Danske Bank

10 key questions about the global economy in 2019

Chief Analyst, Head of International Macro
Jakob Ekholdt Christensen
+45 4512 8530
jakc@danskebank.dk

Senior Analyst
Mikael Olai Milhøj
+45 45 12 76 07
milh@danskebank.com

Chief Analyst
Allan von Mehren
+45 45 12 80 55
alvo@danskebank.dk

Senior Analyst, FX research
Jens Nærvig Pedersen
+45 45 12 80 61
jenpe@danskebank.dk

Senior ECB/ Euro area Analyst
Piet P.H. Christiansen
45 45 13 20 21
phai@danskebank.dk

Analyst
Aila Mihr
+45 45 12 85 35
amih@danskebank.dk

Chief Analyst, Head of FX Research
Christin Tuxen
+45 45 13 88 67
tux@danskebank.dk

Senior Equity Strategist
Bjarne Breinholt Thomsen
+45 45 12 80 57
bt@danskebank.dk

Daniel Brødsgaard
Analyst
+45 45 12 84 83
dbr@danskebank.dk

Jens Peter Sørensen
Chief Analyst
+45 45 12 85 17
jenssr@danskebank.dk

3 January 2019

Important certifications and disclosures are contained from page 18 of this report.

Danske Bank

10 key questions about the global economy in 2019

1. Will there be a recession in advanced economies in 2019?
2. Trade war, cold war or no war? Will US-China find peace in 2019?
3. Is the Phillips-curve finally coming alive in the euro area?
4. Who wins the hiking battle 2019: the ECB or the Fed?
5. Beaten and bruised—Will EM stage a comeback in 2019?
6. Oil price—poised for a rebound?
7. Brexit: deal or no-deal?
8. Comeback or continued deterioration for equities?
9. Rates – have they bottomed out or will Bunds go to 0% again?
10. Is 2019 the year when USD strength is coming to an end?

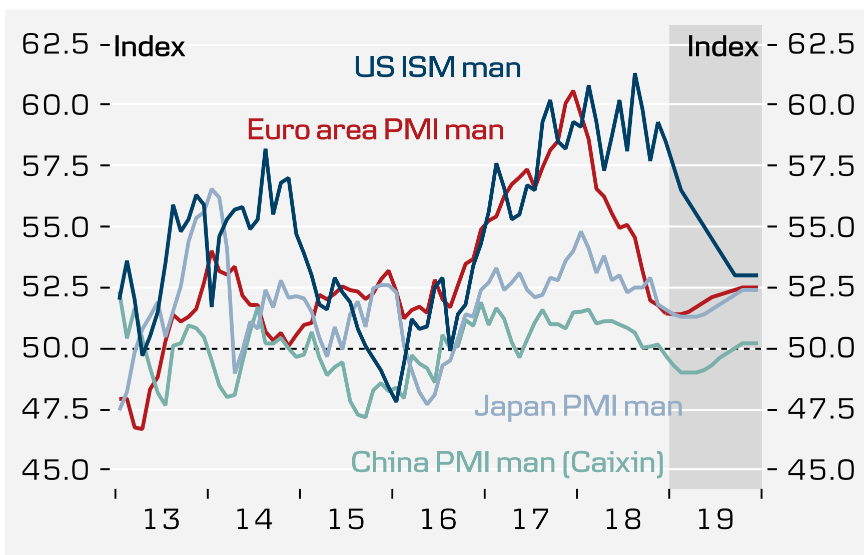
Danske Bank

The short answers

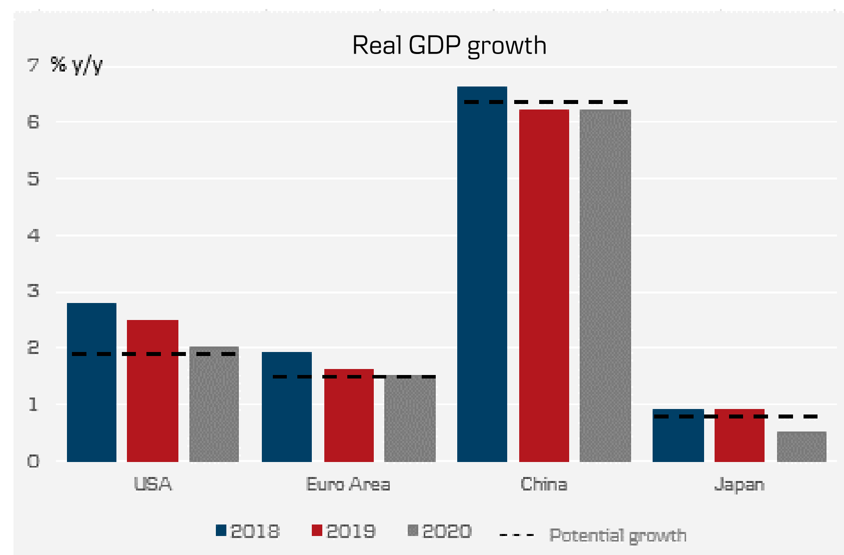
1. Further **moderation of global growth** is expected, especially in Q1—but too early to talk about recession in 2019 in our view – that is more a story for 2020. However, risks are tilted to the downside.
2. A **trade deal between China and US** to be found in H1 19, boosting China's economy and the global cycle.
3. **Wage pressures** are continuing to build gradually in the Eurozone, lifting core inflation towards end-2019.
4. **ECB will make its first rate hike in eight years in December**, while the Fed will slow its rate hiking cycle to two hikes.
5. **The oil price is expected to rebound** toward USD80 per barrel over 2019 as risk sentiment recovers.
6. With the expected trade deal between the US and China and Chinese stimulus, **emerging market sentiment is set to recover** after Q1 19.
7. Difficult to predict how Brexit ends, but '**decent' Brexit still our base-case.**
8. **Oversold equities set for rebound**, even without strong pick-up in global growth.
9. **Overvalued USD will lose momentum in 2019** bringing USD/EUR to 1.25 at the end of this year as the ECB starts signalling a hike.
10. **Bund yields will only rise modestly in 2019** given moderation in global growth and modest increase in inflation pressures.

Q1. The global economy is slowing towards its potential

- Global growth to slow to 3.6% in 2019 from 3.8% in 2018.
- In China, it will get worse in Q1 before it gets better, which will affect the Eurozone. However, a trade deal with the US in H1 and stimuli will support Chinese recovery and the global cycle.
- The US economy will benefit from aftermath of fiscal stimulus and still upbeat sentiment.
- The balance of risks is skewed to the downside if China and US fail to find a trade agreement and the equity market sell-off hits consumer and corporate sentiment.



Source: Markit, Macrobond Financial, Danske Bank

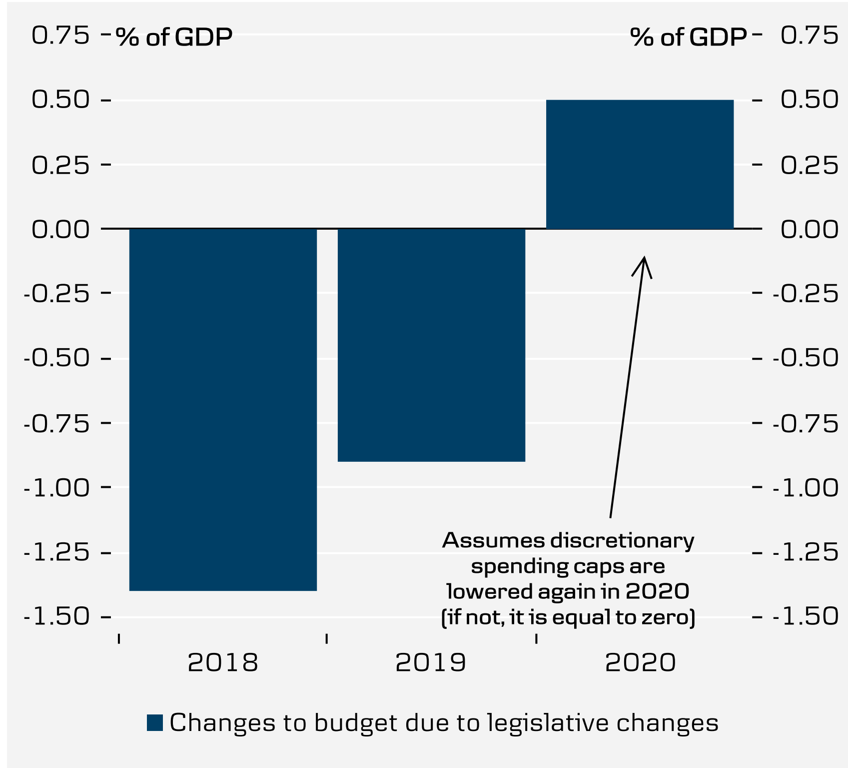


Source: Danske Bank

Danske Bank

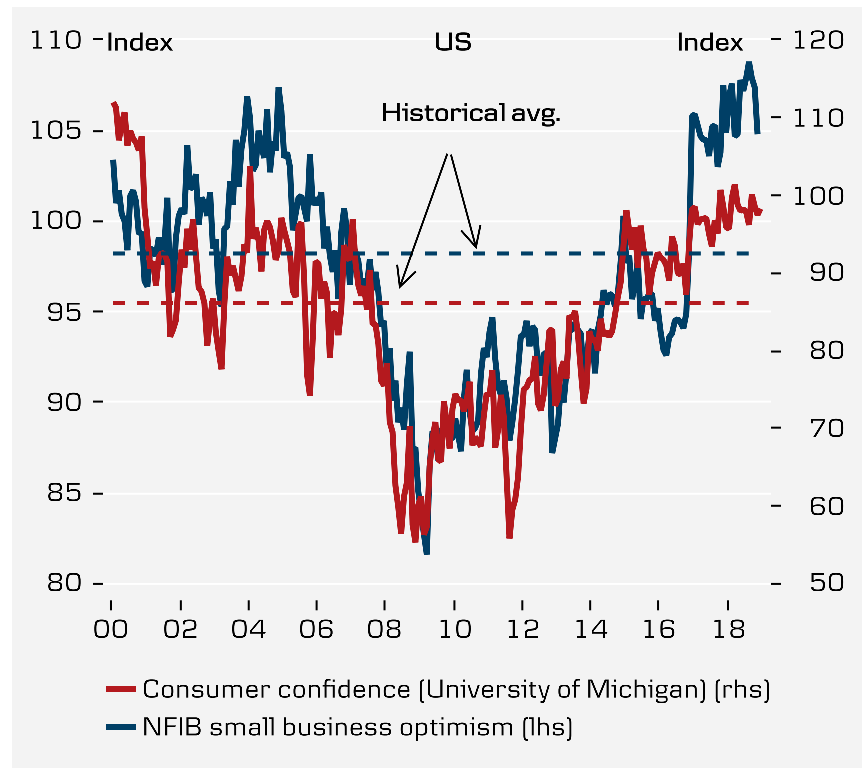
Q1 (continued). Fears of US recession in 2019 are overdone but rising risk in 2020

Fiscal policy remains expansionary in 2019



Source: Danske Bank calculations based on CBO data, Macrobond Financial

Optimism remains high



Source: University of Michigan, NFIB, Macrobond FInancial

The rising recession risk in 2020 is caused by tightening fiscal policy and financial conditions.

Q2. Trade war: US-China deal in H1 19

We see five signs a trade deal is coming in H1

1. **Trump took the initiative for talks.** Before that he said for a long time 'now is not the time to talk'. He also stated he would put more tariffs on China. However, he refrained from it and chose negotiations instead.

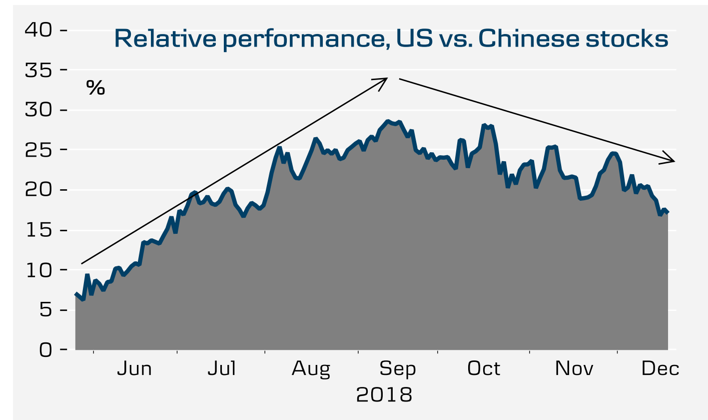
2. **Trump's hand is weakening.** His way of making deals is to keep pushing his opponent – in this case with tariffs. However, recently relative stock performance is going against Trump thus weakening his hand.

3. **Trump wants a deal for the election campaign.** The 2020 Presidential election campaign starts in 2019. A trade deal should involve more Chinese purchases of agricultural goods, natural gas and other goods for up to USD100 bn. It will also involve permanently lower tariffs on cars to 15%. This will benefit voters in important swing states.

4. **Failure of a deal would hurt markets and key voters.** If the ceasefire ends without a deal, the tariff rate is set to increase from 10% to 25% on Chinese goods worth USD200 bn. That would increase uncertainty and push markets lower. At the same time key voters in farm states would still be hurt by the current decline in Chinese imports of agricultural goods. The auto industry is hurt by 40% tariff into China.

5. **China wants a deal to ease the pressure on the economy.** The current headwinds delay the deleveraging campaign and weaken the economy further. A deal sooner rather than later will benefit China.

Trump's hand weakenening – more tariffs could backfire



Two key points from Trump's Art of the Deal

1. Think big

"I like thinking big. I always have. To me it's very simple: if you're going to be thinking anyway, you might as well think big."

...

5. Use your leverage

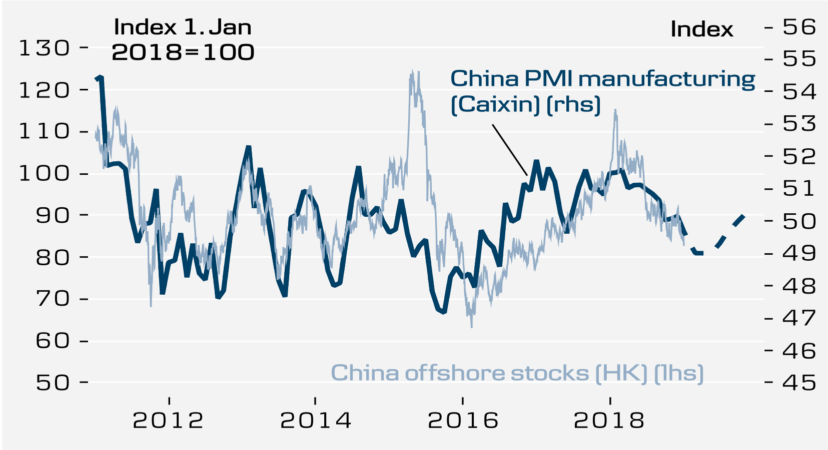
"My style of deal-making is quite simple… I just keep pushing and pushing and pushing to get what I'm after"

Q2 (continued). A US-China trade deal to benefit China and the global cycle

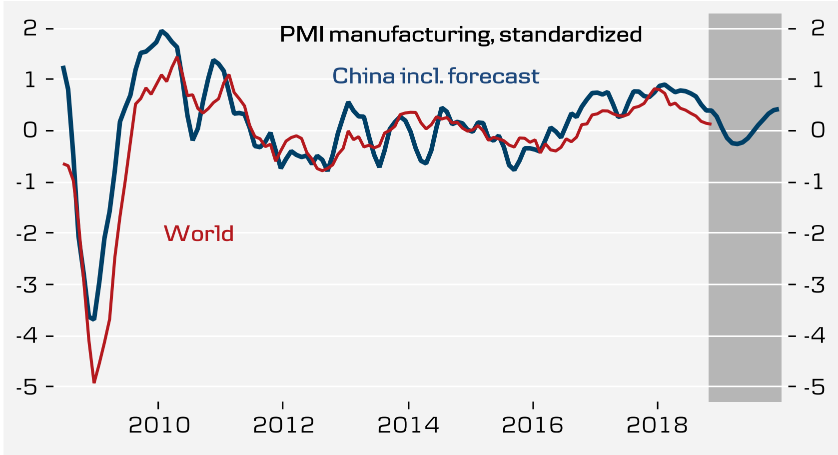
After short-term pain we expect a Chinese 2019 recovery

- A trade deal will lift a drag on the export sector and reduce overall uncertainty
- Stimulus kicks in with a lag during 2019:
  - Monetary policy eased through RRR cuts and measures to boost private bond financing
  - Bank lending targets for private sector lending
  - Increased infrastructure spending
  - Tax cuts for households and corporates
- More tax cuts expected to be announced in 2019

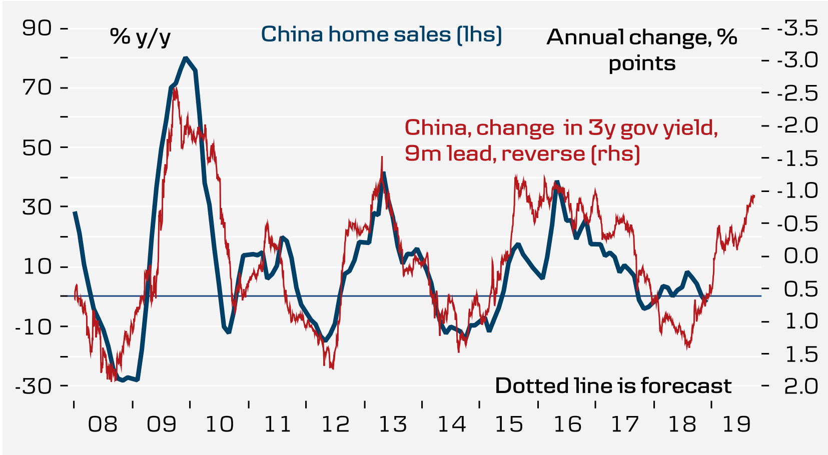
Worse before it gets better – EM to benefit in mid-2019



Chinese recovery in 2019 to support the global cycle



Monetary policy easing led to lower yields – to underpin housing



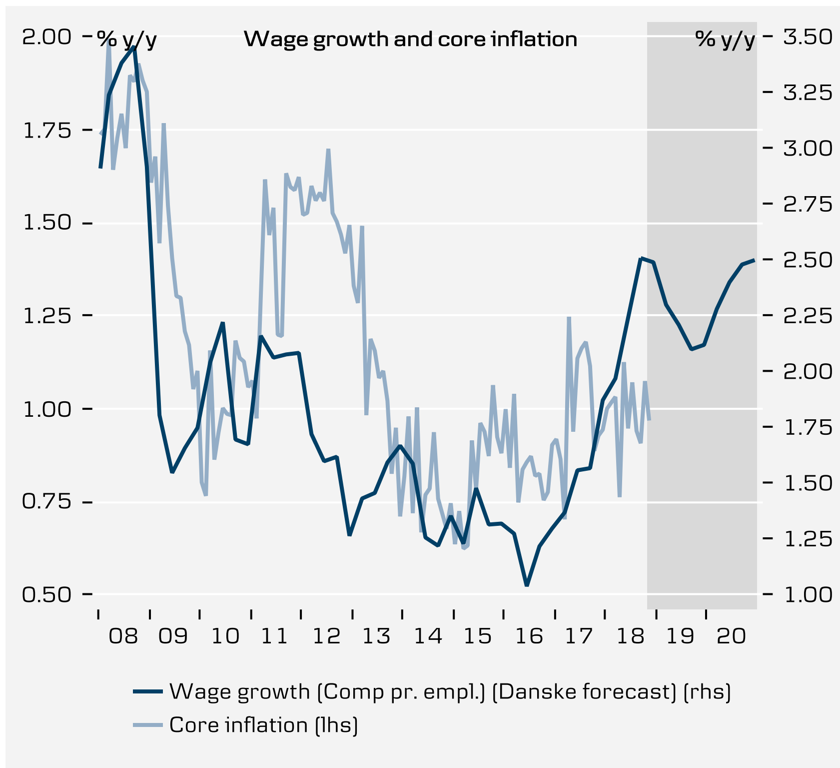
Source: Macrobond Financial, Markit, Bloomberg, Danske Bank

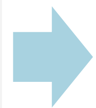
Q3. Is the Phillips-curve finally coming alive in the euro area?

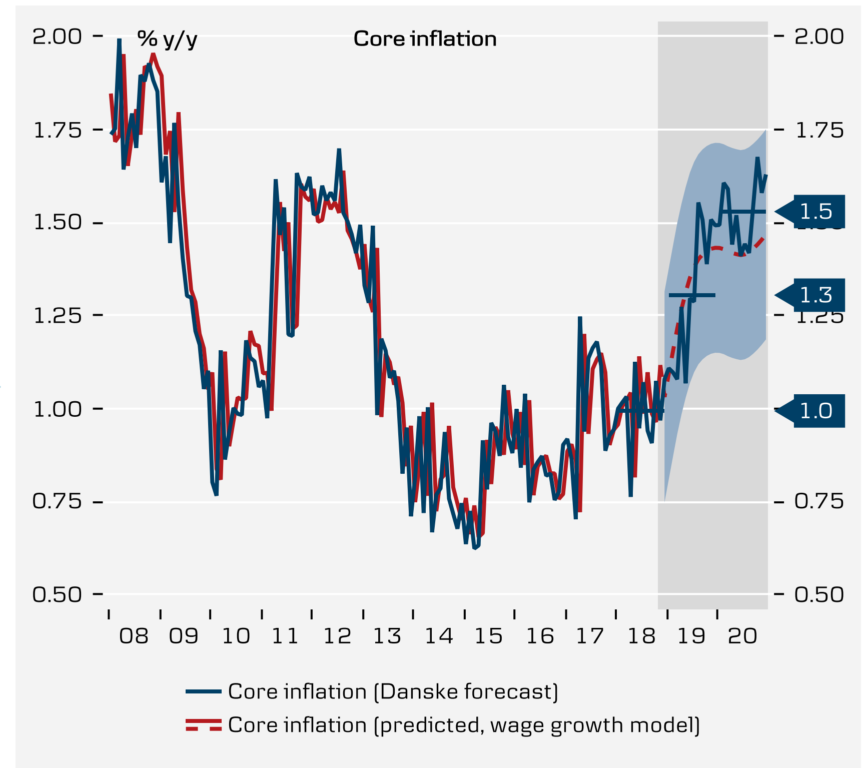
- Wage growth in the euro-area is at the highest level since the financial crisis in 2018.
- Peter Praet (19 Nov): "We expect [wages] will feed through into higher prices in six to 12 months."

→We should see euro area core inflation accelerating from Q2 19 onwards, but gradually and still some way to go to reach 2%

(see also Euro Area Research: Is the Phillips curve finally coming alive in 2019?)







Note: Wage growth rate will decelerate temporarily in 2019, due to the replacement of the CICE (Tax Credit for Competitiveness and Employment) in France, leading to a reduction in social security contributions of employers

Source: Eurostat, ECB, Macrobond Financial, Danske Bank

Model prediction made using: $core_t = \alpha + \beta_1 core_{t-1} + \beta_2\, wage\ growth_{t-6} + \varepsilon_t$

Source: Eurostat, Macrobond Financial, Danske Bank

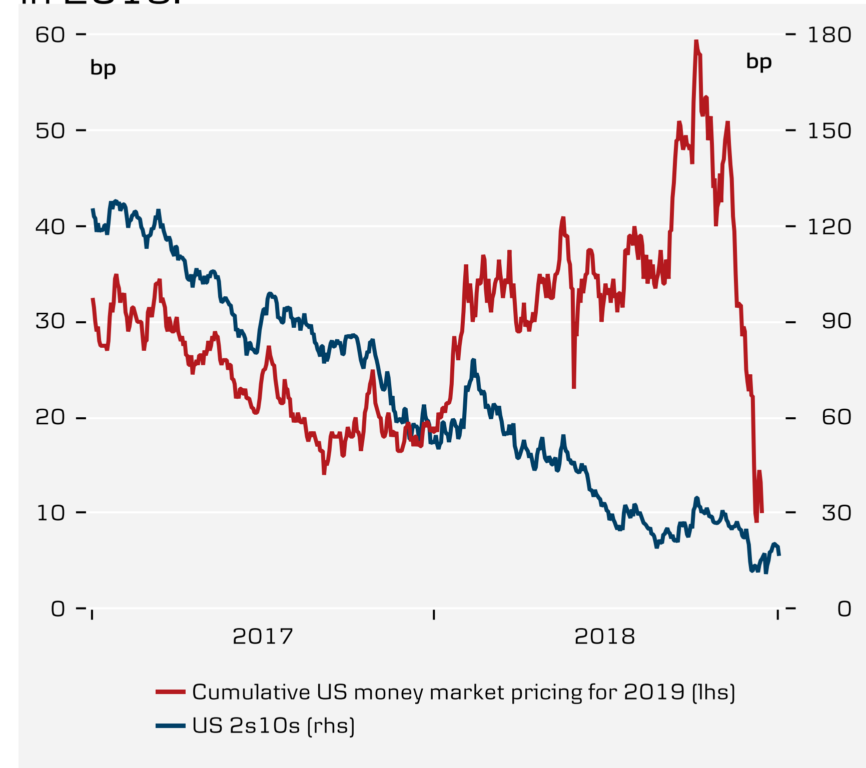
Danske Bank

Q4. Markets have repriced policy expectations in 2019 for Fed and ECB, but who will hike the most?

- Markets have continued to delay the first ECB rate hike and now only price in a 20bp hike at end-2020...

... and we have also recently seen a repricing in the US market with only half a hike priced in 2019.

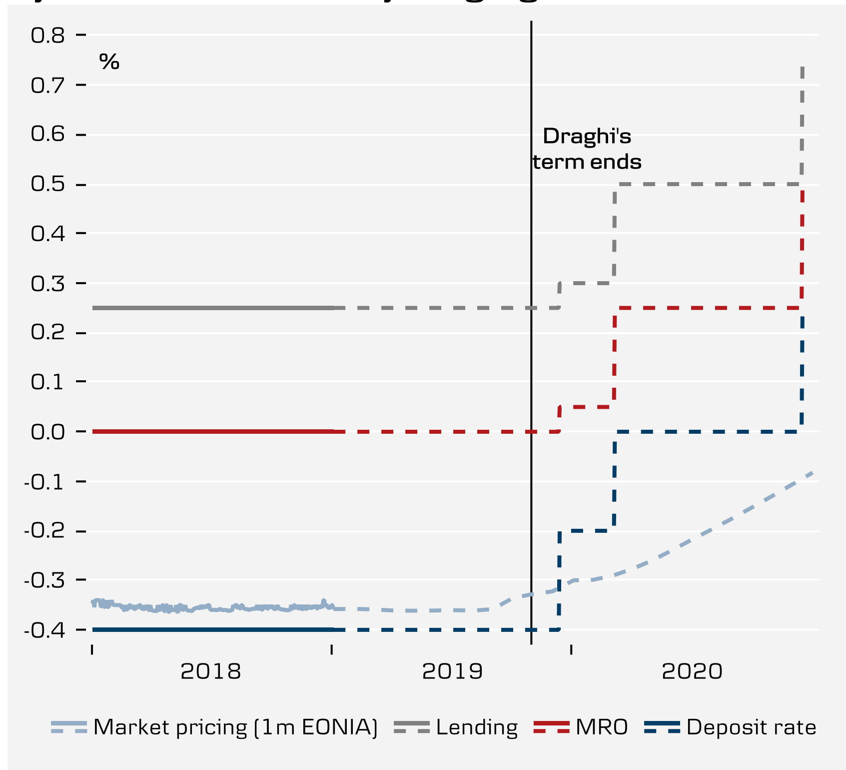
Source: Danske Bank



Note: the cumulative US money market pricing for 2019 is measured by Eurodollar futures.
Source: Bloomberg, Danske Bank

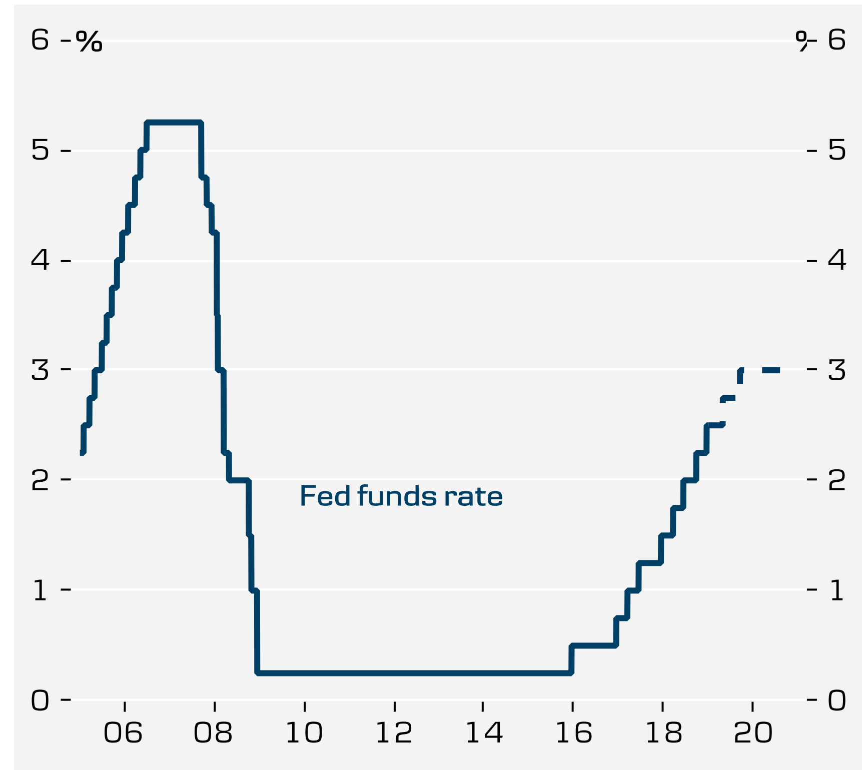
Q4 (continued). But while markets have repriced, we expect the Fed to hike more than the ECB

We expect a 20bp hike in December 2019 by the ECB, driven by wage growth…



Note: The dotted lines for ECB lending-, MRO- and deposit rates are Danske Bank forecasts.
Source: Danske Bank

…while we see the Fed hiking twice this year



The dotted line is Danske Bank's forecast.
Source: Bloomberg, Danske Bank

…But risks are tilted to less monetary tightening on both sides of the Atlantic especially if negative market pressures persist and the global economy weakens more than expected.

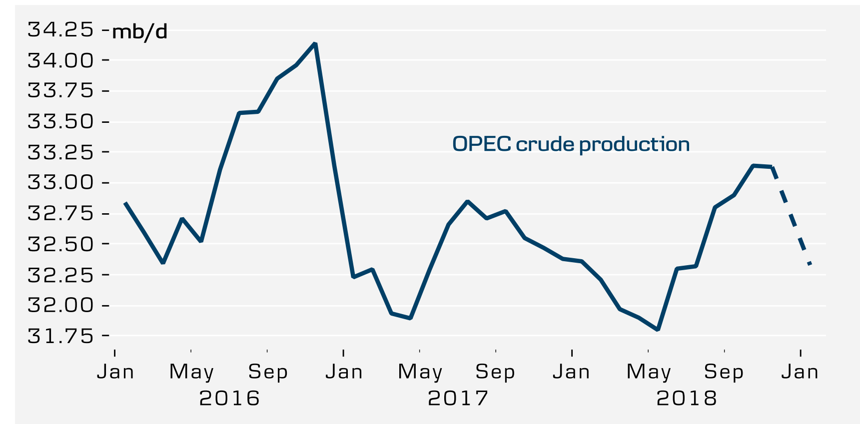
Q5. Oil price – poised for a rebound in 2019? Yes, if risk sentiment recovers

- Oil prices are down this year along with equity markets.

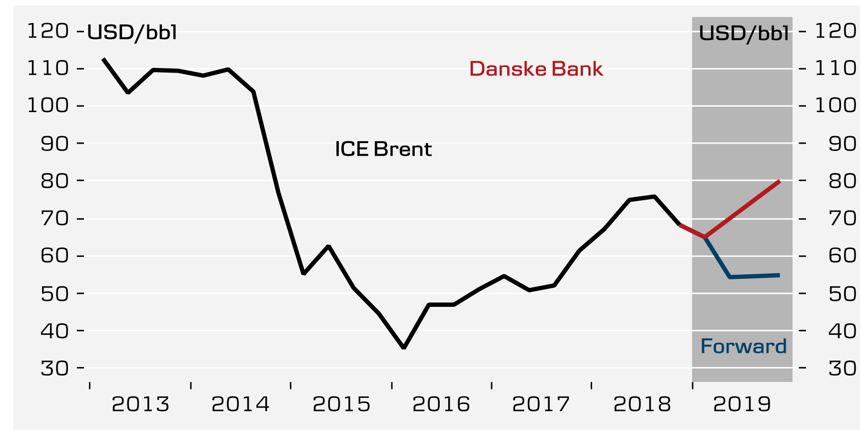
- Although there have been a lot of idiosyncratic oil market stories during 2018, e.g. new sanctions on Iran and OPEC+ production cuts, the oil market is currently in the hands of global risk sentiment.

- We look for the global economy to do fine in 2019 and for equity markets to rebound. That should pave the way for a rebound in oil prices towards USD80/bbl at the end of 2019.

- Keep an eye on oil market developments around April, when temporary waivers on Iran sanctions expire and OPEC+ is set to review output cuts.



Source: Bloomberg, Macrobond Financial



Source: Bloomberg, Macrobond Financial

Q6. Improving outlook for emerging markets after Q1 19

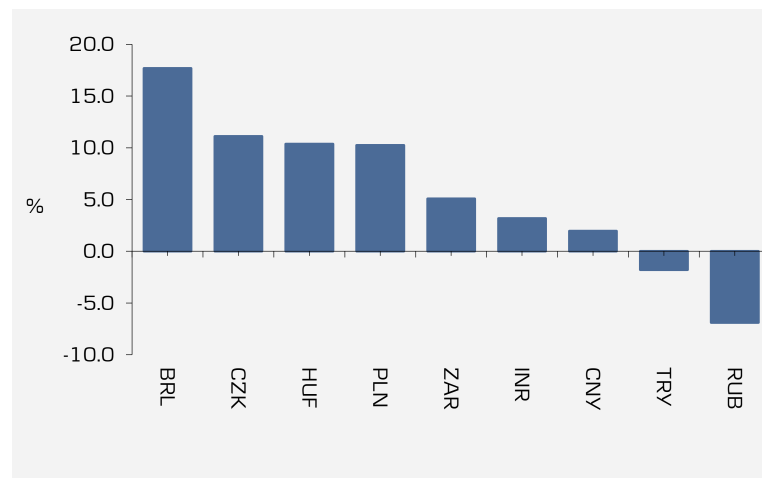
Cautionary signals in Q1 due to China, but we see better conditions later in 2019

		2018				2019			
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
External	China	Rebound in Chinese economy	Slowdown begins	Economy weakness (trade war, lagged effects of tightening)			Recovery: trade deal with US and stimulus effects		
External	Fed	Two hikes		Two hikes		one hike		One hike (or less)	
External	Global liquidity	ECB is starting to prepare markets to monetary	ECB/Fed tightening			ECB/Fed tightening			
External	Geopolitical risks	Tightening of US trade regime postponed	Increased standoff between China and US			US-China ceasefire	US-China trade deal (but Tech War continues)		
Internal	EM fundamentals	Falling inflation, monetary easing and rebound in external demand		EM central banks are coming back to monetary tightening, FX deleveraging goes on		With exception of TRY, positive fundamentals			

EM is still driving force of global growth

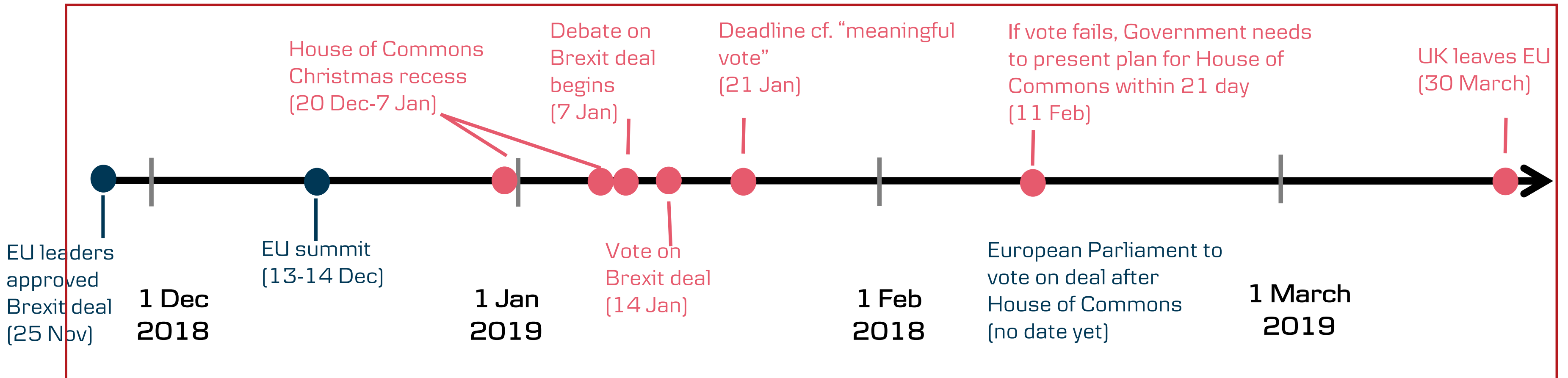
Real GDP growth (% y/y)	2018	2019	2020
Emerging Markets of which	4.8	4.8	4.8
China	6.6	6.2	6.2
India	7.8	7.5	7.2
Russia	1.6	1.3	1.4
Brazil	1.4	2.0	2.6
Turkey	3.5	1.8	2.1
South Africa (SA)	0.5	1.6	2.1
Poland	5.1	3.8	2.7
Hungary	3.9	3.3	2.7
Czech Republic	3.3	3.1	3.0

We are bullish BRL and Eastern European currencies, while bearish on RUB and TRY



Sources of graphs: Danske Bank, Bloomberg, Macrobond Financial

Q7. Brexit: crucial months ahead



Ratification process in Q1 19 (UK Parliament and EU parliament still need to ratify. No national parliaments)

UK formally exits EU

Transition until 31 Dec-20 but may be extended 1-2 years (one time)

Negotiations on future relationship continue.

New relationship comes into force (unless transition is extended). New relationship must be ratified by at least the UK and the EU institutions but most likely also national parliaments like the EU-Canada CETA.

If no permanent deal has been reached, transition is extended or backstop comes into force

Dec 18/Jan 19

30 March 19

1 July 2020

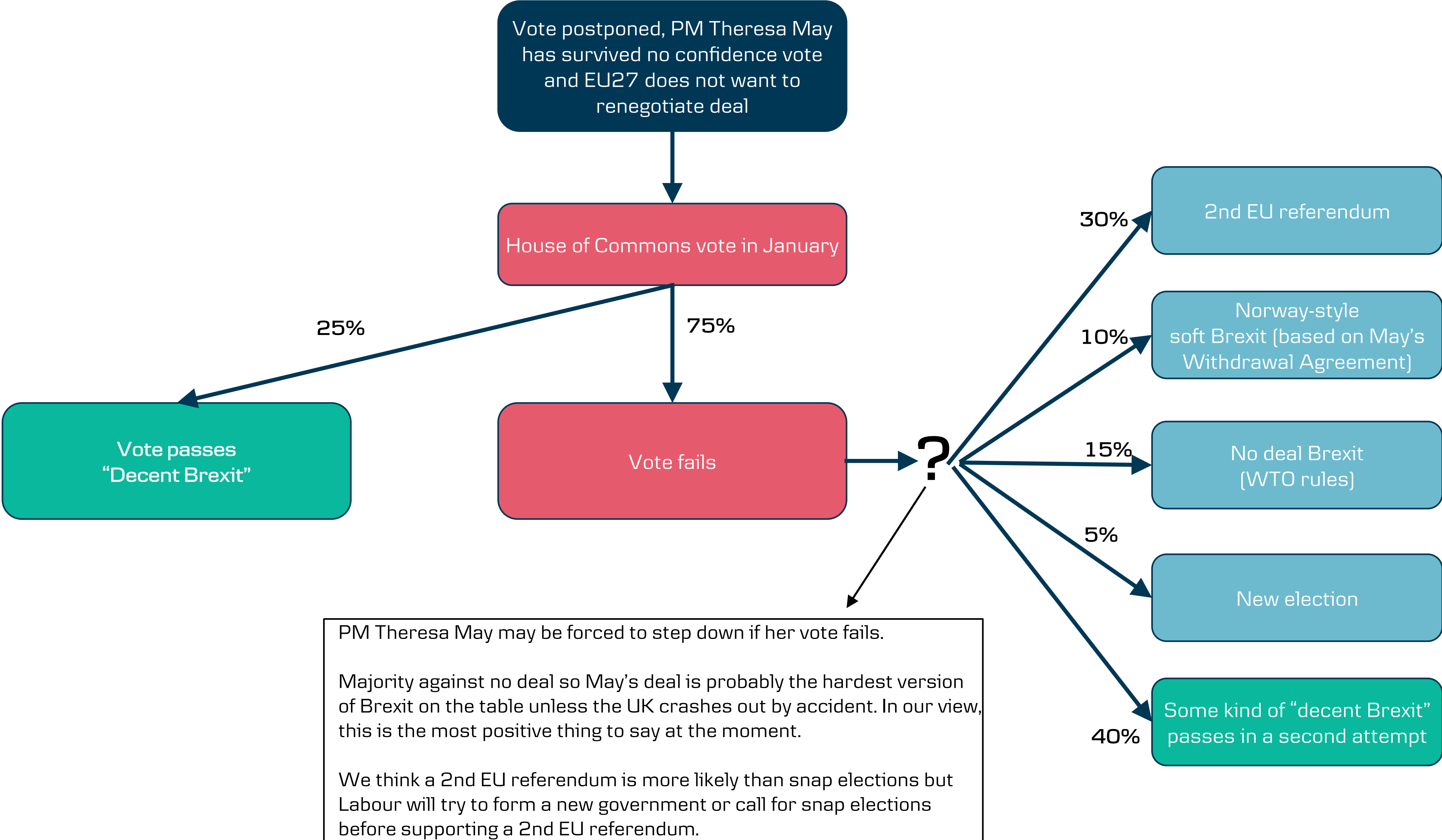
31 Dec 2020

31 Dec 2022

Many assessments (including decision whether to extend transition) need to be make before 1 July 2020

Transition cannot be extended beyond 31 Dec 2022, new future relationship comes into force no later than 1 Jan 2023

Q7 (continued): Very difficult to predict the outcome but our base case is still a 'decent' Brexit



Source: Danske Bank scenarios

Q8. Equities: Short-term macro headwind for equities versus oversold conditions

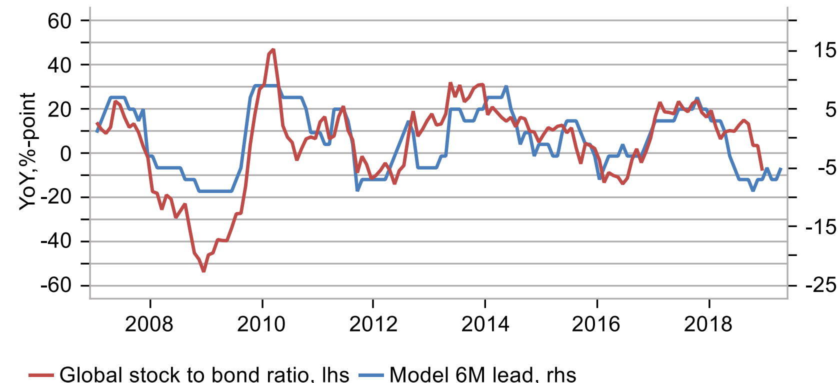
- 2018 was a historical year for equities where strong earnings did not result in good performance. Equities fell even though global earnings rose 15%. This size of divergence between earnings and performance is very rare and only happens when investors fear recession is looming. Therefor recession or not in 2019 is the main question for equity investors.

- As we do not expect a global recession in 2019, we see a good chance of a reversal but it requires that we get renewed macro acceleration. Short term this is questionable as suggested by the chart at the top right.

- With the heavy selloff since October we argue that equities are oversold and we should be in for a rebound even without strong macro numbers.

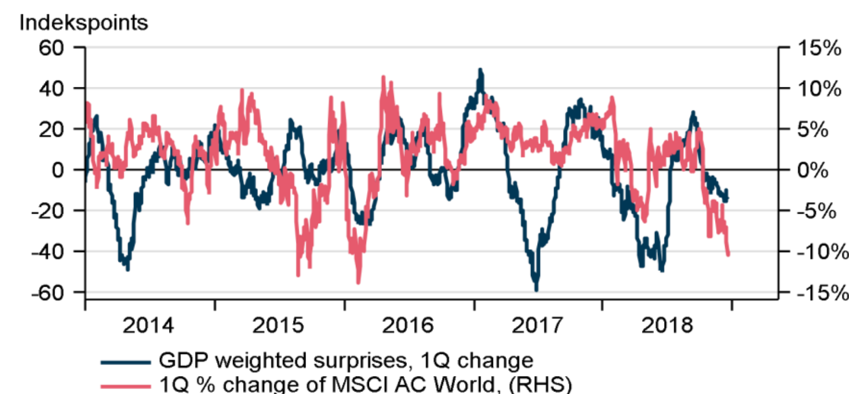
- A combination of low single-digit earnings growth and high single-digit multiple expansion results in a expected return of 10-15% in 2019.

Leading indicator and stock to bond ratio



Source: Macrobond Financial

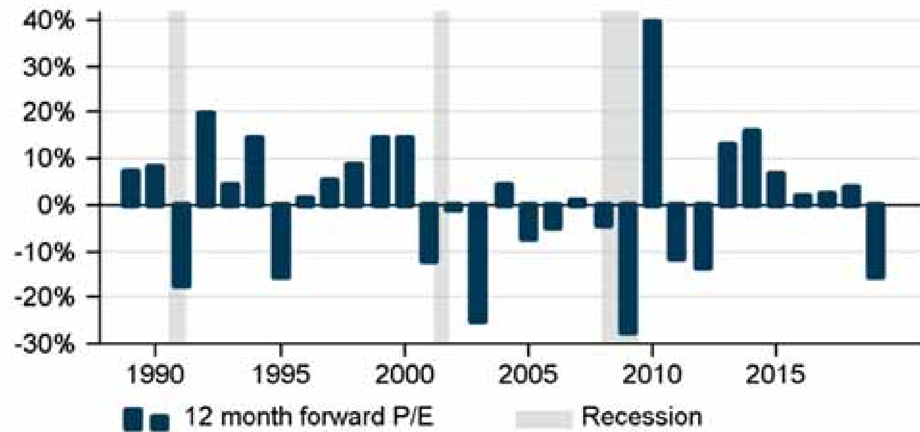
Global stocks vs. macro surprises



Source: Thomson Reuters

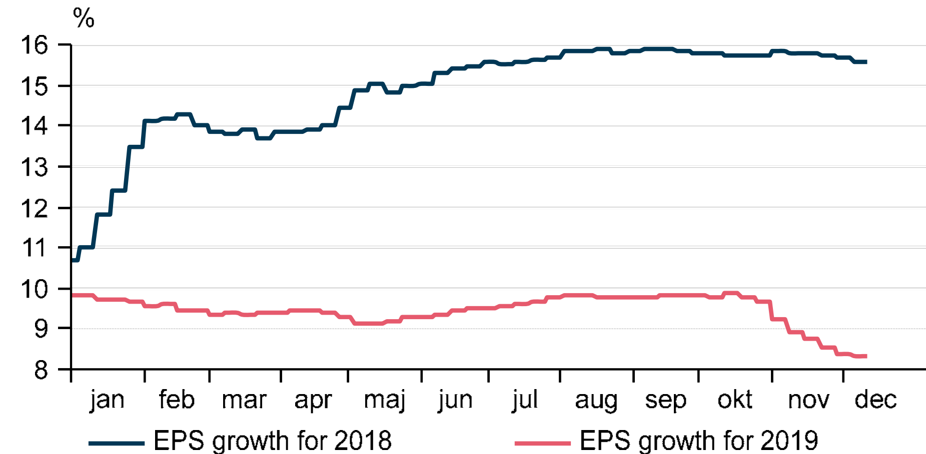
Q8 (continued). Valuation contraction in 2018 a key support for equities in 2019

Record multiple contraction outside recession



Source: Thomson Reuters

Earnings growth returns to a more average level in 2019 (consensus expectations)



Source: Thomson Reuters

- We have had several times before when recession risk was rising and valuation contracting. In periods before, like 1994 and 2011, when recession fear rose for some of the same reasons as we see now. In the following years (1995 and 2012) when recession fear faded again, global equities measured by MSCI World rose by 19% and 17%, respectively.

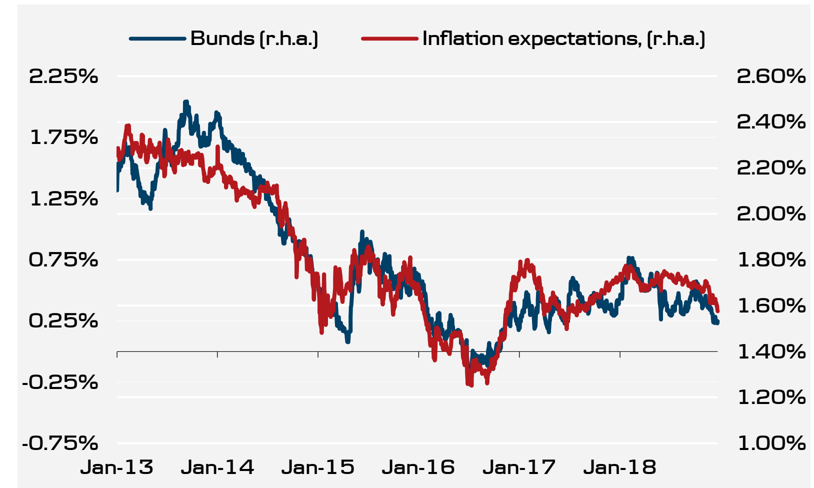
- Earnings growth was impressive in 2018 when analysts lifted expectations more or less continually throughout the year. On top of that companies have delivered above lifted estimates in earnings seasons. 2019 will be a more normalised year and we expect 3-5% earnings growth (consensus currently expects 8%).

- Margins will come under slight pressure next year as wage growth is accelerating. However, with record high margins this should not be enough to stop earnings from growing.

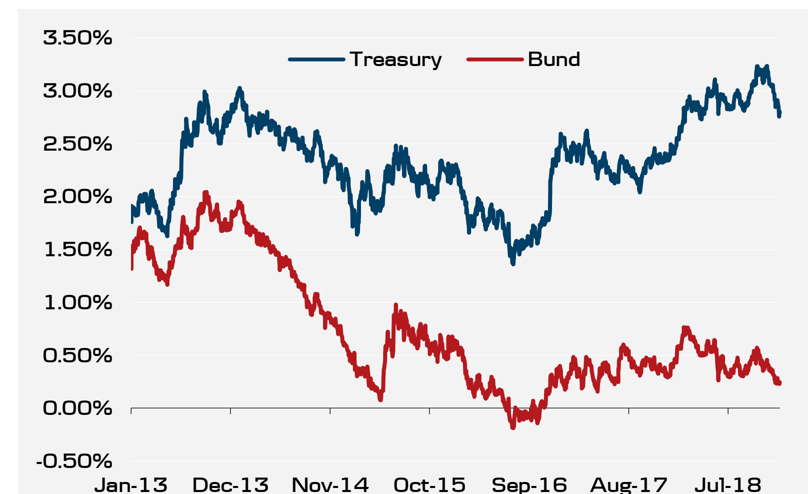
Q9. Have yields bottomed out? Yes, but they will not rise significantly

- We saw a solid rally in both Bunds and US treasuries toward the end of 2018 and early 2019.
- This is driven by a range of factors – slower growth, Brexit uncertainty, Italy, trade war between the US and China, lower inflation expectations/lower oil price, partial shutdown of the US government, widening of credit spreads etc.
- Furthermore, the Federal Reserve is coming towards an end of the hiking cycle, and focus is on whether the Federal Reserve has done too much tightening rather than too little given the reaction in the US bond market after the Fed hike on 19 December.
- Hence, there are plenty of factors that could send the Bund yield towards 0% again.
- **However, we stick to our view that Bunds will range-trade between 0.25% and 0.75% for 2019** as the ECB exits the QE and the Federal Reserve continues scaling down on the balance sheet. Furthermore, there will be plenty of supply of Treasuries going into 2019.
- Finally, the slowdown in inflation expectations is mainly driven by the oil price and we expect to see some stabilisation in 2019.
- Hence, Bunds are trading at the lower end of the range for 2019, but we do not expect a significant increase in yields during 2019.

Inflation expectations decline – Bunds towards 0%



The gap between Treasuries and Bunds are closing



Source. Danske Bank

Danske Bank

Q10. Is USD strength coming to an end? Yes - but some patience still required

EUR/USD: 'Gravity' is currently put off - but 2019 is the year when it reignites, bringing the cross to 1.25 at the end of the year.

USD per EUR

1.6
1.5
1.4
1.3
1.2
1.1
1.0
0.9
0.8

1999 2000 2001 2002 2003 2004 2005 2006 2007 2008 2009 2010 2011 2012 2013 2014 2015 2016 2017 2018 2019

Latest MEVA estimate: 1.30

Danske G10 MEVA for EUR/USD

EUR/USD spot

Spot (31/12/2018): 1.15

Source: Eviews, Macrobond Financial, Danske Bank

Disclosures

This research report has been prepared by Danske Bank A/S ('Danske Bank'). The author of this research report is Jakob Christensen, Chief Analyst, Allan Von Mehren, Chief Analyst, Mikael Milhøj, Senior Analyst, Aila Mihr, Senior Analyst, Christin Tuxen, Chief Analyst, Jens Nærvig Pedersen, Senior Analyst, Bjarne Breinholt Thomsen, Senior Equity Strategist, Jens Peter Sørensen, Chief Analyst, and Daniel Brødsgaard, Analyst.

Analyst certification

Each research analyst responsible for the content of this research report certifies that the views expressed in the research report accurately reflect the research analyst's personal view about the financial instruments and issuers covered by the research report. Each responsible research analyst further certifies that no part of the compensation of the research analyst was, is or will be, directly or indirectly, related to the specific recommendations expressed in the research report.

Regulation

Danske Bank is authorised and subject to regulation by the Danish Financial Supervisory Authority and is subject to the rules and regulation of the relevant regulators in all other jurisdictions where it conducts business. Danske Bank is subject to limited regulation by the Financial Conduct Authority and the Prudential Regulation Authority (UK). Details on the extent of the regulation by the Financial Conduct Authority and the Prudential Regulation Authority are available from Danske Bank on request.

Danske Bank's research reports are prepared in accordance with the recommendations of the Danish Securities Dealers Association.

Conflicts of interest

Danske Bank has established procedures to prevent conflicts of interest and to ensure the provision of high-quality research based on research objectivity and independence. These procedures are documented in Danske Bank's research policies. Employees within Danske Bank's Research Departments have been instructed that any request that might impair the objectivity and independence of research shall be referred to Research Management and the Compliance Department. Danske Bank's Research Departments are organised independently from, and do not report to, other business areas within Danske Bank.

Research analysts are remunerated in part based on the overall profitability of Danske Bank, which includes investment banking revenues, but do not receive bonuses or other remuneration linked to specific corporate finance or debt capital transactions.

Financial models and/or methodology used in this research report

Calculations and presentations in this research report are based on standard econometric tools and methodology as well as publicly available statistics for each individual security, issuer and/or country. Documentation can be obtained from the authors on request.

Risk warning

Major risks connected with recommendations or opinions in this research report, including as sensitivity analysis of relevant assumptions, are stated throughout the text.

Expected updates

Ad hoc.

Date of first publication

See the front page of this research report for the date of first publication.

General disclaimer

This research report has been prepared by Danske Bank (a division of Danske Bank A/S). It is provided for informational purposes only. It does not constitute or form part of, and shall under no circumstances be considered as, an offer to sell or a solicitation of an offer to purchase or sell any relevant financial instruments (i.e. financial instruments mentioned herein or other financial instruments of any issuer mentioned herein and/or options, warrants, rights or other interests with respect to any such financial instruments) ('Relevant Financial Instruments').

The research report has been prepared independently and solely on the basis of publicly available information that Danske Bank considers to be reliable. While reasonable care has been taken to ensure that its contents are not untrue or misleading, no representation is made as to its accuracy or completeness and Danske Bank, its affiliates and subsidiaries accept no liability whatsoever for any direct or consequential loss, including without limitation any loss of profits, arising from reliance on this research report.

The opinions expressed herein are the opinions of the research analysts responsible for the research report and reflect their judgement as of the date hereof. These opinions are subject to change and Danske Bank does not undertake to notify any recipient of this research report of any such change nor of any other changes related to the information provided herein.

This research report is not intended for, and may not be redistributed to, retail customers in the United Kingdom or the United States.

This research report is protected by copyright and is intended solely for the designated addressee. It may not be reproduced or distributed, in whole or in part, by any recipient for any purpose without Danske Bank's prior written consent.

Disclaimer related to distribution in the United States

This research report was created by Danske Bank A/S and is distributed in the United States by Danske Markets Inc., a U.S. registered broker-dealer and subsidiary of Danske Bank A/A, pursuant to SEC Rule 15a-6 and related interpretations issued by the U.S. Securities and Exchange Commission. The research report is intended for distribution in the United States solely to 'U.S. institutional investors' as defined in SEC Rule 15a-6. Danske Markets Inc. accepts responsibility for this research report in connection with distribution in the United States solely to 'U.S. institutional investors'.

Danske Bank is not subject to U.S. rules with regard to the preparation of research reports and the independence of research analysts. In addition, the research analysts of Danske Bank who have prepared this research report are not registered or qualified as research analysts with the NYSE or FINRA but satisfy the applicable requirements of a non-U.S. jurisdiction.

Any U.S. investor recipient of this research report who wishes to purchase or sell any Relevant Financial Instrument may do so only by contacting Danske Markets Inc. directly and should be aware that investing in non-U.S. financial instruments may entail certain risks. Financial instruments of non-U.S. issuers may not be registered with the U.S. Securities and Exchange Commission and may not be subject to the reporting and auditing standards of the U.S. Securities and Exchange Commission.

Report completed: 2 January 2019, 17:35 CET
Report first disseminated: 3 January 2019, 07:00 CET