23 May 2013

Flash Comment

Chinese weakness and monetary policy uncertainty triggers sell-off. The end of the risk rally? Probably not

- This morning, risky assets have been selling off – most notably the Japanese stock market is down more than 7%. The sell-off has continued in European trading with European stocks trading sharply lower, the yen and Swiss franc stronger and emerging markets generally under selling pressure.

Five overall reasons for the sell-off in risky assets today:

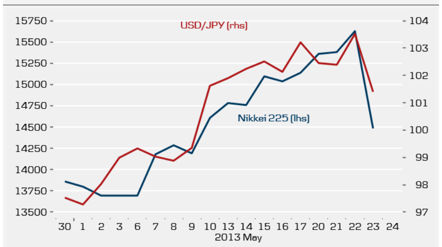
- The first one is the obvious one: that we were simply in for a market correction – profit taking after more than six months of a rally in risky assets. Several stock markets (US, Japan, Germany) are technically in very overbought territory. This normally triggers a correction sooner or later.
- Second and a lot more important – Federal Reserve chairman Ben Bernanke's testimony yesterday to the Joint Economic Committee of Congress has led some market participants to think that the Fed will scale back monetary easing more rapidly as the US economy continues to improve.
- Third, fears of the Fed 'scaling back' are also likely to be leading to – premature, in our view – speculation that the Bank of Japan might be close to starting to scale back its unprecedented monetary easing. The fears might have gained 'support' from some unfortunate comments from Japanese government officials in particular about the development in the Japanese FX and fixed income markets. Hence, if the markets start to fear that the BoJ has shaky hands, it is certainly a very good reason for taking profit on 'the Japan trade'.
- Fourth and probably the initial 'trigger' of the day's sell-off is increased concern about a continued and fairly sharp slowdown in Chinese growth.
- Last, economic data has surprised on the downside for some time now without the market reacting. Given the technically overbought markets and initial talk of a Fed exit, the markets may be catching up a bit with recent months' weak data.

Of these five factors, we believe that the Chinese growth concern is fundamentally the most important as we don't think that the BoJ is anywhere near to scaling back on monetary easing. The Nikkei sell-off might even push the BoJ in the direction of *more* monetary easing and even though the Fed is moving closer towards scaling back, we also think that it would be extremely cautious not to exit the present policies in an abrupt way.

What we would like to see to keep the risk rally going

Fundamentally, we think that the BoJ is far from scaling back monetary easing and we are not in for a sharp change in US monetary conditions. However, the markets are nervous about these issues. Therefore, to keep the risk rally on track we would probably need comforting comments from both central banks on the future of monetary easing.

Nikkei sell-off



Source: Reuters EcoWin

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Hence, we would probably not put on more risk at the moment but we are nonetheless still fairly confident that the Fed and the BoJ are not about to undergo a significant change of course. As a consequence, we expect both central banks – and particularly the BoJ – to come out in the coming days (if the sell-off continues) to reaffirm a commitment to the anti-deflationary monetary policies in place in both countries.

Furthermore, the accumulated 'evidence' is that the fragile recovery has lost momentum. However, China is where there is most uncertainty about the policy response. The People's Bank of China (PBoC) is one of the central banks that has been the most concerned about the negative impact of extremely accommodative monetary policy as highlighted by the recent rapid appreciation of CNY. Policy focus in China is for longer term structural economic reforms and managing medium financial risk. For that reason, there probably will be a greater tolerance of slower growth in China. So far, the Chinese authorities have seemed confident that the slowdown is not the beginning of a prolonged recessionary phase for the Chinese economy, but rather a necessary and desirable adjustment to growth more in line with Chinese fundamentals. Additional monetary and fiscal stimulus in China will require that the manufacturing PMIs move substantially below 50 in coming months and signs that GDP growth could drop below the critical 7.5% target for the Chinese government.

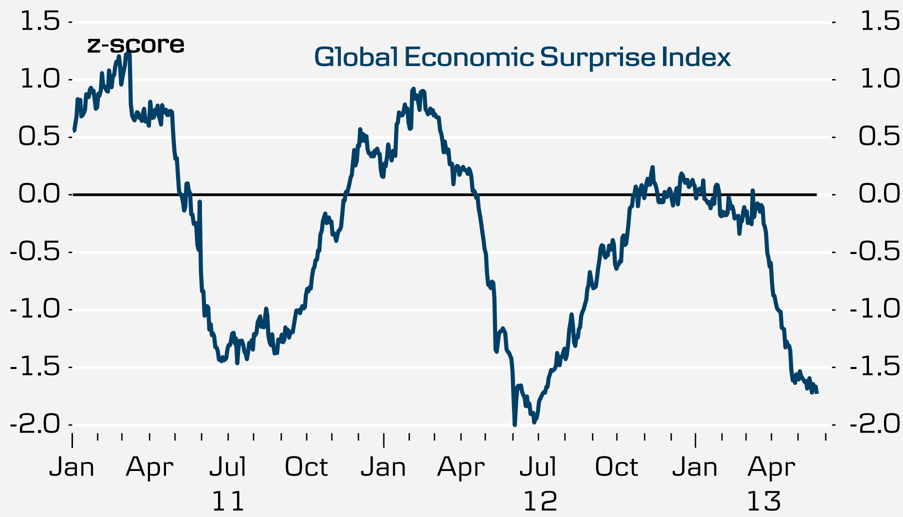
Overall, we are still confident that the global economy is recovering, but it is a soft and patchy recovery that from time to time will also lead to bumps in the markets. However, we feel very confident that the US economy is seeing significant structural improvement which will provide a strong tailwind to growth in coming years: The housing adjustment is over and recovering, fiscal policy tightening is almost coming to an end this year and banks are easing credit standards continuously. We are also not afraid that the Fed will risk tightening prematurely – as was also the key message from Fed chairman Ben Bernanke yesterday. The euro area is also recovering, albeit slowly, as also witnessed by today's Flash PMI and rising German orders.

If the correction turns into a slump – then start worrying about Europe

Overall, we feel fairly confident that the risk rally is still alive and kicking, but we would need reassuring comments from particularly the Fed and the BoJ to recommend stepping up risk taking at the present stage in time.

If, contrary to our expectations, we do not get this, the sell-off in risky assets certainly could escalate and we would especially be worried about what the impact would be on the European markets –particularly the peripheral European markets.

Reality check in markets? Economic surprises have been very negative lately. But we expect it to turn around soon



Source: Danske Bank Markets, Bloomberg

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