5 February 2016

Strategy

Crumbling faith in central banks' inflation mandates

This week saw a sharp fall in inflation expectations and a sudden and abrupt weakening of the US dollar. These developments point to further weakness in the world economy and commodity markets, and raise question marks over whether the G3 central banks can steer the world economy through murky waters.

Inflation expectations and interest rates have fallen sharply...

The combination of falling oil prices and renewed concern about the strength of the world economy prompted a sharp decline in both inflation expectations and benchmark interest rates. Both short and long-term inflation expectations are now at all-time lows. Thirty-year inflation expectations in Europe and the US are now 1.6% and 1.8%, respectively. Basically the markets are saying that neither the Fed nor the ECB will be able to fulfil their mandates for the next 30 years! On the back of the decline in inflation expectations, we also saw a sharp fall in interest rates. Ten-year US treasury yields have now declined from 2.3% at the beginning of the year to 1.85%, while German yields have declined from 0.6% to 0.3% since the beginning of the year.

...as has USD on fresh concerns about health of US economy

The decline in service sector expectations raised fresh doubts about the health of the US economy. On Wednesday, the ISM non-manufacturing index dropped to 53.5 in January from 55.8 in December. This punctured the belief that the US service sector would be immune to weaknesses in the US manufacturing sector, the oil sector and more generally the global economy. US policymakers are now clinging to the labour market as one of the last areas of strength.

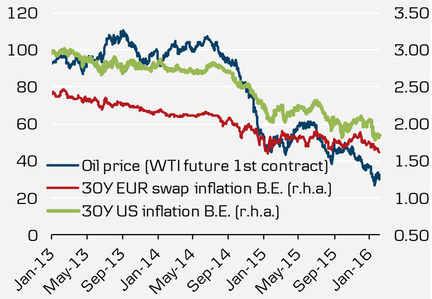
The fresh signs of weakness in the US economy have led to a sharp reassessment of US monetary policy. In addition, the speech by FOMC member Dudley on Wednesday gave the market further reason to expect a delay to the next rate hike. In his speech, Dudley expressed concerns about the tightening of financial conditions since the Federal Reserve raised interest rates in December and that the US economy was not immune to a strong dollar and weaknesses in the global economy. The market pushed its expectations about the next rate hike further out from March to August 2017.

The reassessment of US monetary policy led to a significant weakening of the US dollar. Since Wednesday the dollar has fallen by 2.7% against the euro while the broader dollar index, DXY, is down by 3%. This fall does not come as a surprise to us. As flagged in our piece on Wednesday (*Why EUR/USD is set to rally in 2016—now is the time to prepare),* we argued that *the only* factors supporting the USD vs the euro were relative rates. As the market pushed out its expectation about the next rate hike, it lost faith in the dollar. We argue that there are fundamental factors supporting EUR/USD such as (1) it being undervalued, (2) the large euro area current account surplus, (3) the stronger business cycle outlook in Europe vs the US, (4) stretched short EUR/USD positions, (5) bigger terms of trade benefits from the low oil prices and (6) falling commercial FX hedging of EUR. While the EUR/USD move this week was in line with our view of a stronger euro, we think the cross may have increased too far and rapidly and we may see a short-term rebound in the dollar against the euro.

Key points

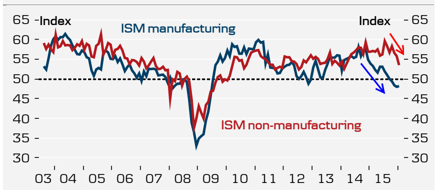
- This week has seen further declines in inflation expectations and interest rates.
- Concerns about the US economy prompted a sharp fall in the dollar.
- The fall in inflation expectations raises questions about the central banks' ability to fulfil their inflation mandates, especially with the policy vacuum until March.
- Yellen's testimony on Wednesday will be crucial in providing guidance to market.

Long-term inflation expectations have reacted strongly to fall in oil price



Source; FOMC, Danske Bank Markets.

US services sector is not immune to global developments



Source; Danske Bank Markets.

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However, this should give way to renewed EUR strength in the latter half of the year as fundamental factors become increasingly important.

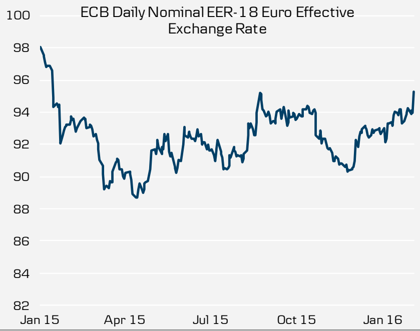
Sharp fall in inflation expectations raises questions about G3 central banks' ability to fulfil their inflation mandates

The sharp fall in inflation expectations is a huge challenge facing the major central bank in fulfilling their inflation mandates. Certainly the market does not seem convinced the central banks have the ability to do so given 30-year inflation expectations in the US and Germany are below 2%. The ECB and BOJ have already acted almost in conjunction. Following its surprise move to adopt negative interest rates for the first time ever, the BOJ governor this week signalled that rates could be lowered further. The ECB has also flagged that monetary easing will come in March. In the Bundesbank (of all places), Draghi gave an ultra-clear hint to markets that the ECB will move forcefully in March, stating in a speech that comes close to his famous "do whatever it takes" speech in 2012, that fighting deflation today is by no means different from the inflation fight in the 1970s and that premature tightening, such as in the US in 1936-37, may run the risk of a reversal at a later stage. However, so far the market seems to be saying that central bank talk is cheap and action is warranted as risk rallies have faded fairly quickly.

The big question is whether will the Fed will change course. Here Fed chair Yellen's testimony at the Fed's semi-annual Monetary Policy Report to Congress on Wednesday will be extremely important in providing some guidance on how the Fed sees the situation. We will listen carefully to any comments on what to expect from the Fed this year. In our view, it will not risk tightening too much, too quickly. If that happens, we think risk sentiment may remain depressed. We think it will require clear indications from Yellen that the Fed is prepared to delay raising rates before we can get a risk rally benefiting equities, oil and the US dollar.

The main problem is that markets are caught in a policy vacuum until March. During this period, there is a risk that we get further hints from China, the US and elsewhere that the global business cycle is taking a turn for the worse. In that case, central banks will only be able to *signal* further easing, but will not be able to act. Certainly the ECB will be very worried about the strength of the euro. Hence, the wait until March may be a very long one, in which we may well see further abrupt swings in market sentiment.

Euro strength is back to January 2015 levels



Source: Bloomberg

Global market views

Asset class	Main factors
Equities	
Moderately positive on 3M and 12M horizon	We assume that the ECB, PBoC and BoJ will continue to ease and there will be a dovish tilt to the Fed's hikes. Given that, we expect further downward pressure on margins in industrials and we could see weaker US macro data. Our base case is that the US consumer will stay healthy. However, if the downward margin pressure in industrials leads to layoffs then we are facing a different scenario in terms of equity market development.
Bond market	
Core yields: Bund yields close to bottoming out, higher medium term	ECB is to cut the deposit rate again, but still upward pressure to long end from the US medium term
US-Euro spread: Wider	Policy divergence to widen spread further especially in short and mid segment of curve
Peripheral spreads to tighten further from here	QE, improving fundamentals and search for yield
Credit spreads to continue widening somewhat	ECB supportive, but outweighed by the oil rout and associated turbulence
FX	
EUR/USD - near-term lower, rebound further out	Temporary support from too dovish re-pricing of Fed rate hikes, medium-term to rise on strong EUR fundamentals
USD/JPY - rangebound on a medium-term horizon	Upside risk from further BoJ easing
EUR/SEK - stuck between 9.10-9.50 near term, lower medium term	Battle between Riksbank and the market for now, further out EUR/SEK to fall on strong Swedish fundamentals
EUR/NOK - higher short term, then lower as cycle turns	Relative rates, oil and liquidity to cap downside short term, eventually lower on 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 and weaker dollar
Metal prices - staying low	Chinese manufacturing slowdown to cap upside; consolidation in mining industry puts a floor under prices
Gold prices - flat near term	Short-term support from re-pricing of Fed rate hikes
Agriculturals - risks remain on the upside	Attention has turned to La Niña weather risks in H2 2016

Source: Danske Bank Markets

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