11 May 2017

Strategy

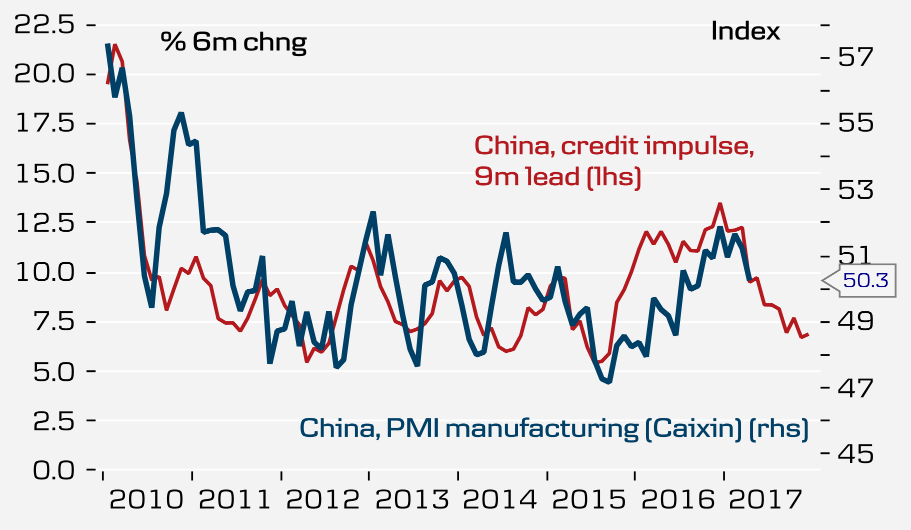
Downside risks to China – and what it means for markets

Since January, we have highlighted that a China slowdown was brewing in 2017 (see *Why China's Growth is Strong Now – and Why it Will Slow in 2017*, 5 January). **We are now seeing increasing evidence of this taking place**: PMI decreased sharply in April, commodity prices for oil and metals have lost momentum and the Chinese stock market has fallen over the past month to the lowest level in four months (see also *China Leading Indicators: The slowdown is a reality*, 2 May).

As we have argued for some time, Chinese tightening measures to reign in soaring house prices are set to slow growth in 2017. A 'normalisation' of infrastructure investments after the big boost in 2016 is also set to drive lower activity this year.

While we have been looking for the slowdown to be moderate, an increase in financial stress lately poses a clear downside risk to China's growth this year (see *Research China: Financial stress on the rise again*, 4 May). In *China Daily* on 5 May, an *editorial* started out '*China is in the midst of what proponents are heralding as its harshest crackdown on financial risks in history: a campaign that is by no means a fleeting gesture'*. *China Daily* is state media and tends to represent the views of the leadership. While tackling financial risks in China is important, there is a clear danger that this is taking place when China was already set to slow down and that it is exacerbating the downturn. **It comes on top of the risk of protective trade measures from US President Donald Trump in H2, once his trade investigation and steel probe are finished around mid-year.** This could hurt Chinese exports.

China's credit tightening set to slow the economy in 2017



Source: Macrobond Financial, Bloomberg, Danske Bank

Key points

- Chinese growth is slowing down – and the downside risks from financial stress are rising.
- This points to a weaker global cycle, less tailwind to risk assets and downward pressure on bond yields.
- We do not believe the euro area PMI can continue to decouple from US and China PMI.

Rising stress in China – sharp rise in yields set to hurt indebted companies

Source: Macrobond Financial, Danske Bank

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Boost to global reflation reverses – rising risk for global markets

So, how should a weaker Chinese economy affect the global economy and markets?

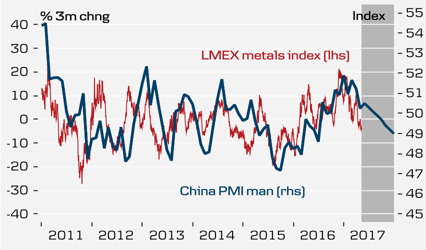
1. **Lift to global growth reverses:** China is by far the biggest contributor to the global economy, driving one-third of global growth. The country was a major driver behind the global recovery in 2016. Commodity exporting emerging markets benefited strongly from both higher volumes and prices and developed markets saw a lift to exports to China and other emerging markets countries. With China slowing in 2017, the lift to the global economy reverses and this is a big reason why we look for a peak in the PMI cycle in H1.

2. **From reflationary to disinflationary force:** The sharp rise in commodity prices seen in 2016 was pulled largely by higher Chinese activity. With Chinese companies consuming 50% of global metals, China is a major driver of commodity prices. In the past few months, both metal prices and oil prices have declined, which in our view is linked partly to the softer Chinese economy. With the commodity price boost turning into a drag on global inflation, we believe global central banks will lose an important pillar in their mission to push inflation higher on a sustained basis; not least in the euro area, where slack is still ample and wage pressures low (see *Research: Euro area wage growth should stay subdued, not supporting core inflation significantly*, 5 May).

3. **Less support to risk sentiment:** A softer global cycle and rising downside risks from China have already had an impact on Chinese stocks, commodity prices and inflation markets, where euro area 5Y5Y breakeven inflation is back at 1.6% – the level reached when the ECB initiated its asset purchase programme in January 2015. So far, though, risk sentiment in the US, Europe and emerging markets has stayed upbeat on the back of strong profit growth and relief that political uncertainty is reduced following the election of Emmanuel Macron as the new French President. We recently turned neutral on equities on a short- to medium-term horizon.

4. **Downside pressure on long bond yields:** While Fed hikes and a possible change of forward guidance from the ECB are putting upward pressure on bond yields, the disinflationary force from China will put a downward pressure on yields. We believe these two forces will even each other out and expect range-trading markets for some time. Hence, we recommend investors take a tactical approach to acting in the bond market, trading the range rather than having a clear directional bias.

Weaker metal prices point to further China slowdown

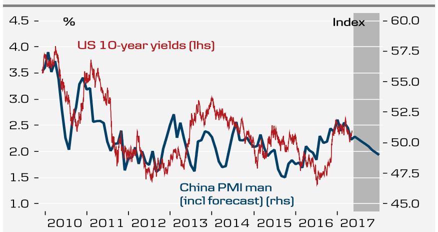


Source: Macrobond Financial, Danske Bank

Still no spillover in equity markets from China – yet

Source: Macrobond Financial, Danske Bank

Weaker China cycle puts downward pressure on yields, all else being equal

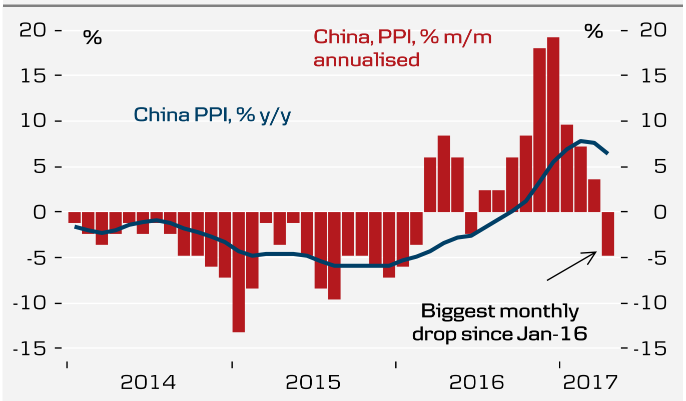


Source: Macrobond Financial, Danske Bank

Chinese economy set to weigh on global cycle this year

Source: Macrobond Financial, Danske Bank

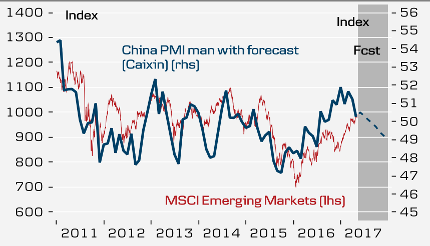
Chinese reflation boost reverses – PPI declined in April



Source: Macrobond Financial, Danske Bank

5. **Headwind for emerging markets assets:** So far, there has been very little impact on emerging markets outside of China. Emerging market equities have continued higher despite lower commodity prices and rising stress in China. However, if we are right that the China slowdown will continue this year, emerging market assets will start to face some headwind from this angle. Emerging markets are still a popular carry game among investors, though. Therefore, we stick to our overweight on emerging markets versus developed markets for now, as the carry from higher yields and lower valuation in stocks is attractive and drives flows into emerging markets. However, any sign of spillover from China to other emerging markets should be on the radar screen.

A China slowdown will give headwind to emerging market stocks



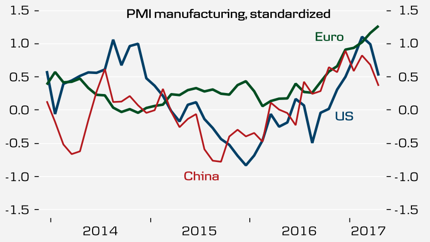
Source: Macrobond Financial, Danske Bank

Can the euro area decouple? We don't think so

So far, we have yet to see the same signs of a peak in euro business cycle indicators that we are witnessing in the US and China. Euro PMI has continued to move higher and points to robust growth. The economic surprise index in the euro area is also still high. This stands in sharp contrast to the steep fall that has taken place in the US. This raises the question whether the euro area PMI can continue to decouple.

We doubt this is the case. **Part of the impetus for euro area manufacturing is currently coming from the export sector. This factor is likely to fade, with China slowing down**. Euro area private consumption has also faced headwinds from a decline in real wage growth moving into negative territory (due to the rise in inflation) after a period of a decent increases in purchasing power when inflation was 1.5 percentage points lower than wage growth. **Overall, we look for euro PMI to peak soon and follow the US and China lower.** We do not expect a big setback or the recovery to derail but simply believe that the pace will slow a bit. However, **in combination with a weaker global backdrop, this means the current very positive picture of the euro area will be less upbeat when we get to the end of the year**. With inflation set to decline to around 1.0-1.5% in early 2018, we still believe the ECB will extend asset purchases into the new year but reduce our estimate of the pace to EUR40bn per month.

Can the euro area continue to decouple from the US and China?



Source: Macrobond Financial, Danske Bank

Global market views

Asset class	Main factors
Equities Neutral positioning on stocks short and medium term DM (UW), EM (OW) DM: US (UW), Euro Area (OW), Japan (N). EM: China/Asia (OW), LatAm (N), Russia/Eastern Europe (OW)	The reflation trade, which has been ongoing since August/September 2016, is coming to an end, with equities hovering around all-time highs established in early March but having difficulty breaking out from there. For equities to move substantially higher, yields need to rise, as bond markets have not yet brought the promise of a normalisation of growth and inflation. However, we do not think there is big correction ahead of us, as growth data is still very upbeat. Moving forward, we think equity markets will trade largely in a range.
Bond market	
German/Scandi yields – set to stay in recent range for now, higher on a 12M horizon	German yields are no longer being kept low by 'political uncertainty' but still low core inflation and an apparent peak in the global manufacturing cycle are set to keep yields low in 2017. However, the risk picture has become more two-sided given the risk the ECB will change its rethoric slightly next month.
EU curve – set to steepen 2Y10Y when long yields rise again	The ECB is set to keep a tight leash at the short end of the curve and with 10Y yields stable the curve should change little on a 3M to 6M horizon. Risk is skewed towards a steeper curve earlier than we forecast.
US-euro spread – stable Peripheral spreads – tightening but clear risk factors to watch	Economic recovery, QE and better fundamentals, particularly in Portugal and Spain, point to further tightening but banking recapitalisation plans (Italy) and a fear of a new move higher in core eurozone yields (ECB tapering fears) remain clear risk factors. Periphery spreads often widen when core yields move higher.
FX	
EUR/USD – stuck around 1.10 near term, higher in 6-12M	While Fed-ECB policies should cap upside near term, the cross is set to test new year highs in H2.
EUR/GBP – slightly lower post election, then rangebound for extended period	If May stays in power post June election, GBP could strengthen slightly, then be rangebound (0.8200-0.8650) over Brexit negotiations.
USD/JPY – likely to test 115 near term, gradually higher longer term	Near term supported by Fed rate hike expectations and risk sentiment. Longer term, to edge higher driven by 10Y US rates.
EUR/SEK – range near term, then gradually lower	Gradually lower on relative 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	OPEC cuts almost fully implemented, extension about priced. Downside risk from more hawkish central banks.
Metal prices – range bound, downside risk	Underlying support from consolidation in mining industry, industrial cycle nearing a peak. Downside risk from financial stress in China
Gold price – range bound	Tug of war between higher US rates and geopolitical risks.
Agriculturals – rising again	Recent fall on lower oil only temporary.

Source: Danske Bank Markets

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Expected updates

None.

Date of first publication

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