Strategy

Oil price plunge a double-edged sword

Oil prices took another nosedive on Thursday on the news that OPEC had refrained from cutting current oil production despite the recent decline in oil prices. The Brent oil price plunged below USD72/bl on Friday morning, leading to a total decline of USD43/bl since the peak in June. The signal from OPEC is clear: it does not want to bear the burden of adjusting production lower to allow for other countries outside OPEC to produce more. So, although the decline in prices is hitting many OPEC countries, OPEC has chosen short-term pain for longer term gain as the price is now falling below the marginal cost of many oil investments in, for example, US shale industry.

The lower oil price is very good news for western consumers (see Strategy: Big drop in oil price to boost consumption, 21 November). In the US, gasoline prices this week fell below USD2.80 per gallon for the first time in four years and a similar development is being seen in Europe, although the weaker euro is dampening the decline. Other commodity prices – including food – are also falling and adding to the downward pressure on inflation.

As we expect oil prices to stay low in the short term, we now forecast inflation will reach 0.1% y/y in December. There is also now a clear risk that euro area inflation could fall to zero or potentially dip into negative territory if oil prices fall further. While in principle this should not be a big problem as it is driven by commodity prices, it may still lead to new headlines about deflation risk and add to the pressure on the ECB. A real challenge for the ECB is that lower inflation also tends to drive wage growth down and hence inflation could easily get stuck at a low level far below 2%. Hence, the further decline in oil contributes further to the probability that the ECB will implement quantitative easing in government bonds. The low inflation pressure was evident in the data for November, when headline inflation stayed at 0.3% y/y and core inflation remained at 0.7% y/y.

Although lower oil prices should be positive for the global economy, it is a bit of a double-edged sword. At some point, the decline in prices could be so big that it causes financial distress in oil exporting countries. Russia in particular seems vulnerable. We do not think we are close to systemic risk but it is increasingly a factor to follow. A big decline in the oil price in 1997-98 was one factor causing pressure on Russia that eventually led to the Russian default in August 1998. We do not believe the situation is as bad today but again it is a factor to follow; not least in the short term as many stock markets have been performing very strongly and some have moved into short-term overbought territory measured on momentum indicators. When this is the case, markets tend to be more sensitive to event risk.

Risk assets supported by recovery expectations and liquidity

The performance of risk assets has continued to be strong, with US stocks reaching new highs and euro stocks also shooting higher, closing in on the highs seen back in June.

Key points

- Lower oil price set to support consumers but keep an eye on financial risks.
- Risk assets supported by recovery expectations and liquidity.
- Euro area is bottoming.
- US soft patch set to be short.
- US yield curve set to flatten further.

Commodity prices in steep decline lately

Markets pricing global H1 recovery

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More spread compression has been evident in both credit and peripheral bond markets. The signs of bottoming in the euro area cycle (see below), strong outlook for US economy in 2015 and the highest liquidity burst in global liquidity in three years in 2015 are all factors fuelling stronger risk appetite.

As highlighted above though, several markets are technically overbought and hence the likelihood of a short-term correction is increasing, especially if focus turns to the vulnerabilities in emerging markets where a looming Fed rate hike next year will cause more headwind. However, we still believe the medium-term outlook for risk assets is positive as we look for stronger growth in 2015 and the hunt for yield continues in a world of record-low core bond yields.

**Euro area bottoming**

Following falling business surveys throughout the year, evidence is mounting that the euro area is bottoming. The German ifo business confidence, the ZEW index, EU business confidence and PMI order-inventory balance all rebounded in the most recent reading. As we have argued previously, we believe the main factor behind the euro slowdown this year has been uncertainty related to the Ukraine crisis, which, in combination with a build-up in inventories, made companies slam on the brakes over the summer (see **Strategy: Euro area weakness due to Ukraine crisis**, 14 November). Details of German GDP for the past two quarters confirm this story very clearly: while consumption growth held up well rising 0.4% q/q on average in the two quarters, fixed investment growth fell on average 1.3% q/q and inventories subtracted 0.2 percentage points over the two quarters. Export growth actually held up well, rising 1.5% q/q on average, so the decline in exports to Russia has been more than compensated by stronger exports to other countries, such as the US.

While uncertainty related to the situation in Ukraine and Russia is still there, we believe the bottom in business surveys suggest that the negative sentiment effect is fading. At the same time, other factors support the growth outlook: (a) decent growth in export markets as Japan recovers and the US economic performance stays strong, (b) a weaker euro, (c) a lower oil price, (d) fiscal stimulus and (e) improving credit availability. We look for the euro area recovery to resume and gather some pace again in the first half of 2015. The gradual improvement in credit flows was also visible in the money and credit data for October (see **Flash Comment: Euro area: bank lending continues to decline at a slower pace**, 27 November).

**US soft patch set to be short**

While US data this week confirmed a picture of slower US growth going into Q4, they also suggest it will only be a moderate and temporary slowdown. Durable goods orders were a bit weaker than expected, pointing to slower pace of investment following a robust pickup in capital expenditure over the summer. Core shipments, which is a good indicator of machinery investment, fell 1.3% m/m in October adding to a decline in September of 1.3% m/m. Initial jobless claims also rose from 292,000 to 313,000, the highest level in two months. Consumer confidence for November also showed a surprising decline from 94.1 to 88.7 (consensus 96.0).
However, data on consumer spending showed that consumption of goods stayed strong rising 4.6% 3M/3M annualised. The average since 1990 is 3.4% 3M/3M annualised. This is important for the manufacturing sector and suggests the underlying growth rate is quite strong. Housing data continues to be on the soft side, as the trend in both pending home sales and new home sales, released this week, stayed weak in October. We continue to see downside risk to ISM manufacturing in coming months but mainly because it is at a very high levels. Our models suggest it should fall back to around 55 over the coming months from the current level of 59.0. However, it would mainly reflect that ISM has been out of sync with the actual economy lately and not be a sign of new weakness. Our expectations for the US in H1 are still quite positive and based on lower oil prices, strong job growth, healthy wealth gains and overall strong sentiment.

**Bond yields keep grinding lower, more curve flattening**

Despite a sharp rise in risk appetite and more growth optimism, 10-year bond yields in the US and Germany continue to grind lower. German 10-year yields reached a new low falling below 0.7%. Declining inflation expectations and the outlook for significant liquidity are likely to be the main factors behind the decline. **We believe the pressure on bond yields will continue to be on the downside in the short term as this theme has further to go.**

As the short end of the yield curves of both the US and Germany is more or less locked for now, the decline implies a strong curve flattening. **In the US in particular, we believe the trend of curve flattening is here to stay for the coming year.** As we get closer to the first Fed hike next year, the two-year yield is likely to push higher and add to the flattening, especially because the market is still very unprepared for actual hikes from the Fed next year. The market is pricing only one hike, whereas the Fed itself is projecting four to five hikes of 25bp, leading to an end-point of 1.375% in 2015. It is not unusual though that the market has a hard time pricing in Fed hikes well ahead. However, as we move into a three-month window from the first hike, expectations normally adjust and two-year yields shoot higher. This was evident in 2004 when the Fed started its ‘measured pace’ hiking cycle, which led to 17 rate hikes over a two-year period. The bond market did not really sell off until March 2004 and the Fed hiked in June. Over this three-month period, two-year yields rose nearly 150bp.

**EUR/USD and USD/JPY treading water**

While there has been lots of action in commodity currencies that are under pressure from the decline in oil prices, the big crosses are mostly treading water currently. EUR/USD has been broadly flat during November, partly due to stretched positioning as investors are very long the USD (see IMM Positioning: Bullish USD bets regain momentum – at a new record high, 24 November). Relative economic surprises are also turning less in favour the USD, as US data has become a little more mixed, while euro area indicators show signs of bottoming.

However, as we move closer to the first Fed hike and the short end of US reprices, we should see a resumption of the decline in EUR/USD and we target 1.20 on a six-month horizon (see FX Forecast Update: The Fed and the rest, 18 November).

The JPY weakness has also stalled this week following a very rapid move higher in USD/JPY. Minutes from the latest Bank of Japan meeting suggested a low probability of more easing and pointed to some negative factors of too much JPY weakening. We still believe though that the direction is for a weaker JPY in the short term as, among other things, the USD should strengthen further when we move closer to a Fed hike.

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**Source: Macrobond Financial**
## Global market views

<table>
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<tr>
<th>Asset class</th>
<th>Main factors</th>
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<tbody>
<tr>
<td><strong>Equities</strong></td>
<td>Strong US outlook, moderate Chinese growth, a sharp fall in the oil price and the continued easing bias at the ECB. Bank of Japan and People’s Bank of China is supportive of equities. In addition, equities are still attractive versus bonds.</td>
</tr>
<tr>
<td><strong>Bond market</strong></td>
<td>Moderation in US growth, ECB QE expectations building, inflation to stay low. Policy divergence drives short-end spread wider, longer-end spread stable as close to historical highs. Volatility to remain higher into year-end. Neg. policy rate and improving fundamentals support search for yield. Added liquidity from ECB, stable fundamentals and search for yield.</td>
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<tr>
<td><strong>FX</strong></td>
<td>Lower on 0-6 months on diverging growth and monetary policy. USD/JPY to break sharply higher on BoJ easing and pension reforms. \ Lower following Riksbank on Swedish growth outperformance, valuation. \ EUR/NOK to fall on stabilizing oil prices, growth outperformance.</td>
</tr>
<tr>
<td><strong>Commodities</strong></td>
<td>OPEC overproduction and global growth concerns to weigh near term. Limited risk of supply disruptions. Chinese growth concerns a near-term negative factor, supply side risks. \ Trending down as first Fed hike draws closer. Geopolitical concerns a supportive factor. \ Near-term stabilisation, extreme weather is key upside risk.</td>
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*Source: Danske Bank Markets*
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