15 December 2017

Strategy

Strong economy and low rates continue

Economic data still strong

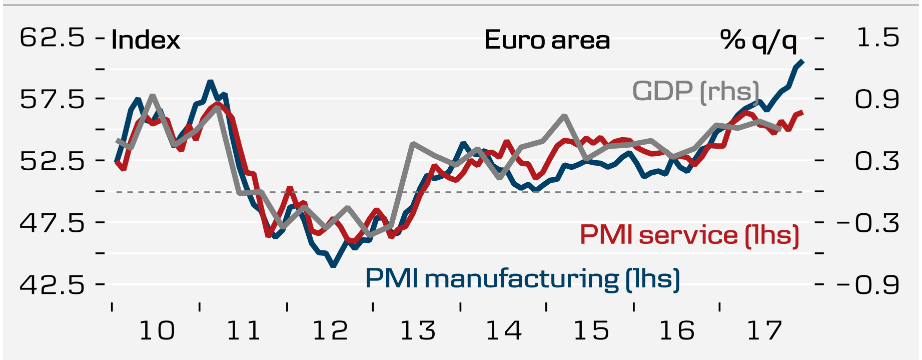
As we argued in our semi-annual global outlook *The Big Picture – Global economy still on a roll*, 4 December, the world economy is in good shape. **Growth across regions is quite strong compared with previously in this cycle, inflation remains muted, central banks are tightening monetary policy only gradually and there are not many risk factors to worry about near term.** We expect the global expansion to continue in coming years. Economic data and events over the past week have supported this view.

In the euro area, PMI manufacturing and PMI services rose and PMI composite now indicates 0.8% q/q GDP growth in Q4, which would be one of the strongest quarters since the 2011-13 European debt crisis. **Although soft economic indicators have had a tendency to over-estimate hard economic data recently, 2017 is still the strongest year since the crisis in terms of economic growth in the euro area.** Labour market data show euro area employment was 1.7% higher in Q3 17 than in Q3 16 (the strongest employment growth rate since the crisis).

In the US, NFIB small business optimism rose to one of the highest levels ever recorded, as tax reform is moving closer, although not a done deal yet. Combined with strong consumer confidence, it suggests the expansion will continue in coming years and that growth will become more balanced, driven by both consumption and investments. Retail sales in November indicate private consumption growth is strong here in Q4. Despite the expansion having lasted longer in the US than in Europe, it is interesting that inflation remains muted in the US. CPI core was once again weaker than expected (0.1% m/m versus 0.2% m/m expected), implying a CPI core inflation rate of just 1.7%.

In terms of political risks, it is good news that last Friday the UK and EU reached an agreement on the first phase of Brexit negotiations (divorce bill, Irish border and citizens' rights). Although EU leaders have not yet officially said the deal is 'sufficient' to move negotiations forward to transition and the future relationship, we believe this should be a formality. While it is too early for markets to price out the Brexit premium in GBP yet, as uncertainty remains high on what Brexit really means in terms of the future economic relationship, the better negotiating environment is promising for reaching a final deal eventually. This is one reason we expect EUR/GBP to move lower on Brexit clarification in 6-12M.

Very strong PMIs in the euro area

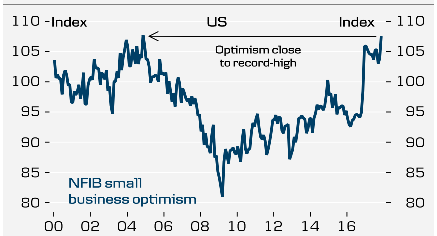


Source: IHS Markit, Eurostat, Macrobond Financial

Today's key points

- Recent economic data releases support our view that the global expansion continues, not least in the euro area, where PMIs have been very strong in Q4.
- It is too early for markets to price out Brexit risk just yet but it is positive that negotiations are moving forward.
- Central bank meetings support our view that global monetary policy tightening will be gradual.
- The environment is positive for risk assets such as equities; we believe EUR/USD will move higher and yields will stay low.

Extremely high optimism in the US



Source: NFIB, Macrobond Financial

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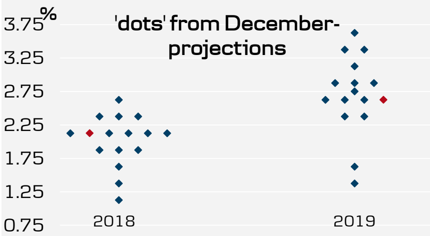
Central banks tightening monetary policy only gradually

We have had many central bank meetings this week, all of which support our view that global monetary policy will be tightened only gradually. The Fed hiked the target range by 25bp to 1.25-1.50% as expected, while still signalling three hikes in 2018 and slightly more than two in 2019. This was interpreted dovishly by the markets, as Janet Yellen revealed that 'most' FOMC participants have included some fiscal stimuli from tax reform in their projections but still the dot signals were broadly unchanged. While, all else being equal, higher growth means the dot plot should have been revised higher, the persistent low inflation pulls in the other direction, netting each other out. For more, see *FOMC Review – Broadly unchanged Fed signal*, 13 December.

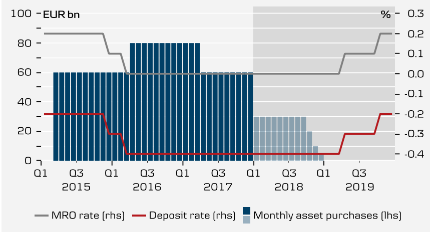
Fed expects three hikes in 2018 and slightly more than two in 2019



Source: Federal Reserve

The ECB delivered a fairly balanced policy message without further hints about a shift towards a more 'holistic' view on inflation and the economy despite a stronger growth and inflation outlook. We expect discussions about QE exit and policy normalisation to gain prominence in spring 2018. However, as QE is set to continue until at least September, we do not expect the first ECB hike before Q2 19. For more, see *ECB Review – Christmas mood leaves QE exit decisions for 2018*, 14 December.

ECB set to taper QE purchases to zero in Q4 18



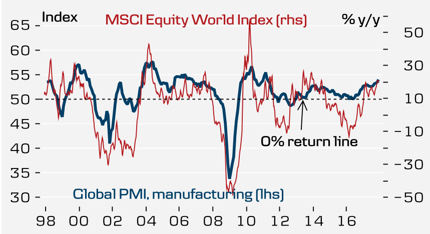
Source: ECB, Macrobond Financial, Danske Bank

The Bank of England (BoE) did not change either the Bank Rate or its signals about future rate hikes. However, it noted that the Brexit deal on phase 1 may support business and consumer confidence and hence the economy. We believe the BoE will stay on hold in 2018 and not hike before Q1 19, as, in our view, it is too optimistic on wage growth and hence underlying inflation pressure and is reluctant to tighten too much relative to the ECB. Economists are divided on whether the BoE will hike in Q4 18 or Q1 19, while markets have priced in the first hike in Q4 18. Regardless of when the next hike comes, the BoE is still signalling that the hiking cycle will be gradual and limited in its extent.

Market views

A combination of strong global cycle, muted inflation and few near-term risks is usually a good environment for risk assets such as equities. We remain positive on equities.

Strong global cycle good news for equities



Source: IHS Markit, MSCI, Macrobond Financial

We still believe EUR/USD will move higher in 2018 and target 1.25 in 12M. While relative rates could possibly weigh a bit in the near term, we expect the FX market to focus increasingly on the potential for debt flows to support the single currency in the ECB's 'exit' process, which is only just getting started. We are long EUR/USD on a 12M horizon via options in *FX Top Trades 2018*, 6 December.

Despite central banks having begun the process of tightening monetary policy gradually, we expect policy rates to remain substantially below pre-crisis levels due to a low natural rate of interest. In the US, we expect US yields to move higher, as markets are still pricing the Fed too softly but **we expect the flattening of the UST 2Y10Y curve to continue**. The short end is pushed higher by Fed rate hikes, while the long end could be kept low by investors buying 'high yielding' US fixed income assets, low inflation expectations and a lower neutral rate. **In Europe, we expect a steeper curve**, as we think the ECB maintains a tight grip on the short end of the curve, while the long end is pushed higher by US yields and a smaller QE programme. We have a 12M 0.7% forecast for 10Y Germany. For more, see *Yield Outlook – Central bank exit but only modestly higher long yields*, 14 December.

Global market views

Asset class	Main factors
Equities Positive on 3-6 month horizon.	Strong business cycle and near double digit earnings growth in most major regions. Low rates and bond yields drive demand for risk assets.
Bond market	
German/Scandi yields – set to stay in recent range for now, higher on 12M horizon	Inflation set 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. ECB on hold for a long time.
EU curve – 2Y10Y set to steepen when long yields rise again. Flattening	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 but that is a 6M to 12M forecast.
US-euro spread - set to widen marginally	The Fed's QT programme (balance sheet reduction) is set to happen at a very gradual pace and the effect on the Treasury market should be benign. Yet, market pricing for Fed hikes is still dovish for 2019 and yields should edge higher on a 12M horizon.
Peripheral spreads – tightening but still some factors to watch	We expect economic recovery, ECB stimuli, better fundamentals, particularly in Portugal and Spain, an improved political picture and rating upgrades to lead to further tightening despite the recent strong moves. Italy is the big risk factor but it is very expensive to be short Italian bonds.
FX	
EUR/USD – consolidating near term but upside risks in 2018	EUR/USD to be rangebound near term. We still see the cross moving firmly into mid-1.20s supported by valuation and debt-flow reversal in 2018.
EUR/GBP – in range near term but GBP to strengthen eventually	We still see EUR/GBP within 0.8650-0.90 in coming months as the Brexit risk premium is likely to persist despite progress in negotiations. Longer term, GBP should
USD/JPY – gradually higher longer term but challenged near term	Policy normalisation at the Fed and eventually at the ECB, while the Bank of Japan is staying dovish, means support for EUR/JPY and USD/JPY alike on a 12M horizon.
EUR/SEK – risk to the topside on housing market, Riksbank pricing	Housing market risk premium to keep SEK under pressure alongside too aggressive Riksbank market pricing. Eventually lower but not story in coming quarters.
EUR/NOK – lower but watch out for year-end NOK-seasonality	NOK headwinds towards year end but longer term we expect the NOK to rebound on valuation, growth and real-rate differentials.
Commodities	
Oil price – range trading	June review weakens impact of extension of OPEC+ output cuts. Geopolitical tensions around Saudi Arabia and Iran on the rise. Temporary disruption on Forties

Source: Danske Bank

Disclosures

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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Expected updates

None.

Date of first publication

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

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