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Harr's View

The central bank game changer – winners and losers

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Good evening all

Today, I discuss whether central bank actions will be successful in driving the global economy and financial markets and the implications for Scandinavia. This week, the Fed was dovish and we continue to expect it to cut rates by 25bp in July and an additional 50bp during the fall (see our review *here*). We now see a higher than 50% probability that the Trump-Xi meeting on the side-lines of the G20 summit in Japan at the end of next week will end with a ceasefire and a resumption of trade talks (see *here*). **The trade talks will still be difficult, though, and I do not believe a ceasefire on trade will be enough for the Fed to hold off on a cut in July.** Meanwhile, I believe it is highly unlikely that the Fed will cut rates by 50bp in July. The Fed cut by 50bp when it began its easing cycles in 2001 and 2007, respectively, but the situation was direr during those times than it is now. In my view, the current situation is more similar to 1998 when the Fed cut by 25bp in September and again in October and November by 25bp each time.

I believe that US yields will drop further, but only moderately as they have already fallen substantially and I do not expect the Fed to cut aggressively. I expect the US yield curve to steepen a bit further (especially 2y10y) on rising inflation expectations and Fed cuts. Fed easing should support slightly lower US mortgage rates, lower credit spreads and higher equities. Hence, I believe that Fed cuts will provide some support for the US housing market, non-residential investments and private consumption. **It will also lead to a weaker USD, particularly versus Latin-American currencies with large USD debt, and currencies supported by central banks that are either hawkish (NOK) or challenged (JPY and CHF), see *here*.** However, looser US monetary policy will have less influence on the weak global manufacturing cycle. I expect trade war worries to continue to weigh on the global manufacturing cycle near term even if the Xi-Trump meeting next week ends with a positive outcome.

Following the ECB meeting early this month, I argued that it was dangerous for the ECB not to react to inflation expectations collapsing, especially because the collapse in inflation expectations reflects the market's lack of confidence in the ability and willingness of the ECB to act (see *here*). **Hence, in my view it was crucial that Draghi showed his willingness to act this week. As a result, we have changed our call and now expect the ECB to cut rates by 20bp, introduce a tiering system, extend forward guidance and restart QE (see *here*).** We believe the ECB will open up for easing at its meeting in July and announce the package in September. I believe the ECB will act even if data turns out mildly better than expected. Following recent experience, the ECB will understand that if it does not act, it will be penalised by markets. I also have high confidence that the ECB will announce a package of measures. However, in my view it is highly uncertain how exactly the ECB will protect the banking sector from 'lower for longer', the size of the rate cut and the size and the composition of the QE programme.

Draghi's determination this week reduced the 'credibility premium' in Eurozone inflation expectations, which I believe is fair. However, I worry that further easing will demonstrate ECB's lack of ability to influence growth, inflation and inflation expectations. I do not believe that slightly reduced borrowing costs for households, non-financial corporations and sovereigns, which are already very low, will have much impact. **The Fed's action will put a floor under Eurozone inflation expectations, but I do not expect them to keep up with the expected rise in US inflation expectations.** I expect the trade war to weigh on China near term with spill-over effects on the Eurozone. Europe is also facing other worries such as Italy's debt challenges and Brexit, which could damage sentiment in H2.

What do dovish global central banks imply for the Nordics? The dovish Draghi had no impact on Norges Bank (NB) which hiked rates by 25bp on Thursday taking the policy rate to 1.25% (see our review *here*). The central bank was hawkish and the rate path implies a 70-80% probability of a rate hike in September. We expect another 25bp hike in September and additional hikes next year. **The hawkish NB and dovish Fed should drive broad-based NOK strength, as argued by our Norwegian strategist, Kristoffer Kjær Lomholt.** Meanwhile, the market is beginning to price in rate cuts from the Riksbank. In April, the Riksbank changed its forward guidance following the change in ECB's forward guidance in March. However, as argued by our Swedish team the Riksbank is unlikely to cut rates as growth, inflation and inflation expectations are holding up reasonably well. The Riksbank-ECB divergence might trigger interesting opportunities in FX and FI markets in coming months. Finally, Denmark. We expect that Danmarks Nationalbank (DN) will cut by 10bp if the ECB cuts by 20bp. EUR/DKK in the high end of the trading range and FX intervention in the beginning of the year mean that DN will cut less than the ECB, as argued by our DKK strategist, Jens Nærvig Pedersen, see *here*.

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

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