11 December 2015

Strategy

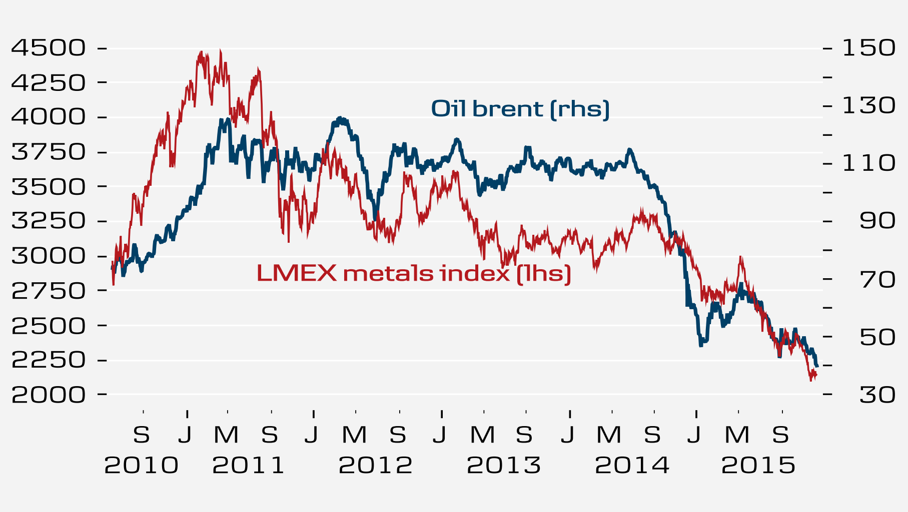
Slipping in oil again?

The main event over the past week has been another slide in oil prices, taking them to levels not seen since the financial crisis in 2008. Once again, oil prices surprised by falling even further below what is deemed sustainable longer term where an equilibrium price is seen as closer to USD60 (see *Oil Update: Forget OPEC – it is all about costs*, 10 December 2015). However, the problem with oversupply short term due to weak demand from China and so far a limited supply response is keeping downward pressure on prices. The main driver for this week's push lower was the lack of supply response from OPEC at its meeting. There is clearly a risk we could see a further slide short term. However, we continue to expect a gradual return to equilibrium prices over the coming year as production moves down in non-OPEC countries in response to a sharp decline in investment activity.

A further decline in oil prices is currently the main risk to our forecasts for growth as well as inflation. While lower oil prices are normally a positive thing for global growth, this is no longer the case, in our view. Rather, **lower oil prices increase tail risks for the global economy** as they make a bad situation even worse for countries such as Russia and Brazil. The decline in oil is accompanied by a drop in industrial metal prices as well, adding to the pain for commodity exporters. The drop also increases the **risk of more stories of big commodity companies having problems,** as was the case with Glencore earlier this year.

The stress from lower oil prices is clearly visible in US high yields spreads where the energy sector constitutes just below 20% of the market.

Chart 1: Commodity prices pushing lower again

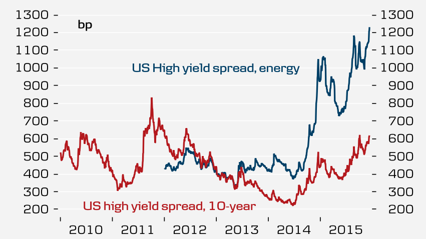


Source: Bloomberg, Danske Bank Markets

Key points

- Lower oil prices increases tail risk from emerging markets and US high yield....
- ... but gives support to consumers
- Stocks take a hit but set to get support from bottom in manufacturing cycle
- The Fed to hike but revise dots lower – the ECB is done easing
- CNY under attack

Chart 2: Stress in energy spills over to broad US high yield market



Source: BEA, Danske Bank Markets

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Lower oil prices are not all bad, though. For consumers in both the US and euro area, this will add further support (Chart 3). It works as a significant tax cut to consumers, thus underpinning overall growth.

Clearly, the decline in oil prices creates downside risks for our inflation forecasts. Note, though, that even with unchanged oil prices, inflation is likely to move higher over the coming year, with a big part of the move coming in the next couple of months (see Chart 4).

Stocks taking a hit but we remain positive medium term

The rise in tail risks from lower oil prices has reduced risk appetite this week and sent stock markets lower globally. The disappointment from the ECB last week has also worked as a short-term tailwind.

However, we remain positive in the medium term. Monetary policy is still very easy – also with the Fed raising rates slowly – and the search for yield should continue to underpin risk assets including stocks. We also believe we are at a turning point in the global manufacturing cycle (see below).

Bottom in global manufacturing – inventory cycle turning

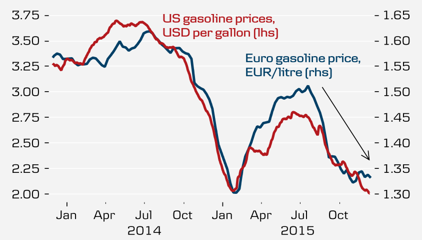
While tail risks are going up with lower oil prices, we see signs that the global manufacturing cycle is turning (see also *Global Outlook: Bottom in global manufacturing cycle*, 10 December 2015). The order-inventory balance has turned higher over the past months in the US, euro area and China. These are normally good indicators for turning points in the manufacturing cycle. Inventory indices in both the US and China have plummeted, suggesting that the recent weakness is much related to a depletion of inventories. However, as we have highlighted many times, in order to reduce inventories you need to produce *less* than the demand for a while. However, when inventories have come down, production needs to recover to the level of demand. With good support to demand from consumers from lower gasoline prices, we strongly believe we are at an inflection point in manufacturing. In China, a combination of inventory depletion and stimulus kicking in should also lead to a rebound in activity.

Fed to emphasise slow hiking cycle, ECB is done easing

While we expect the Fed to raise rates next week, the relatively soft macro backdrop is likely to lead the Fed to revise down the 'dots' that show its projection for the coming years. We believe it will signal three hikes next year instead of four, which is also our own new forecast for the Fed (see Global Outlook link above). However, we believe the Fed will need to step up the pace in 2017 to five hikes over the year, as wage growth is expected to push higher as the slack will be gone by then and growth continues above trend.

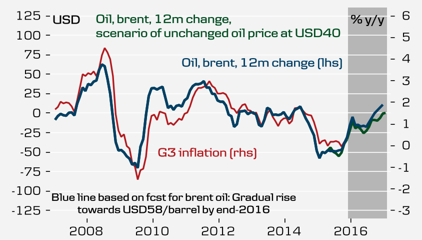
The disappointing ECB meeting last week has resulted in speculation about whether the ECB will be forced to ease again in 2016. From a market perspective, the Eonia curve remains inverted and prices in around a 50% probability of another deposit cut next year. **In our view, the bar for additional ECB easing is quite high** and dependent on incoming economic data with the inflation development being crucial (see *Presentation – Euro area and ECB Outlook: Hot topics in 2016*, 10 December 2015).

Chart 3: Lower gasoline prices work as a tax cut for consumers



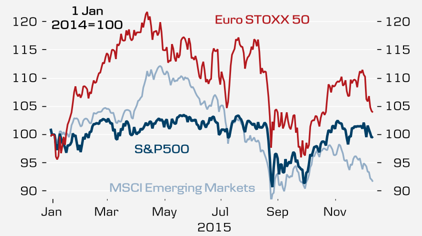
Source: BEA, Danske Bank Markets

Chart 4: Oil prices key for inflation



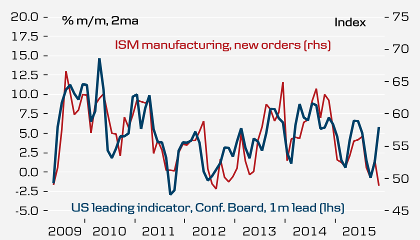
Source: BEA, Danske Bank Markets

Chart 5: Stocks take hit from higher tail risks – EM feeling the heat again



Source: BEA, Danske Bank Markets

Chart 6: ISM should turn higher soon



Source: BEA, Danske Bank Markets

We think additional pricing of further rate cuts (especially in March next year) is too aggressive. **We also see value in positioning for higher inflation**, as our inflation forecast is above what is priced in. Over time, the yield curve should steepen from the long end in a usual end-of-easing move.

We believe EUR/USD will be range trading in the short term, before heading higher in 2016. Our call for a rise in EUR/USD is probably our biggest non-consensus view at the moment and we are getting a lot of push-back on this. However, we believe that markets underestimate what higher inflation and a re-acceleration in euro area growth will do for prospects of ECB policy. Next year could very well be the one where the theme turns from further ECB easing to talking about an exit when we get through the year. Unemployment continues to decline in the euro area and as the structural unemployment rate has increased over the past years, there is probably not as much slack in the euro area as many market participants believe. At the same time, our medium-term valuation models suggest that the euro is undervalued; hence, gravity works towards a stronger euro – not a weaker one. While monetary policy is likely to diverge with the Fed increasing rates and the ECB on hold, the impact of this may not be as strong as many believe. Positioning is heavily skewed towards a stronger USD and history suggests that relative rates have less of an impact when this is the case. The bottom line is that we still expect EUR/USD to end 2016 around 1.16 versus the USD.

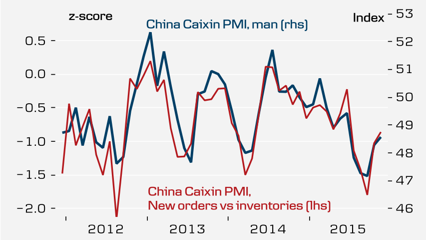
CNY under attack – intervention and selling of bonds to increase

CNY depreciation pressure has intensified over the past 1½ months with USD/CNY moving from 6.31 at end-October to 6.45 currently. Importantly, though, this is not China deliberately weakening its currency but rather the market speculating on a devaluation and selling CNY (or CNH in the offshore market). That it is not China weakening the currency is clear from the fact that it intervened quite significantly in November to stem the weakening of CNY. Hence, the FX reserves fell by close to USD90. While part of this was related to valuation because euro reserves became worth less in USD terms due to euro depreciation, the majority of the decline was related to intervention. **So, why is the currency weakening?**

1. Following the decision by the IMF to include China in the SDR (on 30 November), some hedge funds and investors are speculating that China will now devalue the CNY (or passively let it weaken) as there is no longer a political need to hold it steady.
2. With the Fed likely to hike rates and the PBoC widely expected to cut rates further, relative rates should increasingly push in the direction of a weaker CNY versus USD.

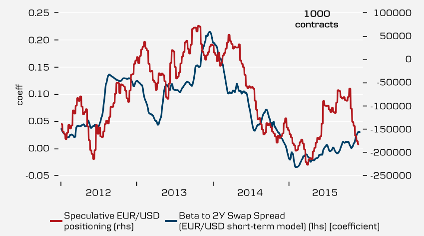
The move higher in USD/CNY following the SDR inclusion has been in line with our view, although the pace is currently faster than we expected. One of our top trades for the next 12 months has been to position for a higher USD/CNH. **However, we doubt that China will allow a bigger devaluation of the CNY of say 10-15%. We expect a move to 6.65 in the USD/CNY 12 months from now.** China has strongly highlighted this year that a devaluation would be destabilising for the global financial system (we agree) and it is afraid it will trigger significant capital outflows with a further negative impact on the economy. However, it is likely that the PBoC will need to show its hand more strongly in coming months with extensive intervention to stem the decline of the CNY. We believe this will be the case. It would also mean that China would see a further significant decline in FX reserves and be in the bond market selling both US and euro bonds.

Chart 7: Chinese PMI bottoming



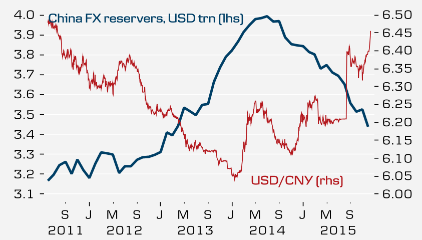
Source: BEA, Danske Bank Markets

Chart 8: Relative rates matter less when positioning is stretched



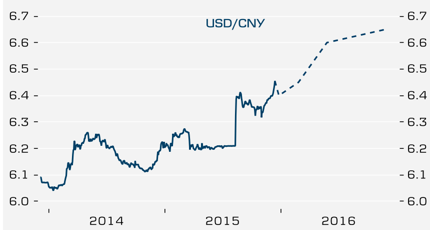
Source: BEA, Danske Bank Markets

Chart 9: Markets are pushing CNY weaker – PBoC trying to defend it



Source: BEA, Danske Bank Markets

Chart 10: We expect a further decline of CNY but no big devaluation



Source: BEA, Danske Bank Markets

Global market views

Asset class	Main factors
Equities	
Moderately positive on 3M horizon, positive on 12M horizon	A turn in the global manufacturing cycle across regions and the easing stance of ECB, BoJ, BoE and PBoC support equity markets. However, an early Fed hike and lower oil prices would have a dampening effect on markets
Bond market	
Core yields: Bund yields bottoming, higher medium term	The ECB has delivered last easing in this cycle and tight labour market points to Fed hikes in Dec 2015
US-Euro spread: Wider	Policy divergence to widen spread
Peripheral spreads to tighten further from here	QE, ECB rate cuts, improving fundamentals and search for yield
Spreads to stay stable/tighten as central bank boost liquidity	ECB support but emerging market instability the risk
FX	
EUR/USD - lower near term, rebound further out	Relative rates to weigh near term, then rebound on no renewed policy divergence and strong EUR fundamentals
USD/JPY - slightly higher near term, range medium term	Even with unchanged BoJ measures relative rates will give some support as Fed starts hiking
EUR/SEK - stuck between 9.10-9.50 near term, lower medium term	Battle between Riksbank and ECB for now, further out EUR/SEK to fall on Swedish growth outperformance
EUR/NOK - higher short term, then lower	Relative rates and liquidity to cap downside short term, but eventually lower due to positioning and fundamentals
Commodities	
Oil prices - range-bound near term, subdued recovery in 2016	Price support from OPEC is gone; now awaiting non-OPEC supply cuts ahead as costs weigh on producers
Metal prices - staying low	Chinese manufacturing slowdown to cap upside; consolidation in mining industry puts a floor under prices
Gold prices - flat near term	Low oil price and Fed getting ready to hike keeps a lid over gold price
Agricultural risks remain on the upside	Trending up again as El Niño weather is key upside risk

Source: Danske Bank Markets

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