Strategy

Volatile volatility is here to stay

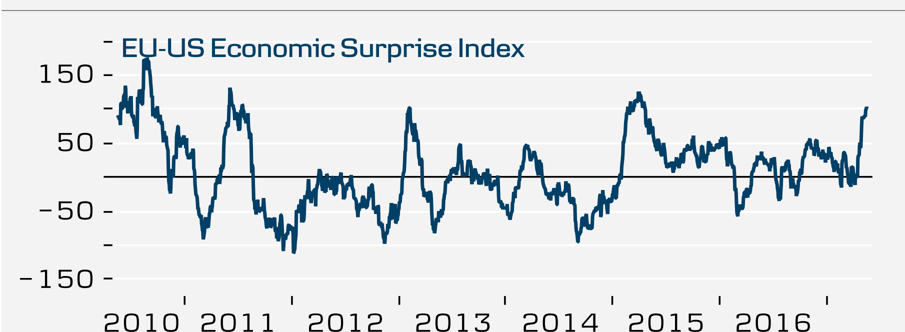
The beginning of the end of the USD's bull run

Over the past week, volatility has spiked, equities have corrected lower, the US dollar has collapsed and global yields have dropped. This is as expected as the cycle turns lower. Our quantitative business cycle model has turned increasingly negative with a synchronised move lower across Europe, the US, Japan and emerging markets. The market perception that volatility would fall after the French election as political risk in the eurozone is gone is incorrect, as focus shifts from politics to the economy. **Volatility in markets is likely to become more volatile as the cycle turns lower (see Chart 1).** Of course, recent news regarding President Trump's interference in the FBI investigations is disturbing and has added to the rise in volatility, but the fundamental driver, in our view, is the turn lower in the cycle. **Expect volatility across asset markets to become more volatile near term.**

Since the great recession, China has been leading the global industrial production (IP) cycle (see Chart 3). China had several mini-cycles in the period 2013-14 but that can be explained by the authorities' stop-go policies in those years. We are that the cycle in China is now turning lower as the authorities tightening measures to reign in house prices as well a normalisation of infrastructure investments is set to drive lower growth near term. For more details, see *Research: China leading indicators – the slowdown is a reality*, 2 May 2017. **China was the positive story in 2016 but this is set to turn in 2017.**

The recent strength of the EUR and fall of the USD can be explained by a repricing of both Europe and the US. The difference in the economic surprise indices between the eurozone and the US is at the highest level since spring 2015 (see Chart 2) and PMIs in the eurozone have been marching higher consistently since September 2016, while the cycle in China and the US is faltering (see Chart 4). Eventually, there will be a spill-over from the IP cycle in China and US into the eurozone as there always is, but for now, the eurozone is shining. However, EUR/USD has moved very far, very rapidly in a very short period of time and that was the reason we decided yesterday to take profit on our long EUR/USD recommendation from FX Top Trades.

Chart 2: Widening gap in EU and US economic surprise indices

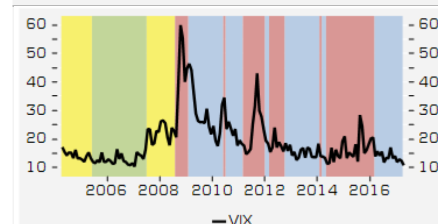


Source: Macrobond Financial, Danske Bank Markets

Key points

- Volatility in markets is set to become more volatile as the cycle turns lower.
- The USD's fall and EUR's strength is as expected given the divergence in economic performance. We remain medium-term EUR/USD bullish.
- Expect FI markets to range-trade with a possible slight bullish bias near term on the lower cycle and falling inflation expectations.
- We have turned near-term bearish on equities as we are in the interim period between two reflation periods.

Chart 1: Volatility set to rise as economy decelerates*



**Red quadrants refer to economic deceleration.*
Source: Danske Bank Markets

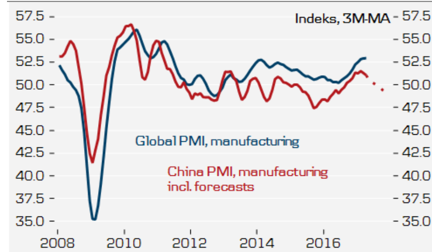
Global Head of FICC Research
Thomas Harr
+45 45 36 67 31
thhar@danskebank.dk

In the medium to long term, we remain bullish on EUR/USD as fundamentals such as valuation and current-account balances suggest a much higher EUR/USD over time. We forecast EUR/USD at 1.16 in 12M. More broadly, we are currently envisaging the beginning of the end of the USD's multi-year bull run.

Historically, the move lower in the IP cycle tends be bullish for fixed income (FI) markets. Of course, the cycle is only one of many factors affecting FI markets including positioning, central bank behaviour and inflation expectations. The market is long US Treasuries but only mildly so. Meanwhile, market inflation expectations are falling sharply in the US. In the eurozone, the market will stay tuned to the ECB meeting on 8 June, where we expect the central bank to include hawkish wording but not change forward guidance in terms of whether rates will stay at current 'or lower levels'. **In summary, we expect US and eurozone FI to be range-trading near term with a possible slight bullish bias supported by a turn lower in the cycle, particularly in the eurozone, and lower inflation expectations.**

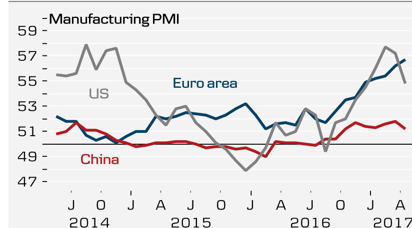
In equities, we think the recent sell-off is part of establishing the bottom in the trading range and we do not think we have established the bottom yet. Up until a few days ago we were hovering around the top in the trading range and now with global data rolling over (but not crashing), we think the bottom in the trading range will be established. Our bearish short-term view on equities is supported by our quantitative business cycle model discussed above and the fact that European stocks are at very overbought levels. Over a three-six month period, we are neutral on equities. Global growth is rolling over but we are not heading for a recession. As we await the second reflation wave, we are stuck in the interim period where we will be in a trading range but not a crash.

Chart 3: China has been leading the global cycle since the global crisis



Source: Macrobond Financial, Danske Bank Markets

Chart 4: The eurozone is the shining star – for now



Source: Macrobond Financial, Danske Bank Markets

Global market views

Asset class	Main factors
Equities Our short term trading opportunity stance (0-1month): Sell on rallies Our strategy stance (3-6M): Neutral on equities vs cash	We think the sell-off is a part of establishing the bottom in the trading range and we do not think we have established the bottom yet. We think we are in an interim period between two reflation periods and in this period markets will trade in a range. Up until a few days ago, we were hovering around the top in the trading range and now with global data rolling over (but not crashing), we think the bottom in the trading range will be established. On 3-6M, we are neutral on equities. The cycle is turning lower but we are not heading for a recession. As we await the second reflation wave, we are stuck in the interim period where we will be in a trading range, but not a crash. In this environment, defensives will outperform cyclicals.
Bond market	
German/Scandi yields – set to stay in recent range for now, higher on 12M horizon	German yields are no longer being kept low by 'European politics' but still low core inflation and an apparent peak in the global manufacturing cycle are set to keep yields low in 2017. However, the risk picture has become more two-sided given the risk the ECB will change its rhetoric slightly next month.
EU curve – set to steepen 2Y10Y when long yields rise again	The ECB is set to keep a tight leash at the short end of the curve and 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 – stable Peripheral spreads – tightening but clear risk factors to watch	Economic recovery, QE and better fundamentals, particularly in Portugal and Spain, point to further tightening, but banking recapitalisation plans (Italy) and a fear of a new move higher in core eurozone yields (ECB tapering fears) remain clear risk factors. Periphery spreads often widen when core yields move higher.
FX	
EUR/USD – set to test new highs in H2	While Fed-ECB policies should cap further upside near term, the cross is set to test new year highs in H2.
EUR/GBP – slightly lower post election, then range-bound for extended period	If Theresa May stays in power, GBP could strengthen post the June election, then be range-bound (0.8200-0.8650) over Brexit negotiations.
USD/JPY – gradually higher longer term	Challenged by US cyclical and political risks near term but set to edge higher driven by 10Y US rates further out.
EUR/SEK – range near term, then gradually lower	Gradually lower on fundamentals and valuation this year but near-term SEK potential limited by the Riksbank.
EUR/NOK – range near term, then gradually lower	Cross set to move lower on valuation, growth and real-rate differentials normalising but NOK vulnerable to global risk appetite.
Commodities	
Oil price – range-bound, downside risk	OPEC cuts almost fully implemented, extension about priced in. Downside risk from more hawkish central banks.
Metal prices – range-bound, downside risk	Underlying support from consolidation in mining industry, industrial cycle nearing a peak. Downside risk from financial stress in China
Gold price – range-bound	Temporary support from lower USD and US political turmoil.
Agriculturals – rising again	Recent fall on lower oil only temporary.

Source: Danske Bank Markets

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None.

Date of first publication

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