

Strategy

What the US and Denmark had in common this week and what it means for global financial markets

Denmark and US adopt expansionary fiscal policies late in the economic cycle...

Normally the week ahead of Christmas is characterised by holiday peace setting in over politics and financial markets alike. At this time, government budget deals for the next year are typically safely sealed and investors have closed their positions awaiting the new investment year. However, this year, two countries, Denmark and the US, stood out as their politicians frantically scrambled to get fiscal packages through their parliaments.

In the US, the Republican Party achieved a major political boost by getting tax reform approved by both chambers of congress. The tax reform, costing an estimated USD1,500trn over the next 10 years, lowers corporate income tax from 31% to 21% and cuts the top marginal personal income tax rate from 39.6% to 37.0% while offering incentives for US companies to repatriate foreign income.

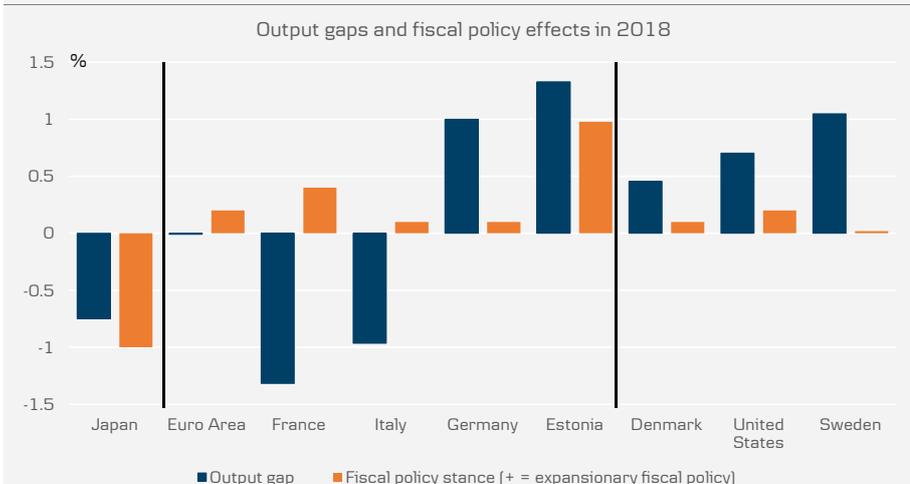
In Denmark, the Danish government managed to find agreement on a new budget for 2017. Similarly to the US republican party, the Danish government also attempted to push through tax cuts but failed in the end due to a lack of parliamentary support but plans to make another attempt to get the reform through in January.

So, apart from the political drama, what did these events have in common in the two countries? Well, the US tax reform and the Danish budget mean that fiscal policies in both countries will be expansionary next year (in Denmark, admittedly on a rather limited scale). Admittedly, other countries, such as Germany, Sweden and Estonia, may also be in such a situation (judging from IMF WEO data).

Today's key points

- Both Denmark and the US have adopted expansionary fiscal policies for next year, with both operating close to full employment.
- The US is using up limited fiscal ammunition in good times instead of saving it until the economic cycle turns.
- The combination of rather strong US economic growth and a further boost from a tax reform underscores our overweight US equities.
- The US tax reform creates some upside risk for our forecast for US 10-year rates.
- The EUR/USD should still move higher in 2018.
- The US tax reform could be a mixed bag for emerging markets.

Fiscal policy set to be pro-cyclical in several advanced economies in 2018



Note: The fiscal policy stance is measured by the change in the structural primary balance using IMF WEO October 2017 data except for Denmark, which is based on the recently budget document for 2018
Source: IMF WEO October 2017, Denmark's Ministry of Finance, Danske Bank calculations

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While such expansionary policy may make sense politically (especially for the Republicans in the US ahead of next year's mid-term elections), it is difficult to see the economic rationale, as both countries are operating very close to full employment and have estimated positive output gaps in 2017 (see chart below). Under these circumstances, fiscal policies should ideally be used to temper domestic demand, not add further fuel to the fire.

Another issue, mainly for the US, is that the tax cuts use up limited fiscal ammunition in good times instead of saving it until the economic cycle turns. The underlying US fiscal situation is already quite vulnerable, as public net debt amounts to almost 80% of GDP (in gross terms almost 110% of GDP) and the public deficit accounts for more than 4% of GDP. Given the forthcoming spending pressure from pension and healthcare obligations, the congressional budget office projects US net public debt will rise to 90% of GDP over the next decade, even before the tax cuts. With the tax cuts, the Committee for Responsible Federal Budget (CRFB) projects this net debt burden will rise even further to 100% of GDP by 2027. While US interest payment on this rather large debt stock is pretty small at the moment due to the low interest rates, the IMF projects the debt service burden to grow quite strongly as interest rates climb. Luckily, Denmark does not face the same fiscal challenges because the public debt is fairly low and the pension system is fully funded.

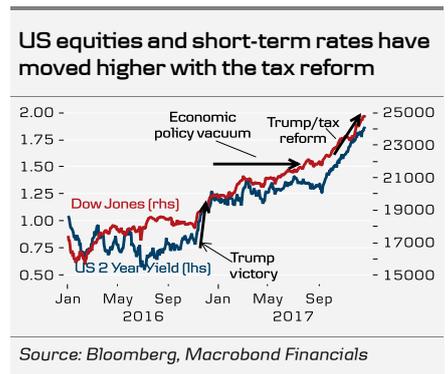
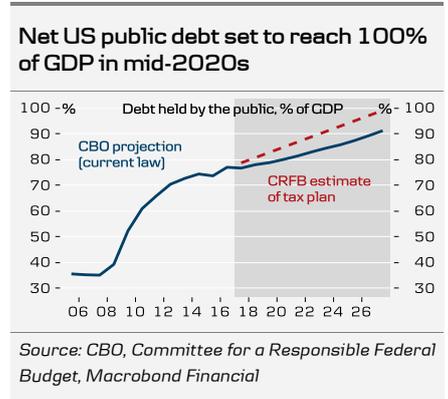
The key uncertainty for investors is what, in particular, the US tax reform (given Denmark is rather small in the grand scheme of things) will mean for investors.

Higher US equities and interest rates – uncertain USD effects

In our view, the tax reform should have a positive impact on US economic growth and therefore US equities. We have already seen a move higher over the fall as markets increased their expectations of the tax reform. The combination of rather strong US economic growth and a further boost from tax reform underscores our overweight US equities.

However, the additional growth effects of the US tax cuts for the US economy may be more limited than normal. First, the income tax cuts are targeted mainly at high income earners, who have a low marginal propensity to consume. Second, investments may not increase significantly despite the possibility of deducting investment costs, as credit has been cheap and easy in recent years. Third, fiscal multipliers (i.e. how much additional economic growth can fiscal expansion generate?) tend to be low when the output gap is almost closed, as is the case in the US right now. In aggregate, we expect the reform to lift US GDP growth by around 0.2-0.3pp in 2018.

In theory, the combination of looser fiscal and tighter monetary policies (which will be the case with the Fed hiking rates and reducing its balance sheet next year) should push up US interest rates, which in turn should aide the USD. Indeed, we have seen short-term interest rates in the US move higher as the likelihood of the tax reform increased. The impact on the long-end of the US curve has been more limited but 10-year US yields did jump around 11bp over the past week. However, we do not expect a major sell-off in fixed income, such as after the election of Donald Trump. Given the rather limited growth impact and the still muted inflation pressures (which we see continuing in 2018), we maintain our call that the Fed will hike rates only two to three times next year. However, there may be slight upside risk to our forecast for 10-year US yields of 2.7% in 2018.



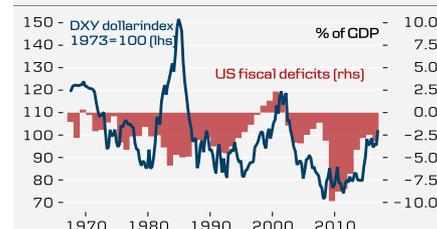
Despite the boost to US interest rates and the possible US corporate repatriation flows back into the US, the impact on the USD has been rather limited. What is at play? Well first of all, the scale of repatriation flows may be constrained by two factors compared with 2005 when such a feature was in place. First, it is likely a significant portion of reinvested earnings held abroad for tax purposes is already denominated in USD to avoid balance sheet volatility given the substantial USD strength in recent years. In addition, the USD now also seems overvalued against EUR and GBP (see table below). This could further lower repatriation volumes. Finally, judging from history, the USD tends to perform relatively poorly when the US fiscal situation is weaker, as the current account weakens. Hence, we maintain our view that EUR/USD should move up to about 1.25 over the next year.

Emerging markets – US tax reform is a mixed bag

After a very good 2017 for emerging markets, they are again back on investors' wish lists. The uncertainty is what the US tax reform means for emerging markets and, more broadly, what the outlook is for emerging in 2018. On US tax reform, we think it could be a mixed bag for emerging markets. While they generally thrive on higher US and global growth given their export dependence, the impact of the tax reform should be fairly limited. However, if the tax reform should push US interest rates materially higher (which is not our base case), it would be likely to ignite capital outflows from emerging markets and put pressure on countries with large current account deficits or USD debt, such as Turkey.

However, overall we still see general good prospects for emerging markets in 2018, although there are clearly some risks to watch out for (for more details see *Emerging Markets Briefer: Slowing down to single-digit growth*, 20 December). In our view, the biggest risk to emerging markets comes from China and the likely slowdown in construction activity, which, in particular, is likely to hit commodity prices and therefore commodity-producing countries, such as Chile, with large exposure to China. Geopolitical and domestic risks, with presidential elections in Brazil, Russia, Colombia and Mexico, are likely to cause some volatility in 2018. On emerging market FX, we remain bullish on CEE currencies as well as on the RUB.

Weak US fiscal situation tend to imply a weak USD



Source: Intercontinental Exchange (ICE), U.S. Congressional Budget Office (CBO) and Macrobond Financial.

Bullish on Eastern Europe, bearish on TRY

	3M Forecast vs Spot	Bullish?	3M Forecast vs 3M Forward
PLN	↗ 0.13%	Neutral	0.37%
HUF	↗ 1.17%	Yes	1.08%
CZK	↗ 0.82%	Neutral	-0.04%
RUB	↗ 1.33%	Yes	2.49%
TRY	↘ -3.15%	No	-0.51%
ZAR	↘ -1.25%	Yes	1.18%
BRL	↘ 2.66%	Yes	3.79%
CNY	↘ -0.52%	Neutral	0.17%
INR	↗ 0.32%	Yes	0.59%

Note: A positive number indicates stronger EM currency. PLN, HUF and CZK are against EUR, the rest are against USD.

Source: Bloomberg and Danske Bank

Global market views

Asset class	Main factors
Equities Positive on 3-12 month horizon.	Strong business cycle and near double digit earnings growth in most major regions. Low rates and bond yields drive demand for risk assets.
Bond market German/Scandi yields – set to stay in recent range for now, higher on 12M horizon EU curve – 2Y10Y set to steepen when long yields rise again. Flattening US-euro spread – set to widen marginally Peripheral spreads – tightening but still some factors to watch	Inflation set to stay subdued despite decent growth. Stronger euro keeps euro inflation outlook down. ECB to normalise gradually only, due to lack of wage pressure and stronger euro. ECB on hold for a long time. The ECB keeps a tight leash on the short end of the curve. With 10Y yields stable, the curve should change little on a 3-6M horizon. Risk is skewed towards a steeper curve but that is a 6M to 12M forecast. The Fed's QT programme (balance sheet reduction) is set to happen at a very gradual pace and the effect on the Treasury market should be benign. Yet, market pricing for Fed hikes is still dovish for 2019 and yields should edge higher on a 12M horizon. We expect economic recovery, ECB stimuli, better fundamentals, particularly in Portugal and Spain, an improved political picture and rating upgrades to lead to further tightening despite the recent strong moves. Italy is the big risk factor but it is very expensive to be short Italian bonds.
FX EUR/USD – consolidating near term but upside risks in 2018 EUR/GBP – in range near term but GBP to strengthen eventually USD/JPY – gradually higher longer term but challenged near term EUR/SEK – risk to the upside on housing market, Riksbank pricing EUR/NOK – lower but watch out for year-end NOK-seasonality	EUR/USD to be rangebound near term. We still see the cross moving firmly into mid-1.20s supported by valuation and debt-flow reversal in 2018. We still see EUR/GBP within 0.8650-0.90 in coming months as the Brexit risk premium is likely to persist despite progress in negotiations. Longer term, GBP should Policy normalisation at the Fed and eventually at the ECB, while the Bank of Japan is staying dovish, means support for EUR/JPY and USD/JPY alike on a 12M horizon. Housing market risk premium to keep SEK under pressure alongside too aggressive Riksbank market pricing. Eventually lower but not story in coming quarters. NOK headwinds towards year end but longer term we expect the NOK to rebound on valuation, growth and real-rate differentials.
Commodities Oil price – range trading	June review weakens impact of extension of OPEC+ output cuts. Geopolitical tensions around Saudi Arabia and Iran on the rise. Temporary disruption on Forties

Source: Danske Bank

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None.

Date of first publication

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