17 November 2017

Strategy

Consolidation from stretched levels

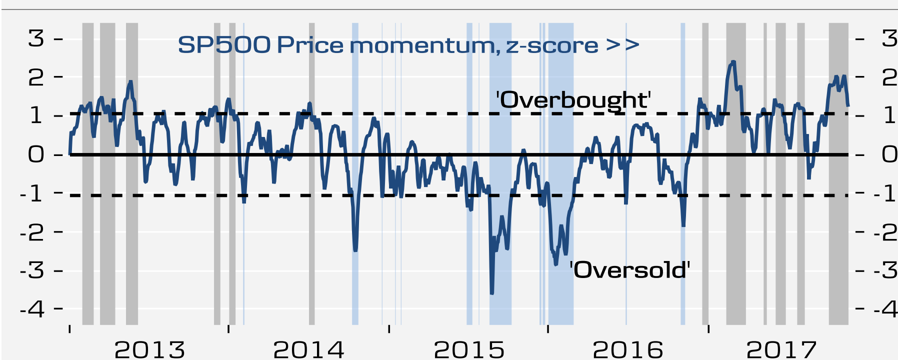
Correction should be temporary

This week we have seen some risk-off in equity markets with the S&P 500 now more than 1% lower than a week ago, as markets are correcting from stretched levels (see chart below). Looking at the S&P 500, US stocks still seem overbought and **in the short run US stocks may fall further, as investors take profit from the long rally before year-end**. In Europe, price momentum is back to neutral. The global surprise index is also high, thus limiting the scope for further increases in the index. **In our view, the market correction should still prove temporary, as fundamentals are still strong with a growing economy and low risks**. Global GDP growth was strong in Q3 and also looks promising in Q4, as optimism among businesses and consumers remains high across regions, although growth is no longer accelerating but stabilising at strong levels. Profits also seem strong in Q4, and in our view valuation is still decent. Equity volatility (VIX) has increased, but in our view, there are not many risk factors out there, at least not in the short term, which together with central banks only tightening gradually is positive for equity markets.

US tax cuts have become more likely

An important market theme for the rest of the year is whether Republicans are able to pass tax cuts in the US or not. The likelihood has increased significantly, as the Republicans think it is very important for their chances of maintaining control over Congress after the mid-term election in November next year, which also explains why more Republicans have accepted deficit-financed tax cuts (USD1,500bn over ten years). However, there are still many hurdles left (especially as there is opposition to the tax revenue raisers, which are supposed to pay for some of the tax cuts) and although **our base case is that Republicans will be able to pass something eventually**, there is still some probability that the whole thing explodes, just like with the attempt to repeal Obamacare. By 'something' we mean that tax cuts will be watered down compared to what is on the table right now in terms of how much they can cut taxes in percent within the USD1,500bn frame. As an example, it costs USD1,500bn to cut corporate tax rate to 20% by itself, meaning there is no room for income tax cuts without finding financing elsewhere.

Stock markets have corrected from stretched levels

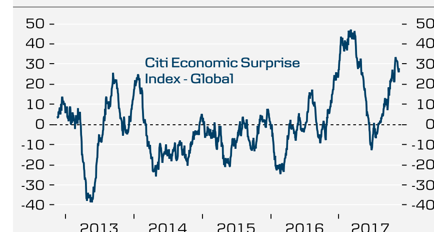


Source: Bloomberg, Danske Bank, Macrobond Financial

Key points

- In the equity market, we have seen a correction from stretched levels but it should prove temporary.
- Likelihood of US tax cuts has increased and will remain a market theme for the rest of the year.
- Any dips in EUR/USD should be shallow and short-lived and we expect it to move higher again next year.
- We think risks to our outlook for yields over the next couple of months have now become more symmetric and that the downside potential for yields should not be neglected.

Global surprise index is high



Source: Bloomberg, Citi, Macrobond Financial

Senior Analyst
Mikael Olai Milhøj
+45 45 12 76 07
milh@danskebank.dk

EUR/USD still set to move higher next year

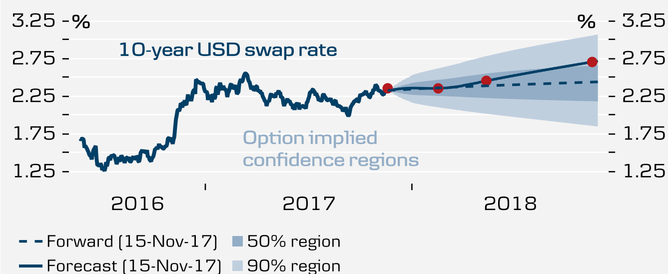
This week we have published our monthly FX forecast update, see *FX Forecast Update: Scandi meltdown will not endure the winter cold*, 16 November. The drastic deterioration of housing market sentiment has weighed heavily on the SEK over the past weeks, which has spread to the NOK. Globally, **we think EUR/USD will trade within the 1.1479-1.1880 range towards year-end but continue to stress that a 2018 rebound towards 1.25 is on the cards** and that upside risks dominate the longer-term outlook. In the near term, we could see dips in EUR/USD due to among other things the US tax reform discussed on the previous page. That said, we still stress that any dips should be shallow and short-lived, as fundamentals still provide support to the cross and as notably a reversal in debt flows is a key source of upside EUR risks over the medium-term. **We see EUR/USD at 1.16 in 1-3M but expect a move towards 1.25 in 12M.**

Risks to 10Y yields have become more two-sided

We have also published our monthly yield outlook this week, see *Yield Outlook: Risk to 10Y yields is now more two-sided*, 16 November. **Global yields have declined on the back of the low risk sentiment in global equity markets, which has pushed investors into the 'safe' global bonds.** We think the move lower underlines that – despite the ECB scaling back on bond purchases, strong global growth and Fed rate hikes – we should not expect to see a rapid further rise in either US or European long yields (10Y). That said, **we think risks to our outlook for yields over the next couple of months have now become more symmetric and that the downside potential for yields should not be neglected** (we have previously argued that the risk to rates was asymmetric on the upside given global central banks' normalisation policies), especially in the US, where the 'high yielding' US bond market stands out.

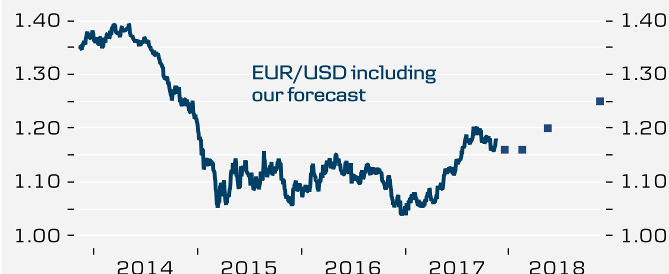
In the US, we still expect a flattening of the US curve for the 2Y10Y on a 12M horizon. The short end could be pushed higher by further Fed rate hikes, as markets have only priced in 1.5 hikes next year (against our expectation of two hikes and the Fed's signal of three hikes). The long end is kept low by investors buying 'high yield' US fixed income assets and the fact that the so-called equilibrium rate has declined, see *Strategy: Natural rate key to understand central banks*, 29 September. **In Germany, we expect a modestly steeper yield curve for the 2Y10Y in 2018.** We expect the ECB to maintain a tight grip on the short-end of the curve in 2018. However, this is not the case for the 10Y segment of the curve, which we expect to be pushed by higher US yields and a smaller QE programme. We have a 12M 0.75% forecast for 10Y Germany.

We still expect US 10Y to move higher in the coming year



Source: Bloomberg, Danske Bank, Macrobond Financial

EUR/USD to range-trade in the coming months before moving higher again



Source: Danske Bank, Macrobond Financial

General market themes

Asset class	Main factors
Equities	
Correction from stretched levels but still positive on equities	Correction from stretched levels but we are still positive on equities due to strong global growth, low risks and only gradual tightening of monetary policy.
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	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 relatively dovish 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. The focus on Catalonia and its call for independence is a risk for Spanish government bonds.
FX	
EUR/USD – consolidating near term but upside risks in 2018	EUR/USD to remain within 1.1479-1.1880 range near term. We still see the cross moving firmly into mid-1.20s supported by valuation and debt-flow reversal in 2018.
EUR/GBP – upside risks remain but GBP to strengthen eventually	Deteriorating growth prospects and Brexit mess to keep EUR/GBP afloat near term. 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 the Bank of Japan is staying dovish, means support for EUR/JPY and USD/JPY alike on a 12M horizon.
EUR/SEK – range near term, gradually lower further out	Gradually lower in the longer term on fundamentals but near term SEK potential is limited by relative rates as SEK remains high-beta ECB derivative via the Riksbank.
EUR/NOK – upside risks in Q4 persist, then gradually lower	NOK headwinds near term due to positioning, oil price and rates potential but longer term we expect the NOK to rebound on valuation, growth and real-rate differentials.
Commodities	
Oil price – rising volatility	Geopolitical tensions around Saudi Arabia and Iran on the rise. Concerns about implications of unstable Venezuelan debt situation.
Metal prices – to fall back	Sentiment is turning negative again, as Chinese construction activity set to slow. Tighter supply to cap lower bound.
Gold price – range-bound	Tug of war between safe-haven demand from rising global geopolitical tensions and negative impact of hawkish Federal Reserve.
Agriculturals – trending higher	Weather-related supply concerns supporting prices.

Source: Danske Bank

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