Danske Bank Wealth Management
Quarterly View Q3 2017

Financial markets in a sweet spot

Highlights

Danske Bank

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Goldilocks: A sweet spot for investors

Sensible economic growth and low inflation may extend the equity upswing, but expect more modest returns going forward.

The global economy currently finds itself in the best possible investment scenario – a Goldilocks scenario of low inflation and stable growth that is hovering slightly above the expected long-term average.

Both equities and bonds thrive in this environment, but given that yields are very low we find risk assets like equities more attractive than bonds. We therefore have a 5% overweight in equities compared to our expected long-term distribution between equities and bonds, and our overweight is focused on European equities. In contrast, we have underweighted bonds by 5%.

We expect the global upswing to continue and economic growth in both 2017 and 2018 to be above the long-term average. Moreover, we still see no sign of inflationary pressures increasing – which all in all provides fertile ground for further equity market growth.

A golden mean in the economy

Global growth that is neither too high nor too low tends to extend an economic upswing, as growth is sufficient for corporate revenues and earnings to increase, while low inflationary pressures mean interest rates and thus the cost of borrowing money can be kept down, which stimulates demand.

Hence, the risk of overheating ▸▸

5-8%

Our expected return from global equities over the coming 12 months.

European equities account for the overweight in our equity holding at the moment.

As long as Goldilocks reigns, remaining on the sidelines could prove expensive for investors.

Why investors love Goldilocks

- A Goldilocks economy is one where growth is neither too high nor too low but just right, so the economy neither overheats nor slides into recession. Moreover, inflation is low, so central banks can pursue an accommodative monetary policy with low interest rates, which supports the economy.
- A Goldilocks scenario for the economy is very positive for investors, as both the equity and the bond markets usually perform well.
- The expression refers to the fairytale about Goldilocks, who discovers the house of the three bears in the forest. The bears are not home, so Goldilocks goes into the house, where she eats the baby bear's porridge. First she tastes the father bear's porridge, which is too hot, then the mother bear's porridge, which is too cold. But the baby bear's porridge is just right – just like economic growth in a Goldilocks scenario.
- The economic term Goldilocks probably stems from the article 'The Goldilocks Economy: Keeping the Bears at Bay', written in 1992 by economist David Shulman of the non-defunct investment bank Salomon Brothers.

▸▸ is low, while recession can be kept at bay. This is particularly supportive of equity markets, though we do not expect equity prices to rise at the same pace as in the past year, as the acceleration in global growth has peaked and the macro data is no longer delivering upside surprises.

Moreover, economic confidence indicators in Europe, the US and China have started to turn down – but from high levels, and the indicators continue to point to economic growth, not a contraction.

More modest equity returns ahead

However, more modest growth does indicate a moderation in corporate earnings growth, which will limit the potential for equity prices to rise, so we have therefore recently reduced our overweight in equities from substantial to moderate.

Global equities have over the past 12 months generated a very handsome return of 20.2% (measured in EUR), but we expect a more modest return on equities of 5-8% in the coming 12 months. Nevertheless, this is still a reasonable potential return compared to the low yields on bonds, and as long as Goldilocks reigns, remaining on the sidelines could prove expensive for investors.

The challenge, however, is that we don't know when Goldilocks will decide to scarper. Predicting the turns in the business cycle is very difficult, and the current upswing is rather distinct from what we are generally familiar with – most of all because we are in uncharted waters in terms of monetary policy, with central banks in recent years stimulating the economy by buying up huge quantities of bonds in order to keep interest rates low and pour liquidity into the market.

Be prepared for Goldilocks to run away

As an investor, you therefore have to control your risk exposure so you avoid unpleasant surprises when Goldilocks eventually runs away.

If you have not regularly adjusted your portfolio, the handsome return on equities means the share of equities in your portfolio has increased, while the share of bonds has shrunk – and bonds usually constitute the stabilising element in a portfolio. This means, in other words, your portfolio currently carries a higher risk than, for example, a year ago – and perhaps also a higher risk than your investment profile indicates. Hence, a major correction in the equity market could have a more negative impact than you expect.

We therefore recommend that you rebalance your portfolio before the summer and ensure you have the right spread across asset classes, such as equities and bonds, and a healthy risk spread within each individual asset class.

How equities and bonds would be hit

When Goldilocks disappears we can expect greater volatility in the equity ▸▸

Forecast: Economic growth in 2017/2018

% y/y	2017 Danske Bank	2017 Consensus	2018 Danske Bank	2018 Consensus
USA	2.0	2.2	1.9	2.3
Euro zone	1.7	1.7	1.6	1.6
Japan	1.2	1.3	0.8	1.0
China	6.3	6.6	6.0	6.3
Global	3.2	3.3	3.1	3.3

Source: Bloomberg and Danske Bank as of 23.06.2017

▸▸ market than in the past year, and it is irrelevant whether she runs away because inflation accelerates or growth unexpectedly declines. Both will puncture the enthusiasm of the equity market and could trigger a rotation across regions and sectors.

That is why it is important you have the right spread in your equity investments, so you have a bulwark to protect you from being unnecessarily hard hit by price falls in particular regions or sectors.

> *When Goldilocks disappears we can expect greater volatility in the equity market than in the past year.*

Out with US equities – in with corporate bonds

WE REDUCE OUR EQUITY WEIGHTING: Our current equity overweight of 5% is a reduction relative to the overweight of 10% we had until recently. More specifically, we have adjusted our equity weighting by reducing our overweight in US equities to neutral, while we have maintained our overweight in European equities.

WE INCREASE OUR WEIGHTING IN CORPORATE BONDS: We have increased our exposure to global investment grade corporate bonds by 5 percentage points. Investment grade corporate bonds have a high creditworthiness rating, and we see an opportunity here for an attractive return compared to government bonds. The European Central Bank (ECB) is supporting bond prices via its bond purchase programme.

WE MAINTAIN OUR FOCUS IN THE US: Despite reducing the weighting of US equities we are maintaining our focus here on SMEs. We still view these companies as being the most shielded from the consequences of any potential trade policy initiatives from Trump, as they are less dependent on exports than the largest corporations. Moreover, they stand to benefit most from the US upswing and Trump's long-heralded tax reform, should it surprise positively.

The picture for bonds is less clear-cut:

Goldilocks running away because of rising inflation would hit returns negatively, as bond yields would have to rise and prices fall.

Goldilocks running away because of declining growth would, on the other hand, pull in the opposite direction. Bond prices could rise, though the return potential would be limited by the already low level of bond yields. There is a limit to how far yields could fall from here – and hence also on the extent to which prices could rise.

However, none of these scenarios alters the fact that you should maintain the proportion of bonds in your portfolio that your investment strategy prescribes. If you are in doubt about whether you have the right strategy, you should contact your advisor and determine an appropriate strategy relative to your risk appetite, investment horizon and ability to absorb a loss.

The European economy with Germany in the vanguard is still demonstrating considerable strength, though we expect it to slow slightly like China and the US. This photo shows German Chancellor Angela Merkel at the opening of a new factory in the Daimler group.

Why equity tailwinds will slow

The outlook of more modest corporate earnings growth will probably put a damper on the equity market.

High corporate earnings growth has driven much of the impressive increase in equity prices over the past year. When companies earn more money they become worth more.

However, we expect corporate EPS (earnings per share) growth to slow in the coming 12 months. Q1's double-digit EPS growth may have been maintained in Q2 when Europe, in particular, was the locomotive and where the basis for comparison (Q2 2016) is low. But it will be uphill after that.

Equity momentum has peaked

With the most pronounced acceleration in economic growth behind us, it is difficult to see what could drive corporate earnings higher at their current pace. Likewise, uncertainty on the oil price remains considerable, which could affect investments in the energy sector.

All in all, this points to the equity market finding things a little more difficult going forward compared to the past year, so we therefore expect a more modest return on equities of 5-8% over the coming 12 months versus 20.2% in the past 12 months (measured in EUR). Everything suggests momentum in the equity market has peaked, though we still expect to see sensible EPS growth, which will be supportive for equities.

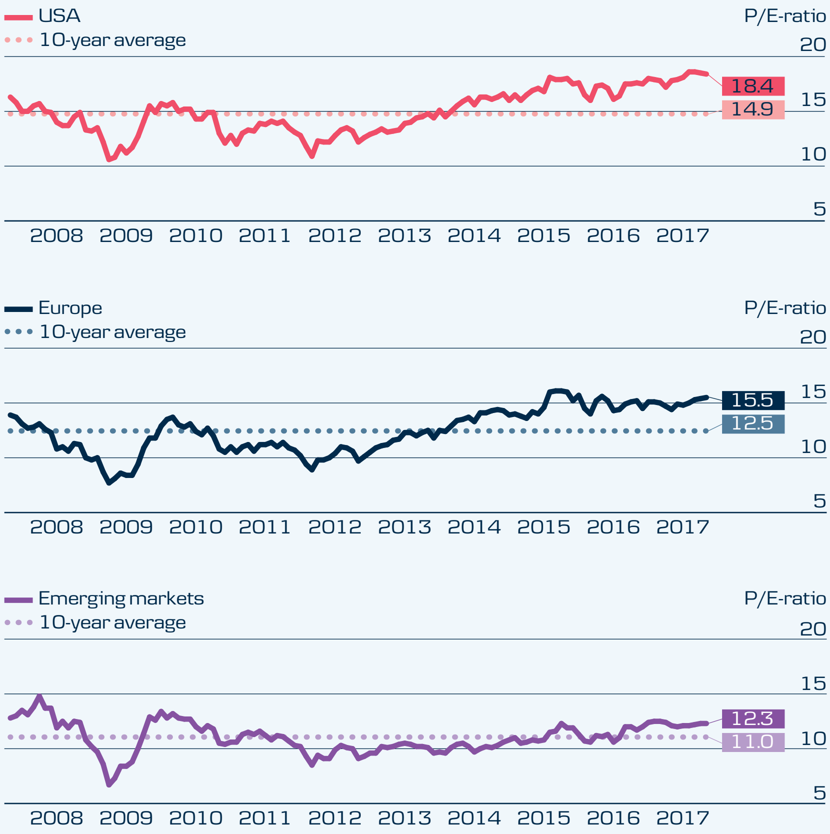
Look at valuations too

Investors should also take a look at equity valuations. Markets are not currently being driven by them, but with a relatively high forward P/E of 16.2 for companies globally, valuation constitutes a significant potential headwind if a spanner is thrown into the works and growth, for example, slows. This is particularly true in the US, where valuations are very stretched.

Nevertheless, equating a high valuation with a lower return going forward is a risky conclusion to make. Further earnings growth could stabilise or reduce the ratio between equity prices and expected earnings (P/E), as we saw during the period 2003-2008.

Equity valuations on the high side

Historically speaking, equity valuations in the US, Europe and the emerging markets are currently relatively high in P/E terms. Forward P/E values – in other words, the market-price-to-expected-earnings ratio for companies – are significantly above the average for the past 10 years.



Source: Macrobond, data for the period 01.05.2007-01.05.2017.

Janet Yellen
Job: Chair of the US Federal Reserve
Background: Economist with a long career at the US central bank. Economic advisor to Bill Clinton.

Mario Draghi
Job: President of the European Central Bank
Background: Economist and banker who has worked at the Bank of Italy and Goldman Sachs, etc.

Central banks caught in a dilemma – increased risk of policy mistakes

We see monetary policy as one of the prime sources of disquiet in the financial markets in the coming quarters.

The US central bank, the Fed, is currently being challenged by its dual monetary policy mandate of pursuing an inflation target of 2%, while simultaneously aiming to create sustainable, maximum employment in the US.

- LABOUR MARKET is very solid with full employment. This would tend to support monetary policy tightening – in other words, rate hikes – to avoid the labour market overheating via wage pressures.
- INFLATION is below 2% and inflation expectations are low. This supports an accommodative monetary policy that would stimulate demand and thus pull inflation higher.

The Fed is currently placing more emphasis on the labour market and assuming that inflation will probably rise to the 2% target in the medium term. Hence, the Fed again hiked interest rates at its June meeting and also announced a tapering of the huge holding of bonds that the central bank has bought as part of its QE programme (quantitative easing).

Inflation could surprise investors – and the Fed

However, the current low level of yields in the bond market reflects how investors do not share the Fed's inflation expectations, and this viewpoint could be further supported by, among other things, the recent decline in the oil price, which may pull inflation lower. Hence, inflation rising in line with Fed expectations would be a surprise for investors. Market yields would climb and bond ▸▸

QE

Quantitative easing is the term used to describe the central banks' buying up of bonds to stimulate the economy. The purchases push interest rates lower and pump more liquidity into the market.

2%

The inflation target for both the ECB and the Fed. Central banks assess this to be the optimal level of inflation for economies to thrive.

Monetary policy supporting growth and equities

Despite the uncertainty on when the central banks will tighten monetary policy and by how much, monetary policy is still providing the financial markets with more of a tailwind than a headwind. All in all, we will most likely continue to see an accommodative monetary policy in the US and Europe in the coming year, which will support both the prospects for growth and risk assets like equities.

▸▸ prices fall, which could easily cause some disquiet in the financial markets.

Inflation rising higher or faster than the Fed expects would likely create even more turmoil. In that case, the Fed could be forced to step more firmly on the brakes – in the shape of rate hikes – which would very probably produce even greater volatility in the financial markets and hit risk assets like equities negatively.

That being said, there is nothing at the moment to indicate the Fed will be caught behind the curve. Nevertheless, the dilemma facing the Fed of very high employment combined with low inflation generally increases the risk of a policy mistake, where the Fed either tightens too slowly or too fast, potentially harming economic growth and hence the financial markets.

Liquidity will disappear from the market – liquidity that for several years has supported risk assets like equities.

The art of selling USD 4,500bn worth of bonds

Another major challenge for the Fed is selling off its large holdings of bonds that the central bank bought up to keep yields down and pump liquidity into the market – ultimately to kick-start economic growth.

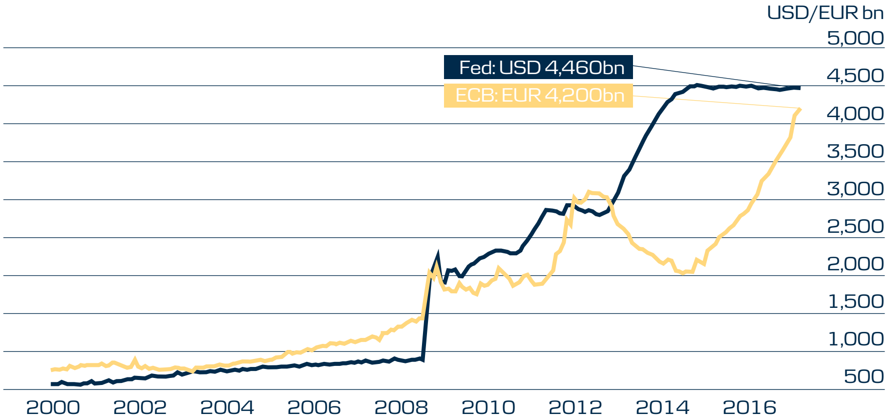
The Fed has accumulated US government bonds totalling around USD2,500bn and mortgage bonds for around USD2,000bn. The central bank has already announced that it will begin to reduce its holding, though a date has not yet been set.

Hence, investors are well aware that the sell-off is on its way, but that does not mean it will be unfold quietly and calmly. Liquidity will disappear from the market – liquidity that for several years has supported risk assets like equities regardless of the state of the economy.

The crux of the matter is, in our opinion, whether investors perceive the central bank reducing its holdings as raising interest rates or removing surplus liquidity, which is what this really is. The latter should not trigger any unrest, while the former would likely send bond yields higher.

Central banks have been hoarding securities

Central banks in Europe (ECB) and the US (Fed) have been buying up huge quantities of bonds since the financial crisis in an attempt to stimulate the economy. The graph shows the dramatic increase in their balance sheets, and at some point they will have to divest those bonds again to trim their books and return to a more normal level. That could create turmoil in the financial markets.



Source: Macrobond as of 21.06.2017

New rhetoric from the ECB could cause yields to surge

Like the Fed, the European Central Bank (ECB) faces a dilemma. Growth is strong, but inflation is low. However, unlike the Fed, the ECB has just a single mandate – an inflation target of 2% – and inflation is still lagging behind that target. Hence, despite robust growth the ECB cannot yet raise interest rates and pull them out of negative territory, but higher interest rates are purely a matter of time and investors are closely tracking the inflation numbers.

We know the ECB's bond purchase programme will expire at the end of the year, so the ECB has to make some sort of announcement in the coming months. The big question is how hard the ECB's tone will be in relation to a potential extension of the bond purchase programme, and whether the central bank will warn of an upcoming rate hike. We expect the ECB will extend its bond purchase programme at least six months into 2018.

However, with German 10-year yields at 0.25% you have to acknowledge the ECB has successfully anchored bond investors in a low-yield environment, and that increases the risk of a significant upsurge in yields when the ECB changes its rhetoric.

China has to puncture its credit bubble, but avoid a bang

Keep an eye on China – the most serious macroeconomic risk.

We view China as the most serious macroeconomic risk in the coming year. New members are set to be elected to the powerful Politburo Standing Committee, the country's top decision-making body, in November, and this could well prompt an increased focus on reforms and on slowing the explosive credit growth the country has experienced in recent years.

A tightening of the money market heralded the start of attempts to tame runaway credit growth, but until the new leadership is in place we will not be overly concerned. The government will do everything in its power to avoid creating unnecessary turmoil and is ready to stimulate the economy if needed.

Uncertainties on the horizon

The pace of reform will very probably pick up once the new leadership is in place, and in the short term that could put pressure on growth. There could, for example, be a reform of state-owned 'zombie' enterprises, which are being kept artificially alive by government funds, not least in the commodity sector. Or there could be even more focus on shifting the economy away from being investment and export driven and instead being driven by household demand.

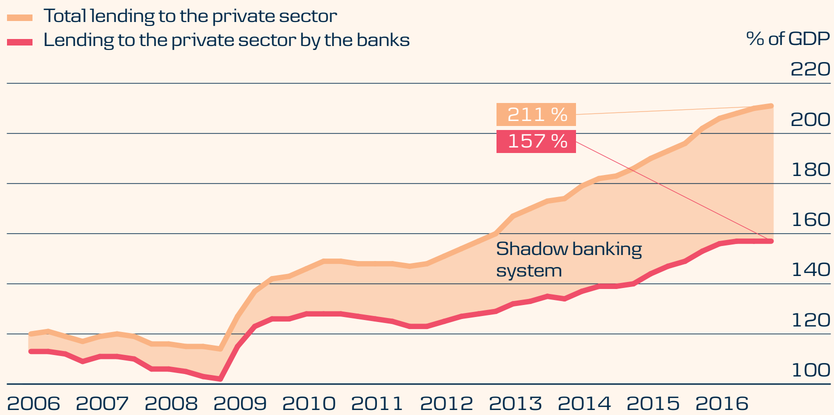
International investors have, however, gradually learned to live with economic growth being on the wane in China. The country has matured, and growth in an emerging market nation slowing as the country moves higher up the development ladder is completely natural.

Nevertheless, a more rapid than expected slowdown – or simply the fear of one – could trigger concerns among investors. We saw this in summer 2015 and in early 2016, when global equity prices tumbled on the back of, among other things, worries about Chinese growth.

> *Attempts to slowly let the air out of the Chinese credit bubble will intensify so it does not suddenly burst with a bang.*

Chinese debt levels soaring

Private sector debt amounted to 120% of Chinese GDP at the start of 2006, whereas the latest calculation in October 2016 showed that figure had climbed to 211%. Of this, bank lending accounted for 157%, while the remaining 54% consisted of loans from other, non-bank financial enterprises – also called the shadow banking system. This is a growing challenge for the Chinese economy, as the shadow banking system is not subject to the same regulation as the banks.



Source: Macrobond.

China's credit bubble needs a slow puncture

As well as reforms, we expect attempts to slowly let the air out of the Chinese credit bubble will intensify so it does not suddenly burst with a bang, but this is a risky task. Non-bank lending in particular has exploded, and the fear is that the consequences for the financial markets in China could be very negative if the government cracks down on this type of lending, as many companies use these loans to invest in the financial markets.

Donald Trump has to acknowledge he has not yet been able to push through the items on his political agenda that investors were most looking forward to.

Equities defy Trump's pipe dreams

Donald Trump has disappointed on fiscal policy, but that's not all negative from an investor's perspective.

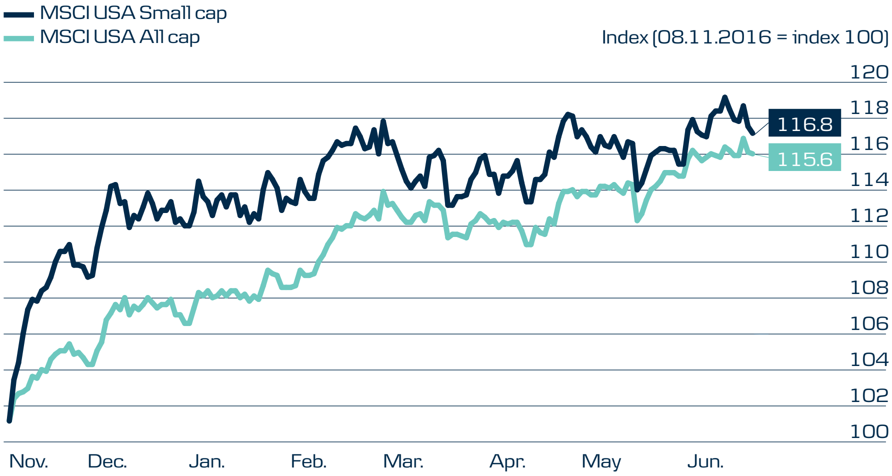
During the US election campaign Donald Trump promised significant fiscal easing in the form of tax cuts and infrastructure investment – but so far this has just been talk from the US president. Even though Trump's lofty promises pushed equities higher in the wake of his election victory, his lack of concrete results has not noticeably affected equity prices. Nor had we expected the lack of action to have any impact, for Trump or not, an economic upswing is under way.

Trump is, in fact, having difficulty getting any domestic policy whatsoever passed. We view an announcement on tax reform in 2017 as unrealistic, and it has now been confirmed that his grandiose investment plans for infrastructure will likely never amount to anything much.

However, Trump's lack of success is not all negative from an investor perspective. Large-scale fiscal stimuli in the US would have given the Fed an excuse to tighten monetary policy more aggressively and thus risk choking the current economic Goldilocks scenario. Without Trump's fiscal easing, the economy can calmly and quietly cruise on, potentially allowing the upswing to be extended.

Strong equity price growth since the election

Trump's fiscal disappointments so far have not managed to spoil the strong price growth demonstrated by US equities since the presidential election in November last year. US small cap companies appeared poised to reap the greatest benefits from Trump's policies and they surged after his election win. Since then the excess return has been reduced relative to the broader US equity market (all cap).



Source: Macrobond as of 21.06.2017, return data are total return, calculated in USD.

We still have the most important election in Europe to come

Even though the welcome outcome of the French election has caused the political fog to lift for a while in Europe, it is not completely gone. And while the German election on 24 September appears to be a done deal, with the nationalist and EU-critical Alternative für Deutschland unlikely to even get close to gaining power, the picture is different in Italy, where Beppe Grillo's Five Star Movement, according to the opinion polls, will be so big that it will be hard to avoid them being in a future government.

The financial markets would not welcome a win by the Five Star Movement given its intense EU scepticism. The Italians are among the most EU sceptical in Europe, so if Beppe Grillo puts EU membership to a vote there is a real risk of the Italians voting to leave. The parliamentary election must be held by spring 2018, and it promises to be something of a thriller for the financial markets.

Always remember your risk as an investor
This publication is based on Danske Bank's macroeconomic and financial market expectations. Deviations from our expectations could potentially affect the return on any investments negatively and result in a loss.

Danske Bank has prepared this material for information purposes only, and it does not constitute investment advice. Always speak to an advisor if you are considering making an investment based on this material to establish whether a particular investment suits your investment profile, including your risk appetite, investment horizon and ability to absorb a loss.

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