08 June 2018

Strategy

Global growth still supports equities

From boom to cruising speed

Yesterday, we published our biannual The Big Picture, containing our updated macro forecasts for the global economy (see *The Big Picture – From boom to cruising speed*, 7 June). Following a strong end to 2017, we see clear signs that the business cycle is losing momentum. **While global growth might be decelerating, we do not expect it to turn into a marked downturn over the next few years – rather, we believe growth in the world economy should go from boom to cruising speed in line with its potential.** We expect global growth to come in at 3.8% this year, declining to 3.7% in 2019 and 3.6% in 2020.

The risks to our forecasts are skewed on the downside, from an escalation of trade tension into a full-blown trade war and a renewed Italian debt crisis. Unfortunately, the positive developments in the US-China trade conflict did not last long and the risk of renewed escalation over coming weeks has increased, as US President Trump has announced he will impose tariffs on USD50bn imports from China despite China having agreed to buy more US goods to bring down the trade balance (see *US-China Trade Talks – Why things are getting tricky*, 4 June. In Italy, markets are still waiting for indications of whether or not the new Five Star-League government will back down on some of its promises.

Higher volatility but fundamentals support equities

Last year was quite extraordinary, as growth rose across regions and risks diminished. Increasing economic growth, very high optimism among businesses and consumers and record-low volatility (as measured by the VIX index) were a good cocktail for equities, which rose steadily over the year. This year, with slower economic growth and more risks stemming from the political situation in Italy and the US-China trade conflict, it is not a big surprise that volatility has increased. However, **as economic growth remains above potential and earnings growth is solid, we still expect equities to move higher but the ride is going to be bumpier than in 2017**. Then again, it was 2017 that was extraordinary and we have just returned to a more 'normal' situation.

Our updated global macro forecasts

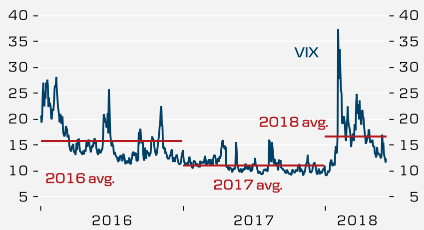
% y/y	Actual	Danske Bank	Consensus	Danske Bank	Consensus	Danske Bank	Consensus
Global	3.7	3.8	3.8	3.7	3.7	3.6	3.3
USA	2.3	2.6	2.8	2.4	2.4	2.0	1.9
Euro area	2.4	2.1	2.3	1.7	1.9	1.6	1.7
UK	1.8	1.1	1.4	1.2	1.5	1.2	1.8
Japan	1.7	1.0	1.2	1.1	1.0	0.5	0.4
China	6.9	6.6	6.5	6.4	6.3	6.2	6.2

Source: Bloomberg, Danske Bank

Today's key points

- Global growth has slowed but is set to stay above the potential growth rate.
- Volatility has increased but fundamentals support equities in 3-12M.
- Gradual monetary policy tightening amid muted inflation pressures.
- EUR/USD lower for longer but not forever.

Volatility is higher but remember it was 2017 that was extraordinary



Source: Bloomberg, Macrobond Financial

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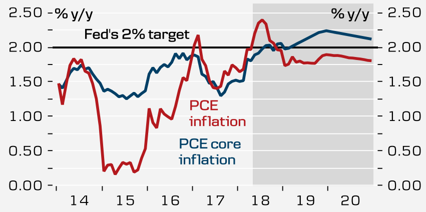
Gradual monetary policy tightening amid muted inflation pressure

Despite the expansion, especially in the US, having lasted for some time and the labour markets having tightened substantially, **inflation and wage growth pressures remain modest**. We believe some of the explanation is in the relatively muted inflation expectations and globalisation pressures. We believe the biggest upside risk to inflation is in the US, given its sizeable fiscal expansion and limited slack in the economy, and we think US PCE core inflation is set to move slightly above 2%, although it is likely to be a gradual process given that inflation is quite persistent in nature. **The Federal Reserve is unlikely to panic by hiking aggressively on the back of this, as it has said it can accept core inflation moving slightly above 2% temporarily, as core inflation has run under the 2% target for a long time.** While we think the Fed will raise the target range by 25bp to 1.75-2.00% next week, we do not think it will make big changes to its current policy strategy and still believe it is on track to deliver a total of three to four hikes this year. For more, see *FOMC Preview – A step closer to neutral*, 8 June.

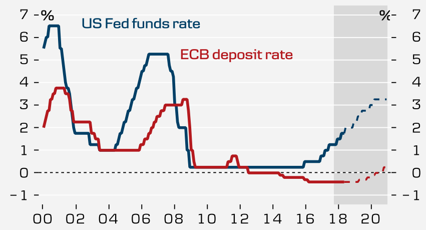
US PCE core inflation set to move slightly above 2% over the forecast horizon



Source: BEA, Macrobond Financial, Danske Bank forecasts

The expansion is a bit younger in Europe and the ECB is still fighting a tough battle against too low inflation relative to its 2% target. The ECB is still on track to end its QE programme this year but we think it is too early for Mario Draghi and the ECB to change their forward guidance at next week's meeting, although the probability has increased since Chief Economist Peter Praet's hawkish comments a couple of days ago. We expect the ECB to wait until July. In any case, **the first ECB rate hike is still unlikely before the end of 2019, so in Europe we still expect to have a negative key policy rate over the next few years**. For more, see *ECB Preview – End of QE approaching but no formal announcement just yet*, 8 June.

Fed and ECB set to raise rates only gradually

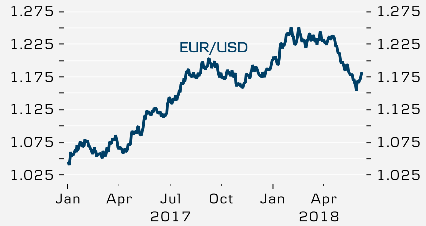


Source: Macrobond Financial, Danske Bank forecasts

EUR/USD lower for longer but not forever

EUR/USD has been on a rollercoaster ride this year. It went above 1.25 in early February and reached its low at the end of May, slightly above 1.15. It has rebounded slightly since then and is currently trading a bit above 1.18. **We have revised our EUR/USD forecast profile, as a hesitant ECB and USD carry is set to keep the cross lower for longer** and EUR/USD does not seem to be heading back to the mid-.20s near term. **We now see the cross at 1.17 in 1M, 1.17 in 3M (previously 1.19) and 1.20 (1.23) in 6M. We still believe the next big move remains higher though and think it will move to 1.25 in 12M (1.28).** On a 6-12M horizon, we expect the ECB to end QE and believe forward guidance on rates will take centre stage. Although the first hike is distant, this should allow EUR/USD gravity to kick in, as the eurozone capital tide turns. For more, see *FX Strategy – EUR/USD lower for longer – but not forever*, 8 June.

Next big move in EUR/USD is still up



Source: Bloomberg, Macrobond Financial

Financial views

Asset class	Main factors
Equities	
Positive on 3-12 month horizon.	Short-term volatility, but fundaments still supports equites on a 3-12 month horizon
Bond market	
German/Scandi yields – lower for now, higher in 12M	ECB set to normalise only gradually due to a lack of wage pressure and a stronger euro. ECB on hold for a long time.
EUR 2Y10Y steeper, USD 2Y10Y flatter	The ECB keeps a tight leash on the short end of the curve but 10Y higher as US has an impact.
US-euro spread – short-end to widen further	The spread in the short-end is set to widen further as the Fed continues to hike.
Peripheral spreads – tightening	Economic recovery, ECB stimuli, better fundamentals, an improved political picture and rating upgrades to lead to further tightening despite the recent strong moves. Italien politics remains a clear risk factor.
FX & commodities	
EUR/USD – lower for longer... but not forever	Rangebound (1.15-1.21) on a 0-6M horizon but supported longer term by valuation and capital-flow reversal due to ECB 'normalisation'.
EUR/GBP – gradually lower over the medium term	Brexit uncertainty dominates now but GBP should strengthen on 6-12M on Brexit clarification and Bank of England rate hikes.
USD/JPY – higher eventually	US yields decisive near term; downside risks reduced on postioning correct. Longer term higher on Fed-Bank of Japan divergence.
EUR/SEK – downside now, but sticky above 10	Downside risks near term but SEK-negatives remain lower growth, subdued inflation and too aggressive Riksbank pricing.
EUR/NOK – to move lower but near-term topside risk	Positive on NOK on valuation, relative growth, positoning, terms of trade, the global outlook and Norges Bank initiating a hiking cycle.
Oil price – wide outcome space	Tug of war between geopolitical risks and OPEC+ getting ready to normalise output.

Source: Danske Bank

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This research report has been prepared by Danske Bank A/S (‘Danske Bank’). The author of this research report is Mikael Olai Milhøj, Senior Analyst.

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Ad hoc.

Date of first publication

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