8 September 2017

Strategy

Strong cycle while US debt limit risk is postponed

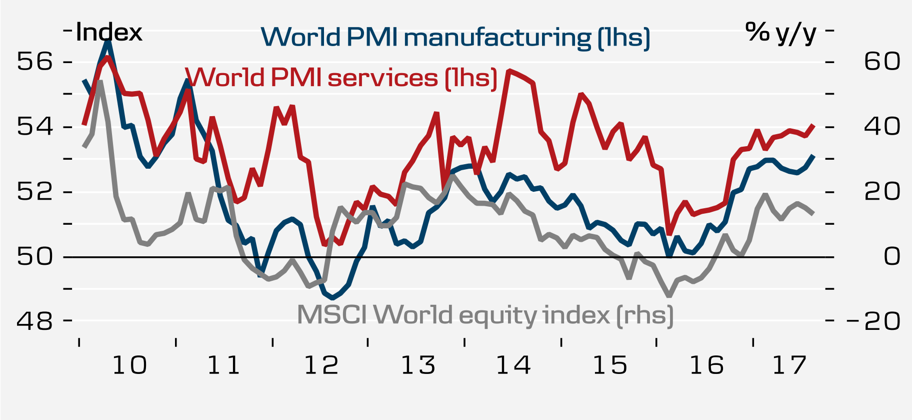
Global PMIs indicate strong global growth

In *Event risk to the fore*, published last Friday 1 September, we wrote event risks have returned to markets after being away for some time. However, **at least for a few months, we do not have to worry about the US debt limit**, after President Trump surprisingly struck a deal with the Democrats. The deal includes Harvey aid for Texas, extends government funding and suspends the debt limit until December. The deal caught us by surprise, as we thought the administration would be willing to fight harder for a longer lasting solution to the debt limit issue – however, the Republicans seem to be surprised as well. While the deal merely kicks the can down the road (see *Flash Comment US: Debt limit fight postponed amid increased Fed uncertainty*, 7 September), it means that in the very short term we only have to worry about the rising tensions with North Korea and the hurricanes hitting the US. As we still think the probability of an armed conflict with North Korea is low and hurricanes usually just have a short-lived impact on the economy, **it is difficult to be very concerned at the moment, especially as global PMIs suggest the world economy is in very good shape**. Based on the VIX, it also seems that investors are calm, as it remains very low historically**.** While the postponement of a more long-lasting solution to the US government budget and debt limit issues means we may not see a short-term relief rally in the equity markets, **we still think equities are a buy on dips in the short term, as the global economy is strong**.

Return of USD scarcity is postponed

In *FX Edge: The return of USD scarcity*, 29 August 2017, we highlighted that a solution to the debt ceiling issue would pave the way for an increase in the US Treasury cash balance in Q4 and a corresponding tightening of USD liquidity. However, due to the three-month suspension of the debt limit, the tightening of USD liquidity is likely postponed, possibly into 2018, as the stricter deadline is some months after December, as the Treasury can now "refill" some of the extraordinary measures it has exhausted in recent months. We still see value in positioning for tighter USD liquidity and a wider EURUSD CSS in 2018, see *FX Edge: The return of USD scarcity – postponed*, 7 September.

Strong cycle is good news for equities

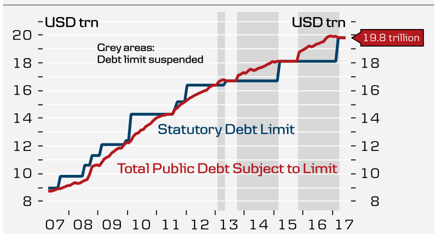


Source: Markit Economics, Bloomberg, Macrobond Financial

Today's key points

- Combination of strong global PMIs and postponement of US debt limit risk is good for equities.
- Trump's deal on the debt limit means that the return of USD scarcity is postponed, likely until next year.
- Any dips in EUR/USD should be shallow and short-lived. EUR yields to range trade before rising next year, as markets price in an ECB tapering premium.
- Fed to begin quantitative tightening at upcoming meeting but direction next year uncertain due to vacant seats.

US debt limit suspended until mid-December



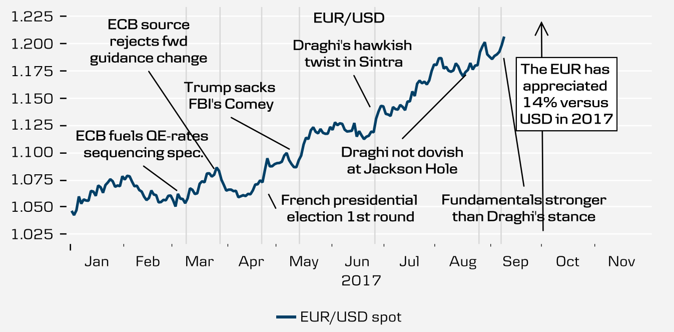
Source: US Treasury, Macrobond Financial

Senior Analyst
Mikael Olai Milhøj
+45 45 12 76 07
milh@danskebank.dk

Any dip in EUR/USD should be shallow and short-lived

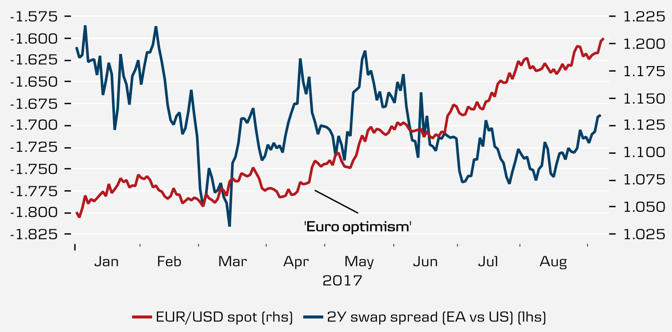
As expected, the ECB left its policy measures unchanged at this week's meeting and President Draghi indicated that any decision on the future of the QE programme will most likely come at the next meeting in October**. It remains our base case that the ECB will, at the October meeting, announce the QE programme will continue in H1 18 albeit at a reduced pace of EUR40bn per month**. For more see *ECB review: Warming up to QE extension in October*, 7 September.

ECB's Draghi was not able to talk EUR/USD down, as EUR momentum is strong



Source: Macrobond Financial

Decoupling of relative short nominal rates and EUR/USD recently



Source: Bloomberg, Macrobond Financial

There was a lot of focus on the strong EUR at the meeting, but despite Draghi's effort to sound dovish (not least as the ECB revised down its inflation forecasts for 2018 and 2019 by 0.1pp due to the EUR appreciation), he could not talk EUR/USD down and EUR/USD ended higher than it started, despite a rally in EUR fixed income. **The EUR momentum is strong and looking at IMM positioning data, investors are short USD and long EUR**, see *IMM Positioning Update: investors add USD shorts*, 4 September. Still, the market will keep in mind that the ECB is unlikely to tolerate further EUR appreciation in the short term, which should put a soft cap on EUR/USD ahead of the October meeting. However**, we think any dip should be shallow and short-lived and still look for a move higher in EUR/USD in 6-12M, as upside risks dominate.** As we argued in *FX Edge: Power of flows*, 23 August, equity flows and speculative positioning, rather than relative interest rates, have been key to explaining EUR/USD movements this year.

The euro fixed income market rallied after the ECB meeting (especially in the periphery), as the EUR is the key variable at the moment. The more the EUR appreciates, the more likely it becomes that the ECB will extend its QE programme and postpone hikes. **We think EUR yields will continue to range trade for the rest of the year but think markets will begin to price in an ECB tapering premium next year.**

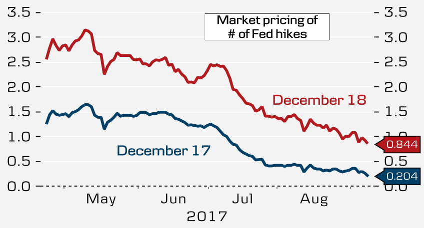
Big unknown what direction Fed goes next year

The Fed's blackout period ahead of the FOMC meeting on 20 September begins next week and three of the voting FOMC members (Brainard, Kashkari and Kaplan) took the opportunity this week to express concerns about inflation, as it continues to run below the 2% target. **While the Fed will most likely announce "quantitative tightening" at the upcoming meeting, the dovish speeches support our view that it is not a given the Fed will hike again in December although it remains our base case**. The problem for the Fed is that it has two goals – maximum employment and 2% inflation – but only one instrument (the fed funds target range). The reason we still believe the Fed will hike in December is that the core FOMC members put more weight on the labour market data, not least due to

Yellen's strong belief in the Phillips curve. NY Fed president Dudley supported this view in his recent speech. We think the probability of a December hike is 55%, so we seem in between market pricing (20%) and the consensus among analysts. **We still think risk is skewed towards the Fed pausing its hiking cycle, as it is likely still too optimistic on inflation due to the low inflation expectations**, which we have highlighted on several occasions, see e.g. *FOMC review: Smidgen dovish but it does not alter the overall picture*, 26 July. We still see a case for slightly higher US yields in Q4 as the markets reprice the probability of a December hike although the US debt limit risk returns in Q4.

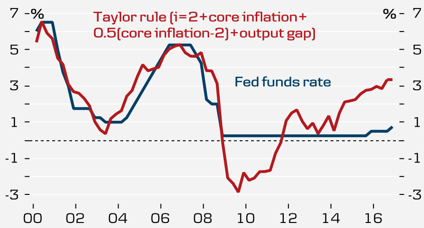
Still, the biggest unknown with respect to the Fed is what happens next year, not least following the announcement that Vice Chair Stanley Fischer has resigned with effect on or around 13 October due to personal reasons. **Fischer's resignation leaves four vacant seats out of seven on the Fed Board of Governors**. The governors are nominated by Trump but the nominees are subject to Senate approval. The number of vacancies may increase to five if Trump does not reappoint Yellen, which we do not expect, although the probability has increased after the *Wall Street Journal* reported that Trump is unlikely to nominate Gary Cohn as next Fed chair given Cohn's comments in reaction to Trump's statements after the Charlottesville riot. As Trump does not seem interested in monetary policy (he seems to think of economic policy in terms of trade policy and tax reform/deregulation/infrastructure investments), we think his Republican advisors will advise him to nominate traditional Republican candidates, which would likely lead to a more hawkish and rule-based Fed. A simple Taylor rule, which links the fed funds rate to inflation and unemployment, suggests the rate should be around 3% now (although we think this rule overestimates the appropriate level of the fed funds rate, as structural factors have lowered the so-called neutral rate (the appropriate interest rate level when the output gap is closed and the economy is in equilibrium). Overall, the risk is that the Fed may become less independent and raise rates too much.

Very soft Fed pricing – repricing in Q4



Source: Federal Reserve, Bloomberg, Macrobond Financial

Very simple Taylor rule suggests the fed funds rate should be 3%



Source: Federal Reserve, CBO, BLS, Macrobond Financial

Global market views

Asset class	Main factors
Equities	
Our short-term trading opportunity stance (0-1month): Buy on dips Our strategy stance (3-6M): Neutral on equities vs cash	We keep our short-term buy-on dips stance, as we think the fundamental factors (the global cycle and earnings) are still strong. So far, history shows that geopolitical shocks are not able to offset the equity markets as long as the cycle is strong. On a 3-6m basis, we remain neutral on equities, as we have been since April this year.
Bond market	
German/Scandi yields – set to stay in recent range for now, higher on 12M horizon	Inflation 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. Focus on possible tapering, but that is more of a 2018 story.
EU curve – 2Y10Y set to steepen when long yields rise again	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 earlier than we forecast.
US-euro spread set to widen marginally	The Fed's QT programme (balance sheet reduction) is to happen at a very gradual pace and impact on the Treasury market should be benign. Yet market pricing for Fed hikes is very dovish and yields should edge higher on 12M horizon. The market is positioned for lower US yields and vulnerable if we see a FI sell-off.
Peripheral spreads – tightening but still some factors to watch	Economic recovery, ECB stimuli, better fundamentals, particularly in Portugal and Spain and an improved political picture are expected to lead to further tightening despite the recent strong moves. Italy is the big risk factor. But very expensive to be short Italian bonds.
FX	
EUR/USD – consolidating near term but upside risks in 2018	EUR/USD has turned for good as ECB has reluctantly allowed 'reverse gravity' to kick in but upward momentum should wear off near term. Upside risks dominate in 2018.
EUR/GBP – upside risks remain but GBP to strength eventually	Deteriorating growth prospects, BoE on hold and Brexit mess to keep EUR/GBP above 0.90 in 3M. Downward move on Brexit clarification and valuation further out.
USD/JPY – gradually higher longer term but challenged near term	Policy normalisation at the Fed and eventually at the ECB while BoJ is in it for the long run means support for EUR/JPY and USD/JPY alike throughout our forecast horizon.
EUR/SEK – consolidation near term, gradually lower further out	Gradually lower in the longer term on fundamentals but near term further SEK potential is limited by a cautious Riksbank.
EUR/NOK – range-bound near term, then gradually lower	Headwinds near term due to low oil prices but longer term NOK rebound on valuation, growth and real-rate differentials normalising.
Commodities	
Oil price – range-bound	Supported by weak USD, declining US crude stocks and halt in further rise in US oil rig count. Precationary buying due to Hurricane Irma.
Metal prices – rally to fade	Underlying support from consolidation in mining industry, better China data lately. China to slow again after National Congress adding downside risks in the medium term.
Gold price – range-bound	To monitor development in global geopolitical risks.
Agriculturals – stabilisation	Dry weather created supply concerns but prices have come down again lately.

Source: Danske Bank

Disclosure

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

Analyst certification

Each research analyst responsible for the content of this research report certifies that the views expressed in the research report accurately reflect the research analyst's personal view about the financial instruments and issuers covered by the research report. Each responsible research analyst further certifies that no part of the compensation of the research analyst was, is or will be, directly or indirectly, related to the specific recommendations expressed in the research report.

Regulation

Danske Bank is authorised and subject to regulation by the Danish Financial Supervisory Authority and is subject to the rules and regulation of the relevant regulators in all other jurisdictions where it conducts business. Danske Bank is subject to limited regulation by the Financial Conduct Authority and the Prudential Regulation Authority (UK). Details on the extent of the regulation by the Financial Conduct Authority and the Prudential Regulation Authority are available from Danske Bank on request.

Danske Bank's research reports are prepared in accordance with the recommendations of the Danish Securities Dealers Association.

Conflicts of interest

Danske Bank has established procedures to prevent conflicts of interest and to ensure the provision of high-quality research based on research objectivity and independence. These procedures are documented in Danske Bank's research policies. Employees within Danske Bank's Research Departments have been instructed that any request that might impair the objectivity and independence of research shall be referred to Research Management and the Compliance Department. Danske Bank's Research Departments are organised independently from and do not report to other business areas within Danske Bank.

Research analysts are remunerated in part based on the overall profitability of Danske Bank, which includes investment banking revenues, but do not receive bonuses or other remuneration linked to specific corporate finance or debt capital transactions.

Financial models and/or methodology used in this research report

Calculations and presentations in this research report are based on standard econometric tools and methodology as well as publicly available statistics for each individual security, issuer and/or country. Documentation can be obtained from the authors on request.

Risk warning

Major risks connected with recommendations or opinions in this research report, including as sensitivity analysis of relevant assumptions, are stated throughout the text.

Date of first publication

See the front page of this research report for the date of first publication.

Disclaimer

This research has been prepared by Danske Bank A/S. It is provided for informational purposes only. It does not constitute or form part of, and shall under no circumstances be considered as, an offer to sell or a solicitation of an offer to purchase or sell any relevant financial instruments (i.e. financial instruments mentioned herein or other financial instruments of any issuer mentioned herein and/or options, warrants, rights or other interests with respect to any such financial instruments) ('Relevant Financial Instruments').

The research report has been prepared independently and solely on the basis of publicly available information that Danske Bank considers to be reliable. While reasonable care has been taken to ensure that its contents are not untrue or misleading, no representation is made as to its accuracy or completeness and Danske Bank, its affiliates and subsidiaries accept no liability whatsoever for any direct or consequential loss, including without limitation any loss of profits, arising from reliance on this research report.

The opinions expressed herein are the opinions of the research analysts responsible for the research report and reflect their judgement as of the date hereof. These opinions are subject to change and Danske Bank does not undertake to notify any recipient of this research report of any such change nor of any other changes related to the information provided in this research report.

This research report is not intended for, and may not be redistributed to, retail customers in the United Kingdom or the United States.

Disclaimer related to distribution in the United States

This research report was created by Danske Bank A/S and is distributed in the United States by Danske Markets Inc., a U.S. registered broker-dealer and subsidiary of Danske Bank A/S, pursuant to SEC Rule 15a-6 and related interpretations issued by the U.S. Securities and Exchange Commission. The research report is intended for distribution in the United States solely to 'U.S. institutional investors' as defined in SEC Rule 15a-6. Danske Markets Inc. accepts responsibility for this research report in connection with distribution in the United States solely to 'U.S. institutional investors'.

Danske Bank is not subject to U.S. rules with regard to the preparation of research reports and the independence of research analysts. In addition, the research analysts of Danske Bank who have prepared this research report are not registered or qualified as research analysts with the NYSE or FINRA but satisfy the applicable requirements of a non-U.S. jurisdiction.

Any U.S. investor recipient of this research report who wishes to purchase or sell any Relevant Financial Instrument may do so only by contacting Danske Markets Inc. directly and should be aware that investing in non-U.S. financial instruments may entail certain risks. Financial instruments of non-U.S. issuers may not be registered with the U.S. Securities and Exchange Commission and may not be subject to the reporting and auditing standards of the U.S. Securities and Exchange Commission.