10 October 2014

Strategy

Global growth losing momentum amid new risks

Stock markets and bond yields fell further during the week, as growth worries are on the rise and focus turned to the risk from Ebola spreading more in the developed world. European stocks took the biggest hit as recession fears resurfaced after German orders and industrial production for August weakened significantly. Euro Stoxx 50 is now trading back at the lows in early August when the fear over the Ukraine crisis was at its highest.

OECD leading indicators also confirmed the picture of softer growth in developed markets as the release for August showed the fifth consecutive decline for the G3 countries, normally a sign to keep low equity exposure as the bigger corrections tend to happen during phases when leading indicators decline. **While we are positive on stocks in the medium to long term, the recent macro developments as well as risk factors suggest to stay cautious in the short term.**

In terms of the global growth picture things could very well turn worse before it gets better. The only pillar of strength currently is the US but it will be increasingly difficult for the US to maintain the strong momentum going into H2. As we highlighted last week, the surprise index has been high but is coming down and it is likely to go lower before we see any stabilisation in the euro area or Japan. Next week's US retail sales will be important to gauge how much growth momentum may ease in the US. Car sales were quite soft in August. While we expect some softening in US data over the coming months, we still believe growth will stay quite robust supported by a strong job market and decent real wage growth, among other things. Initial jobless claims this week supported this picture as the 4-week moving average fell to the lowest level since 2006.

In the euro area there are still no signs of bottoming and this could very well last the rest of the year. Looking into next year we expect growth to be underpinned by a weaker euro, strong real wage growth (due to low inflation) and further easing of lending standards following the Asset Quality Review this year.

Lower oil prices is a good thing, isn't it? Depends on who you ask

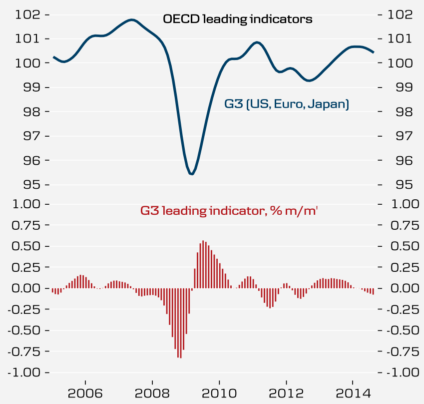
The decline in global risk appetite has also added to the decline in oil prices. Brent oil dropped below USD89per barrel extending the cumulative drop to USD26 from the recent peak in mid-June at USD115. Normally a lower oil price would be welcomed. It reduces energy costs and boosts consumer purchasing power, which is good for growth. In fact, the decline in oil prices does give support to consumers in both the US and the euro area and is as such a supportive factor for the recovery.

However, if you are a central bank fighting deflation fears and a de-anchoring of inflation expectations, lower oil prices may cause headaches. The drop in oil has contributed to a further dive in 5y 5y inflation expectations in the euro area to a new low at 1.82% (see chart).

Key points

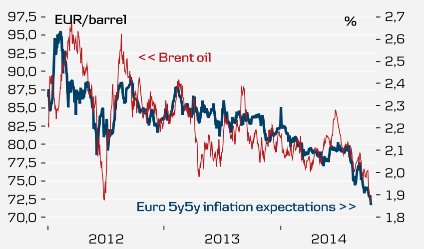
- Risk appetite under pressure as global growth falls and risks rise
- Lower oil prices push inflation lower but support growth
- Downward pressure on bond yields while the USD consolidates

Developed markets losing momentum



Source: Macrobond Financial

Lower oil prices should be good – but may add to the ECB's many headaches



Source: Macrobond Financial

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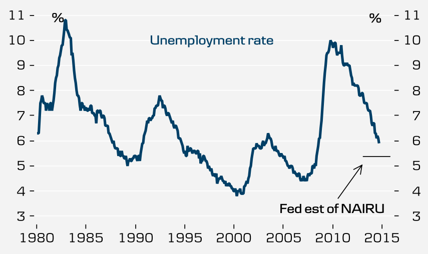
It may seem a bit odd that lower oil prices today should affect inflation expectations five years from now but the inflation market tends to correlate with commodity prices, partly due to technical reasons related to the short-term carry earned on inflation-adjusted bonds. Something that the ECB may highlight. The decline in oil prices also puts further downside pressure on actual inflation in the short term and thus increases the risk of 'second-round effects', where wage increases follow inflation lower and thus reducs the inflation pressure further. The decline in oil prices therefore increases the likelihood of real QE in sovereign bonds from the ECB sometime in 2015.

Are US labour resources still 'significantly underutilised'?



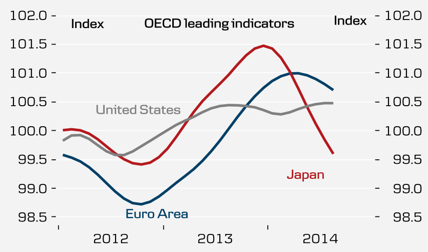
Source: Macrobond Financial

The Fed taking notice of stronger USD and weaker global growth

The struggling stock market got some unexpected help in the minutes from the latest Fed meeting. However, it only lasted one day and stocks went down again. Not a good sign for the short term.

The Fed tends to be quite responsive to market turmoil and rising risk factors, though, and if there is a further sell-off while data soften a bit, it may very well turn to a more dovish tone. The decline in oil prices and low wage growth is giving the Fed flexibility to do that, even though the US economy is generally on a stronger footing and lower oil prices are going to support consumers. The Fed has historically focused on a risk management approach in which it rather keeps policy too easy to insure against a negative scenario, because if necessary it can always hike rates faster later. This point of view was also expressed in the FOMC minutes this week.

US leading indicator may very well follow euro area and Japan lower soon

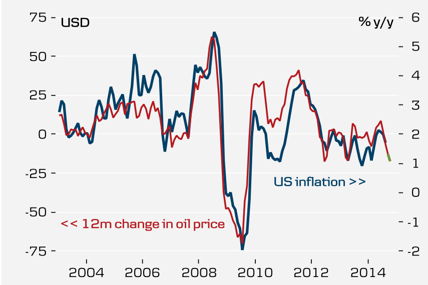


Source: Macrobond Financial

It means that our call for an April hike is on thin ice for now and the consensus of a June hike is getting more probability. The forecast of a hike in April was based on the view that unemployment is falling much faster than the Fed expects and that it will hit the long run estimate of 5.4% already in Q2 next year (it is currently 5.9%). If we are right in our call that the global economy turns better in the early part of 2015, an April hike could easily come back on the agenda but for now sentiment may continue to change in favour of a later hike. This will give support to risk assets at some point but it may be too early.

Given the current turmoil it is likely that the Fed will keep the 'considerable time' language in its statement at the 29 October meeting and even though the unemployment rate is quite low now, it may choose to keep the 'significant underutilisation' description of labour resources in order not to rock the boat.

Lower oil price to push US inflation back down towards 1%

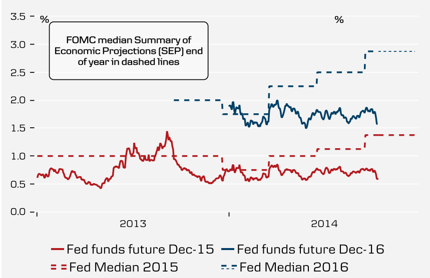


Source: Macrobond Financial

Generally takes time before policymakers act

When market rumbles set in the market turns to policymakers for relief but it may take a while before we see a real step up on the policy side. The ECB is likely to drag its feet into QE of sovereign bonds. The message from the ECB at the latest meeting was clear: we have done a lot and we are still waiting to see the results of the measures. Mario Draghi was clearly annoyed that there was already a call to do more. This will likely continue in the short term – not least because QE is very unpopular in Germany. Nevertheless, eventually the ECB will have to defend its mandate and to get inflation higher it will need to do more.

Market pricing of Fed policy moving further away from Fed projections



Source: Macrobond Financial

In China premier Li Keqiang this week repeated that the government prefers reform to stimulus, which does not hint at immediate measures coming up. The approach actually seems wise. Reform is the main key to continuing to climb the development ladder of which China has only gone a third of the way. However, the Chinese government will eventually react if the growth target is under threat. Li Keqiang thus also said that China should ensure that it meets the 2014 economic goals and that it has sufficient policy tools for the economy. Judging from the past years, China tends to react when the PMI hits the 48-49 level. It will take a few more months but we are likely to see another mini-stimulus package. Emerging market stocks tend to be correlated with Chinese PMI but to bottom when the economy turns weak enough that stimulus is expected. It suggests some more downside risk, though, before stabilisation sets in.

Bank of Japan has also been very reluctant to signal more easing. However, as the global economy softens and Japanese data continue to be weak, the pressure will rise for Bank of Japan to do more. It takes time, however.

Yields lower on weaker growth and lower inflation expectation

Bond yields turned lower again in the past weeks following a short rebound in early September. Euro recession fears, lower US surprise index and declining inflation expectations have been behind these moves. The market reacts to impulses, not valuation. Hence, even though 2-year yields in the US reflect a much lower path of rate hikes than the Fed projects, it has not stopped yields from going even lower. Momentum beats valuation, at least in the short term.

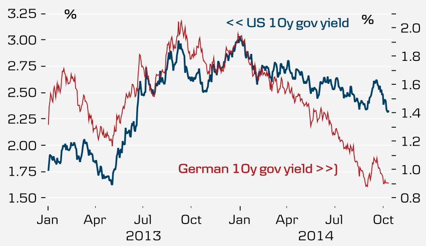
We believe the impulses will continue to be negative for yields in the short term, as US growth softens and there is a risk of a further decline in risk appetite. Expectations for QE in the euro area will continue to build and a somewhat softer rhetoric from the Fed is also likely.

The USD may see some consolidation in the short term, as US surprises diminish and the market postpones the expectations for Fed hikes further. However, in the medium term the story remains the same: we are going to see a divergence in monetary policy, as the US starts raising rates while the ECB and possibly Bank of Japan ease further. This implies that the rising USD trend will resume at some point.

PMI not yet weak enough for stimulus – but it may be in a few months

Source: Macrobond Financial

Downward pressure on yields continues in the short term



Source: Macrobond Financial

Global market views

Asset class	Main factors
Equities	
Moderately positive on 3m view, positive on 12m view	Continued global recovery in the medium term combined with stimulus from especially BoJ and ECB will support equities. On company level data starts to look promising as well; Earnings growth in Q2 showed strong momentum across the board, capex in the US is picking up and earnings revisions are positive for 2014 and 2015 for most regions.
Bond market	
Downward pressure on yields short term, longer term moderate rise	Lower long-term growth and inflation expectations and hedging flows weigh on long bond yields in short term
US-Euro spread: Wider 2-5y, stable longer maturities	Policy divergence drive short end spread wider, longer end spread stable as close to historical highs
Peripheral spreads to continue gradual tightening	Added liquidity, search for yield, improving fundamentals. Volatility to pick up some-what
Credit spread to tighten gradually still, but risk of higher vol	Added liquidity, search for yield, good fundamentals. Geopolitical and idiosyncratic risk creates jitters
FX	
EUR/USD - consolidation short term, medium term lower again	EUR/USD to fall further on diverging monetary policy, growth and portfolio flows
USD/JPY - higher	USD/JPY to break higher on pension reforms, portfolio outflows and diverging monetary policy
EUR/SEK - lower	EUR/SEK to decline on growth and valuation
EUR/NOK - more downside especially in the short term	EUR/NOK to decline on growth and carry in a world of low global growth and zero interest rates
Commodities	
Oil prices - stable prices rest of the year	Substantial supply shock to weigh in 2014. Limited risk of supply disruptions
Metal prices sideways before trending up in 2015	Support from global recovery, supply side risks.
Gold prices to correct lower still	Trending down as first Fed hike draws closer. Geopolitical concerns a supportive factor.
Agricultural risks remain on the upside	Near term stabilization, extreme weather is key upside risk.

Source: Danske Bank Markets

Disclosure

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