6 January 2017

Strategy

2017 starts off where 2016 ended

Global recovery gathers pace after the New Year...

One of the noteworthy features towards the end of 2016 was the improving momentum in the world economy. The first economic releases in 2017 lend further support to a strengthening global industrial production cycle. The manufacturing PMI released this week in China, Italy, Spain, Germany, Greece and the US all surprised to the upside. The global PMI manufacturing index is now at its highest level since 2014.

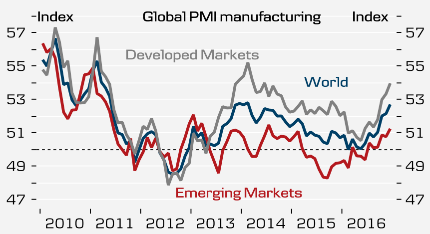
...and so does the global reflation trend

One of the other central market themes was increasing signs of global reflation. This trend was further strengthened this week with the release of inflation numbers in the eurozone showing that inflation rose to 1.1% y/y in December from 0.7% y/y in November. This is the highest growth rate since July 2013. The rise in inflation was mainly driven by energy and food price inflation, while core inflation remains rather muted at 0.9%. The slack in the labour markets, particularly in the periphery countries, should keep wage growth subdued during this year. In the US, the ISM prices paid component surged to 65.6 from 54.5, reaching the highest level since 2011.

Fixed income – despite higher inflation, too early for tapering in Europe

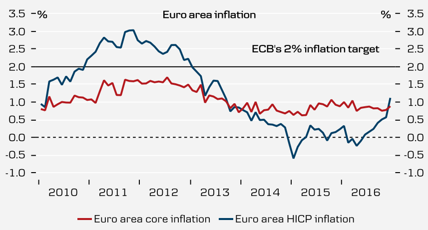
The global reflation now also seen in Europe has sparked a debate about whether the ECB will soon start to consider tapering its QE programme. In our view, this is premature given the weak underlying inflation pressures, notably with significant labour-market slack in periphery countries (see *Five Reasons the ECB Will Not Announce QE Tapering in 2017*, 4 January 2017). Notably we think that the ECB is too optimistic about wage growth, and hence the sustained pick-up in inflation. Nevertheless, we expect a steepening of the curve in the euro area. However, the ECB QE may mitigate some of this effect.

Chart 1: Strong synchronised recovery across regions...



Source: Macrobond Financial

Chart 2: ...and headline inflation increasing in Europe, although core remains modest.



Source: Macrobond Financial

Key points

- Global recovery and reflation gain momentum with strong PMI numbers and euro inflation prints this week.
- However, US yields have peaked for now, while the European curve will steepen.
- Turbulence in Chinese FX market spilling over into major FX markets.
- Equity market rally to take a breather for now, but we recommend buying on the dips.
- Near-term risk factors to watch out for are stretched surprise index, further China turbulence and Trump inauguration on 20 January.

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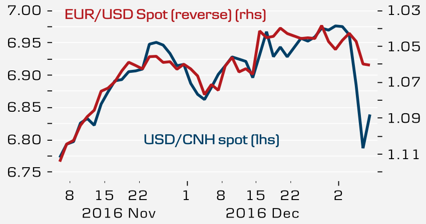
On the US side, it is clear from the Fed minutes released this week that the FOMC is facing tremendous uncertainty with regard to the economic outlook, notably relating to the size of possible fiscal easing by the Trump administration. We continue to expect two hikes this year (in June and December) with a risk of third hike, but for now we see US yields as having peaked, although they may gain new upward momentum later this year.

FX markets – turbulence in Chinese FX markets spilling over into major markets

One of the most noteworthy trends in the early days of 2017 has been the volatility in the CNH/CNY markets. Similar to last year, the main driver appears to be concerns about rising outflows and fears of an acceleration in January following the resetting on 1 January of the USD50,000 quota that all Chinese citizens can buy every year. The Chinese authorities have in our view pre-emptively been tightening liquidity conditions in the CNH market to put a stop to the depreciation of the CNY versus the USD as well as introducing more administrative curbs on buying FX by Chinese citizens. Given that many hedge funds and other investors entered 2017 with significant short positions, the sharp rise in the CNH seen over the past two days probably relates to a squeeze of these short positions. Despite the strengthening of the CNH/CNY against the USD in recent days we still see a weakening of the CNY throughout 2017 due to the combination of weakening growth and concerns about high debt levels. The squeeze of short CNH positions is also one of the reasons for the upward move in the EUR/USD in our view, together with Fed worries about the strength of the USD in the minutes from the meeting in December. We still see the USD gaining strength vs. the EUR in the next months followed by an upward move in EUR/USD later this year.

Chart 3: Recent USD movement driven by Chinese FX turbulence

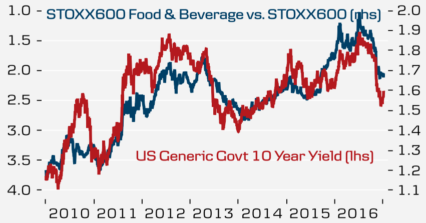


Source: Bloomberg

Equities – rally taking a breather, but buy on dips

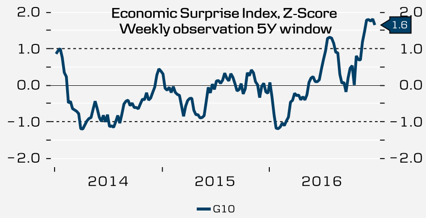
The clear winner from the stronger outlook for global economic growth and inflation has been equity markets. However, after the recent rally, we think that the market may take a breather waiting for clearer signals about Trump's policy intentions, notably on the fiscal front. Indeed we have over the past week seen defensive stocks outperform the general index as the US yields have fallen back. We may see further moderation or even a fall in equity markets surrounding the inauguration of Mr Trump as president. However, in our view this would be a buying opportunity as we expect markets to rebound when the Trump administration presents its concrete fiscal plans over the next month. Where do we see most value? In our view the US offers quite attractive valuations as stock prices do not fully reflect the possible EPS growth. We also like Japan and Russia/Eastern Europe. In contrast we are cautious on Europe as equity prices already factor in potential EPS growth, in our view.

Chart 4: Defensive stocks starting to outperform the general index in the US



Source: Bloomberg, Danske Bank Markets

Chart 5: G10 surprise index at 'stretched' levels



Source: Bloomberg, Danske Bank Markets

What are the near-term risk factors to look out for?

What may derail the positive momentum in the global economy and positive risk sentiment in 2017? So far the markets have shrugged off a more hawkish Fed, (a brief period of) political uncertainty in Italy and simmering tensions between China and the US.

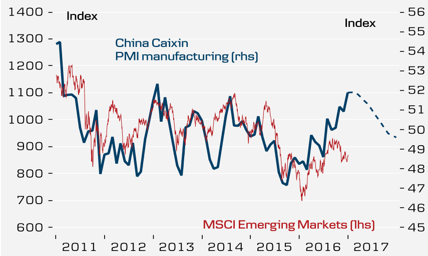
However, there are a few important factors to watch out for in our view in the near term.

Stretched surprise index. With the improvement in the global business cycle, economic releases have surprised positively. As a result the surprise index has been elevated recently. This is typically followed by a fall-back in the index either as market expectations are raised or economic momentum stalls. A string of 'disappointing' economic releases that fall short of market expectations may well weigh on market sentiment.

China. The FX markets in China has already seen a turbulent start to the year as mentioned above, but the broader market impact of this turbulence has so far been limited. However, we see the risk of a moderation in the economic momentum in China in the coming months (see *Why China's growth is strong now - and why it will slow in 2017*, 5 January 2017). In our view this will lead markets to focus more on the structural vulnerabilities of the Chinese economy, which may have negative repercussions for global financial markets, notably emerging markets.

Market volatility surrounding Trump's inauguration. Almost two months after Donald Trump's victory in US presidential elections, there still remains notable uncertainty about the exact domestic and foreign policy agenda of the new Trump administration. One thing that is clear already is that he is not afraid to shake things up. This has been particularly clear with respect to China over Taiwan. We are concerned that relations will sour further between the two countries once Trump is inaugurated, as China is likely to toughen its stance if the newly appointed US president continues to push for closer Taiwan relations. A scaling up of the US-China conflict would be negative for markets. Another risk is a tough protectionist stance from Trump administration.

Chart 6: Moderation of Chinese growth likely in next few months



Source: Macrobond Financial, Danske Bank Markets

Table 1: Global market views

Asset class	Main factors
Equities	
Overweight stocks short and medium term Overweight DM, underweight EM Overweight US, Japan and Russia/Eastern Europe; underweight Europe, Nordics, China and LatAm	Ahead of the inauguration of Donald Trump as 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 do 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 would probably be the starting gun 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 may mitigate 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 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 and JPY weakness	USD/JPY set to remain supported near term by relative monetary policy and risk appetite.
EUR/SEK – gradually lower but risk of near-term squeeze higher	Gradually lower on relative fundamentals and valuation in 2017. Given the last month's move we see risk of short-term spike higher.
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.
Metal prices – near-term downside risk from tigther monetary conditions in US and China	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 – strong output keeping a lid over prices	Attention has turned to *La Niña* weather risks over the winter, large stocks limit upside risk to prices.

Source: Danske Bank Markets

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