Danske Bank Asset Management
Quarterly House View Q4 2018
INSTITUTIONAL

Populism making its mark on the financial markets

The US president's political agenda carries an increasing risk of triggering a major crisis in the financial markets and could kill off the synchronous global upswing. Nevertheless, we see an attractive potential in equities – not least in Asia.

Danske Bank

The terms of Brexit remain unclear. Here, British street artist Banksy's graffiti involves the 12-star EU logo on a building in Dover.

Threats to the financial markets are mounting

A storm of political and geopolitical risks is circulating over the financial markets and has in 2018 skewed developments among equities, with emerging markets being left somewhat behind, in our view.

By Anders Svennesen, CIO, Danske Bank Asset Management

Trade wars, sanctions on Iran and Russia, crisis in Turkey, spiralling budgets in Italy – and not forgetting an increasing likelihood that British voters will have to return to the polls for a de-facto vote on Brexit.

A storm of political and geopolitical risks has swept in over the financial markets, and the winds are unlikely to abate in the coming months. Fundamentally, however, we assess these risks to be incapable – individually – of triggering a global recession. Nevertheless, the sum of these events has clearly increased the risk of a crisis that could potentially tip the global economy into a recession.

To top it all off, the US's political decisions on trade have pushed China to change the direction of its economic policy. The US is tightening monetary policy, China easing, and as a result the US dollar (USD) has strengthened, which presents a challenge to emerging markets in particular. Hence, we are in the midst of a synchronous global upswing, but given the divergence in economic policies we may soon find ourselves having to drop the word synchronous.

These times of high uncertainty are precisely when investors can benefit from having secure government bonds in their portfolio.

Trade war unlikely to threaten upswing

Countries like Turkey and Russia are in fact already experiencing economic hardships, while the trade war will undoubtedly slow global growth. That in itself can be more than sufficient to darken equity market sentiment, as investor uncertainty increases ▸▸

Expected return from global equities of

8-10%

over the coming 12 months in local currency.

↑ Overweight in equities

↓ Underweight in bonds

when growth falters. Uncertainty should initially materialise in lower confidence indicators, while hard economic data will subsequently confirm or refute these signals – and investors will then react accordingly.

As yet, however, we see no sign of a nascent recession in any of the major economies, though we still expect that growth has peaked and will slow this year and next.

China is and will be the country to keep an eye on as one of the main candidates for triggering a global crisis.

We estimate the trade war could potentially pare 0.2-0.5 percentage points off global growth over the coming 12 months but that the upswing will nevertheless remain intact. We are therefore maintaining our overweight in equities via our surplus of emerging market equities, though we would advise investors to check that portfolios are still aligned with their risk profile. These times of high uncertainty are precisely when investors can benefit from having secure government bonds in their portfolio.

More potential spanners in the works

At Danske Bank we have been cautioning since the start of the year that an economic regime shift is under way, with rising interest rates, increasing inflation and greater volatility. All of this was spawned by the robustness of the global upswing, which provided the perfect opportunity for central banks to normalise their massive quantative easing programmes that have kept the global economy and the financial markets buoyant since the financial crisis struck.

Efforts to normalise monetary policy are in full swing, though the number of potential spanners that could be thrown into the works has greatly increased in 2018.

This has prompted speculation and discussion about whether we can successfully shift from an economic regime of no inflation and ultra-low interest rates to a new regime of modest inflation and rising interest rates without a crisis to wipe the board clean.

Populism is the biggest risk

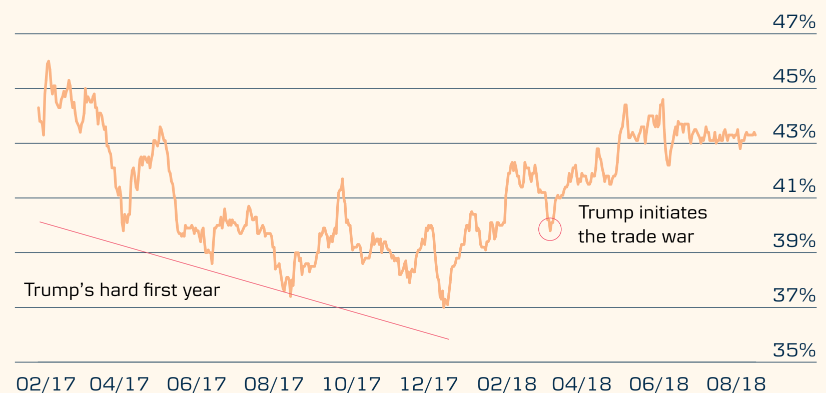
In our view the biggest risk to the financial markets is populism – and more specifically the US president, Donald Trump. Donald Trump's political agenda is to fulfil his election promises, which in itself is an admirable goal, but also entails an increasing risk of triggering a major crisis.

Donald Trump got a tax package passed at the end of 2017 that completely contradicts normal economic policy thinking and has further

Trade war a boon for Trump

For US President Donald Trump the ongoing trade war has been a winning cause on the domestic political stage. The share of voters who rate Donald Trump as doing a good job as president has risen since he initiated the trade war in March this year. We therefore expect he will fan the flames of the trade war at least until the US midterm elections on 6 November this year.

Share of voters who rate Donald Trump as doing a good job as president



During his first year as president Donald Trump received the poorest satisfaction scores ever for a US president – around 10 percentage points on average below Bill Clinton, who had the second-lowest rating.

Donald Trump initiated the trade war by imposing tariffs on steel and aluminium and has since added more targeted tariffs – especially on Chinese goods – to protect US companies and jobs.

Source: Macrobond (RealClearPolitics), 27.01.2017-16.08.2018

Even though the US labour market is experiencing full employment, the US government deficit is rising.

spurred growth and activity. In the middle of the US upswing, Donald Trump enacted the most significant easing of fiscal policy since the 1960s – and also the first pro-cyclical easing of fiscal policy since then. Normally an economy is stimulated to get things moving and not to shift it from fourth gear to sixth. Moreover, the tax package is not financed and the annual government deficit is projected to rise from 3.2% of GDP in 2016 to 4.7% in 2019 by the government's own budget office. If these estimates prove accurate, the US government deficit will be the biggest for an economy running at full employment since World War 2. When investors decide this is a problem, market turmoil will erupt.

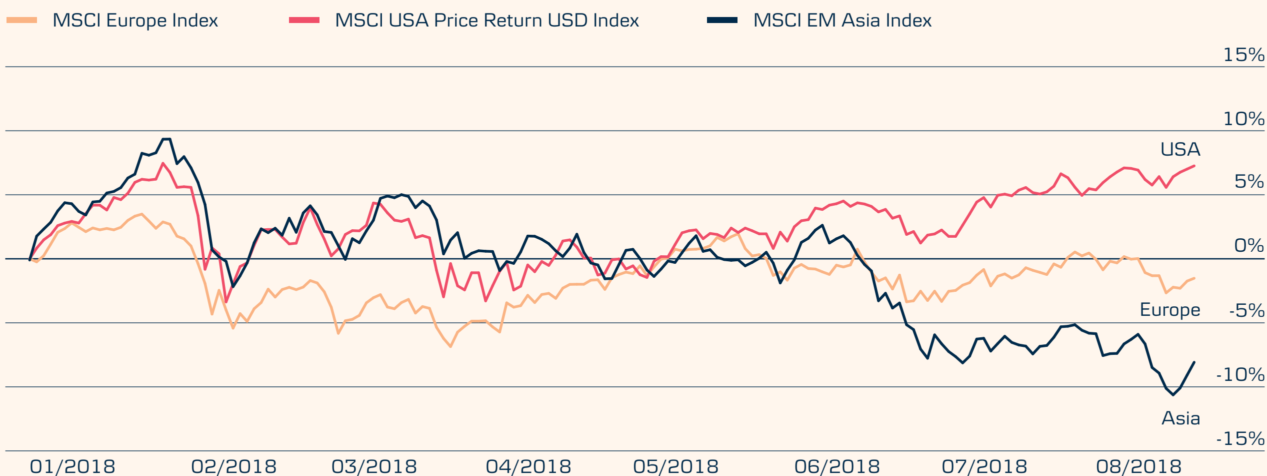
In addition, the high rate of economic growth may send inflation up faster than expected. The US economy has rarely been stronger than it is at present, and there are currently so many job vacancies in the US that all unemployed Americans could find work if they had the qualifications. This could force the US central bank, the Fed, to tighten monetary policy faster. However, doing so would likely create turmoil in the financial markets, which to date have bought into the expectation that the Fed would only tighten monetary policy gradually and potentially let the economy overheat to ensure inflation reaches target.

Trump's policies have a global impact

Beyond the US, Donald Trump's ▸▸

US equities in solo race

Equity markets in 2018 have been characterised by very diverging prices across different regions. While US equities have risen solidly, Asian equities have been hit hard, for example by the trade war, which has not yet had any noticeable effect on US equities. We expect to see a certain rebalancing between the markets at some point.



Source: Macrobond, price index, 01.01.2018-21.08.2018

stance on trade has forced other countries to change their economic approach, resulting in divergent global policies. Increased import tariffs are de facto fiscal tightening; someone has to pay, and ultimately there will be less money to spend on other things. To counter the negative impact on growth, China has shifted from tightening to easing monetary policy in order to support its economy against the negative effects of the trade war.

The Chinese authorities have long been focused on reducing credit growth and the risks associated with high levels of debt in the private sector, but they are now being forced to ease monetary policy, which could easily compromise any attempt to dampen credit growth.

Hence, we are in a situation where the Fed is tightening monetary policy while the Chinese are easing – a fundamental driver for the weakening of China's currency, the yuan, against the dollar. On top of this comes the relatively better outlook for growth in the US compared to the rest of the world, which is adding further strength to the dollar.

Dangerous combination of exchange rates and interest rates

The dollar has not only been strengthened against the yuan, but also against other emerging market currencies that more or less track the Chinese yuan – in Asia due to trade and competition between the countries, and also because China is a key buyer of commodities from other emerging markets. The combination of a strong dollar and rising global interest rates is not good for countries with a current account deficit and/or a high level ▸▸

Donald Trump's political agenda is to fulfil his election promises, which in itself is an admirable goal, but also entails an increasing risk of triggering a major crisis.

Three candidates for triggering a global crisis

There are currently numerous catalysts that could trigger a major or minor crisis. Apart from the ongoing political and geopolitical risks, we see three candidates that could trigger a global crisis when taking a deeper, more fundamental view.

1. Bond market bubble

The central banks' massive bond buyback programmes since the financial crisis have pushed the price of financial assets higher, while inflation on goods and services has been pushed ever lower. Yields are as such much too low and do not reflect the true risk of lending money to a particular debtor. True, yields have corrected in the US and better reflect the outlook for growth and inflation, but now the question is what yield investors will demand to carry on financing government spending given that the US government deficit is steadily rising.

2. Credit crisis in China

Levels of debt in China have exploded since the financial crisis and currently amount to 250% of GDP compared to 120% around 10 years ago. Hence, rising global interest rates increasingly constitute a risk factor for the Chinese economy. The government is aware of the problem and is trying to dampen credit growth, particularly among corporates.

3. Stretched US equity market

US equity valuations are at historical highs, inflated by seven years of accommodative monetary policy, which makes US equities a crisis candidate. Other forces than monetary policy have gradually taken over as drivers of the US equity market, which has helped justify the increase in prices and valuations. Not least among these is strong corporate earnings growth, modest inflation and robust economic growth. Yet the question still remains of whether the impressive price rises seen since the financial crisis are sustainable in the long term when growth really begins to slow, or if there will be a bill to pay for pursuing an accommodative monetary policy.

Turkey has enjoyed impressive economic growth under President Recep Erdogan, but the economy has in part been driven by heavy borrowing from abroad.

We see a greater chance of positive surprises in the emerging markets and a greater risk of negative surprises in the US.

of debt in foreign currency, which thus becomes more expensive to service. This has piled pressure on emerging market economies and subsequently caused both equity and bond prices to fall. In addition, long-simmering crises in countries such as Turkey have now fully erupted, stoked by political conflicts with the US and the general pressure on emerging markets.

However, we do not expect the market turmoil caused by Turkey's financial challenges to be a precursor to a broader crisis for emerging markets in the style of the Asian crisis in 1997/98. Emerging market debt in foreign currency is generally considerably less now than back then, plus most of the countries now have floating exchange rates, whereas the Asian crisis erupted on the back of speculation against the countries' fixed exchange rate regimes.

That being said, China is and will be the country to keep an eye on as one of the main candidates for triggering a global crisis – and that risk has risen of late. Yet, there is every reason to expect that China can avoid a crisis, or at least kick the problem further down the road via massive economic stimulation that fends off a crisis for now but does not solve the challenges of the credit bubble in the longer term.

China's public finances are running a surplus, government debt is not a problem and foreign debt is relatively limited. In short, there is still considerable scope, economically speaking, to stimulate. Furthermore, there is a political will to stabilise the situation – China will do anything to avoid a crisis. They have also demonstrated their ability to do this many times and have already begun to take steps.

Global synchronised swimming more uncertain

In summary, populist policies have put us in a situation where economic conflicts of interest and the risk of a major market correction – which at worst could potentially lead to something even more detrimental – have risen.

Nevertheless, we expect the global economy to ride out the storm and the expansion to continue this year and next. That being said, the impressive synchronised swimming performance the global economy has maintained for the past few years is beginning to falter, and we expect the significant volatility seen across financial markets in recent months will continue in the coming quarter. Donald Trump needs the support of his base, so he will fan the flames of the trade war at least until the US midterm elections on 6 November this year.

Hence, while investors should be prepared for the trade war to potentially drive markets, we expect that ultimately a solution will be negotiated and that geopolitical tensions will ease. This is also in the best interests of Donald Trump.

Should Trump continue to ▸▸

Wisdom of history

Economic history has taught us we are extremely bad at predicting recessions and financial crises – or more correctly at reacting to signs of an imminent crisis. Often there are multiple signals indicating the approach of a crisis, but they have typically been ignored by politicians, central bankers, investors, etc.

History has also taught us we do not necessarily need a full-blown financial or economic crisis to trigger a correction in equity markets. Equity markets are often hit by signals that warn of an impending financial or economic crisis that never really materialises.

increase tariffs, he will soon hit US consumers in their wallets as a string of consumer goods become more expensive. We are not saying there is an easy fix or that a solution will arrive immediately after the midterms, but Donald Trump's rhetoric will presumably ease and so will the trajectory of the trade war. We expect this will be well received by investors.

Higher expectations for emerging markets

Even though China is in the eye of the storm, we are maintaining our overweight in emerging market (EM) equities, where the outlook for corporate earnings is good and valuations attractive. We also prefer Asia to Latin America or Eastern Europe. Trade war or not, we estimate Asia presents the best opportunities for exposure to the consumers of the future.

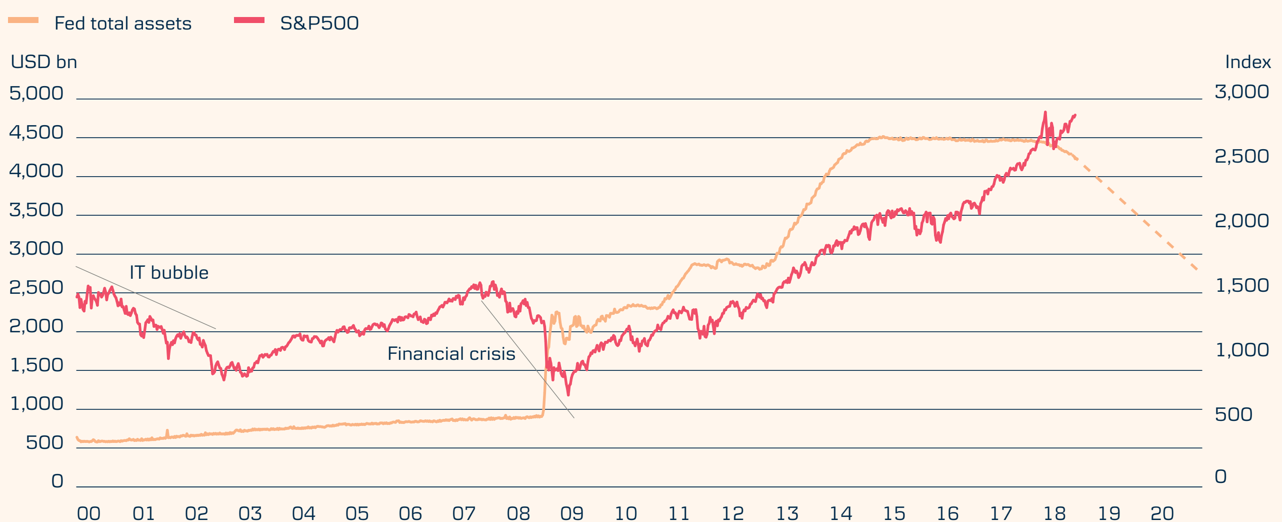
True, emerging markets have underperformed all other equity markets this year, while weakened EM exchange rates do not help much in terms of return in Nordic currencies, in fact quite the reverse. However, looking 6-12 months ahead, we expect the dollar will weaken, while a detailed analysis of the economic data leads us to believe a lot of negativity has already been priced in with regard to financial market performance and growth prospects across the EM countries – and Europe too for that matter. In contrast, the risk of disappointment is greater in the US on all fronts. In other words, we see a greater chance of positive surprises in the emerging markets and a greater risk of negative surprises in the US.

We acknowledge that the growth picture is currently strong in the US and that US equities have therefore outperformed everything else. However, we see a high risk that the potential in the US is almost gone and that investors will soon be forced to take into account the fact that the trade war will also hit US companies.

While the strong dollar is cushioning the impact of high import tariffs on input into US manufacturing, the competitiveness of US corporates is being weakened. And here we should remember that while US dependence on exports is low compared to many other economies, some 43% of all earnings in S&P500 companies are still generated abroad.

Can equities defy monetary policy?

The US central bank, the Fed, has since the financial crisis injected liquidity into the economy by buying back bonds, and currently has bond holdings of more than USD 4,000bn. This has helped keep the economy buoyant and lift equity markets, but the Fed is tapering its purchases and will continue to do so in the coming years. The question then is whether US equity prices can continue to climb while the Fed reduces its bond holdings and sucks liquidity out of the economy.



Source: Macrobond.

We are currently overweight emerging market equities, with India one of the countries we see greatest potential in.

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	→	Neutral weight
Global government bonds	→	Neutral weight

EQUITIES - REGIONS
Regional allocation within the asset class equities

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

EQUITIES - EMERGING MARKETS
Country allocation within the emerging markets region

Country		Allocation
Brazil	↓	Underweight
India	↑	Overweight
Russia	↓	Underweight
China	↑	Overweight

EQUITIES - SECTORS
Sector allocation within the asset class equities

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

Source: Danske Bank

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.

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