Q3 2018

QUARTERLY/OUTLOOK

By #**SAXO**STRATS

SAXO GROUP

Q3 2018

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THIS COULD END VERY BADLY

BY STEEN JAKOBSEN

Global tensions are ratcheting higher by the day, fuelled by the foolish policies of foolish leaders. Tit-for-tat trade wars and agendas that pander only to self-interest are jeopardising the global economy.

We are entering one of the most dangerous periods for the global economy since the Berlin Wall fell in 1989. The 'trade war', which was never supposed to happen in the first place, is now making headlines every day. The short-sightedness of the world's governments is remarkable, and given the history of trade wars, profoundly alarming.

There are three possible paths from here:

1. A 'mild' crisis where the US, China, and Europe all reach higher tariff levels but stop short of creating outright 'walls' – probability: 25%.
2. A more severe crisis with escalating trade tensions into the November 6 US mid-term elections and beyond (where President Trump must show his base that he is living up to his promises of 'getting the US a better deal') – probability: 50%.
3. A move on par with the Smoot-Hawley Tariff Act of June 1930 – probability: 25%.

Note that every one of these scenarios leads to weaker global growth! There are no winners in a trade war, and the trend is pointing in the wrong direction as nationalist agendas erode the status of global institutional frameworks.

History teaches us that this can end badly. The worst example was the US Smoot-Hawley Act of 1930, which raised tariffs by 45% on over 20,000 imported goods. The Act was borne of an electoral promise to protect US farmers, who made up 25% of the US population prior to the Great Depression. The fallout from this disastrous legislation was instant:

- May, 1929: Smoot-Hawley passes the House; stock prices drops to 191 points.
- June 19, 1929: Senate Republicans revise the bill; the market rallies, hitting its peak of 216 on September 3.
- October 21. Senate adds tariffs to non-farm imports; Black Thursday stock market crash.
- October 31. Presidential candidate Hoover supports bill; foreigners start withdrawing capital.
- March 24, 1930, Senate passes the bill; stocks fall.
- June 17, 1930. Hoover signs the bill into law; stocks drop to 140 in July.

Dow Jones Industrial Average, March 1928 to December 1931. Source: Bloomberg

Global trade fell 65% in the wake of the Smoot-Hawley Act. US exports fell from $7 billion in 1929 to $2.5 billion

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in 1932 and farm exports fell by two-thirds. Ironically, grain prices collapsed, leaving millions of farmers destitute.

In 1989 Francis Fukuyama wrote his famous essay, 'The End of History and the Last Man'. His argument, in the context of the crumbling Soviet empire and Tiananmen protests, was that the victory of Western liberal democracy was secured as "history... appeared to culminate in liberty: elected governments, individual rights, an economic system in which capital and labour circulate with relatively modest state oversight".

But Fukuyama's arguments haven't aged well. As globalisation took off, cracks in the economic model started to show. Most will argue that globalisation is driven by technology; the internet supersedes borders and thus creates economies of scale and price transparency. The standard theory of trade teaches us that while trade may raise aggregate growth and income, it can also produce winner and losers.

If the loser is a big economy or a strong political power, they may impose restrictions – tariffs, for example – to counter the competitive disadvantage.

What makes trade issues more challenging today is that currencies no longer follow the paths that current account dynamics imply they should. A country running a current account surplus is supposed to see a strong/higher currency, but in today's world, the big current account surplus economies all seek to avoid currency strength versus the global dollar standard in order to maintain competitiveness and avoid the risk of deflation (and the scary effect of that deflation in an over-indebted world).

THERE ARE NO WINNERS IN A TRADE WAR

Enter President Trump, who is now telling the world that he will no longer accept this status quo, and that the current framework is unfair to the US.

The Trump narrative goes something like this: "we helped Europe after World War Two with the Marshall Plan. We helped Korea and Japan after the Korean War,

SOURCE: TWITTER

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and WWII as well, and we even helped China by giving them access to the World Trade Organization in 2001. What did we get in return? Nothing! Except deficits as far as the eye can see."

This is the story President Trump has been telling his voters forever, and one that he endorsed long before he became president.

Consensus still holds that an outright trade war will be avoided, but this ignores the mid-term elections in the US. It's not just about Trump, either – it also has a lot to do with China's move to raise its global profile along every axis.

Take this recent story from Xinhua: [President Xi urges breaking new ground in major country diplomacy with Chinese characteristics]. This is an effective declaration to the world that China is now competing with the US and its allies for global leadership in trade and even governance. The characteristically cryptic language used still sends a clear message: "[Xi Jinping] also urged the efforts to firmly safeguard China's sovereignty, security and development interests, take an active part in leading the reform of the global governance system, and build a more complete network of global partnerships, so that new advances will be made in major country diplomacy with Chinese characteristics to create a favorable environment for, and make due contributions to, building a moderately prosperous society and a great modern socialist country in all aspects".

China's chief approach to this vision is so far a mercantile one via its commitment to the One Belt, One Road plan.

Beijing may have already given up on the US as a long-term export market – the longer it keeps its market

> A STEEP ESCALATION OF GLOBAL TRADE BARRIES COULD SLOW WORLD TRADE GROWTH BY MORE THAN 6%

share, the better - but the OBOR Plan B has already been initiated and it's a plan that circumvents the US. The US, of course, is now actively breaking down the very international organisations that have supported growth and globalisation since the end of World War II and after the fall of the Berlin Wall.

A United Nations report from May of this year states it plainly: trade war could trigger 'a sharp drop in global investment and trade'.

The scenario outlined by the UN suggests that a steep escalation of global trade barriers could reduce world gross product growth by 1.4% in 2019 and slow world trade growth by more than 6%. Trade losses of this magnitude are roughly half those experienced in 2009, the worst year of the global financial crisis. If the recent trend towards increasing trade disputes were to escalate into a spiral of retaliation, the repercussions for the world economy, including many developing countries, could prove far more severe.

Waning global growth, falling credit impulses globally, and massive complacency on the risks of a trade war are our unfortunate warnings for the rest of 2018.

STEEN JAKOBSEN, CHIEF ECONOMIST & CIO

Steen Jakobsen first joined Saxo Bank in 2000 and has served as both Chief Economist and Chief Investment Officer since 2009. He focuses on delivering asset allocation strategies and analysis of the overall macroeconomic and political landscape as defined by fundamentals, market sentiment and technical developments in the charts.

THE DRUMBEAT OF TROUBLE IS SOUNDING

BY PETER GARNRY

This year began with markets continuing their 2017 jubilance. It didn't last. Following a massive volatility shock in late February, equities veered from the path of continual gains while macro prints faltered as well. With trade war now providing an even more perilous background for equity markets, it's fair to say that the long-predicted troubles are starting to wash ashore.

ESCALATING TRADE TENSIONS DRIVEN BY A MISGUIDED US GOVERNMENT WILL ONLY ADD TO THE TROUBLE FACING FINANCIAL MARKETS

The year started with lively animal spirits and high hopes for the global economy. Everything went well (maybe too well?) and global equities stormed 5% higher in January. Much has changed since then, with European macro disappointing by the most in six years, the biggest one-day volatility shock in more than a decade hitting equities in late February, China's economy clearly slowing down, serious cracks appearing in many emerging market countries, a new political crisis in Europe over immigration that might end the new German government before it has really started, a new populist government in Italy, and the emergence of a potentially serious trade war between the US and key trading partners.

Our view is that in the second half of 2018, equity markets will begin to negatively discount 2019 which is likely to be a year in which the US government will run its largest deficit to nominal GDP since 2013 at the same time as the Fed's tightening likely peaks due to increases in the target rate on top of a balance sheet reduction.

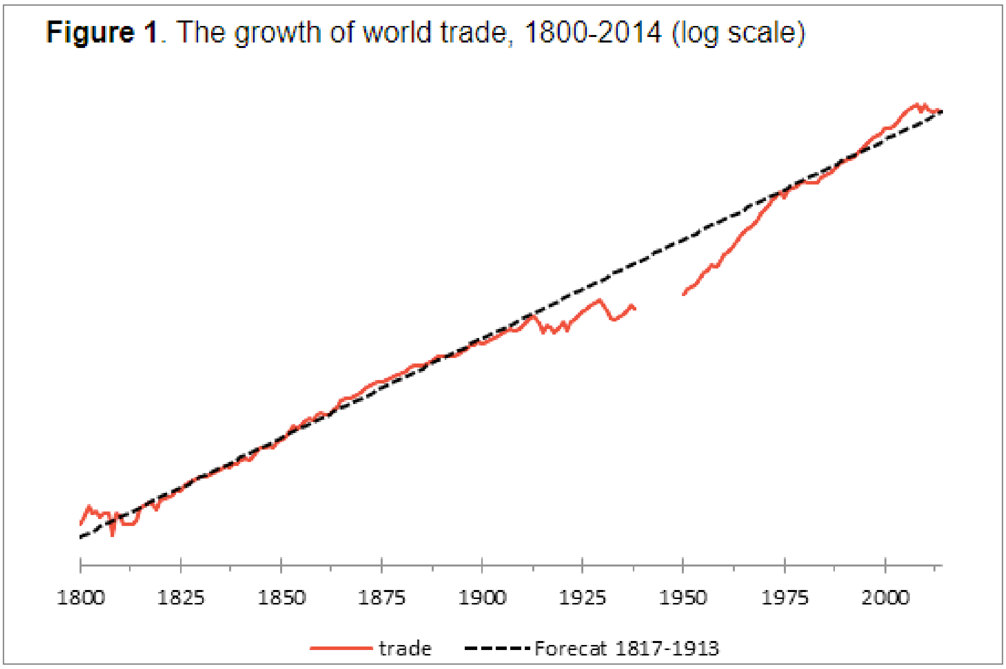
Escalating trade tensions driven by a misguided US government will only add to the trouble facing financial markets.

WHAT ARE THE FACTS ON TRADE?

Trade war is a complicated theme because trade statistics can be bent to fit any agenda leaving room for populists and anti-globalists to distort the reality of trade. Trade barriers have two components: tariffs, which are essentially a tax added to the imported product, and non-tariffs which are mostly regulatory. With trade war on the horizon we have dedicated a big part of our Q3 outlook to trade. Here are some facts:

Global trade has grown by 4.2% per annum in the past 215 years, a 6,437-fold increase, despite many horrible wars setting back trade with the two world wars as the biggest setbacks. But the long-term trend underscores what economists have known for centuries: free trade increases wealth and forces countries to specialise and divert resources to industries with comparative advantages. This strong trend is not likely to be derailed by misguided populist governments, and history quite clearly shows that there are no winners in a trade war. Rational countries should find a compromise.

THE DRUMBEAT OF TROUBLE IS SOUNDING



SOURCE: WORLD TRADE, 1800-2015, GIOVANNI FEDERICO & ANTONIO TENA-JUNGUITO (2016)

There is another interesting fact hidden in the global trade data. Measured by the distribution of world exports, Europe remains the largest trading region in the world with Asia as the number two (and growing fast relative to other regions). The US accounts for less than 20% of world trade and here lies the ugly truth for President Trump: the region is becoming less relevant to the world.

When a country runs a trade deficit on a particular item such as steel, it is because the country's steel industry is not competitive (if there are no significant differences in trade barriers between the two countries). By importing a product produced cheaper in another country, the home country can divert its resources to those sectors that are most productive and increase overall wealth. This is the simple principle behind free trade and the reason why the US should not prioritise steel production. The vast wealth increase over the past three decades has come from industries such as semiconductors, software, biotechnology, healthcare equipment, and finance.

The current US government's stance on global trade will lead to suboptimal wealth creation.

The Trump administration is very focused on tariffs, which, depending on how the statistics are created, can show major or only minor differences. But even more interestingly, Credit Suisse showed in a report from 2015 that the US has the highest non-tariffs in the developed world, making it difficult for foreign companies to enter US markets. Trade policy is obviously a complex issue.

In a recent speech, Federal Reserve chair Jerome Powell said that the Fed's business contacts had begun discussions about postponing hiring and investments amid growing concern over trade policy. Together with Daimler's recent profit warning, which was directly linked to the trade war between the US and China, we expect the trade war to begin having a negative impact on companies and the economy.

HISTORY QUITE CLEARLY SHOWS THAT THERE ARE NO WINNERS IN A TRADE WAR

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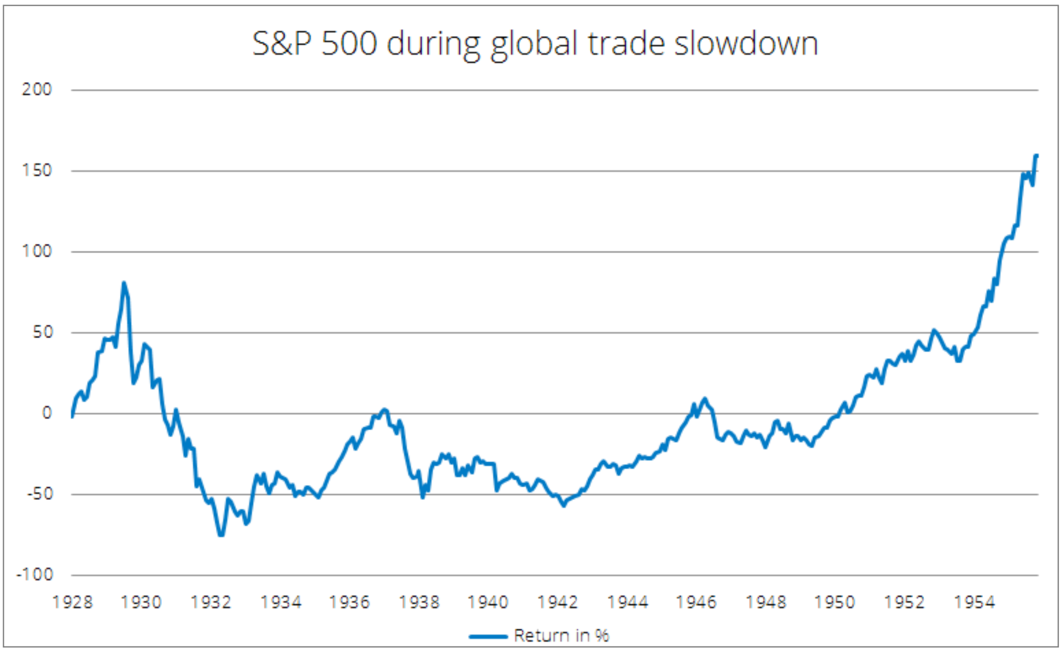


SOURCE:
BLOOMBERG AND SAXO BANK

What does history say about trade wars and slowdowns in global trade when it comes to returns on equities? The S&P 500 returned 1.3% per annum during the period from 1928 to 1953 (excluding dividends), which historically is a very low return for equities; even including dividends, the return is around half of the historical trend.

That period was obviously characterised by poor economic policies during the 1930s, declining global trade, and then the devastating World War II, but it seems apparent that disruptions in global trade are associated with weak equity returns.

TROUBLE IS ALREADY HERE

The trade war issues engulfing the political discourse in 2018 are disguising the real trouble already brewing in the global economy. The US interest rate normalisation and US fiscal deficit explosion will most likely lead to a policy mistake in 2019 with EM being hit severely and the impact 'boomeranging' into the world economy, unless the Fed acknowledges that its policies should only be domestically oriented (despite this being its explicit mandate).

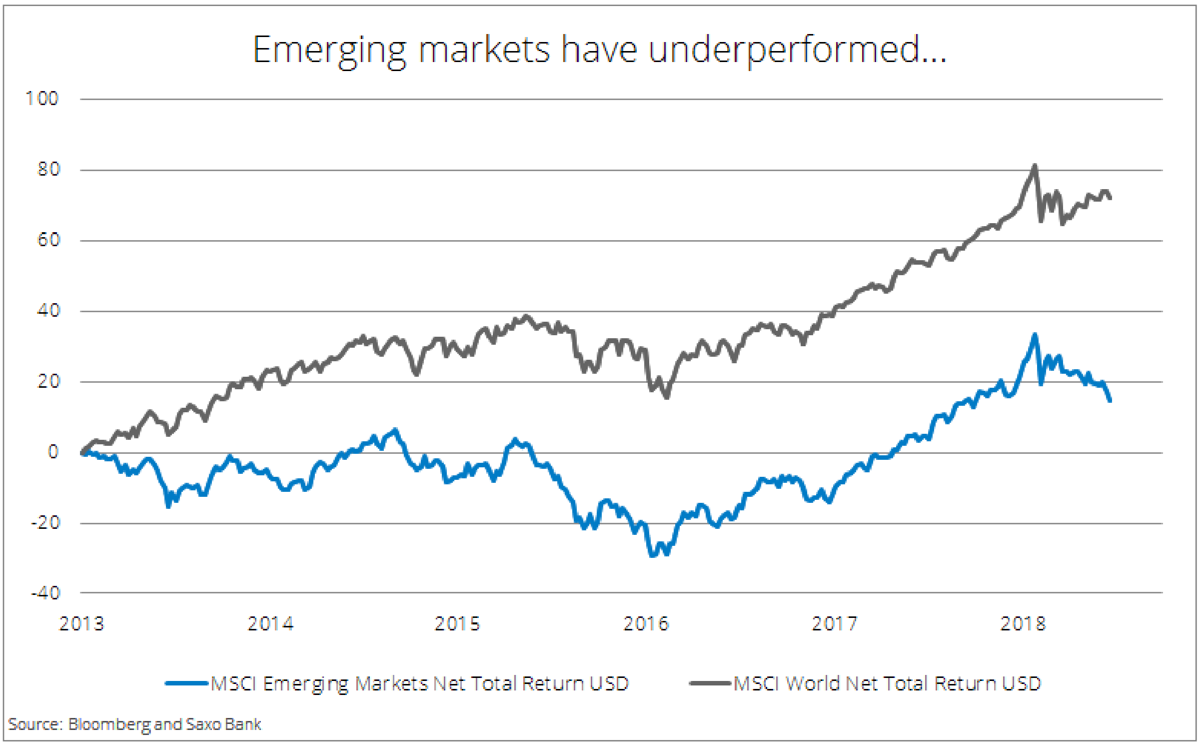
Markets are forward-looking; we expect them to adjust their views on 2019 as the second half of the year progresses. Given that trouble is already here, we are defensive on equities and recommend investors to stay away from cyclical sectors and overweight non-cyclical technology, health care, and consumer staples. On a factor basis, the combination of leverage, quality, and momentum is expected to perform best; this means that good stocks can be found outside the recommended sectors mentioned, but they have to fulfil this factor criteria.

The most vulnerable countries in an escalating trade war scenario with the US are the trade surplus countries such as China, Canada, Mexico, Japan, and Germany. These countries should be underweighted until the trajectory on global trade policy is clearer.

IT'S CRUNCH TIME FOR EMERGING MARKETS

In a recent opinion piece in the Financial Times, Reserve Bank of India governor Urjit Patel warned of a potential USD double whammy for emerging markets due to current US fiscal and monetary policy amplifying EM weakness in 2019. This warning from an insider should not be treated lightly.

THE DRUMBEAT OF TROUBLE IS SOUNDING



SOURCE: BLOOMBERG AND SAXO BANK

EM equities are down year-to-date in USD as currency crises have popped up everywhere, and most notably in Argentina, Turkey, and Russia. The Fed's balance sheet reduction peak in 2019 together with expanding US fiscal deficits will most likely push interest rates higher unless real interest rates fall. These trends will create negative dynamics for EM as funding costs will go up, squeezing both the private and public sectors that have relied on cheap USD funding post- the financial crisis to fuel their rebound.

We recommend investors to be underweight EM except Chinese technology which is still attractive due to regulatory protection by the Chinese government and a vast and growing domestic market that will not be derailed even during a global trade slowdown.

TECHNOLOGY IS A UNIQUE SECTOR

While global equities have experienced trouble this year, the technology sector continues to print solid returns for investors, thereby enhancing its attractiveness even more. An interesting feature of technology companies is their low debt leverage (net debt is minus 0.62 for the MSCI World Information Technology index), which makes the sector the least sensitive to changes in monetary policy.

In addition, the sector has the highest return on invested capital and uses less capital expenditure than others. The combination of these factors has pushed the valuation premium over global equities to 27% which is a fair aggregate premium to pay for the only sector that delivers on growth every earnings season.

THE DRUMBEAT OF TROUBLE IS SOUNDING

SOURCE: BLOOMBERG AND SAXO BANK

Information technology is by far the most dominant sector in the US equity market but globally the sector is still second to financials with a market cap weight of 15.8%. Measured as industry groups, the group Software & Services (with a weight of 8.9%) is very close to overtaking Banks (9.9%) as the most important industry group in the world.

As we have stated in previous Quarterly Outlooks, the technology sector has changed from being dominated by hardware to being dominated by software which has much more attractive features for shareholders. We recommend investors to stay overweight software.

The biggest risks to the technology sector are regulation and global semiconductor disruption from an escalating trade war. At this point, the probabilities for both scenarios having major impacts on the technology sector in the short term are low.

THE MUSIC IS ABOUT TO STOP

Regular readers will know that we have been predominantly positive on global equities since 2010 and even during the euro crisis we remained constructive due to valuations. We never joined the bandwagon of a bubble in global equites or even technology companies.

Nine years into the global expansion, however, the structural issues of debt-fuelled growth have not disappeared. The financial sector is stronger, but the economy as a whole is still fragile and sensitive to interest rate changes. With credit spreads overextended, equity valuations above average, and monetary policy normalisation in effect, the world will soon experience a setback.

We are consequently defensive on equities (but not outright negative yet) and recommend investors to be overweight non-cyclical technology, health care, and consumer staples.

PETER GARNRY HEAD OF EQUITY STRATEGY

Peter Garnry joined Saxo Bank in 2010 and is the Head of Equity Strategy. In 2016 he became responsible for the Quantitative Strategies team, which focuses on how to apply computer models to financial markets. He produces trading strategies and analyses of the equity markets as well as individual company stocks, applying advanced statistics and models to beat the market.

USD-NEGATIVE TRADE WAR

BY JOHN J HARDY

The market got a bit ahead of itself in positioning for further strength in the euro and weakness in the US dollar in Q2. But after the enormous correction and USD rally, we look for the USD to find a top in the second half of the year and to begin heading lower again. The world can't afford a strong dollar and once the Trump tax and fiscal stimulus fade, the US will have a hard time finding s to offset its enormous external imbalances.

> ONCE THE TRUMP TAX AND FISCAL STIMULUS FADES, THE US WILL HAVE A HARD TIME FINDING THE USD BUYERS TO OFFSET ITS ENORMOUS EXTERNAL IMBALANCES

In our Q2 outlook we waxed negative on the longer-term prospects for the US dollar and the mounting dysfunction of the USD's role as the world's chief reserve currency. Ill-timed to say the least, as the greenback rallied sharply in Q2 after several quarters of weakness. We did, however, point to speculative positioning risks as a complicating factor in the near-term and the USD rally has now removed most of this hurdle for dollar bears.

As well, while the dollar remains too expensive, the other chief hurdle for USD bears remains policy divergence. On the fiscal policy front, there is no fiscal impulse to be found outside the US, while the US launched a hair-on-fire fiscal stimulus via Trump's tax reform. On the central bank policy front, most of the rest of the world is in a state of glacial tightening while the Federal Reserve continues to tighten apace, both in terms of rate hikes and a steady ratcheting of the quantitative tightening programme.

At the beginning of Q3, the Fed's quantitative tightening schedule is scheduled to reach $40 billion per month in balance sheet reductions, followed by a move to the maximum pace of $50 billion per month in Q4. Dollar bulls hope that the rate hike pace could even accelerate as the US economy finally appears on the edge of wearing away the last vestiges of the output gap and overheating due to the excesses of the Trump tax reform stimulus.

But our longer-term conviction on an eventual turn back to USD weakness has not notably softened. A few longer- term reasons the USD could weaken soon again.

THE US IS LATE-CYCLE: The Trump tax reform stimulus has been likened to pouring gasoline on an already late-cycle economic bonfire. Thus, there could be a brief further spike in the US inflation indicator that gets the market overworked about the prospect for much higher Fed rates this year and next, but we suspect the US economy will quickly hit the wall as soon as Q4. Early indicators of an oncoming recession have been in abundance, from rock-bottom savings rates to a rapidly flattening yield curve that could even invert in H2. Historical Fed cycles have often seen a sharp peak in the hiking cycle followed by a rapid decline – with 2005-07 the chief exception.

TRADE WAR RISKS: The Trump administration's aggressive stance on trade could prove a significant USD negative as trade disruptions will also reduce the

USD-NEGATIVE
TRADE WAR

recycling of reserves into the greenback as US trade partners look to avoid adding to US dollar reserves or seek to avoid the currency entirely. The latter is particularly the case for China, which clearly has a long-term strategy aimed at raising the profile of its currency in its trade relationships. As China's energy import volumes mount steeply, the launch of the yuan-denominated oil contract in Q1 is arguably a gambit to eventually supplant (at least regionally) the petrodollar with a petroyuan. As well, let's recall that Trump's picking of trade fights has been as frequent with traditional geopolitical allies, like those within NAFTA and the EU, as it has with those further afield.

Trump focusing on Bank of Japan or European Central Bank policies and their implicit aim to keep the JPY and EUR weak could suddenly turn the tide in USDJPY and EURUSD.

(Admittedly, the flip-side risk is actually one of CNY weakness and USD strength versus Asian EM currencies if China chooses to abandon its strong yuan policy.)

STRUCTURAL DEFICITS: The US' large deficits have always been a focus, but they have been made worse by the ballooning budget deficits set in motion by the Trump tax reforms. Extensive fiscal stimulus in a late-recovery environment is an unusual mix and will make US external deficits even larger.

Once the inevitable recession does arrive (Fed tightening nearly always eventually ends in a recession), there will be no room to expand stimulus further without the currency taking a hit as savers wouldn't be able to absorb expanded deficits, which would then have to be monetised by the Fed, eroding the currency's value.

In the meantime, the risks for USD bears are those of timing and a drawn-out squeeze on USD liquidity, especially offshore, as the Fed continues to tighten policy if the US economy shows another quarter or more of resilience or even overheating. We have already seen strong pressure on EM currencies this year as US rates have risen with the dollar. Too many EM actors have funded in US dollars in recent years, taking EM foreign-denominated debt exposure to record highs estimated at $19 trillion, an exposure they can ill afford once currencies and economies begin to weaken.

The EMs with a current or recent history of external deficits like Turkey, Brazil, and South Africa have been hit the worst, but even EMs running surpluses could be under significant pressure in the near term due partly to trade wars and the risk of a stagnating China (more on this below). And EMs may find that the Powell Fed is deaf to their cries as the Fed's policy focus is squarely on domestic considerations.

MOST OF THE REST OF THE WORLD IS IN A STATE OF GLACIAL TIGHTENING WHILE THE FED CONTINUES TO TIGHTEN APACE

USD-NEGATIVE
TRADE WAR

CURRENCY OUTLOOK BRIEFS

The US dollar looks set to act as the currency market's chief driver for the balance of 2018 as the policy mix is most dynamic in the US and is likely to remain so, while it is mostly static elsewhere. We anticipate that the USD upside will roll over in the months ahead.

USD – the argument that the Fed tightens until something breaks is a valid one – the question is more 'when' than 'whether'. Will the prospect of an incoming recession rear its head already later this year, or is that too early? If the long end of US yields remains relatively anchored, USD upside risks could prove minimal in H2, even if additional Fed hikes are priced in.

EUR – after the euro's great rise into early 2017, those banished existential risks came back to haunt the single currency in Q2 as a populist Italian government formed and Germany's Chancellor Merkel faces a challenge from within her own coalition on the immigration issue. The EU needs to define its future before the next recession overwhelms it, but the euro looks increasingly too cheap at or below 1.1500, so we'll keep our eyes peeled for technical reversals.

JPY – we like our win-win scenario for the Japanese yen, i.e. the idea that either the BoJ is finally dragged into a more normalised stance by inflation or by the strength of its economy or both, and if not, the yen could look less unattractive if risk appetite rolls over or the pace of tightening weakens elsewhere. As well, the diplomatic hurdle is rather high for any further USDJPY upside beyond 110.00 as Japan may come under scrutiny for its (let's be honest) weak currency policy focus by the Trump administration.

GBP – the Brexit morass knows no end and Q3 could merely provide more uncertainty on further delays within this timeline, given the lack of progress thus far. This would of course keep sterling traders guessing. More supportive for sterling, at least, is the Bank of England's apparent readiness to hike rates again in August; it has declared a lower 1.5% policy rate at which it will begin to shrink its balance sheet.

CHF – the EURCHF normalisation trend that really got underway after the French election last year has faltered on the rocks of fresh EU existential threats after the Italian election and Germany's domestic political tensions over migration arose. Looking for a nervous EURCHF range with potential for volatility on the downside if the EU struggles with existential questions; 1.2000 looks like a strong resistance level.

CAD, AUD, NZD – the AUD and NZD have finally come under pressure from their rapidly eroding yield spreads with the US and worries that China is finally wobbling are an added threat. Furthermore, new Reserve Bank of New Zealand governor Adrian Orr has made a splash with a two-way policy guidance. CAD may be better positioned for now, but faces an ugly mix of factors domestically and from the US when the latter's economy eventually rolls over.

NOK AND SEK – Norway is edging ever so slowly into a tightening stance could support at the margin while SEK is very cheap, but deservedly so until the Riksbank ends its status as the terminal dovish policy laggard. Swedish elections coming up in September could prove contentious.

USD-NEGATIVE
TRADE WAR

EM CURRENCIES

EM currencies are likely to remain under pressure as long as the Fed moves in a tightening direction and the US dollar does likewise; the next recession may not be kind to EM either. In addition, China's economy is dealing with its own soft patch and its strong CNY policy may yield to a sideways-at-best CNY policy while heavily China-exposed exporters could be in for more relative weakness in the EM space than they were previously, when the focus was more on the more fragile cases.

ELECTION FEVER – TRY, MXN, BRL

Three of the weaker EM currencies in the first half of the year are facing important elections in Q2 and early Q3. The weakest EM currency over the past year has been the Turkish lira on the unfortunate combination of large external deficits, insufficient FX reserves, and a president who has explicitly warned of political interference with central bank policy and claimed that Turkey's inflation problem can be solved with rate cuts.

After Erdogan's clear victory in the late-June election, he will need to reassure markets if the lira is to recover relative to other EM peers and avoid fresh default fears. The focus on Erdogan has only increased post-election as new constitutional reforms are now in effect that vastly expand the powers of the office of president, effectively bringing about "one-man rule".

The Mexican peso faces a test over the July 1 election where the left-wing populist Obrador looks to gain a strong mandate and the market fears fiscal excess and perhaps further trade tensions with the Trump administration.

In Brazil, the country and BRL face an intolerable wait until the October election. An undercurrent of anti-democratic tendencies has shown up with a massive trucker strike, calls for military rule, and in the form of a pro-military right populist Bolsonaro, who is the new leader in polls in a populace not enthused with their options. The former poll-topping left populist Lula has been jailed for corruption.

JOHN HARDY, HEAD OF FX STRATEGY

John Hardy joined Saxo Bank in 2002 and has been Head of FX Strategy since October 2007. He focuses on delivering strategies and analyses in the currency market as defined by fundamentals, changes in macroeconomic themes, and technical developments.

ONLY CHINA CAN SAVE US

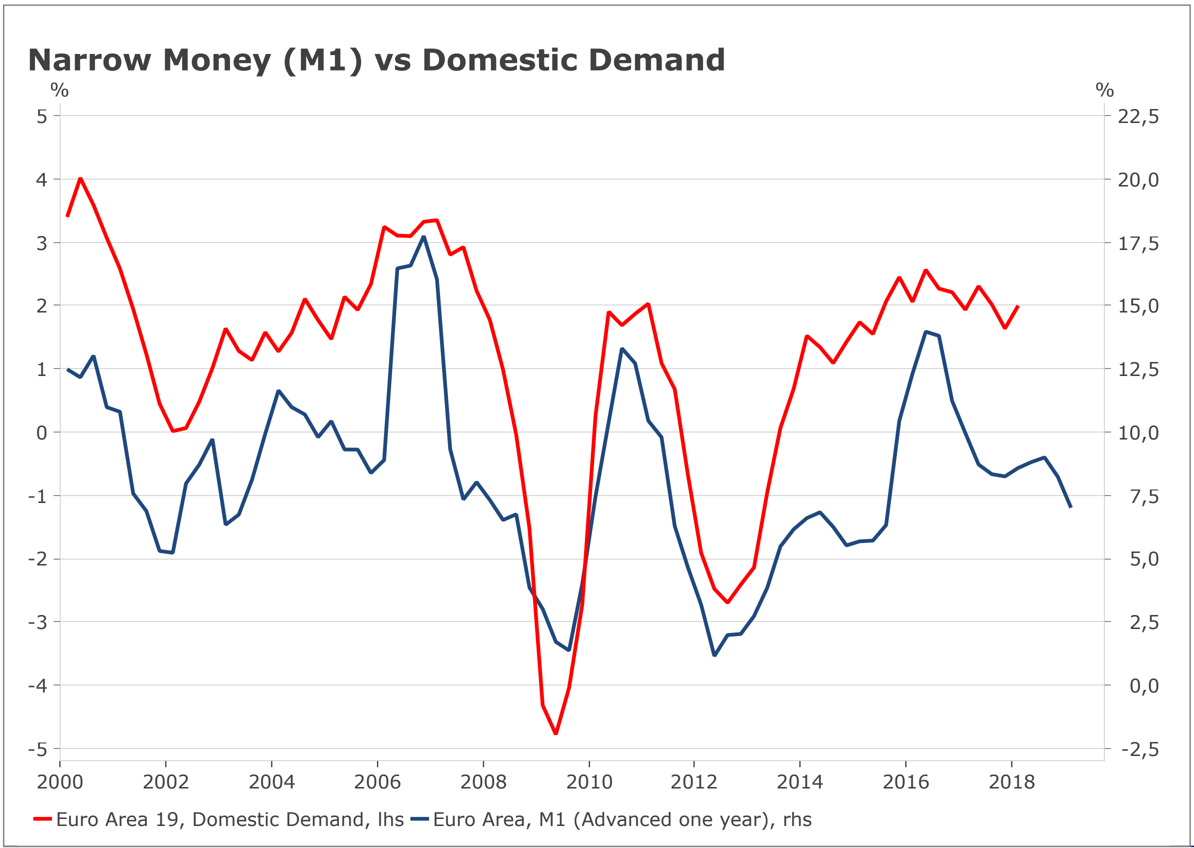
BY CHRISTOPHER DEMBIK

The global economic situation has de-synchronised with a US- and USD-centric trend taking its place. Meanwhile, the European economic situation has deteriorated. While these developments, combined with an incipient trade war, may appear incredibly gloomy, China holds a few key cards that may enable it to keep things from hitting new lows.

Exactly a year ago, we warned against the risk of economic slowdown and the de-synchronisation of global growth. Since then, global PMIs have fallen lower, liquidity stress can be observed in USD money markets, geopolitical risk is surging, and a higher dollar index is causing trouble for emerging markets. In just a few quarters, a growth trend more dependent on the US and the evolution of the US dollar has replaced the global synchronised economic narrative.

THE EUROZONE IS THE BIGGEST DISAPPOINTMENT THIS YEAR

While consensus opinion was extremely optimistic for the euro area in 2018, the economic situation has deteriorated very quickly. The Citi Economic Surprise Index for the Eurozone has plummeted into negative territory since the beginning of this year, reaching its lowest level since 2016. The index is currently the second-worst performer among G10 countries, just behind Canada at minus 68.1.



SOURCE: MACROBOND, SAXO BANK RESEARCH & STRATEGY

ONLY CHINA CAN SAVE US

The sharp slowdown observed in narrow money (M1) along with the contraction in credit impulse (running at minus 0.3% of GDP in Q1 2018) confirm that the rosy "strong euro area growth" narrative is done and that a new and more restrictive credit cycle has just begun. So far, the negative impact of tighter monetary conditions has been limited because aggregate demand is stimulated through the external sector (mostly exports in relation to a weak real Eurozone effective exchange rate) and a growing number of NFCs have enough cash on their balance sheets so as not to require bank lending. However, it is only a matter of time before the tightening of monetary conditions and the impact of geopolitical risk (notably linked to trade wars) can be observed more broadly in the euro area's hard data.

TRADE WAR AND DETERIORATING FINANCIAL CONDITIONS: AN EXPLOSIVE COCKTAIL

Until now, the negative consequences of the trade war have had a rather limited impact on growth. We observe that the prices of some US imports have increased significantly (such as washing machines, whose prices have increased by 20% over the past two months), but the overall effect is still marginal. Most estimates state that the decided measures could have a net effect of 0.1% of GDP for the US and Chinese economies, which is hardly a big deal.

Previous historical examples, such as the quotas on Japanese auto exports implemented by the Reagan administration in 1981, tend to confirm that the negative impact on growth and even the stock market is rather small if a full-blown trade war is avoided. However, history also teaches us that restrictions on trade hurt the countries that impose them first and foremost. Thus, tariffs on Japanese auto exports led to 60,000 job losses in the US in the 1980s.

The most salient feature of the ongoing tensions is that President Trump is genuinely obsessed with bilateral trade imbalances. And just like in every good soap opera, everything can fall apart from one moment to the next. In the case of a full-blown trade war based on the US imposing a 10% tariff on all its imports and all trading partners retaliating with 10% tariffs of their own, European Central Bank researchers found that US GDP growth would fall into recession within 18-24 months and the global growth trend would be reduced to less than 3%. In other words, this could get very serious.

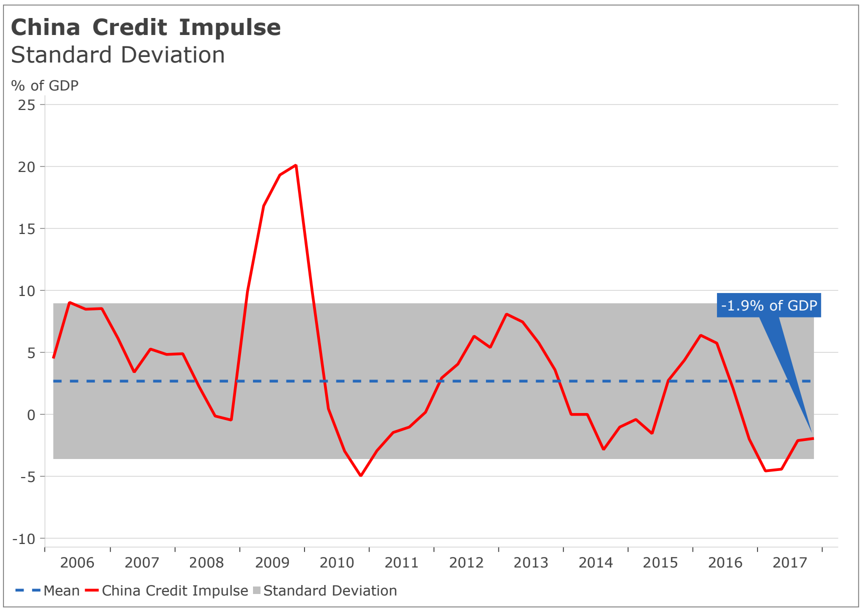
Bearing in mind that financial conditions are deteriorating very fast, things could get extremely dangerous if threats to trade continue to intensify. The market has been buzzing with political noise for months but it has not paid enough attention to the lower credit impulse, higher cost of capital, and lower liquidity (especially in USD money markets). From our viewpoint, it is rather unlikely that the current surge in protectionism would be able, on its own, to create a new economic crisis. However, it could still trigger it by being the straw that breaks the camel's back.

CHINA MIGHT RESCUE GLOBAL GROWTH

Nonetheless, everything is not as gloomy as it seems. So far, China has only responded to the US measures by using the same tools, and without seeking escalation. If China really wanted a full-blown trade war, the most efficient method would be to send sanitary inspectors to local companies key to the US production chain and shut them down for a few weeks or months. The impact would certainly be much more devastating for US companies than any rise in tariffs decided by Beijing.

> HISTORY TEACHES US THAT RESTRICTIONS ON TRADE HURT THE COUNTRIES THAT IMPOSE THEM FIRST AND FOREMOST

ONLY CHINA
CAN SAVE US



> CHINA WILL DO ITS BEST TO AVOID A FULL-BLOWN TRADE WAR BECAUSE FINANCIAL AND MONETARY STABILITY ARE CRUCIAL TO ITS FUTURE ECONOMIC DEVELOPMENT

SOURCE: MACROBOND, SAXO BANK RESEARCH & STRATEGY

By refraining from such a course of action, China seems inclined to play the appeasement card and be ready to support the global economy. On the back of weaker economic data and higher trade tensions, China has decided to ease its monetary policy for the third time this year. Last week, the People's Bank of China cut its reserve requirement ratio by 50 basis points, leading to the release of about RMB 700 billion in liquidity to support SME loans and debt-to-equity swaps in early July.

China is doing what is has always done in instances of economic slowdown: it is stepping in to strengthen the economy and push credit impulse back into positive territory. China credit impulse is still in contraction, evolving at minus 1.9% of GDP, but it is slowly rising from its lowest point since 2010 and might be back above zero sooner than we think if the Chinese authorities consider that it is time to further support the economy against the trade war.

China has still many options to counter the impact of trade tensions. It can resort either to more accommodative monetary policy through the RRR or scope for fiscal stimulus. Rising credit impulse should offset at least part of the effect of US tariffs on Chinese imports and is also expected to provide support to declining economic sectors, such as Chinese real estate, from 2019.

It is complicated at this stage to second-guess the evolution of US trade policy (which is now targeting German auto imports) but it is almost certain that China will do its best to avoid a full-blown trade war and related volatility because financial and monetary stability are crucial to its future economic development.

CHRISTOPHER DEMBIK, HEAD OF MACRO ANALYSIS

Christopher Dembik joined Saxo Bank in 2014 and has been the Head of Macro Analysis since 2016. He focuses on delivering analysis of monetary policies and macroeconomic developments globally as defined by fundamentals, market sentiment and technical analysis.

AUSTRALIA CAN GAIN WHERE THE US FEELS PAIN

BY ELEANOR CREAGH

The looming Sino-US trade war has already sent shudders through global financial markets and if it escalates much further, the fallout could be immense. But amid all the gloom, some pockets of Australian industry could benefit nicely from Chinese tariffs on US goods.

Economists disagree on many things, but something on which there is unanimous agreement is that protectionist trade policies are detrimental to the global economy. The impact of tariffs not only affects global trade flows but, equally importantly, business confidence and investment decisions.

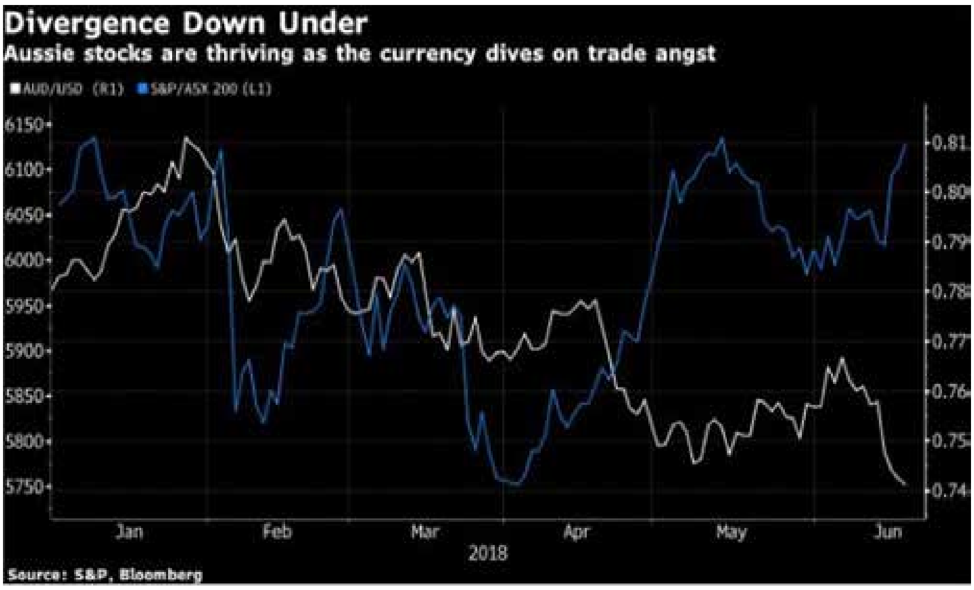
For a small open economy, Australia has been resilient so far to the threat of a Sino-US trade war. The Australian equity market has been the second-best performing market in the Asia-Pacific Region this quarter, but the same cannot be said for the Aussie dollar.

The reason for the Aussie equity market's apparent outperformance is rather benign, and likely a reflection of the inward-looking nature of the ASX 200's constituents.

The top stocks by index weights are the banks and the performance of these stocks is largely related to domestic lending, regulation, and competition. Other large ASX 200 constituents, which depend on resource exports, have benefited from the weaker Aussie dollar and commodity prices.

Further cushioning exporters, the Aussie's downtrend is likely set to continue as the yield differential between the US and Australia rises, with the Reserve Bank of Australia consistent on delaying rate rises.

The Aussie dollar will prolong its struggle in an environment where trade tensions are in the spotlight; especially as the currency is often seen as a quasi-play on China.



SOURCE:
S&P AND BLOOMBERG

AUSTRALIA CAN GAIN
WHERE THE US FEELS PAIN

> WHAT WE HAVE SEEN IN BABY MILK AND FINE WINE WILL COME THROUGH TO OTHER PRODUCTS, GIVING AUSTRALIA A SWEET SPOT AMID A PERILOUS POPULIST MOVEMENT

Modelling the impact of 25% tariffs on US imports of $50 billion worth of Chinese goods is estimated to shave approximately 0.15% from real GDP growth in the US and could add a similar lift to inflation there. In this instance, the effect on Australia would be minimal. However, were there to be a dialling-up in protectionism worldwide amounting to a global trade war, the outcome for Australia could be far more severe. While the impact of the tariffs currently announced is small, the broader concern is the rise in populism, a trend that is spiralling out of control on the global level.

Australia has a deep relationship with China. Over 36% of the country's shipments last year went to China, accounting for 8% of GDP. Rising tensions between the US and China are a concern for Australia as the economy is heavily reliant on exports of coal, iron ore, and education to China. But it is also a longstanding ally of the US.

Chinese demand is not just for base metals – services exports to China from Australia have been rising on average 15% annually over the last decade. Additionally, tourism is on the move – last year there were 1.4 million Chinese tourists with Chinese visitors accounting for about 25% of total visitor spending. Consumer goods like wine, vitamins, and other quality Australian food produce have also seen significant growth in value of exports of approximately 40% per year, according to the Australian Bureau of Statistics.

On that basis it is not surprising that in a recent speech by Reserve Bank of Australia governor Phillip Lowe, he resolutely confirmed Australia's commitment to China, stating that "Australia and China together can be a force supportive of an open global trading system". The statement, of course, indicates that the central bank knows which side Australia's bread is buttered on.

SOURCE:
IMF, BLOOMBERG

AUSTRALIA CAN GAIN WHERE THE US FEELS PAIN

China's tariffs on US imports, due to start on July 6, include beef, cotton, wheat, sorghum, rice, wine, nuts, and dried fruit, alongside other sectors like metals, drugs, and automobiles.

In the event of these mutual tariffs beings implemented on July 6, could there be any sweet spots for Australia? Australia is well known for quality produce and some producers stand to gain as they could find that their products become more competitive for export to China.

The agriculture sector has underperformed against almost all other asset classes for several years. We are in the midst of the second-longest economic expansion in history and the US has a growing twin deficit, household savings are low, and liquidity is contracting, which could pose problems in the long run. Given worries about the outlook for global growth and inflation potentially not meeting expectations, the sector could present an opportunity, particularly in Australia. In fact, commodities have never been so cheap relative to US stocks, and as the graph below illustrates, commodities tend to rally later in the business cycle prior to a recession.

Chinese tariffs on US agricultural products could provide an opening for Australian exporters to fill for Australia to expand its economic imprint. If 25% tariffs are imposed on US suppliers to China, Australian beef exporters

SOURCE: BLOOMBERG

would offer a far more competitive price with Australia having the advantage of maritime trade routes through the APAC region.

This also applies to other products exported from Australia (nuts, dried fruit, wine, vitamin/mineral supplements). This could make Australia's agricultural export industry an area where Australia could benefit from trade diversions. To add fuel to the fire, the Australian government has also begun negotiations with the European Union on a free trade agreement. Trade on agricultural products is "significantly constrained" by EU tariffs, according to Australian trade minister Steven Ciobo, who said in a recent speech that "while countries are building barriers, we are knocking them down to create new opportunities for Australian businesses."

THERE ARE NO WINNERS
– EXCEPT INFLATION

AUSTRALIA CAN GAIN WHERE THE US FEELS PAIN

STOCKS IN THE LOCAL MARKET THAT COULD BE INDIRECT BENEFICIARIES

ELDERS FINE FOODS (ELD) exports processed beef from Australia and New Zealand to China and could be a beneficiary of both rising demand for meat in China and decreased imports from the US. The Chinese middle class will grow from 12% of its population in 2009 to 73% in 2030, firing up demand for high-end food products as incomes increase.

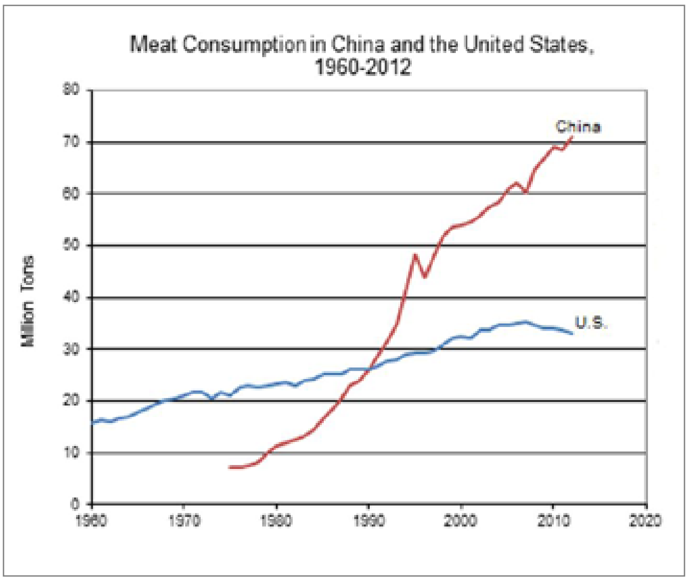
AUSTRALIAN AGRICULTURAL COMPANY (AAC) is a world-leading provider of beef and agricultural products and is a pure play beef stock. AAC has the largest cattle stock in Australia and is trading at multi-year lows.

SELECT HARVESTS (SHV) is Australia's largest almond grower and processor. Select Harvest commenced Chinese consumer package product sales last year, however, its focus has been the Indian market. The Select Harvests' food division manufactures comparable products to US brands that have previously had market share in China, so it looks like the company could wrangle market share from US exporters of processed almonds and dried fruits.

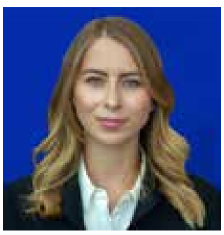
GRAINCORP (GNC) operates a growing agribusiness company and wheat is among the products it distributes. US grain suppliers currently have a large market share in China, but with impending tariffs, this could change.

BLACKMORES (BKL) is one of the larger and more established "clean and green" Australian brands to benefit from the rising wealth in Asia and the increased focus on health in the region. Blackmores already has a strong export business in China. The regulatory environment in Australia is rigourous, which means Australian products can be less price-competitive compared to products manufactured in other countries. Tariffs on US products could erode this price competition.

These stocks could be attractive standalone investments given China has a similar proportion of city dwellers as the US did in 1940, meaning there are still decades of above-average growth and urbanisation to occur in China. It is a bonus that these stocks serve as a trade war hedge. As living standards rise so will per capita consumption, increasing consumption of all things through a structural demand change over the next 10 years. What we have seen in baby milk and fine wine will come through to other products, giving Australia a sweet spot amid a perilous populist moment.



SOURCE: USDA



ELEANOR CREAGH, MARKET STRATEGIST

Eleanor Creagh joined Saxo Bank in 2018 and serves as the bank's Australian Market Strategist, responsible for creating, implementing, and monitoring equity strategies and research for traders and investors, as well as developing quantitative models and customised mathematical frameworks for institutional clients. Eleanor holds a double major in Finance and Economics from the University of Sydney.

CHALLENGED COMMODITIES

BY OLE HANSEN

Commodity prices have come under fire into mid-2018 on a hawkish Fed, a stability-oriented Opec, and numerous other factors. The key fulcrum into Q3 is the developing trade war, which likely holds the keys to dollar and demand direction.

Following a strong start to the year, the outlook for commodities has become increasingly challenged as multiple headwinds have started to emerge. In crude oil, a multi-month rally ran out of steam after the Opec+ group of oil-producing nations agreed to increase production to stabilise the price. Precious and semi-precious metals, meanwhile, were challenged by continued dollar strength and the diverging direction of central bank rates. Industrial metals wobbled on emerging signs that some of the world's biggest growth engines, not least China, showed signs of slowing.

The rally across key agriculture products highlighted in our Q2 outlook became unstuck as traders took fright from trade war tensions which have put US exports of corn to Mexico and not least soybeans to China at risk. Fundamentals, however, remain supportive given an outlook of tightening global fundamentals which should result in a sizeable inventory draw through the current 2018/19 crop season.

The current robustness of the US economy compared with the rest of the world has led to divergence in monetary policy between the Federal Reserve and other major central banks.

As such, the global economy has seen a more challenging environment as the dollar strengthens and liquidity becomes tighter, particularly in emerging market economies carrying heavy debt loads.

Adding to this, the current risk of trade protectionism means questions are being raised about the impact on growth and subsequent demand going forward. This is potentially one of the biggest challenges commodities will face over the coming months.

The Citi Economic Surprise indices, which measure data surprises relative to market expectations, show the recent deterioration in economic data from key economies, especially China.

SOURCE: BLOOMBERG AND SAXO BANK

CHALLENGED COMMODITIES

THE OUTLOOK FOR COMMODITIES HAS BECOME INCREASINGLY CHALLENGING AS MULTIPLE HEADWINDS HAVE STARTED TO EMERGE

If the US and China fail to reach a compromise on trade, a global trade war may pose a broader challenge; such a development would add further headwinds to growth and subsequent demand for multiple commodities from energy to metals while potentially throwing a life-line back to precious metals.

The second half of 2018 could see crude oil initially supported by strong demand as well as continued geopolitical risks related to supply concerns from Venezuela and Iran as the deadline for the implementation of US sanctions approaches. These concerns may, however, eventually be replaced by a shifting focus towards demand growth which could begin to slow down among emerging market economies.

Saudi Arabia and Russia seem to have drawn a line in the sand with $80/barrel as the level above which demand destruction could begin to emerge. On that basis, we maintain the view that Brent crude oil will remain rangebound between $70/barrel and the low $80s over the coming months before downside price pressure starts to emerge ahead of year-end.

Due to the supply risks that emerged during the second quarter and which is likely to grow into the second half, we are raising our end-of-year price on Brent crude oil to $74/b, and $70/b on WTI crude oil. The reason we are not raising it further is due to our expectation that demand growth worries will begin to emerge during the final quarter.

SOURCE: SAXO BANK

CHALLENGED COMMODITIES

Gold's performance turned sharply lower during June as the yellow metal struggled to find a defence against the stronger dollar and Fed chair Powell's hawkish stance on continued normalisation of US rates. Three quarters of gains were reversed after traders grew frustrated following the yellow metal's inability to break key resistance above $1,360/oz on multiple occasions.

The deteriorating outlook during June has challenged but not destroyed our positive outlook for gold. Gold's negative correlation to the dollar remains a key challenge in the short term, but given the short-to-medium-term dollar-negative outlook highlighted by Saxo Bank Head of FX Strategy John Hardy, we believe this headwind will fade over the coming quarter.

Having picked major fights on trade with friends and foes it is our belief that President Trump will sooner or later go on the attack against the stronger dollar as greenback strength complicates his vision of reducing the US trade deficit.

Despite the fading focus on inflation, which was a key driver at the beginning of the year, we believe that investors will continue to seek diversification and protection against potentially mispriced financial and geopolitical risks.

While the short-term technical outlook is challenged as the quarter begins, it is worth noting that hedge funds have cut bullish bets to a 2½-year low. An improved technical outlook could force renewed buying from traders focusing on momentum and technical price levels. The price action during June showed that the 200-day moving average just above $1,300/oz had become a major level of resistance and one that needs to be retaken in order to get buyers off the fence and back into the market.

It is our assumption that local support can be established ahead of the long-term support levels around $1,236/oz (the previous low from last December which also corresponds with a trendline from the December 2015 low).

Our end-of-year call for gold is $1,325/oz and $17/oz for silver, which translates into a XAUXAG ratio of 77.50.

SOURCE:
SAXO BANK

CHALLENGED COMMODITIES

Silver remains stuck within a narrowing trading range that has been in place for the past 18+ months. Two attempts during the past quarter to break above its 200-day moving average helped trigger two major corrections. Sentiment on that basis remains challenged into Q3, especially if the latest signs of economic slowdown begin to translate into further weakness among industrial metals.

Gold, however, holds the ultimate key to silver's direction and given our views on the yellow metal, we see silver continuing to challenge resistance before eventually moving higher.

IF THE US AND CHINA FAIL TO REACH A COMPROMISE ON TRADE, A GLOBAL TRADE WAR MAY POSE A BROADER CHALLENGE

SOURCE: BLOOMBERG COMMODITY INDEX, SAXO BANK

CHALLENGED COMMODITIES

CRUDE OIL	
UPSIDE	DOWNSIDE
Geopolitical instability and sanctions cutting supply by more than expected.	Trade wars and an EM slowdown reduce demand growth outlook.
Shale oil production growth slows on rising cost pressures and bottlenecks in the delivery chain.	Opec and non-Opec producers fail to maintain discipline, resulting in a collapse in the agreement to curb production.
Inflation hedge and backwardation attract demand from investors.	Increased supply from non-Opec suppliers such as Canada, Brazil, and Kazakhstan.
The dollar resumes its weakness.	The dollar continues its ascent as global growth slows and trade tariffs bite.

GOLD (PRECIOUS METALS)	
UPSIDE	DOWNSIDE
Market pricing in too much US growth => too optimistic on rate hikes => lower yields => weaker dollar.	The dollar stays bid on continued central bank divergence.
Mispriced financial and geopolitical risks attract increased demand as a portfolio diversifier and hedge.	FOMC turns more hawkish as focus switches from inflation to controlling "rich" asset prices.
An improved technical outlook forces a strong buying reaction from funds after they cut net-longs to a 2.5-year low.	

OLE HANSEN, HEAD OF COMMODITY STRATEGY

Ole Hansen joined Saxo Bank in 2008 and has been Head of Commodity Strategy since 2010. He focuses on delivering strategies and analyses of the global commodity markets defined by fundamentals, market sentiment and technical developments.

THE DRAGON
IN THE TRADE WAR STORM

BY KAY VAN-PETERSEN

President Trump has made a great many aggressive statements in launching the current trade war, but the truth is that despite its hitherto muted response, Beijing has a great many levers to pull should it wish to shift the balance of power away from Washington.

"

IN A FULL-BLOWN TRADE WAR SCENARIO, CHINA HOLDS A GREAT MANY CARDS

AT THE EDGE OF THE ABYSS

We are at the cusp of the tipping point on a global trade war started by President Trump. What at the start of the year seemed to be a lot of posturing – huff and puff, heavy on headlines but short on detail – is now escalating to other countries, putting US products, industries, and companies in the face of potential tariff retaliation measures.

What gets dangerous here is that we are moving from a programme of rational, business-centric, and sound economics to the one that our politicians and so-called world leaders live and die by: ego and saving face.

The risk is that after the November 6 US mid-term elections – the vote for which Trump is currently playing peacock – Washington may not prove able to take a more conciliatory tack, even if it tries. We may need a whole new administration to gain back ground, which could mean anything from 2020 to 2024, assuming Trump does not step down, or is not otherwise forced out of office (impeachment).

CLIENTS' ONE CONCERN ON CHINA

Time and time again, the repeated concern I keep hearing expressed by clients is what China's response to Trump's tariff initiatives might be. After all, the president's expressed aim is to close the US trade deficit with China and bring jobs back to the US. There are many different options available to China on this front, and some could prove very dire indeed.

If Beijing chooses to play hardball, it has two choices, in our view. The first is a nuclear option, and the other is a very heavy stealth pathway.

The Nuclear Trade Option is one we highlighted early in the year in our weekly Macro Monday Cross-Asset Call, and it involves a two-step move by China.

MOVE ONE: Sell a significant amount of US Treasuries. This would be structurally sound given the combination of a less accommodative Federal Reserve rising rates as well as the fact that a lot of new supply is coming onto the market.

MOVE TWO: "Sorry, what's that? You want to take your tariffs up to 20%? OK, no problem: we have just devalued the yuan to the USD by 20%". Obviously the key critique here is that China would not do this given its plan for the yuan to become a world reserve currency, not to mention financial stability, etc. Do note that it takes decades, multiple generations, and a global sequence of events to become a global reserve currency; when we look back at the yuan 25 to 50 years from now, this period will be but a speed bump.

THE DRAGON IN THE TRADE WAR STORM

Also note how no one talks about the devaluation that just happened a few years ago... bottom line here is, Beijing doesn't need to actually execute the Nuclear Trade Option. It just needs to imply that it would if pushed further.

"Operation Stealth" would be a lot more tacit and would involve a China placing a domestic boycott/ban/red tape/harsher operating requirement on US companies operating in China. Imagine the billions of dollars that US automakers, technology firms (how many million iPhones are sold in China?), industrial companies (Caterpillar, Deere), consumer discretionary goods manufacturers (Coach, Harley Davidson, bourbon distillers), and agricultural producers (soybeans) get from China's 1.4 billion consumers.

GLOBAL MACRO AND UNINTENDED CONSEQUENCES

The best global macro traders and investors know the significance of unintended consequences coming from fiscal, monetary, and geopolitical policies. Consider how Russia had very little domestic agriculture (especially dairy and cheese) before the Russian sanctions (Moscow historically exported energy and imported a lot of the country's foodstuffs); today there are a lot of domestic options in Russia that did not exist a few years ago.

This theme could play out a lot more heavily in China, i.e. if this trade spat is really about China's "Made in China 2025" move towards being a more consumer-driven economy with higher-end manufactured goods, then could Trump not accelerate this process with his attempts to slow it down? Are we looking at "Made in China 2022"?

Adding to these options, of course, is the threat of a move to devalue the CNY. The truth is that in a full-blown trade war scenario, China holds a great many cards.

> BEIJING DOESN'T NEED TO ACTUALLY EXECUTE A NUCLEAR TRADE OPTION. IT JUST NEEDS TO IMPLY THAT IT WOULD

KAY VAN-PETERSEN, GLOBAL MACRO STRATEGIST

Kay Van-Petersen joined Saxo Bank in 2014 as a Global Macro Strategist, based in Singapore. He focuses on delivering strategies and analyses across asset classes based on monetary & fiscal policies, global geopolitical landscapes as well as other macroeconomic fundamentals. He also takes into account market sentiment, technical and momentum factors, and corporate bonds with attractive risk and return.

MUCH FEAR
BUT OPPORTUNITY TOO

BY ALTHEA SPINOZZI

The third quarter of 2018 will be a volatile one, and we expect an inversion of the yield curve by year-end or in the first quarter of 2019. That said, with volatility comes opportunity, and we are looking to investment grade US bonds and high yield short-term corporates to outperform.

We believe that Q3 will be a transitional period where we will see a continuous worsening of credit spreads that will ultimately lead to an inversion of the yield curve by the end of this year or the beginning of 2019. Although an inverted yield curve does not cause a recession in and of itself, we believe that the combination of an increasingly hawkish Federal Reserve and an overheated economy may accelerate the path towards recession.

We believe that positioning in riskier assets will continue to be light; investors will steer away from so-called supply chain economies and sectors sensitive to tariffs, such as information technology and energy, so long as there is no clarity regarding the rumbling trade war. Political noise in the EU area will also be monitored closely with a particular focus on Italy as we get closer to October, when the 2019 budget will be presented.

At the same time, we believe that a volatile environment such as the current one still offers good opportunities. The sell-off that we have seen in the previous two quarters led to a progressive widening of credit spreads, hence value can be found in US investment grade bonds and selective high yield corporates. However, it is important to keep an eye on diversification and stay short on duration as credit spreads continue to be under more stress amid uncertainties and central bank policies.

MAIN RISKS IN Q3: TRADE WAR, EU INSTABILITY, AND CENTRAL BANK POLICY

TRADE WAR: It is becoming increasingly difficult to price in the risk associated with a trade war, especially when President Trump's political strategy is not clear and it is hard to forecast what the next move will be. Many believe that the rhetoric that Trump is using is a negotiation tactic to strike a deal with China that will ultimately put America First, however we believe that the longer this topic appears in the headlines, the more pressure will be exerted on credit spreads in general. This will imply that:

1. Long-term Treasury yields will remain subdued for longer. We will not see the 10-year Treasury yield trading above 3% until fears of a trade war disappear.
2. Emerging markets will be put under considerably more pressure. Especially those countries that have interconnected supply and revenue chains with China, such as Taiwan, Malaysia, South Korea, Hong Kong, and many others.
3. US trading partners will also suffer. Canada and Mexico are the ones that could potentially suffer the most as their economies are dependent on that of the US. Sectors that depend on international supply chains, such as the technology and the energy sector, will the most harmed.

Risks related to a trade war make us cautious and this is why we prefer to stay in short durations (maturities between one and three years) and steer clear of debt issued by weak emerging markets that depend on Chinese exports.

INSTABILITY IN THE EU: The Italian elections sent shockwaves throughout the bond market, but as soon the country's new government was formed, sovereigns from the periphery stabilised, leading investors to believe that the worst was over. But in our opinion, many are undervaluing the Italian situation, and there is a high probability that news regarding Italian debt may cause more volatility in EU rates as we approach the presentation of the 2019 budget in October.

MUCH FEAR BUT OPPORTUNITY TOO

The new right-wing populist government is composed of politicians belonging to well-known Eurosceptic parties that have often criticised the EU's guidelines on public spending, immigration, and even sanctions against Russia. Although the new government has reassured the international arena regarding its position on the country's EU membership and the euro, we cannot rule out that the populist government will confront the EU again regarding debt forgiveness.

The new Italian government has a sizable spending plan, which includes the introduction of a minimum income and a flat tax. The funding of such policies will inevitably break EU budget rules and push Italy's national debt higher.

Another event that should trigger alarm bells is the approaching departure of Mario Draghi as president of the European Central Bank. Draghi has been pro-periphery and he never hesitated to help Mediterranean countries during the debt crisis of 2011/2012. Now that he's departing, the real question remains whether his successor will also be friendly to the periphery, or if his policies are going to favour the interests of other continental powers such as France and Germany.

We believe that amid the political noise, Portuguese sovereign debt will be the most resilient in the periphery, while Spanish, Greek, and Italian sovereigns will suffer the most as volatility increases in the EU area.

FLAT YIELD CURVE AND FED POLICIES: The Fed has become increasingly hawkish since Jerome Powell became chair. According to Powell's last statement a couple of weeks ago, the Fed is looking to hike interest rates twice again this year and four times in 2019. This means that by the end of December we should see the short-term rates at 2.5%, and if long-term interest rates don't rise due to uncertainty surrounding a possible trade war and the sustainability of the EU, the US yield curve should soon invert.

In the past, inversions of the yield curve have preceded recessions with a lag of between one and four years, therefore it remains one of the best indicators to predict future recessions. However, the Fed is putting this phenomenon in doubt by continuing with its data-driven approach to rate hike decisions. The idea behind an inverted yield curve being a misleading indicator is that lower yields might be related to lower neutral interest rates and lower term premiums, or the extra return that investors require to hold longer-dated versus short-term securities.

According to Fed governor Lael Brainard, the current low term premiums might be caused by the central bank's large balance sheet investments in US Treasuries. Thus, once the Fed disinvests from these assets, term premiums on the long part of the curve should rise and the yield curve should steepen up to its original shape.

We believe that the Fed's dismissal of the notion that an inverted yield curve can be a leading indicator of a recession is dangerous. Although the backdrop for the US economy remains healthy in the short term with consumer spending rebounding, strong GDP numbers and incredibly hot 2019/2020 earnings estimates, if the Fed continues with its hiking pattern, it will accelerate the arrival of another recession.

RISKS RELATED TO A TRADE WAR MAKE US CAUTIOUS AND WE PREFER TO STAY IN SHORT DURATIONS AND CLEAR OF DEBT ISSUED BY WEAK EMERGING MARKETS

MUCH FEAR
BUT OPPORTUNITY TOO

FIGURE 1:
IN BLUE: SPREAD BETWEEN 10 YEARS AND 2 YEARS TREASURIES.
IN RED: PAST US RECESSIONS.
SOURCE: BLOOMBERG

THREE RISK AREAS TO WATCH IN Q3

EMERGING MARKETS AMID STRONG US DOLLAR, UNCERTAINTY IN THE EU, AND TRADE WAR: In our Q2 report we took a cautious view on weaker emerging markets, and now that we are facing the risk of a full-blown trade war between the United States and China, we like this space even less. Throughout the past quarter we saw South Africa, Argentina, Indonesia, and Turkey suffer from deep currency crises provoked by a strong dollar and rising interest rates in the US. We believe that these countries will continue to remain vulnerable throughout this quarter as well, with the likely exception of Argentina which has been recently approved for a $50 billion aid package by the International Monetary Fund, putting investors at ease as the country has sufficient reserves to meet debt maturities. Because of the potential trade war between the US and China, we are underweight supply chain economies in the Pacific rim, and to a certain extent Taiwan, Hong Kong, and South Korea.

INDUSTRIES HIT BY TARIFFS: TECHNOLOGY AND THE ENERGY SECTOR: As a trade war escalates there are sectors in developed and emerging economies that will most likely suffer from high tariffs and may be hit by potential downgrades. The sector we believe that will be hurt the most is technology as a trade war would disrupt the supply chains of technology companies, eroding revenue from foreign sales. Companies such as Apple, which assembles its iPhones in China (while the components are made elsewhere) and Qualcomm, which is Chinese firm ZTE's key supplier, could be the first in line to be affected as trade war headlines increase uncertainty. Another sector that we believe will be negatively affected is the energy sector, as China is looking to cut US oil imports to avoid higher tariffs.

THE RETURN OF VOLATILITY IN ITALIAN SOVEREIGNS: It is likely that we will see volatility in Italian sovereigns resume in September 2017 when the government releases its 2019 budget proposal. The recent ascent to power of several Eurosceptics, including Alberto Bagnai as president of the senate finance committee and Claudio Borghi as top economic adviser to prime minister Matteo Salvini, is putting the intentions of the government to remain in the single currency and abide by the EU budget deficit guidelines in doubt. If this is to be the case, we are going to see a widening of the spread between 10-year BTPs versus 10-year bunds, with the spread spiking to 300 basis points. However, the biggest movement would be in the short end of the Italian yield curve as doubt will arise on the ability and willingness of the country to pay short-term maturities. If this transpires, the spread between two-year BTPs and bunds of the same maturity could spike by as much as 400bps, and Italian two-year yields could potentially hit their 2012 high of 5%.

MUCH FEAR
BUT OPPORTUNITY TOO

THE THREE BIGGEST OPPORTUNITIES IN Q3

INVESTMENT GRADE US BONDS: The widening of investment grade spreads is becoming more pronounced while the S&P 500 has recovered from its April lows. Many have related this phenomenon to the M&A binge that we have seen lately. When a company merges or acquires another, it also absorbs the debt of the acquired/merged company; as leverage increases, it is normal to see credit spreads widening. However, as investment grade bonds are becoming cheaper the real question is whether investors will continue to invest in the equity market, which continues to be overly expensive. At this point, considering the macroeconomic backdrop and global political uncertainty, bonds look more appealing than equities, and US investment grade corporates look particularly ripe for allocation.

WE BELIEVE THAT AN INCREASINGLY HAWKISH FED AMID AN OVERHEATED ECONOMY MAY ACCELERATE THE PATH TOWARDS RECESSION

FIGURE 2:
US IG OAS (BLUE) VERSUS S&P 500 (ORANGE),
SOURCE: BLOOMBERG

MUCH FEAR
BUT OPPORTUNITY TOO

HIGH YIELD SHORT-TERM CORPORATES IN USD AND EUR: We believe that the high yield space still offers interesting opportunities, especially when default rates are just 3% and forecasted by Moody's to halve by April 2019. As the economic backdrop remain solid, high yield corporates in US dollars and euros should offer interesting returns. We prefer short-term high yield bonds with a maximum three-year maturity, but it is important to cherry pick and avoid weaker companies in sectors that are not positioned to take advantage of the late economic cycle or that are exposed to a high-tariff environment. Investors should be aware that corporate debt has surged 49% since the financial crisis and the majority of this debt has been issued by lower-rated companies. Therefore, it is important to beware of bonds with higher durations that can quickly widen when the economy starts to slow down and we approach a recession.

FLATTENING OF THE YIELD CURVE: This may be the biggest trade for Q3 2018. As the Fed remains hawkish, we can expect short-term rates to rise faster than long-term rates which we believe will remain below 3% for longer due to political tensions. As per Figure 3, we can see that two-year Treasury yields have broken their descending trendline and that the resistance level is at 3.1%. If the Fed continues with the hiking path outlined by Powell, two-year Treasury yields should trade above 3% by Q2 2019.

This should steer investors away from bonds with shorter maturities unless they offer a yield considerably higher than two-year Treasuries. Currently, the two-year Treasury is trading with a 2.54% yield; if Powell is expected to hike six times between now and the end of 2019 we can expect two-year yields to hit at least 3%. Therefore, bonds with maturities in Q4 2019 and H1 2020 would need returns of at least 400bps to be appealing. This is why we prefer high yield corporates in the short term.

For long maturities, however, we like US investment grade corporates, which as mentioned above are trading cheaper compared to the beginning of the year and should be supported as the curve continues to flatten this year and the next.

SOURCE: SAXO BANK

ALTHEA SPINOZZI, FIXED INCOME SPECIALIST

Althea Spinozzi is a sales trader at Saxo Bank, and specialises in fixed income products within the global sales team. Spinozzi joined Saxo Bank in 2017 and maintains an active approach in bond trading focusing on maximising total return. Because of her background in leveraged debt, she is particularly focused on high yield and corporate bonds with attractive risk and return.

THE LONG ROAD
TO A GLOBAL TRADE WAR

BY JACOB POUNCEY

The history of trade liberalisation shows that despite populist rhetoric, eliminating barriers to trade empowers the average citizen. But now, as the US and China take further steps towards a full-blown trade war, investors must position themselves very carefully.

> A TRADE WAR BETWEEN THE TWO MOST ECONOMICALLY INTERTWINED SUPERPOWERS CAN ONLY WORK TO SLOW THE GROWTH OF TRADE; IT CANNOT STOP THE CONTINUAL MARCH TOWARD GLOBALISATION

This section of our Q3 report will recap brief events in US trade policy that could provide insights on the future of global trade and the potential effects of an escalating trade war on Chinese and US citizens.

Modern trade policy was arguably kick-started in 1930 after the US Congress passed the Smoot-Hawley act. The legislation raised tariffs on both agriculturals and industrials in the midst of the Great Depression. Other countries retaliated with similar tariffs and strengthened trade amongst one another, outside of US influence.

The protectionist legislation came in response to the isolationism and nationalism growing in the United States after the First World War and leading into the Great Depression. This time period has an eerie similarity to today. The US is moving toward protectionist and isolationist policies under President Trump after almost a decade of roaring markets. However, during the next major election cycle after the protectionist act was passed, Franklin D. Roosevelt campaigned against the Smoot-Hawley act and eventually won the presidential nomination. The question of whether Trump's tariffs will be a campaign issue in 2020 remains to be seen.

Once in office, FDR signed the Reciprocal Trade Agreements Act of 1934, ushering in a new wave of liberal trade policy that dominated until the present day. The act increased the political incentives to lower tariffs, while decreasing incentives to raise tariffs, through increased lobbying from export companies in the US benefitting from the new trade policies. The act gave the president the right to negotiate bilaterally and ended in 19 trade agreements in just five years. Despite the trade liberalisation, world trade grew at paltry 0.83% between 1929-1938, according to Frederico and Junguito (2016).

The RTAA is important because the act provided the first structured framework on international trade paving the way for the General Agreement on Tariffs and Trade in 1947. GATT was the first international trade agreement with some weight, signed by 23 nations for the purpose of "substantial reduction of tariffs and other barriers to trade and to the elimination of discriminatory treatment in international commerce."

Eventually, GATT was replaced by the 123-signatory World Trade Organization; since the formation of GATT/WTO, global trade growth averaged 5.1% from 1950-2007.

THE LONG ROAD
TO A GLOBAL TRADE WAR

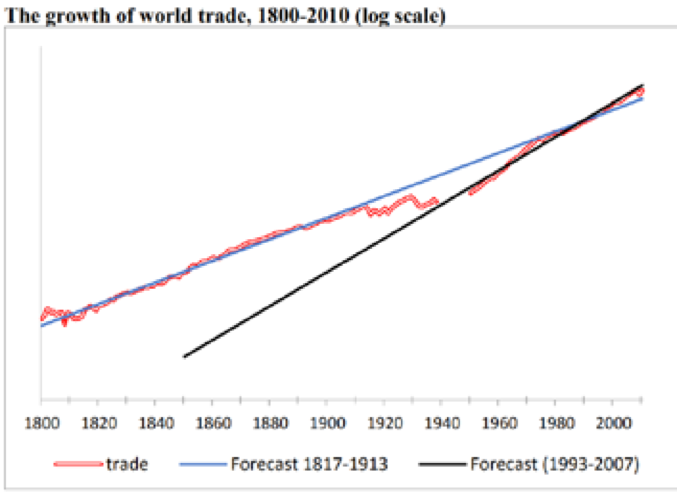
Prior to the creation of the WTO, the US passed the Trade Expansion Act of 1963 allowing the president to unilaterally impose a tariff to an item found to be a threat or to impair national security. This act has been used 16 times since 1981 and was most recently used by Trump to levy tariffs on steel and aluminium imports this year.

These tariffs set by Trump have primarily been used primarily to affect China's exports with additional products and possibly countries in the pipeline under the current administration. China is the number one trade partner globally for the United States, accounting for an average 45% of the US trade deficit since 2009 (and 36% since 2001, when China joined the WTO).

However, despite China's 2011 induction into the WTO and the subsequent ballooning of trade between the US and China, a trade war between the two most economically intertwined superpowers can only work to slow the growth of trade; it cannot stop the continual march toward globalisation and free trade. The International Monetary Fund states that a fully symmetric retaliation (i.e. a border adjustment tax) in a trade war is completely neutral based on a recent study, but retaliation exclusively through import tariffs can have an adverse effect on world trade and result in a fall in world GDP.

Average citizens (of each country!) are the losers during these altercations as they must shoulder the economic and social costs of increased tariffs. These two economies will experience cost-push inflation as the factors of production using imported goods will become more expensive, thus decreasing aggregate supply and forcing the price up.

However, the prudent investor can utilise this unique time in global trade history to position their portfolio to capitalise on – and defend against – the effects of these two superpowers posturing for a total trade war.



SOURCE: FREDERICO- TENA (2016A) AND APPENDIX C

SOURCE: U.S. CENSUS AND SAXO BANK

AVERAGE CITIZENS ARE THE LOSERS DURING THESE ALTERCATIONS

THE LONG ROAD
TO A GLOBAL TRADE WAR

SOURCE: STATISTICAL APPENDICES.
*SIGNIFICANT AT 10%; ** SIGNIFICANT AT 5%; *** SIGNIFICANT AT 1%
§ LOG-LINEAR ESTIMATE

	RATES (*100)	TOTAL (%)
1800 - 1817 §	0.49	8.7
1817 - 1865	3.97***	598.6
1866 - 1913	3.07***	310.1
1919 - 1929 §	5.37***	71.0
1929 - 1938 §	-0.83	-7.2
1950 - 1973	8.08***	541.3
1973 - 1980	3.96***	32.0
1980 - 2007	5.86***	386.9
1817 - 1913	3.62**	3215.9
1919 - 1938 §	1.48	32.5
1950 - 2007	5.10***	1823.6

	CHINA	EUROPEAN UNION	WORLD, Not Seasonally Adjusted	CHINA percentage of whole
1994	-29505.1		-150627	19.58823
1995	-33789.5		-158805	21.27741
1996	-39520.2		-170213	23.21804
1997	-49695.5	-16964.6	-180523	27.52863
1998	-56927.4	-28582.8	-229758	24.77709
1999	-68677.1	-45228.1	-328819	20.886
2000	-83833	-58719.7	-436105	19.22314
2001	-83096.1	-64637.2	-411898	20.17398
2002	-103065	-85692.2	-468265	22.00995
2003	-124068	-97871.6	-532350	23.30574
2004	-162254	-110729	-654830	24.77806
2005	-202278	-124462	-772372	26.1892
2006	-234101	-118595	-827971	28.27412
2007	-258506	-110243	-808762	31.96316
2008	-268040	-95807.4	-816199	32.84002
2009	-226877	-61201.5	-503582	45.0527
2010	-273042	-79672.9	-635362	42.97417
2011	-295250	-99395.2	-725447	40.69903
2012	-315102	-116383	-730446	43.13835
2013	-318684	-125415	-689470	46.22158
2014	-344818	-144334	-734482	46.94704
2015	-367328	-155899	-745483	49.27387
2016	-346996	-146845	-736577	47.10936
2017	-375576	-151363	-795690	47.20136
			2001-2017 avg	36.36186
			2009-2017 avg	45.44559

JACOB POUNCEY, CRYPTO ANALYST

Jacob Pouncey first joined Saxo in 2017 as their go-to crypto guy. He has followed the cryptocurrency and blockchain space since 2013. Jacob focuses on delivering in-depth crypto market analysis. He has a deep understanding of the technology and fundamentals that drive the Crypto Asset space. Jacob tends to focus on medium and long-term indicators for market analysis.

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