30 September 2016

Strategy

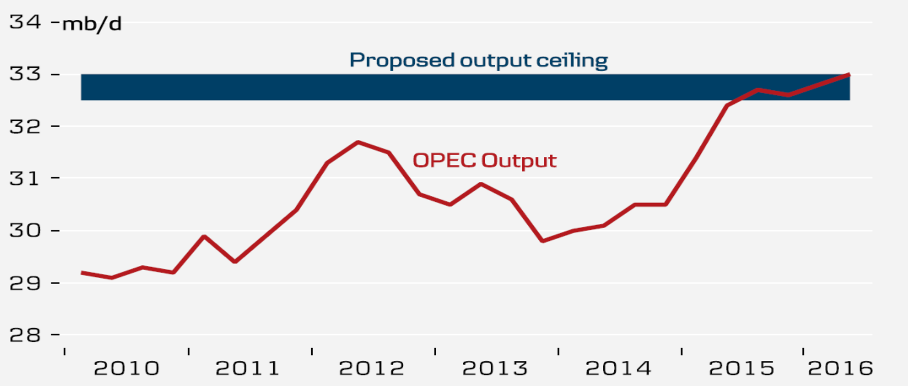
Oil, China and the downside risk to growth

Oil prices have risen sharply this week as OPEC on Wednesday said that its members agreed to cut output to around 32.5-33.0m bpd from the current level of 33.2m bpd. We believe that any sustained rise in oil prices is likely to be short-lived. Firstly, the proposed cut would be a small cut in supply (see Chart 1). Secondly, there is a risk that the OPEC countries will actually be cautious about handing market shares back to, for example the US, when the final agreement has to be reached on 30 November at the official OPEC meeting. If the market starts to doubt whether the deal will be carried out, oil prices could quickly reverse. Expect oil prices to stay highly volatile near-term, although moving higher over the medium term.

Data for the global industrial (IP) cycle in September in the form of eurozone manufacturing PMI, German IFO and China's Caixin PMI manufacturing have come out better than expected, supporting the case for a moderate recovery. It appears that relief that Brexit did not have a more damaging effect on sentiment is currently supporting investments and consumption in the eurozone. In China, we expect the recovery to hold up during most of 2016. However, we expect it to lose steam in 2017 as the fiscal stimulus fades, with the biggest boost to construction likely to fade as well (see Chart 2). Worryingly, the debt problem in China continues to worsen with the recent sharp credit creation only kicking the can further down the road (see Chart 3). US data are mixed, supporting our case that growth in Q3 is not as strong as many (including the Fed) believe.

As such, global growth is currently moving sideways, but we see risks skewed to the downside, with political uncertainty in the US and Europe and rising protectionism potentially weighing on sentiment. This week, the World Trade Organisation (WTO) revised down its 2016 forecast for world trade to 1.7% and just 1.8% in 2017. 2016 marks the first year in 15 years in which world trade will grow slower than GDP growth – a truly worrying sign. Rising geopolitical risks centred on the West's, particularly Europe's, relationship with Russia, Turkey and the Middle East could weigh on sentiment.

Chart 1: OPEC's cut is close to current levels



Source: Macrobond Financial

Key points

- OPEC supply cut is not a game changer.
- Protectionism and geopolitics pose risks for global growth.
- Core interest rates in Europe to stay depressed despite higher HICP inflation.
- Europe's banking woes are not a EUR negative; expect EUR/USD to remain in a narrow 1.10-1.14 range.
- We recommend a structurally underweight position in equities versus cash

Chart 2: China home sales to ease further – set to dampen construction into 2017

Source: Macrobond Financial

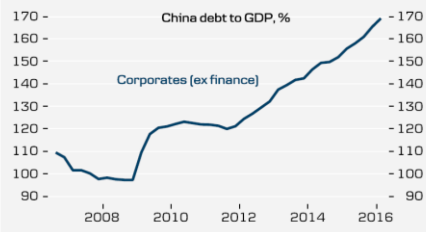
Global Head of FICC Research
Thomas Harr
+45 445 13 67 31
thhar@danskebank.dk

What does all this imply for markets? **We maintain our long-held view that interest rates will stay low for longer.** A gradual increase in oil prices will clearly support our call that CPI inflation in the eurozone will rise. On Friday, September HICP inflation rose to 0.4% from 0.2% and we expect inflation to reach 1% in December. Still, a lot of the expected near-term rise in CPI will be driven by base effects and we expect that the ECB will revise its forecasts for core inflation downward.

The current environment is neither very positive nor negative for the broad USD. We expect EUR/USD to be stuck in a tight range near-term in line with our 1M and 3M forecasts at 1.12. We view recent market turmoil regarding European banks, notably Deutche Bank, as having mixed EUR impacts. Deleveraging of non-eurozone assets by eurozone banks is a EUR positive while concerns about the potential negative impact on growth in the eurozone is a EUR negative. **Our highest conviction view among major currencies is that the British pound (GBP) will weaken a lot further.** The uncertainty with respect to when the UK will trigger Article 50 and the terms at which the country will withdraw from the EU will mitigate capital inflows to the country, in our view. This will weaken GBP given the UK's large current account deficit. We expect EUR/GBP to edge substantially higher to 0.92 in 6M.

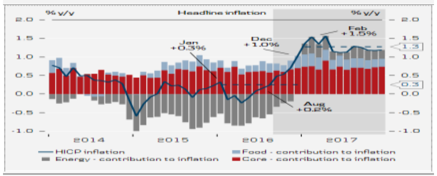
We believe the global environment has negative implications for risky assets, including equities. The risk of set-backs is high due to stretched valuations and weak earnings. We recommend a structurally underweight position in equities versus cash.

Chart 3: China needs to deleverage in the corporate sector



Source: Macrobond Financial

Chart 4: The energy drag will turn into a tailwind in Eurozone



Source: Eurostat, Danske Bank

Global market views

Asset class	Main factors
Equities	
Short term (0-1 month): sell on rallies Medium term (three-six months): underweight equities vs cash	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 banks' anchoring of bond yields provides a cushion for a setback, hence, our structurally underweight position in equities vs. cash. We have moved our short-term stance to sell on rallies.
Bond market	
Core yields: low for even longer with risk of steeper curve 2y10y	We expect the ECB to announce in Q4 that it will prolong the QE programme by another six months.
US-euro spread: wider but not before we see Fed hikes	Fed on hold until 2017. Risk of earlier hike is evident. Market priced too soft. Long end sell-off to impact long EUR rates.
Peripheral spreads: ECB support	QE buying, bond scarcity and hunt for yield means further tightening. But politics remains an unknown.
Credit spreads: neutral	ECB keeping spreads contained.
FX	
EUR/USD - 1.10-114 range near term, then higher	Valuations and CA differential support cross in the medium to long term; short-term downside risks from relative rates.
EUR/GBP - further GBP weakness in next few months	Political uncertainty and financial account flows to send cross higher.
USD/JPY - neutral with short-term risks skewed slightly to the downside	Expect near-term stabilisation in the 100-103 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 a spike higher near term before moving lower in 2017.
Commodities	
Oil price – uncertainty about details of OPEC deal	OPEC has lost leverage over oil price; demand concerns limiting upside for prices.
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 – bouncing on repricing of Fed and other major central banks	Dovish major central banks support demand for gold.
Agriculturals – support from disruptive weather, higher oil price	Attention has turned to La Niña weather risks in H2 16.

Source: Danske Bank Markets

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None.

Date of first publication

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