25 May 2018

Strategy

Risk off? Yes - but both Italy and EM issue to be contained

In a week where risk sentiment soured markedly on the prospect of a debt-willing coalition government in Italy, and a continued stream of negative data surprises out of notably the eurozone, the unabated rise in US 10Y yields seemingly came to an at least temporary halt. While the latter may spur some provisional relief for emerging markets, the euro area is set to face near-term headwinds still from the Italian issue hitting at an unpleasant time of cyclical weakness. Indeed, even as US yields may be taking a breather, there may be more USD strength in store short term. Indeed, our quantitative cyclical lead models continue to hint that the US holds a relatively favourable cyclical position, see *MacroScope – More weakness coming.* Hence, risk sentiment could suffer for some time still despite more signs of trade-war relief this week, see *US-China trade talks: 'Grand bargain' moving closer.*

Italy unlikely to spur new euro debt crisis

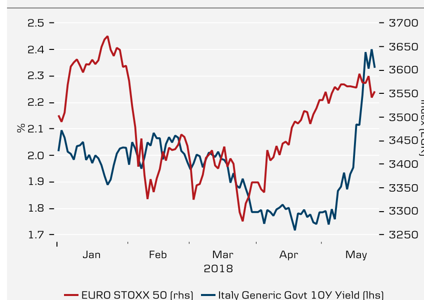
Following complacency in the immediate aftermath of the election, markets have over the past week been hit hard by renewed Italian debt worries as the two anti-establishment parties Five-Star Movement and Northern League are set to form a government with technocrat Giuseppe Conte as prime minister. The appointment of a new finance minister will be key to the market direction from here, but it is clear from the draft programme laid out by the parties that the new government plans a fiscal expansion of 6-7% of GDP, see *Italian election monitor: Rising market pressure set to challenge spending plans* for details.

Crucially, we do not see recent developments as the start of a new euro debt crisis. First, we think it will be difficult for the coalition government to fully implement this though as i.) budgetary measures require approval in both chambers of parliament and this may prove difficult to achieve, not least due to possible defections in the face of rising market pressure on Italian yields, and ii.) president Mattarella will likely play an active role in ensuring fiscal and political sustainability and accordance with international treaties of any new bills. Second, Italy is somewhat different now than just a few years back: i.) both foreigners and Italian banks have reduced their exposure to Italian government debt markedly, ii.) rating-wise Italian bonds remain comfortably above 'junk' status with all rating agencies and thus still easily qualify as collateral in ECB auctions. **That said, until more clarity regarding actual policy implementation is obtained, an Italy risk premium will likely continue to depress sentiment in the eurozone and weigh on the single currency.**

Key points

- Risk sentiment has soured markedly as Italian debt worries and USD strength have weighed
- The new Italian government implies market uncertainty for now but we do not see the debt issue leading to a new euro crisis
- US yields show first signs of settling down a bit – and indeed we think the uptick could take a breather in the near future
- USD strength could stick around near term as the US holds a favourable cyclical position still but should abate further out
- Emerging markets to remain wobbly near term but we do not see a contagious situation – however, the dust has not settled in Turkey yet

Risk sentiment continues to sour in Europe (Italy)



Source: Bloomberg, Macrobond Finanical, Danske Bank.

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Rise in US yields not unstoppable

A key question lately has been that of whether US yields have embarked on an unstoppable uptrend – and, given the recoupling of USD with it recently, whether dollar strength is here to stay. The rise in notably US 10Y seen since the autumn to now stand around 3% has in our view been driven by both an uptick in inflation expectations, and a repricing of the term premium due to the sheer increase in rate volatility. **We stress however that US yields have come a long way now, not least in light of the decline in the so-called 'natural' (equilibrium) rate of interest in past decades.** Thus, we see the repricing of the term premium taking a breather now, and envisage that it will take a while before we see a more sustained break of the psychologically important 3% level.

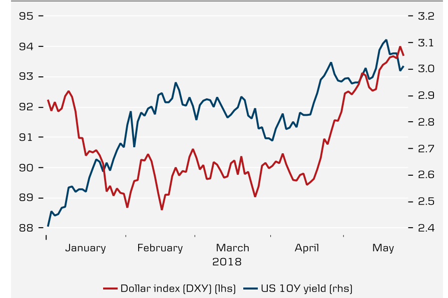
The big question is then whether the Fed's apparent preference to allow an inflation overshoot – confirmed this week by minutes from the latest FOMC meeting - will foster another uptick in inflation expectations; in our view, this is a prerequisite for more upside in e.g. 10Y yields. It might eventually but near-term potential is limited in our view as the US is also entering a soft patch activity-wise. **Thus, we still look for continued curve flattening in the US and thus limited upside to rates beyond the 5Y segment.** Notably in relative terms, we expect EU and US 10Y yields to grind slowly higher together, making little room for continued spread widening and thus little EUR/USD downside potential from this angle.

Emerging markets: it ain't over 'till US strength abates

Emerging markets (EM) and their currencies in particular have been hit significantly by the decline in risk sentiment, higher US yields and a stronger USD - and for oil-importing countries like Turkey and India, the recent uptick in oil prices is adding to external pressures. Following a 25% rise in USD/TRY since early March, the central bank delivered a 300bp emergency rate hike this week. This has however failed to stem TRY selling pressure as markets speculate that the willingness to tighten the overheating economy remains limited within Erdogan's government ahead of the June election. **More emergency hikes are likely with the lira under continued pressure,** see *Flash Comment - Turkey: external pressures, emergency hike and the outlook for the TRY.*

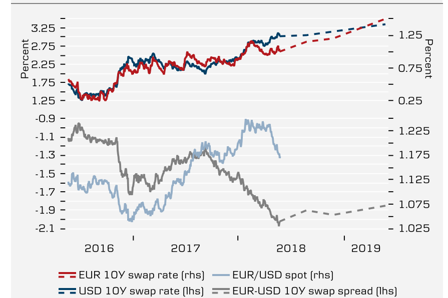
Of course, recent developments spur the more wide-raging question of whether this is the start of a contagious crisis in the EM sphere. In light of the amount of outstanding foreign debt and current-account deficits, apart from Turkey, notably Mexico, India and Brazil look vulnerable. **That said, given the loss of momentum we see in US yields and USD appreciation ahead as argued above, the EM currencies should look into some relief shortly.** Further with risks still on the upside in notably oil prices, oil exporters should enjoy some support nonetheless, but Turkey will likely be challenged still.

US yields and the greenback on the rise - but momentum may be fading



Source: Bloomberg, Macrobond, Danske Bank.

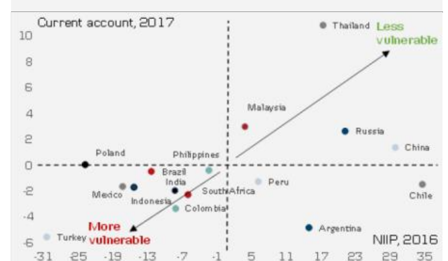
Yields set to grind higher in tandem – EU-US rate spread little changed in 12M



Source: Bloomberg, Macrobond, Danske Bank.

Note: dotted lines are Danske Bank forecasts

Axis of vulnerability in the EM sphere



Source: IMF, Macrobond, Danske Bank.

Financial views

Asset class	Main factors
Equities	
Positive on 3-12 month horizon.	Near double-digit earnings growth in most major regions. Low rates drive demand for risk assets.
Bond market	
German/Scandi yields – in range for now, higher in 12M	ECB set to normalise only gradually due to a lack of wage pressure and a 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 has an impact.
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	Economic recovery, ECB stimuli, better fundamentals, an improved political picture and rating upgrades to lead to further tightening despite the recent strong moves. Italy is a growing risk after the new government has been formed.
FX & commodities	
EUR/USD – USD strength is temporary	USD strength near term but 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 should strengthen on 6-12M on Brexit clarification and Bank of England rate hikes.
USD/JPY – lower short term	US yields decisive near term; downside risks reduced on postioning correct. Longer term higher on Fed-Bank of Japan divergence.
EUR/SEK – risk on the topside	Negative on the SEK due to lower growth, subdued inflation and too aggressive Riksbank 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 – upside risks near term	Rising prices on supply concerns, falling inventories and geopolitical risks (Iran). Upside risks remain key for the near term.

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 Christen Tuxen, Chief Analyst.

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