21 April 2017

Strategy

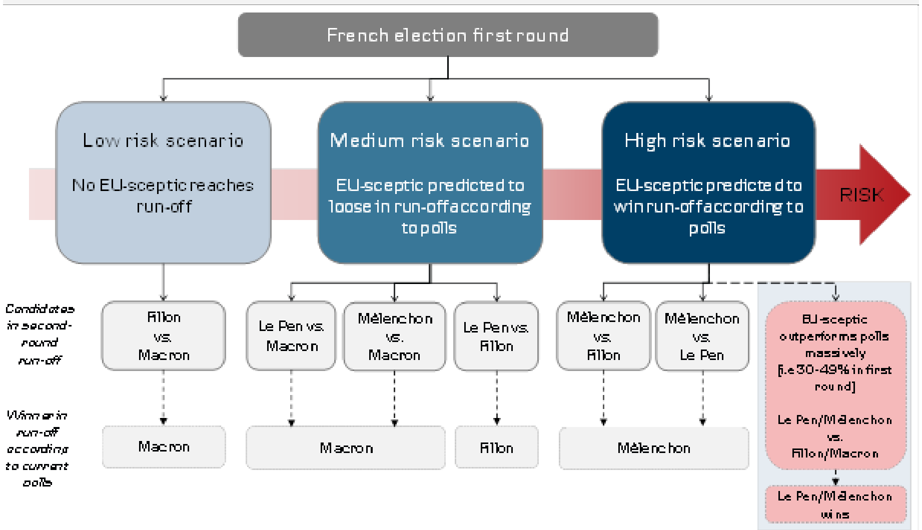
Winds of political change blowing over Europe

This week is dominated by political headlines in Europe. The first round of the French presidential election is upon us on Sunday. It has been awaited (or feared) for months, or basically since last year's surprise Brexit outcome and Donald Trump's victory, which served as a reminder that populist movements are taking hold in western politics. Also, as if the political calendar was not crowded enough already, UK Prime Minister Theresa May has called a general election for 8 June. In the midst of this frantic European political calendar, economic data releases and central bank views are almost taking a backseat to political events. Hence, the title of our *FX Forecast Update* this week: *Political risks are in charge*. However, before turning to the likely outcome and market implications of these key political events, it is worth taking a look at our latest take on the global business cycle.

Our global business cycle model points to weakening growth momentum ahead

Our leading macroeconomic model MacroScope this week pointed to further weakening momentum in the global business cycle in the period ahead. The model paints a picture of the underlying macro environment on a three- to six-months horizon. While the underlying macro environment is getting more bullish, the market has already rallied and is in neutral to slightly overbought territory now. This points to a rising risk that we are moving into a scenario that tends to entail more frequent corrections in risk markets. In other words, the sensitivity to external shocks such as perceived adverse political events will increase.

From low to high risks in the French presidential election

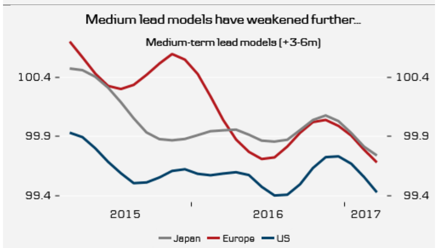


Source: Danske Bank Markets

Key points

- Elections in Europe come against the backdrop of the global business cycle looking to lose momentum.
- First round of French presidential elections too close to call.
- Relief rally expected if mainstream candidates go to second round.
- A run-off between Marine Le Pen and Jean-Luc Mélenchon cannot be precluded and could set off a major market correction.
- The UK election is likely to strengthen Theresa May's hand in the upcoming Brexit negotiations.

Business cycle signal continues to weaken across regions



Source: Danske Bank Markets

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Stakes are high and outcomes unpredictable ahead of first round of the French presidential election

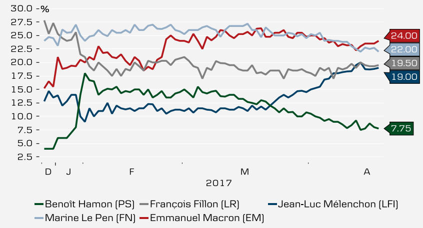
Although Macron seems set to be the likely winner of the French presidential elections, none of the leading four candidates can be written off at this time. The race between the four leading candidates Marine Le Pen, Emmanuel Macron, François Fillon and Jean-Luc Mélenchon has narrowed over the past month and the outcome is likely to be tight (see *French Election Monitor No. 3: Markets hold their breath as first election round draws near*, 21 April). Also, the terror event in Paris last night may swing some voters towards Le Pen. Recent weeks have seen a surge in the polls of the far left-wing candidate after a strong performance in the TV debates. Although a run-off on 7 May between Le Pen and Macron still seems to be the most likely outcome according to the polls, the other two major candidates cannot be written off, especially as almost a quarter of the voters are still undecided and the turnout is expected to be low due to widespread dissatisfaction with the established political class. Also, as we know from last year's elections, some caution should be taken with regard to polls.

The different election outcomes could have widespread implications for France and the EU more generally. Both Mélenchon and Le Pen share a similar EU-sceptic and anti-globalisation stance. Mélenchon wishes to renegotiate EU treaties and hold a subsequent EU referendum on the result as well as ending the independence of the ECB. Both candidates support expansionary fiscal policies with little regard to the EU deficit rules. They also liken a 'France-first' to public procurement and investment policies. On the other hand, a victory by Fillon and to some extent Macron would be likely to be followed by a reform drive in the French economy and the EU more generally.

We have divided the range of possible outcomes into three scenarios: a 'low-risk' scenario entailing no EU-sceptic candidates making it to the second round; a 'medium-term' risk scenario where an EU-sceptic candidate makes it to the second round but an established candidate looks likely to be the winner; and a 'high-risk' scenario, where Le Pen and Mélenchon face each other in the second round or if one of them receives much stronger than expected support in the first round (30-49% of the votes), increasing the chances that they will beat either Macron or Fillon in the second round.

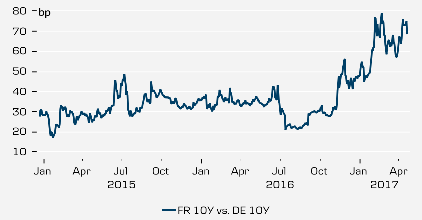
What is the initial market reaction following the first round likely to be? In the 'low-risk' scenario, we will probably see a relief rally, sending equities and the EUR up, while fixed income markets would be likely to see some sell-off. In the 'medium-risk' scenario, we expect the market reaction to be fairly modest, as markets are most likely positioned for this already. However, in the high-risk scenario, we may easily see a sharp equity market sell-off given possible ramifications for the French economy and the EU as well as the euro. We think there will be a sell-off in French government bonds. We see the EUR/USD falling to the lower part of the current range of 1.04-1.10 in this scenario.

First round proving a four-horse race



Source: Macrobond Financial

Fixed income markets certainly pointing to a risk of a 'French accident'



Source: Macrobond Financial

Possible market implications of the first round of the French elections

	Equities Stoxx 500 (% change)	FX EUR/USD level	Fixed income French 10-year yield (bps)	German 10-year yield (bps)
Current level	3436	1.0750	0.96%	0.23%
High risk	-10%	-3 big figs	+10bp	-5bp
Medium risk	2%	unchanged	+0-5bp	Unchanged
Low risk	2%	+1 big fig	-10bp	+5bp

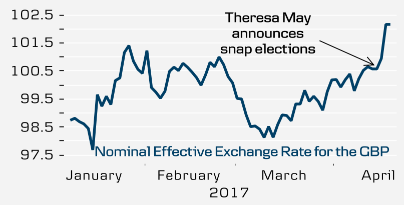
High risk scenario: EU-sceptic candidate predicted to win run-off according to
Medium-term risk scenario: EU-sceptic candidate predicted to loose in run-off according to polls
Low-risk scenario: No EU-sceptic candidate make it to the second round

Source: Danske Bank Markets

UK election likely to strengthen Theresa May's hand in the upcoming Brexit negotiations

The surprise of the week was the decision by UK Prime Minister Theresa May to call snap elections scheduled for 8 June. This move is no doubt an attempt to strengthen her powers both within and outside the conservative party, as the polls point to a solid victory for the Conservative Party. Such a victory, increasing the party's majority in parliament beyond the current 330 seats (326 seats required for majority), would make her less vulnerable during the upcoming Brexit negotiations to the threat from fractions within the Conservative Party that either want a tougher line in the Brexit negotiations (e.g. like UKIP) or seeking to soften terms or even to reverse the Brexit decision. Such a scenario is by no means guaranteed, as the Conservative Party may fail to clinch as strong a victory as expected (leaving a status quo situation) or we could even see Labour, the Liberal Democrats and possibly the SNP forming some sort of a coalition that would allow them to reverse the Brexit decision. The market is clearly positioning for a weakening of the Brexit terms as the GBP has strengthened on the back of the news. Short term, the general election means there is one more uncertainty factor for the GBP, as the sample space for UK-EU relations has suddenly widened again, with a chance now that Brexit may be softened (or cancelled altogether should the May government be ousted). However, our base case remains that May will stay in power and negotiate a 'decent Brexit' (neither too hard nor too soft). This would mean a level shift higher for EUR/GBP post the June election. However, the probability of other outcomes has clearly risen

GBP has strengthened with the news of new elections



Source: Barclays Capital

Global market views

Asset class	Main factors
Equities	
Neutral positioning on stocks short and medium term	The reflation trade, which has been ongoing since August/September 2016, is coming to an end, with equities hovering around all-time highs established in early March, but having difficulty breaking out from there. For equities to move substantially higher, yields needs to rise, as bond markets have not yet brought the promise of a normalisation of growth and inflation. However, we do not think there is big correction ahead of us as growth data is still very upbeat. Moving forward, we think equity markets will trade largely in a range.
DM (UW), EM (OW)	
DM: US (UW), Euro Area (OW), Japan (N). EM: China/Asia (OW), LatAm (N), Russia/Eastern Europe (OW)	
Bond market	
German/Scandi yields – set to stay low for now, higher on a 12M horizon	For now, German yields are being kept low by political uncertainty, low inflation pressure and ECB purchases. The outlook for low core inflation and an apparent peak in the global manufacturing cycleto keep yields low in 2017.
EU curve – set to steepen 2Y10Y when long yields rise again	The ECB is set to keep a tight leash at the short end of the curve and with 10Y yields stable the curve should change litlle on a 3 to 6M horizon.
US-euro spread – stable	
Peripheral spreads – tightening but clear risk factors to watch	Economic recovery, QE and better fundamentals in especially Portugal and Spain point to further tightening, but politics (French presidential election), banking recapitalisation plans (Italy) and a fear of a new move higher in core eurozone yields (ECB tapering fears) remain clear risk factors. Periphery spreads often widen when core yields move higher.
FX	
EUR/USD – rangebound near term, higher in 6-12M	Political risks near term and could weigh on the pair but the cross should edge higher longer term as ECB looks to the exit.
EUR/GBP – higher post UK election, then rangebound for extended period	With May to stay in power GBP should weaken post the June election and stay rangebound (0.84-0.88) during Brexit negotiations.
USD/JPY – downside risks near term	Risks on the downside near term on geopolitics but USD/JPY set to edge higher driven by 10Y US rates longer term.
EUR/SEK – range near term, then gradually lower	Gradually lower on relative fundamentals and valuation in 2017 but near-term SEK potential limited by the Riksbank.
EUR/NOK – range near term, then gradually lower	Cross set to move lower on valuation and growth, real-rate differentials normalising but NOK vulnerable to global risk appetite.
Commodities	
Oil price – range bound	OPEC cuts almost fully implemented, extension in H2 is about priced in, geopolitical risks regaining focus
Metal prices – range bound	Underlying support from consolidation in mining industry, recovery in global manufacturing. Is the market losing patience with Trump?
Gold price – range bound	Tug of war between higher US rates and subdued risk sentiment. Geopolitical risks regaining focus
Agriculturals – rising again	Recent drop on lower oil only temporary.

Source: Danske Bank Markets

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Expected updates

None.

Date of first publication

See the front page of this research report for the date of first publication.

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