20 November 2015

Strategy

Global recovery but China deleveraging a drag further out

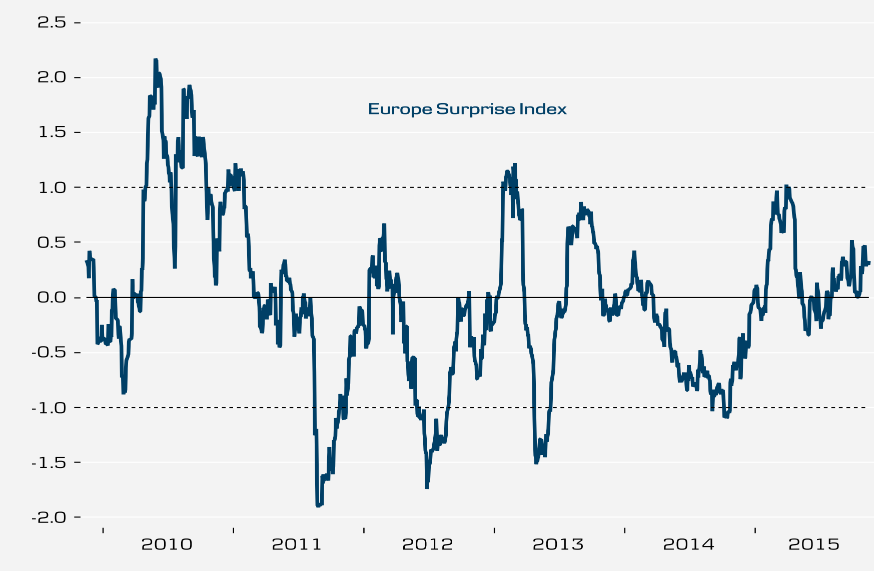
In *Strategy: The global IP cycle is bottoming out*, 6 November 2015, we argued that the global industrial production (IP) cycle is bottoming out and we are now seeing further signs of that. **Our MacroScope models, which provide systematic macro signals, have turned more positive in November**. First, the global signal strength has turned positive for the first time since April. Second, synchronicity has improved significantly as more models across regions have turned positive. Finally, the medium-term models, which provide the best signal for the change in growth momentum on a three-four month horizon have turned positive in the US, Europe and Japan (see Chart 2). The clearest signal is in Europe, where the latest data has shifted the medium-term model to a clear picture of positive momentum after sending somewhat mixed signals over the past two months.

Based on historical performance, this is supportive for risk assets, particularly equities and especially in Europe where the signal is most clear. In our view, this will be further supported by a very aggressive ECB on 3 December. Yes, market expectations are running high that the ECB will deliver but ECB board members this week have done nothing to dampen expectations of aggressive easing, which is exactly the reason to believe that they will be very aggressive. **For euro yields, we see the current environment as broadly neutral with ECB easing being counterweighed by higher US yields and a turn higher in the global IP cycle.**

Key points

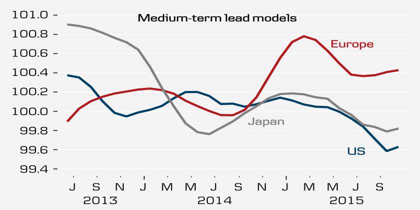
- Our MacroScope models have turned positive for the first time in more than six months.
- This is positive for equities, particularly European equities, neutral for euro FI.
- Previous Fed rate hiking cycles suggest that the USD will weaken after lift-off.
- CNY to weaken after RMB inclusion into SDR has been settled.

Chart 1: Europe is recovering



Source: Macrobond, Danske Bank Markets

Chart 2: Medium-term lead models turning higher



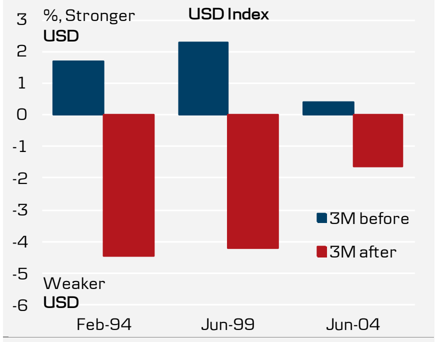
Source: Macrobond, Danske Bank Markets

Global Head of FICC Research
Thomas Harr, Phd.
+45 45 13 67 31
thhar@danskebank.dk

In the midst of a global cyclical recovery and a stabilisation in China, challenges for global growth over the medium term remain, with the industrial/investment cycle in China in a structural decline. China has experienced more than 30 years of investment boom with investment to GDP reaching close to 50% at its peak. Meanwhile, total leverage (government, household and corporate) rose to around 225% in 2013 from around 165% in 2008 and there are no signs that the tide has turned yet. The build-up in leverage since 2008 came in the aftermath of the significant fiscal and credit stimulus in late 2008 and early 2009. In coming years, China will have to deleverage exactly as the west has been forced to do since the global financial crisis. **This, combined with the much overdue rebalancing of its economy from investment- to consumption-driven growth, will drive a consistent slowdown in the Chinese economy over the medium term.** This will be a major drag on the global economy in coming years and will have important implications for investment returns over the medium term.

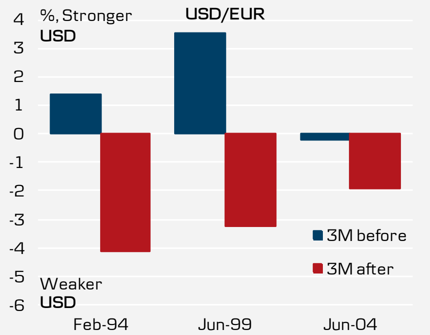
Several clients have asked us how the USD and EUR/USD will trade into and after the ECB and Fed meetings in December. In Chart 3 , we show the USD performance through the DXY Index and against the EUR over the last Fed rate hiking cycles in 1994, 1998 and 2004. **We note that the USD tends to strengthen in the three months prior to the start of the Fed hiking cycle while weakening thereafter.** Then some clients are arguing that this time is different as the Fed is tightening exactly at the same time as the ECB will ease. However, the 1994 Fed rate hiking cycle was accompanied by a Bundesbank easing cycle. Again, this time may of course be different due to other reasons but it does make a point. And the DXY index has already rallied 3.87% since 16 September (three months prior to the expected Fed hike) and the euro has fallen 5.1% over the same period. **We expect one final leg of USD strength, EUR weakness over the coming one-three months but we have come a very long way and the medium-term outlook is for a higher EUR/USD** (for example, see *FX Forecast Update – The final leg of the USD rally*, 16 November 2015). CNY has been stable since China changed its fixing methodology and weakened the CNY in August. However, with the IMF's Managing Director Christine Langarde's statement on 13 November that she supports the staff's finding that the Renminbi (RMB) should be included in the Special Drawing Rights (SDR) alongside USD, EUR, GBP and JPY, we expect that the Chinese authorities will allow gradual CNY depreciation.

Chart 3: The USD falls when the Fed hiking cycle starts



Source: Bloomberg, Danske Bank Markets

Chart 4: EUR/USD rises when the Fed hiking cycle starts



Source: Bloomberg, Danske Bank Markets

Global market views

Asset class	Main factors
Equities	
Moderately positive on 3M horizon, positive on 12M horizon	China's economy recovers and this is lifting markets. Support from euro area, US growth and the easing stance at ECB, BoJ, BoE and PBoC supports equity markets. However, a early Fed hike would have a dampening effect on markets
Bond market	
Core yields: Bund yields lower short term, higher medium term	ECB has opened the door for new rate cuts and more QE, whereas tight labour market points to Fed hikes in Dec 15
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 markets instability the risk
FX	
EUR/USD - lower in 3M , 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 continue to support the cross with Fed hikes coming up
EUR/SEK - stuck between 9.30-9.60 near term, lower medium term	Battle between Riksbank and ECB for now, further out EUR/SEK to fall on Swedish growth outperformance
EUR/NOK - range trade short term, then lower	Relative rates and liquidity to cap downside short term but eventually lower on positioning and fundamentals
Commodities	
Oil prices - downwards pressure near-term, recovery in 2016	Rebalancing to support recovery next year. Geopolitical risk factor looming
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, El Niño weather this year is key upside risk

Source: Danske Bank Markets

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