17 February 2017

Strategy

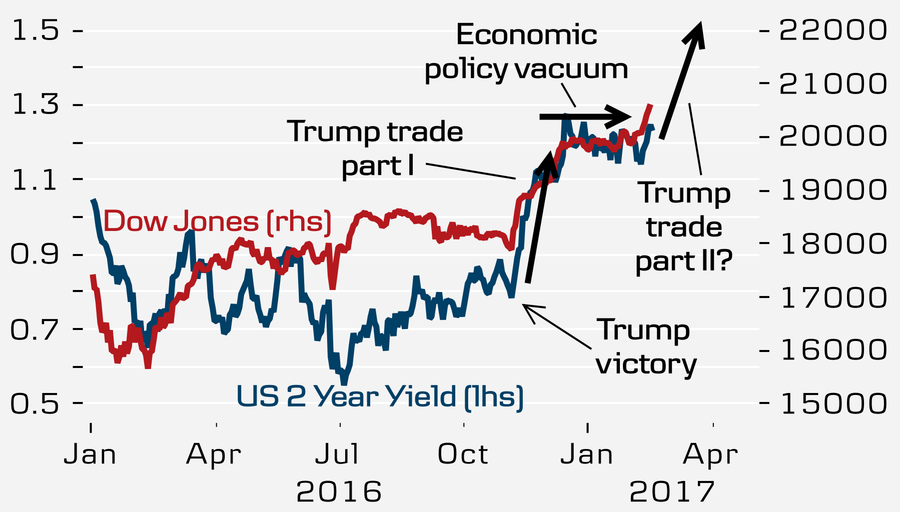
Trump Trade — Part II?

The initial market reaction to Donald Trump's victory in November was startling. As the market expected a major fiscal easing together with financial deregulation in the US, **e**quity markets rose sharply, while the USD and US yields soared (see chart below). This gave birth to new Trumpeconomics, Trumpflation, etc.

Markets left empty handed on concrete details on the new economic reform measures. Instead, the new Trump administration seemed busier, tweeting prolifically, implementing a controversial immigration ban and creating doubts about the US's relationships with important trading partners such as Europe, Mexico and China. With the market growing more impatient with Trump's economic policy agenda, the Trump trade rally fizzled out and equity markets and US yields have traded more or less flat while the USD lost momentum.

However, this may be about to change, as the Trump administration finally seems to be pushing forward with its economic reform agenda. First, he now has a Treasury Secretary following the US Congress's approval of Steve Mnuchin on 13 February after some foot-dragging by the Democrats. Concurrently, Trump has announced that he will provide details about his tax reform on 28 February. We can only guess about the size and nature of the reform but we believe it is likely to entail a combination of corporate and income tax cuts together with some elements of cross-border tax adjustment. In addition, the Trump administration has started dismantling the Dodd-Frank reform; last Friday, Trump signed an executive order asking the heads of the regulatory agencies together with Treasury Secretary Mnuchin to come up with measures in the next 120 days to deregulate the US financial sector to encourage more lending to the private sector.

After a pause, another leg of the 'Trump Trade' may reignite



Source: Macrobond Financial

Key points

- After a lot of political noise, the Trump administration is finally starting to gear up the economic policy agenda.
- This may reignite the second leg of the 'Trump trade' following a brief pause.
- We recommend positioning for a stronger USD and a leap higher in US equity markets in coming months.
- US yields may also increase but the crux is the Fed reaction to Trump's fiscal plans.
- A stronger USD and higher US yields, together with a Chinese economic slowdown, are likely to weigh on emerging market currencies over the next few months.

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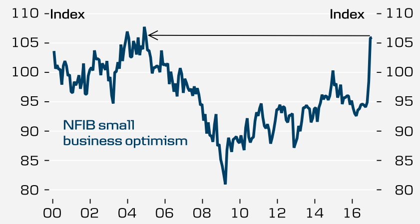
While the size and impact of the tax reform is highly uncertain, it will come at the backdrop of strong US economic momentum. Data released this week points to a US economy continuing to grow at above-trend pace; Strong retail sales for January showed that private consumption started the year on a strong footing, while consumer confidence continues to be high. Both the Empire and Philly index (two regional manufacturing PMIs) surged in February, suggesting that growth in the US manufacturing sector continues to increase after a couple of very difficult years and we may soon begin to see a pickup in investments. Optimism among small businesses have risen significantly after President Trump's victory and is at the highest level since 2004.

Animal spirits? Optimism highest among small US businesses since December 2004



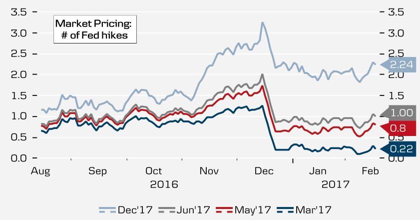
Source: Danske Bank Markets

Fixed income – the pressure is building for higher yields

A key question is what will happen to fixed income markets as the Trump economic reform agenda becomes clearer. So far, the 10Y US Treasury yields have traded in a relatively tight range around 2.40% since the big sell-off in November 2016 despite the continuing risk rally in equities and credit markets.

One reason why yields have not been able to join 'the party' is probably positioning, as many investors are already positioned for higher yields. However, foreign demand might also play a role. Monetary policy keeps yields in both Germany and Japan at a very low level and, with rising global inflation, the higher yields in the US are much more attractive for long-only investors, as they are met with negative real rates in their home markets.

Market pricing of Fed hikes starting to leap higher again



Source: Danske Bank Markets

However, if we get more clarity on Trump's economic plans it might be the trigger for higher yields in both the US and Germany/Scandinavia. In our view, the crux for the market will be the policy response from the Federal Reserve. We already know that a significant number of FOMC members have not taken a new more aggressive fiscal policy into account.

That said, we do not think the clarity will be high enough for the FOMC to hike rates as a direct response at the next FOMC meeting on 15 March. However, the risk is skewed towards more rate hikes than previously expected by the market. Following the latest comment from Fed Chair Janet Yellen that the central bank is nearing its dual goals, we believe three rate hikes in the US is a likely outcome. The market is pricing in a March rate hike with approximately a 40% probability.

Hence, we continue to hold the view that both 10Y US treasury and 10Y German Bund yields will end the year well above the current level. We have a year-end target of 0.90% for Bund yields and 3.0% for US 10Y Treasury yields. For more, see *Yield Forecast Update: Higher yields an H2 17 theme*, 13 February.

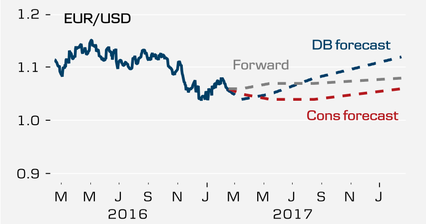
Equities – bullish US equities

The impact on economic growth from fiscal easing and corporate tax cuts for US companies will, in our view, be a strong positive catalyst for US earning growth. In a scenario where the corporate income tax is lowered to 20% from the current level of 39%, we think the price/earnings ratio would fall from the current 18x to around 15x. This would translate into potential upside of around 10% from current prices. We continue to see cyclicals outperforming defensives given the underlying EPS and GDP growth trends. At the same time, we remain underweight Europe amid political risks and a still-subdued earnings outlook.

FX – US dollar strength near term

We think that the combination of Trump's economic policy agenda (corporate tax reforms, border tax adjustments and a possible home investment act 2) will support the USD near term. We published an FX strategy discussing the impact of each of these measures on the USD in detail (see *Why EUR/USD will fall near term; rally medium term*, 13 February). In our view, relative rates between the US and the eurozone and political uncertainty in Europe in the run-up to, notably, the French election in April/May will send the EUR/USD lower to 1.04 in 1M and 1.05 in 3M. However, we maintain our long-held view that the cross will move higher in H2 as we are EUR/USD bullish on valuation and the record-high EU-US current account differential. In addition, we believe that a substantially larger US budget deficit would be negative over time for the USD, as US real interest rates would fall.

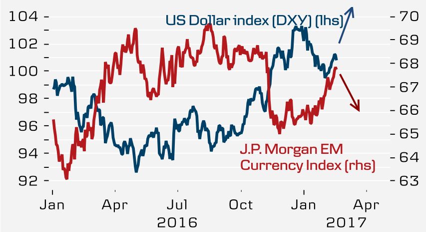
US dollar strength set to resume in coming months but weaken against EUR in H2 17



Source: Danske Bank Markets

In line with our call in *Emerging Market Briefer: A murky outlook for emerging markets in 2017*, 19 December, emerging market currencies have performed relatively well in the first quarter so far. Not only has the pause in USD strength and stabilising US yields aided emerging market currencies but China's economic growth and commodity prices have also held up quite well. We think that a stronger USD and possibly higher US yields as part of a reigniting Trump trade could exert pressure on emerging market currencies in coming months. At the same time, we think that Chinese economic growth may lose steam, which we think will be negative for notably emerging market commodity-producing currencies. Hence, after a strong run, we look for weakness in the BRL, TRY and ZAR.

Emerging market currencies likely to come under pressure from stronger USD



Source: Danske Bank Markets

Global market views

Asset class	Main factors
Equities	
Overweight stocks short and medium term	The reflation trade with cyclicals outperforming defensives is still in play as the underlying EPS and GDP growth trends are still intact.
Underweight developed markets, overweight emerging markets Overweight US, Japan, Nordics and Russia/Eastern Europe; underweight Europe and LatAm; neutral on China	The very communicative new president in the US is not able to offset this. In our view, his policy agenda is still about growth.
Bond market	
Higher yields after period of consolidation, further steepening 2Y10Y curve	The US FI market is now more or less priced according to our view for 2017 and, after the recent spike in US yields, the upside potential for the next three months should be limited.
US-euro spread: slightly wider in 2017	As we move further into 2017, we could see a tightening of the USD-EUR spread in the 10Y segment as the strong USD caps the upside potential for longer US yields and an end to ECB QE is coming closer.
Peripheral spreads: tightening but clear risk factors to watch	Economic recovery and QE should mean further tightening but politics (French Presidential election), banking recapitalisation plans and a potential new move higher in eurozone yields remain clear risk factors. Periphery spreads often widen when core yields move higher.
Credit spreads: neutral	
FX	
EUR/USD – lower over coming months on momentum, relative rates, politics	USD set to remain supported by Trump and the Fed in the near term. EUR/USD to head higher beyond 3M.
EUR/GBP – risk skewed on the upside in run-up to when the UK is likely to trigger Article 50	Longer term, we expect EUR/GBP to settle in the 0.83-0.88 range. Short-term risk skewed on the upside on 'hard' Brexit risks.
USD/JPY – short-term risks skewed on the upside on higher US rates	USD/JPY set to remain supported near term by relative monetary policy and risk appetite.
EUR/SEK – range near term after recent decline, gradually lower medium term	Gradually lower on relative fundamentals and valuation in 2017 but near-term potential limited.
EUR/NOK – gradually lower but technicals are near-term support factors	Cross set to move lower on valuation and growth, real rate differentials normalising.
Commodities	
Oil price – OPEC cuts almost fully implemented, US crude stocks are still growing	Support from positive growth and inflation sentiment; OPEC hesistant about extending deal in H2
Metal prices – awaiting clarity on Trump's plans on infrastructure and defence spending	Underlying support from consolidation in mining industry, recovery in global manufacturing and US fiscal spending.
Gold price – support from political uncertainty	Rising yields and USD keeping a lid on the gold price
Agriculturals – abundant supply keeping a lid on prices	Attention has turned to *La Niña* weather risks over the winter, consolidation seen in some parts of the market.

Source: Danske Bank Markets

Disclosures

This research report has been prepared by Danske Bank Markets, a division of Danske Bank A/S ('Danske Bank'). The authors of the research report are Jakob Christensen, Chief Analyst, and Arne Lohmann Rasmussen, Chief Analyst.

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Expected updates

None.

Date of first publication

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