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Harr's View

The Fed-ECB divergence and what it means for markets

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Good evening all

Today, I discuss whether financial markets have gone too far in terms of pricing in the global slowdown. What are the scenarios that could rationalise current market pricing? I expect the global economy to weaken modestly in coming months following the escalation of the US-China trade war, *as I discussed a few weeks ago*. I only expect a modest global slowdown, as I do not foresee a significant tightening of US financial conditions. In recent weeks, the market raised its expectations of Fed rate cuts, currently pricing in around 65bp of cuts this year and a total of 100bp by the end of 2020. This week, the Fed clearly signalled it is ready to cut rates. Chair Powell said the Fed is closely monitoring the implications of trade negotiations and 'will act as appropriate to sustain the expansion with a strong labour market and inflation near our symmetric 2% objective'. After markets closed on Friday, Trump tweeted that tariffs to be implemented on Monday against Mexico are 'indefinitely suspended'. This is important for the US economy, as Mexico is the second-largest source of US goods imports, after only China. That said, we see no signs that either the US or China is about to blink. The Xi-Trump meeting at the G20 summit in late June is crucial for whether we get a further escalation leading to an all-out economic war (see *here* for our latest comment). In my view, the US economy is slowing gradually due to the trade war, the global slowdown and fading fiscal stimulus. Meanwhile, the core PCE price index, which is the Fed's preferred inflation measure, is significantly below 2%. **Therefore, I believe the Fed will cut rates soon – likely by 25bp in July and a few more times during the autumn.**

This week, the ECB rolled its forward guidance of keeping interest rates at present levels to 'at least through the first half of 2020'. At the press conference, ECB President Mario Draghi said the Governing Council discussed the possibility of restarting QE, cutting rates and a further extension of forward rate guidance. The ECB expects growth and inflation to fall in coming quarters (growth at 0.2% q/q in Q2 and 0.3% q/q in Q3 from 0.4% q/q in Q1, inflation at 1.5% y/y in Q2 and 1.1% y/y in Q3). The Eurozone may need to face a more substantial slowdown and inflation disappointment than the ECB currently projects for the central bank to act, as our ECB economist Piet Christiansen argues. However, the problem for the ECB is that the market does not believe in its narrative. The market now prices in 5bp of cuts by end 2019 and 10bp by mid-2020, while euro curves flattened after the meeting. *I have previously argued* that restarting QE or cutting rates would not help much in terms of lifting inflation in the Eurozone. *I have also argued* that Europe is not Japan, as low inflation appears to be less entrenched in Europe. However, inflation expectations have started to de-anchor in the Eurozone, in my view. **Therefore, it is dangerous for the ECB not to react to inflation expectations collapsing, which reflects that the market questions the lack of ability and willingness from the ECB to act. I believe the market will continue to challenge the ECB in coming months and price in additional easing.**

The collapse in inflation expectations and expectations of monetary easing are driving the move lower in US and Eurozone yields. In my view, it is difficult to foresee a turning point just yet and I see more downside risk to US yields. Over the coming months, the Fed's easing cycle and the US-China trade war will drive global markets. This week, US interest rate curves steepened. **I expect US curves to steepen further as we approach the first Fed cut, which will be in accordance with the experience ahead of previous Fed easing cycles.** This week, the USD weakened particularly versus cyclical currencies such as the NZD, CAD and NOK, but it also dropped against the EUR as predicted by our FX strategist Jens Nærvig Pedersen, see *here*. The market is long USD and the USD is overvalued against most currencies. **In my view, the multi-year strength of the USD is ending, as Fed easing will erode the carry attractiveness of the greenback.**

This week, equities and to a lesser extent credit markets rebounded, while oil and metal prices were down. In my view, the rally in equities reflects the power and credibility of the Fed following Powell's comments on Tuesday. Trump's Mexico tweet on Friday night will likely lift sentiment early in the coming week. **We still expect global equity markets to head lower near term, as risks are rising, while rewards are muted.** However, relatively solid hard data, stable service confidence indicators and expectations of Fed easing will limit the downside. We expect a stabilisation in the global economy in the autumn. Ultimately, we expect that the US and China will reach a trade deal because the market stress and economic damage will become too much for Trump to enter an election, but uncertainty is elevated. At that time, inflation expectations may rebound supported by Fed easing and global markets may reflate, with credit spreads compressing and equity markets rallying. However, Brexit and in particular Italy's debt challenges will limit reflation in the Eurozone, in my view.

That was all for today's comment. I wish you a great Sunday night and coming week, best regards, Thomas

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