2 September 2016

Strategy

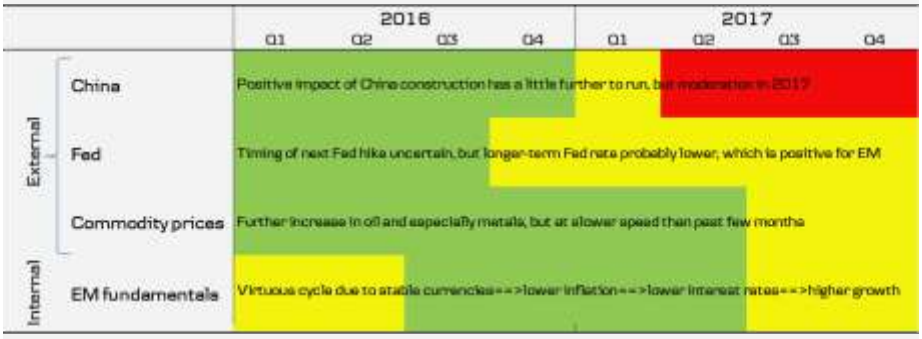
The Fed will not spoil the emerging market rally for now

Recent weeks have seen renewed speculation that the Fed is about to hike rates. Hawkish signals from Fed officials have suggested that an interest rate hike is drawing closer (see *Strategy: A checklist for the US economy*, 26 August) and the market consequently assigned a larger possibility of a rate hike, even in September. However, the relatively weak jobs report showing non-farm payrolls growing 151,000 in August combined with the relatively weak ISM manufacturing number yesterday, which fell from 52.6 in July to 49.4 in August, means it is unlikely the Fed will hike rates in September. Yet, the market is still assigning quite a high probability to possibility the Fed could hike rates before year-end (still little more than 50%).

The more hawkish line from the Fed has turned focus to emerging markets, which have staged a remarkable comeback this year. After years in the doldrums, both emerging market currencies and equities have rebounded this year (see Chart 1). The UK's vote to leave the EU in late June did not spoil the party – quite the contrary, as the market continued to head upwards throughout the summer. However, typically a more hawkish Fed spells trouble in emerging markets as we saw when the tapering discussion started back in 2013. The big question facing investors is whether the emerging market rally will come to a halt now that they have finally ventured into emerging markets.

We believe the prospects for emerging markets remain decent especially with the Fed likely to be on hold until at least end-2016 (see Chart 2) as outlined in *Emerging Markets: Still decent prospects even with a possible Fed rate hike in 2016*, 30 August. We might see some volatility and weakness in emerging markets in the run-up to a possible Fed hike later this year but we do not expect a sustained sell-off for a number of reasons. (1) The Fed has signalled recently that the long-term Fed neutral rate is probably lower than previously thought, which means the worst case for emerging markets is not so bad anymore as their borrowing costs will not rise as much as in the past. (2) The Fed's hiking cycle is likely to be gradual. (3) Most emerging markets have seen sharp improvements in external balances since 2013 and their currencies are in undervalued territory. Indeed, we think that any emerging market weakness in the run-up to a Fed hike could be a buying opportunity.

Chart 2: Decent prospects for emerging markets in 2016 but clouds gathering in 2017

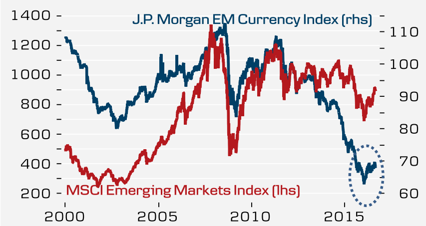


Source: Macrobond Financial

Key points

- With the relatively weak job report today and weak ISM number yesterday, we believe the Fed is unlikely to hike rates in September.
- Yet, the market is still assigning a relatively high probability of a hike in 2016.
- In our view, the prospects for emerging markets remain decent especially with the Fed likely to be on hold at least until end-2016.
- China will continue to act as a positive impetus for the rest of the emerging market space in 2016, although less so in 2017.
- We remain Overweight emerging markets versus developed market equities.

Chart 1: Rebound in emerging market assets but still at low levels historically



Source: Danske Bank Markets

Chief Analyst
Jakob Christensen
+4545128530
jakc@danskebank.dk

Furthermore, we think China will continue to experience a fairly solid performance in 2016, acting as a positive impetus for the rest of the emerging markets space. Chart 3 shows that China is tremendously important to emerging market assets given its sheer size and that it consumes almost half the world's metals. We called for a rebound in the Chinese construction sector in the spring and the recovery has had a positive spillover effect on metal prices. We think the recovery has further to run at least this year, notably in the construction sector. Yesterday's relatively strong PMI number also points to a continued recovery in 2016. However, we expect a moderation in Chinese growth rates in 2017 as the impact of fiscal and monetary stimulus fades and debt concerns become more prevalent. We expect the China story to provide support to metals prices this year but a Fed hike may increase the downside risk to our fairly bullish commodity price call. Regarding domestic fundamentals, many emerging markets will also benefit from a virtuous cycle as the stable FX has lowered inflation pressures in the economies, providing room for policy cuts. However, political and budget challenges warrant caution in some countries (notably South Africa).

Equities: still overweight emerging markets vs developed markets

Since the spring, we have had a positive view on emerging market equities. Yesterday, we sent out *Equity Strategy: Hunting high and low*, 1 September, maintaining an Overweight in emerging markets relative to developed markets. The reason is the still-attractive valuations in many emerging markets (relative to historical averages) and relatively strong expected earnings growth. Despite the general perception, economic growth has held up fairly well in manufacturing emerging markets and we are starting to see relief in oil-producing countries on the back of higher oil prices and sizeable FX adjustments in many of the countries. More specifically, we keep Asia (including China) as an Overweight position, while EMEA and LatAm are still Neutral. Within developed markets, we moved the US to Underweight and Europe to Overweight, while keeping Japan on Underweight. From an overall asset allocation perspective, we remain Underweight equities versus cash.

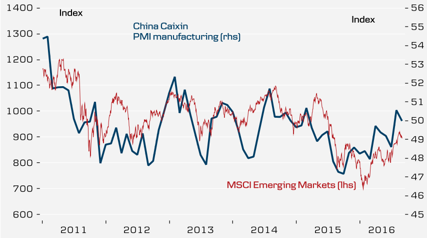
FX: EUR/USD range short term but higher medium term

In the FX market, we expect EUR/USD to stay in the 1.10-1.14 range in coming months before the cross moves higher, as structural flows are supportive of the EUR and it is fundamentally undervalued on our medium-term models. After a relatively strong performance in August on the back of heightened US rate hike expectations, the USD has come under a bit of pressure following the weak ISM manufacturing report yesterday and non-farm payrolls today. Typically, a weaker USD short term supports emerging market currencies and hence our bearish view on the US dollar in the medium to longer term should be positive for emerging markets. Today's relatively weak job report should also give near-term support to emerging market currencies and we remain notably positive view on the RUB.

Fixed income: flattening yield curve in the US

We expect a possible rate hike in the US to have an impact primarily on the short end of the curve. We expect the long-term rates (10-30 years) to be held down by two factors: (1) the perception by the Fed that the long-term neutral rate is lower, which should among other things mean lower nominal yields; and (2) that foreign demand for US Treasuries should remain high given the US Treasury market is the only market with 10-year yields above 1.5%. In both Germany and Japan, 10-year rates are negative. Nevertheless, we expect slightly higher US 10-year swap-rates in coming quarters but believe the yield curve will start to flatten as illustrated in Chart 6 to the right. In the eurozone, we expect the ECB to prolong QE with core yields remaining low for longer. In the emerging markets space, we expect the stronger emerging market currencies over the past half year to help bring down inflation and hence lead to lower rates, such as in Brazil and Russia. Going forward, we still see value in local currency debt given that we think emerging market currencies will see a relatively stable path and the high carry that these countries offer, especially relative to developed markets.

Chart 3: China is very important for emerging market assets

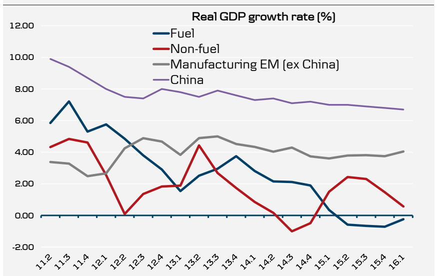


Source: Macrobond Financial

Chart 4: Equity pricing still cheap in most emerging markets

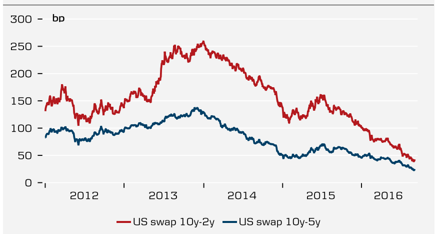
Source: Macrobond Financial, Danske Bank Markets

Chart 5: Real GDP growth is holding up in manufacturing emerging markets and has bottomed in oil producing emerging markets



Source: Macrobond Financial

Chart 6: Yield curve expected to flatten further in the US



Source: Macrobond Financial

Global market views

Asset class	Main factors
Equities	
Short term (0-1 month): buy on dips Medium term (three-six months): underweight equities vs cash	The hunt for yield as a theme has led equity markets to bounce back after Brexit. Growth is above expectations but has still not broken out of the range. Risk of setbacks is high due to stretched valuations and still fairly weak earnings but central banks anchoring of bond yields provide a cushion for a setback; hence, our structurally underweight position in equities vs cash but still buy-on-dips stance on a shorter-term perspective.
Bond market	
Core yields: low for even longer with increased uncertainty	We expect the ECB to prolong the QE programme by another six months.
US-euro spread: wider but not before we see Fed hikes	Fed on hold until 2017. Risk of earlier hike is evident. Market priced too soft.
Peripheral spreads: ECB support	QE buying and hunt for yield means further performance.
Credit spreads: neutral	ECB keeping spreads contained.
FX	
EUR/USD - 1.10-1.14 range near term, then higher	Valuations and CA differential support cross in the medium to long term; short-term downside risks from relative rates.
EUR/GBP - further GBP weakness in next few months	BoE monetary easing and financial account flows to send cross higher.
USD/JPY - risks skewed to the downside	BoJ easing limits downside potential stemming from fundamentals and relative current account flows.
EUR/SEK - to move gradually lower over coming months	To move lower on relative fundamentals and valuation.
EUR/NOK - risks skewed to the upside on Norges Bank easing	Global factors, oil price end Norges Bank to keep cross in range in coming months, then lower on valuation and fundamentals.
Commodities	
Oil price – consolidation in US oil sector leading to recovery	OPEC has lost leverage over oil price; However, possible Fed hike increase downside risks
Metal prices – positive outlook anticipating recovery in Chinese construction	Consolidation in mining industry puts a floor under prices, awaiting support from higher global economic growth.
Gold price – bouncing on repricing of Fed and other major central banks	Brexit risk leads to safe-haven flows and more dovish major central banks support demand for gold.
Agriculturals – support from disruptive weather, higher oil price	Attention has turned to La Niña weather risks in H2 16.

Source: Danske Bank Markets

Disclosures

This research report has been prepared by Danske Bank Markets, a division of Danske Bank A/S ('Danske Bank'). The author of this research report is Jakob Ekholdt Christensen, Chief 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.

The research reports of Danske Bank are prepared in accordance with the Danish Finance Society's rules of ethics and 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 a sensitivity analysis of relevant assumptions, are stated throughout the text.

Expected updates

None.

Date of first publication

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

General disclaimer

This research has been prepared by Danske Bank Markets (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 in this research report.

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/S, 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.