20 January 2017

Strategy

The end of the world as we know it?

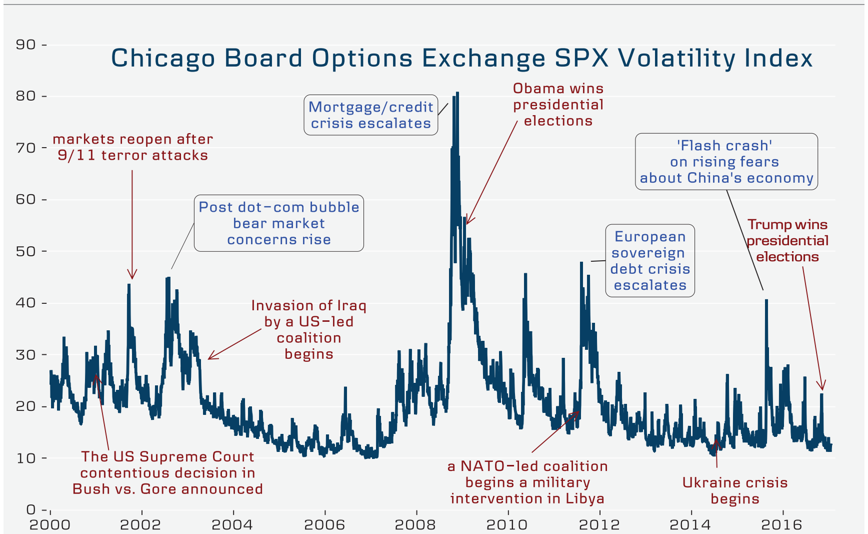
This week could easily mark the end of the world as we know it. Its events are likely to set apart traditional economic and political global alliances that we have grown used to since the World War II. So far, the market is taking a relatively complacent view of the risk in the upcoming changes, with the VIX index (also known as the global fear index) trading close to a decade low. However, we think that the resetting and formation of new trade and economic alliances are typically complicated and could in our view entail significant risks to the global economic recovery, both in the short term and down the road.

- **The inauguration of Donald Trump as US president is likely to mark a new era for US economic and foreign policies.** We are already used to a new communication style through Twitter. More fundamentally, the new US administration points to a shift in US foreign and trade relations, with Trump reaching out to Russia, while taking a rather confrontational approach to China on both Taiwan and trade. Even US and European relations may become cooler, at least Trump's comments that the UK will not be the only country to leave the EU are unlikely to have gone down well with EU member states.
- **Theresa May's Brexit speech on Tuesday served as a reminder of an intrinsically difficult period ahead for the UK and Europe.** While the speech did not contain much news, it reminded us that the UK divorce from what can be described as a 33-year marriage of convenience with the EU is likely to be contentious and complicated. While risks are clearly on the UK side, the unity in the EU will also be tested, for example on how to deal with the lack of UK contribution to the EU budget, which accounts for 15% of all contributions. The EU budget is one of the most contentious issues in the EU. While the British pound rebounded after May's speech, we think it will come under pressure as triggering Article 50 comes closer, seeing the EUR/GBP moving to 0.88 in 3M.

Key points

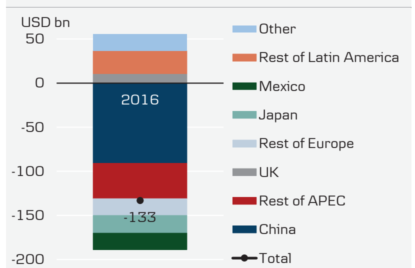
- Trump inauguration, May's Brexit speech and China's presence at Davos may well mark the end of the world as we know it.
- Markets taking a relatively relaxed view on risk with the VIX index trading close to decade lows…
- …and awaiting a more concrete economic policy announcement from the Trump administration.
- The possible shift towards more protectionism may well hurt the global economic outlook.
- We are bullish on Russia, which is a likely winner from the new era.

Markets taking a very relaxed view on global risk—VIX index close to decade low



Source: Macrobond Financial

China and rest of Asia 'guilty' for most of US current account deficit



Source: Macrobond financials and Danske Bank Markets

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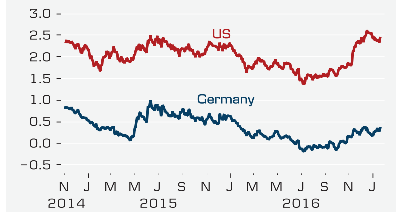
- **Chinese President gave an unprecedented speech at the World Economic Forum (WEF) in Davos**. For the first time ever, a Chinese President gave a speech at the WEF. In stark contrast to the signals from the new US administration, President Xi Jinping emphasised that co-operation is the only way to solve the challenges facing the world economy and that China would keep its doors open to the rest of the world, hoping other nations would follow suit. Admittedly China is not the best example when it comes to free trade, with incoming US commerce secretary Wilbur Ross stressing afterwards that China is the 'most protectionist' major economy in the world and said China 'talks much more about free trade than it actually practices'. However, there is probably no doubt that China wants to assert a bigger and more active role in the governance of the global economy, such as in the IMF, where China has now sought a bigger say and its currency has been included in the SDR basket. We also think that China will seek closer alliances with the rest of the emerging markets in view of more restrictive US trade and foreign policy regime.

What have been the market implications so far of these possible shifts in world order? So far, markets have taken a relatively sanguine view on the impact. Equity markets have generally rallied, apart from a few badly hit emerging markets such as Mexico and Turkey, probably because the underlying global economic recovery is fairly strong and there are prospects of a more expansionary fiscal policy in the US. As a result, we are overweight equities. However, markets are now clearly waiting for concrete economic policies from the Trump administration, with both the upward move in US yields and the US dollar losing some momentum. Furthermore, we think there is an increasing chance that global risk sentiment could be affected by a possible stand-off between China and the US. More long-term there may be risks to a global recovery from more protectionism in the world economy. The IMF this week flagged these risks in its global economic update.

Who looks to be the winner so far from the emerging new global order? One candidate is Russia, which looks to benefit from (1) warmer feelings from the new US administration, (2) China seeking closer ties, (3) a rebound in oil prices and (4) strong economic institutions, with a large degree of central bank independence and prudent ministry of finance. This also underpins our long-held moderately bullish call on the rouble, which is among our FX top trades for 2017. Russian stocks are among the most undervalued globally when comparing price-earnings to their long-term value and many major Russian banks are doing very well at the moment from high interest margins given relatively low financing costs and still high lending rates (though we think that the Russian central bank will embark on significant lowering of its policy rates as inflation expectations are brought further under control). While ending the Western sanctions against Russia is not our base case this year, we believe it is clearly a likely upside for Russia with Trump in the White House. We also think that if the US were to lift its Russian sanctions, Europe would follow suit even if it came from the Trump administration. In such an event, we think that Russian equity markets would be lifted by 10% and the USD/RUB would fall under 49.00 by the end-2017.

Increase in global yields taking a breather



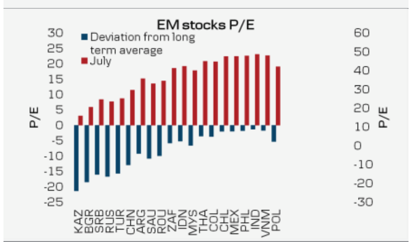
Source: Danske Markets

We are overweight equities, favouring US and Russia and rest of Eastern Europe

ASSET ALLOCATION Asset Class	Weight %	Recommendation u	n	o
EQUITIES	**45,0**			
Developed markets				
Nordic	15,0			
- Cyclicals	15,0			
- Defensives	20,0			
- Financials	10,0			
US	10,0			
Europe (excl. UK)	15,0			
UK	20,0			
Japan	10,0			
Emerging markets	**5,0**			
China, Asia	15,0			
Latin America	15,0			
Central Europe and Russia	15,0			
FIXED INCOME	**45,0**			
CASH	**10,0**			

Source: Danske Markets

Russia is among the most undervalued equity markets in the emerging markets space



Source: Danske Bank Markets

Global market views

Asset class	Main factors
Equities	
Overweight stocks short and medium term Underweight DM, overweight EM Overweight US, Japan, Nordics, and Russia/Eastern Europe,, underweight Europe and LatAm, Neutral on China	Ahead of the Trump inauguration of Donald J. Trump as the next US president equities will like fare well. The inauguration could very well be an inflection point leading to a period with more flat trading in equities as markets waits for policy signals. US fixed income markets does seem to indicate that most of the reflation trade is priced in. However, we do not think this is the case with equities. So, a expansionary fiscal policy signal is the starting signal for a second leg in the reflation trade.
Bond market	
Higher yields, further steepening 2Y10Y curve	More expansive fiscal policy in the US and Fed outlook adds to steepening trend in Europe. Higher inflation prints, tapering fears later in 2017 and a global recovery also point to a steeper curve. However, the ECB QE mitigate some of the effects.
US-euro spread: slightly wider in 2017	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. As we move further into 2017 we could in fact see a tightening of the USD -EUR spread in the 10Y segment as the strong USD caps the upside for longer US yields and as an end to ECB is coming closer.
Peripheral spreads: tightening	Economic recovery and QE mean further tightening but politics, tapering and a new move higher in Euro zone yields remain clear risk factors.
Credit spreads: neutral	
FX	
EUR/USD – lower over coming months on momentum, relative rates	USD set to remain supported by Trump and 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. Risk skewed on the upside over the short to medium term due to Brexit.
USD/JPY – short-term risks skewed to 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	Cross set to move lower on valuation and growth, real rate differentials normalising.
Commodities	
Oil price – OPEC hesitant about extending deal through H2, crude stocks remain high	Support from positive growth and inflation sentiment; near-term focus implementation of OPEC deal, US crude stocks.
Metal prices – focus turns to Trumps plans on infrastructure and defence spending	Underlying support from consolidation in mining industry, recovery in global manufacturing and US fiscal spending
Gold price – hawkish Fed weighing on gold price	Rising yields and USD pushing gold price down.
Agriculturals – abundant supply keeping a lid over prices	Attention has turned to *La Niña* weather risks over the winter, consolidation seen in some part of the market

Source: Danske Bank Markets

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None.

Date of first publication

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