SAXO BANK

PRESS RELEASE

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Saxo Q3 Outlook: The global fiscal panic

Saxo Bank, the online trading and investment specialist, has published today its Q3 2019 Quarterly Outlook for global markets, including trading ideas covering equities, FX, currencies, commodities, and bonds, as well as a range of central macro themes impacting client portfolios.

"Central banks' response to the looming economic slowdown and trade war has been panic cutting interest rates and signaling new extremes of easing, while politicians are warming to the idea of Modern Monetary Theory. Our model indicates that the low point in the economic cycles lies in the third quarter for China, and in the first to second quarter for the US, UK and Europe. Furthermore, we could be headed for a massive repeat of the 1970s global supply shock," **says Steen Jakobsen, Chief Economist and CIO, Saxo Bank.**

"Companies globally are scrambling to make sense of the trade war, Brexit and the disintermediation of a multilateral system in a world where environmental costs are about to explode, driven by consumer concerns and a wave of Green politicians getting into the political driving seats.

"The credit impulses globally continue to indicate that the economic low point is ahead of us, not behind us. Our model indicates that it lies in the third quarter for China, and in the first to second quarter for the US, UK and Europe.

"Today globalisation has reached its maximum, even without the trade spat. China produces everything, so the "making things cheaper" process has run out of room. Add to that the potential trade war and massive focus on the environmental impact of all facets of consumption, from plastics to packaging, airline and sea transport pollution, and, with central banks wrongly focused on excessively low inflation, you get a perfect storm brewing that will turn the tide back toward inflationary outcomes. From anti-globalisation, higher unit cost of production due to environmental considerations, a fiscal push into infrastructure and shoring up injured global supply chains — all that creates a massive repeat of the 1970s global supply shock.

"The shock this time will come sometime after the global fiscal expansion set to arrive in the third and fourth quarter. In this situation, the markets that stand to benefit the most will be commodities and real resources, infrastructure plays, wages and gold. By the summer of 2020 – one year from now – we will have seen the end of any belief in monetary policy moving the needle, and will be witnessing extravagant spending driving inflation to levels beyond anyone's expectations, just a couple of quarters after inflation, once again, has been pronounced dead."

Against this uncertain backdrop, Saxo's main trading ideas and themes for Q3 include:

Global equities show the biggest disconnect since 2007

Society has reached an important inflection point on several fronts which will have profound implications for global equities and investors. We have reached the end of globalization as we have known it since the early 1980s. Large imbalances can be seen across the environment, inequality, credit and the global supply chain.

Peter Garnry, Head of Equity Strategy, said "OECD's leading indicators on the global economy is still declining with April's number marking the 17th consecutive monthly decline. The global economy at its weakest point since July 2008 and the probability of a recession is still elevated and not fully reflected in equity valuations. South Korea, one of the world's economies most tuned globalisation, is showing significant weakness with its leading indicators declining for 23 straight months in April and to levels not seen since early 2012. The South Korean economy has historically been one of the best indicators on the global economy, so we expect more pain to come in the second half of the year."

"The recession probability is much higher than what global equities are currently reflecting with the yield curve and leading indicators sending the strongest warning signals to investors. But history has often showed a final bullish move in equities despite clear evidence of an incoming recession. This is exactly what we are witnessing today. The Fed put is used as an excuse to buy equities as it presumably increases the equity risk premium, but history shows that the first rate-cut is often a reliable signal that a recession is coming which reduces short-term cash flows and rises return expectations as investors get more risk adverse. The short-term is not correctly discounted in equities based on our forecast of the future, but it is the long-term expectations that we believe make the disconnect between equities and reality the biggest."

It's finally time for the USD to weaken

The US Federal Reserve is playing catch-up, and, if we see material signs of weakening in the third quarter, the Fed will axe rates to the effective zero bound instantly and could even restart quantitative easing before year-end. All this points to a weakening of the US dollar in the second half of 2019.

John Hardy, Head of FX Strategy, said: "The most remarkable development in currencies over the first several months of 2019 was the resilience of the US dollar despite the whiplash-inducing reversal in Fed expectations from hawkish in late to December to dovish and then more dovish with each subsequent Fed appearance in 2019.

"Given the risks of a growth slowdown in the US already baked into the cake, from the weak credit impulse to the rolling off of the impact of Trump's tax reforms, we should expect clearer signs of a weaker US economy to emerge. For the second half of 2019 we will be looking for a transition to a weaker US dollar as the Fed is set to deliver strong easing.

“The collapsing rate outlook from the Fed and its willingness to bring back the policy punchbowl will make the rest of the world look less bad, though there are residual risks that any ugly episodes of general market deleveraging could drive bouts of USD strength against the most vulnerable currencies, the Turkish lira, for example. Elsewhere, the world doesn’t look great, but the lack of room to move further on the monetary policy front will encourage a more rapid transition to fiscal policy options.”

Commodities are set to benefit

The global fiscal panic, which is likely to result in governments spending money they don’t have, has the potential to drive a boom in commodities, not least gold as inflation looks likely to come roaring back. And a weaker US dollar could give gold and commodities overall the boost that has been lacking in recent years.

Ole Hansen, Head of Commodity Strategy, “Five years of range-bound gold trading look set to come to an end over the coming months as the yellow metal takes aim at $1,483/oz, the 50% reversal of the 2011 to 2015 sell-off. Driving the initial move higher are expectations that global central banks will cut rates to spur growth, which has proven increasingly difficult to achieve with trade wars disrupting global supply chains. While US Federal Reserve easing cycles in the past have coincided with a strong dollar, we may already have seen the maximum potential for USD strength early in the Fed’s shift. On that basis, we ask if it is finally time for the USD to weaken? That would give gold and commodities in general the tailwind that has been missing in recent years.

“The biggest risk to our scenario of rising commodity prices is the potential for a major trade deal between the US and China reducing the markets’ expectations for how much US rates will have to fall.

”With silver trading at a 26-year low relative to gold, we see some additional upside, not least due to investors having preferred to trade silver from the short side for a while. In copper, we may already have seen the low point around $2.60/lb in high grade and $5,750/tonne in LME. Crude oil’s gyrations during the past six months look set to persist, with multiple drivers creating a very difficult market to navigate.
We expect that Opec and Russia will reaffirm their commitments to keeping oil production capped for the remainder of the year.

”Agriculture commodities will be keeping a close eye on the clouds - or lack of them - in the sky. The problems that farmers in Europe and the Black Sea region faced last year due to drought have moved to the US this past quarter. Torrential rain and flooding have sharply reduced the prospect for US corn production, while the quality of wheat has also been called into question. Soybeans, while also rallying, have struggled to gain momentum amid the trade war and the outbreak of African swine fewer reducing demand from China."

Global policy panic to boost bonds

European government bonds have rallied powerfully since the end of 2018, with periphery issuers, such as Greece, benefiting the most. European sovereign debt valuations are likely to be well supported throughout the summer, and a further rally could be ahead if the unfolding economic slowdown triggers a new loosening of monetary policy.

Althea Spinozzi, Bonds Specialist, added: "We believe that European sovereign debt valuations will continue to be supported throughout the summer, and they may tighten a little further as monetary policies remain extremely dovish. European Central Bank president Mario Draghi's last speech made clear that the ECB is ready to increase monetary stimulus if the economy does not improve. At this point, not only inflation is disappointing, but the data show weakness in the biggest EU economy, Germany, as economic sentiment plummeted in June, while uncertainty over US foreign policy is weighing on economic forecasts.

"The market is too dovish in pricing three US interest rate cuts this year, starting in July. The Federal Reserve just finished hiking rates four times last December, reaching a "comfortable" level at the moment.

"European and US corporate bonds have been rallying since the beginning of the year, reaching levels previously seen at the end of 2016, at a time when economic conditions were robust and well before the Fed and the ECB started to talk about raising interest rates. Now the economic backdrop is weaker amid slowing growth and escalation of trade war, so it is hard to justify low yields on corporate bonds.

"Since the resignation of British prime minister Theresa May last month, we have seen 10-year gilt yields inevitably fall below 1%, exactly as was seen in 2016 after the Brexit referendum. The message that the bond market is sending is clear: things are going to get worse before they get any better. This has serious implications for investors with sterling as a base currency as it means that they need to pay up for good-quality assets, but if they venture into the junk space, yields are so high that they may be irresistible."

Fiscal policy to the rescue in the Eurozone

Growth in the Eurozone could be derailed in the coming quarters, and such a slowdown would trigger a new phase of expansionist fiscal policy. The size and the effectiveness of the next round of stimulus, however, remain uncertain, and some European governments will have little incentive to act.

Christopher Dembik, Head of Macroeconomic Analysis, said: "Interest rates are structurally extremely low. In other words, the cost of debt is low so it reduces the urgency to reduce debt. Recently, for the first time ever, the 10-year government bond interest rates of Austria, France and Sweden have fallen below zero. For some Eurozone countries, up to 88% of the total outstanding public debt is with negative yields for maturity up to 2032. This is the new normal in the Eurozone. Consequently, in major European countries, the cost of debt is totally manageable.

"There is little room left for monetary policy. The European Central Bank is confined to the zero lower bound, which means that lower rates have less positive effect than in the past, as they are already very low or negative. The ECB could resort to a new round of quantitative easing, in case of an economic downturn or de-anchoring of inflation expectations, as early as 2020, but to be effective, it will need to wield a more massive bazooka than in 2015, and the effects are still uncertain. What we know with more certainty is that QE tends to be associated with negative distributional effects (exacerbation of wealth inequality) that can only be mitigated by fiscal redistribution."

Monetary madness in the 'miracle' economy

With the global economic outlook weakening and the Australian economy losing momentum, the Reserve Bank of Australia already in June began what is likely to be a series of cuts to its cash rate, which will probably land at 0.5% next year or even by year-end. Easier monetary policy will be required to deal with slackness in the labour market, weakness in the housing sector and falling consumption.

Eleanor Creagh, Market Strategist, commented: "Australia's near 30-year recession-free run, the envy of central bankers around the globe, is now at risk as economic malaise grips. The "wonder, down under" that escaped zero interest-rate policy, negative interest-rate policy and quantitative easing has not managed to vanquish the business cycle and will not be so lucky this time around. Easier monetary policy will be required given the sizeable spare capacity remaining in the economy which continues to lose momentum and is running well below potential. The weakness is likely to lead to a further rise in unemployment and persistent disinflationary pressures, even before a potential global shock appears.

"In the current low-rate environment and for the foreseeable future, fiscal policy therefore has a far more active role to play. So, what is the bigger problem? Governments shirking their responsibilities to focus on infighting instead of policy reform. Monetary stimulus is ineffective for the challenges we face, and bureaucrats in Canberra must have realistic expectations about what central banks can achieve to stimulate the economy. Monetary policy will never replace sound economic policy. So, rather than relying on central bankers to clean up the mess, the government must deliver productivity-enhancing reforms, infrastructure spending and other fiscal measures to restore confidence and start a self-sustaining recovery in economic growth.

"Where there is a policy power vacuum, the RBA must be ready to step in and do the heavy lifting in case of an enduring threat to growth and employment. Although the RBA hopes it will not need to resort to unorthodox measures, once the conventional policy toolkit has been exhausted, the RBA would probably turn to quantitative easing if the economic outlook were to deteriorate further. Asset purchase programmes could take several forms, depending on the objective."

To access Saxo Bank's full Q3 2019 outlook, with more in-depth pieces from our analysts and strategists, please go to: www.home.saxo/insights/news-and-research/thought-leadership/quarterly-outlook

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About Saxo Bank

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