Danske Invest
Outlook for Q3
2016

Investor brief

Political turmoil and Chinese growth will set the agenda in Q3

Macro-economy and allocation: *After a period of declining uncertainty, Q2 ended on a dramatic note as the UK voted to leave the EU – setting the scene for a jittery third quarter that will be marked by renewed political and financial market uncertainty in Europe, an upcoming presidential election in the US and expectations of slower growth in China. Our overall equity weighting is neutral: we are maintaining our underweight in emerging market and European equities, while we have an overweight in US equities.*

*Neutral risk-weighting on equities
*Overweight in US equities
*Renewed uncertainty ahead

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Political turmoil and Chinese growth will set the agenda in Q3 2016

We enter a Q3 marked by considerable political uncertainty due to the UK voting to leave the European Union (EU) and expectations of a recession in Europe. The US economy continues to grow at a fair pace, though the presidential election and a potential rate hike by the central bank, the Fed, may put a damper on global equities – as might expectations of a growth slowdown in China. Given the above scenario, we have a neutral risk-weighting on equities.

By Bo Bejstrup Christensen, chief analyst at Danske Invest

A BRIEF RECAP:
Growth in Europe, China and the US

Whereas Q1 was a very dramatic quarter for investments, everything was going well in Q2 until disaster struck. The early part of the quarter saw markets improve in line with our expectations as fears of a potential US recession eased, while anxieties about the European banking system also calmed, in part due to the European Central Bank, the ECB, launching a new package of monetary policy initiatives. Last but not least, decent numbers confirmed not only that China's economy was continuing to grow but that it was actually picking up on the back of stimulatory measures enacted by the Chinese authorities. China's housing market was particularly strong in Q2, which helped calm market fears to the extent that global equities rose in April and May.

A stable quarter with an abrupt and dramatic end

The second quarter also saw the US Fed signal a potential rate hike in the not-too-distant future, perhaps even during the summer. Calm and optimism reigned until the UK referendum on whether to leave or remain in the EU. As you will know, the 'leave' camp, who wanted the UK out of the EU, won the vote, sending the markets into a tailspin. Hence, the second quarter of the year ended with huge political uncertainty both in the UK and in the rest of Europe.

LOOKING AHEAD:
Turbulence – but not a new global crisis

Europe is now in the spotlight and the only thing we know for sure at the moment is that the continent faces an extended period of political uncertainty. We estimate Europe will slip into recession in the third quarter of this year. Whether that will be a technical recession with two consecutive quarters of negative growth is an open question, but our view is that growth in the EU will fall significantly. However, we expect to see positive growth return in spring 2017. We are also fully convinced this is not the start of a new global crisis, as both the UK's central bank, the Bank of England, and the ECB will ensure financial stability.

Emerging markets set to stall

Turning to the US, we still expect growth to pick up further, so the US central bank will therefore continue to focus on a potential rate hike despite post-Brexit uncertainty postponing any change for now. Our view on China is rather different, as we expect the government's economic stimulation to ease and both investment and growth to slow as a result. This scenario will very probably spill over onto the growth rates of a number of other emerging market economies in Q3.

> *We are also fully convinced this is not the start of a new global crisis.*

EUROPE:
Political turmoil in the UK

The focus in Europe is mainly on the UK, which has entered a period of huge uncertainty. The ruling Conservative Party now has to find a new leader and the country a new prime minister following the resignation of David Cameron in the wake of the Brexit vote. Meanwhile, the main opposition party, Labour, is deeply divided. Regardless of whoever eventually becomes the leader of the country and the leader of the opposition, the UK will have a more Eurosceptical approach. Many leading EU politicians have called on the UK to start the official exit proceedings from the union, by triggering 'Article 50', as quickly as possible, while others, including the German chancellor Angela Merkel, have urged a degree of caution. All in all, the level of political uncertainty is extreme and will remain so for a long time yet. ▸▸

▶▶ Europe in recession

Given the shock the political uncertainty represents, we now expect Europe to slip into recession in the third quarter. Faced with such high levels of uncertainty as at present, companies often undertake two measures: First, they try to raise liquidity. The easiest way for companies to do this is to liquidate their inventories, and if companies are to reduce inventories that means cutting production. The second measure we often see enacted, and which could help push the economy into recession, is that companies become more reluctant both to invest and to hire. Given the shock unfolding on the political front in the UK, we expect companies will very probably initiate both measures in the short term – across both the UK and the EU.

USA: Strong housing market and a solid bank system

We remain optimistic on the US and estimate growth has risen from around 1% to now hover just below 2%. While the turmoil in Europe may well create some unease in the very short term, we estimate the combined strength of the US housing market and the US bank system will be enough to push growth above 2% in autumn 2016. Employment should increase further on the back of this, so finding available labour will likely become increasingly difficult given how far the recovery has progressed. Hence, what we are probably now seeing is the final stage of the US recovery, where wage growth really begins to gain traction. We currently estimate wage growth has accelerated to around 3% or perhaps even higher.

Rate hike back on the table

If our expectations for the US of decent rates of growth, continued employment growth and further falls in unemployment pan out, both wage and price inflation should rise towards the US Fed inflation target of 2%. We therefore maintain our view that the US, which in July 2016 enters its eighth year of continuous economic expansion, is on track for one of ▶▶

ALLOCATION SCORECARD

Fig. 01

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

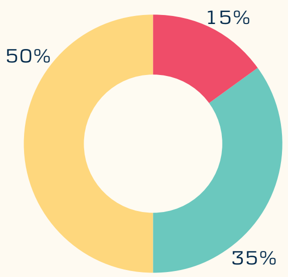
	Outlook (-3 -2 -1 0 +1 +2 +3)	Bias
Market risk (3 mth.)[3]	+1	Up
Risk appetite	0	Neutral

NOTES: [1]No specific time horizon attached to the expectations, which are based on the latest allocation meeting in Danske Capital on 01.07.2016. [2]Expresses degree of certainty for the stated expectation. [3]Expresses 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.*



RECESSION
5% (negative and falling growth)

RECOVERY
0% (negative growth, but turnaround under way)

EXPANSION
50% (positive and accelerating growth)

SLOWDOWN
45% (growth is positive, but slowing)

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

▸▸ the longest upswings in US history. That scenario should be sufficient to get the Fed back to work once the uncertainty in Europe has eased and we therefore expect the central bank will continue to raise interest rates – probably not here during the summer but as autumn approaches and the focus of the financial markets shifts towards the presidential election.

> *Our view is that the authorities will not continue to stimulate the economy to the same extent.*

EMERGING MARKETS:
Stimulus measures keeping growth buoyant

In the emerging markets, all eyes will be on China. We are pleased to see that growth appears to have stabilised, though we are also convinced the stabilisation has been driven by the authorities' powerful stimulus measures. The government has loosened fiscal policy – and let the bank system finance the easing via, for example, infrastructure investment – while at the same easing credit conditions for first-time homebuyers, etc. These initiatives have caused house sales to rise, but both driving forces are temporary. Maintaining growth levels in China requires further government stimulation, either via additional infrastructure investment or via a continued easing of home loan requirements.

Chinese growth losing steam

Our view is that the authorities will not continue to stimulate the economy to the same extent, which is why we anticipate that both investment and housing market growth will decline in Q3. As we still consider the number of unsold homes to be very high, especially in the smaller towns, we also estimate that construction activity in the housing market will begin to plateau and perhaps even decline towards the end of the quarter. If that happens, then not only China but also many other emerging market economies will lose steam. Hence, going into Q3 we are sceptical about the sustainability of the effect of higher commodity prices and recent positive developments in the emerging markets generally.

CURRENT MACRO BAROMETER Fig. 03

Danske Invest's Macro Barometer describes the current strength of the global economy and the economies of the US, Europe and China. Danske Invest regularly uses the Macro Barometer as a guide for asset allocation – in other words, how investments should be divided between equities, bonds and corporate bonds. The Macro Barometer differentiates between whether the economy is in recession or expansion (growth) and between whether growth is accelerating or slowing. This then gives four possible phases in all for a particular economy at a particular time.

	Expansion	Slowdown	Recession	Recovery
Global economy		●		
USA	●			
China		●		
Europe (eurozone)		●		

EXPANSION – positive and accelerating growth. Equities and corporate bonds typically perform best, while rising yields hit the return on bonds.

SLOWDOWN – growth is positive, but slowing. It is not clear which asset will perform best in this phase. Themes and trends play a greater role than normal for market developments.

RECESSION – negative and falling growth. Government and mortgage bonds typically outperform equities.

RECOVERY – negative growth, but a turnaround is under way. Equities and corporate bonds typically perform best, but as yields are still falling, bonds also do well.