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Harr's View

Market turmoil to continue until growth stabilises

Thomas Harr, PhD, Global Head of FI&C Research, +45 45 13 67 31, thhar@danskebank.com

Happy New Year all

Today I discuss the recent financial market turmoil, what it says about the economy and how the future looks. I primarily focus on the US, as it is at the centre of recent volatility. In the week before Christmas, volatility in financial markets rose sharply and US inflation expectations collapsed. The market now expects the Fed to cut rates over the coming 18 months. Over the past week, markets reversed sharply with equities rebounding, credit spreads tightening and the oil price rising. What is going on? **In my view, we are currently at an inflexion point.** I view this in the framework of George Soros's reflexivity. Market participants do not base their decisions on the actual state of the economy, but on their perception of reality. Market participants' decisions influence the economy, which in turn affects the policy response, which feeds back into markets. Those feedback loops occur constantly but may be more powerful now, as there could be a larger discrepancy between market participants' perception of reality and the true state of the economy.

What is the market's perception of the current state of the economy? Historically, US equities and credit markets weaken just before a recession, while government bonds rally during disinflationary stagnations. However, equities and high-yield bonds also tend to fall and government bonds rally when the economy slows, even if it is not heading for a recession. US equity prices are currently 13-14% below the peak in early October last year, US government bonds (7-10Y) have delivered around 5-6% return in the same period, while US high-yield bonds have lost close to 8%. The current sell-off in the US equity and credit markets and the rally in government bonds are substantially smaller than the ones experienced around the recession in 2001 and during the global financial crisis in 2008-09. The current correction is also smaller than several other corrections over the past 30 years driven by shocks and slowdowns, such as in 1998 (Russian default, long-term capital management) and 2011-12 (European debt crisis). That said, the recent equity correction is relatively large in a historical context and is similar in depth to the equity sell-off during July 2015-February 2016, but the recent credit correction and government bond rally are substantially smaller than at that time. **As such, the market does not expect an imminent US recession but clearly a slowdown.**

What does reality look like? We expect the global manufacturing cycle to weaken further over coming months. (See *here* for a global overview). The trade war is hurting in particular China's export/industrial cycle (see *this piece* by our China economist, Allan von Mehren). The spill-over from China and the trade war are weighing on the manufacturing cycle in the US and Europe. Meanwhile, tighter financial conditions in the US dampen investments. We expect China and the US to reach a trade deal, but that will only lift data from early Q2. **Hence, I believe that the manufacturing/export part of the US economy is set to slow further near term, but that a large part of the domestic economy, including private consumption and the labour market, is set to hold up well.** What are the likely policy responses? I believe the Fed this week signalled that it is on hold for now and China cut the banks' reserve requirement ratio. We expect further easing from the Chinese authorities in coming months, which eventually should put a floor under growth expectations in China, supporting the global economy.

What does this imply for markets and the economy? In late November, *I argued* that risk premiums across asset classes should edge higher over the next couple of months, but fall back when growth expectations stabilise and/or the Fed pauses. I do not believe that growth expectations have stabilised yet, but the Fed is signalling a pause. During recent monetary policy cycles, equities have weakened during Fed easing and strengthened during Fed tightening. As such, the economic cycle has dominated the monetary policy cycle for equities. **In the current correction, I believe that equities are key and we may need to see a stabilisation in growth expectations before equities stabilise and head higher.** In December, *I argued* that core European government bonds would underperform in 2019 and that European equities would outperform. This is still my view, but it is more of a Q2-Q4 story - not a Q1 one. In December, equity and credit markets weakened and government bonds rallied. Historically, there tends to be a positive correlation between December performance and the following Q1 performance, but a negative correlation between December performance and next year's performance. I expect this to be same this time.

Finally, I want to flag our quarterly *Nordic Outlook*, which we published on Friday. The current slowdown in the global manufacturing cycle is set to hit Sweden more than Norway. This supports our expectations of a growth outperformance of Norway relative to Sweden, feeding into our market views on those economies.

That is all for today's comment. On that note, I wish you a great Sunday night and coming week. Best regards, Thomas

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