23 March 2018

Strategy

Slowly fought trade war amid increasing Libor/OIS spread

Trade war is slowly fought

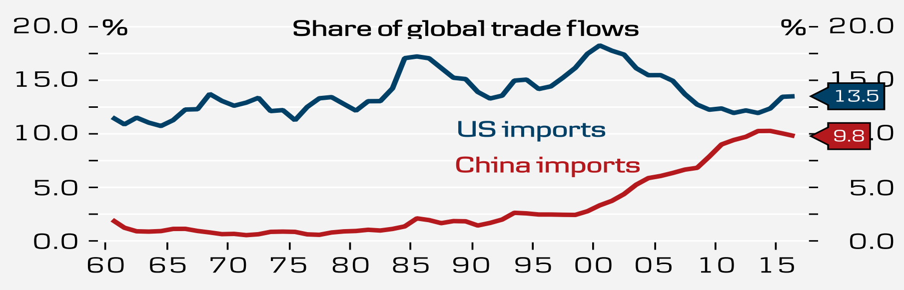
Market focus remains on trade policy, as markets are still concerned about a full-blown trade war. Yesterday, Trump announced he will impose tariffs on USD60bn of imports from China, targeting 10 strategic sectors (e.g. robotics and electric vehicles) laid out by China in its ‘Made in China 2025’ plan and restricting Chinese investments in US companies. **As the plan is not finished yet, it supports our view that this is going to be a very slowly fought trade war and the theme will pop up every now and then ahead of the US mid-term election in November.** Until we get more information about what Trump is actually going to do, China will stick to its moderate retaliation to Trump’s tariffs on steel and aluminium for now. However, officials have said China will take further steps if necessary, most likely targeting imports of US aircrafts and soybeans and possibly other goods. See *Flash Comment: Moderate Chinese retaliation - but keeping the powder dry*, 23 March 2018. While important on a political level, the direct effect on Chinese GDP should not be overestimated. **Trump is targeting approximately USD50bn of Chinese goods, corresponding to 10% of Chinese exports to the US, or 0.4% of Chinese GDP**.

Only slightly steeper Fed rate path due to Trumponomics

Despite trade war concerns, the Fed hiked rates at its meeting this week and lifted its rate hike signal for next year by nearly one full 25bp hike, now signalling a total of five hikes from now until year-end 2019, as the Fed thinks it is appropriate to tighten a bit more due to more expansionary fiscal policy. See *FOMC review: Only slightly steeper rate path due to Trumponomics*, 21 March. **We still believe the overall policy mix is going to be more expansionary, posing upside risk to the US inflation outlook**. See *Part 1: Global Inflation – US stimulus and closing output gaps pose upside risk*, 26 February.

Despite the Fed continuing its gradual hiking cycle, we stress that short-term rates are not a key driver of EUR/USD at present. **The Fed needs to change its course on policy more dramatically for it to impact USD crosses and we still see EUR/USD in the 1.21-1.26 range near term with markets being more focused on trade policy**. Our medium-term story remains unchanged, as capital flow reversal and valuation should support EUR/USD on a 6-12M horizon. We target 1.28 in 12M.

China has become more important for global trade over the past 15 years



Source: World Bank World Development Indicators, Macrobond Financial, Danske Bank

Today’s key points

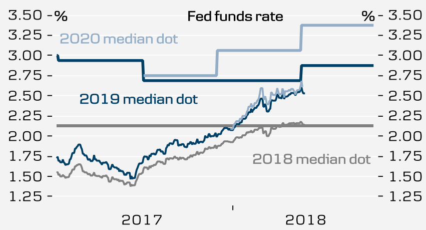
- Trade war is very slowly fought.
- The Fed lifted its rate path slightly due to Trumponomics.
- We are keeping an eye on the increasing Libor/OIS spread.
- Brexit transition deal is not a game changer for EUR/GBP.

Ten focus sectors identified in ‘Made in China 2025’

1. Agricultural equipment
2. Rail equipment (high-speed trains)
3. High-end numerical control machinery and automation
4. New materials
5. Maritime engineering and high-tech vessel manufacturing
6. Aerospace and aviation equipment
7. Electrical equipment
8. Energy-saving vehicles
9. Information technology
10. Biomedicine and high-performance medical apparatus

Source: China Daily, 30 March 2015

Fed is still priced too softly next year



Source: Federal Reserve, Bloomberg, Macrobond Financial

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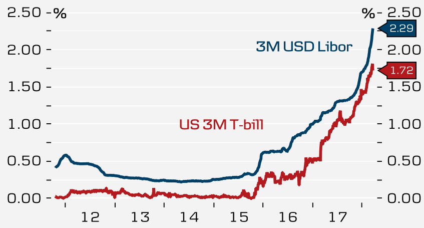
Higher Libor/OIS spread is on our radar

The 3M Libor/OIS spread has been on the rise recently and has now reached 55bp, the highest since 2009 (higher than during the European debt crisis and the panic in 2016). The spread is a measure of the premium banks pays to borrow in the interbank market relative to the risk free 3M OIS swap rate and is usually considered a stress indicator. **As there are no other indicators of increasing stress in the banking sector, it seems like the price of USD liquidity is the main driver, in our view. We see four main reasons for the higher 3M USD Libor rates:** (1) higher issuance of US Treasury bills due to higher US deficit has increased US T-bill yields, (2) the US Treasury has begun rebuilding its cash buffer at the Federal Reserve after the resuspension of the US debt limit, (3) the Fed has begun reducing its balance sheet and the pace is increasing and (4) US repatriation of overseas earnings is removing a large cash pool from the global USD funding market.

We are not concerned yet but it is one thing we are looking out for right now. We expect spreads to remain relatively wide going forward due to the balance sheet reduction and US repatriation but the flow effect from the recent US T-bill issuance and the rebuild of US Treasury's cash buffer at the Fed should be transitory.

High 3M USD Libor rates driven partly by higher US T-bill yields

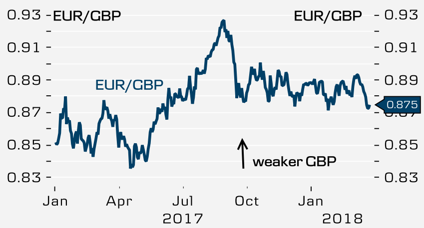


Source: Macrobond Financial

Brexit transition deal is not a game changer

This week, the EU and UK reached an agreement on a transition period lasting from 30 March 2019 until year-end 2020. While positive, it is not the game changer and in any case a deal was widely expected. The negotiations on the future relationship are going to be much more complicated, not least with respect to the outstanding Irish border issue. EUR/GBP fell on the transition agreement but we do not expect EUR/GBP to move significantly lower before we get more clarification on what the future relationship is going to look like. We target EUR/GBP at 0.86 in 6M and 0.84 in 12M. Our call for a lower EUR/GBP is also supported by Bank of England, as the BoE meeting this week has not changed our view that the BoE will hike twice this year (May and November), see *Bank of England review: BoE still on track for a May hike*, 22 March.

Brexit transition deal not a game changer for EUR/GBP



Source: Bloomberg, Macrobond Financial

Financial views

Asset class	Main factors
Equities	
Positive on 3-12 month horizon.	Strong business cycle and near double digit earnings growth in most major regions. Low rates drive demand for risk assets.
Bond market	
German/Scandi yields – in recent range for now, higher in	ECB to normalise gradually only due to lack of wage pressure and stronger euro. ECB on hold for a long time.
EUR 2y10y steeper, USD 2y10y flatter	The ECB keeps a tight leash on the short end of the curve.But 10Y higher as US impact.
US-euro spread - short-end to widen further	The spread in the short-end to widen further as Fed continues to hike
Peripheral spreads – tightening	Economic recovery, ECB stimuli, better fundamentals, an improved political picture and rating upgrades to lead to further tightening despite the recent strong moves. Italy still a risk
FX & Commodities	
EUR/USD – rangebound near term	In 1.21-1.26 range for now; supported longer term by valuation and capital-flow reversal due to ECB 'normalisation'
EUR/GBP – gradually lower over the medium term	Brexit uncertainty dominates but GBP shouyld strengthen in 6-12M on Brexit clarification and BoE rate hikes.
USD/JPY – lower short term	JPY to strenghten in coming months due to portfolio flows into Japan, stretched JPY positioning and fragile risk markets.
EUR/SEK – risk to the topside	Negative on the SEK due to lower growth, subdued inflation and too aggressive RB pricing; eventually EUR/SEK lower but not in H1 18
EUR/NOK - to move lower, but near-term topside risk	Positive on NOK on valuation, relative growth, positoning, terms-of-trade, the global outlook, and Norges Bank initiating a hiking cycle.
Oil price – starting to correct lower again	June review weakens impact of extension of OPEC+ output cuts. Geopolitical tensions around Saudi Arabia and Iran looming. Support from falling USD.

Source: Danske Bank

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This research report has been prepared by Danske Bank A/S ('Danske Bank'). The author of this research report is Mikael Olai Milhøj, Senior Analyst.

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