13 October 2019

Harr's View

Geopolitical rally to fade but China cycle to drive markets

Thomas Harr, PhD, Global Head of FI&C Research, +45 45 13 67 31, thhar@danskebank.com

Good evening all

Today, I discuss the cross asset outlook in light of recent developments in the US-China trade war, Brexit and the China cycle. This week, interest rates rose, stocks rallied and the US dollar weakened. Clearly, geopolitics largely drove markets this week, but in my view fundamental drivers are also at play. First geopolitics. On Friday night, the US and China as expected reached a 'phase 1' trade agreement (see our Flash Comment *here*). Trump claims that China agreed to buy USD40-50bn annually of US agricultural goods (this has not been confirmed by China), while the US would refrain from raising tariffs of USD250bn of Chinese imports to 30% from 25%, which was scheduled to take place on Tuesday. The completion of the phase 1 trade agreement might occur over the coming 3-5 weeks.

In my view, the partial trade agreement reduces the risk of an all-out economic war between the US and China. However, I believe the uncertainty will persist for companies closely integrated into global value chains, particularly those with a direct link to US-China trade. This might still weigh on global business confidence and investments. The difficult part of the negotiations remains and trade tensions could escalate again. China wants the US to roll back tariffs and not just refrain from raising tariffs. However, there is still a risk that Trump will raise tariffs in December. Meanwhile, the US wants China to change its industrial policies (Made in China 2025 and subsidies more generally), which is a red line for Beijing. The fact that China will buy more US agricultural goods will help US farmers, but it will not lift the confidence of global companies with other links to the US-China trade war.

On Brexit, optimism emerged when the Irish PM Varadkar on Thursday said that he now sees a 'pathway to a deal'. On Friday, the European Commission stated that the EU and the UK have agreed to intensify discussions in coming days. Details are scant, but media speculate that UK PM Johnson no longer insists that Northern Ireland would have to leave the EU custom union, while Varadkar might also has softened his stance. Local media report that the UK and the EU are currently negotiating a deal where Northern Ireland could remain politically part of the EU customs union, but one legally administered by the UK. This might ensure that there would be no need for customs checks on the Island of Ireland (but in the Irish Sea), while allowing Northern Ireland to benefit from trade deals struck by the UK with other countries. The unknowns are whether 1) the UK and the EU will be able to reach a solution during the coming weeks, and 2) the DUP and the hard Brexiteers will support the deal. The chances of PM Johnson securing a deal took a hit on Saturday when DUP deputy leader Nigel Dodds said Northern Ireland would have to remain fully part of the UK customs union.

Recently, we have argued that a Brexit extension and a snap election is the most likely outcome. This remains our view. If we are right, Brexit uncertainty will continue to weigh on European business confidence near-term and EUR/GBP should head back towards 0.90. If we are wrong (I would be happy to be wrong here) and the EU and the UK in fact secure a deal by 31 October, it would be a significant positive for the European economy as it would remove a substantial amount of uncertainty for companies and consumers. It would also support a higher EUR/USD and a lower EUR/GBP (down to around 0.84 in my view). Regardless of the outcome, GBP volatility should remain elevated in the coming weeks. However, in my view other factors are at play in driving markets, which often fly under the radar. China's business cycle appears to be stabilising (see *here*). This is slightly earlier than we had expected given the escalation of the trade war in August, but likely reflects a combination of infrastructure investments, residential construction and the weakening of the renminbi. **China is driving the global manufacturing cycle as I argued *here*. A Chinese stabilisation now should provide some support for the Eurozone cycle towards the end of the year.**

What do the geopolitical developments and the Chinese cycle imply for asset class performance? Since the trade war escalated in early May, US and European core FI have outperformed, whereas US high yield, DM equities and in particular EM equities have underperformed. However, the trend changed in early September, likely related to news that the US and China had agreed to trade talks in October, better China data, and the ECB's inability or unwillingness to act more forcefully at its meeting on 12 September. **In my view, the euphoria in markets over a US-China trade deal and a Brexit breakthrough last week are likely to fade in the coming week. This should drive a weaker GBP while last week's sell-off in USD versus Scandi currencies should fade, see *here*.** However, we are unlikely to go back to the horror in August, when markets faced significant risks of an all-out economic war between the US and China and a hard Brexit. In addition, China is stabilising. These factors could support a gradually better performance of equities relative to core FI. On tomorrow's Macro Strategy View podcast, our UK economist Mikael Olai Milhøj and I will discuss the crunch time in the Brexit negotiations. Stay tuned. That is all for today. I wish you a great Sunday night and coming week, best regards, Thomas.

Disclosures

Danske Bank A/S ('Danske Bank') has prepared this research report. The author of this research report is Thomas Harr, Global Head of FI&C Research.

Analyst certification

Each research analyst responsible for the content of this research report certifies that the views expressed in the research report accurately reflect the research analyst's personal view about the financial instruments and issuers covered by the research report. Each responsible research analyst further certifies that no part of the compensation of the research analyst was, is or will be, directly or indirectly, related to the specific recommendations expressed in the research report.

Regulation

Danske Bank is authorised and subject to regulation by the Danish Financial Supervisory Authority and is subject to the rules and regulation of the relevant regulators in all other jurisdictions where it conducts business. Danske Bank is subject to limited regulation by the Financial Conduct Authority and the Prudential Regulation Authority (UK). Details on the extent of the regulation by the Financial Conduct Authority and the Prudential Regulation Authority are available from Danske Bank on request.

Danske Bank's research reports are prepared in accordance with the recommendations of the Danish Securities Dealers Association.

Conflicts of interest

Danske Bank has established procedures to prevent conflicts of interest and to ensure the provision of high-quality research based on research objectivity and independence. These procedures are documented in Danske Bank's research policies. Employees within Danske Bank's Research Departments have been instructed that any request that might impair the objectivity and independence of research shall be referred to Research Management and the Compliance Department. Danske Bank's Research Departments are organised independently from, and do not report to, other business areas within Danske Bank.

Research analysts are remunerated in part based on the overall profitability of Danske Bank, which includes investment banking revenues, but do not receive bonuses or other remuneration linked to specific corporate finance or debt capital transactions.

Financial models and/or methodology used in this research report

Calculations and presentations in this research report are based on standard econometric tools and methodology as well as publicly available statistics for each individual security, issuer and/or country. Documentation can be obtained from the authors on request.

Risk warning

Major risks connected with recommendations or opinions in this research report, including as sensitivity analysis of relevant assumptions, are stated throughout the text.

Expected updates

Weekly.

Date of first publication

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

General disclaimer

This research report has been prepared by Danske Bank (a division of Danske Bank A/S). It is provided for informational purposes only. It does not constitute or form part of, and shall under no circumstances be considered as, an offer to sell or a solicitation of an offer to purchase or sell any relevant financial instruments (i.e. financial instruments mentioned herein or other financial instruments of any issuer mentioned herein and/or options, warrants, rights or other interests with respect to any such financial instruments) ('Relevant Financial Instruments').

The research report has been prepared independently and solely on the basis of publicly available information that Danske Bank considers to be reliable. While reasonable care has been taken to ensure that its contents are not untrue or misleading, no representation is made as to its accuracy or completeness and Danske Bank, its affiliates and subsidiaries accept no liability whatsoever for any direct or consequential loss, including without limitation any loss of profits, arising from reliance on this research report.

The opinions expressed herein are the opinions of the research analysts responsible for the research report and reflect their judgement as of the date hereof. These opinions are subject to change and Danske Bank does not undertake to notify any recipient of this research report of any such change nor of any other changes related to the information provided herein.

This research report is not intended for, and may not be redistributed to, retail customers in the United Kingdom or the United States.

This research report is protected by copyright and is intended solely for the designated addressee. It may not be reproduced or distributed, in whole or in part, by any recipient for any purpose without Danske Bank's prior written consent.

Disclaimer related to distribution in the United States

This research report was created by Danske Bank A/S and is distributed in the United States by Danske Markets Inc., a U.S. registered broker-dealer and subsidiary of Danske Bank A/A, pursuant to SEC Rule 15a-6 and related interpretations issued by the U.S. Securities and Exchange Commission. The research report is intended for distribution in the United States solely to 'U.S. institutional investors' as defined in SEC Rule 15a-6. Danske Markets Inc. accepts responsibility for this research report in connection with distribution in the United States solely to 'U.S. institutional investors'.

Danske Bank is not subject to U.S. rules with regard to the preparation of research reports and the independence of research analysts. In addition, the research analysts of Danske Bank who have prepared this research report are not registered or qualified as research analysts with the NYSE or FINRA but satisfy the applicable requirements of a non-U.S. jurisdiction.

Any U.S. investor recipient of this research report who wishes to purchase or sell any Relevant Financial Instrument may do so only by contacting Danske Markets Inc. directly and should be aware that investing in non-U.S. financial instruments may entail certain risks. Financial instruments of non-U.S. issuers may not be registered with the U.S. Securities and Exchange Commission and may not be subject to the reporting and auditing standards of the U.S. Securities and Exchange Commission.

Report completed: 13 October 2019, 17:20 CEST

Report first disseminated: 13 October 2019, 19:15 CEST