20 October 2017

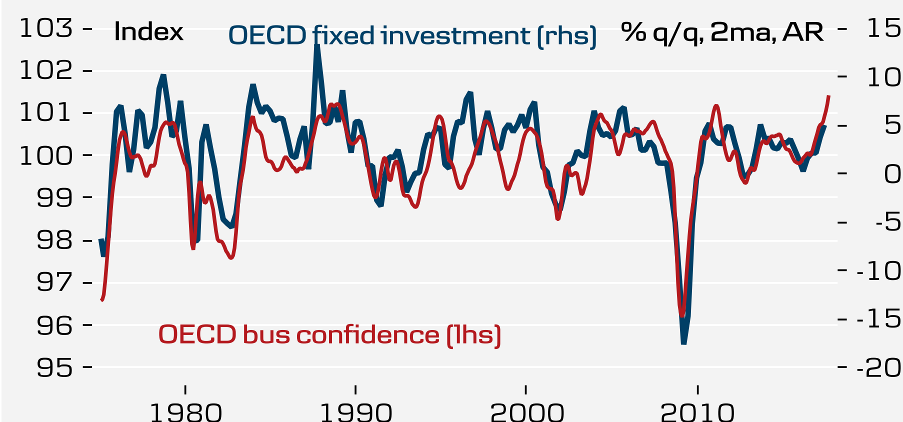
# Strategy

## Goldilocks in risk assets?

Global equity markets and other risk markets continue to perform well, supported by what looks like a 'goldilocks' scenario for risk assets:

1. **Synchronised global recovery.** All regions of the world are participating in the global recovery currently as growth is robust in the US, euro area, China and Emerging Markets outside China. This is reflected in record high OECD business confidence that is set to drive an investment boom across the world (see Chart 1). The global rebound has ignited a double-digit expansion in profits due to rising demand and growth in producer price inflation.
2. **Few global imbalances.** Although the global recovery is maturing, there are still no significant imbalances that require any adjustment period. A recession tends to follow a period of overinvestment and/or overconsumption. We do not see this happening in the US or Europe. In China, one could argue that investment levels are too high but we believe the government can sustain this for another three to five years.
3. **Subdued core inflation keeps central banks in check.** While producer price inflation has picked up, it has not spilled over to consumer price inflation pressure. Core inflation is generally low, which is keeping the central banks on a cautious normalisation path.
4. **Low return on safe assets.** The low rate environment continues to drive a search for yield in risk assets. Lower long-term neutral policy rates increase discounted cash flows of future profits and thus justify higher equity price/earnings ratios.
5. **Low tail risks.** The risk picture is muted, with North Korea being the main risk. A US-China trade war is also not on the radar this year as was feared previously.

**Chart 1: Record strong business confidence to drive global capex recovery**




*Source: Macrobond Financial, Danske Bank*

### Key points

- Risk assets are supported by a long list of favourable factors – not least of all strong profit growth and cautious central banks.
- A moderate slowdown in China would cause some headwind for EM assets – but should not derail global recovery.
- Bond yields and EUR/USD to stay range-bound in the short term.

**Chart 2: Strong profit growth**

*Source: MSCI, Macrobond Financial, Danske Bank*

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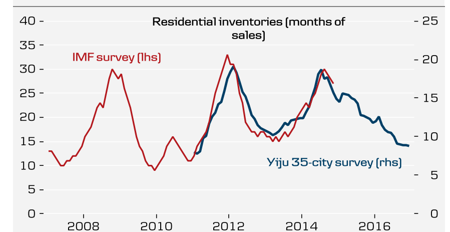
Hence, although risk assets have performed well, we continue to see further moderate upside in equities in the medium to long term. So far, market corrections have been fairly shallow as investors are quick to buy into any weakness. As long as the recovery continues and risks are muted, we expect this pattern to continue. The Catalan issue has raised concerns in Spain recently. However, these developments are not likely to have any material impact on growth and profits and should thus only lead to a temporary dip in the market.

## Could China spoil the fun? Signs of slowdown materialising

**The main candidate to take the air out of the global recovery is China.** We expect the economy to slow down over the next year but only moderately, see *China Outlook: Moderate slowdown and CNY stabilisation*, 13 October 2017. However, it will provide less of a tailwind for global markets – not least in Emerging Market (EM) assets where performance has been strong, fuelled in part by the strong pickup in the Chinese economy. History suggests that falling economic momentum in China can trigger corrections in EM (Chart 4). We expect EM to be supported by the search for yield behaviour, still attractive valuations and generally good fundamentals. However, with China slowing, the risk-reward is less favourable (see also *Emerging Markets Briefer: Emerging Markets at a crossroad – mind the risks*, 29 September 2017).

**Chinese home sales for September released this week added to evidence that a moderate slowdown is in the pipeline** (Chart 5). We have argued for this for some time based on financial tightening and a range of regulatory measures implemented to cool the housing market. The reason we look for only a moderate slowdown of the Chinese economy is that residential inventories are generally at a low level and that the export sector should do fine due to continued growth momentum in the US and the euro area. Private manufacturing investments are also likely to pick up, as China's profit growth has been strong this year. So, even though China is set to slow down, we do not expect it to derail the global recovery.

**Chart 3: Low inventories to cushion construction slowdown in China**




Source: IMF, EM Advisors Group, Danske Bank

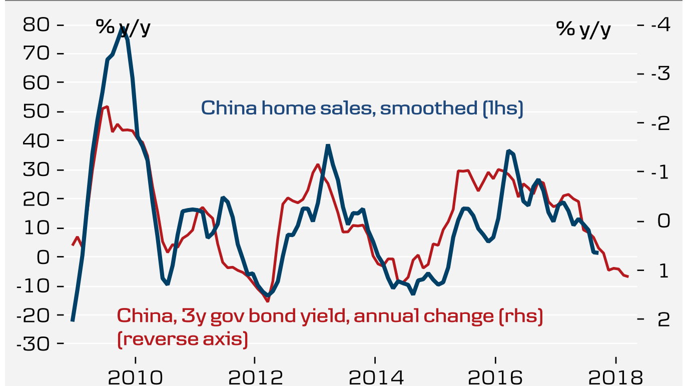
## Fixed income and FX markets looking to the ECB next week

While the current environment is favourable for risk assets, where does that leave bond yields? **We have argued for range-trading for the rest of 2017 for some time and continue to see bond yields remaining mostly unchanged over coming quarters**. While central bank tightening – all else being equal – points to higher bond yields, there are other forces keeping bond yields in check. First, we are probably close to the peak in ISM

**Chart 4: Slowdown in China to cause some headwind for EM**

Source: Macrobond Financial, Danske Bank

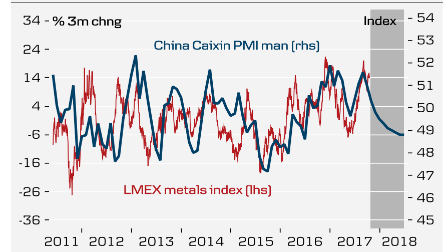
**Chart 5: China housing market slows as policy is tightened**




Source: Macrobond Financial, China NBS, Danske Bank

manufacturing in the US. Of the past 11 bond bear markets, only one has taken place when ISM was declining (2006)Bond yields tend to rise the most in the acceleration part of the cycle and then move sideways or even decline subsequently. This is also what we have seen this year. Also, there is a very strong search for yield behaviour pushing investors out on the yield curve, creating demand for long bonds. Finally, we expect the slowdown in China to cap the upward pressure on inflation as it would put a lid on demand for commodities. China consumes 50% of global metals and is thus a major driver of metals markets. The upward trend in commodity prices that started in early 2016 is therefore ending in our view.

Chart 6: Chinese slowdown to cap metal price inflation

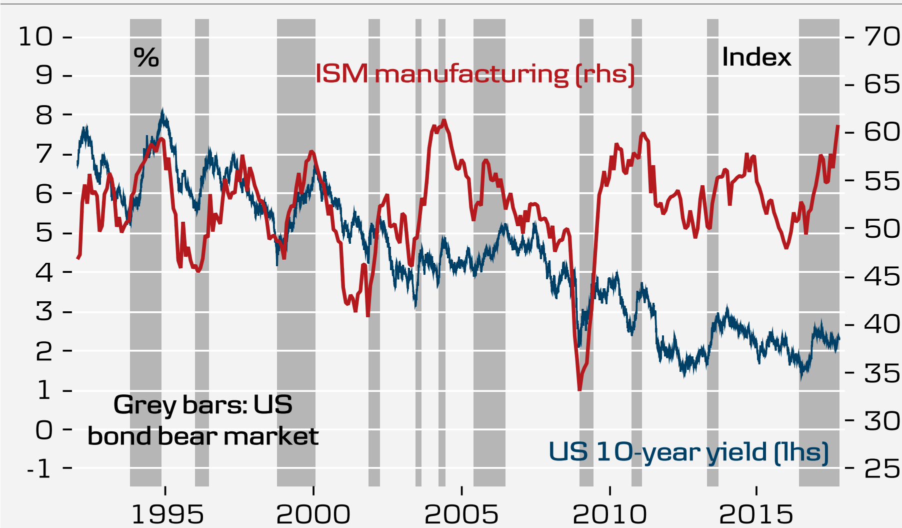



Source: Macrobond Financial, Danske Bank

Bond and FX markets will be looking ahead to the ECB meeting on Thursday, see our *ECB preview: Ready to scale back QE*, 18 October 2017. In line with recent ECB communication, **we now look for the ECB to scale back QE to EUR30bn (from EUR40bn) but to extend it for nine months** until September 2018. On top of this, the ECB expects the reinvestment flow to be EUR15-20bn so they will continue to be a big buyer in European fixed income for most of next year. After recent ECB communication, we believe the ECB announcement will be broadly expected by markets and should have limited impact.

With regard to the FX market, we do not expect any significant reaction in EUR/USD, as we already saw substantial repricing of the ECB in the FX market over the summer. **We still see EUR/USD around current levels on a 1-3M horizon** with the risks skewed slightly to the downside, although any dips in EUR/USD should be shallow and short-lived. **Longer term, we continue to stress that a 2018 rebound towards 1.25** is on the cards, as upside risks still dominate the longer-term outlook.

Chart 7: US bond bear markets almost only take place when ISM is rising (grey areas show bond bear markets)




Source: Macrobond Financial, Danske Bank

## Global market views

| Asset class | Main factors |
|---|---|
| **Equities** | |
| Positive on equities | We are positive on equities, as we think the global business cycle is still strong, risks are low and central banks are only tightening monetary policy gradually. |
| **Bond market** | |
| German/Scandi yields – set to stay in range for now, higher on 12M | Inflation 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. Focus on possible tapering, but that is more of a 2018 story. |
| 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 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 relative dovish and yields should edge higher on 12M horizon. |
| Peripheral spreads – tightening but still some factors to watch | Economic recovery, ECB stimuli, better fundamentals, particularly in Portugal and Spain, an improved political picture and rating upgrades are expected to lead to further tightening despite the recent strong moves. Italy is the big risk factor. But very expensive to be short Italien 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 has turned for good as ECB has reluctantly allowed 'reverse gravity' to kick in but upward momentum should wear off near term. Upside risks dominate in 2 |
| 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 BoJ is staying dovish, means support for EUR/JPY and USD/JPY alike throughout our forecast |
| EUR/SEK – consolidation near term, gradually lower further out | Gradually lower in the longer term on fundamentals but near term further SEK potential is limited by a cautious Riksbank. |
| EUR/NOK – upside risks in Q4, then gradually lower | [illegible] differentials. |
| **Commodities** | |
| Oil price – range trading | Bouncing on Iraqi-Kurdish tensions. OPEC mulling 9M extension of cuts to end-2018 |
| Metal prices – to fall back | Short-lived rally ahead of Chinese National Party Congress - sentiment likely to turn negative again as China is set to slow again after congress. |
| Gold price – range-bound | Tug of war between safe haven demand from rising global geopolitical tensions and negative impact from hawkish Federal Reserve. |
| Agriculturals – trending higher | Weather related supply concerns supporting prices. |

*Source: Danske Bank*

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