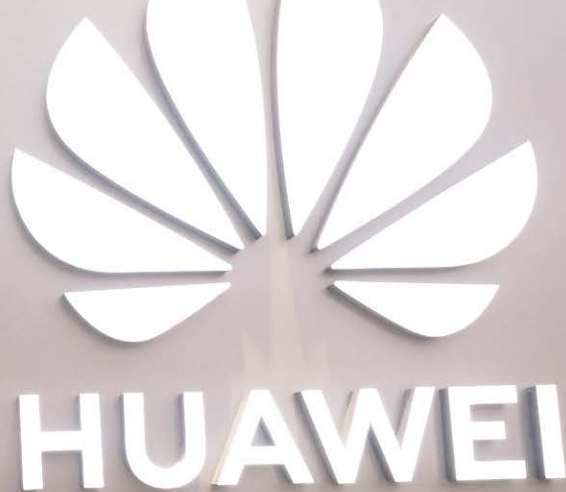




Danske Bank  
Quarterly House View Summer 2019

## *In the eye of the storm*

A single tweet from US president Donald Trump sent the financial markets into a tailspin, but it will not, in our view, choke the underlying growth in the economy and equity prices. The ongoing market turbulence has, however, nudged us into adjusting our approach to equities.



The trade war between the US and China is not only about tariffs. China's Huawei is now on the list of companies that may not have access to US technology without official approval, while Google has suspended part of its collaboration with the company, so future Huawei phones will, for example, not have access to YouTube or Gmail.

# Strategist: Equities will survive Trump's trade war

The escalation in the trade war between the US and China has effectively slammed the brakes on this year's upturn in global equity markets. But while uncertainty is currently high, we continue to see a fine return potential for equities in the slightly longer term.

All was fine and dandy for equity markets in 2019 until Donald Trump grabbed his phone on 5 May and fired off a tweet on new, higher tariffs on Chinese goods. Sino-US trade talks were progressing too slowly because the Chinese were running away from agreed deals, declared the US president, who wanted to ramp up the pressure on the Chinese.

Market sentiment immediately shifted from harmony to uncertainty,



*Storms do pass, and when the wind eventually drops we expect that equities will continue to offer the most attractive return potential.*

and that is where we have been since - in the midst of a storm where equity prices have risen and fallen on the back of the latest announcements from the US and China. Uncertainty has been further fuelled by tensions between the US and Iran, which are also affecting oil prices, a potential resurgence in the trade dispute between the US and Europe, although Trump delayed the battle to possibly the second half of this year, and a slowdown in several economic key figures of late. Meanwhile, Trump has now also threatened to slap tariffs on all goods from Mexico until illegal immigration to the US is halted.

The month of May has therefore seen many dramatic media headlines, significant equity volatility and falling yields as investors have sought sanctuary in the bond markets. We are in a state of crisis it would seem - but how bad are things actually?

### Look at returns

Until Donald Trump's infamous tweet, global equities were up almost 17% this year, and they have fallen 6% (in local currency) since then. Hence, ▶▶



By Lars Skovgaard Andersen, senior strategist at Danske Bank.

Expected return from global equities of

**4-7%**

over the coming 12 months in local currency.

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↑ Overweight in equities

↓ Underweight in bonds



*Both the European Central Bank in Frankfurt (photo) and the US central bank have signalled rate hikes are still some way off, which puts a supporting hand under the economy. Actually we are increasingly likely to see an interest rate cut in the US.*

2019 has still generated a very decent return despite the storm that has swept through the financial markets in the past month.

Moreover, storms do pass, and when the wind eventually drops we expect that equities will continue to offer the most attractive return potential. That is why we are maintaining a slight

overweight in equities in our portfolios and a matching underweight in bonds.

It is also worth remembering back to the final quarter of 2018, when everything was up in the air in the financial markets and investors feared the worst, yet just a few months into 2019 we had regained the lost ground and were looking ahead with renewed

optimism – which underlines just how quickly market sentiment can shift when the storm blows itself out.

#### **Investors reacted as expected**

That the escalation in the US-China trade war created uncertainty and subsequently a fall in equity prices was quite natural. Expectations of an ▶▶

## ↗ What could pull equity prices higher?

- ↑ **STRONG CONSUMERS:** The outlook for consumers looks solid, as unemployment is continuing to fall in the US and Europe, while wages are rising – though not fast enough to cause problems with inflation.
- ↑ **GROWTH IS WELL-BALANCED:** We are benefiting from reasonable economic growth rates that are, nevertheless, not strong enough for central banks to hike interest rates – and in our opinion that is a healthy economic climate for equities. Companies are also benefitting from the low interest rates, while investors need not fear interest rates rising.
- ↑ **RATE HIKES ON HOLD:** We are not expecting any interest rate hikes from central banks in the US or Europe in the coming 12 months. On the contrary, the outlook is for a further round of monetary policy stimulation via so-called TLTRO loans, which are loans to banks on favourable terms, and we are increasingly likely to see an interest rate cut in the US.
- ↑ **LOW, LONG YIELDS:** The escalation in the trade war has prompted investors to seek a safe haven in bonds, which is helping to keep long-term yields (10-year) at a low level in Europe and the US. This benefits the economy, which is stable without firing on all cylinders.
- ↑ **ECONOMIC STIMULATION IN CHINA:** The escalation in the trade war could cause the authorities in China to stimulate the economy further to keep growth stable. Whereas they previously mainly stimulated via investments in infrastructure, they are now increasingly focused on stimulating domestic demand. This is a step towards redirecting the economy towards being more consumer-driven.
- ↑ **POTENTIAL FOR SURPRISES:** Given the modest expectations for corporate earnings growth during the rest of 2019, there is a potential for positive surprises if economic growth can regain its momentum.

## ↖ And what could pull lower?

- ↓ **TRADE WAR COULD GET OUT OF HAND:** The worst case scenario is the trade war escalating sharply or the conflict dragging on for a long time – and this is currently the biggest risk for the economy and the financial markets. Both the Americans and the Chinese want to squeeze more concessions out of each other, and after the US expanded the dispute to include Chinese tech companies both trust and the negotiating climate have deteriorated.
- ↓ **OTHER POLITICAL RISKS:** The trade war is just one of the current political uncertainties. The trade dispute between the US and Europe could also flare up, while Brexit could again move centre-stage as we approach the new deadline for the UK to exit the EU in October this year. Furthermore, tensions between the US and Iran risk escalating.
- ↓ **RENEWED FEARS OF A RECESSION:** We are in the late phase of the economic cycle, and that could – as it did at times 2018 – trigger a new round of jitters about whether the upswing has finally petered out and the next recession is in sight.





Increased tensions in the Middle East between Iran and the US have created uncertainty in the oil market, and the US has sent the aircraft carrier USS Abraham Lincoln to the region.

imminent trade deal had been a major driving force behind the rise in equity prices this year.

However, we should remember that this was just one piece in the overall picture. Equities have also benefitted from central banks in Europe and the US postponing rate hikes until far into the future, the authorities' initiatives to stimulate the economy in China and a string of solid corporate earnings. Hence, when we look at the full picture, it still appears more positive than negative to us over the coming 12 months - though there is no doubt that the short-term outlook is more muddled than a month ago.

**Could get worse before it gets better**

Since the US raised tariffs in May from 10% to 25% on Chinese exports worth USD 200bn, the Chinese have responded in kind by raising tariffs to 25% on USD 60bn worth of US goods, and we risk more of these aggressive tit-for-tat actions before things get better. Moreover, the trade war is beginning to expand, so it is no longer only tariffs that are in focus. The Americans are, for example, blocking Chinese tech companies' access to US technology, while many US firms are finding it harder to do business in the Chinese market - with customs procedures taking longer and more time needed to obtain ▶▶

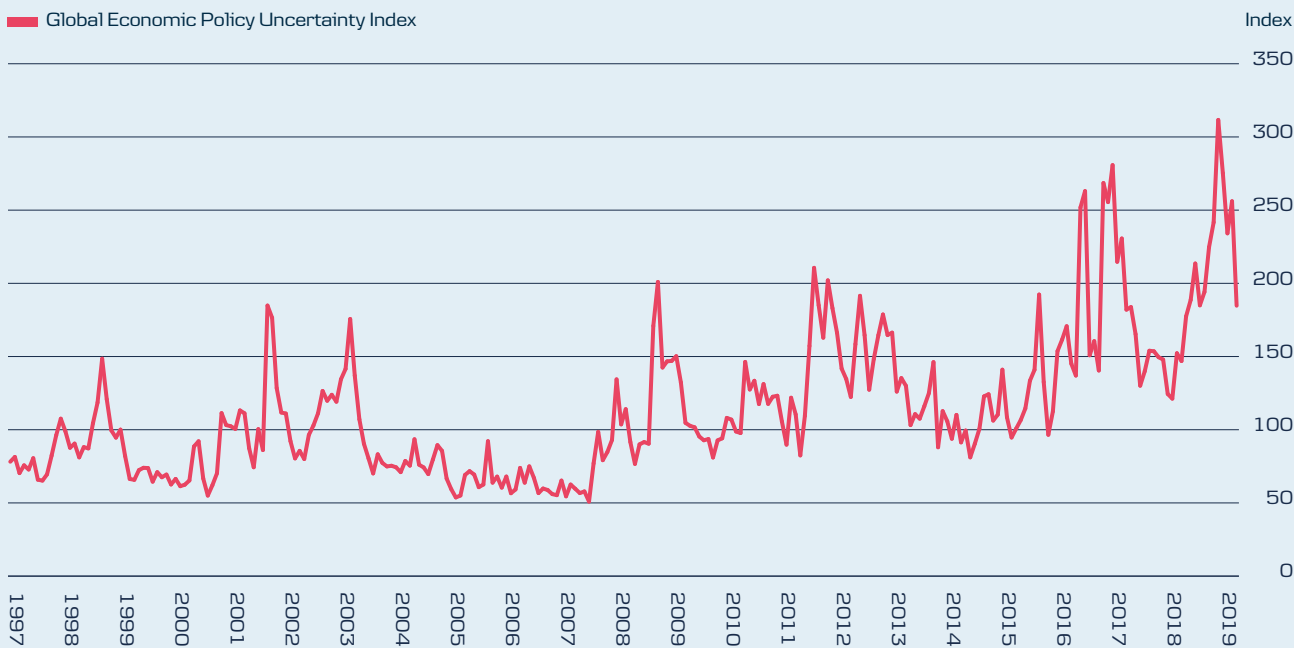


*Both countries are suffering on account of the trade dispute, so our main scenario remains that they will agree a reasonable deal in the next six months.*



*Global economic policy uncertainty can spike again*

Global uncertainty has recently been record-high, according to the so-called Global Economic Policy Uncertainty Index. The index data does not yet reflect the renewed trade war uncertainty, which can make it spike once again. The uncertainty index is prepared by a number of economists and students from US universities and is based on how much selected media write about economic policy uncertainty. The index goes back to the start of 1997 and has at no time been as high as lately - even during the financial crisis in 2008-2009 and the European debt crisis a few years later.



Source: Macrobond



*Overall, we see more factors pulling equities higher than lower, though there is a significant risk of further price volatility in the short term.*

necessary licences and approvals. Furthermore, the Chinese have hinted they might potentially stop selling rare earth metals, which are vital to the production of various IT equipment in the US.

The longer it takes to reach a deal, the more uncertainty can take hold of global growth and spoil the overall picture - and this is clearly a risk. Perhaps the two parties need to experience even more pain before they feel ready to make the necessary concessions. Negotiations appear to have hit a wall, and perhaps we will have to be much closer to the G20 summit in Japan in late June before the two nations feel impelled to return to the negotiating table. Donald Trump and the Chinese president, Xi Jinping may still meet and discuss trade during the G20 meeting.

Both countries are suffering on account of the trade dispute, so our main scenario remains that they will agree a reasonable deal in the next six months. Our main scenario is also one reason why we continue to see value in equity markets in the coming year and are maintaining a slight overweight.

**Potential drivers for equities**

We should also remember that the trade dispute continuing will increase the likelihood of central bank monetary policies remaining accommodative. Inflation is under control and we find it

difficult to envision any monetary policy tightening as long as the trade dispute remains unresolved. The greater uncertainty could, moreover, cause the Chinese authorities to stimulate the economy further to counter the negative impact of the trade war.

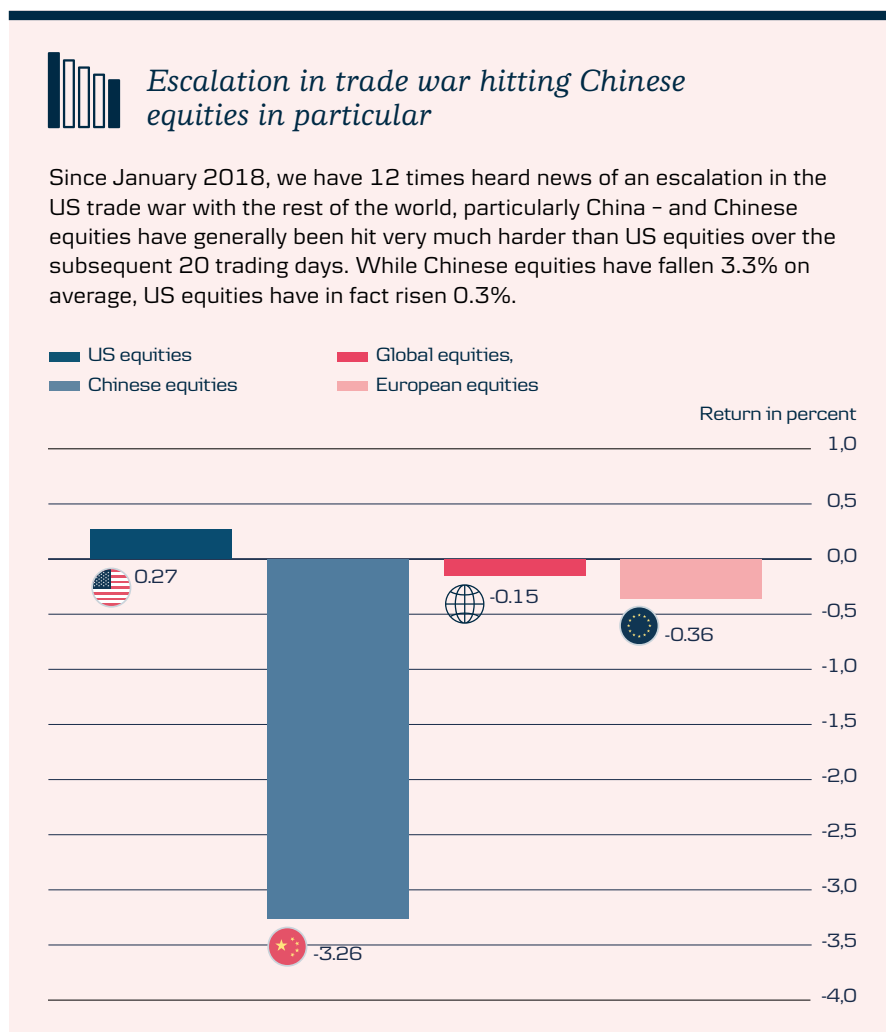
Looking at corporate earnings, they have generally surprised on the upside in the first quarter of the year, and this trend could continue if global growth remains intact. Should the trade war drag out, however, it could well hit the economy and corporate earnings.

equities higher than lower, though there is a significant risk of further price volatility in the short term. We expect global equities to produce a return of 4-7% in the coming 12 months, while our expectation of low interest rates for an extended period tends to make bonds less attractive than equities.

Nevertheless, bonds should still comprise an important component in any portfolio, as they help increase stability - and that is a very desirable quality, not least in turbulent times like these.

**Expect a return of 4-7%**

Overall, we see more factors pulling



Source: Macrobond, MSCI index, total return, local currency.



## Where we see the most attractive return potential

### Overweight in Europe – underweight in Japan

In the current situation, we see the greatest return potential in European equities. After an economic slowdown in Europe in 2018, the current weakness is already priced into equities, in our view. However, while we are seeing signs of stabilisation, a trade deal and more positive global sentiment are needed for economic momentum to pick up from current levels in Europe. Europe is often compared to Japan, which is suffering from very sluggish economic growth. However, we see several key differences in these economies and their equity markets. Structural growth in Europe remains higher, while lower government debt means more leeway for fiscal stimulation. In addition, the European Central Bank has more cards to play than Japan's central bank when it comes to monetary policy stimulation.

European stocks have higher dividend yields than Japanese stocks and Europe is, in fact, the highest yielding market among the major equity regions. In times of uncertainty, dividends can be a good source of income, and European

dividend yields are almost the same as yields on high yield bonds. Furthermore, we see corporate profitability in Japan as close to its peak, while European corporate profitability is both higher and still has more room to rise, in our view. Hence, our overweight in European equities is balanced by an underweight in Japanese equities.

### Focus on dividend stocks of good quality

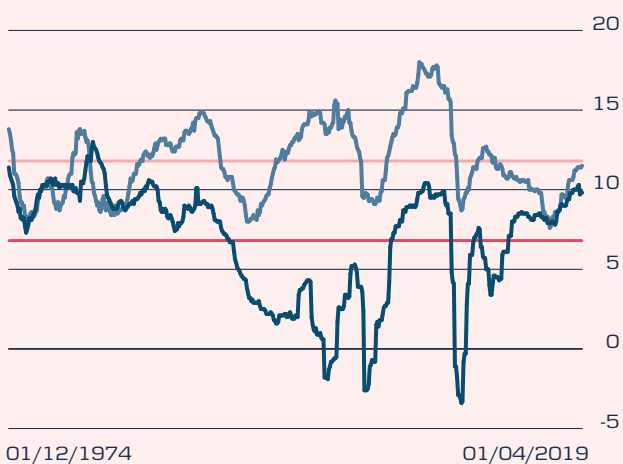
Uncertain times mean having the right equities is more important than ever. Investors typically seek safety in defensive sectors like utilities, consumer staples and health-care, but valuations here are relatively high at the moment compared to the equity market in general. So-called quality equities are another category that is typically robust during times of turbulence. These are companies that have stable earnings and modest debt, and we have had a lot of focus on quality equities in recent quarters, but these too are beginning to have high valuations. We are therefore leaning more towards dividend stocks, which also tend to be robust but at the same time have a more attractive return potential right now. We are particularly focused on dividend stocks of high quality – in other words, companies where we can continue to expect solid earnings and reasonable dividend payments, even if the economy heads south.

### Greater potential in European equities

While return on equity (ROE) for Japanese equities is considerably above the historical average, European equities lie slightly below their historical average. Companies' ROE typically peaks at the end of an economic upswing, so our expectation is that European equities still have some potential – and more than Japanese equities.

■ ROE, Japanese equities  
■ ROE, European equities  
■ Historical average, Japan  
■ Historical average, Europe

Return on equity (ROE) in per cent.



01/12/1974

01/04/2019

Source: Macrobond.

### Investment grade bonds are the solid middle way

Political uncertainty, worries about economic growth and accommodative central banks have reduced yields on government bonds to a minimum – and we continue to expect very low yields and hence very low returns for the rest of the year here. Given the current risks, we are at the same time reluctant to invest in high-yield bonds – in other words, bonds of low credit quality that tend to pay a higher return – as market volatility and uncertainty can have a profound impact on prices here. We are therefore maintaining our overweight in investment-grade bonds – ie, corporate bonds of high credit quality – as a solid middle way. These bonds should potentially give a better return than government bonds, but with a lower risk than high-yield bonds.

### Uncertainty casting a shadow over emerging markets

We have long been overweight in emerging market equities, but the escalation in the trade war has recently caused us to reduce our holding to a neutral weight – and likewise we also have a neutral weight in emerging market bonds. Higher tariffs and the risk of a further escalation in the trade war will hit many emerging market countries with a close trading relationship to China, for example, because they supply raw materials to the Chinese. This may put pressure on emerging market bonds and equities in the short term. Nevertheless, we still see an attractive potential here in the longer term due to the higher structural growth in emerging markets than in the developed markets.



*In May, Donald Trump postponed a potential increase in import tariffs on cars from Europe until the autumn. Generally speaking, the struggling European car sector seems to have started to put the worst behind it.*

# 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

Equities	↑	Overweight
Bonds	↓	Underweight
Cash	→	Neutral weight

## BONDS

### Allocation within the asset class bonds

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

## EQUITIES - REGIONS

### Regional allocation within the asset class equities

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

## EQUITIES - SECTORS

### Sector allocation within the asset class equities

Consumer discretionary	→	Neutral weight
Energy	→	Neutral weight
Financials/Real estate	→	Neutral weight
Utilities	→	Neutral weight
Industrials	→	Neutral weight
IT	→	Neutral weight
Materials	→	Neutral weight
Consumer staples	→	Neutral weight
Healthcare	→	Neutral weight
Communication services	→	Neutral weight





# Who are we?

Strategy & Macro | Danske Bank House View



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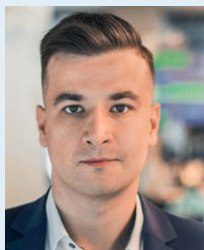
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**Always remember your risk as an investor:**

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