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Strategy

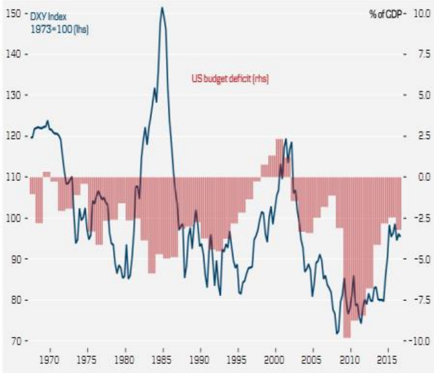
The danger of the consensus view

Since the Donald Trump US presidential election victory, a strong consensus has formed that the USD will strengthen substantially and that US rates will head a lot higher. The story goes that Trump-led fiscal stimulus will drive a higher US neutral rate and a stronger USD – much like during the first Ronald Reagan administration in 1981-84.

Near term, we agree – rising US growth expectations will drive a stronger USD and higher global rates. As we have pointed out recently (see *Strategy: The case for reflation – what it means and what to watch,* 18 November), the US economy was already gaining speed before the Trump victory. Over the past few weeks, euro area October retail sales, Germany factory orders and China PMI Manufacturing have all surprised substantially on the upside, suggesting that the US-led recovery is spreading to Europe. However, for us, the view of a stronger USD is a short-term one and there is a high risk that the push higher in global yields will lose steam.

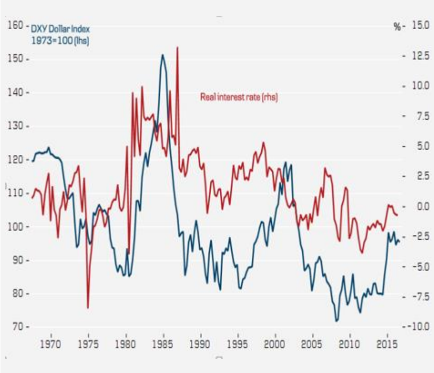
For a start, there is a lot of uncertainty about the type of US fiscal stimulus and how quickly it will filter through to the economy. For example, the infrastructure spending that Trump has been advocating will not be financed by the federal government but rather by a 'deficit-neutral system of infrastructure credits'. There is no guarantee that Congress will agree to the tax credits or that business will respond as intended. In addition, Trump's tax cuts will tend to benefit the 'better off', who have a lower propensity to consume and hence a lower fiscal multiplier (see Table 1). Finally, the output gap in the US is largely closed, which suggests that fiscal stimulus will be more inflationary than growth boosting and there may be a negative growth impact beyond a year (see Table 2 overleaf).

Chart 1: The USD tends to weaken when the US budget deficit widens...



Source: Macrobond Financial; Danske Bank

Chart 2: ...and Trump is not Reagan, as real interest rates will NOT rise



Source: Macrobond Financial, Danske Bank

Key points

- The market is convinced that significant US fiscal stimulus will drive a stronger USD and higher rates – particularly US rates.
- However, there is high uncertainty regarding the type of US fiscal stimulus and how it will filter through to the economy.
- For now, we are USD bulls and bearish US FI.
- However, an inflationary US fiscal boost should over time lead to a weaker USD – not a stronger one.

Table 1: US fiscal multipliers are low for tax cuts for higher income earners

Ranges for US fiscal multipliers	Estimated Multipliers	
	Low Estimate	High Estimate
Purchases of Goods and Services by the Federal Government	0.5	2.5
Two-Year Tax Cuts for Lower- and Middle-Income People	0.3	1.5
One-Year Tax Cut for Higher-Income People	0.1	0.6

Source: Congressional Budget Office

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As such, there is a substantial risk that at some point during 2017 the market will be disappointed with US growth prospects. From a USD perspective, Trump/Janet Yellen are very different from how Reagan/Paul Volker were during the early 1980s, when significant fiscal stimulus was combined with a much more hawkish outlook, driving a rapid increase in real interest rates (see Chart 1 and Chart 2). Indeed, we see the risks skewed towards the Fed lowering its long-term neutral rate at next week's meeting. In our view, the FOMC will shift in a more dovish direction in 2017 due to the change in voting rights, even taking into account that Trump may appoint hawkish governors for the two vacant seats. We note that the Fed's trade-weighted dollar has reached the strongest level since 2002. If the USD becomes too strong, the Fed will turn dovish exactly as it did early this year. Hence, Trump's policies should lead to higher inflation and higher inflation expectations and lower US real interest rates. This is exactly the opposite of the Reagan/Volcker period and is not USD bullish – quite the opposite. **Lower real interest rates should lead over time to a weaker USD – not a stronger one**.

Meanwhile, it is becoming increasingly costly to be bearish on US FI if you do not get the timing right. For example, the 10Y UST yield is around 2.44%. Taking into account the carry and roll-down, the 10Y UST yield will need to be above 2.70% in 12 months for investors to make money being short 10Y UST now. We need only remind ourselves about what happened in 2014 when the USD rallied strongly. At end-2013, most observers were expecting a sharp increase in US rates but instead the 10Y UST yield fell to 2.17% at end-2014, from 3.03% at end-2013. For 2017, it is difficult to imagine both that the USD will rally sharply and that US rates will head a lot higher. Something has to give**. In our view, the USD will be first to give, when we expect dollar strength in late 2016 to early 2017 to give way to a broadly weaker greenback later in the year**.

Table 2: Fiscal multipliers are low when output is close to potential and Fed will react (as of now)

The effect of a one dollar increase in aggregate demand over eight quarters	Output well below potential, no Fed response		Output close to potential, typical Fed response	
Quarter	Low	High	Low	High
1	0.5	1.5	0.5	1.4
2	0.0	0.6	0.0	0.5
3	0.0	0.3	0.0	0.1
4	0.0	0.2	-0.1	-0.1
5	0.0	0.0	-0.1	-0.3
6	0.0	0.0	-0.1	-0.3
7	0.0	0.0	-0.1	-0.3
8	0.0	0.0	-0.1	-0.3
TOTAL	0.5	2.5	0.2	0.8

Source: Congressional Budget Office

Table 3: Global market views

Asset class	Main factors
Equities	
Overweight stocks short and medium term	Cyclical recovery.
Overweight US, underweight Europe and Nordics, underweight emerging markets (EM)	Fiscal boost to US will raise earnings relative to Europe. High risk of protectionism and tighter monetary policy hurting EM assets.
Bond market	
Higher yields, further steepening 2Y10Y curve	More expansive fiscal policy in the US adds to steepening trend. Tapering, higher inflation prints and a global recovery also point to a steeper curve. ECB QE should mitigate some of the effects.
US-euro spread: slightly wider in 2017	The Fed hike is moving closer, adding upside potential to the long end of the US curve but ECB tapering and higher inflation prints are risks for the European bond markets, which could potentially tighten the US-Euro spread given that European yields are record low.
Peripheral spreads: tightening	Economic recovery and QE mean further tightening but politics and tapering remain clear risk factors.
Credit spreads: neutral	The ECB is keeping spreads contained.
FX	
EUR/USD - lower going into FOMC meeting in December and early 2017	USD set to remain supported by Trump and Fed in the near term. EUR/USD to head higher beyond 3M.
EUR/GBP - risk skewed on the upside in the run-up to when the UK government is likely to trigger Article 50	Expect EUR/GBP to settle in the 0.83-0.88 range near term. Risk skewed on the upside over the medium term due to Brexit.
USD/JPY - neutral with short-term risks skewed on the upside	USD/JPY set to remain supported near term by relative monetary policy and risk appetite.
EUR/SEK - set to stay elevated in coming months before turning in 2017	Gradually lower on relative fundamentals and valuation in 2017. Near term, the SEK will remain weak due mainly to the Riksbank.
EUR/NOK - short-term risks skewed on the upside	At YE, liquidity set to prove a headwind for NOK. Cross set to move lower next year on valuation and real rate differentials normalising.
Commodities	
Oil price - OPEC rally over; awaiting response from non-OPEC	Support from positive growth and inflation sentiment; near-term focus implementation of OPEC deal.
Metal prices - rallying on outlook for US infrastructure spending	Underlying support from consolidation in mining industry and recovery in global manufacturing.
Gold price - change in risk sentiment negative for gold price	Rising yields and USD pushing gold price down.
Agriculturals - strong output has sent prices down again	Attention has turned to *La Niña* weather risks over the winter, large stocks limit upside risk to prices.

Source: Danske Bank Markets

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None.

Date of first publication

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