16 June 2017

Strategy

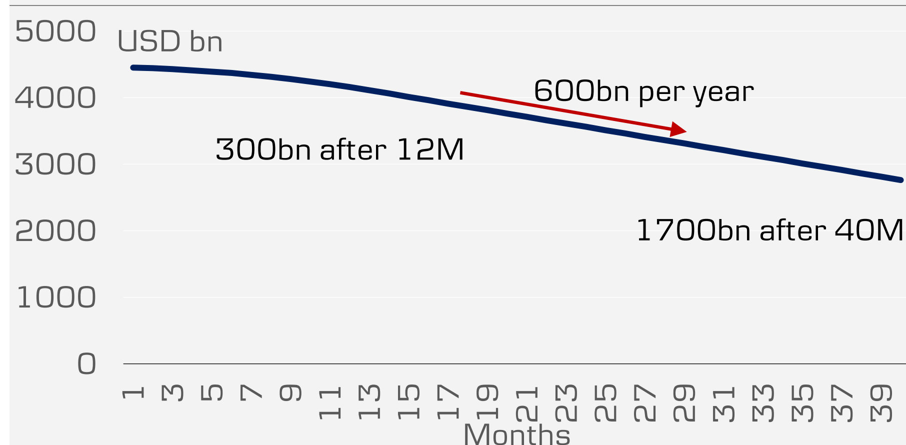
Fed heading for the exit door

The most anticipated event this week was clearly the FOMC meeting announcement on Wednesday night. A key question was to what extent a so-called data-dependent Fed would factor in a string of weak data, notably on the inflation side and change the stance of its monetary policy. Markets had remained remarkably convinced that a hike was in the making but we were less sure and stood by our call that the data-dependent Fed would keep rates unchanged and instead announce details about their plan for reducing the balance sheet, also called quantitative tightening.

In the end, the Fed both hiked its policy rate by 25 basis points AND laid out its plans for the reduction of its balance sheet. At the same time, the Fed continued to signal another hike this year and three hikes next year. How did Fed governor Yellen sell this rather hawkish twist to monetary policy and what will the market implications be in the near and longer term?

The FED meeting on Wednesday clearly signalled a shift in the Fed's focus. It downplayed the drop in core inflation as temporary (although Yellen did say that they are monitoring inflation developments 'closely') while attaching greater importance to the fall in unemployment rates, which they expect will reignite wage growth and help push up inflation to the central bank's two percent target. With the US economy expected to grow close to 2% over the next two years, we should see further falls in the unemployment rate.

Fed outlines details on its balance sheet reduction



Note: A Danske Bank scenario
Source: Danske Bank

Key points

- The Fed strikes a hawkish tone, hiking rates and setting out its balance sheet reduction...
- ...rating the tightening labour markets as more important than recent weak inflation prints.
- Further flattening of the US yield curve likely.
- We maintain our equity call of 'sell-on-rallies' near-term...
- ...as well as our tactical bearish EUR/USD trade recommendation.
- We see rising risk from China to the global outlook.

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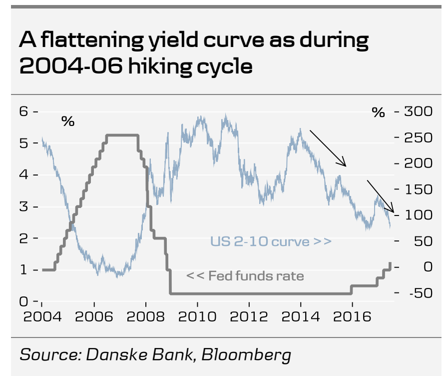
But we have doubts how fast this will translate into a higher wage growth and thereby inflation. At the press conference, Yellen did acknowledge that the US Phillips curve is rather flat (meaning that the low unemployment rate is not yet translating into higher nominal wage growth) and that the estimate of the unemployment rate below which wages start to rise faster is uncertain. Following the meeting, we are still expecting a hike in December but have become less certain while now only expecting 1-2 hikes next year (down from 3).

Fixed income: long-term yields kept in check

While the more hawkish Fed has certainly put upward pressure on the shorter end of the yield curve, the case for higher longer term yields is more uncertain at least near term. So far the longer-term US yields have declined following the Wednesday meeting. While the balance sheet reduction will soon be started by the Fed, it will still be re-investing sizeable amounts. Furthermore, the relatively weak inflation pressures and expectations also limit the pressure on long-term yields. Furthermore, both Bank of Japan (this morning) and the ECB (last week) signalled no rush to exit their quantitative easing programmes, which will also help keep a lid on global long-term rates. Hence we continue to see the longer-term yields being held in check for most part of 2017.

A flattening yield curve as during 2004-06 hiking cycle



Source: Danske Bank, Bloomberg

Equities: sell on rallies near-term

The Fed decisions on Wednesday are not fundamentally changing our view. We still see equities going through a mild downward adjustment following sizeable gains in the spring and stretched valuations. However, if we get a third hike this year as signalled in the dots (our take would be in December), then this could change and we would find ourselves in a situation similar to 2004-05, where US-T sold off, while equities fared fairly well.

FX – further downside to EUR/USD near-term, higher later in 2017

The hawkish twist to the Fed's decision on Wednesday is clearly aiding the USD. This has lent support to our tactically bearish EUR/USD trading recommendation. We continue to see further downside for the cross near-term with the ECB being side-lined in coming months by a sustained deterioration in the inflation outlook and a Fed determined to move on with policy normalisation. Furthermore, the mixture of a BOJ continuing its extraordinary easing programme and the Fed moving towards the exit should also support the USD/JPY, where we see the cross moving to 112 in 1-3M and 116 in 6-12M.

Rising risk of a slowdown in China

It was noteworthy that the Fed removed the monitoring of 'global economic and financial developments' from its statement on Wednesday, indicating that it is less concerned about the negative impact of global developments on the US economy. This may in our view be a bit premature as we see rising risks of an economic slowdown in China after the withdrawal of stimulus measures and the crackdown on the shadow banking sector. This week we saw a further slowdown in credit supply, falling to the lowest level since October last year, mostly on account of a sharp contraction in shadow banking finance. Adding in a more hawkish Fed, the pressure on Chinese economies markets may grow in the coming months, which risks having repercussions for the global economy.

Policy tightening to dampen growth in China

Source: Danske Bank, Bloomberg

Global market views

Asset class	Main factors
Equities	
Our short-term trading opportunity stance (0-1month): Sell on rallies Our strategy stance (3-6M): Neutral on equities vs cash	We think we are in an interim period between two reflation periods and in this period markets will trade in a range. On 3-6M , we are neutral on equities. The cycle is turning lower but we are not heading for a recession. As we await the second reflation wave, we are stuck in the interim period where we will be in a trading range, but not a crash. In this environment, defensives will outperform cyclicals.
Bond market	
German/Scandi yields – set to stay in recent range for now, higher on 12M horizon	The ECB did not rock the boat atn the June meeting and has created a "low volatility and carry friendly environment" . Still low core inflation, muted wage growth and and an apparent peak in the global manufacturing cycle are set to keep yields low in 2017. QE is set to be supportive for the rest of 2017 at least - too early to price 'tapering'.
EU curve – 2Y10Y set to steepen when long yields rise again	The ECB still keeps a tight leash on the short end of the curve and with 10Y yields stable, the curve should change little on a 3-6M horizon. Risk is skewed towards a steeper curve earlier than we forecast.
US-euro spread – stable	The Federal Reserve raised rates by 25bp as expected by the market, and announced the initial steeps for a QT programme, where the balance sheet is reduced at a very gradual pace. The signals from the Federal Reserve regarding QT is very clear that they aim to limit the market impact. If they begin in the start of 2018, there will still be a significant reinvestment need into US Treasuries and US MBS. Hence, the impact on the Treasury market is expected to be benign in the coming months.
Peripheral spreads – tightening but still some factors to watch	Economic recovery, ECB stimuli, better fundamentals, particularly in Portugal and Spain, the French elections will lead to further tightening despite the recent strong move.. The EU commision and the Italian Finance minister has reached an agreement in princple on MPS, and thus a model for banking recapitalisation plans in Italy has been presented. Futhermore. the risk of early Italian election has also diminished. Hence, we are entering a summer with stable to tighter spreads between the core and periphery.
FX	
EUR/USD – summer slide likely, but set to test new highs in H2	While Fed-ECB policies should halt further upside near term and drive move below 1.10 over the summer, but cross is set to test new year highs in H2.
EUR/GBP – range-bound for extended period	GBP to be haunted by added uncertainty post election and risk of further weakness near term; sterling caught in undervalued territory during Brexit negotiations.
USD/JPY – gradually higher longer term	A BoJ not ready for exit to cap JPY upside. Challenged by cyclicals but continued Fed tightening set to support USD into the summer.
EUR/SEK – range near term, then gradually lower	Gradually lower on fundamentals and valuation this year but near-term SEK potential limited by the Riksbank.
EUR/NOK – range near term, then gradually lower	Cross set to move lower on valuation, growth and real-rate differentials normalising but NOK vulnerable to global risk appetite.
Commodities	
Oil price – range-bound, downside risk	Downside pressure from bearish fundamentals and stronger USD. Approaching a natural floor where US producers forced to scale back on future production increases
Metal prices – range-bound, downside risk	Underlying support from consolidation in mining industry, industrial cycle nearing a peak. Downside risk from slowdown in global growth
Gold price – range-bound	Tug of war between geopolitical uncertainty and stronger USD
Agriculturals – rising again	Shrugging off negative impact from lower oil prices and higher USD

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 Jakob Ekholdt Christensen, Chief Analyst, Head of International Macro and Emerging Market Research.

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