

Strategy

Political super cycle not over yet – next stop, Italy

Imminent ‘Italexit’ seems unlikely for now

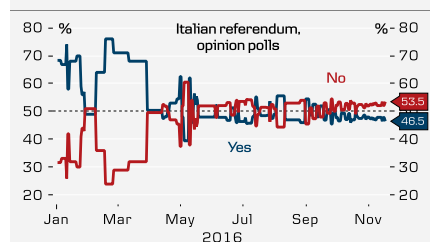
Although we are now past both the UK’s EU vote and the US presidential election, the political super cycle is certainly not over yet and elevated political uncertainty will continue to be a major market theme in the coming year. Next year we have many elections in Europe, most notably the Dutch general election before 15 March, the French presidential election in April/May and the German general election between 27 August and 22 October. Also, the two years of Brexit negotiations between the UK and the EU begin early next year, as the UK’s PM Theresa May has stated that the UK will trigger Article 50 by the end of March. In addition, President-elect Donald Trump’s inauguration is scheduled to take place on Friday 20 January 2017 and it is still very difficult to say what to expect of his presidency. However, before we come to all that, **focus is on Italy, as the Italians are set to vote on the constitutional reform proposed by Prime Minister Matteo Renzi on 4 December.**

If rejected, which seems likely if one dares to look at the opinion polls (be careful!), the referendum could throw Italy into new political disarray and increase uncertainty stemming from the rising euro scepticism across the euro area. Recently, PM Renzi has said that the government will fall if he loses the referendum, which increases the probability of an early election in Italy. If that is the case, the anti-establishment Five Star Movement may win, as the party is currently head-to-head with Renzi’s PD party. Still, **we think an imminent ‘Italexit’ seems unlikely for now** given that the support for the EU has increased in Italy after the Brexit vote and Five Star Movement no longer advocates as strongly for an exit.

Key points

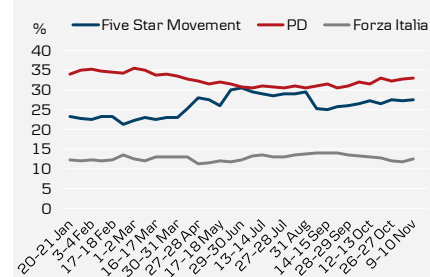
- Political super cycle is not over yet – elevated political uncertainty still a major market theme.
- We think an imminent ‘Italexit’ seems unlikely for now.
- Solid US data lends support to reflation case.
- Fed not expected to spoil the party – will only hike gradually

Referendum polls showing ‘no’ vote in the lead (undecided not included)



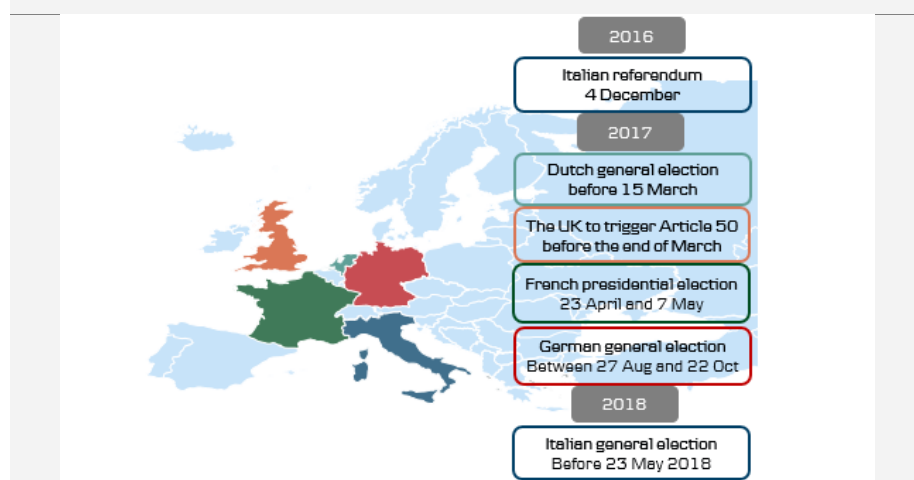
Source: Macrobond Financial, Danske Bank

Polls show Five Star Movement head-to-head with Renzi’s PD



Source: SWG, Danske Bank Markets

Elevated political uncertainty will continue to be a major market theme



Source: Danske Bank Markets

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While the economic impact is limited in the short-term, we think a ‘no’ vote is likely to imply fewer structural reforms in Italy and continued problems in terms of bringing the economy to a solid recovery. **A high political risk premium is already priced in the Italian government bond market**, with Italy having underperformed Spain by 30bp since early September, mainly on political woes. **For more on the Italian referendum see *Research Italy: No ‘Italexit’ in the case of a ‘No’ in the referendum*, 22 November.**

We view European politics as a negative for the EUR, with the Italian referendum and in particular the French election as the biggest risks. Our view is that rising European political risks in combination with the prospect of a more hawkish Fed and expectations of a ‘Homeland Investment Act (HIA) 2’ will drive EUR/USD lower in the coming months. **We expect EUR/USD to reach 1.04 in 3M** before the cross begins to move higher again to 1.12 in 12M, as we maintain our long-held view that the undervaluation of the EUR and the wide eurozone US current account differential are EUR positives, see also our latest *FX Forecast Update*, 16 November.

Solid US data lends support to reflation case

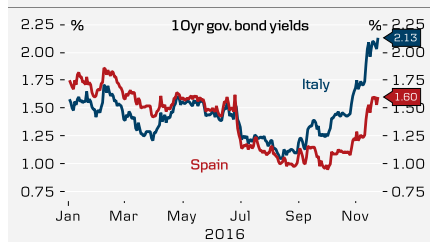
In our *Strategy piece* from last Friday, we discussed the case for reflation, what it means and what to watch. We stated that we see a case for reflation in the US but less so in the euro area. One of the points in our four-point checklist is that growth needs to move above trend to reduce excess capacity and push inflation up. **US growth rebounded in Q3 after a weak H1 16 and this week we got several economic indicators, which showed that the US has continued to grow at above trend pace in Q4.** First, the consumer confidence indicator from University of Michigan rose sharply in November driven by both higher current conditions and expectations suggesting that private consumption will continue to be a main growth engine in the US. Second, core capex shipments (a good indicator for business investments in equipment) seem to have bottomed out and new orders suggest shipments will soon begin to move higher. Third, Markit PMI manufacturing in November rose to the highest level since October last year, supporting our view that the global business cycle has turned. This is supported by our MacroScope models for October, which showed a synchronised recovery signal across regions.

As anticipated, it does not seem like either the US election or the Trump victory have affected the economy in the short-term (although, admittedly, we have only a few data points) and we expect the US economy to grow around 2% on average in the coming quarters. Donald Trump’s proposal of a more expansionary fiscal policy through tax cuts and more infrastructure spending, which we think will have the biggest impact on growth in 2018, is just adding to the reflation case. **We are still overweight US equities and underweight Emerging Markets equities.**

Fed not expected to spoil the party – will only hike gradually

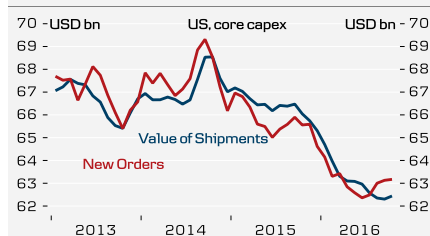
Another important point of the reflation story is that the Fed does not spoil the party before it gets started. We expect the Fed to tighten monetary policy only slowly despite the fact that the US output gap is already nearly closed. It is important to remember that the FOMC turns more dovish next year due to shifting voting rights. Many of the dovish members (including Fed Chair Yellen) have said that it may be a good idea to let the economy run a bit hot (with core inflation above the 2% target) to undo some of the structural damage to the economy caused by the financial crisis. **Besides a hike in December, we expect the Fed to hike twice both in 2017 and 2018, i.e. a total of five Fed hikes from now until year-end 2018.** Markets have repriced Fed significantly after the Trump victory and now expect a total of four hikes until year-end 2018. We expect US 10yr yields to reach 3% in 12M, see also *Yield Forecast Update*, 18 November.

Higher yield spread between Italy and Spain ahead of the Italian referendum



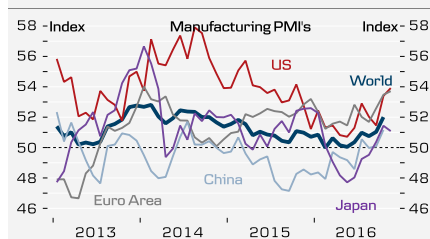
Source: Macrobond Finacial, Danske Bank

US core capex shipments seem to have bottomed out



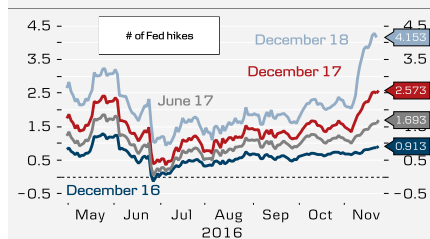
Source: Census Bureau

Global manufacturing PMIs have turned



Source: Markit Economics

Significant repricing of Fed since the election



Source: Bloomberg

Trump still a risk factor

That said, uncertainty is high, also for the US economy, as we do not know how Donald Trump will be as President. In Trump's first video update, he talked mostly about tougher immigration rules and withdrawing from free trade deals and did not mention economic policy at all. It could be an early warning sign that one should not get over-optimistic on how growth-friendly Trump actually is, as his expected measures on immigration and trade are likely to weigh on the long-run growth potential in the US. A smaller than expected stimulus package from Trump may lower the growth expectations for late 2017 and 2018. Still, it is worth repeating that the US business cycle going into 2017 has turned (which it would have regardless of the election result).

Global market views	
Asset class	Main factors
Equities Overweight stocks short and medium term Overweight US, underweight Europe and Nordics, underweight EM	Cyclical recovery. Fiscal boost to US will raise earnings relative to Europe. High risk of protectionism and tighter monetary policy hurting EM assets.
Bond market Hier yields, further steepening 2Y10Y curve US-euro spread: slightly wider in 2017 Peripheral spreads: tightening Credit spreads: neutral	More expansive fiscal policy in the US adds to steepening trend. Tapering, higher inflation prints and a global recovery also point towards a steeper curve. ECB QE should mitigate some of the effects. The Fed hike is moving closer, adding upside to the long end of the US curve. But ECB tapering and higher higher inflation prints are risks for the European bond markets, which could potentially tighten the US-Euro spread given that European yields are record low. Economic recovery and QE means further tightening. But politics and tapering remain clear risk factors. The ECB is keeping spreads contained.
FX EUR/USD - lower going into FOMC meeting in December EUR/GBP - lower short term on re-prising of Brexit risk premium after Trump USD/JPY - neutral with short-term risks skewed to the upside EUR/SEK - set to stay elevated in coming months before turning in 2017 EUR/NOK - short-term risks skewed to the upside	USD to remain supported by Trump and Fed in the near term. Higher in 2017. Expect EUR/GBP to settle in the 0.83-0.88 range near term. Risk skewed to the upside over the medium term due to Brexit. USD/JPY to remain supported near term by relative monetary policy and risk appetite. Gradually lower on relative fundamentals and valuation in 2017. Near term the SEK will remain weak mainly due to the Riksbank. At YE, liquidity set to prove a headwind for NOK. Cross to move lower next year on valuation and real rate differentials normalising.
Commodities Oil price – uncertainty about details of OPEC deal Metal prices – rallying on outlook for US infrastructure spending Gold price – change in risk sentiment negative for gold price Agriculturals – strong output has sent prices down again	Support from positive sentiment; market doubting OPEC deal and rising USD weighing on oil price. Underlying support from consolidation in mining industry and recovery in global manufacturing. Rising yields and USD pushing gold price down. Attention has turned to La Niña weather risks in H2 16, large stocks limit upside risk to prices.

Source: Danske Bank

Disclosures

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Expected updates

None.

Date of first publication

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