5 October 2018

Strategy

Stagflation? Growth slows, while inflation pushes higher

Global growth continues to slow. Global PMI for September showed another drop, pointing to further slowing of the global economy (Chart 1). The weakness was most pronounced in the euro area and China. The US is still a pillar of growth but it is also pretty much the only region with robust activity. This most likely reflects the big fiscal boost this year that has lifted both investment and consumer spending. We expect global growth to stabilise soon and continue at cruising speed. The euro area is set to bottom out and despite the US-China trade war, we believe both monetary and fiscal easing in China will serve as a cushion to growth. We expect US growth rates to slow down from the 4+% in Q2 but to remain above trend over the next year.

Inflation pressures rising. Despite slower growth, we have witnessed rising inflation pressure over the past months. The oil price is pushed higher as Iran oil exports are hit by US sanctions. In addition, the labour markets in the US, the euro area and Japan are getting tighter, thereby pushing up wage growth. As unemployment falls further, this trend is set to continue.

US bond yields at new cycle high, the Fed on autopilot. The robust US economy and rising inflation pressure led to a new high in US bond yields this week. The 10-year treasury yield rose sharply on Wednesday and increased to 3.23%, the highest level in seven years (Chart 3). Fed chair Jerome Power this week continued to signal that policy rates are more or less on autopilot in the coming quarters until the long-term neutral rate around 3% is reached in mid-2019. In an interview, he said, 'interest rates are still accommodative, but we're gradually moving to a place where they will be neutral', see *CNBC*. The surge in bond yields put pressure on the stock markets on Thursday.

Italy reigniting fears in the bond markets. Italy put itself in the limelight again as the initial budget proposal pointed to a 2.4% budget deficit over the next three years – much higher than expectations. It led to a big sell-off in the Italian bond market, which took the bond yield spread to Germany to a five-year high at 3 percentage points (Chart 4). The EUR also took a hit. During the week, the Italian government signalled that the deficit for 2020 and 2021 would be 2.1% and 1.8%, respectively, which led to some relief in the market, see *Bloomberg*. However, bond yields are still at elevated levels signalling a fear that Italy could get on an unsustainable debt path and face downgrades. Part of the concern is that the government is much too optimistic in its growth assumptions (rumoured to be 1.6% versus a rate currently around 1.0%). A failure to realise the assumed growth rates could push the deficit above the EU's 3% limit. On the positive side, there is so far limited contagion to other markets such as the Spanish bond market or the credit market.

Trump closes trade deal with Canada and Mexico but likely to escalate versus China. US President Donald Trump finally closed the deal with Canada leading to the new USMCA agreement, which replaces the old NAFTA deal. Trump called it 'the most important trade deal we've made so far'. While Trump is getting a win out of it in the short term, it may backfire in the end. President of the Canadian Chamber of Commerce,

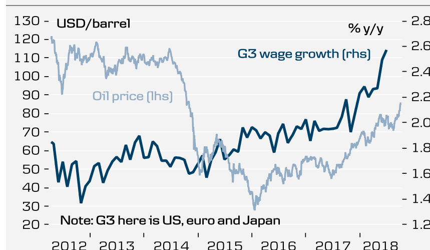
Key points

- Global growth is slowing...
- ...but inflation pressure is rising
- US bond yields at new high
- Italy reignites debt crisis fears
- Trump closes deal with Canada and Mexico but likely to escalate versus China

Chart 1. Global PMI now below long term average

Source: Macrobond Financial, Markit

Chart 2. Inflation pressure up on higher wage growth and oil prices



Source: Macrobond Financial, OECD, Bloomberg

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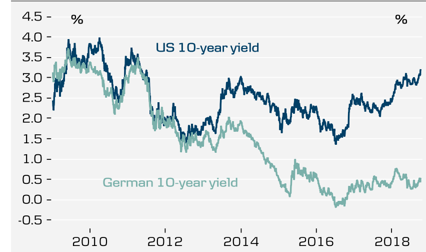
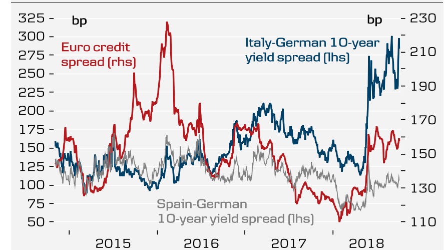
Perrin Beatty, thus said 'Canada must remember the lesson this turbulent period has provided: we must never again allow ourselves to be overly dependent on one trading partner'. A similar lesson is learnt in China. Hence, countries may now start to diversify their trade away from the US. Similarly, many countries have signalled a wish to reduce the dependence on the USD, as it gives the US a powerful instrument to put pressure on other countries to follow its line. It is an instrument that no one expected would be used but now the fear about too much dependency on the US economically and financially has grown. China's President has also stated clearly that China will need to be more self-sufficient and maybe that is not a bad thing, see *SCMP*. Speaking of China, the remaining big battle on the trade front is between US and China. It is a much bigger challenge, though, and we see a high risk of more escalation with US tariffs on all Chinese imports next year. Eventually it will hurt both countries, though, and a deal should be reached during 2019.

Chart 3. US bond yields push higher - highest level in seven years



Source: Macrobond Financial

Chart 4. Italy reigniting debt crisis fears but limited contagion so far



Source: 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 from 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 – range trading rest of year	On the rise as supply tightens and trade concerns ease

Source: Danske Bank

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