



Danske Invest
Outlook for Q2

2016

Investor brief



Calmer markets – but uncertainty ahead

Macro economy and allocation: While the first quarter of the year was one of the most dramatic for investments in a long time, the second quarter may provide some breathing space before a series of upcoming events could again create uncertainty in the financial markets. We currently have a positive outlook on the economy and an overweight of global equities, but expect to reduce risk later in the year.

- *Preference for the US and Europe
- *Underweight in the emerging markets
- *Concerns cloud the horizon



Calmer markets – but uncertainty ahead

Moving into Q2, we expect to see a further pick-up in the US, relatively stable growth in China and decent growth in Europe – in other words, a much-needed breathing space after the opening months of the year, which were plagued by recession fears and significant price volatility. We are currently positive on the economy and have an overweight of global equities, though further market unrest threatens.



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A QUICK RECAP:

The first quarter of the year was one of the most dramatic for investments in a long time. Six weeks in, global equities had fallen by more than 10% and the headlines were dominated by fears of a new recession, a new bank crisis in Europe and weakness in China.

Oil prices came under a lot of pressure at the start of the year – and while low oil prices are generally positive for consumers and the economies of the US, the eurozone, Japan and China, they hurt many industries and companies exposed to the oil sector. The fall in the oil price therefore created considerable market uncertainty, with investors trying unsuccessfully to get an overview of how hard the fall would hit the oil sector – could some companies collapse? – and of the consequences for oil-dependent developing economies. US recession fears were thus a major theme at the start of the year.

Another major theme in Q1 was once again the opaque Chinese economy. Slowing growth and a currency (CNY) devaluation in the first few days of the year fuelled uncertainty about just what China's central bank and government wanted to achieve and how bad the situation actually was in China.

Europe, meanwhile, faced a poisonous cocktail of disappointing data and serious political issues, particularly the refugee crisis and the debate surrounding the UK's EU in-out referendum plus the first signs of stress linked to the bank sector:

The market turned in February. China got its currency under control and gradually improved communication on its aims for the country's economy and the yuan. Next, oil prices began to stabilise and, finally, the first in a string of more positive economic data from both the US and Europe appeared. On top of this, the European Central Bank (ECB) eased monetary policy significantly.

LOOKING AHEAD:

Accelerating US growth, essentially stable Chinese growth and decent levels of growth in Europe present an overall world picture that, in our view, should benefit global equities in Q2. We also see the market for European corporate bonds as particularly attractive. Our positive view on Q2 should be seen against the ECB continuing to pursue an extremely easy monetary policy with the prospect of low interest rates for some time yet and the US central bank (Fed) set to hike interest rates at just a modest pace.

Looking ahead to Q3 and Q4, however, we have a number of concerns. In Europe, the UK will hold its so-called Brexit referendum towards the end of Q2, on 23 June, and the refugee crisis will doubtlessly continue. Worries are also being expressed about just how long China can continue to stimulate its economy, while a presidential elec-



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tion and further rate hikes are on the agenda in the US.

USA:

Fears of recession continue to fade

We are, however, still optimistic for now, mainly because of our positive view on US growth. Job creation has been stronger than expected and unemployment has fallen. Wage growth is also showing signs of picking up and the housing market is doing just fine. Moreover, manufacturing growth appears set to recover after struggling under a strong dollar and low oil prices. While low oil prices are good for consumers, they are bad news for companies that sell machinery and equipment to the oil sector.

The financial system is solid

In our view, the main point going forward is that the financial system is solid and the banks are generally still easing credit standards. In addition, the dollar has become more stable over the past six months and we expect the manufacturing and oil sectors to eventually adjust to the low oil price. All in all, that means stability, and such a scenario should provide fertile ground for US growth in Q2. ▶▶

►► We estimate US growth to be between 1.0% and 1.25% at present and expect it to rise towards 2.0-2.5% within the next three to nine months. We estimate the US Fed will continue to hike interest rates in this scenario. Our forecast is for the Fed to raise interest rates twice this year due to the relative strength of the US economy.

EUROPE: Stable growth and low unemployment

Europe has so far come through its period of political uncertainty relatively unscathed. Despite the headlines focusing on political risks, including the refugee crisis and the debate on the UK's membership of the EU, we estimate growth has remained stable at between 1.5% and 2.0% for about a year now. Unemployment is at 3- to 4-year lows, though still relatively high and without the wage pressures we are beginning to see in the US.

Economic support on several fronts

Europe's domestic economy is being supported on four fronts. First, the low oil price is positive for Europe. Second, Europe, in contrast to the US, is benefitting from a weaker currency. Third, the ECB has eased monetary policy over the past couple of years and, fourth, the banks have finally woken up, though there is certainly no lending spree as yet. These factors have contributed to raising growth and bringing down unemployment in the eurozone.

Bank system needs the ECB

The crux of the matter here is that three of these four growth factors are temporary. Oil prices will not fall forever, the euro's decline has slowed for now and there is a limit to how far lending rates can be pushed down. This means the ECB has to ensure the European bank system is still standing when all the other positive factors have gone. The banks simply must lend money to companies and consumers, and to support this process the ECB has focused on ensuring ample liquidity for the banks and

ALLOCATION SCORECARD

Fig. 01

Current expectations on various asset classes on a scale from -3 (negative) to +3 (positive) ¹	Outlook							Conviction ² 1-5
	-3	-2	-1	0	+1	+2	+3	
Equity, developed markets								3
Equity, global emerging markets								2
Global inflation-linked bonds								2
EU short bonds								4
EU long bonds								2
EU investment grade bonds								3
EU high-yield bonds								3
US high-yield bonds								2
EU senior bank loans								3
US senior bank loans								3
Emerging market debt (HC)								2
Emerging market debt (LC)								2

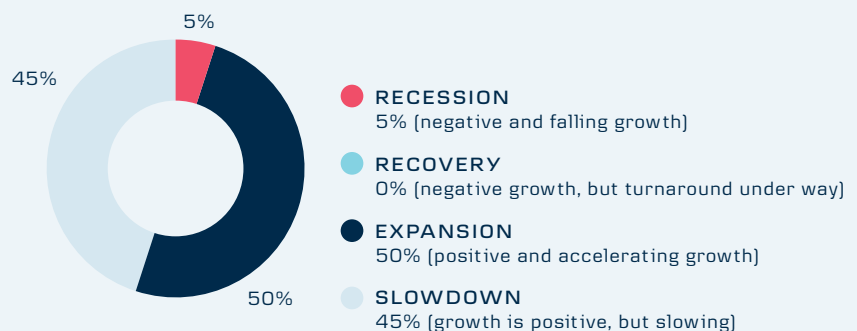
	Outlook							Bias
	-3	-2	-1	0	+1	+2	+3	
Market risk [3 mth.] ³								Neutral
Risk appetite								Down

NOTES: ¹No specific time horizon attached to the expectations, which are based on the latest tactical allocation meeting in Danske Capital on 07.12.2015. ²Expresses degree of certainty for the stated expectation. ³Expresses current estimate of return potential in the traditionally most risky assets.

GLOBAL MACROECONOMIC OUTLOOK

Fig. 02

Most likely macroeconomic development over a 6-month horizon.*



NOTE: *Based on Macro Barometer by Danske Invest's chief analyst Bo Bejstrup Christensen and his team of analysts.

▶▶ providing them with incentives to lend more money.

We still see the mainly positive message for the eurozone as being that it has a central bank that is fully prepared to support growth and the bank system, which is why we expect European interest rates to remain exceptionally low for quite some time yet.

**EMERGING MARKETS:
All eyes still on China**

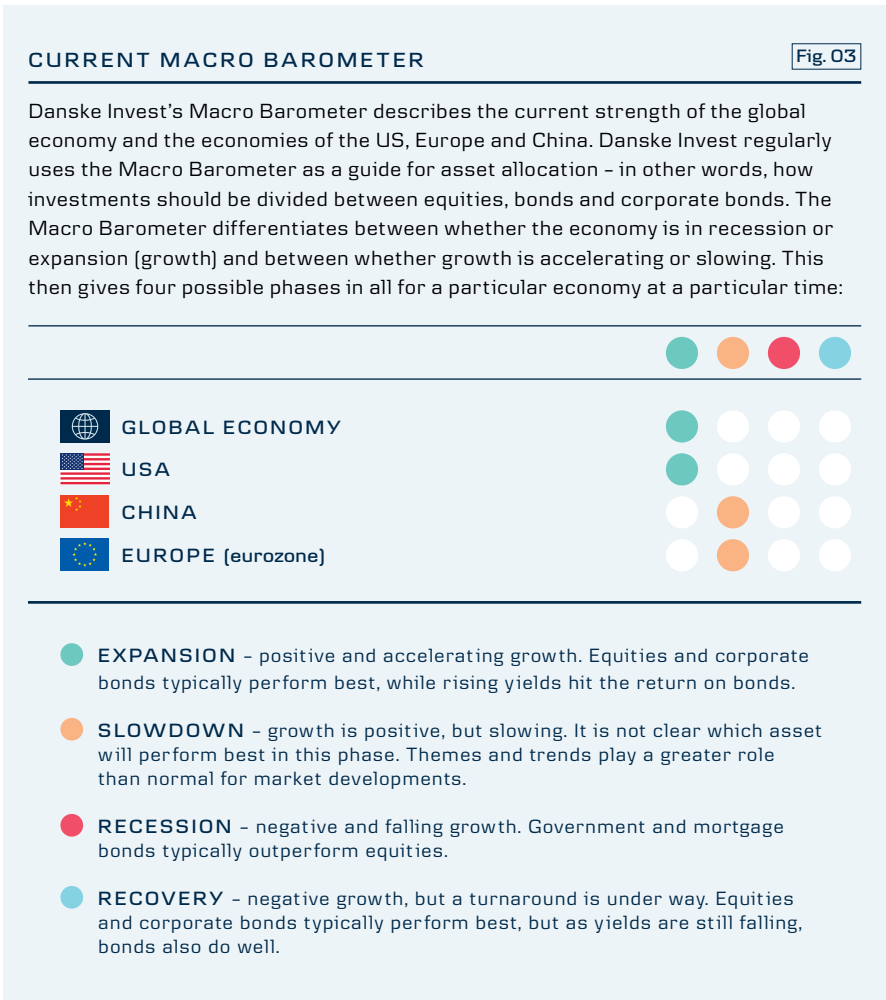
Turning to the emerging markets, all eyes will again be on China in Q2. The good news is that the looser economic stance of the Chinese authorities has paid off. The housing market has stabilised after previously being in recession – home sales are up, house prices are appreciating and the slowdown in the construction sector appears to be over. Furthermore, China clearly has plenty of resources to protect its currency and should be able to keep the yuan relatively stable going forward.

Emerging markets get a breather

Overall, we estimate the positive sentiment stemming from China’s more accommodative monetary policy, lower expectations for Fed rate hikes and the ECB’s easy monetary policy stance will help boost commodity prices. We expect market sentiment to remain positive in the very short term. First, because the impact of China’s accommodative monetary policy will be felt in the coming months and, second, because the US Fed will not be raising interest rates for some time yet. Hence, even the hard pressed emerging market economies should have a relatively good Q2.

Dark clouds on the horizon

Looking further ahead to the end of Q2 and beyond, however, we are more concerned. Loosening up the Chinese housing market (higher credit growth and reduction of down payment required for home purchases) is a one-off shot in the arm. The measures simply bring forward some of tomorrow’s growth to today – and unfortu-



“*Europe’s domestic economy is being supported on four fronts.*”

nately the current high rate of lending growth is also unsustainable. Our concern is therefore that in three to six months’ time we may once more be suddenly discussing whether Chinese growth is again set to fall.

We are not suggesting a collapse, but we envisage a scenario where China faces a number of major structural problems in its housing market and an industrial sector that is strugg-

ling with overcapacity and the government’s desire for lower levels of pollution.

Rising us interest rates will hit emerging markets

Our second worry is future US interest rate hikes. The Fed is on a short break, but we expect the central bank will again raise interest rates later in the year, which would be negative for emerging market economies. Hence, our long-term scepticism on the emerging markets is still in place, but our overall message for the second quarter is that these economies will get a much needed breathing space.

DISCLAIMER

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