Q2 2019
QUARTERLY OUTLOOK
By #SAXOSTRATS
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GROUP

Q2 2019

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CAN THE CENTRE HOLD?

BY STEEN JAKOBSEN

In a world moving quickly towards nationalism and anti-globalisation, the biggest loser will be the region that benefited the most from the big peace dividend of the Berlin Wall coming down: Europe, and Germany in particular.

Germany runs a current account surplus of 8.2% of GDP while Europe overall is at 2.6% of GDP. But does this represent a shining success? Not for investors in Europe. The major German companies, its great marquee names, trade at recession levels of four to five times P/E; its banks trade at 0.2 price to book. This is hardly the stuff of legend.

The gulf between European valuations and their US counterparts remains high with Europe trading at a massive discount. Part of this lies with the composition of business – Europe has fewer technology firms and more privately owned companies. In fact, the most truly successful companies in Europe remain in private hands, and for good reason as they refuse to cave to short-term, quarterly earnings report-centred strategies.

The view from the outside is that Europe is a perennial basket case. This is an easy conclusion to reach if you don't understand Europe's history, its vested interests, the peace dividend and the need for government to sell the naive illusion of fiscal self-rule.

The reality on that front, of course, is quite different. After all, where was Greece, Cyprus, Portugal, and Spain's independence in the early 2010s?

Within Saxo, we firmly believe that any macro change has to come from a breakdown or a crisis, and as such we see 2019 and 2020 as key years for Europe's evolution. We foresee populist parties getting 20% if not 25% of the popular vote in May's European parliament elections... and that's good news!

WE FIRMLY BELIEVE THAT ANY MACRO CHANGE HAS TO COME FROM A BREAKDOWN OR A CRISIS

Why is it good news? Europe's overarching goal has long been "more Europe" rather than "a better Europe". After May, the new commission will play host to various populist platforms and voices who goal is for a more minimal Europe, and this will occur alongside a European Central Bank that is at a total loss in terms of new initiatives after a decade of ZIRP and no growth to show for it.

The presence of a counter-trend is itself hopeful.

The most important factor though is the collapse of German growth. We see a risk of recession there by Q4 even without a trade spat with the US.

CAN THE CENTRE HOLD?

Germany, with its (very successful) “industry 3.0” model, is being left behind. Underinvestment in the technology sector leaves it unprepared as “industry 4.0” rolls in, and its internet speed ranking (29 of 32 countries tracked by the OECD) is just one of many symptoms. Germany needs to catch up in terms of digitalisation, in terms of programmes for working women, with new airports and more overall infrastructure spending.

The lapse of Germany will reopen the Franco-German “hotline” as well as making the debt issue a pan-European issue, and not one of Germany versus the PIIGS, or austerity versus free spending.

Germany grew too complacent, and so did the EU as a whole. Now the new reality has to see Berlin expand spending to be of benefit to the rest of Europe. Overall, a new common ground will be found from a more fragmented Europe.

Investors long convinced by talk of basket cases would be unwise to count out Europe. It is, after all, perfectly positioned to benefit from automation, AI, digitalisation and a capital market that is cheap by any standard (and due to this precise narrative).

Q2 will see the noise increase; the “basket case” narrative will be spread far and wide and the EUR, led by the ECB, will probably test 1.05 if not 1.03 versus the dollar. The next 12 months, however, will be 2000 all over again.

In early 2000, I wrote myself a little note: “if EURUSD trades down to 0.90, buy, buy, buy”. I am pulling out my yellow pad again now: if EUR trades below 1.03, buy both it and the Stoxx 600 index because while Europe may have problems, it still has the most important component of productivity: the best public education system in the world.

Let’s hope I am proven right.

WE SEE A RISK OF RECESSION IN GERMANY BY Q4 EVEN WITHOUT A TRADE SPAT WITH THE US

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.

EUROPEAN EQUITIES: **THE GREAT DIVERGENCE**

BY PETER GARNRY

European equities are global laggards, with weak earnings and low valuations keeping prices well below those of their US counterparts. As we prepare to exit the era of convergence and increasing globalisation, Europe looks set to fall further behind. The question is, what can policymakers do?

WITH THE US-CHINA TRADE CONFLICT, IT SEEMS LIKELY THAT THE WORLD IS ENTERING A NEW WORLD ORDER WITH DIVERGING VIEWS AND MORE NATIONALISM GUIDING TRADE POLICIES

In this Q2 Outlook we have chosen to focus on Europe and the outlook for the region's equities. The depressing reality is that European companies have had negative real growth in operating earnings as the region lacks a strong technology sector that capitalises on the digital age.

EUROPE'S EARNINGS DEPRESSION

The period after the financial crisis in 2008 was unique in many ways. Monetary policies were experimental to an unprecedented degree, leading to negative yields on many assets around the world. Global equities have delivered phenomenal returns despite lacklustre economic growth, and this was driven largely by US equities, and US technology companies in particular, monetising our digital world.

The post-2008 crisis has also delivered several European political crises with Brexit being the latest one. The US and China have increasingly diverged in terms of worldview, leading to a trade war that has impacted economic activity significantly. On top of this, the period has seen inequality rise with populism following in its footsteps. Everywhere we look, the world is diverging more than converging (which was the main theme from 1982 to 2008).

SOURCE: BLOOMBERG AND SAXO BANK

For global equity markets, this broad divergence can be seen in the major earnings divergence between US and European companies. Operating income (EBITDA) is up 50% since January 2009 for US companies, whereas European companies have seen 0% growth. European earnings are down 13% in real terms, translating into what we would call an earnings depression for Europe.

The difference in earnings power has also made its mark on valuation metrics. US equities are valued 43%

EUROPEAN EQUITIES: **THE GREAT DIVERGENCE**

higher than European equities measured on 12-month trailing EV/EBITDA. The difference in earnings power and valuation has been driven by multiple factors, but the most important is Europe's lack of a strong technology sector. The US, meanwhile, has won the battle for domination of the information age, and especially its monetisation.

AVOID EUROPE'S CYCLICAL COUNTRIES

Adding to Europe's difficulties is its big bet on globalisation through a highly-tuned export machine, with Germany leading the pack. Europe and especially Germany have benefitted the most from the existing world order of increasing global trade under the US military umbrella (which in turn reduces the need for military expenditures).

SOURCE: BLOOMBERG AND SAXO BANK

With the US-China trade conflict, it seems likely that the world is entering a new world order with diverging views and more nationalism guiding trade policies. In this world, Europe and Germany are big losers. One option for Europe is to reduce exposure to the US and increasing it to China, but that strategy comes with great political risk.

Europe's sensitivity to global trade has been felt by citizens for more than a year now. The Organisation for Economic Co-operation and Development's leading indicators on the euro area have been declining since December 2017 and have been below trend (meaning below 100) since August 2018, mimicking leading indicators on the global economy. As a result, European equities are still 6.6% below their recent peak in January 2018.

Contracting economies with below-trend activity have historically delivered negative equity returns. Consequently, we remain defensive on equities until there is evidence of a turning point.

Within Europe, this macro environment is typically bad for Europe's cyclical equity markets such as Germany, Italy, the Netherlands, Norway and France. The equity markets that usually do relatively well in a poor economic environment are Denmark, Spain, Sweden, Switzerland and the UK.

EUROPE AND ESPECIALLY GERMANY HAVE BENEFITTED THE MOST FROM THE EXISTING WORLD ORDER OF INCREASING GLOBAL TRADE UNDER THE US MILITARY UMBRELLA

EUROPEAN EQUITIES:
THE GREAT DIVERGENCE

	Below trend		*Above trend*	
Market	**Contracting**	**Expanding**	**Contracting**	**Expanding**
Canada	0.0%	0.8%	-0.4%	1.5%
United States	0.1%	1.2%	0.2%	1.0%
Belgium	-1.2%	0.4%	-0.5%	0.8%
Denmark	-0.4%	0.6%	0.1%	2.1%
Finland	-0.6%	-0.4%	-1.9%	1.8%
France	-0.7%	0.4%	-0.7%	1.3%
Germany	-1.1%	0.3%	-0.7%	1.4%
Italy	-1.1%	-0.2%	-1.1%	1.2%
Netherlands	-1.1%	0.9%	-0.4%	1.2%
Norway	-1.4%	0.8%	-0.4%	1.7%
Spain	-0.2%	-0.3%	-0.5%	1.1%
Sweden	-0.3%	1.1%	-0.7%	1.6%
Switzerland	-0.2%	0.8%	0.1%	1.3%
United Kingdom	-0.4%	0.9%	-0.2%	1.0%
Australia	0.7%	1.2%	-0.4%	1.0%
Hong Kong	0.3%	1.4%	-0.8%	0.8%
Japan	-0.7%	0.6%	-1.1%	0.8%
Singapore	-0.3%	1.3%	-1.3%	0.8%
China	-1.2%	1.8%	-2.5%	1.0%
South Korea	1.3%	0.8%	-1.9%	-0.3%
Taiwan	-0.5%	1.5%	-1.7%	0.6%
India	0.1%	0.2%	-0.3%	1.1%
Brazil	-0.5%	0.5%	-1.3%	1.3%
South Africa	-0.1%	0.8%	-1.0%	1.0%
Average	*-0.4%*	*0.7%*	*-0.8%*	*1.1%*

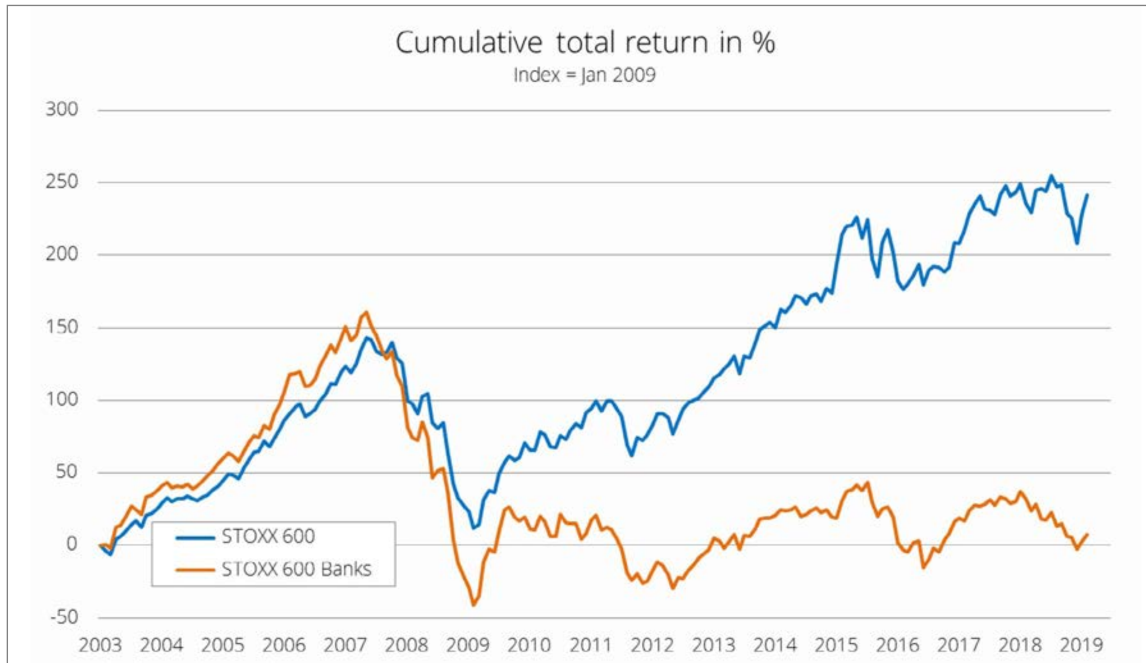
SOURCE: BLOOMBERG AND SAXO BANK
* TABLE SHOWS AVARAGE MONTHLY TOTAL RETURNS IN USD

On a positive note, South Korea's leading indicators turned higher in January, indicating a potential green shoot which will, if it continues, lift Europe's economic activity and potentially also its equity markets. The reason we are closely watching South Korea is that its economy and equity market have historically turned before those of its global counterparts.

A BROKEN BANKING SECTOR AND THE GERMAN SYNDROME

One of Europe's biggest problems remains the banking sector. The total return on Europe's banking sector is zero since January 2003; in real terms, it's -28.5% over a 15-year period. This is an ugly parallel to Japan's zombie banks after its meltdown in the 1990s.

EUROPEAN EQUITIES: **THE GREAT DIVERGENCE**



SOURCE: BLOOMBERG AND SAXO BANK

Europe's policymakers, including the European Central Bank, were too slow to recognise the realities of the post-crisis economic landscape. The Federal Reserve quickly introduced quantitative easing, and sharply increasing reserves in the system that could then be parked at the Fed at 50 basis points helped recapitalise the US financial system. In Europe, however, QE came much later, and probably too late to really resolve the issue: Europe's banks are still *undercapitalised* and poor profitability is constraining credit transmission.

Europe has also agreed to implement costly banking regulations, driving up costs on an already weak sector.

It has been 10 years since Lehman Brothers' bankruptcy and Europe's banking sector has still not healed; this will continue to be an anchor constraining growth and equity returns.

The latest political attempt in Germany to merge Deutsche Bank and Commerzbank is a clear signal as to the current political system's ability to understand the nature of the problem. Banks are already too big and complex, jeopardising the overall system, and Berlin wants to increase banking sector concentration despite popular outcry. A sensible approach would be to increase competition instead of limiting it.

PETER GARNRY, HEAD OF EQUITY STRATEGY

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EUROPE
MOST TO LOSE AND MOST TO GAIN

BY JOHN J HARDY

As the global economy stumbles towards a slowdown, the Eurozone faces a complex set of challenges that will require forceful solutions. Whether the bloc's leaders can summon the determination to effect change will decide how deep the damage will be.

THE EURO COULD STRUGGLE TO RALLY UNTIL A PATH TOWARDS EMU DEEPENING OPENS UP

SPOTLIGHT ON THE EU, WHICH HAS BOTH THE MOST TO LOSE AND TO GAIN

Europe is in a potential lose-lose situation as we await the outcome of the US-China trade negotiations. The friendlier the deal, the more likely that China could shift some of its import demand away from Europe and towards the US. With or without a friendly deal, risks point to ongoing de-globalisation and a growth slowdown that would be double trouble for the European Union, the world's largest trade surplus economic bloc.

As Europe stumbles towards recession later this year or early next year, the old existential questions will inevitably rise once more to dog the EU political and financial landscape. In short, Europe deserves a considerable portion of our attention as Q2 will inevitably prove an important pivot point for the EU. Either we see escalating signs of further dysfunction or a more determined shift by EU governments to get ahead of the risks of rising populism and the unworkable fiscal/European Central Bank foundation of the EMU.

Fortunately for Europe, the EU economy would be the most receptive economy to a financial sector house cleaning and fresh fiscal impulse, given widespread austerity. But unfortunately, the dysfunction of multiple sovereign fiscal authorities using the same currency and same central bank persists (i.e. everyone is essentially funding themselves in a foreign currency – for better, as with Germany, or for worse as on the periphery).

Worse still for the ECB is that the extend-and-pretend option is simply no longer available. Interest rates are already negative, leaving no policy room there. As for balance sheet expansion, with a balance sheet of some EUR 4.7 trillion, the ECB can't simply lurch back into quantitative easing, at least not under the former "capital key" rules of its 2015-2018 QE, under which it was required to purchase sovereign bonds in proportion with each EU member's GDP.

One key case in point is Germany: there simply aren't enough German bunds available on the open market to buy as German outstanding debt is too small and the country continues to shrink that supply with fiscal surpluses.

Another challenge for Europe is that it is perhaps the least well-positioned economic bloc for the global slowdown we see coming. When the global economy goes into a soft patch or worse, it is the surplus economies most leveraged to global demand that suffer the most. Given that Europe is the only major economic bloc running a large aggregate surplus, it – and Germany in particular - is particularly poorly positioned for a global growth slowdown, as we already saw in the second half of last year when Q3 German GDP dipped into negative territory and Q4 GDP registered a flat, 0.0% quarter-on-quarter rate.

If the global economy goes from slow to worse, Germany is likely to find itself at the epicenter of any EU recession.

THE SHIFT TO A WEAKER DOLLAR MAY TAKE SOME TIME THIS YEAR

EUROPE – MOST TO LOSE AND MOST TO GAIN

How Europe will deal with recession and existential threats – particularly given that the core economies may suffer the worst stresses as we outline above –over the rest of 2019 and into 2020 is uncertain. In that light, key political changes are on their way this year: EU parliamentary elections are up in late May and offer the next key test of the rise of populism. Although the populists don't speak with one voice, coming as they do from all across the traditional political spectrum, they could still prove a disruptive force.

Rest assured, however, that the pro-EU forces have a plan; the political and ECB handover after the May elections will bear close watching on that front. The likely new chief economist at the ECB, Ireland's Stephen Lane, is strongly pro-EMU and has a portfolio of plans for deepening EMU capital markets with a European "safe asset" – some kind of semi-mutualised bond and even something called sovereign-bond-backed securities, or SBBS. But that's just a plan for the plumbing – the real test is structural and one of political will as the EU's government heads would have to make the commitment to mutualise at least a solid portion of their sovereign balance sheets to realise this vision.

Given the election cycle, 2019 is the pivotal year for putting new key EU figures in power, including the new ECB head later this year and new heads of the EU Council and Commission.

The nominee in waiting for the ECB presidency could become clear in Q2, but with central bank policy from here likely taking its cue from fiscal forcing, the political side of the equation may weigh far more. Down the road, a deeper and more integrated EU capital market would provide a strong fillip to the euro, but will the coming EU political leadership have the will to go there? The euro could struggle to rally until a path towards EMU deepening opens up. The alternative is too complicated to discuss here, but doesn't necessarily mean a weak euro if the end result is that some of the periphery achieves devaluation by partial funding in parallel new currencies rather than exiting the EMU.

Our key theme for Q1 was the great "policy panic" as central banks reacted to the ugly deleveraging tantrum of Q4'18. That panic is now complete, as our CIO Steen Jakobsen wrote in his macro outlook just after the March Federal Open Market Committee meeting. First it was the Bank of Japan and the ECB, but now they are joined by the Fed throwing in the towel on the attempt to normalise policy. In the case of the Fed, we still have the end of balance sheet tightening to taper and stop and a couple of hundred basis points of rates to cut, as well as plenty of room for restarting QE, given the excess of US Treasury supply from President Trump's huge deficits. But because such a move toward an easier Fed stance would likely coincide with increasingly weak US growth and deleveraging markets, the shift to a weaker dollar may take some time this year.

Elsewhere, our least favourite currencies in a weakening global growth environment are the commodity dollar currencies, where housing bubbles are in various stages of unwinding, inevitably impacting the credit and therefore growth outlooks. Our longer-term bullish call on commodities should eventually offset downside risks, but these risks will prevail until central bank policy in these countries looks like it does for the rest of the DM – i.e. more or less ZIRP and central bank balance sheet expansion to clean up the private credit mess.

Growth risks remain a concern for emerging markets, but we think China provides a backdrop of stability as it seeks to maintain a stable currency and attract capital inflows to deepen its capital markets and accommodate its transition to becoming a deficit country (a key step in shifting the CNY to an eventual reserve asset). The JPY could do well during bouts of risk deleveraging this year, but the Japanese government is perhaps the most ready to switch on the fiscal stimulus, with the BoJ happy to cooperate as it seeks to avoid yen volatility.

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A REALITY CHECK FOR THE EURO AREA

BY CHRISTOPHER DEMBIK

The problems facing the Eurozone economy are neatly illustrated by fresh German data showing soft exports and contracting factory orders. While Chinese fiscal stimulus should help get Europe's biggest economy back on track, expansionary fiscal policy across the bloc, as well as interest rate normalisation, are also necessary to ameliorate the ills of the euro area as a whole.

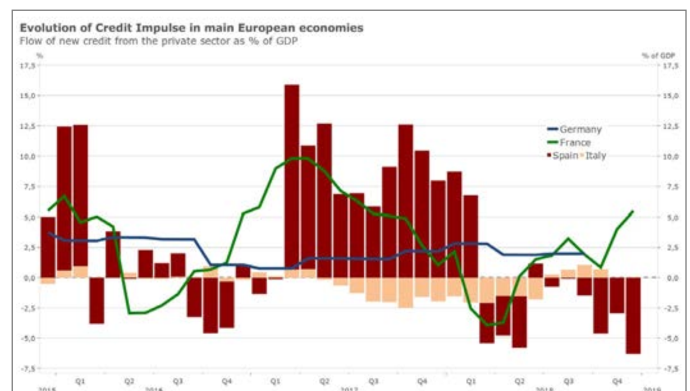
There is no such thing as global decoupling. Unsurprisingly, headwinds from China's slowdown are starting to hit Europe and the US. The Organisation for Economic Co-operation and Development's euro area leading indicator, which is widely used by asset allocators globally, has fallen sharply over the past few months. The year-on-year rate stands at its lowest level since the end of 2012.

At the same time, large declines in core European industrial production data can be observed, especially in Germany, which accounts for one-third of European industrial activity. This slowdown came as a shock for many policymakers, but we feel that it was predictable. Over recent quarters, our leading indicators (notably credit impulse) led us to warn clients and investors against the risk of lower growth in Europe.

LOW CREDIT IMPULSE AND CHINA

The euro area faces two main issues: low credit impulse and the Chinese slowdown. The euro area credit impulse, a key driver of economic activity, is running at 0.4% of GDP, which is rather low compared with its four-year average of 0.8%. A country-by-country analysis shows that the risk of growth decoupling between core countries and the periphery of the euro area is emerging again. In France and Germany, credit impulse is positive, at 1.7% and 0.6% of GDP respectively. By contrast, the credit impulse is sharply decelerating in the periphery; it was close to zero in Q4'18 in Italy and sits at -2.1% of GDP in Spain, a level not seen since the end of 2013.

This tends to indicate that a more restrictive credit cycle, especially in the periphery, has started. This will have a negative impact on domestic demand as it is highly correlated to the flow of new credit in the economy, and ultimately on growth as well.



SOURCE: MACROBOND, SAXO BANK STRATEGY & RESEARCH

On the top of that, the euro area, which has been more and more reliant on Asian growth since the financial crisis, is hit hard by low economic activity in China. The two charts below show the drop in Germany's export data; trade, which accounts for 46% of the country's GDP, looks soft. Germany's factory orders, at constant prices, are in contraction and close to their 2012 nadir. In other words, we are looking at a decline in the manufacturing sector months ahead as well as weak sentiment in the automotive industry. Digging further into the data, the most striking chart is German export growth to China, which has fallen sharply since the beginning of 2018 and is now in contraction as well.

A REALITY CHECK FOR THE EURO AREA

SOURCE: MACROBOND, SAXO BANK STRATEGY & RESEARCH

SOURCE: MACROBOND, SAXO BANK STRATEGY & RESEARCH

The bright side is that China has opened the credit tap again, starting in the spring of 2018. We expect Chinese economic stabilisation by Q3 and a positive impact to Europe by Q4'19-Q1'20. Meanwhile, domestic measures to stimulate the economy need to be taken at the European level.

MONETARY POLICY OPTIONS

As it is so often the case, all eyes are on the European Central Bank. In a bid to win time and avoid a tightening squeeze hitting Eurozone banks, March saw the ECB announce a new round of TLTRO and a modification of forward guidance to extend its first rate hike into 2020. In our view, this is only a first step towards a more accommodative stance. As of today, discussions among ECB watchers are notably evolving around the idea of pushing the repo rate back to zero. The rationale behind this idea is that the benefit of negative rates is rather low; they are essentially a tax on banks that tends to further enfeeble the weakest banks. So far, the positive impact has been limited and has strongly depended on the structure of banks. The normalisation of the repo rate would be an easy move to reduce pressure on the banking sector if the risk of a tightening squeeze appears again.

FISCAL PUSH IN H2'19

These measures alone will not be enough to stimulate growth. They may help to push the credit impulse higher but other measures to support demand are also required. As economic data will continue to disappoint in the coming months, we believe that a new consensus for looser fiscal policy will emerge in European countries in H2'19. An accumulation of negative German data could be the perfect trigger to set off expansionary fiscal policy in Europe. If fiscal expansion is equivalent to 1% of GDP in Germany, it could lead to an average increase in the output of other European countries by 0.15% after two years, with the strongest impact on small, open economies sharing a land border with Germany to be around 0.4% according to Beetsma, Giuliodori and Klaassen[1]. Though the spillover effect of fiscal expansion usually tends to be small, it is largely positive and, coupled with the ECB's accommodative monetary policy and China's credit impulse, could be the right answer to ongoing headwinds.

[1]SEE BEETSMA, R., GIULIODORI, M. AND KLAASSEN, F., "TRADE SPILL-OVERS OF FISCAL POLICY IN THE EUROPEAN UNION: A PANEL ANALYSIS", ECONOMIC POLICY, VOL. 21, ISSUE 48, 2006, PP. 640–687

A REALITY CHECK FOR THE EURO AREA

OUR MAIN MACRO TAKEAWAYS FOR Q2'19

- The euro area is reacting late to cyclical downturns in the domestic credit market and in trade developments.
- We see growing risks to growth in the periphery of the euro area and we expect that Germany will experience disappointing growth this year.
- The outcome is likely to be more fiscal expansion after the EU parliamentary elections and further monetary stimulus in a tricky period for the ECB as it will be looking for its next president.

THE EURO AREA FACES TWO MAIN ISSUES: LOW CREDIT IMPULSE AND THE CHINESE SLOWDOWN

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DEBT-FINANCED SPENDING VERSUS RISING POPULISM

BY ELEANOR CREAGH

The relentless rise of populism, in all its guises, at once exposes Europe's deep structural flaws and presents it with an imperative to reform. Modern Monetary Theory is increasingly proposed as a solution to growing inequality, but beware: it is no panacea.

Europe, born of liberal democracy and multilateralism, is now a continent whose political foundation is under threat as the ascent of populism, political intolerance and simmering geopolitical tensions threaten to undo the liberal world order. This rising populist tide is ever-swelling in the run-up to May's EU parliamentary elections. These elections promise to fragment the existing state of affairs as a vast swathe of dissatisfaction and backlash against globalised society in the context of anaemic Eurozone growth rises to prominence, albeit without any clear idea of what might replace the status quo.

From Trump and the China-US trade war to Brexit and the gilets jaunes, the threats of this regime shift are evident. The tectonic plates are shifting, even if we are yet to feel the consequences of the extremist versions of these movements, like a hard Brexit. After a 30-year spate of deregulation and laissez-faire economics, this new paradigm will create a different business and investment environment and the implications will be far-reaching, creating fresh headwinds and therefore risks. For those wishing to dismiss this unfolding (and global) transition as insignificant, think again!

These forces are complex, deep-seated and contain multiple moving parts, rendering both the cause and effect uncertain. This narrative is far from complete, but we have attempted here to articulate some of the concerns and threats to basic assumptions that have underpinned asset prices and equity returns.

Populism is not a new phenomenon. In fact it is as old, if not older, than democracy itself. The philosophy itself is hard to define, but simply put, the root of the movement stems from the conflict between "ordinary" people and the minority "elite", where the alienated masses present a deep dissatisfaction and mistrust of the prevailing establishment.

There are many narratives that can explain the surge in populism, but from where I stand, the most compelling is derived from the result of "hyper-globalisation", a term coined by economist Arvind Subramanian. Since the 1980s, the shift towards a new economic order of globalisation, free markets and technological advances has enabled huge growth in global GDP, generated wealth and driven up corporate profits, and lifted millions out of poverty. For developing countries like India and China, this has presented huge opportunities, but the West also has also capitalised on cheap labour and product markets. This, then, set global disinflation in motion, suppressing bond yields and increasing leverage, which in turn have boosted asset prices since the 1980s.

THE CURRENT NEW POLITICAL ERA IS THE RESULT OF DECADES OF SOCIETAL SHIFTS AND THE SOLUTION COULD TAKE DECADES TO WORK THOUGH

DEBT-FINANCED SPENDING VERSUS RISING POPULISM

But this shift, which for years has been viewed as only beneficial, has not been without its losers. For the West, three decades of hyper-globalisation have spurred an unprecedented wealth transfer away from labour. Corporate profits as a percentage of GDP have risen steadily, while real wages have stagnated, leaving wealth concentrated among the few and income inequality up sharply. Pre-tax incomes of the top 1% are now at levels last seen in 1929, on the eve of the Great Depression.

Global corporations have plundered the gains as workers have grappled with this breakdown in equality alongside new competition from cheap migrant labour and automation alike, with labour all the while taking a smaller slice of the pie as taxation and rent-seeking dwarf real gains. Throw in high house prices, a crippled welfare state, deflation and lower growth pushing down yields and penalising savers, and labour's pie looks increasingly worse. Moreover, when the 2008 crisis hit, instead of undercutting this system, the policy response and the failure to clear markets exacerbated the situation.

QE worked to reflate asset prices, but not wages or productivity, spurring further inequality and eroding confidence in the establishment's ability to navigate Western economies. Given all this, the backlash is not all that surprising.

Indeed, it might be surprising that it didn't happen sooner.

What does this mean for markets, economic policy and the threat to globalisation? As the backlash intensifies, so will the battleground, making it increasingly difficult to price risk and determine the policy response against a complicated and polarising backdrop.

Aside from reactive or palliative redistribution policies, any response that will bring real improvement and tackle the misfortunes of those caught on the wrong side of globalisation seems a long way off. The current new political era is the result of decades of societal shifts and the solution could itself take decades to work though. We hope not, but there is little evidence to the contrary.

As development and inequality specialist Branco Milanovic wrote:

"Neoliberals and the centre-right have now for a decade agreed that something has to be done to reduce inequality of wealth and income. But whenever there is any proposal, they are against it. I conclude they are in favour of inequality reduction by magic."

Europe's exports account for 50% of GDP (double that of China), which leaves the bloc vulnerable to the global slowdown. Combine the growing populist stance with an already wilting economy, unable to stimulate growth and employment even with the European Central Bank's €2.6 trillion money-printing scheme, and the forecast becomes one of change. As resistance to previous economic policy consensus grows and austerity is shunned by the ever-growing tribe of populists, the conversation is shifting.

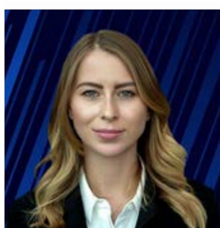
A push towards radical fiscal expansion to stimulate demand under the guise of Modern Monetary Theory is likely not the utopian answer we are searching for. The experiment could end with far more pronounced structural imbalances, runaway inflation, currency corruption and the corruption of the monetary system as we know it.

DEBT-FINANCED SPENDING VERSUS RISING POPULISM

For better or worse, however, this idea is gaining traction, particularly in the US. While MMT itself is not applicable to the Eurozone because the countries are not monetary sovereigns and do not have their own currencies (and are thus unable to print money independently to fund their own debts), this doesn't mean that the ideologies will not gain popularity within the bloc as populists take hold of the agenda in May.

The result will be a rejection of fiscal austerity and a debt-financed spending spree of policies that aim to engender a more just economic distribution. Although the cynic in me would say the motivations are less pure, for politicians this is a smokescreen for pushing a "popular" political agenda and debt monetisation with increased government and policy interference.

COMBINE THE GROWING POPULIST STANCE WITH AN ALREADY WILTING ECONOMY... AND THE FORECAST BECOMES ONE OF CHANGE



ELEANOR CREAGH, MARKET STRATEGIST
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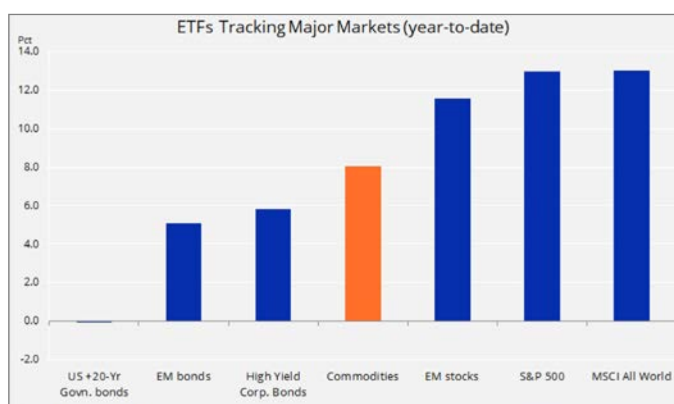
COMMODITIES **POWER AHEAD**

BY OLE HANSEN

Commodities have cast off the caution that defined the start of this year and powered to strong collective gains, led by energy and industrial metals. As we enter the second quarter the mood is still good, with crude oil riding atop a wave of price-supportive supply news, gold encouraged by a dovish Fed and copper pinning its hopes on a US-China trade détente.

The commodity sector delivered a surprisingly strong return during the first quarter of 2019 with the Bloomberg Commodity Index trading higher by 9%. This remarkable development relates to the fact that the rise was led by growth-dependent commodities such as energy (+17%) and industrial metals (+12.5%).

Markets, including commodities, began the year on the defensive with growth concerns and US Federal Reserve-led liquidity tightening raising concerns about the prospects for 2019.



SOURCE: BLOOMBERG, SAXO BANK

ONLY A MAJOR CHANGE IN THE OUTLOOK FOR DEMAND FOR OIL WILL ALTER THE CURRENT POSITIVE SENTIMENT

The year, however, was only a few weeks old before global policy panic set in. In early January, the Fed hit the pause button before abandoning it at the end of the quarter while calling a halt to further quantitative tightening. The Bank of Japan and the European Central Bank followed suit with their own measures, while in China the government stepped in with various initiatives to stabilise the economy as the chance of a trade deal between Washington and Beijing helped sentiment further.

Crude oil's near-40% rally from the December low has resulted in both WTI and Brent clawing back half the losses seen between October and December. With global demand growth holding up despite the prospect for lower global growth, the market has instead been left to focus on a near-perfect storm of price-supportive supply news.

Aggressive production cuts (both voluntary and involuntary) from the Opec+ group of producers have seen supply from these countries drop by more than was expected. Saudi Arabia was probably angered by the price collapse following the surprise US decision to grant waivers to buyers of Iranian oil and has been cutting production aggressively since then. In addition to these cuts, which hinge on continued cooperation between Russia and Saudi Arabia, the involuntary cuts from Venezuela and Iran (down 1.6 million barrels/day during the past year) have added an additional layer of support.

COMMODITIES **POWER AHEAD**

The six-month waiver that the US granted to buyers of Iranian oil back in November is due to expire in early May and this has raised some questions about what will happen next. But with Opec+ continuing to cut production and the US forcing down exports from Iran and Venezuela, only a major change in the outlook for demand will alter the current positive sentiment.

Several Opec producers, and Saudi Arabia in particular, need oil back above $80/barrel to meet their fiscal obligations and they are unlikely to be satisfied with Brent at $70/b. On that basis, we expect supply to be kept tight over the coming months, thereby supporting a potential extension towards $75/b before it eventually runs out of steam amid renewed concerns about the negative impact to global growth.

SOURCE: SAXO BANK

The dramatic recent turnaround at the Fed is seen as bullish for gold as the return to a dovish stance highlights the risk of a gold-supportive recession within the next 12 months. The second quarter, however, may not yet provide the spark gold needs to break strong resistance between $1,360/oz and $1,380/oz. Into the second half, however, a formidable challenge could be seen amid support from a weaker dollar, stable to lower bond yields and concerns about global stocks' ability to forge higher amid raised growth concerns.

We should always keep in mind that many investors buy gold to hold an insurance policy against adverse movements across other investments such as stocks. On that basis, it is worth keeping a close eye on flows in and out of the exchange-traded products often used by long-term investors. So long as stocks continue to show their current resilience, gold is unlikely to mount a strong enough challenge at the massive area of resistance between $1,360/oz and $1,380/oz.

THE DRAMATIC TURNAROUND SEEN AT THE FED OF LATE IS SEEN AS BULLISH FOR GOLD

COMMODITIES **POWER AHEAD**

SOURCE: SAXO BANK

Investors who remain bullish about gold might consider silver, as it remains the "forgotten metal" and is trading 12% below its five-year average relative to gold. Another is platinum, which should be supported by its historic $700-plus discount to palladium and its $400-plus discount to gold.

High-grade copper has managed to reclaim half of what was lost in the aftermath of the US-China trade war breaking out last year. The combination of an eventual de-escalation of the trade conflict and the Chinese policy easing already in place, combined with a relatively tight supply outlook, should continue to provide the support copper needs to yield a positive return in 2019. However, having already returned to our H2'19 target of $3/lb we see the upside as limited into the second quarter. On that basis we are looking for a potential $2.8/lb to $3.05/lb trading range to emerge.

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.

YOU CAN'T FIGHT GRAVITY

BY KAY VAN-PETERSEN

The global policy panic seen in Q1 saw the world unable to escape its QE dependence, with central banks pivoting to a degree of support that will remain in place until structural failure. The "QE for life" era, though, holds some implications of its own, and we see China's gravitational pull as perhaps the key factor.

There has been a huge shift in the global macro backdrop over the last six months and it has huge structural significance for both Asia and the world as a whole. The crux of the matter is that central bankers, led by the Federal Reserve and European Central Bank, have unequivocally failed to attain escape velocity from quantitative easing. The gravitational pull of addiction to loose money has led to pampered stock and bond markets, as well as some remarkable events.

Fed chair Jerome Powell's Fed now seems to belong to vice-chair Richard Clarida (who, it should be noted, was previously at one of the biggest bond shops on the planet). The Fed hiking cycle, meanwhile, is down for good with a wooden stake through its heart – we went from expecting two hikes in 2019 (after a December 2018 downgrade) to no hikes. Additionally, there is already an end in sight for the balance sheet unwind, despite its having barely got through 10% so far.

Mario Draghi's ECB has also moved firmly back into stimulus mode in a year that was supposed to see it look to raise rates. The "hawkish Fed" and the "hawkish ECB" must now be classified alongside the unicorn and all the other mythical beasts.

No one should be surprised that we couldn't escape this QE world, particularly given debt levels that are now north of $250 trillion as compared to $175 trillion before the financial crisis. The speed with which we have been pulled back in, however, was surprising. The implication is now that, until a "great debt reset" (read: haircuts, restructuring and a debt jubilee) that could still be five to 10 years away, it's back to QE for life.

NO ONE SHOULD BE SURPRISED THAT WE COULDN'T ESCAPE THIS QE WORLD, PARTICULARLY GIVEN DEBT LEVELS THAT ARE NOW NORTH OF $250 TRILLION AS COMPARED TO $175 TRILLION BEFORE THE FINANCIAL CRISIS

Does the level of debt and excessive money printing in the system matter? No and yes… or rather, it doesn't matter until it does. It's just like any bad habit: at first, it's just a taste here and there, then it becomes a regular occurrence and some time after that, there is notable structural change. We will need a global recession before we see the great debt reset but until then, the QE-for-life theme has quite a few implications.

For one, it will continue to extend this business cycle even further, despite the fact that we are presently in the tail-end. The 2020 US elections, Tokyo 2020 and the Chinese Communist Party's centenary in 2021 – not to mention a likely forced fiscal spend in the Eurozone at some point – will carry overall global growth.

Taking the world back to looser monetary policy and lower yields will be bullish for bonds and equities.

YOU CAN'T FIGHT GRAVITY

Expect new cyclical lows in bond yields (for example, and as we have long mentioned, Australian 10-years are already taking out the 1.81% lows). Structurally speaking, I also expect a much weaker USD over the course of the year. The world needs a weaker USD to flourish and what the world needs, it tends to eventually get.

Lower yields mean less financing and a lower cost of capital for global companies and emerging market corporates. A structurally weaker USD will remove years of headwinds for EM assets. It should also be a tailwind for higher commodities, which are generally supportive of EM as whole.

For China, there are a lot of moving parts. The market is still anticipating some form of resolution on the US trade deal, although repeated delays of the long-awaited Trump/Xi summit could be bearish in the short term. It's also worth bearing in mind that the market is acting like there will almost certainly be a deal. As such, a no-deal scenario would be a disaster for equities – we could see a retest of the December lows – and a boon for higher bond prices and a stronger USD.

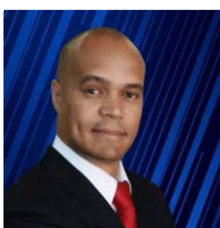
There is another gravity effect in China over the long term and that's the multi-generational move from a positive current account economy (outwardly driven) to a negative current account economy (inwardly driven). This is all part of Beijing's plan to be more reliant on domestic consumption than on exports to the rest of the world. That's over around $1 trillion of China-bound inflow over the next three to five years; to put that in context, it's over +7% of China's 2018 GDP of $13.5 trillion.

Saxo Chief Economist and CIO Steen Jakobsen made a very contrarian call towards the end of last year that Chinese equities were likely close to the bottom and that they would outperform in 2019. The 30%-plus gains from the lows in the Shanghai Composite show that he was precisely correct – not just on direction, but more importantly on timing.

It's also worth noting that while we are not far from all-time highs in US equity indices (we have already seen new all-time highs in certain stocks), Shanghai at around 3,100 is still around 40% lower than its 2015 high of 5,180. We also have huge China equity inclusions in the MSCI EM index coming that will take us from 5% to 20% (in +5% increments slated for May, August and November. The bounce in Chinese equities is likely telling us that, for now at least, we've seen the worst in the underlying Chinese economy and could be in for some positive surprises, particularly in Q2'19 growth data.

Beyond this, there are significant structural inbound flows headed to the Chinese equity and bond markets as China continues to open up to the world. If you have not done so already, check out Saxo's **China Bond Connect** to access the $12 trillion-plus Chinese bond market.

THE BOUNCE IN CHINESE EQUITIES IS LIKELY TELLING US THAT, FOR NOW AT LEAST, WE'VE SEEN THE WORST IN THE UNDERLYING CHINESE ECONOMY



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.

WHY SOVEREIGNS ARE **Q2'S INVESTOR FAVOURITES**

BY ALTHEA SPINOZZI

The Federal Reserve finally reacted to the escalating likelihood of a global recession with a sharp dovish turn last month, joining the ranks of the European and Chinese central banks. This is unhappy news for already-fragile EM and corporate bonds, especially in the high-yield space, but it augurs well for sovereigns.

The first quarter of 2019 saw a U-turn in central bank policy. With data pointing to a global slowdown, policymakers do not wish to take chances. That's why we have seen the Federal Reserve stall its rate hike plans, the European Central Bank commit to whatever support measures are needed and the People's Bank of China push stimulus in the form of fiscal policy.

We believe that this global policy panic will play in favour of global sovereigns. Credit spreads will also be supported, but investors should remember that dovish central bank policies may prolong the late-cycle period. They will not, however, be sufficient to entirely avoid the recession we believe is coming in Q4'19 or early 2020. This means that while credit valuations will be supported for longer, credit risk will remain very high; in this context, investors should stay cautious and avoid taking on unnecessary risk, especially in the high-yield and emerging market spaces.

DOVISH FED EQUALS STRONG SOVEREIGNS

The global policy panic sparked by the December sell-offs has seen the Fed turn away from quantitative tightening and its own rate hike schedule. As such, we will see more of what we saw before Powell: a continuous flow of resources aimed at incentivising investment, which in return does not pick up, leading inexorably towards recession.

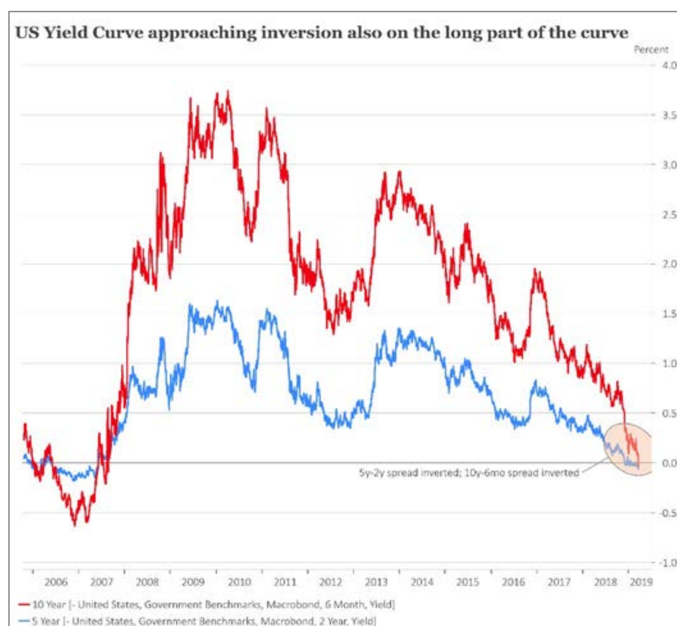
A dovish Fed is good news for bond investors even amid muted economic growth. Treasuries will gain from the unconditional support even though if it is now clear that recession is coming. In the wake of the March Federal Open Market Committee meeting we have seen yields on the mid-to-long part of the curve falling faster than short ones, meaning that the spread between the five- and two-year Treasury yields has fallen to -6.6 basis points, which is the lowest we have seen in more than a decade. More importantly, the spread between 10-year Treasuries and the monthly T-bills went also negative, indicating an inversion in the mid-long part of the curve as well.

Besides being a sign of a recession, an inversion between 10-year and six-month yields also indicates that Treasuries and high-quality credits with maturities between seven and 10 years become particularly attractive as valuations will be supported by the Fed, which will soon need to replace mortgage-backed securities in its balance sheet with Treasuries matching the same maturities.

Things are going to be different in the credit space. As the longer part of the yield curve inverts even further and we enter recession, we will start to see investors selling

A DOVISH FED IS GOOD NEWS FOR BOND INVESTORS EVEN AMID MUTED ECONOMIC GROWTH

off risky assets, and thus a quick worsening of both IG and HY credit spreads. While high-rated credits may in some cases represent a buying opportunity, we urge investors to remain cautious within the high-yield space. A recession might push default rates to levels unseen since the crisis.



SOURCE: MACROBOND

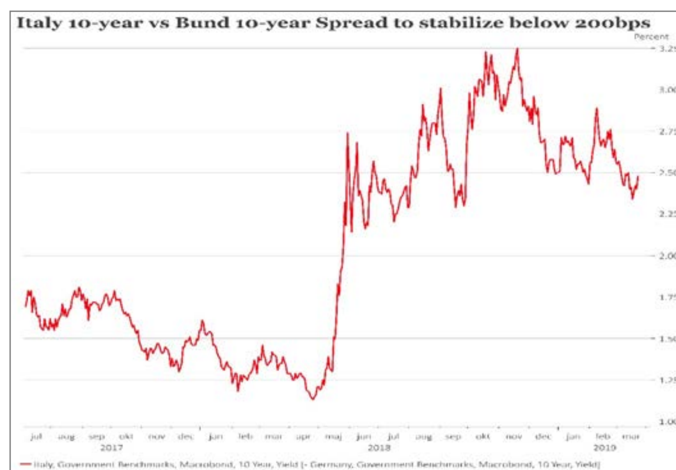
EUROPEAN FIXED INCOME

We also favour sovereigns versus credits in Europe, where we believe credit spreads have tightened excessively since the beginning of the year, especially in the HY space. It is presently near-impossible to find investment grade corporates in EUR that offer a decent pick-up against their related benchmarks. This is why, as we approach recession, sovereigns will be favoured while corporates will suffer widening as recession approaches.

We believe that the 10-year German bund yield will continue trading below 0% as an economic slowdown deepens within the euro area. This will not, obviously, constitute a great opportunity for fixed income investors, who would pay more in commissions to trade the bund than either the net return or the limited increase in value could provide.

We prefer peripheral sovereigns, which still provide interesting yields amid political uncertainties and an economic slowdown. The biggest opportunity at the moment lies in Italy, which is paying a yield of approximately 2.5% for the 10-year BTP. Now that the country has entered recession and has been able to push its policy agenda within the framework of the European Union, it will have less incentives to leave the bloc, hence its anti-EU sentiment will slowly wane as the country tries to remain afloat. This should tighten the BTP-bund spread below 200 bps by the end of this year, a level previously seen before the 2018 elections. Also, the deal that Italy signed in March with China should benefit BTP valuations.

Indeed, we believe that while the international arena is against the steps taken by Italy to endorse the "Belt and Road" infrastructure project, the EU will not risk imposing punitive sanctions on a member country that is already in recession, while on the other hand, Chinese investors will have more incentives to be invested in the Italian bond market.



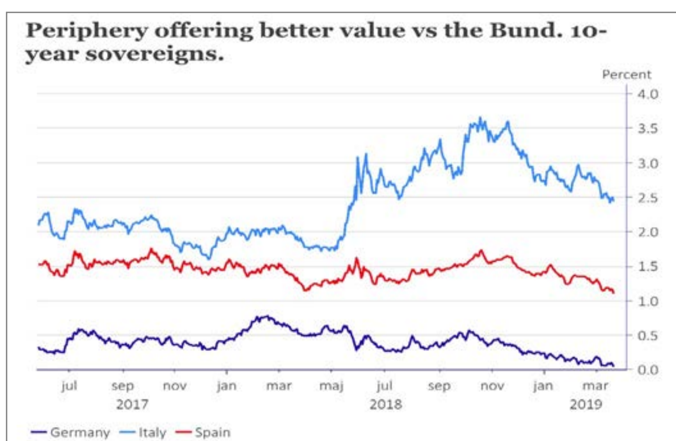
SOURCE: MACROBOND

Spanish government bonds seem also positioned for a rally. The 10-year SGB presently offers a yield of 1.16%, but there remains a degree of uncertainty due to the April 28 elections. We believe that the elections will provide some momentary noise, but that the market's focus will return to the country's solid economy once they are over.

WHY SOVEREIGNS ARE
Q2'S INVESTOR FAVOURITES

INVESTORS SHOULD STAY CAUTIOUS AND AVOID TAKING ON UNNECESSARY RISK

The Spanish economy is well-diversified, and the banking sector is emerging from a successful restructuring that makes it less susceptible to systematic risk.



SOURCE: MACROBOND

CHINESE SOVEREIGNS CONTINUE TO PERFORM THROUGHOUT THE YEAR

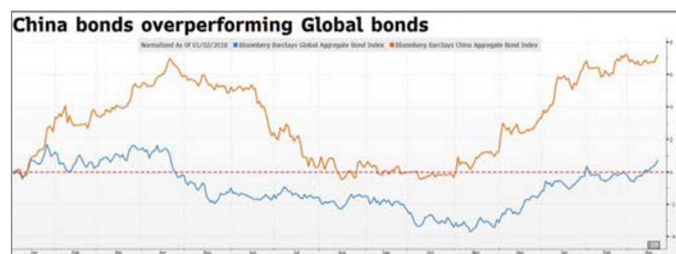
The biggest opportunity out there remains China. Beijing's efforts to open its economy and provide suitable monetary and fiscal policies will see China's stock rise in the international arena. In 2018, Chinese government bonds were among the best performing sovereigns. The yield on the 10-year CGB has fallen from close to 4% at the beginning of 2018 to 3.1% recently. This shows that these instruments have taken on a safe-haven role within emerging markets amid the uncertainty provoked by the China-US trade war.

This year, China is fighting with a different crisis: a slowing economy. While trade tensions seem to have come to a resolution, slowing growth in China could threaten both the country itself and the wider EM space. As such, the Peoples Bank of China will not allow this to happen; we have already seen it implement fiscal policies such as tax cuts that aim to support the economy.

PBoC support is important for CGBs, but we believe the opening of the Chinese financial market to foreign investors is even more important. A law passed in March will level the playing field between domestic and foreign investors, removing barriers that were previously a concern to international capital.

With CGBs set to be included in the Bloomberg Barclays Global Aggregate Index in April, we will start to see real money flowing towards these assets. There are already talks on the way to include these securities in the FTSE World Government Bond Index and the JP Morgan Government Bond Index as well.

In our view, we will soon witness a bull steepener with the short part of the curve outperforming the longer part as foreign investors move to shorter maturities.



SOURCE: BLOOMBERG

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.

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