12 October 2018

Strategy

Equity sell-off is temporary despite slower growth

Equity sell-off is temporary, equities are still set to move higher in 3-12M. This week has been hard for the equity markets and on Wednesday the US S&P500 experienced the biggest daily drop since the correction in late January/early February. We see two main reasons for the US-driven global sell-off. First, investors have become more realistic about the monetary policy outlook due to strong macro indicators. US yields have moved higher driven by higher real rates. As long as higher yields are growth-driven (opposed to inflation-driven), the equity markets should be able to absorb higher bond yields. Secondly, there are now signs that US stocks are catching up with the trade war, as some companies have begun to complain about rising materials costs hitting profit margins. We stick to our view that on a 3-12M horizon, equities will outperform bonds, as the expansion is set to continue. The coming weeks will be driven primarily by earnings reports, where companies are likely to comment on margin pressure from both the tight labour market and the trade war. If we are right, then volatility could continue.

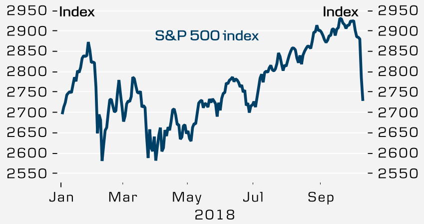
China eased monetary policy over the weekend. Last weekend, China eased monetary policy by reducing the Reserve Requirement Ratio by one percentage point for a range of banks. We still believe the trend of higher USD/CNY is set to continue, as China keeps easing monetary policy, whereas the Fed continues on a tightening path (our Fed call is four hikes from now until year-end 2019, see *FOMC review: Gradual Fed hikes are set to continue*, 26 September). That said, it seems that China has taken steps to halt the CNY depreciation, as CNH money market rates have moved sharply higher, which is a sign that Chinese authorities are tightening liquidity making it more expensive to fund short selling of the currency. We look for USD/CNY to hit 7.20 in 12M.

The IMF cut its global GDP growth forecasts slightly for both this year and next year. The IMF now sees global growth at 3.7% in both years, down from 3.9% previously, which, however, is still above potential. The main reasons for the downward revision are the US-China trade war and slower growth in key emerging markets such as Latin America (Argentina, Brazil and Mexico), emerging Europe (Turkey), South Asia (India), east Asia (Indonesia and Malaysia), the Middle East (Iran) and Africa (South Africa). In last week's Strategy piece, we discussed the fact that growth is slowing while headline inflation is moving higher due to higher energy prices, see *Strategy: Stagflation? Growth slows, while inflation pushes higher*, 5 October. Our base case remains that global growth will stabilise soon and continue at cruising speed. The euro area is set to bottom out, and despite the US-China trade war, we believe both monetary and fiscal easing in China will serve as a cushion to growth. We expect US growth rates to slow down from the 4+% in Q2 but to remain above trend over the next year, also supported by very expansionary fiscal policy.

Today's key points

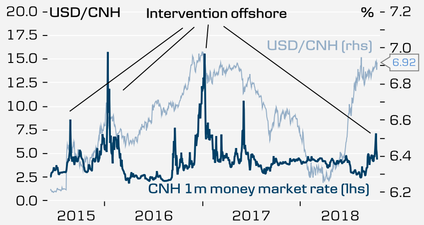
- Equity self-off is temporary; equities are still set to move higher in 3-12M.
- China has eased monetary policy but does not want CNY to depreciate too quickly.
- IMF has cut its global GDP growth forecasts slightly.
- Brexit-optimism has led to an appreciation of GBP.

US-driven global equity sell-off



Source: Bloomberg, Macrobond Financial

CNH money market rates moving higher



Source: Bloomberg, Macrobond Financial

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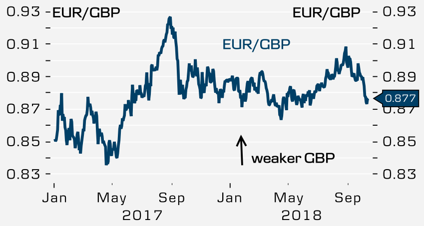
Brexit-optimism has led to an appreciation of GBP. With the Conservative Party Conference over, there are media reports that constructive negotiations are taking place between the UK government and the EU and that a deal is moving closer. Some reports suggest that a deal may be as imminent as Monday (the Irish border remains the biggest obstacle). However, it is important to stress that this is only about the withdrawal agreement under Article 50 and not about the framework of the future relationship – we still do not know what that looks like. This is what the two sides are set to negotiate in the coming month, ahead of the likely extraordinary EU summit in mid-November. The problem for the UK government is that it must not be too vague, otherwise it is a difficult ‘sell’ in the UK. Other positive news for PM Theresa May is that around 30 Labour MPs are considering voting in favour of her Brexit-deal, whenever it is put to the House of Commons, as they fear a ‘no deal scenario’. If so, PM Theresa May does not need to rely on the votes of hard Brexiteers, who have repeatedly said they would vote down any Brexit-deal keeping the UK too close to the EU.

EUR/GBP was trading as high as nearly 0.91 by the end of August but is currently trading at 0.877 on higher Brexit-optimism. Our base case remains a ‘decent Brexit’, in which the UK exits in an orderly manner but does leave the single market, see *Brexit Monitor: Get ready for the end-game*, 27 September. We expect EUR/GBP to break lower once a no deal scenario can be ruled out and forecast a move down to 0.83 in 12M.

EUR/GBP has moved down on higher Brexit-optimism



Source: Bloomberg, Macrobond Financial

Financial views

Asset class	Main factors
Equities	
Positive on 3-12 month horizon.	Fundamentals still supports equities on a 3-12M horizon. In the short run trade tension and the situation in Italy could lead to continued high volatility, but an expected strong earnings season should stabilise market
Bond market	
German/Scandi yields – stable for now, higher in 12M	Strong forward guidance from the ECB. Core inflation remains muted. Range trading for Bunds for the rest of 2018. Still higher in 2018.
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. EUR 2Y10Y mainly steeper in 2019.
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 (Italy special case)	ECB forward guidance, better fundamentals, an improved political picture (ex. Italy) and rating upgrades to lead to renewed tightening after recent widening. Italy remains a special case.
FX & commodities	
EUR/USD – lower for longer... but not forever	In a range around 1.15 in 0-3M as USD carry and political risks weigh but supported longer term by valuation and 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 with political uncertainty as a significant downside risk. Longer term higher on Fed-Bank of Japan divergence.
EUR/SEK – downside in warm-up to first hike	Lower as first hike from Riksbank looms by year end - but it could be one-and-done which should limit SEK strength thereafter.
EUR/NOK – set to move lower still	Positive on NOK on valuation, relative growth, positioning, terms of trade, global outlook and Norges Bank initiating a hiking cycle.
Oil price – range trading rest of year	On the rise as supply tightens and trade concerns ease

Source: Danske Bank

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