Danske Bank
Quarterly House View Autumn 2019

A vital vitamin infusion for the global economy – and your portfolio

Right now, central banks are keeping growth and equity markets afloat – assisted by consumers. Despite a minor tsunami of uncertainties washing over the world, we still see a decent return potential in equities, though the value of bonds in your portfolio is difficult to overestimate at the moment, even if yields are at historical lows.

Danske Bank

Two women on a bench in China. The escalating trade between the US and China is absolutely the biggest threat to the global economy and the financial markets.

Bumpy road ahead

Accommodative monetary policy and solid consumption are lifelines for the global economy and your investments now that the trade war has escalated. While we continue to see a potential in equities, bonds play an essential role in portfolios at the moment.

If there is one thing that investors have learnt in recent months, it is how quickly the world can change. Investors have been forced to adapt on a near daily basis to the latest reports and events from the political, geopolitical and economic spheres; the US-China trade war, Brexit uncertainty, conflict in the Strait of Hormuz, tensions in Kashmir, protests in Hong Kong, the threat of an Argentinean default, the inversion of the US yield curve, and more – not to mention a steady stream of economic figures and central bank announcements that have to be digested.

So while we still see a reasonable return potential in equities compared to other asset classes, there is no doubt that the road ahead will be bumpy – and the trade war is by far the biggest bump of them all.

Just as we thought a ceasefire was falling into place over the summer, Donald Trump fired off a new tweet announcing further tariff hikes on Chinese goods totalling USD 300 billion from 1 September – the Chinese response was to stop buying US agricultural goods.

So how did Trump react to this serious escalation in trade hostilities? He postponed the additional tariffs on selected Chinese goods, such as mobile phones and laptops, in order to rescue Christmas shopping for US consumers...just for China to warn of new increases in Chinese tariffs on US goods last week, whereby Donald Trump promptly reciprocated with further tariffs on Chinese goods. In ▸▸

Nevertheless, we remain convinced that the global economy, despite everything, is still moving in the right direction below the choppy surface waters – even though uncertainty is definitely much greater than six months ago.

By Lars Skovgaard Andersen, senior strategist at Danske Bank.

Expected return from global equities of

4-6%

over the coming 12 months in local currency.

↑ Overweight in equities

↓ Underweight in bonds

addition, Donald Trump now wants US companies to stop producing goods in China.

Trade war developments show with great clarity how quickly and unpredictably things can change, with every shift and announcement currently resulting in new upturns or downturns in the financial markets. Nevertheless, we remain convinced that the global economy, despite everything, is still moving in the right direction below the choppy surface waters – even though uncertainty is definitely much greater than six months ago. We are therefore maintaining a slight equity overweight in our portfolios and a similar underweight in bonds.

Trade war is unfortunately not just a bilateral issue

As mentioned, the trade war in particular is a threat to economic growth, and as things look right now, we would not expect a trade deal between the US and China to materialise until at least next year – and probably not until after the US presidential election in November 2020.

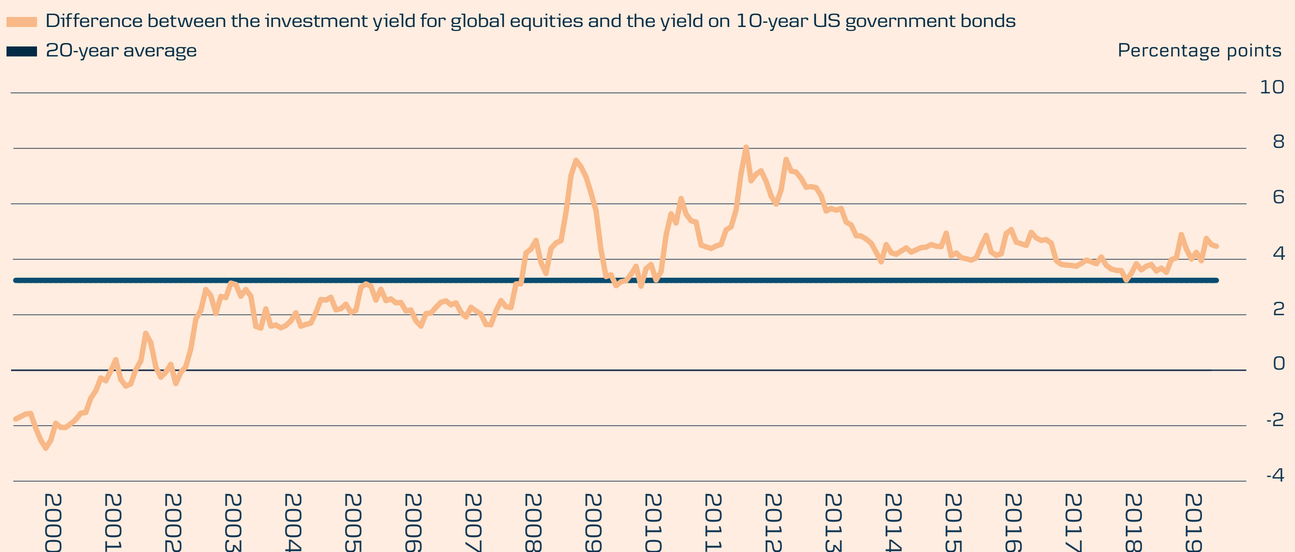
As things look right now, we would not expect a trade deal between the US and China to materialise until at least next year – and probably not until after the US presidential election in November 2020.

Until then, the steeper tariffs that the US and China have slapped on each other's goods will result in higher costs for both companies and consumers, weaken the manufacturing sector and have a negative impact on both business confidence and the corporate world's appetite for investment.

And unfortunately the trade war is not just a bilateral issue between the US and China. Lower levels of growth in China have hit China's demand for goods from European exporters, so the trade war is a global concern that has resulted in downgrades to expected future growth around the world.

Still decent earnings from equities relative to bonds

In order to better compare investments in equities with bond yields, we can convert corporate profits into a so-called investment yield that shows earnings per share in per cent. This investment yield can then be compared with the bond yield – and here the earnings yield for global equities is at a decent level relative to the yield on 10-year US government bonds. The graph below shows developments in the difference between the two yields.



Source: Macrobond for the period 01.07.1999-01.07.2019.

In addition to the accommodative monetary policies of the central banks, consumers are keeping up steam in the global economy.

Consumers and central banks keeping economy afloat

The good news is that private consumption and the service sector are still in fine fettle and supporting the economy. In both the US and Europe, consumers comprise the most important source of support for economic growth, but if the slowdown in manufacturing deteriorates further, companies might be prompted into cutting back on new hires – or at worst begin to fire employees – and that would undermine consumption. We are already seeing nascent signs of this in Germany.

For now, though, we assess the labour market to be strong enough overall to continue to support the economy. High levels of employment, rising wages and low inflation are a solid combination.

Moreover, the trade war and the slowdown in growth have persuaded central banks to change course, easing monetary policy instead of tightening:

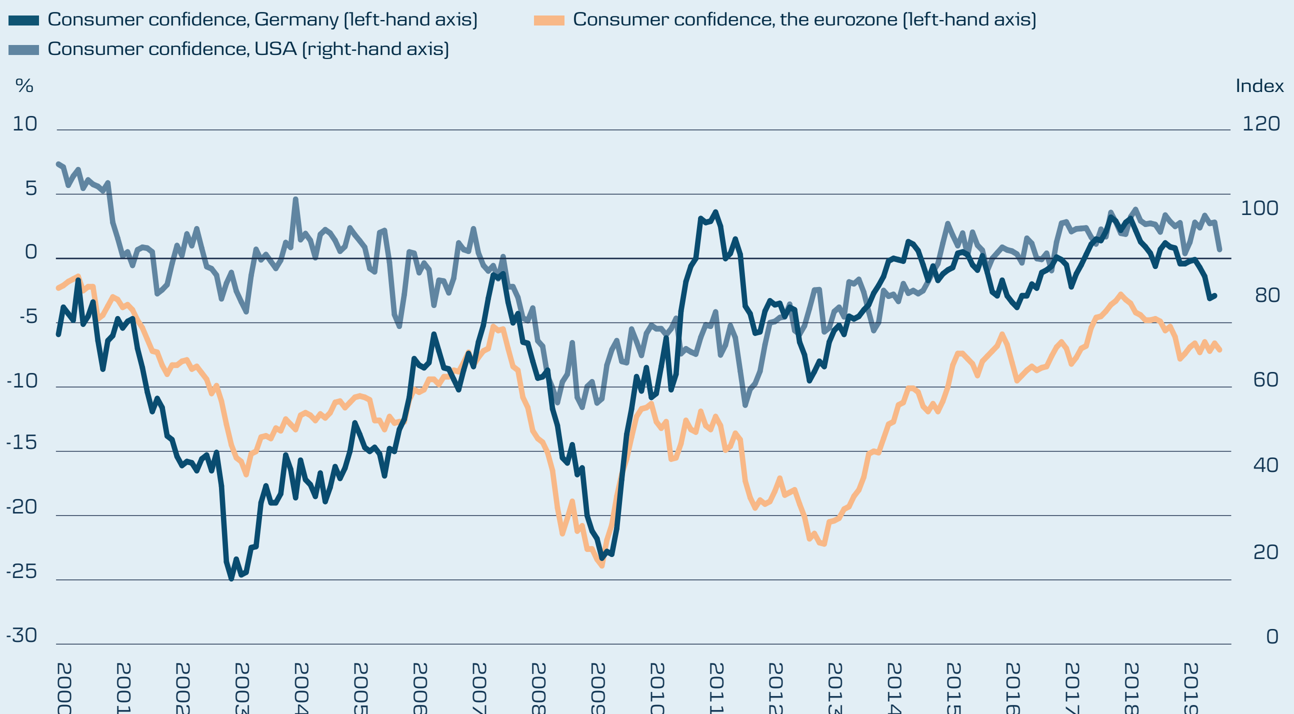
- In the US, the central bank, the Fed, lowered interest rates at the end of July, and we have pencilled in five more rate cuts in the coming year.
- In Europe, we look for a single rate cut from the European Central Bank this year plus a return to quantitative easing (bond buybacks).

Monetary policy stimulation from the central banks will thus be another factor that supports growth and corporate ▸▸

We assess the labour market to be strong enough overall to continue to support the economy. High levels of employment, rising wages and low inflation are a solid combination.

Consumer mood still buoyant

Consumption is an important driver for the global economy at the moment, and confidence indicators for consumers are still at decent levels, though we have seen some setbacks, especially in Germany.



'Source: Macrobond per 01.08.2019'

Popular protests in Hong Kong are dragging out, and are one of the political and geopolitical uncertainties we are focused on at the minute.

Bonds are the supplement that keep your portfolio strong and healthy and less vulnerable.

earnings. Figuratively speaking, central banks are right now providing a very essential vitamin infusion to the global economy – and hence also to our expectation that equities will continue to have greater potential than bonds. We currently do not envisage an imminent economic recession.

Maintain focus on equities, but don't forget bonds

The combination of solid private consumption, accommodative central banks and low or negative yields on bonds make us currently see more value in equity markets. However, as we have outlined, numerous uncertainties could push equity markets off course, and so we also have more modest return expectations than earlier this year. We expect a return of 4-6% over the coming 12 months.

Looking at bond markets, the prevailing low or negative yields mean a very modest return potential. Nevertheless, bonds currently constitute an extremely important component of a well diversified portfolio. Bonds are a stabilising element that provide a certain degree of security, and especially in uncertain times like these the value of this characteristic is difficult to overestimate. Just as the central banks' monetary policies provide a vital vitamin infusion for the global economy, bonds are the supplement that keep your portfolio strong and healthy and less vulnerable to the ups and downs that will continue to be the reality for investors in the time ahead.

What our strategist will be closely watching in the coming months

TRADE WAR: Will the US and China maintain the status quo, or will things develop for the better or worse? Will Donald Trump make good on his threats of a tariff war with Europe?

BREXIT: Deadline for Brexit is 31 October – what will Boris Johnson do, how tough will he be with the EU, will the UK hold new elections, and will the EU make any concessions for the UK? Expect another round of Brexit noise.

US ELECTION: The US presidential election campaign is heating up, with the race to be the Democrats' choice to face off against Donald Trump intensifying. At the last presidential election, political announcements on lower medicine prices hampered equities in the healthcare sector – could there be a repeat.

MONETARY POLICY: Mario Draghi, head of the European Central Bank, will be passing the baton to Christine Lagarde – could this have an effect on monetary policy in Europe? And what announcements and easing will there be from the central bank generally?

CONSUMPTION: Consumers are incredibly important for maintaining growth in the global economy at the moment – how is consumer data developing?

GERMAN FISCAL POLICY: Focus in Germany is increasingly turning to the options for fiscal policy easing to kick-start the economy, which is limping along. Will we see concrete initiatives, and will these reflect the talk of easing that supports the green transition.

ARGENTINEAN ELECTION: Argentina goes to the polls in October – will the new president work with the IMF to resurrect the ailing Argentinean economy? In August, fears of the opposite have triggered intense financial market jitters – there could be a repeat.

CLIMATE: The UN is holding a climate conference in New York in September ahead of the all-important World Climate Summit in Chile in December – can this further fuel the green transition and unlock the investment opportunities it potentially holds?

HONG KONG: Will the popular protests against China's influence on Hong Kong die down, or will the situation escalate further. Should the Chinese ultimately step in to curb the protests (which we do not expect), this could affect stability in the region, including Taiwan's appetite for closer relations with China in the future, and that could potentially have an effect on the financial markets.

ITALIAN POLITICS: The newly formed government decreases the chance of yet another autumn budget fallout with the EU. However, domestic political tensions remain, and the risk of new elections is still real. Remember, one can never be too certain about anything when it comes to Italian politics.

The yield curve inverting has spooked investors

The US yield curve inverted in mid-August, and historically an inversion has been one of the best indicators of an upcoming recession.

The yield curve shows the correlation between bond yields and maturities, and normally the curve rises – the longer the maturity, the higher the yield. In contrast to this normal state of affairs, an inverted yield curve is one where short yields (such as 2-year government yields) are higher than long yields (such as 10-year government yields). An inversion of the yield curve could be prompted by market expectations that the economy has reached a point where the Fed needs to stimulate again (which the Fed is in the process of doing) and the expected future rate cuts are first priced into long yields, which thus dip below short yields.

An inversion of the yield curve should not in itself give cause for panic and an equity sell-off. For if you attribute the inversion of the yield curve significance, then you must rightfully accept what follows and see how the economy and equities have actually reacted subsequent to previous yield-curve inversions.

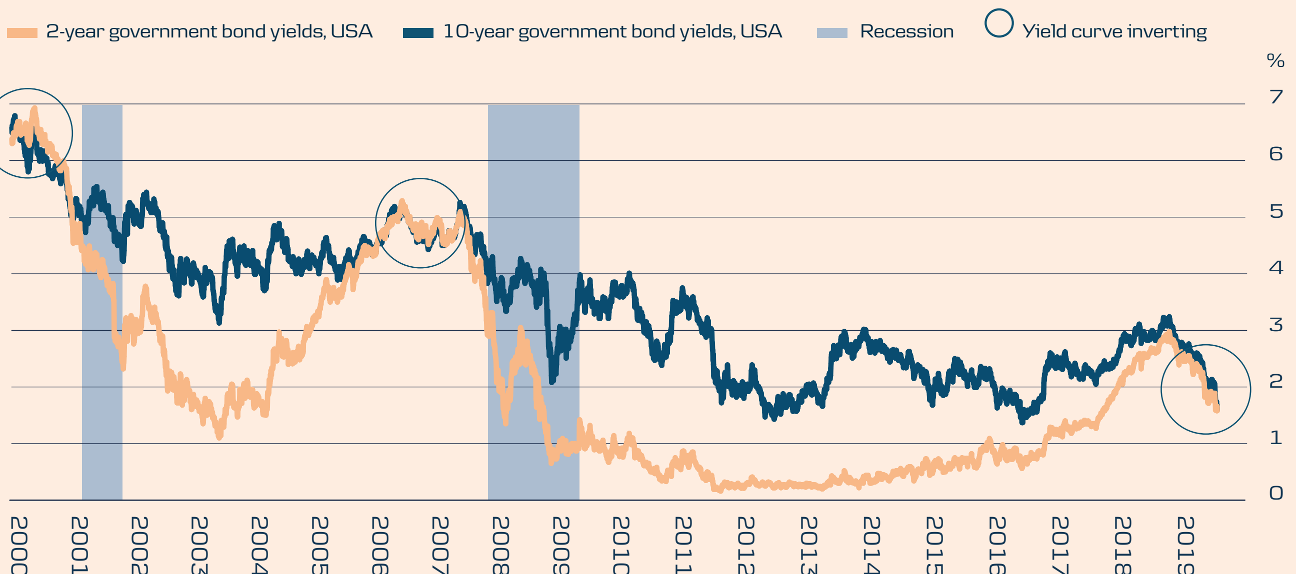
Here, there are two facts in particular we would highlight:

- Since the mid-70s, it has taken an average of 17 months from the yield curve has inverted until the economy slides into recession
- And even after the yield curve has inverted, equities have over the same time span only given a negative return in the following the 12 months in two out of seven cases, while the average return has been 14.1%.

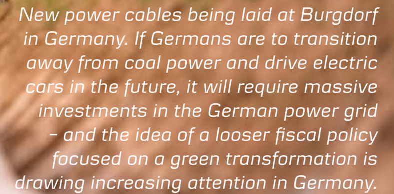
Looking at the bigger picture, it is also uncertain how much significance we should attribute to historical yield patterns. Remember that since the financial crisis in 2008-09 central banks have pursued monetary policies via means (quantitative easing) we have never seen before. Moreover, there is nothing in Danske Bank's models to indicate an imminent recession.

The US yield curve has inverted again

The last time long yields (10-year) were lower then short yields (2-year) was ahead of the financial crisis and prior to that in connection with the dot.com bubble.



Source: Macrobond for the period 03.01.2000-14.08.2019..



New power cables being laid at Burgdorf in Germany. If Germans are to transition away from coal power and drive electric cars in the future, it will require massive investments in the German power grid – and the idea of a looser fiscal policy focused on a green transformation is drawing increasing attention in Germany.

5 questions every investor should be asking

What will happen if the Chinese currency, the yuan, continues to be weakened?

Following the latest round of tariff hikes from Donald Trump, the Americans accused the Chinese of responding by letting their currency, the yuan, depreciate. The yuan weakening improves the competitiveness of Chinese companies, and so can to some extent absorb the negative impact of the trade war on the Chinese economy.

A further weakening of the yuan would probably act as a red rag to Donald Trump and prompt a stepping up of the rhetoric surrounding the trade war, which would increase overall uncertainty and could harm economies and equity markets – and force yields to fall further.

Donald Trump has threatened a currency war, where the Americans intervene in the FX markets to weaken the dollar, but his problem is that he would need the help of the US central bank, which he does not control – regardless of how much he would like to. Therefore, he would have to resort to the tools he has at his disposal, such as a further escalation of the trade war, even though it has not so far caused the Chinese to acquiesce to his wishes.

Could the economy bounce back?

Right now the global economy is weakening, and that should in our opinion be the starting point for investors in the immediate future. However, a US-China trade deal materialising sooner than expected would remove a major uncertainty factor and give the global economy a shot in the arm. Increased stimulation of the economy in China and a more accommodative fiscal policy in the US are other factors that could lift growth. Politics, in other words, is the name of the game.

Do central banks have enough tools in their tool chests?

Some investors are worried whether the Fed and the ECB have sufficient tools to extend the economic upswing. Clearly the Fed – and particularly the ECB – have less scope to cut interest rates than was the case with previous economic slowdowns. However, they also have the option of a new round of quantitative easing (QE); in other words, the central banks could buy up bonds to push down interest rates and send more liquidity into the markets.

The effectiveness of QE is open to debate: nevertheless, our assessment for the short term at least is that central banks have the necessary tools to stimulate the economy sufficiently – in part because central banks have in recent years regularly and successfully expanded the palette of monetary policy tools they can use, and they still have as yet unused tools to draw on.

Do fundamentals still essentially bode well for equities?

Corporate earnings growth has been mediocre in 2019, even though the latest reporting season saw a few positive surprises. Estimates for earnings growth in 2020 remain high, so the macro-economy failing to improve means we could risk these expectations having to be corrected. Central banks' accommodative monetary policies will be the decisive factor that could support economic growth and corporate earnings and thus avert any major disappointments. Looking at equity valuations, they are not cheap from a historical perspective, though in the prevailing low-yield environment they still look reasonably attractive relative to bonds.

Is there scope for a fiscal boost to the economy?

Yes, the politicians still have the option to stimulate growth through fiscal policy measures, such as tax cuts and public investment. We expect China to up its fiscal policy support for the economy in order to offset the negative effects of the trade war – but whereas the Chinese previously stimulated broadly, for example via huge public investments in construction projects that also benefited the exporters of goods and commodities to China, the Middle Kingdom is now more focused on stimulating domestic consumption. Hence, China's fiscal policy initiatives will not have the same positive spill over impact on the global economy as earlier.

In the US, the debt ceiling (a continually recurring theme) has been suspended for two years, meaning the door is open to the financing of fiscal policy growth measures if Donald Trump wants to go in that direction.

In Germany, the economic slowdown has intensified the debate on the potential for fiscal policy stimulation, so there is also a possibility here of fiscal support for the economy going forward – and this would be a strong joker for the European economy. Germany has a much lower government debt than the US and thus more elbow room to employ fiscal stimulation, but the Germans have not had need of it earlier, plus the Germans themselves have defined limits for how much their debt can grow. The question is whether there would be political support to loosen these limits.

Our current allocation

We are overweight US equities and underweight Japanese equities

We currently see the greatest return potential in US equities. We have seen how US equities have so far outperformed other equity markets when the trade war has escalated, plus consumption appears strongest in the US. This justifies the higher valuation on US equities relative to other markets, just as the higher valuation is also reflective of the US having more growth companies within technology, etc. Moreover, we expect higher corporate earnings growth in the US than in Europe and Japan in 2020, plus the Fed has more ammunition at its disposal than the other major central banks. We see less upside potential in Japanese equities, which are suffering from the lacklustre pace of economic growth in Japan and a central bank with limited room to manoeuvre. Furthermore, if Trump intensifies his focus on imported car tariffs, this will not only hit European equities but also Japanese. We are therefore continuing to underweight Japanese equities to offset our overweight in US equities.

No great potential in either Europe or emerging markets

The trade war is a black cloud hanging over both Europe and the emerging markets. Focusing on Europe first, growth has slowed further and Germany, which used to be the jewel in the crown of the European economy, looks particularly weak. The industrial and financial sectors weigh more heavily in Europe than in the US, and these sectors are suffering from the trade war and low interest rates, respectively – while on top of this comes Brexit, which means great uncertainty for UK equities. However, as a counterweight to these challenges, we expect a certain degree of support from ECB monetary easing, while the very low or negative yields on European bonds will tend to push investors towards European equities. Overall, we have a neutral weight in European equities. Emerging market equities, headed by China, have also been hit hard by the trade war, and we expect this will continue. While corporate earnings expectations have been lifted a little, uncertainty will loom large in the shorter term. That being said, China's stimulation of its economy is a supporting factor, and this is why we also have a neutral weight in emerging market equities.

Seek safety in bond markets

Investing in bonds would seem instinctively wrong when yields are so low or even negative, as they are at present. Yet bonds are a compelling necessity if you want a diverse portfolio and some degree of certainty in these uncertain times, and here it is especially high quality bonds – such as government bonds and investment grade corporate bonds – that add stability to portfolios. Investment grade bonds are, in our view, priced fair and can generate a reasonable excess yield relative to risk. Moreover, monetary policy easing by the Fed and the ECB as well as diminishing risk appetite may continue to increase demand for bonds, so there may be further minor price gains in the not too distant future. That being said, our assessment is that yields are close to bottom, though in the shorter term increased uncertainty could potentially push yields further down.

Emerging market bonds a better choice than high yield corporate bonds

While we are focused on security, we also have to investigate the opportunities for return in the bond markets – remember: no risk, no return. Our current assessment is that the riskier portion of bond investments in a portfolio should have an overweight in emerging market bonds at the cost of high yield corporate bonds, which right now give a historically low excess return relative to the most secure government bonds. Excess returns from emerging market bonds, which are primarily EM government bonds, are in our view comparatively more fair, even though the expected excess return of course comes with a risk. The trade war and a potential currency war could weaken emerging market economies and undermine government budgets. On the other hand, we expect that investors' continued search for return in the prevailing low interest rate environment will help support the asset class.

Consumer cyclicals is one of the sectors where we see greatest return potential at the moment – not least in the US.

Current allocations

Danske Bank expects that overweighted assets will outperform the market in general and that underweighted assets will underperform. With an overweight we therefore currently have a higher proportion of that asset in our portfolio than we expect to have over the long term, and with an underweight a lower proportion.

OVERALL ALLOCATION
Allocation by asset class

Asset class		Allocation
Equities	↑	Overweight
Bonds	↓	Underweight
Cash	→	Neutral weight

BONDS
Allocation within the asset class bonds

Bonds		Allocation
Local bonds	→	Neutral weight
Investment grade	↑	Overweight
High yield	↓	Underweight
Emerging market bonds	↑	Overweight
Global government bonds	↑	Overweight
Global inflation-linked bonds	↓	Underweight

EQUITIES - REGIONS
Regional allocation within the asset class equities

Region		Allocation
USA	↑	Overweight
Europe	→	Neutral weight
Emerging markets	→	Neutral weight
Japan	↓	Underweight
Denmark	→	Neutral weight

EQUITIES - SECTORS
Sector allocation within the asset class equities

Sector		Allocation
Consumer discretionary	↑	Overweight
Energy	→	Neutral weight
Financials/Real estate	↓	Underweight
Utilities	↑	Overweight
Industrials	↓	Underweight
IT	→	Neutral weight
Materials	→	Neutral weight
Consumer staples	→	Neutral weight
Healthcare	→	Neutral weight
Communication services	→	Neutral weight

Source: Danske Bank

Who are we?

Strategy & Macro | Danske Bank House View

Lars Skovgaard
Andersen
Senior strategist

Christian
Lie
Senior strategist

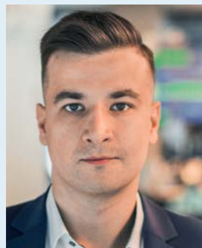
Kaisa
Kivipelto
Senior strategist

Maria
Landeborn
Senior strategist

Tuukka
Kemppainen
Senior Strategist

Sofie Manja
Eger Huus
Senior strategist

Anders Haulund
Vollesen
Strategist



Povilas
Stankevičius
Strategist

Always remember your risk as an investor:
This publication is based on Danske Bank's macroeconomic and financial market expectations. Deviations from our expectations could potentially affect the return on any investments negatively and result in a loss.

Danske Bank has prepared this material for information purposes only, and it does not constitute investment advice.

Always speak to an advisor if you are considering making an investment based on this material to establish whether a particular investment suits your investment profile, including your risk appetite, investment horizon and ability to absorb a loss.

Danske Bank A/S
Holmens Kanal 2-12
1092 Copenhagen K

Phone +45 33 44 00 00
CVR no. 61 12 62 28
danskebank.com