28 September 2018

Strategy

Central banks still key actors for markets

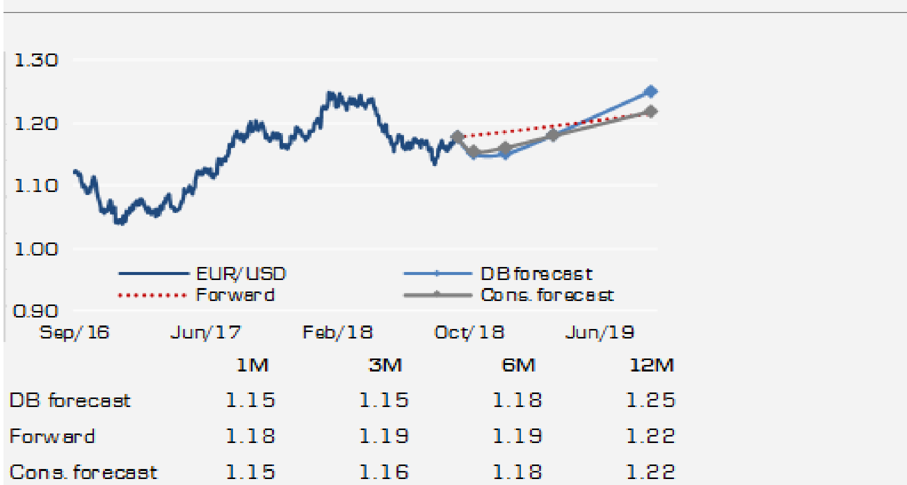
Markets waiting for ECB's signal of the first rate hike

Despite political uncertainty, the economy and central banks are still the most important drivers for markets overall. The global economy still seems in good shape, at least when looking at GDP growth, although growth in Europe and China is not as high as last year. The US is still growing solidly. **This is good for equities, which we still expect to perform**.

This week was packed with ECB speeches. Given that the ECB meeting earlier this month was quite boring, **markets were caught by surprise by the hawkish twist from ECB President Mario Draghi**, who said that he sees *'a relatively vigorous pick-up in underlying inflation'*. This is quite interesting, as Draghi never chooses words by accident. On the ECB's forward guidance, Draghi said that *'the "through the summer 2019" formulation is a calendar-based element, which refers to when we anticipate conditions that might warrant a first rate increase'*, which means **the ECB meeting in September 2019 is set to be a live meeting**. Markets reacted by sending European yields and EUR/USD higher, which, in our view, highlights an important point: **market participants are not waiting for the first hike to actually arrive before reacting**. Indeed, it is when easing stops - rather than when hikes occur - that currency appreciation is seen and vice versa.

The next big move in EUR/USD is up when the first ECB hike draws closer and we forecast 1.25 in 12M. We still expect a steeper EUR yield curve on a 12M horizon. The ECB maintains a relatively tight grip on the short end of the curve, while the 10Y segment of the curve is pushed higher by rising US yields, the end of ECB QE and the pricing of ECB rate hikes in 2019-20. **Our base case is still that the ECB waits until December 2019 to hike for the first time (20bp).** While our euro area inflation forecast is in line with the ECB projection this year, our profile is lower for next year making a December hike more likely than a September hike. A 10bp hike is priced in by September 2019 and 20bp by December 2019.

We expect the next big move in EUR/USD is up



	1M	3M	6M	12M
DB forecast	1.15	1.15	1.18	1.25
Forward	1.18	1.19	1.19	1.22
Cons. forecast	1.15	1.16	1.18	1.22

Source: Bloomberg, Danske Bank

Today's key points

- Market participants are not waiting for the first ECB hike to actually arrive before reacting.
- The next big move in EUR/USD is up, when the first ECB hike draws closer. We forecast 1.25 in 12M.
- The US economy is in great shape despite trade war concerns supporting the case for further Fed rate hikes and higher US Treasury yields.

Senior Analyst
Mikael Olai Milhøj
+45 45 12 76 07
milh@danskebank.dk

Important disclosures and certifications are contained from page 3 of this report.

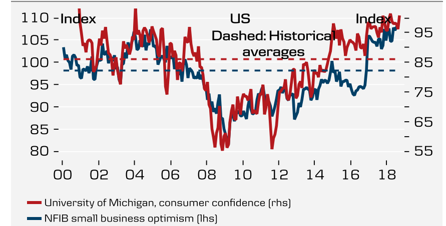
US Treasury 10Y yields above 3%

Despite trade war concerns, the **US economy is in good shape with solid growth**, increasing employment, low unemployment, gradually rising wage growth, small business optimism the highest on record, consumer confidence surging to an 18-year high and underlying inflation pressure hovering around 2%. Especially the signs of increasing wage pressure are encouraging and the important technical 3% level has been broken and 10Y US Treasury yields are trading close to 3.1%.

As expected, the Federal Reserve raised the target range by 25bp to 2.00-2.25% at its meeting this week and hinted that another hike in December might be in the cards. The signal for next year was also unchanged at three additional hikes. This is in line with our call. **In our view, the Fed is on autopilot until neutral is reached,** which the Fed now believes is 3%. After that it is more stop and go, depending on how the economy evolves. **We believe the Fed is able to continue hiking**, as we think the real economy will remain strong and we do not forecast an inversion of the yield curve, which is normally considered a strong recession indicator. Markets are only pricing 2.6 hikes from now until year-end 2019, whereas we expect a total of four, so market pricing still seems too soft to us.

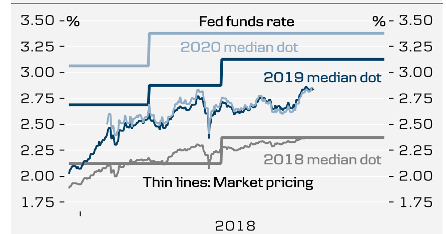
We still see a case for both higher 2Y and 10Y US Treasury yields. The short end is pushed higher as the Fed continues hiking and the markets start pricing them in. In the long end, we expect to see a modest increase in the US term premium, which remains quite subdued. We also assume an effect on the yield level from the more expansive US fiscal policy, which boosts US bond supply. We forecast US Treasury 2Y yields at 3.15% and US Treasury 10Y yields at 3.25% in 12 months.¨

US: very high optimism among businesses and consumers



Source: NFIB, University of Michigan, Macrobond Financial

Markets do not believe the Fed is going to hike as much as the Fed signals



Source: Federal Reserve, Bloomberg, Macrobond Financial

Financial views

Asset class	Main factors
Equities	
Positive on 3-12 month horizon.	Fundamentals still support equities on a 3-12M horizon. However, despite strong earnings, higher risk premium is expected in the short run, among other things due to trade tensions
Bond market	
German/Scandi yields – stable for now, higher in 12M	Strong forward guidance from the ECB. Core inflation remains muted. Range trading for Bunds for the rest of 2018. Still higher in 2018.
EUR 2Y10Y steeper, USD 2Y10Y flatter	The ECB keeps a tight leash on the short end of the curve but 10Y higher as US has an impact. EUR 2Y10Y mainly steeper in 2019.
US-euro spread – short-end to widen further	The spread in the short-end is set to widen further as the Fed continues to hike.
Peripheral spreads – tightening (Italy special case)	ECB forward guidance, better fundamentals, an improved political picture (ex. Italy) and rating upgrades to lead to renewed tightening after recent widening. Italy remains a special case.
FX & commodities	
EUR/USD – lower for longer... but not forever	In a range around 1.15 in 0-3M as USD carry and political risks weigh but supported longer term by valuation and ECB 'normalisation'.
EUR/GBP – gradually lower over the medium term	Brexit uncertainty dominates now but GBP should strengthen on 6-12M on Brexit clarification and Bank of England rate hikes.
USD/JPY – higher eventually	US yields decisive near term with political uncertainty as a significant downside risk. Longer term higher on Fed-Bank of Japan divergence.
EUR/SEK – downside in warm-up to first hike	Lower as first hike form Riksbank looms by year end - but it could be one-and-done which should limit SEK strength thereafter.
EUR/NOK – set to move lower still	Positive on NOK on valuation, relative growth, positioning, terms of trade, global outlook and Norges Bank initiating a hiking cycle.
Oil price – downside risk rest of year	OPEC increasing output and escalation of trade war has increased near-term downside risks.

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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