21 October 2016

Strategy

The final leg of the USD rally

At Thursday's meeting, the ECB kept all policy rates unchanged, maintained its monthly QE purchases of EUR 80bn and did not change its intention to end purchases in March 2017. At the press conference, Mario Draghi initially said that the Governing Council had not discussed an extension of QE but also said that they had not discussed a tapering of QE either. **We still believe that the ECB at its December meeting will announce an extension of its current QE programme to September 2017.** (For details see *ECB Review: No ECB QE tapering discussion – we expect QE extension*, 20 October).

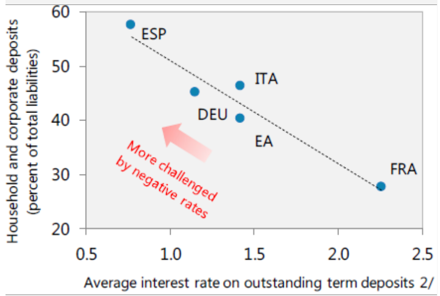
Recent research has shown that banking systems with a) a high share of variables rate loans, b) a large deposit base compared to total funding; and c) a small share of fee income will suffer under a negative rate environment (see *IMF Working Paper*, August 2016). Italy, Portugal and Spain all have a high share of variable loans while Spain in particular has a large share of deposits compared to total liabilities (see Chart 1). In addition, the direct costs of negative deposit rates are likely to be greater for banks in large surplus countries such as the Netherlands and Germany where the Target 2 settlement of capital flows generates large amounts of excess liquidity in their banking systems. It is likely that the ECB in particular will be concerned about the relatively short end of the yield curve, which has the largest transmission to banks' deposit and lending rates. This rules out further ECB interest rate cuts whereas an extension of the QE programme should be less damaging for banks.

From our discussions with clients, it is clear that everyone is very concerned about politics in Europe. In our view, Brexit negotiations will set the tone for EU politics. Based on recent comments it is likely that both the EU and the UK will begin Brexit negotiations from a 'hard Brexit' starting point. The EU will have to signal a tough stance to ensure that other countries are not tempted to follow the UK. Meanwhile, it appears that the UK government wants to have a say in controlling immigration. However, it will be a 'game of chicken' where the UK may blink first as it is not obvious from polls that the UK population wants to control

Key points

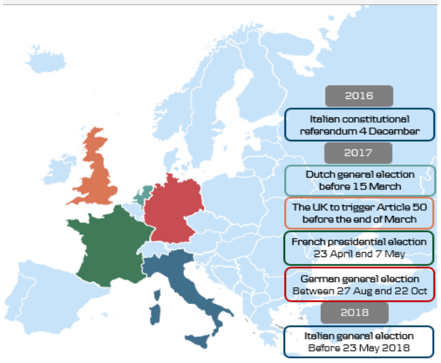
- The ECB is likely to extend QE in December and avoid stimulus, which would hurt the European banking sector.
- We expect EUR/USD to fall near term on relative monetary policy expectations, politics.
- We see EUR/GBP heading towards 0.92 on 3-6M. USD/CNY uptrend to continue.
- Short term, we see equities as a buy-on-dips.

Chart 1: Non-MFI deposits as a share of total liabilities and interest rates on deposits



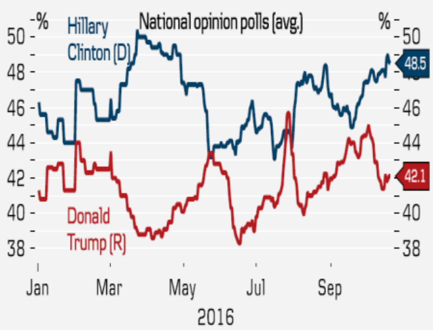
Source: Bloomberg L.P., Haver and IMF staff calculations

Chart 2: Political uncertainty on the rise in Europe



Source: Danske Bank Markets

Chart 3: Political uncertainty is declining in the US



Source: RealClearPolitics.com, Macrobond Financial

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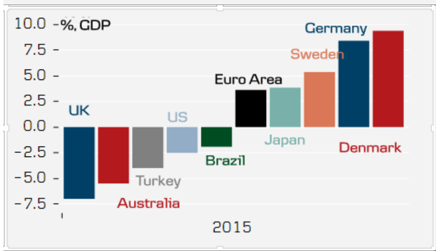
immigration rather than having full access to the single market. The EU's stance during the negotiations will of course be highly dependent on the outcomes of upcoming referendums and elections (see Chart 2).

The political risks and relative monetary policy will weigh on EUR/USD where yesterday's downside break of 1.0950 opens the door for further losses towards 1.0700-1.0850. Positioning is not yet stretched short EUR/USD, which supports a greater role for relative rates. We see political risks in Europe as more EUR negative than USD negative as Clinton appears to be the likely winner of the US election. (Chart 3). We expect it to be sell-the-rumour, buy-the-fact with the EUR/USD bottoming in December and heading convincingly higher in 2017 on the large Eurozone-US current account differential and valuation. We also note the continuing rise in USD/CNY (and USD/CNH). This is in line with our view and we expect it to continue to head higher into year-end on broad USD strength and China's need for a weaker exchange rate.

Finally, on FX the British pound (GBP) has plunged. The UK runs one of the largest current account (CA) deficits and the funding of that will be pressured if the UK opts out of the single market (see Chart 4). Still, markets may to a significant extent already be priced for a hard Brexit. We believe the British pound will weaken further against both the USD and the EUR, but that will play out over the coming 3-6 months. It will be 'sell the rumour, buy the fact' with respect to the UK's triggering of article 50 and the GBP is likely to strengthen later in 2017.

As we argued a couple of weeks ago, we believe that there is a macro-case for higher long-end bund yields given higher inflation and inflation expectations in Europe and that the market is likely to price in ECB tapering long before it occurs. However, timing is difficult and our view is more of a 6-12 months view rather than a short-term view. Short term, we see equities as a 'buy-on-dips' after a reasonable start to the earnings season in the US, while we remain underweight on equities versus cash on a 3-6 month view as earnings expectations in 2017 look unrealistic.

Chart 4: The UK has a massive CA deficit



Source: Macrobond Financial

Global market views

Asset class	Main factors
Equities	
Short term (0-1 month): buy-on-dips Medium term (three-six months): underweight equities vs cash	The hunt for yield as a theme has led equity markets to bounce back after Brexit. Growth is above expectations but has still not broken out of the range. Risk of setbacks is high due to stretched valuations and still fairly weak earnings but central bank anchoring of bond yields provides a cushion for a setback, hence, our structurally underweight position in equities vs. cash. Our short-term stance is buy-on-dips.
Bond market	
Risk of steeper 2y10y curve is rising	ECB to prolong the QE programme by another six months. But tapering is looming
US-euro spread: wider but not before we see Fed hikes	Fed on hold until 2017. Risk of earlier hike is evident. Long-end sell-off to impact long EUR rates
Peripheral spreads: ECB support	QE buying, bond scarcity and hunt for yield mean further tightening. But politics and tapering remain risk factors.
Credit spreads: neutral	ECB keeping spreads contained.
FX	
EUR/USD - lower near term on ECB, technicals. Then higher.	Short-term downside risks from technicals, ECB; valuations and CA differential support cross in the medium to long term.
EUR/GBP - further GBP weakness in store over next 6M	Political uncertainty and not least financial account flows to send cross higher.
USD/JPY - neutral with short-term risks skewed slightly to the upside	Expect range trading in the 103-106 range.
EUR/SEK - to move gradually lower over coming months	To move gradually lower on relative fundamentals and valuation.
EUR/NOK - short-term risks skewed to the upside	Latest move lower on Norges Bank and oil seems excessive. Risk of spike higher near term before moving lower in 2017.
Commodities	
Oil price – uncertainty about details of OPEC deal	Rising USD and market doubting OPEC deal to send oil price lower.
Metal prices – recovery in Chinese construction fading in 2017	Consolidation in mining industry puts a floor under prices, awaiting support from higher global economic growth.
Gold price – support from central banks is fading	Looming Fed hike and ECB tapering fear has hit gold price.
Agriculturals – support from disruptive weather, higher oil price	Attention has turned to La Niña weather risks in H2 16.

Source: Danske Bank Markets

Disclosures

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None.

Date of first publication

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