by global recovery, suppressed risk premiums and Fed-BoJ divergence longer term.
EUR/SEK – risk to the topside on housing market, RB pricing	Housing market risk premium to keep SEK under pressure alongside too aggressive Riksbank market pricing. Eventually lower but not a H1 story.
EUR/NOK – set to move lower	NOK headwinds towards year fading - we expect the NOK to rebound on valuation, growth and real-rate differentials.
Commodities	
Oil price – temporary support from freezing weather in US	June review weakens impact of extension of OPEC+ output cuts. Geopolitical tensions around Saudi Arabia and Iran looming. Weaker USD.

Source: Danske Bank views

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This research report has been prepared by Danske Bank A/S ('Danske Bank'). The author of this research report is Mikael Olai Milhøj, Senior Analyst.

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Ad hoc.

Date of first publication

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