13 January 2017

Strategy

High economic surprise indices a short-term risk

As data has continued to beat expectations globally the so-called economic surprise indices have reached very high levels (chart 1). This reflects the good economic news supporting the case for strong synchronised growth momentum going into 2017 as we highlighted in *Five Macro Themes for 2017*, 1 December 2016. **However, the high level of surprise indices is also a slight warning for markets, as history suggests that it is hard to sustain these levels for long**. This is because expectations are typically moved higher after a period of good news and at the same time data moves in cycles and a string of strong data is often followed by some moderation. High expectations and softer data can quickly lead to disappointments.

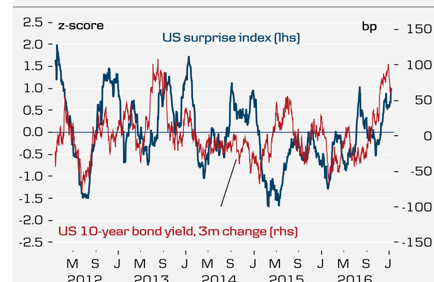
This is important because the reflation theme partly hinges on continued positive surprises and markets have already come some way in pricing in reflation. With steep yield curves in the bond market, investors may find more comfort in buying long-dated bonds again if the data starts to moderate, or take profit on short positions which also leads to higher demand for bonds. It is also interesting that US bond yields have actually fallen lately despite continued positive surprises. It may be another sign that the bond sell-off is stabilising for now**. Our medium- to long-term view is still one of higher bond yields by the end of 2017. But we could be in for a period of consolidation before the next leg up in yields**.

Stock markets have also lost some upward momentum lately. A lot of investors have moved to overweight of equities versus bonds on the back of a positive news flow. Hence the flow into equities may be ebbing a bit. If surprise indices peak soon it could provide some short term headwind. Be aware, though, that historically equities have outperformed when the

Key points

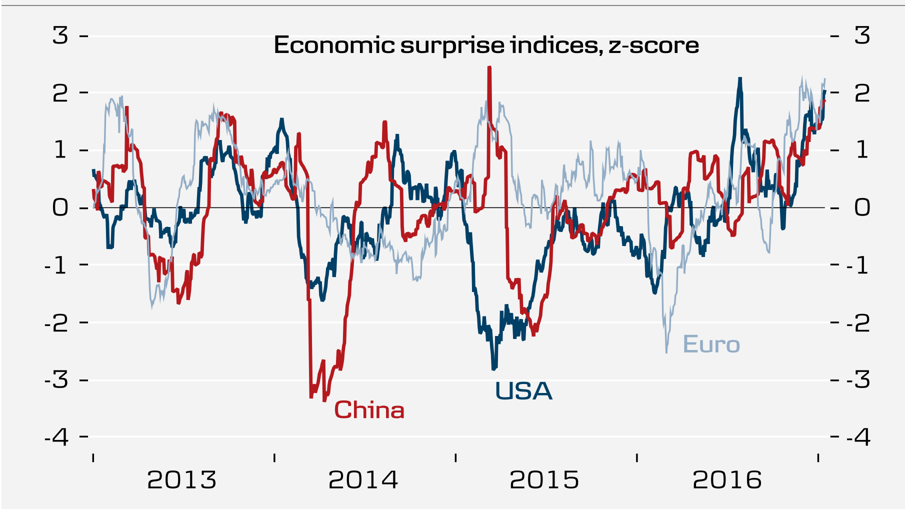
- Very high surprise indices normally do not last for long - a short-term risk for yields
- A strong clash between Trump and China is a rising risk
- EUR/USD moves in tandem with US-German rate differential
- Oil rally is over for now
- Euro growth finished 2016 on a strong note

US change in yields and surprise index has some correlation



Source: Danske Bank Markets

High level for surprise indices rarely lasts for a long time

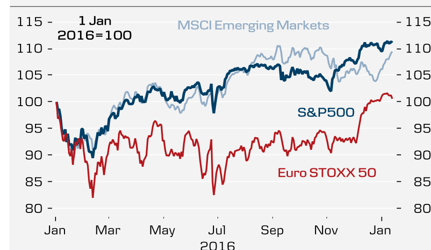


Source: Macrobond Financial

Chief Analyst
Allan von Mehren
+45 45 12 80 55
alvo@danskebank.dk

business cycle is in expansion territory. Hence **our medium-term view is still positive on the stock market**. Donald Trump is also seen as a positive factor for stocks in the longer term as he begins to execute on his plans of reducing taxes and rebuilding US infrastructure.

Stock markets have stalled a bit lately



Source: Danske Bank Markets

China-US relations heading for collision - a rising risk factor

However, how positive Trump will be for the stock market also depends on how his policies against China will evolve. We are increasingly concerned that the US and China are heading for a collision in 2017. It could involve trade war, and the risk of a military confrontation in the Taiwan Strait or the South China Sea has increased. The people Trump has selected in his team of advisors and in his government are all very critical of China and have painted a picture of a big military threat from China (just take a look at Peter Navarro's page *www.deathbychina.com* and watch some of the videos there. Peter Navarro is leading a new Trade Council in the White House). Trump has started out quite confrontationally by receiving a call from the Taiwanese President in November and signalling that the One-China Policy could be used as a bargaining chip in trade negotiations. China sees the US support for the One-China policy (in place for over 40 years) as a red line not to be crossed and use of Taiwan as a negotiating tool will likely backfire for Trump, see also *Flash Comment: A clash between the US and China a rising risk for market*, 12 December 2016.

Long list of potential issues of conflict between US and China

1. Trade
2. Taiwan - One-China policy
3. South China Sea
4. THAAD (see *link*)
5. North Korean threat

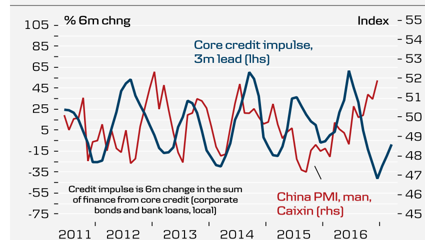
Source: Danske Bank Markets

Two days ago the nominee for Secretary of State Rex Tillorson added another front - The South China Sea - in the clash with China by saying: 'We're going to have to send China a clear signal that, first, the island-building stops and, second, your access to those islands also is not going to be allowed.' The South China Sea is another red line for China as control over the Sea is critical to secure the transportation way for Chinese exports. The bigger the military threat to China, the more important the control of this Sea will become. Hence **by rattling the sabre Trump is making China even more determined to keep control of this area**. China is not likely to bend on either the Taiwan issue or the South China Sea and could well be willing to go to war to prove this.

Add to this an increasing **threat from North Korea** (over which the US is very critical of China) and the South Korean deployment of the US anti-missile system Terminal High Altitude Area Defense (THAAD), which China sees as a threat to its own defence system, see the Reuters article *South Korea considering complaint to China over THAAD retaliation*, 12 January 2017. The mix of tense issues in this region means it reacts best to careful diplomacy – which does not seem to be Trump's preferred way.

It is hard to tell how this will develop and China so far has responded in a muted way to US comments on Taiwan and the South China Sea. However, this is because a) Trump is not yet President and b) so far it is only comments and policies have not changed. But if the US starts to make real changes to policies on these matters, China will no doubt respond strongly, not least in a year of political transition with the 19th National Congress of the Communist Party in the autumn**. If we get an escalation of the tensions involving trade war, or some sort of military confrontation between the US and China, this could give a hit to risk sentiment during 2017.**

Our Chinese credit impulse indicator still points to a slowdown ahead



Source: Danske Bank Markets

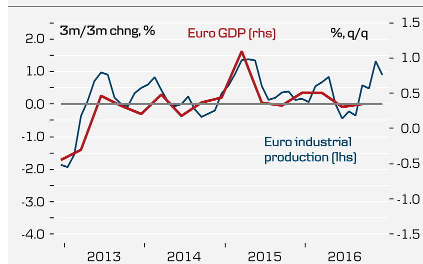
Chinese credit growth in line with our slowdown scenario

On the economic front, China released money and credit data over the past week. **Credit numbers were a bit higher than expected but overall still point to some slowing of growth during 2017** (see chart). Credit saw a big boost at the beginning of 2016 but has come off since then. The latest numbers show a small rise in credit again towards the end of last year, but still in line with softer growth than what was the case at the end of 2016.

Euro production numbers confirm strong finish to 2016

In the euro area this week's data on industrial production (IP) confirmed that 2016 finished on a strong note. Production rose 1.5% m/m which adds to a strong performance in Q4. IP is normally a good indicator for GDP and it points to euro GDP growth in the area of 0.75% q/q corresponding to 3% annualised. This would be the strongest rate since early 2015 when the euro area witnessed a strong recovery and if confirmed it would be a strong starting point for 2017. As Q4 16 provides the base for 2017 it does point to some upside risk to 2017 growth estimates. The euro sentix survey similarly showed a strong increase, mirroring the positive growth picture.

Euro IP points to strong GDP in Q4



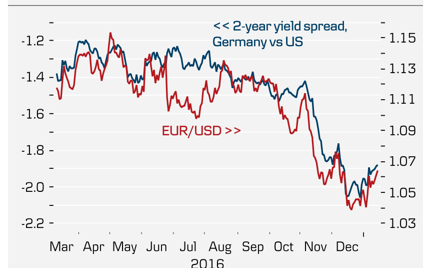
Source: Danske Bank Markets

EUR/USD higher on rate differential

EUR/USD has moved a bit higher in the past week to the highest level in a month. It went hand in hand with a higher yield German-US short end yield spread, as US 2-year yields moved a bit lower while German yields are higher. The rise in short German yields may be due to a correction to the sharp decline after the ECB meeting in December, when the short end of the German yield curve saw big declines in yields when the ECB announced it would buy below the deposit rate of -40bp. We still look for EUR/USD to move lower on a three-month horizon as the market prepares for the next Fed hike and uncertainty over European politics intensifies around the French elections in April/May. But we retain the view that EUR/USD will move higher later in the year on the back of strong current account flows in favour of the euro area and that the euro is fundamentally undervalued.

The decline in the USD has not only been against the EUR but the Greenback has also weakened versus JPY and Asian currencies. USD/CNY has also moved lower lately - partly due to China's intervention in the offshore market that led to sharp increases in CNH money market rates. The sharp increase made it more expensive to short CNH and has likely deterred short sellers of the currency in the short term from putting bearish bets on the Chinese currency.

EUR/USD higher this week...

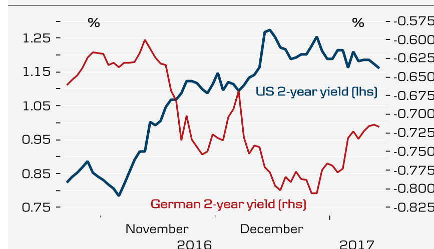


Source: Danske Bank Markets

Oil prices stabilising around USD55 per barrel

Over the past week, we have seen some set-back in oil prices and it seems the market is stabilising around USD55 per barrel. The decline this week has happened on the back of: 1) doubts over output cuts from OPEC as well as non-OPEC countries and 2) a rise in US oil production and rig count, suggesting that the higher prices will attract more US oil onto the market. Current levels are in line with our forecast and we continue to see a small increase in oil prices towards USD60 by the end of the year, as the market is well supported by strengthening demand due to the global recovery this year.

...US yields lower, German higher in '17



Source: Danske Bank Markets

Global market views

Asset class	Main factors
Equities	
Overweight stocks short and medium term Underweight DM, overweight EM Overweight US, Japan, Nordics and Russia/Eastern Europe; underweight Europe and LatAm; neutral on China	Ahead of the inauguration of Donald J. Trump as the next US president equities are likely to fare well. The inauguration could very well be an inflection point leading to a period with more flat trading in equities as markets wait for policy signals. US fixed income markets seem to indicate that most of the reflation trade is priced in. However, we do not think this is the case with equities, so an expansionary fiscal policy signal could be the starting signal for a second leg in the reflation trade.
Bond market	
Higher yields, further steepening 2Y10Y curve	More expansive fiscal policy in the US and the Fed outlook add to steepening trend in Europe. Higher inflation prints, tapering fears later in 2017 and a global recovery also point to a steeper curve. However, the ECB QE mitigates some of the effects.
US-euro spread: slightly wider in 2017	The US FI market is now more or less priced according to our view for 2017 and after the recent spike in US yields the upside potential for the next three months should be limited. As we move further into 2017 we could in fact see a tightening of the USD-EUR spread in the 10Y segment as the strong USD caps the upside for longer US yields and as an end to ECB QE is coming closer.
Peripheral spreads: tightening	Economic recovery and QE mean further tightening but politics, tapering and a new move higher in eurozone yields remain clear risk factors.
Credit spreads: neutral	
FX	
EUR/USD – lower over coming months on momentum, relative rates	USD set to remain supported by Trump and the Fed in the near term. EUR/USD to head higher beyond 3M.
EUR/GBP – risk skewed on the upside in run-up to when the UK is likely to trigger Article 50	Longer term, we expect EUR/GBP to settle in the 0.83-0.88 range. Risk skewed on the upside over the short to medium term due to Brexit.
USD/JPY – short-term risks skewed to upside on higher US rates	USD/JPY set to remain supported near term by relative monetary policy and risk appetite.
EUR/SEK – range near term after recent decline, gradually lower medium term	Gradually lower on relative fundamentals and valuation in 2017.
EUR/NOK – gradually lower	Cross set to move lower on valuation and growth, real rate differentials normalising.
Commodities	
Oil price – OPEC, non-OPEC rally over; negative impact from hawkish Fed	Support from positive growth and inflation sentiment; near-term focus implementation of OPEC deal, US crude stocks.
Metal prices – focus turns to Trump's plans on infrastructure and defence spending	Underlying support from consolidation in mining industry, recovery in global manufacturing and US fiscal spending.
Gold price – hawkish Fed weighing on gold price	Rising yields and USD pushing gold price down.
Agriculturals – abundant supply keeping a lid on prices	Attention has turned to *La Niña* weather risks over the winter, consolidation seen in some part of the market

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 author of the research report is Allan von Mehren, Chief Analyst.

Analyst certification

Each research analyst responsible for the content of this research report certifies that the views expressed in the research report accurately reflect the research analyst's personal view about the financial instruments and issuers covered by the research report. Each responsible research analyst further certifies that no part of the compensation of the research analyst was, is or will be, directly or indirectly, related to the specific recommendations expressed in the research report.

Regulation

Danske Bank is authorised and subject to regulation by the Danish Financial Supervisory Authority and is subject to the rules and regulation of the relevant regulators in all other jurisdictions where it conducts business. Danske Bank is subject to limited regulation by the Financial Conduct Authority and the Prudential Regulation Authority (UK). Details on the extent of the regulation by the Financial Conduct Authority and the Prudential Regulation Authority are available from Danske Bank on request.

The research reports of Danske Bank are prepared in accordance with the recommendations of the Danish Securities Dealers Association.

Conflicts of interest

Danske Bank has established procedures to prevent conflicts of interest and to ensure the provision of high-quality research based on research objectivity and independence. These procedures are documented in Danske Bank's research policies. Employees within Danske Bank's Research Departments have been instructed that any request that might impair the objectivity and independence of research shall be referred to Research Management and the Compliance Department. Danske Bank's Research Departments are organised independently from and do not report to other business areas within Danske Bank.

Research analysts are remunerated in part based on the overall profitability of Danske Bank, which includes investment banking revenues, but do not receive bonuses or other remuneration linked to specific corporate finance or debt capital transactions.

Financial models and/or methodology used in this research report

Calculations and presentations in this research report are based on standard econometric tools and methodology as well as publicly available statistics for each individual security, issuer and/or country. Documentation can be obtained from the authors on request.

Risk warning

Major risks connected with recommendations or opinions in this research report, including a sensitivity analysis of relevant assumptions, are stated throughout the text.

Expected updates

None.

Date of first publication

See the front page of this research report for the date of first publication.

General disclaimer

This research has been prepared by Danske Bank Markets (a division of Danske Bank A/S). It is provided for informational purposes only. It does not constitute or form part of, and shall under no circumstances be considered as, an offer to sell or a solicitation of an offer to purchase or sell any relevant financial instruments (i.e. financial instruments mentioned herein or other financial instruments of any issuer mentioned herein and/or options, warrants, rights or other interests with respect to any such financial instruments) ('Relevant Financial Instruments').

The research report has been prepared independently and solely on the basis of publicly available information that Danske Bank considers to be reliable. While reasonable care has been taken to ensure that its contents are not untrue or misleading, no representation is made as to its accuracy or completeness and Danske Bank, its affiliates and subsidiaries accept no liability whatsoever for any direct or consequential loss, including without limitation any loss of profits, arising from reliance on this research report.

The opinions expressed herein are the opinions of the research analysts responsible for the research report and reflect their judgement as of the date hereof. These opinions are subject to change, and Danske Bank does not undertake to notify any recipient of this research report of any such change nor of any other changes related to the information provided in this research report.

This research report is not intended for, and may not be redistributed to, retail customers in the United Kingdom or the United States.

This research report is protected by copyright and is intended solely for the designated addressee. It may not be reproduced or distributed, in whole or in part, by any recipient for any purpose without Danske Bank's prior written consent.

Disclaimer related to distribution in the United States

This research report was created by Danske Bank A/S and is distributed in the United States by Danske Markets Inc., a U.S. registered broker-dealer and subsidiary of Danske Bank A/S, pursuant to SEC Rule 15a-6 and related interpretations issued by the U.S. Securities and Exchange Commission. The research report is intended for distribution in the United States solely to 'U.S. institutional investors' as defined in SEC Rule 15a-6. Danske Markets Inc. accepts responsibility for this research report in connection with distribution in the United States solely to 'U.S. institutional investors'.

Danske Bank is not subject to U.S. rules with regard to the preparation of research reports and the independence of research analysts. In addition, the research analysts of Danske Bank who have prepared this research report are not registered or qualified as research analysts with the NYSE or FINRA but satisfy the applicable requirements of a non-U.S. jurisdiction.

Any U.S. investor recipient of this research report who wishes to purchase or sell any Relevant Financial Instrument may do so only by contacting Danske Markets Inc. directly and should be aware that investing in non-U.S. financial instruments may entail certain risks. Financial instruments of non-U.S. issuers may not be registered with the U.S. Securities and Exchange Commission and may not be subject to the reporting and auditing standards of the U.S. Securities and Exchange Commission.