28 October 2016

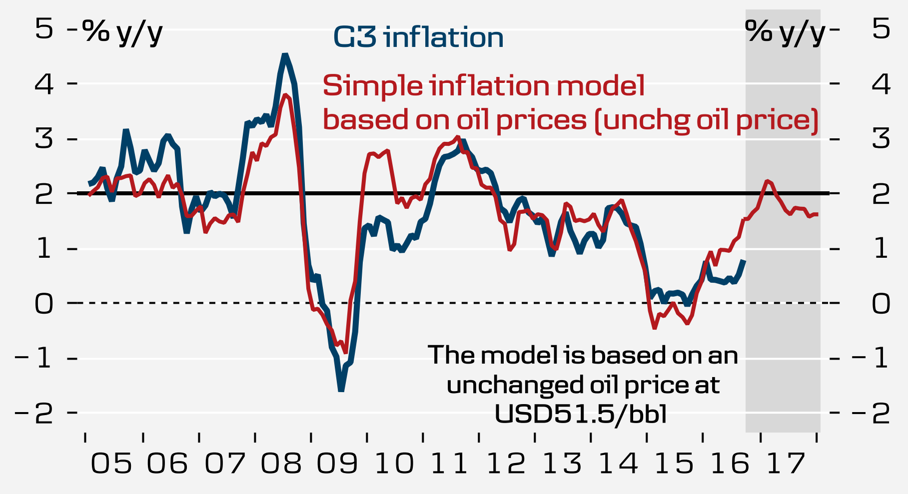
Strategy

Higher inflation to push up inflation expectations further

This week we highlighted that we think global inflation is set to surprise on the upside due to the recent rise in commodity prices, see *Global Inflation: Set to surprise to the upside lifting long-dated inflation pricing*, 27 October 2016. Our forecast is for higher commodity prices, but even if we assume an unchanged oil price, it indicates that global G3 inflation could rise towards 2.0% from the current level of 0.4% (see bottom-left chart). **We expect this to reduce the deflation scare further, thereby supporting the market pricing of inflation**. However, since higher global inflation may not be persistent, as it is driven by volatile commodity prices, **we expect central banks to see through higher inflation and stay accommodative**. This could be positive for long-term inflation expectations as well, as it would be a sign to the markets that the central banks take their remits seriously.

In the euro area, we expect inflation to reach 1.5% early next year, which will be the highest since mid-2013. While the market has started to price higher near-term inflation, longer-dated inflation is still priced very subdued. Our 2017 forecast is much above the current pricing (see bottom-right chart) and **in our view the risk of upside inflation surprises is underpriced as long-term euro inflation pricing is affected by spot inflation**. Higher inflation expectations will of course be welcomed by the ECB but we expect the ECB to maintain an accommodative monetary policy until it sees a convincing upward trend in underlying inflation. A majority of the ECB members, including ECB president Draghi, has seemed eager to kill the recent tapering rumours.

Chart 1: Inflation set to rise even with unchanged oil prices

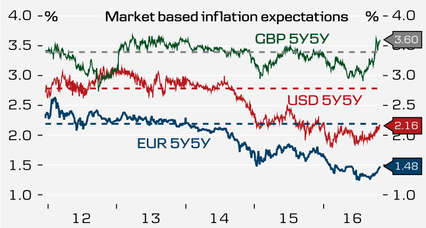


Source: Macrobond Financial

Key points

- Global inflation on the rise – pushing up inflation expectations
- Risk to the upside for bond yields for now on better data, rising inflation and central banks
- Stocks caught between better data and more hawkish central banks
- Euro data surprise to the upside

Euro and US inflation pricing is still very low, UK has picked up



Source: Bloomberg, Macrobond Financial, Danske Bank

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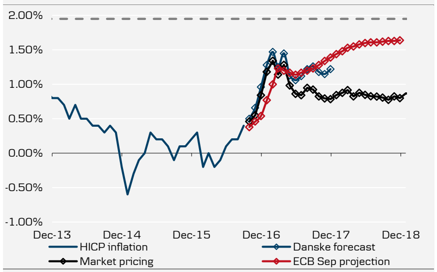
In the UK, both headline and core inflation are likely to rise considerably, especially due to the significant depreciation of the GBP. On several occasions, the BoE has communicated that it accepts inflation will increase above the 2% target in the coming years to support the economy through the Brexit-negotiations. In our view, the BoE's easing bias will be supportive for long-term UK inflation expectations.

In the US, we expect CPI headline inflation to stabilise around 2% next year due to the higher energy prices. CPI core inflation is not expected to move significantly higher as wage growth remains subdued and inflation expectations are low. Recently, more FOMC members including Fed chair Yellen have expressed the idea of letting core inflation overshoot the 2% target. As the Fed turns more dovish next year due to shifting voting rights, this could be supportive for long-term US inflation expectations.

Our 2017 euro forecast is much above the current pricing

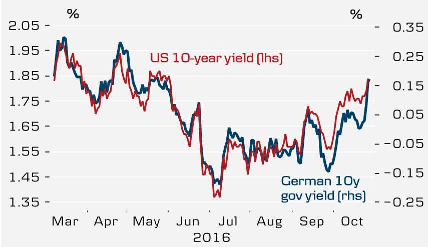


Source: Macrobond Financial, Danske Bank Markets

More fuel to bond market sell off – equities still treading water

The bond market sell-off that started in late September got further fuel this week. Stronger euro data and hawkish comments from some ECB members added to the bearish sentiment. US data also continue to confirm that growth has recovered in H2 causing markets to price a further probability of a gradual Fed hiking cycle into the short end. The market is now pricing two hikes from the Fed by the end of 2017 and a hike in December is priced with 75% probability – probably as high as it can get by now. German 10-year yields shot higher this week from 0 to 20bp and US 10-year yields continue to show 'higher highs' reaching 1.85%. While bonds look a bit technically oversold short term the **bearish tone will probably stay with us for a while** as a Fed hike is moving closer and inflation is likely to continue higher and lift inflation expectations. The sell-off we were looking for next year may have come a bit earlier.

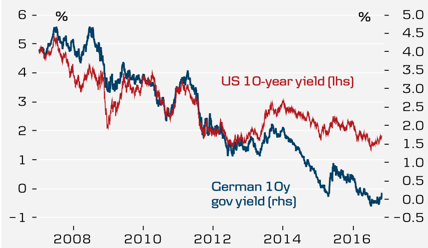
Bond yields pushing higher…



Source: Bloomberg, Danske Bank Markets

However, the sell-off comes after a long rally and eventually markets should settle down. There is still a search for yield in place given the negative short rates in many countries and overall very low yield environment. **The rise in inflation will also prove temporary** as it is mainly driven by commodity prices and central banks are likely to tolerate higher inflation for some time to lift inflation expectations. Hence we do not look for a long sustained bear market, see *Yield Forecast Update*, 14 October 2016.

… but comes after strong rally



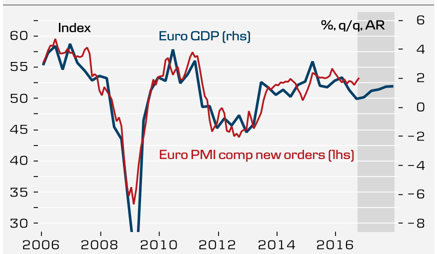
Source: Bloomberg, Danske Bank Markets

Stock markets have been characterised by very low volatility and range trading for a long time now. At this point better data just means more hawkish central banks, which are keeping the markets in check. **Our short-term view continues to be a 'buy-on-dips' stance but longer term we are still underweight** as earnings expectations are too high in our view and valuation is stretched in some markets.

Euro area data surprising to the upside – US investment bottom

Data this week on PMI and German ifo confidence surprised quite clearly to the upside. It points to some upside risk to growth estimates for H2 and 2017 (see chart). In particular, a rise in ifo expectations to the highest level since April 2014 was noteworthy as this is one of the good leading indicators for German growth. Hence it seems that the dent in sentiment related to the UK Brexit is gradually lifting. Stronger growth in the US and China is probably also underpinning business confidence among euro area exporters.

Euro PMI points to some upside risk to growth



Source: Bloomberg, Danske Bank Markets

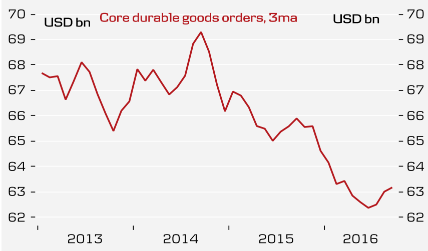
In the US durable goods orders suggest that the worst is behind us on the investment crunch seen over the past 1½ years. Since investment growth has been the key driver behind the slowdown (due to the oil price collapse), it provides support to the case for easing pains and recovering growth over the coming quarters. A bottom in oil rig counts adds to the picture of easing pain. The oil rig count is up 25% over the past three months replacing the collapse starting at the end of 2014.

Chinese profit growth up this year – but should fade in 2017

There has been limited Chinese data this week but industrial profits for September were released showing growth of 7.7% y/y following the strong print of 19.5% in August. Overall profit growth has been just below 10% this year driven by a lift to commodity prices benefiting the large State Owned Enterprises in this sector, which have also seen higher volumes due to the recovery in construction and infrastructure spending. This week iron ore prices saw a further lift pulled by stronger demand from China. This has been one of the big supports for Emerging Markets assets, not least in Brazil where stocks are up close to 50% this year and the real has seen big gains (see chart).

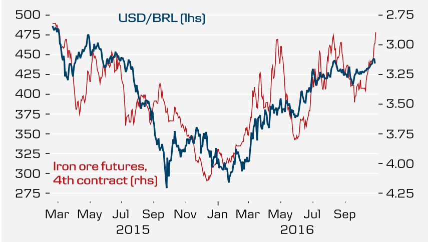
However, as we have highlighted lately we believe growth is bound to fade again in 2017 as the boost from these sectors is likely to fade. This week we published the third China letter based on a trip to Beijing focusing on the growth outlook, see *Research: China letter 3 – growth outlook and reliance on old engines*, 27 October 2016. While growth has recovered our concern is that it continues to be driven by the old engines like infrastructure and construction while private investment growth is weak and consumption growth is trending lower. This is not sustainable and China needs to allow growth to be weaker rather than keep boosting sectors that suffer from overcapacity and will eventually have to face slower growth as the return on additional infrastructure investment is coming down. China now has 80% of the amount of paved roads in the US even though the overall GDP per capita level is only 25% of the US. Infrastructure investment is useful for spreading growth and lowering transport costs and has benefited China, but this engine will have to slow down sooner or later and the more it is boosted now the sooner it will have to slow down.

US durable goods orders suggest the worst is behind on investment crunch



Source: Bloomberg, Danske Bank Markets

Higher iron ore prices on China demand – good for Brazil



Source: Bloomberg, Danske Bank Markets

Global market views

Asset class	Main factors
Equities	
Short term (0-1 month): buy-on-dips	The hunt for yield as a theme has led equity markets to bounce back after Brexit. Growth is above expectations but has still not broken out of the range. Risk of setbacks is high due to stretched valuations and still fairly weak earnings but central bank anchoring of bond yields provides a cushion for a setback, hence, our structurally underweight position in equities vs. cash. Our short-term stance is buy-on-dips.
Medium term (three-six months): underweight equities vs cash	
Bond market	
Risk of steeper 2y10y curve is rising	ECB to extend the QE programme. But tapering and higher inflation prints are looming adding upside to long.end
US-euro spread: wider but not before we see Fed hikes	Fed on hold until 2017. Risk of earlier hike is evident. Long-end sell-off to impact long EUR rates
Peripheral spreads: ECB support	Economic recovery and QE means further tightening. But politics and tapering remain risk factors.
Credit spreads: neutral	ECB keeping spreads contained.
FX	
EUR/USD - lower near term on ECB, technicals. Then higher.	Short-term downside risks from technicals, ECB; valuations and CA differential support cross in the medium to long term.
EUR/GBP - further GBP weakness in store over next 6M	Political uncertainty and not least financial account flows to send cross higher.
USD/JPY - neutral with short-term risks skewed slightly to the upside	Expect range trading in the 103-106 range.
EUR/SEK - to move gradually lower over coming months	To move gradually lower on relative fundamentals and valuation.
EUR/NOK - short-term risks skewed to the upside	Latest move lower on Norges Bank and oil seems excessive. Risk of spike higher near term before moving lower in 2017.
Commodities	
Oil price – uncertainty about details of OPEC deal	Rising USD and market doubting OPEC deal to send oil price lower.
Metal prices – recovery in Chinese construction fading in 2017	Consolidation in mining industry puts a floor under prices, awaiting support from higher global economic growth.
Gold price – support from central banks is fading	Looming Fed hike and ECB tapering fear has hit gold price.
Agriculturals – support from disruptive weather, higher oil price	Attention has turned to La Niña weather risks in H2 16.

Source: Danske Bank Markets

Disclosures

This research report has been prepared by Danske Bank Markets, a division of Danske Bank A/S (‘Danske Bank’). The authors of the research report are Allan von Mehren, Chief Analyst, and Mikael Olai Milhøj, Senior Analyst.

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Expected updates

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