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Strategy

Risk is building of higher US yields

Jackson Hole symposium takes centre stage

For the next couple of months we expect the ECB and Fed to set the tone in the global fixed income market given that a range of important policy meetings are coming up.

The ECB will have to decide if the economic recovery that delivered positive growth for the 17th quarter in a row is strong enough to allow for a slower pace of QE purchases or even an end to the purchases when the programme runs out at end-December. Or if the sudden appreciation of the euro that has shaved tenths off the already modest 2018/2019 inflation forecasts means that fulfilment of the inflation target has become even more difficult to reach for the ECB.

The Fed will have to decide when to implement the announced reduction of the SOMA portfolio (quantitative tightening) and importantly decide whether the rate hikes will continue in light of the tight labour market or rather if it is time to announce a pause given the quantitative tightening and ongoing low US inflation data.

Therefore the market will scrutinise any central bank comments from the upcoming Jackson Hole symposium and especially whether Draghi and Yellen will unveil their plans for the autumn. That said, Reuters this week reported from "ECB sources" that Draghi will not deliver a "policy message" at Jackson Hole this year. But who knows, the market has been surprised before despite what anonymous "ECB sources" apparently have said to various media.

Risk is growing of a US-led fixed income sell-off

This week we published our monthly *Yield Outlook*. Basically we argue that 10Y bond yields in Germany, Scandinavia and the US will remain in a close range around the current level for the rest of 2017 though with small upward pressure. However, in 2018, the picture looks set to change. We think the ECB will have started tapering, the Fed will be on course to deliver further rate hikes and very little is priced into the US curve.

However, we stress that risks to our forecasts are that the drivers we see for higher yields in 2018 materialise much earlier than we forecast.

The ECB might put more weight on the better economic data and argue that an extension of the QE programme is unnecessary. The 'lack' of eligible bonds might also force the bank to end the programme earlier than we expect. If the programme is not extended or scaled back quickly in 2018, it will tend to steepen the yield curve. It is also worth keeping an eye on Sweden. Higher inflation and an already high ownership share by the Riksbank make it unlikely that the Swedish QE programme will be extended into 2018.

In respect of the US market, the risk of a fixed income sell-off this autumn might be even bigger. First of all our business cycle model, Macroscope, is predicting that the US economy will re-accelerate in the coming months. This is contrary to market consensus, where forecasters - according to Bloomberg - in general expect a modest moderation in growth in Q3 and Q4 compared to Q2. According to the Macroscope model, the

Key points

- We stress that risks to our newly updated yield forecasts are that the drivers we see for higher yields in 2018 materialise much earlier than we forecast. This is especially the case for the US fixed income market.
- First of all, our business cycle model, Macroscope, is predicting that the US economy will re-accelerate in the coming months. This is contrary to market consensus.
- Secondly, we are in a situation where the market is positioned for lower yields. When the market is caught wrong-footed it often leads to exaggerated moves.
- Thirdly, the market has flattened the US money market curve and has only priced a 40% probability of a new rate hike this. We think the market underestimates the risk of a December rate hike.
- The 5y point of the US curve is most exposed.

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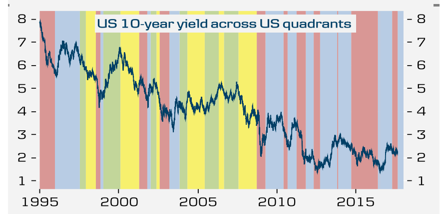
acceleration will move the US economy into the so-called 'Blue' quadrant (accelerating growth) that historically has been associated with higher yields and negative returns for US Treasuries (see chart 1). If we see an acceleration in the economy, we should also expect the US Surprise index to move higher and drag yields along with it (see chart 3).

Secondly, we are in a situation where the market has dramatically changed its positioning from being 'stretched short' US 10Y treasury to being 'stretched long' US 10Y treasuries according to the CFTC/IMM data (see chart 2). Hence, the market might be caught on the wrong foot if we see the predicted growth acceleration and it pushes yields higher. When the market is caught wrong-footed it often leads to exaggerated movements. For more see *IMM Positioning Update*, 14 August.

Finally, we should not forget about the Fed. We still forecast that the Fed will make an announcement on quantitative tightening at the next meeting in September and hike for the third time this year in December This is a view that is increasingly at odds with market pricing especially after the June FOMC minutes showed that the FOMC seems to be more concerned about the inflation outlook than previously expected. But given our Macroscope prediction for US growth, we believe the Fed will look through the low inflation and continue to focus on the tight labour market. In that respect it should be noted that the market is only pricing around a 40% probability of a December 2017 hike. An acceleration in the economy should make a December hike more likely.

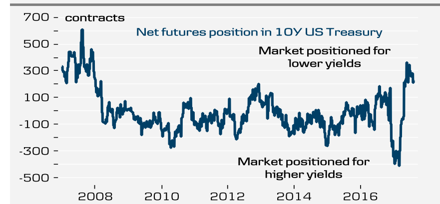
An important question is which part of the US yield curve would be exposed if we see a more pronounced bond sell-off. We argue that the 5Y segment in particular could be sensitive to a re-pricing of Fed expectations, whereas longer maturities should see continued support from foreign investors looking for a yield pickup that is not found in either European or Japanese fixed income markets. Hence, if we see a US-led fixed income sell-off this autumn we should expect a flatter 5y10y curve in the US. The effect on Europe could be different. The ECB is still keeping a relatively tight leash on the 5Y point, whereas the 10Y point could be pushed higher.

Chart 1: US economy moving into the 'blue' fixed income bearish business cycle quadrant



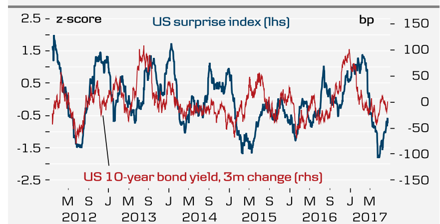
Source: Danske Bank

Chart 2: Market is long US treasuries (positioned for lower yields)



Source: CFTC, Macrobond Financial

Chart 3. US surprise indices to rise and drag yields higher



Source: Danske Bank, Macrobond Financial

Global market views

Asset class	Main factors
Equities	
Our short-term trading opportunity stance (0-1 month): Buy on dips Our strategy stance (3-6M): Neutral on equities vs cash	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 longer-term basis, we remain neutral on equities, as we have been since April this year.
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 area inflation outlook down. ECB to normalise gradually only, due to lack of wage pressure and stronger euro. If the situation in North Korea escalates it could add renewed downward pressure on global yields.
EU curve – 2Y10Y set to steepen when long yields rise again	The ECB is keeping 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 there is 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 – up momentum wearing off but set for 1.20 and beyond in 2018	EUR/USD has turned for good as ECB has reluctantly allowed 'reverse gravity' to kick in but upward momentum set to wear off near term. EUR/USD at 1.22 in 12M.
EUR/GBP – downside risks postponed as BOE stays put	Relative growth and monetary policy support a higher EUR/GBP near-term. Cross to stay above 0.90 in 3M, downward move on Brexit clarification, valuation further out.
USD/JPY – gradually higher longer term	A BoJ set to be sidelined in central-bank exit talk should cap JPY upside for an extended period. Fed and ECB eagerness to tighten to support EUR/JPY and USD/JPY near term.
EUR/SEK – consolidation near term, gradually lower further out	Gradually lower medium-term on fundamentals and valuation longer term but near-term further SEK potential limited by the Riksbank.
EUR/NOK – range-bound near term, then gradually lower	Headwinds near term due to low oil prices but longer term NOK should rebound on valuation, growth and real-rate differentials normalising.
Commodities	
Oil price – range-bound, downside risk	Rebound recently on better China data and robust global growth. Still range bound and now in middle of range.
Metal prices – range-bound, downside risk	Underlying support from consolidation in mining industry, better China data lately. China to slow again after National Congress adding downside risk in the medium term.
Gold price – range-bound	Tug of war between geopolitical uncertainty and stronger USD.
Agriculturals – stabilisation	Dry weather created supply concerns but prices have come down again lately.

Source: Danske Bank

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