Danske Bank

10 key questions about the global economy in 2020

Chief Analyst, Head of International Macro
Jakob Ekholdt Christensen
+45 4512 8530
jakc@danskebank.dk

Chief Analyst
Allan von Mehren
+45 45 12 80 55
alvo@danskebank.dk

Senior Analyst
Mikael Olai Milhøj
+45 45 12 76 07
milh@danskebank.com

Adam Schoolcraft
Graduate
+45 45 14 12 59
adsc@danskebank.dk

Senior ECB / Euro Area Analyst
Piet P. H. Christiansen
45 45 13 20 21
phai@danskebank.dk

Senior Euro Area Analyst
Aila Mihr
+45 45 12 85 35
amih@danskebank.dk

Senior Analyst, FX Strategy
Jens Nærvig Pedersen
+45 4512 8061
jenpe@danskebank.dk

Senior Equity Strategist
Bjarne Breinholt Thomsen
+45 45 12 80 57
bt@danskebank.dk

13 January 2020

www.danskebank.com/CI

Important certifications and disclosures are contained from page 17 of this report

10 key questions about the global economy in 2020

1. The global economic cycle: boom, bust or just a modest muddling through?
2. New targets but the same old problems: where will the ECB and FED reviews end up?
3. Will fiscal policy be the new game in town?
4. The end of Trumpism? Who will win the US election and will it matter to markets?
5. Will China and the US find a permanent trade solution – or will they move further apart?
6. No-deal Brexit risk revisited: can the UK and the EU strike a deal before end-2020?
7. Broad USD strength – will it continue?
8. Will 2020 finally be the year where yields end markedly higher?
9. How much more upside is there for global stocks?
10. Will the Middle East tensions cause a surge in oil prices?

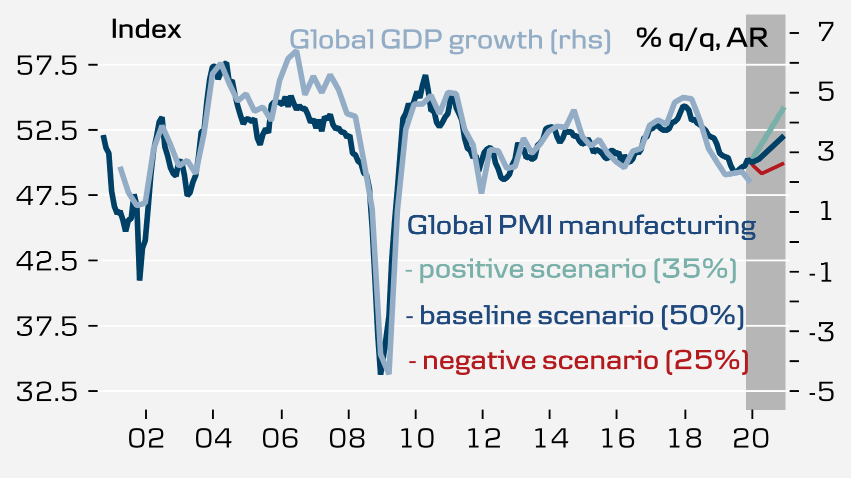
The short answers

1. The **global economy** is set to recover modestly with slight upside risk from a possible phase two US-China trade agreement.
2. The **Fed and ECB reviews** are likely to result in a significant shift in their monetary policy framework, but especially for the ECB the review will not be completed this year.
3. **Global fiscal impulse** is likely to stay lukewarm as the global economy recovers.
4. **President Trump** seems to be running behind but it is too early to make big conclusions. Irrespective of who wins, market reaction will be limited due to a likely divided Congress.
5. In the **trade war between China and the US**, we look for a partial phase two deal in H1 2020 after the completion of phase one in mid-January.
6. The **UK and the EU27** are set to agree on only a limited FTA by 31 December 2020 – but a no-deal Brexit risk still looms.
7. The **broad USD** is unlikely to weaken significantly in 2020 due to an ongoing investor preference for US assets and elevated USD carry.
8. **Bund yields** to stay in a relatively tight range because of technical factors and the economic outlook remaining too weak.
9. Upside for **global equities** limited amid highest valuations in 15 years and likely constant equity risk premiums.
10. There would have to be a significant escalation of the **Middle East crisis** to send oil prices sharply higher this year.

Global economy set to recover modestly with slight upside risk

- Our **base case is for a modest global economic recovery** amid fading headwinds from the trade-war, providing a slight boost to private consumption and investment and recovery in several key emerging markets, including India, Russia, Brazil and Turkey, which benefit from easier monetary policy.
- There are though some **upside risks** to our forecast as a possible phase two deal between China and the US may trigger a stronger rebound in global investments.
- The **key downside risk** for the global economy is a sudden re-escalation of the trade war between China and the US and a full-blown conflict between Iran and the US/Saudi-Arabia in the Middle East, which could trigger a surge in oil prices.

A modest recovery is on the cards…



Source: Macrobond Financial, Danske Bank

…driven in part by emerging markets

% y/y	2018	2019	2020	2021
Global	3.5	2.9	3.0	3.3
USA	2.9	2.3	1.7	1.9
Euro area	1.9	1.2	0.9	1.3
Japan	0.8	1.0	0.5	0.5
UK	1.4	1.4	1.0	0.9
Emerging Markets of which	4.5	3.7	4.3	4.7
China	6.6	6.2	6.0	6.1
India	7.3	6.0	6.8	7.5

Source: Macrobond Financial, Danske Bank

Danske Bank

The Fed likely to shift regime to average inflation targeting, but with limited market impact

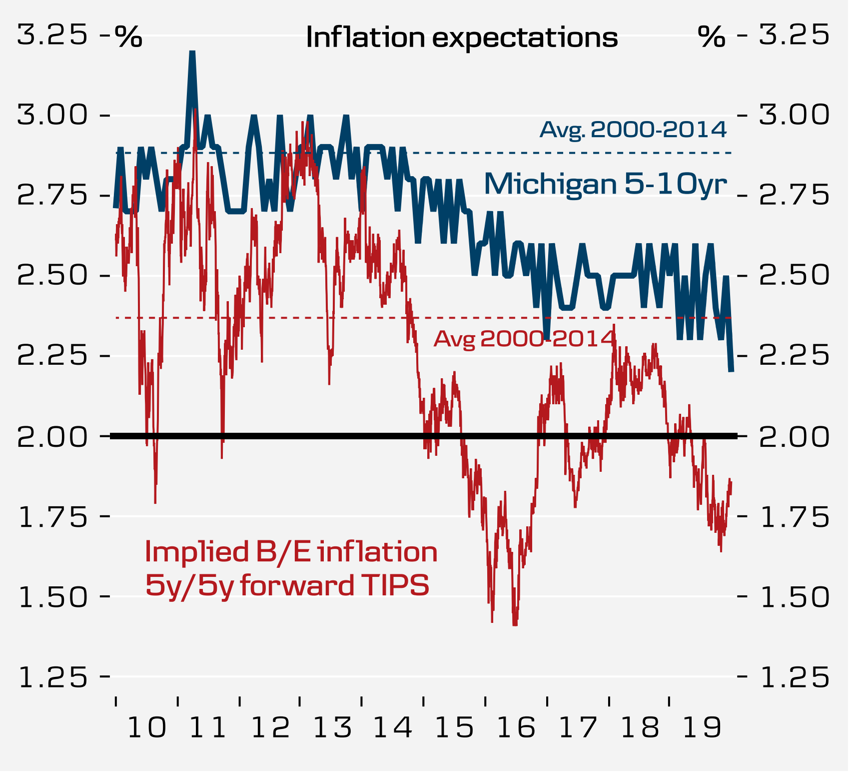
Conclusions from recent policy review conference

At a recent conference that formed part of the overall review the following conclusions emerged.

- **'Stronger and sooner'** is the most effective weapon in monetary policy.
- **Average inflation targeting** (2% inflation on average over a period of time, such that the Fed must make up for too low inflation) produces better outcomes than the current flexible inflation targeting regime and is probably easier to implement than pure price level targeting.
- **Rule-based QE of 25% of GDP** when the effective lower bound is binding is equivalent to lowering rates by 2pp.
- The Fed needs better measures of labour market tightness, as it has underestimated the slack in the labour market.
- The Fed should make **changes to its communication strategy** (suggestions: simplify FOMC statements and introduce a regular monetary policy report).

OVERALL. We expect the Fed to change its regime to average inflation targeting eventually (H2 20 at the earliest with effect from January 2021). We do not expect any major market impact. It takes time for a new regime to become credible and the Fed has already hinted it will not hike even if inflation starts surprising to the upside.

The Fed is fighting low inflation (expectations)



Source: Bloomberg, University of Michigan, Macrobond Financial
Note: Past performance is not a reliable indicator of future performance

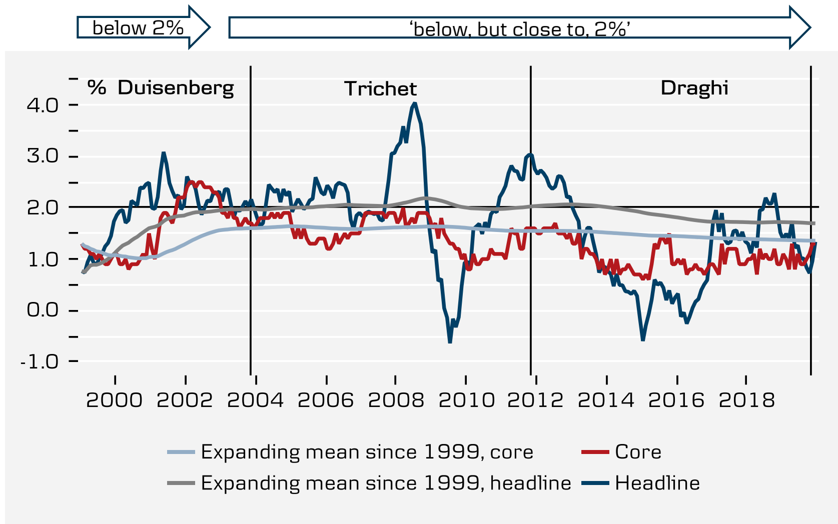
The ECB will start its review – but is unlikely to finish by the end of the year

- The much awaited **ECB strategy review is yet to be formally opened**, but the aim is to conclude it by the end of the year. Such a **review will ultimately bring a large unknown to markets** about the future monetary policy and its implications. That said, we generally believe that the **ECB would like to avoid a significant market impact** on the back of the review. As the outcome of the latest review took effect in 2003, we consider that a large overhaul of the framework is warranted.

- We certainly believe this is a rather **optimistic timeline** as the ECB intends to 'leave no stone unturned'. The similar policy framework review in the US has so far lasted two years and is still ongoing.

- We are still at a very early stage and therefore it is difficult to draw firm conclusions as only very few ECB governing council members have expressed views on a potential design. **We favour a firm symmetric core inflation-style target,** i.e. without the volatility stemming from the energy component, potentially with a tolerance band. However, we believe the most likely outcome may be a symmetric target for headline inflation (with potential for a tolerance band).

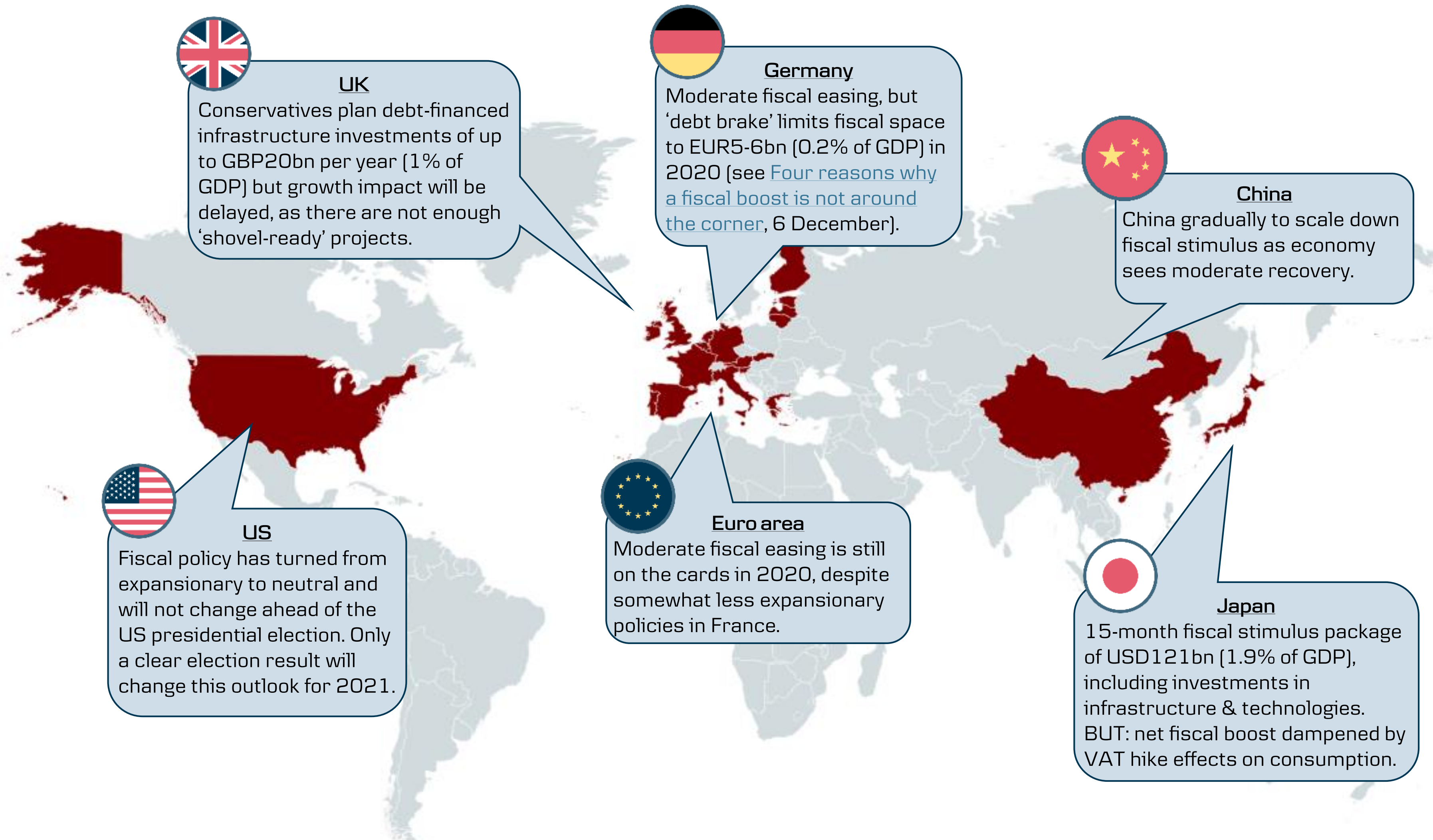
- A large unknown is also how **sustainable finance** will be integrated into the review on the back of the ECB's recent focus. Furthermore, the ECB may also alter the communication format, such as having the chief economist present at the press conferences.



Source: ECB, Eurostat, Macrobond Financial, Danske Bank.

	Minor revision	Large overhaul
Strategy review	Changing mandate to pre-2003 definition of 'below 2%' HICP or clarification of symmetry	All 'price stability' definitions possible (medium-term, average inflation, price level target). All target variables fulfilling 'price stability' (HICP, core, super-core)
Market impact	Unknown. Will depend on outcome of the	Unknown. Will depend on outcome of the exercise
Time horizon	6-9 months	12-24 months

Global fiscal impulse to stay lukewarm as global economy recovers

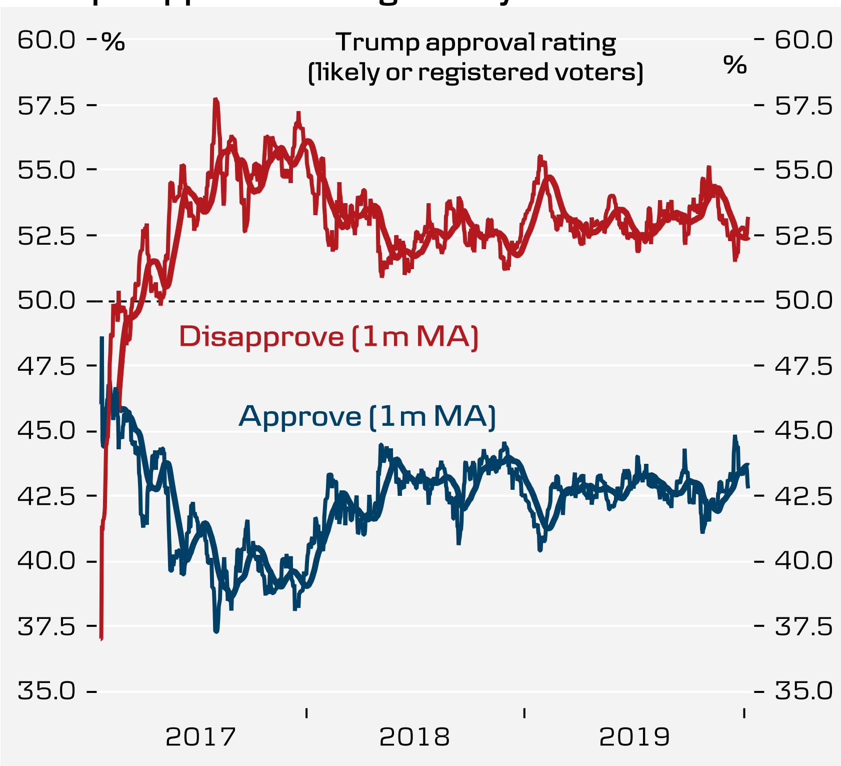


Source: Danske Bank

Danske Bank

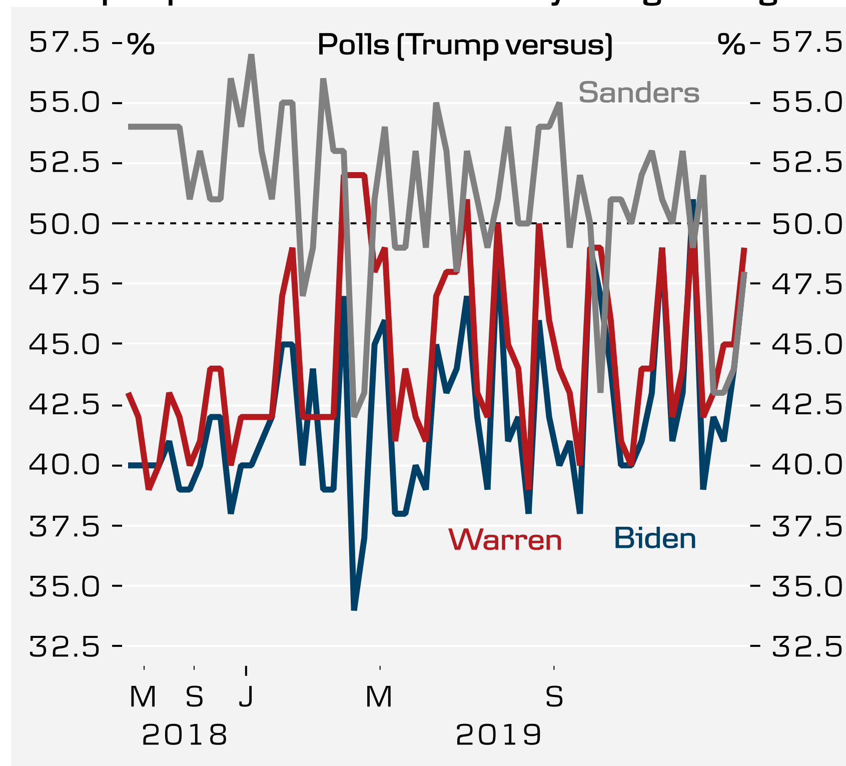
Trump seems to be running behind but too early to make big conclusions yet

Trump's approval rating is very stable but below 50



Source: FiveThirtyEight, Macrobond Financial

Trump expected to lose but not by a huge margin

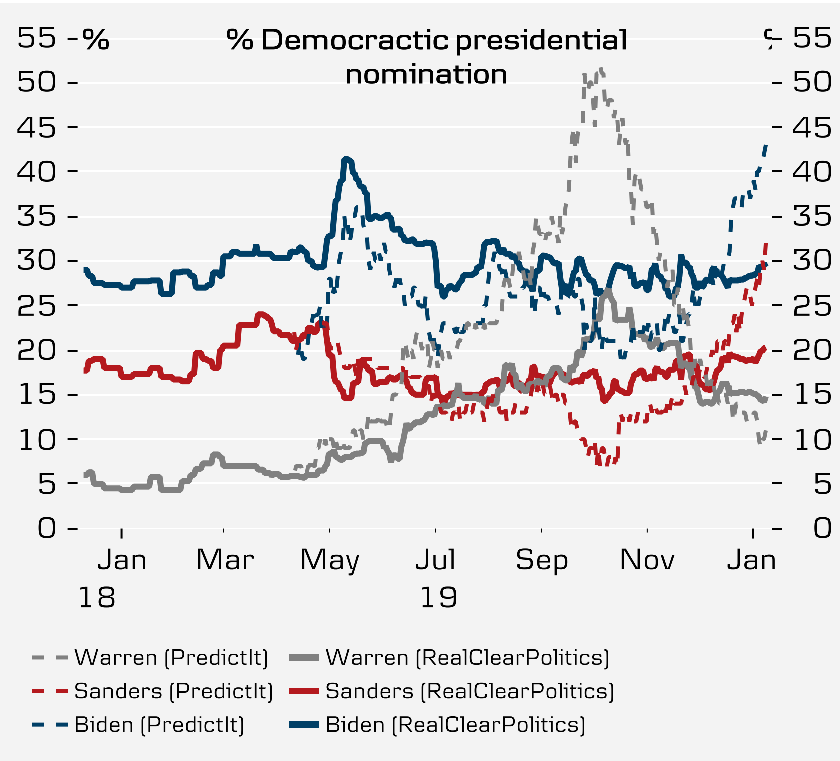


Source: RealClearPolitics, Macrobond Financial

Danske Bank

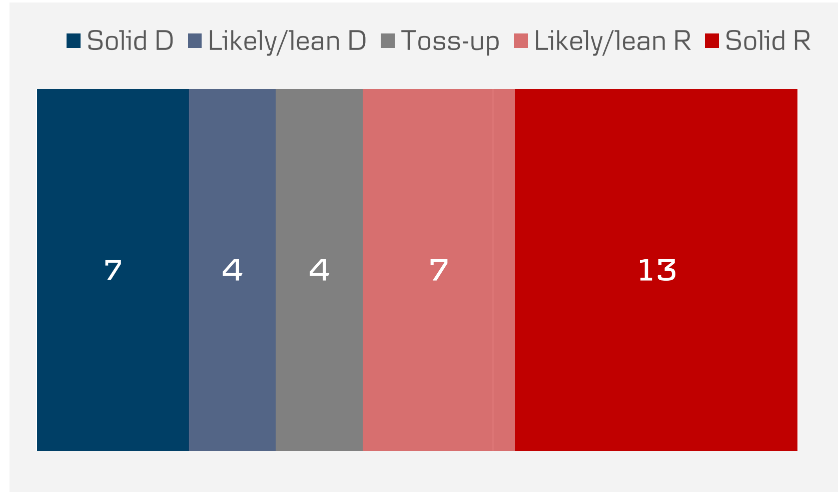
What really matters: limited market reaction if Congress remains divided (our base case)

Joe Biden favourite to win Democratic nomination

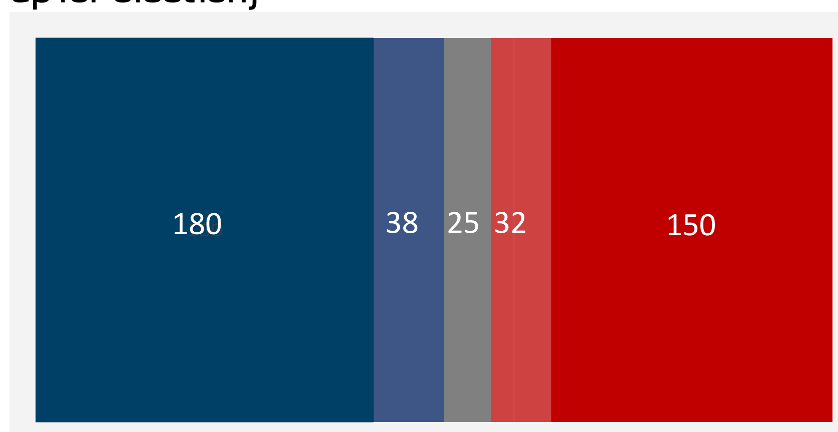


Source: RealClearPolitics, PredictIt, Bloomberg, Macrobond Financial

Republicans are favourites to keep control of the Senate (35 seats up for election)



Democrats likely to retain the House (all 435 seats up for election)



Source: 270towin.com, FiveThirtyEight

Phase one deal marked a de-escalation, focus turns to phase two

- After 1½ years of trade war, a US-China **phase one deal will be signed on 15 January** in Washington.
- Attention will quickly **move to phase two talks**. These will be more difficult as the most thorny issues have been left for this phase (see box).
- The phase two talks are **to be discussed in Beijing** between Donald Trump and Xi Jinping at some point in future (according to Trump tweet).
- US Treasury Secretary Stephen Mnuchin has stated phase two could be done in stages and the two sides might work on **phase 2A, phase 2B etc**.
- Trump has suggested the talks **could continue until after the US November election**. However, given the only limited tariff roll-back in the phase one deal, we expect that China will be eager to close at least a partial phase two deal by the end of H1.
- Alongside the trade talks **US tech protection** and restrictions on Chinese investments into the US are likely to continue. Decoupling has started.

What is in the phase one deal?

- China to buy US goods of extra USD200bn over next two years (agriculture, energy etc.)
- More protection of intellectual property rights
- Ban on forced technology transfer
- Further Chinese opening-up in financial services
- Currency agreement
- Dispute resolution (enforcement mechanism)
- US roll-back of tariffs from 15% to 7½% on goods worth USD120bn

What is on the table in a phase two deal?

- China's industrial policies (subsidies, Made in China 2025 etc.)
- Equal treatment of US and Chinese companies in Chinese market, hence removal of non-tariff barriers
- Further Chinese opening-up in areas such as internet, data and overall service sector
- More roll-back of tariffs
- Enforcement mechanism

We look for a partial phase two deal in H1 20

What will determine if we get a phase two deal?

US election polls. If polls are against Trump ahead of the November election, he may be more willing to compromise and make a deal that adds extra fuel to stock markets and economic sentiment. Currently he looks weak in several important swing states such as Pennsylvania and Michigan. He can only afford to lose 35 electoral votes (EV) compared with the 2016 election. It takes 270 EVs to win the election, Trump won 304 in 2016.

US economy. Similarly, if the US economy loses further momentum, Trump might choose to make a bigger phase two deal to add tailwind to growth.

China 'reformers' vs. 'hardliners'. We believe China is quite firm on how far it will go. When talks broke down in May 2019, China stated there were 'red lines' and that only 80% of US demands could be met. The balance between 'reformers' and 'hardliners' in China will also be important for how much China will move to close a deal.

US willingness to ease export controls. If the US sticks to tough restrictions on tech exports, China will be less willing to meet US demands.

Trump approval rating in 'swing states'

State	Trump net approval rating	Change since Trump took office, points	Electoral Votes in state	
Florida	1		29	
Pennsylvania	-7		20	
Ohio	-5	-19	18	Farm state
Michigan	-14	-22	16	Auto state
Georgia	-3		16	
North Carolina	-1		15	
Virginia	-7		13	
Arizona	-4		11	
Wisconsin	-14	-20	10	Farm state
Minnesota	-13	-17	10	Farm state
Colorado	-15		9	
Iowa	-13	-21	6	Farm state
Nevada	-7		6	
New Hampshire	-16		4	
Maine	-14		4	

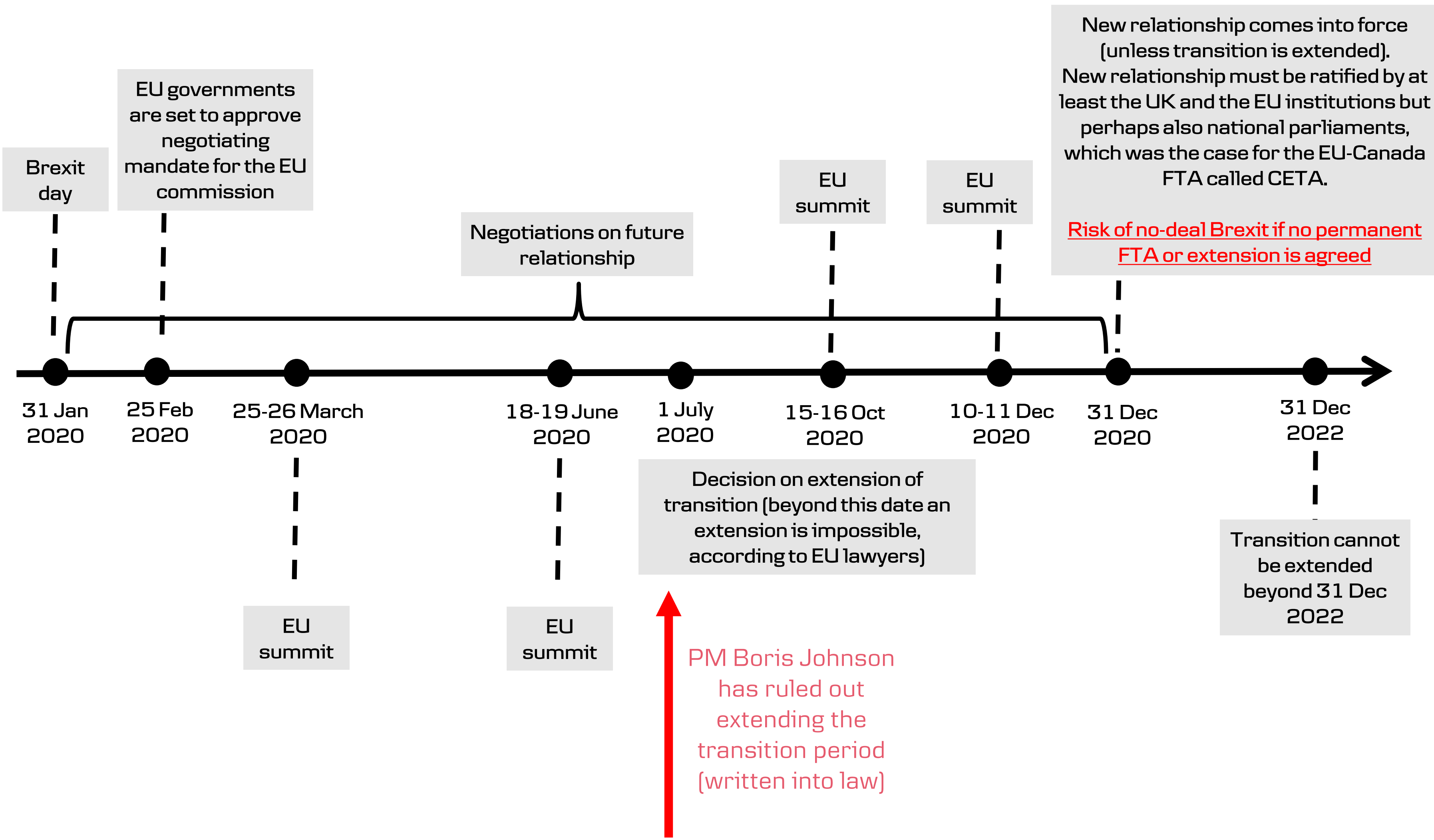
Source: https://morningconsult.com/tracking-trump-2/

What we expect

- Higher than 50% chance of phase 2A deal in H1 adding a few more things to the phase-one deal.
- China is unlikely to meet US demands to dial down industrial policies significantly.
- We see a less than 50% chance of a material new escalation of the trade war in 2020.
- We see a risk of a US car tariff on the EU if polls in the auto state Michigan continue to be weak.

Danske Bank

The UK and the EU27 are set to agree on only a limited FTA by 31 December 2020 – but a no-deal Brexit risk still looms



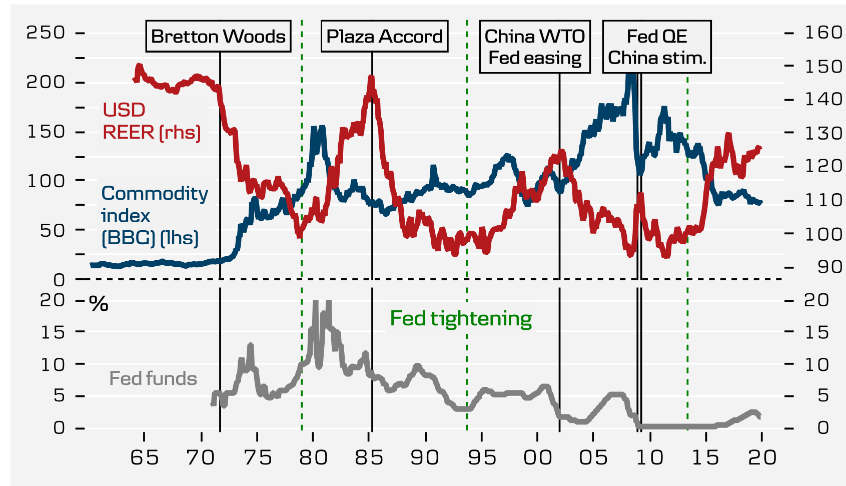
Source: Danske Bank

Danske Bank

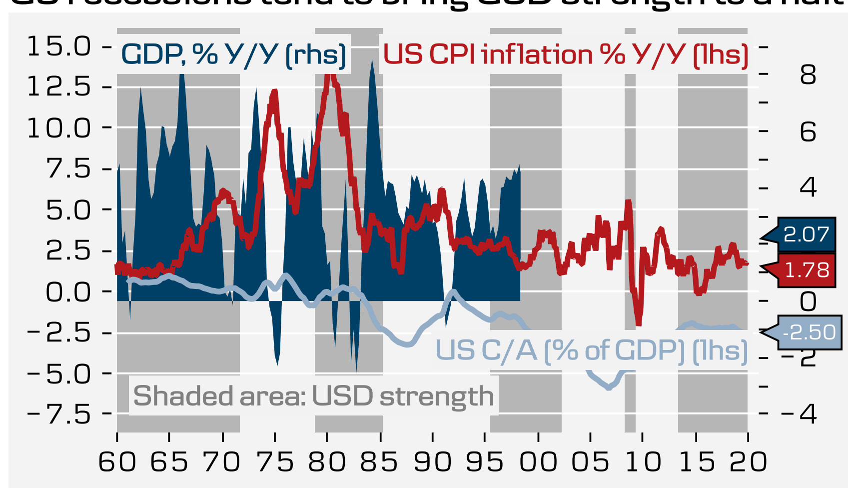
The broad USD is unlikely to weaken significantly in 2020

- Broad US dollar cycles tend to last – and in our view, we are **set to remain stuck in a cycle of continued USD strength** this year.
- The investment environment is set by an investor **preference for US assets**, a **high US current-account deficit**, and **elevated USD carry**. Coupled with **Chinese deleveraging**, this has supported USD in recent years.
- USD appreciation cycles have historically ended in the wake of: (1) a US recession, (2) a political agreement to weaken the USD, and/or (3) a change to global supply chains. **A US recession is currently the most likely of these scenarios, but it is not our base case.**
- In 2020 **the Fed is unlikely to erode USD carry significantly** and the moderate cyclical recovery we envisage is not enough to send USD markedly lower. We see EUR/USD caught in range near term, edging towards 1.15 in 12M.

USD cycles are persistent by nature



US recessions tend to bring USD strength to a halt



Source (both charts): Macrobond Financial, Danske Bank.
Past performance is not a reliable guide to future returns. Note that it is not possible to invest directly in an index.

No, technical factors and the economic outlook remaining too weak do not support it

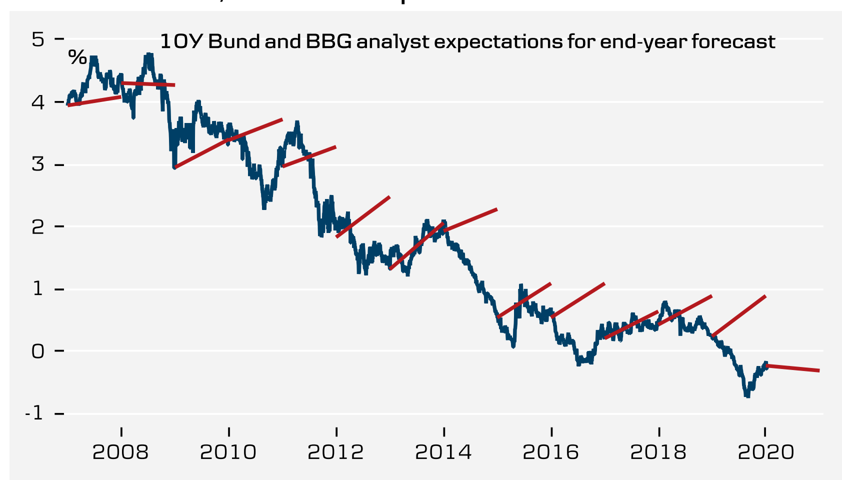
- In 2020, we expect rates to remain in a relatively tight range through the year while acknowledging a mild upside risk.

- On previous occasions, the economic outlook at the start of the year has supported higher rates, however, markets have each time been struck by negative news and technical drivers for lower rates. However, contrary to previous years, we do not see the economic backdrop being able to support a further strong sell-off (of summer-2019 levels). For a change, analyst expectations for yields suggest a small downside risk, according to Bloomberg data.

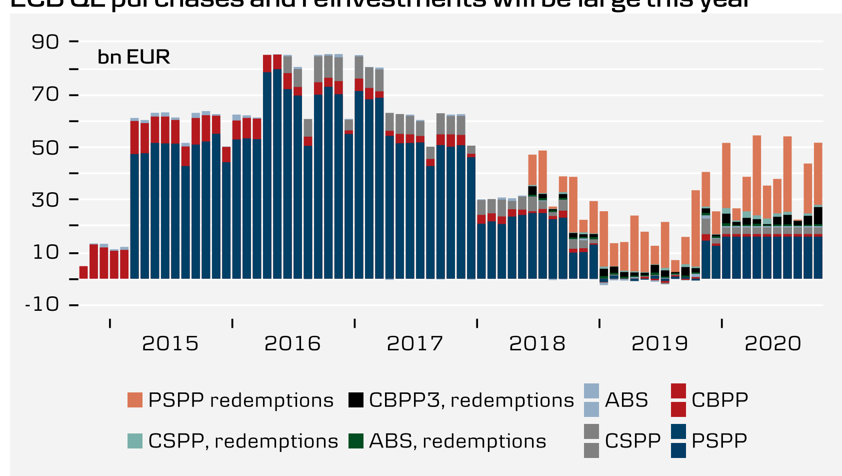
- ECB net purchases and reinvestment needs, plus less issuance for most euro area jurisdictions (see Guide to Q1 issuance and thoughts on supply in 2020, 1 January) will keep downward pressure on yields.

- As the ECB is expected to be on hold, front end yields will stay in a tight range this year, leading to steeper curves coming from the long end of the curve. However, this is a H2 20 story. Near term, we expect yields to remain relatively low as the 'muddling through' likely to be apparent from the economic data and global risk sentiment should support bond prices (lower yields).

For the first time, consensus expects lower rates



ECB QE purchases and reinvestments will be large this year



Source: ECB, Bloomberg, Macrobond Financial, Danske Bank
Past performance is not a reliable indicator of current or future results.

Danske Bank

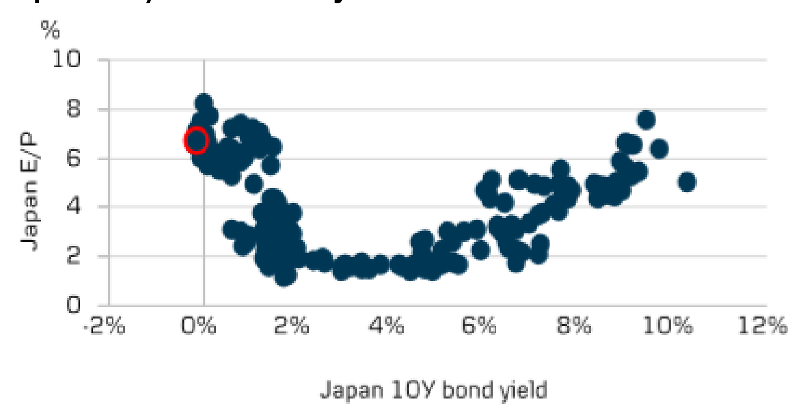
Upside for global equities limited amid highest valuations in 15 years

- The equity risk premium (ERP) is likely to stay flat in 2020 and hence equity returns should be in low single digits.
- A muted recovery, central banks on the sidelines and earnings growth of 2-4% mean that higher valuation through lower ERP is required in order to get high equity returns in 2020, but we argue that will not happen.
- Absolute valuation for global equities is at the highest level for 15 years (chart top right) but some argue that low yields support an even higher valuation for equities.
- We argue that yields sub 2% mean investors start to require higher ERP (chart low right). Looking at historical data and adjusting the valuation for the current yield level actually suggests that valuation should be higher and not lower given the current level of yields. That is why we think ERP will stay flat in 2020.

12-month forward global price earnings

Source: Refinitiv

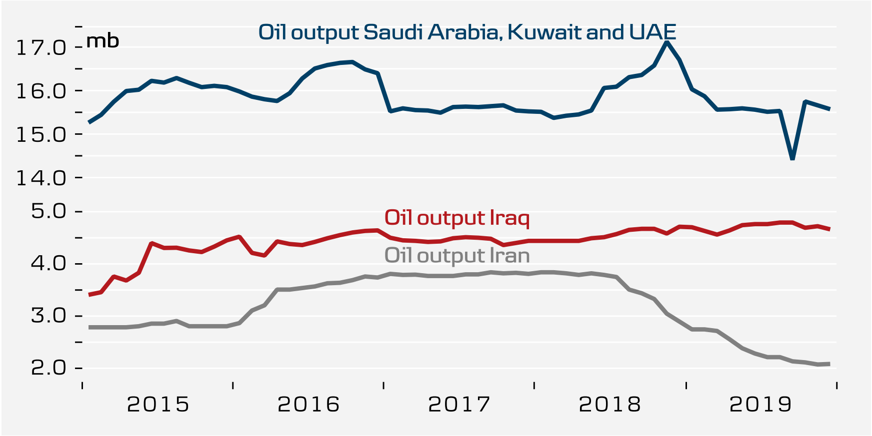
Japan – E/P vs bond yields 1973-2019

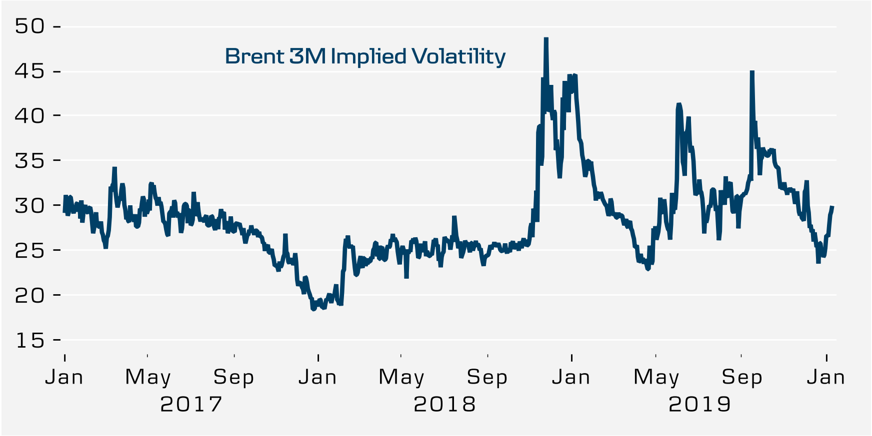


Source: Refinitiv

There would have to be a significant escalation of the Middle East crisis to send oil prices sharply higher this year

- Since September, the oil market has experienced two significant geopolitical shocks triggering sharp oil price shocks.
- Both times calm in the oil market was quickly restored as the shocks did not have lasting effects on world oil supplies.
- While the conflict between the US and Iran will probably continue to flare up momentarily during 2020, we think it will take a significant escalation to send prices higher.
- 1) Iran's output is already severely depressed by sanctions, 2) sanctions on Iraq are easier said than done (most of its exports go to China and India, 3) Saudi Arabia, Kuwait and UAE can swiftly raise output by more than 1.5mb/d and 4) US (and other major oil importers) have large strategic reserves they can utilise to mitigate a sudden output loss.
- Implied volatility in the oil market remains low compared to the spike around the September attack on Saudi Arabia and previous OPEC meetings.
- We forecast an average Brent price of USD60/bbl this year as supply remains strong and demand is depressed by a strong USD.





Source: Bloomberg, Macrobond Financial

Disclosures

This research report has been prepared by Danske Bank A/S (‘Danske Bank’). The authors of this research report are listed on the front page.

Analyst certification

Each research analyst responsible for the content of this research report certifies that the views expressed in the research report accurately reflect the research analyst’s personal view about the financial instruments and issuers covered by the research report. Each responsible research analyst further certifies that no part of the compensation of the research analyst was, is or will be, directly or indirectly, related to the specific recommendations expressed in the research report.

Regulation

Danske Bank is authorised and subject to regulation by the Danish Financial Supervisory Authority and is subject to the rules and regulation of the relevant regulators in all other jurisdictions where it conducts business. Danske Bank is subject to limited regulation by the Financial Conduct Authority and the Prudential Regulation Authority (UK). Details on the extent of the regulation by the Financial Conduct Authority and the Prudential Regulation Authority are available from Danske Bank on request.

Danske Bank’s research reports are prepared in accordance with the recommendations of the Danish Securities Dealers Association.

Conflicts of interest

Danske Bank has established procedures to prevent conflicts of interest and to ensure the provision of high-quality research based on research objectivity and independence. These procedures are documented in Danske Bank’s research policies. Employees within Danske Bank’s Research Departments have been instructed that any request that might impair the objectivity and independence of research shall be referred to Research Management and the Compliance Department. Danske Bank’s Research Departments are organised independently from, and do not report to, other business areas within Danske Bank.

Research analysts are remunerated in part based on the overall profitability of Danske Bank, which includes investment banking revenues, but do not receive bonuses or other remuneration linked to specific corporate finance or debt capital transactions.

Financial models and/or methodology used in this research report

Calculations and presentations in this research report are based on standard econometric tools and methodology as well as publicly available statistics for each individual security, issuer and/or country. Documentation can be obtained from the authors on request.

Risk warning

Major risks connected with recommendations or opinions in this research report, including as sensitivity analysis of relevant assumptions, are stated throughout the text.

Expected updates

Ad hoc.

Date of first publication

See the front page of this research report for the date of first publication.

General disclaimer

This research report has been prepared by Danske Bank A/S. It is provided for informational purposes only and should not be considered investment advice. It does not constitute or form part of, and shall under no circumstances be considered as, an offer to sell or a solicitation of an offer to purchase or sell any relevant financial instruments (i.e. financial instruments mentioned herein or other financial instruments of any issuer mentioned herein and/or options, warrants, rights or other interests with respect to any such financial instruments) ('Relevant Financial Instruments').

The research report has been prepared independently and solely on the basis of publicly available information that Danske Bank considers to be reliable. While reasonable care has been taken to ensure that its contents are not untrue or misleading, no representation is made as to its accuracy or completeness and Danske Bank, its affiliates and subsidiaries accept no liability whatsoever for any direct or consequential loss, including without limitation any loss of profits, arising from reliance on this research report.

The opinions expressed herein are the opinions of the research analysts responsible for the research report and reflect their judgement as of the date hereof. These opinions are subject to change and Danske Bank does not undertake to notify any recipient of this research report of any such change nor of any other changes related to the information provided herein.

This research report is not intended for, and may not be redistributed to, retail customers in the United Kingdom or the United States.

This research report is protected by copyright and is intended solely for the designated addressee. It may not be reproduced or distributed, in whole or in part, by any recipient for any purpose without Danske Bank's prior written consent.

Disclaimer related to distribution in the United States

This research report was created by Danske Bank A/S and is distributed in the United States by Danske Markets Inc., a U.S. registered broker-dealer and subsidiary of Danske Bank A/A, pursuant to SEC Rule 15a-6 and related interpretations issued by the U.S. Securities and Exchange Commission. The research report is intended for distribution in the United States solely to 'U.S. institutional investors' as defined in SEC Rule 15a-6. Danske Markets Inc. accepts responsibility for this research report in connection with distribution in the United States solely to 'U.S. institutional investors'.

Danske Bank is not subject to U.S. rules with regard to the preparation of research reports and the independence of research analysts. In addition, the research analysts of Danske Bank who have prepared this research report are not registered or qualified as research analysts with the NYSE or FINRA but satisfy the applicable requirements of a non-U.S. jurisdiction.

Any U.S. investor recipient of this research report who wishes to purchase or sell any Relevant Financial Instrument may do so only by contacting Danske Markets Inc. directly and should be aware that investing in non-U.S. financial instruments may entail certain risks. Financial instruments of non-U.S. issuers may not be registered with the U.S. Securities and Exchange Commission and may not be subject to the reporting and auditing standards of the U.S. Securities and Exchange Commission.

Report completed: 10 January 2020, 17:32 CET
Report first disseminated: 13 January 2020, 06:00 CET