

Strategy

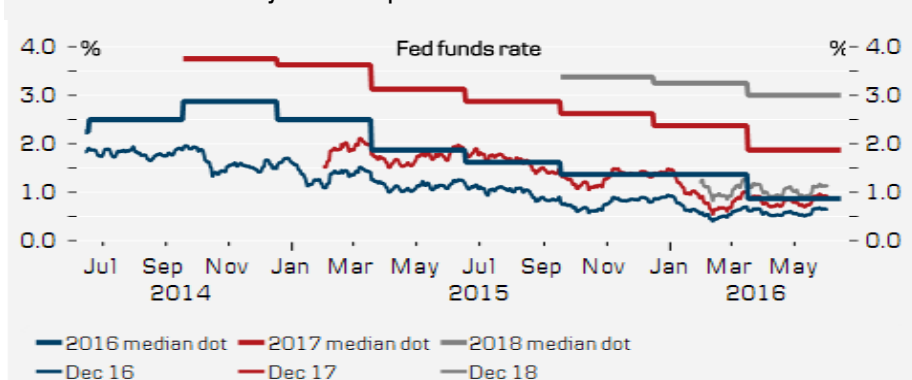
Stronger USD, higher UST yields and lower equities

There are now less than three weeks to the UK's EU referendum. We have always believed that it was slightly more likely that the UK will vote to remain in the EU, but Brexit is more than just a tail-risk for markets. Since early April, the market has moved very far in pricing out Brexit risks in spot FX and equity markets. For example, according to our Brexit risk-premium estimates, 1.25pp is currently priced in the EUR/GBP spot rate. The polls are still very close and we believe they will remain close right up until the referendum day on 23 June (see Chart 1). **As such, the market is currently too complacent about the UK's EU referendum and we believe that the British pound (GBP) and UK/European equity markets will trade on the weak side over coming weeks.** Notably, derivatives in various product areas are pricing in a substantial risk of a Brexit, suggesting that these are where market players have hedged GBP risks.

Fed repricing is the other macro driver for markets near term. According to our estimate, the market is pricing in around a 20% probability of a 25bp Fed rate hike in June and slightly more than a 60% probability of a hike in July. Today's May US labour market report and Fed chairman Janet Yellen's speech on Monday will naturally be important in setting the tone for the next Fed rate hike. But we may need to have the Brexit risks cleared before the market can clearly price in the July hike.

Still, what is important is not only the next Fed rate hike but what will happen afterwards. The market is still only pricing in slightly more than two hikes by end-2017 and around three hikes by-end 2018. This can only be seen as the market pricing in a significant probability of a US recession in 12-18 months' time – too high a probability in our view.

Chart 2: The market may have to reprice the Fed

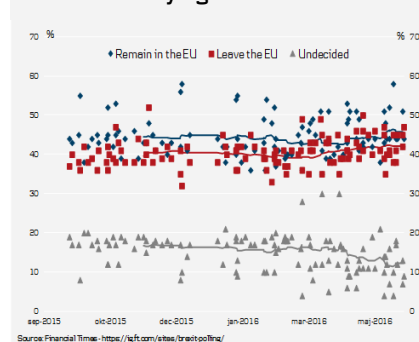


Source: Bloomberg, Danske Bank

Today's key points

- Markets are currently too complacent about Brexit risks, in our view, albeit our base case is that the UK votes to stay in the EU
- The Fed will be re-priced in the case of 'Bremain' – which together with US election risks could trigger higher long-end UST yields
- The USD should strengthen near term versus European currencies and CNY
- We have turned negative on equities on a likely Fed repricing and slashing of earnings estimates

Chart 1: The UK's EU referendum remains a very tight race



Source: Macrobond Financial

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We believe 5y5y UST should steepen in the US as the market underestimates the degree of Fed hikes, particularly further out. In the Autumn, the market will also start to focus on the US election. A win by Donald Trump could put upward pressure on longer-end US yields as prospects of an easing of fiscal policies and a possible change to the current Fed chairman, Janet Yellen, could put upward pressure on short-end US yields.

We still believe in a stronger USD short term, particularly versus European currencies and the Chinese yuan (CNY). Given light positioning, relative interest should matter more and this is exactly what is likely to play out over coming months. There were no additional measures from the ECB at yesterday's meetings but surprisingly they did not revise up their 2017 inflation forecasts. This, in our view, should be interpreted slightly on the dovish side which we see as EUR bearish. We expect a continuing gradual CNY depreciation both in trade-weighted terms and versus the USD (for details see *FX Strategy: More CNY weakness ahead*, 2 June 2016). Importantly, we do not foresee the same kind of dramatic turmoil in the CNY which we saw in August 2015 and January 2016 which triggered broader sell-offs in risky assets.

We recently changed our stance on equities turning to a sell-on-rallies recommendation short term and moderately negative medium term. Fed repricing and the slashing of earnings expectations are the key drivers behind our change in recommendations (see Chart 4 below).

Chart 3: China likely to allow further depreciation of CNY basket



Source: Macrobond Financial, Danske Bank (basket own calculation)

Chart 4: Global market views

Asset class	Main factors
Equities Short term: sell on rallies Medium term: moderately negative	Key drivers for our stance are: 1) The Fed will hike soon and equity markets are simply not ready for this, 2) Earnings expectations for 2017 with increases of 10-15% compared to 2016 are too optimistic. Slashing of earnings expectations will make equities trade lower given that multiples are at highs, 3) The macro environment is stable and 4) Central banks (other than the Fed) will have an easing bias in their stance, but the question is whether low rates are sufficient to spur earnings growth ahead on equities from here.
Bond market Core yields: still low Bund yields in Q2, but higher later in the year US-euro spread: wider but not before we see Fed hikes Peripheral spreads set to tighten further from here Credit spreads: neutral	Higher QE, TLTRO II and 'hunt for yield' but no more rate cuts and higher US yields later this year. We still look for policy divergence in Q4 but for now 'hunt for yield' supports treasuries. QE, improving fundamentals and search for yield. However, a lot of event risk at the moment and ultra-long supply. Initial ECB-driven rally likely over. Technicals still supportive.
FX EUR/USD - Lower near term on relative rates and Brexit fear, then higher USD/JPY - To edge higher near term on monetary and fiscal easing EUR/SEK - Broader range of 9.10-9.50 has been re-established EUR/NOK - Settling in 9.10-9.40 interval now, then lower as cycle turns	Fundamentals support cross in the medium to long term but downside risks short term from Fed and Brexit risks. USD/JPY to rise near term but further out to stabilise on valuation and current account surplus Range-trade near term but lower medium term as the Riksbank becomes more confident in inflation fight Relative rates limit short-term downside potential, fundamentals point to lower EUR/NOK in H2 16.
Commodities Oil price - Consolidation in US oil sector leading to recovery Metal prices - Anticipating recovery in Chinese construction Gold price - Flat near term Agricultural - Upside risks, spillover from rally in palm oil price	OPEC has lost leverage over oil price; sliding dollar and improved growth outlook to drive oil price higher Consolidation in mining industry puts a floor under prices, awaiting support from higher global economic growth Looming Brexit uncertainty, volatility in oil market may support safe haven demand for gold

Source: Danske Bank Markets

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