18 November 2016

Strategy

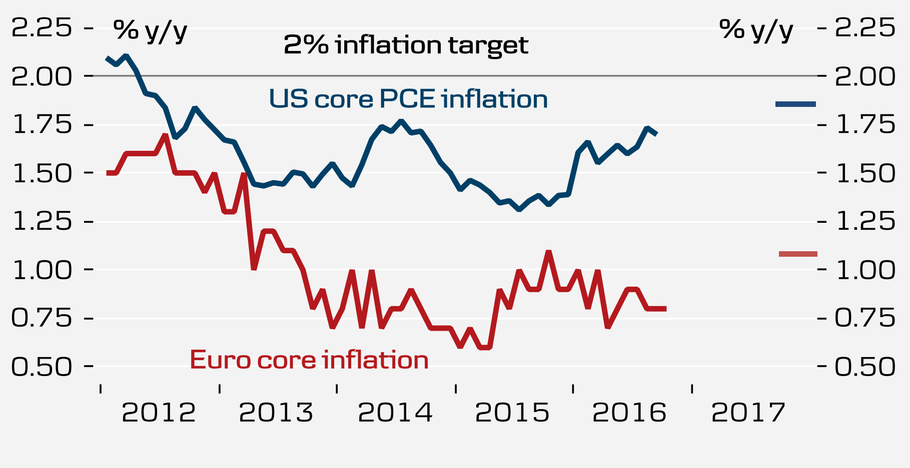
The case for reflation – what it means and what to watch

Following the election of Donald Trump as US president, the reflation theme has gained extra fuel. Industrial commodity prices soared adding to the gains already seen this year. In addition, US market inflation expectations got a big lift. We – and others – have cried wolf over the past couple of years in terms of rising inflation but it did not happen. However, one day it will, and the question is whether that time is now. Based on commodity prices it is almost certain that so-called base effects will push up inflation over the next six months. However, this will only be temporary unless commodity prices continue to trend higher in coming years. **Real reflation is a sustained rise in inflation** in which the economy is running hot, pushing wage inflation higher as well.

Below, we have made a small checklist of factors in order to judge whether the rise in inflation is the real thing – or just a temporary lift**.** Here, we focus mainly on the US and the euro area. Based on the checklist, **we see a good case for reflation in the US whereas it will take more time for the euro area to join**. The euro area has more slack left, still many growth headwinds and no signs of wage inflation picking up. In contrast, the US has more or less closed the output gap and it is likely that the economy will run hot over the next year – not least when the expected fiscal stimulus from Trump sets in at a time when we expect unemployment to be below NAIRU (long-term equilibrium level) and wage pressures have increased.

The **investment conclusion of reflation in the US is higher bond yields, a stronger USD, higher stock prices and rising inflation expectations**. We look for US 10-year yields to hit 3% (currently 2.31%) in 12M. See *Yield Forecast Update*, 18 November 2016. We expect a stronger USD in six months but weakening from six to 12 months, as the main impact of US reflation is likely to be felt over the next six months. See *FX Forecast Update: Trump rally set to extend near term, then reverse*, 16 November 2016.

US core inflation not far from target – still a long way in euro area

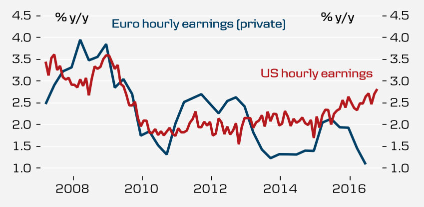


Source: Macrobond Financial

Key points

- We see a case for reflation in the US but less so in the euro area.
- We expect US reflation to lead to a further rise in equities, higher bond yields and a stronger USD over the next six months.

Signs of US wage pressure building – in contrast with the euro area



Source: Bloomberg, Danske Bank Markets

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While we do not see a strong reflation case in the euro area, German bond yields will see a spillover from higher US yields and we look for 10-year bund yields to hit 1% in 12 months' time from the current level of 0.29%. Rising focus on ECB tapering of purchases in 2017 will also put upward pressure on bond yields.

The case for reflation – a four-point checklist and what to watch

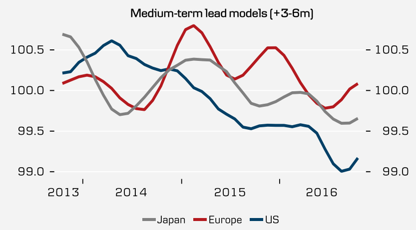
1. **Economic recovery.** In order for the economy to run hot and push inflation up, growth needs to move above trend to reduce excess capacity. This can be checked off for most regions currently. Our MacroScope models for October showed a synchronised positive signal pointing to higher growth in both the US, the euro area, Japan and EM. For the US, the boost to growth in 2018 from stimuli put in place by Trump should keep the recovery on a sustained path. One thing that could stop that from happening would be overheating – and thus too much reflation – which would force the Fed to hit the brakes. However, this is not our baseline scenario.

2. **Closed output gap.** As long as there is plenty of slack in the economy, it is hard to get real price pressure and hit a permanent inflation level of 2% (target in most countries). In the case of the US, we believe we are pretty much there – or will be very soon. Slack has been diminishing for a long time and unemployment is now around the NAIRU level. Wage increases have also started to increase and at 2.8% in October it hit the highest level in seven years. When adjusting for productivity growth, which is low these years, the actual rise in labour cost per unit is already at a high level, pointing to rising cost pressures. For the euro area, however, unemployment is still around 10% and plenty of slack is likely to be left. Wage growth is also very subdued, still around 1% y/y, providing little cost pressures for companies. The IMF and OECD estimate the output gap to be around -1.5%.

3. **Rising commodity prices.** Commodity prices reflect broadly the global output gap. Over the past couple of years, commodity prices fell sharply as the output gap increased in China (high overcapacity in many industries). The decline served as a drag on inflation in other parts of the world, which was reflected in falling import prices. However, this year, commodity prices have bottomed as Chinese construction and infrastructure investment saw a renewed boost. We look for Chinese growth in these sectors to taper off again in 2017 but it may be compensated for by Trump's plans for rebuilding US highways, bridges, ports etc. For now, this reflation factor can be ticked off on a global scale and it is likely to feed into higher producer prices in most countries.

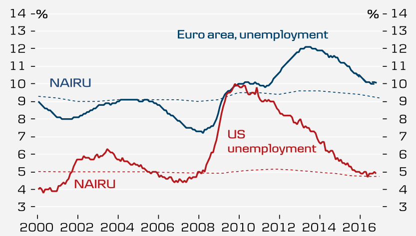
4. **Monetary accommodation.** Finally and importantly, reflation will only come if central banks do not spoil the party before it gets going. This means keeping accommodation in place until market inflation expectations are back in line with the inflation targets and inflation at 2% is reached on a sustained basis. Not just for a couple of months. Keeping monetary policy accommodative does not mean the Fed cannot hike. But it means that it will normalise rates slowly enough for the economy to run a bit hot. This is exactly what the Fed has been communicating and what we expect. The best way to follow the market's faith in the Fed is through market inflation expectations. For the ECB, it is less clear how accommodative it will be. The General Council seems very divided. However, ECB president Mario Draghi seems to be in the dovish camp and today said, 'we do not see a consistent strengthening of underlying price dynamics'. We believe he will get his way and extend the purchasing programme by six months at the December meeting.

A synchronised recovery signal across regions



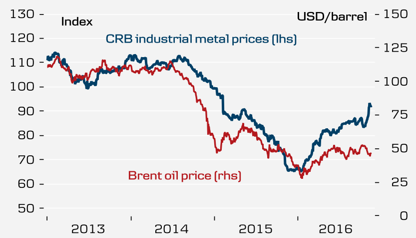
Source: Danske Bank Markets

Output gap pretty much closed in US – but not in the euro area



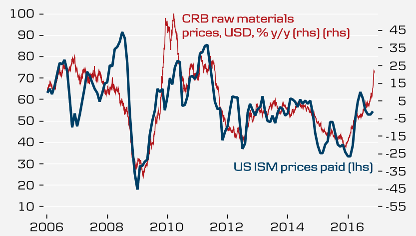
Source: Danske Bank Markets, Macrobond Financial

Deflationary pull from commodities have turned – at least for now



Source: Macrobond Financial

Rising commodity prices to push up US ISM prices paid



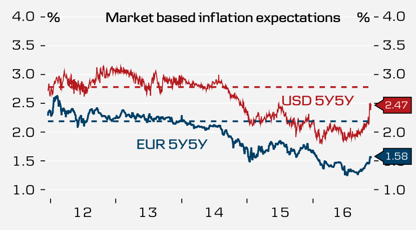
Source: Macrobond Financial

The US can thus tick off pretty much all of the above, which is why we see a good case for reflation to play out. This would, in our view, play out even without Trump's fiscal expansion. However, his policies are likely to add to the reflation case for the US. However, the euro area is further behind in the economic recovery and still has plenty of slack and low wage pressures. Hence, even though we expect a recovery of growth and commodity prices to be less of a drag, a real reflation scenario is not in the cards for now.

Could a USD appreciation stop the fun? It is not likely, in our view, as tempering a too strong USD is part of the reason why the Fed will move very gradually and only raise rates twice in 2017. If the USD strengthened too much, the Fed would simply hold back on rate hikes to allow the economy to run a bit hot and a possible overshooting of the inflation target.

For more on our inflation views see *Global Inflation: Set to surprise on the upside lifting long-dated inflation pricing*, 27 October 2016 and *Strategy: Higher inflation to push up inflation expectations further*, 28 October 2016.

Higher inflation expectations as markets price reflation



Source: Bloomberg, Danske Bank Markets

Global market views

Asset class	Main factors
Equities	
Overweight stocks short and medium term	Cyclical recovery.
OW US and Japan, UW Europe. Neutral on Nordics and UW EM	Fiscal boost to US will raise earnings relative to Europe. High risk of protectionism and tighter monetary policy hurting EM assets.
Bond market	
Hier yields, further steepening 2Y10Y curve	More expansive fiscal policy in the US adds to steepening trend. Tapering, higher inflation prints and a global recovery also point towards a steeper curve. ECB QE should mitigate some of the effects.
US-euro spread: slightly wider in 2017	The Fed hike is moving closer, adding upside to the long end of the US curve. But ECB tapering and higher higher inflation prints are risks for the Europan bond markets, which could potentially tighten the US-Euro spread given that European yields are record low.
Peripheral spreads: tightening	Economic recovery and QE means further tightening. But politics and tapering remain clear risk factors.
Credit spreads: neutral	The ECB is keeping spreads contained.
FX	
EUR/USD - lower going into FOMC meeting in December	USD to remain supported by Trump and Fed in the near term. Higher in 2017.
EUR/GBP - lower short term on re-prising of Brexit risk premium after Trump	Expect EUR/GBP to settle in the 0.83-0.88 range near term. Risk skewed to the upside over the mdium term due to Brexit.
USD/JPY - neutral with short-term risks skewed to the upside	USD/JPY to remian supported near term by relative monetary policy and risk appetite.
EUR/SEK - set to stay elevated in coming months before turning in 2017	Gradually lower on relative fundamentals and valuation in 2017. Near term the SEK will remain weak mainly due to the Riksbank.
EUR/NOK - short-term risks skewed to the upside	At YE, liquidity set to prove a headwind for NOK. Cross to move lower next year on valuation and real rate differentials normalising.
Commodities	
Oil price – gradual rise amid volatility on OPEC doubts	Support from positive sentiment; market doubting OPEC deal and rising USD weighing on oil price.
Metal prices – rallying on outlook for US infrastructure spending	Underlying support from consolidation in mining industry and recovery in global manufacturing.
Gold price – change in risk sentiment negative for gold price	Rising yields and USD pushing gold price down.
Agriculturals – strong output has sent prices down again	Attention has turned to La Niña weather risks in H2 16, large stocks limit upside risk to prices.

Source: Danske Bank Markets

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Date of first publication

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