15 September 2017

Strategy

A tale of three central-bank camps

In a week which saw risk sentiment improving again following set-backs ahead of hurricane Irma and the imposition of harsher sanctions against North Korea, we also saw the Bank of England (BoE) signal a hiking cycle to begin sooner than we and the market were looking for, and the Swiss National Bank (SNB) emphasising its commitment to accommodative policy. **In our view, this served to confirm that central bankers are now divided into largely three camps.**

In the 'exit' camp we have the central banks looking to 'normalise' policy after years of using unconventional measures. A prominent member of this camp is the Fed, which has in fact been in tightening mode since the tapering discussion began back in 2013. But, this week's BoE meeting also clearly cemented that the BoE is keen to start a hiking cycle, see *Bank of England review: November hike is now a close call*. And then importantly, in our view, there is the ECB, which has somewhat started talking about 'reflationary' (rather than deflationary) risks – a wording once again used by ECB chief economist Praet in a speech reiterating the hawkish tone from last week's meeting.

In the 'no exit' camp, we have the central banks keen to avoid joining the 'normalisation' discussions taking place elsewhere, not least as they worry this could bring about unwanted currency strength. The Bank of Japan (BoJ) has clearly placed itself in this camp following the introduction of yield curve control and will likely stay in easing mode for an extended period as price pressure remains weak, see *Research Japan: Running on all engines*. This week's SNB meeting also confirmed that the Swiss are 'in it' (negative rates and a bloated balance sheet) for the long run as sustained price pressure is lacking still.

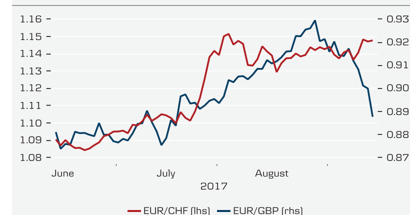
And then there is the group of those in-between, reluctant to side with either camp: arguably these would under 'normal' circumstances be looking to make policy less accommodative but are reluctant to do so as they are uncertain whether underlying inflationary pressure is strong enough to withstand currency strength along the way. This group in our view includes notably the Riksbank and Norges Bank, with the latter struggling with recent low inflation prints and the former insisting the latest inflation uptick is temporary; also both are wary of potentially wobbly housing markets.

Next up for revealing its preferences regarding policy is the Fed with the FOMC meeting next week, see *FOMC preview*, 15 September 2017. We expect the Fed to stay on hold but announce it will begin shrinking its balance sheet in October. The latter is widely expected and should not have a major impact on neither Treasury yields nor USD. But we also expect the median FOMC 'dots' to still signal one more hike this year and three hikes next year, which remain far from market expectations. This week saw a decent inflation print out of the US which, alongside slightly improved prospects of a corporate tax reform in the US, should keep the Fed on track for a December hike, in our view, even if it is an increasingly close call.

Today's key points

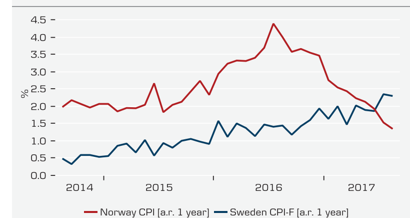
- Central bankers look increasingly divided into those in the 'exit' camp (Fed, BoE, ECB), those in the 'no exit camp' (BoJ, SNB), and those in between (Riksbank, Norges Bank)
- While the Fed looks determined to hike in December, it is unlikely to drive a major sell-off in EUR/USD

SNB welcoming EUR/CHF uptick – EUR/GBP eyeing BoE hikes (again)



Source: Bloomberg, Macrobond, Danske Bank

Norwegian and Swedish inflation diverging



Source: Macrobond, Danske Bank

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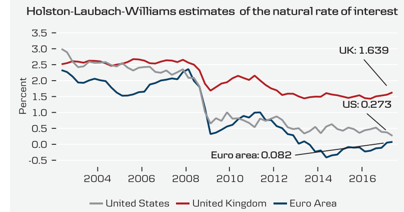
With central banks divided as indicated above, it is tempting to conclude that US yields should move higher and that USD strength could materialise near term. But not so fast: the short end of the US yield curve has struggled to move higher this year, which may be ascribed partly to fading Trump optimism, but which may more broadly be seen in the context of the sustained downward pressure on the natural rate of interest across a range of countries. The latter hints that the longer-term potential for yields to move higher may be limited, which in turn suggests that the potential for the Fed to hike and reduce its balance sheet simultaneously could be rather limited. This week we have seen a decent rebound in US and European bond yields, but we do not see this as the start of a continued sell-off in the bond market.

Natural rates of interest have dropped

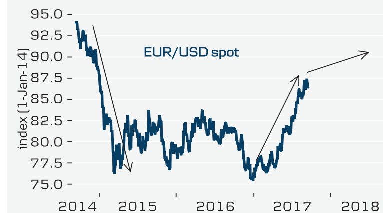


Source: Macrobond Financial, Danske Bank

In the FX sphere, while USD/JPY remains in the hands of US Treasury yields which could be in for a muted rise in 2018, relative interest rates have largely failed to track movements in notably the sustained uptick in EUR/USD in the year so far. **That said, a range of factors should cap EUR/USD upside near term on top of the possible, if limited, downside from a possible December Fed hike.** Speculative positioning is closing in on stretched territory, suggesting risks are tilted to the downside for the cross. Unhedged equity flows seems to be fading and should thus provide less EUR support going forward. Also, our quantitative business-cycle models suggest the US economy is re-gaining momentum while the eurozone is now losing steam a bit.

But, as we highlighted in *FX Edge: Power of flows - EUR/USD eyeing 1.30 longer term,* **the potential for a 'normalisation' in eurozone debt flows as the next leg of ECB exit pricing gains traction is a key source of upside risk for the single currency longer term**. Crucially, the ECB seems increasingly willing to accept EUR appreciation these days as long as it happens gradually and is supported by a strong domestic economy. We look for EUR/USD to trade in a range around the 1.20 mark near term and reiterate our call that any dips in the cross will be shallow and short-lived. **While we still look for a move towards the mid-1.20s further out we emphasise that the speed with which EUR/USD is set to move higher will be reduced going forward. Next to join the 'exit' camp could be the Riksbank, which we think will end its QE scheme this December**. Relatively high inflation prints for the remainder of this year should serve as a cap on EUR/SEK, but significant SEK appreciation from here still requires a marked shift in policy stance from the Riksbank. **We look for continued range-trading in EUR/SEK around 9.50 in the next few months.**

EUR/USD to move at reduced speed ahead



Source: Macrobond Financial, Danske Bank

Global market views

Asset class	Main factors
Equities	
Our short-term trading opportunity stance (0-1month): Buy on dips	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.
Our strategy stance (3-6M): Neutral on equities vs cash	
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 – consoldating 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 send EUR/GBP back 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.
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.

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Expected updates

None.

Date of first publication

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