

Danske Daily

Trade conflict escalates further over the weekend

Market movers today

- Today, we get final service PMIs (including the ISM non-manufacturing index from the US), which will tell us to what extent the manufacturing slowdown is spilling over to the more important service sector (at least in terms of overall GDP growth and jobs growth).
- Also today, we get Sentix Investor Confidence for the euro area, which is probably not going to show more encouraging signs.
- Otherwise, this week we are looking forward to hearing from FOMC members for any signs of whether more cuts are in cards.
- Also, we are looking for any news on trade policy after Trump's escalation last week. To us, it seems like a trade deal has moved further away, see *China Weekly Letter*.

Selected market news

The decision on Thursday night by President Trump to levy new tariffs on Chinese imports was not received well in financial markets. Especially, the global growth and China-sensitive German Dax index came under strong pressure, closing down more than 3% on the day and overnight the Nikkei was down by close to 2.5%.

Risk-averse investors flocked to fixed income and 10Y Bund yields were pushed below -0.5% during Friday's session. In fact, the whole German sovereign curve from zero to 30-year traded below zero for the first time ever, joining Denmark and Switzerland. There are now 12 countries in Europe for which the 10Y benchmark is trading below zero. Ireland could very well be next in line as investors look for markets that offer positive yields. In the US, more than a full 25bp cut is again priced for next month and the US curve has further inverted overnight, as 10Y yields are down 7.0 bp to 1.78%. Hence, we should see another significant drop in European yields when FI markets open this morning.

If anyone believed that China would ‘give in’, the answer came overnight, as the Chinese government asked its state-owned enterprises to halt imports of US agricultural products. Furthermore, the yuan made a spectacular 1.5% drop this morning, pushing USD/CNY above 7.0 for the first time in a decade. According to Bloomberg, the People’s Bank of China said the move was due to “protectionism”. Overall, the trade situation has clearly escalated further over the weekend.

The escalation could potentially be a more fundamental game changer for risk appetite. If Trump thought that financial markets would be ready to ‘accept’ a trade escalation just because the Fed is lowering rates, he could very well be wrong, especially when markets take into account the simultaneously global weakening of the manufacturing cycle.

Global central banks turned more dovish in July due to the trade war concerns. After the latest development, we believe there is little doubt they will now deliver more easing. Note in that respect that USD/JPY dropped below 106 and 10Y JGB yields dropped slightly below the -0.20% lower bound yield target this morning.

Selected reading from Danske Bank

FOMC preview: Starting by cutting 25bp

Brexit Monitor: There is always a but

Vacation Wrap-Up: Market themes over the past three weeks

FX Strategy: Cyclical FX risk remains underpriced among G10

ECB Review: The Grande Finale is scheduled for 12 September

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The Bank of Japan and Ministry of Finance will meet this morning to discuss financial markets. In the wake of the CNY drop, markets will be wondering whether Japan will intervene in FX market and ease monetary policy further.

Scandi markets

In Norway, Real Estate Norway releases July house prices. Generally, the housing market has kept up well in 2019, beating most projections, as the rise in household disposable income has more than countered the negative impact on the market from rising supply, lower population growth, lower migration and higher policy rates. Today's release is unlikely to alter that picture, with OBOS house price data last week showing a national seasonally adjusted monthly rise of 0.7%.

Fixed income markets

In our *Government Bonds Weekly*, which we published on Friday, we argue that there is more curve flattening ahead of us. The hunt for carry, or rather struggle to avoid negative yields, will continue unabated, when we are in a situation where risk markets are under pressure, global central bank are easing and global growth momentum is weakening. We see room in particular for further flattening of the 10s30s curve in EGB markets. The hunt for yield is still the dominant driver for the periphery despite a weakening Eurozone economy. Hence, we still recommend to overweight Spain and Portugal. In semi-core, we prefer Finland and Ireland. That said, periphery might underperform this morning due to the significant weakening of risk appetite seen over the weekend.

Another important driver for periphery is the rating cycle. We expect a positive rating event for Portugal on Friday when Moody's has the country up for review. Fitch will keep the rating/outlook unchanged for Italy. Read more in Government Bonds Weekly.

In the Danish mortgage market, the price of the 1.0% 30Y on-the-run callable mortgage bond is rapidly approaching 100 amid record high prepayments. Hence, on Friday, Realkredit Danmark opened the 0.5% 30Y callable mortgage bond. Currently, we estimate that the 0.5% 30Y callable will be trading at a price around 95. We expect issuance to be low with a price around 95 as the 1% 30Y (interest only) callable bond is open for issuance and is trading close to 100.

Today, we will get the final prepayment numbers for the October term. We still expect prepayments well above DKK160bn on the back of the solid increase in the price of the 1% 30Y callable bond. This would be a record high prepayment, beating the previous record from 2005. Despite the solid daily issuance in the 1% 30Y callables, they have performed well against both govts and swaps given that investors (both foreign and domestic) are scrambling for carry/yield. Even though the 1% callables are approaching 100, we would still buy them. There is still substantial carry relative to Danish government bonds and swaps.

FX markets

In the immediate aftermath of the FOMC meeting last week, we argued that the near-term outlook of low vols/attractive USD carry-to-risk favoured USD longs going into August as long as we did not get (1) significant short-term deterioration in US data, (2) a complete breakdown in US-China trade talks and/or (3) a hefty equity sell-off. From that perspective, Trump's surprise reescalation of the trade war on Thursday has raised the risk of (2), which indeed has driven a setback in the USD with EUR/USD back at 1.11. However, the potential for (3) remains limited by markets pricing in Fed easing on the higher risk of (2), which limits the near-term EUR/USD upside potential in our view, as carry-to-risk still

heavily favours the USD. In today's session we will get more clarity on (1) but we expect the US service sector to remain healthy, which on a lack of other news could drive a slightly stronger greenback in today's session.

The more persistent USD strength also marks a headwind for commodity currencies in AUD, NZD, CAD, NOK and high beta currencies like the SEK that tend to suffer in a strengthening dollar/risk-off environment. The latest sessions have been particularly troublesome for the NOK, with both the global environment weighing on the currency and domestic releases falling short of expectations. Momentum in Norwegian data has eased over the past month, but what makes it tricky is the summer period, when we know the data quality tends to worsen. In other words, the forthcoming August releases have become very important. For now, we still expect Norges Bank to signal a September hike at the 15 August meeting. However, for FX, the global environment remains a more dominant driver, leaving us sidelined in the NOK for now.

Key figures and events

Monday, August 5, 2019			Period	Danske Bank	Consensus	Previous
2:30	JPY	Markit PMI services, final	Index	Jul		52.3
3:45	CNY	Caixin PMI service	Index	Jul	52.0	52.0
8:30	SEK	PMI services	Index	Jul		49.9
9:15	ESP	PMI services	Index	Jul	53.5	53.6
9:45	ITL	PMI services	Index	Jul	50.6	50.5
9:50	FRF	PMI services, final	Index	Jul	52.2	52.2
9:55	DEM	PMI services, final	Index	Jul	55.4	55.4
10:00	EUR	PMI composite, final	Index	Jul	51.5	51.5
10:00	EUR	PMI services, final	Index	Jul	53.3	53.3
10:30	EUR	Sentix Investor Confidence	Index	Aug	-6.9	-5.8
10:30	GBP	PMI services	Index	Jul	50.2	50.2
15:45	USD	Markit PMI service, final	Index	Jul		52.2
16:00	USD	ISM non-manufacturing	Index	Jul	55.5	55.1

Source: Bloomberg, Danske Bank

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