



Danske Bank Asset Management
Quarterly View Q1 2018
INSTITUTIONAL

Bull market has more to give in 2018

Four themes will be of key importance for return and risk in the financial markets in the coming year.



Chinese President Xi Jinping will play a key role in 2018, when investors will be very focused on economic developments in China. Disappointing growth here could trigger a correction in the equity market.

2018 for better or worse

Four questions will be of key importance for investors in the coming year.

The US economic upswing enters its ninth year in 2018, which is something of a performance, historically speaking. US upswings have lasted just under five years, on average, since 1950, so we are already far beyond that. The rest of the global economy is also steaming ahead, and we have seen a broad and pronounced increase in asset prices, with equities, bonds, property and even crypto currencies like Bitcoin all hovering around record levels.

Time periods and records are just numbers, but they nevertheless make us investors nervous. For one thing we can be sure of is that after an upswing comes a downturn - it is almost a law of nature. The longer the upswing lasts, the closer we get to the beginning of the end, and so investors become increasingly sensitive to bad news that might indicate the good times are over.

While the world is changing rapidly and the current upswing is different to its predecessors - with record-low interest rates and low inflation - the dynamics that drive the financial markets and investors have not changed. This is still all about people - about our tem-

perament, fears and greed. The saying "the higher you climb, the harder you fall" seems very apt in this regard - the better things go, the more sensitive we become to bad news.

This is also why we expect the overriding theme for the financial markets next year will be increasing jitters and volatility, prompted by the question: When will the economy turn?

More specifically, we expect the following questions will be very relevant for the financial markets in 2018:

1. Are the financial markets exhibiting signs of a bubble?
2. When will the equity bull market end?
3. What now for China after the all-important party congress?
4. Which current or potential geopolitical conflicts could hit us?

In this Quarterly View we go through the four questions one by one, but first we want to review the state of the global economy in general. Economic performance is, in the end, the decisive ▶▶



Quarterly View by Anders Svennesen, CIO at Danske Bank Asset Management.

Expected return from global equities of

8-12%

over the coming 12 months in local currency.



Overweight
in equities



Underweight
in bonds

►► catalyst for developments in the financial markets – and regardless of which events occur, their impact on the economy is what ultimately determines how far and how long they will pull the financial markets in one direction or the other.

Our main scenario:

Economic upswing

We expect the ongoing economic upswing to continue in 2018, which is why we are entering the new year with an overweight in equities and an equivalent underweight in bonds.

Economic growth has become self-perpetuating in the past year. Economies around the world are firing on all cylinders, as the growth in global trade testifies. The outlook for corporate investments looks particularly promising and constitutes an important driving force for a continued upswing. Investment appetite is one reason why the economy is no longer dependent on central bank artificial respiration in the form of an accommodative monetary policy.

In China, companies are more focused on improving the production apparatus than expanding production

capacity, which points to increasing efficiency. There are very strong signs investment appetite is increasing in Europe too, plus we expect to see consolidations in 2018 via M&A activity, which will also support the European equity market.

Half the US Senate is up for election at the forthcoming mid-terms, with the Republican majority clearly in danger. Hence, 2018 looks set to be another politically exciting year under Donald Trump and will include the replacement of several US central bank members and the long awaited passing of some form of tax cuts.



Data potentially indicating that China is slowing too quickly could create short-term turmoil in the financial markets.

Globally, central bank monetary policies are accommodative and supportive of the financial markets, and we expect this to remain the case in the coming year where we expect a slow and controlled tapering of the accommodative monetary policy.

1. Are the financial markets exhibiting signs of a bubble?

The longer asset prices continue to climb, the more the media, investors and analysts will speculate on whether there is a bubble. The most difficult thing about bubbles, however, is predicting them – and not least when they will burst. In fact, only once a bubble has burst do we really know there had been one. Hence, making statements about the existence of bubbles requires some humility, and with that proviso we present our take on current asset prices below.

EQUITIES: Looking at the current state of the economy we see no immediate signs of an equity bubble. We are in the midst of a bull market where ►►

Bull markets have ended with a bang

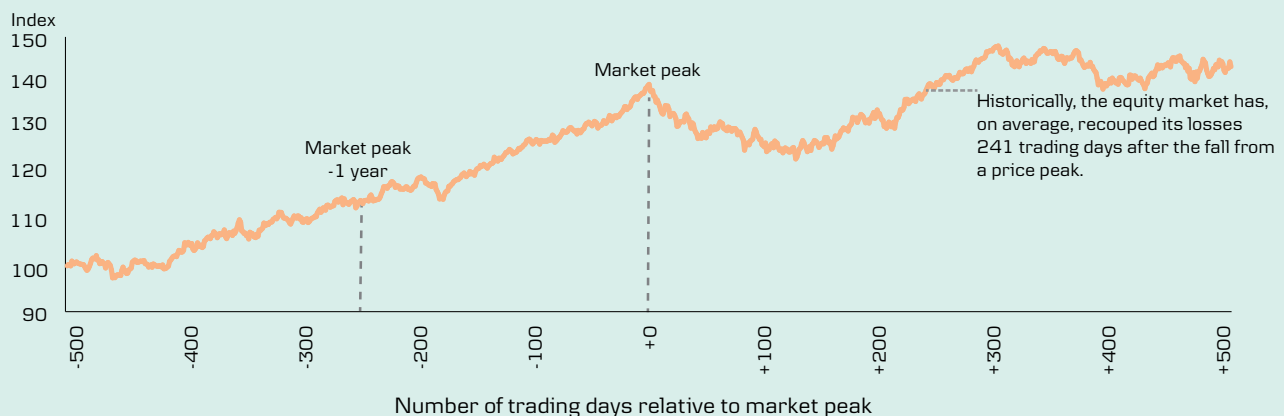
The current bull market is the fifth longest since 1929 and, with a return of 195% since it started, the fifth strongest (as measured by the S&P 500).

It is almost a law of nature that after a bull market with rising prices there follows a bear market with falling prices – but unfortunately predicting when the market will turn is very difficult. Bull markets often continue longer than most investors would imagine, and as an investor exiting a bull market too soon can be expensive in lost returns.

Since 1937, US data have shown that the final 12 months of a bull market have generated a high return of 25% on average, and that return in the final 6 months alone averaged around 16%. These historical returns are, however, no guarantee of future returns.

Historically, the equity market has, on average, recouped its losses 241 trading days after the fall from a price peak.

Accumulated average return up to and after previous peaks in the equity market (indexed)
Based on average daily total returns for the US S&P 500 index since 1937.



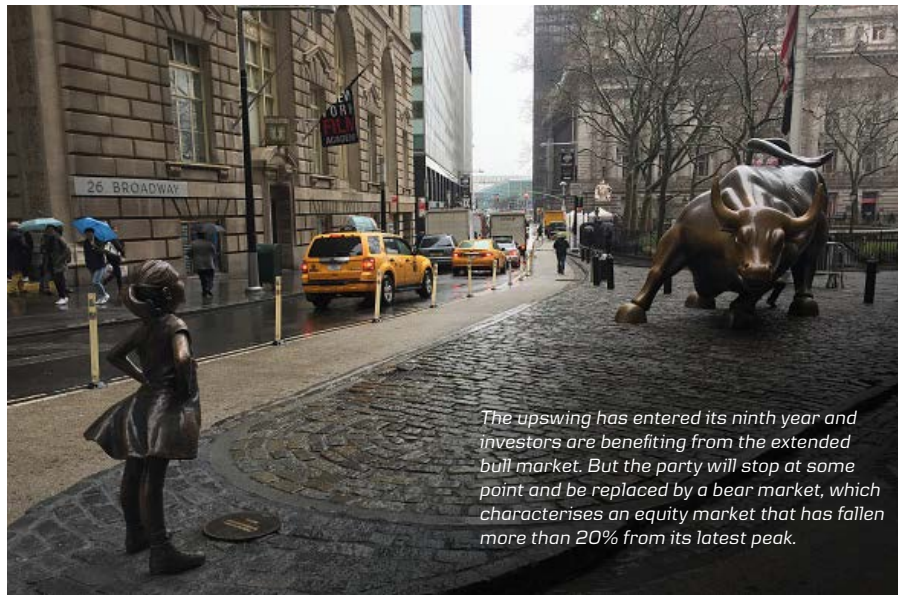
Source: Macrobond and Danske Bank.



We expect the ongoing bull market to continue in 2018, which is also the reason for our current overweight in equities.

corporate earnings justify the increase ► in equity prices - hence, the equity upswing will continue for as long as companies keep delivering on earnings. Valuations on US equities, in particular, are at the high side, though still at levels where our alarm bells are primed up but far from ringing. When the S&P 500 index has previously hit current P/E levels, annual returns have remained positive over the following 10 years, ranging between 1% and 8%. Naturally, however, there is no guarantee this will also be the case going forward.

That being said, we should point out that the high valuations on equities are very closely tied to the very low level of



The upswing has entered its ninth year and investors are benefiting from the extended bull market. But the party will stop at some point and be replaced by a bear market, which characterises an equity market that has fallen more than 20% from its latest peak.

interest rates. Hence, rate hikes could hurt equities if interest rates rise too fast or too far and economic growth and corporate earnings begin to falter.

BONDS: Yields have basically done nothing but fall over the past 30 years - and in our opinion if there is somewhere that could potentially risk becoming a bubble, it is in fixed income. The central banks' massive buyback programmes

have in recent years sent yields down to levels that we view as unnaturally low. Moreover, we also believe central banks themselves will be the ones who puncture this bubble. The US central bank, the Fed, is already in the process, and so far the slow puncture approach of gradual rate hikes appears to be working.

DEBT: Globally, debt accounts for ►►

RISKS: This is where the financial markets might be hit – positively or negatively

Potential event	Expected short-term effects on the financial markets	Expected long-term effects on the financial markets
Economic confidence indicators, especially PMI figures, fall more than expected from current high levels. [Current expectation is that they will begin to decline in 2018, but a calm retreat should have no major impact on market developments].	→ Investor risk appetite will decline. Equities and yields fall, but economic data that pulls in the opposite direction will have a calming effect.	→ Should the decline in confidence indicators continue, the long-term effects will depend on the reaction of the central banks. Further easing would put a floor under the equity market, but returns would be more modest and volatility would rise.
Inflation remains low and the Fed softens monetary policy.	→ Falling yields and renewed strength for risk assets.	→ Economic upswing continues longer than expected, as does upswing in equity markets.
Wage growth surprises on the high side.	→ Yields rise substantially and equity markets fall. The market is currently pricing in just two US rate hikes in 2018 vs. the Fed's own three, but the market will adjust expectations higher.	→ Calm returns to the markets and the upswing continues because economies are robust enough to absorb higher interest rates.
Weak Chinese data trigger fears of a hard economic landing in China.	→ Global equities fall, led by the emerging markets.	→ China stabilises and the markets are again well supported.
Trade war. The US pulls out of NAFTA and triggers fears of a trade war with other countries/regions.	→ Investor jitters send equity markets lower, led by US car stocks together with steel and agriculture, plus the Mexican peso and Canadian dollar weaken.	→ Minimal impact because trade continues as always, and Donald Trump refrains from further measures and is satisfied with the announcement of NAFTA's termination.
North Korea crisis escalates /USA gets involved militarily.	→ Major equity price falls. Flight to safe havens sends yields lower.	→ Depends on which type of war unfolds.
Increased tensions in Saudi Arabia/Middle East that have a negative impact on oil production.	→ Oil price soars and equity markets fall.	→ Other countries increase oil production and oil price increases have no effect on the real economy.

►► 220% of GDP, which is an increase of around 45 percentage points since the financial crisis. However, despite this increased and historical high level of debt, we do not expect it to limit growth in 2018, as we view the debt burden as manageable at present. This is because interest rates are low and the economic upswing is strengthening government budgets. Moreover, debt reduction among households is no longer

a drag on economic growth, which is contributing to the synchronous global upswing. However, if interest rates rise more or faster than expected from current levels (cf. bonds above), growth could weaken considerably, just as a greater debt burden would make debt more difficult to manage.

Government borrowing is what accounts for the rise in debt levels in the developed economies, while the

opposite is true of the emerging markets, where the private sector's level of debt has increased, led by Turkey and especially China. Chinese private sector debt relative to GDP has risen by 95 percentage points in 10 years – and historically all emerging market countries that have experienced a 30 percentage point increase over a decade have subsequently experienced some form or other of bank crisis. We therefore consider Chinese credit growth to be one of the greatest risk factors in 2018, but as outlined in more detail in our China section, we expect the Chinese authorities will be able to reign in credit growth.

A difficult balancing act for central banks

Central banks have contributed to the economic upswing by pursuing historically accommodative monetary policies, and now it is vitally important that they move away from this stance at the right pace. Central banks raising interest rates too fast or too far entails a risk of choking economic growth, while if they move too slowly there is a risk of economies overheating.

The US central bank (the Fed) is in the lead on monetary policy tightening and is treading cautiously. Historically (since 1971), the Fed has enacted 5.8 hikes per year, in average, during periods when rates were raised. But since the initial rate hike during the current upswing, in December 2015, the Fed has so far only raised interest rates four times by 0.25 percentage points over a period of almost two years.

In relation to US economic growth, the Fed has so far struck a sensible balance with regard to tightening, and we expect this slow and controlled pace to continue.

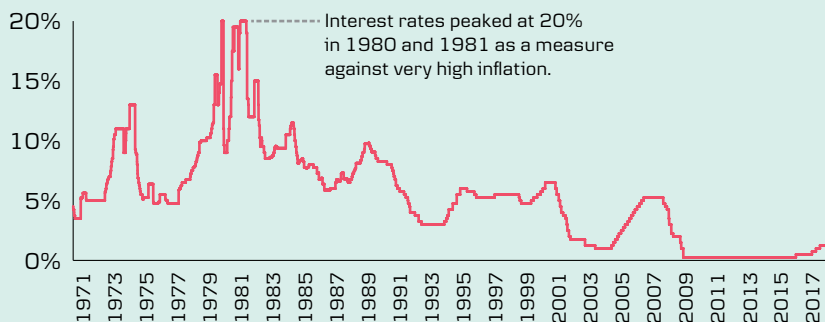


Jerome Powell will become the new Chair of the US central bank in 2018. He is expected to continue the cautious pace of monetary policy tightening.

5.8

is the average number of rate hikes per year in periods of Fed monetary policy tightening. Over the past two years the Fed has hiked four times.

Federal Funds Target Rate



Source: Macrobond

HOUSING MARKET: There appears to be a widespread perception that the Nordic housing market (with the exception of Finland) is overheated and that a correction is on its way. We agree the property markets in Norway and Sweden constitute a risk to financial stability and that a major correction in the housing market could potentially trigger a crisis. However, even if the bubble bursts, it will be a Nordic problem and not one that will derail the global upswing.

Swedish house prices began to fall in the autumn after many years of rising strongly. This could prompt a significant slowdown in economic growth in Sweden, which has to a large extent been fuelled by house building. Private consumption, too, may slow if house prices continue to decline. Hence, interest rate hikes have been postponed indefinitely in Sweden. Norway has also experienced falling house prices in the wake of very strong price appreciation, particularly in the Oslo area. However, the Norwegian economy is not as dependent on housing investment and there are signs the decline in prices will not continue.

House prices in Denmark remain lower than 10 years ago, and in contrast to back then economic growth is not dependent on further price rises and credit. Hence, the housing market represents only a small risk in Denmark, even though prices in some areas have risen very strongly and risk falling again. In Finland, rising house prices are a local phenomenon in certain areas and do not present a significant risk to the economy. ►►



The US central bank, which is headquartered in Washington, will attract its fair share of attention in 2018, when more rate hikes are expected. Historically, movements in the spread between the US 2-year and 10-year yield have been one of the best indicators of a turn in the economic cycle. The 10-year yield has declined below the 2-year yield ahead of previous recessions – it is normally the other way round.

► 2. When will the equity bull market end?

Like bubbles, bull markets with rising prices often last longer than we expect. In contrast to bubbles, however, bull markets are somewhat easier to identify. Here, the driving force is economic fundamentals – and as long as the macroeconomic factors are in place, equity markets will continue to be supported and follow a positive, rising trend.

Historically, what triggers bear markets with falling prices is turns in the economic cycle. Many other types of events can trigger corrections, which are temporary setbacks in a bull market, but the most pronounced and long-lasting downturns are triggered by economic slowdowns – or in the worst case scenario a recession.

If you can predict the turn in the economic cycle and thus when a bull market will expire, there is good money to be earned in the financial markets, but unfortunately this is practically impossible. In hindsight, finding the indicators that best predicted the phases of the economic cycle is easy, but at the end of the day it all comes down to a qualitative assessment.



Historically, what triggers bear markets with falling prices is turns in the economic cycle.

One of the best indicators of a shift in the economic cycle has historically been the US 2-10-year yield spread. All previous recessions have followed in the wake of an inversion of this yield spread – in other words, when the 10-year yield is lower than the 2-year: it is usually the other way round. This happens, for example, when the market prices in that the Fed's rate hikes have reached a level where they will have a negative effect on the economy. This can feed expectations that the Fed will eventually have to stimulate again, and future expected rate cuts are first priced into long yields, which thus become lower than short yields. But not surprisingly the challenge is to correctly predict interest rates. Our forecast is that the 2-year US yield will rise to 2.10% in 12 months and the 10-year yield to 2.70%. Hence, we see no sign of the yield spread inverting in 2018 and thus no warning signals from that front.

Final sprint to equity market peak

History also shows that exiting a bull market too soon can be expensive in lost returns. Since 1937, the final 12 months of a bull market have on average generated a return of 25% – and, as mentioned, we currently expect the ongoing bull market to continue into 2018. With our overweight in equities we are therefore following the upward trend and riding the bull, though we are also remembering to protect ourselves – by maintaining a well diversified portfolio of both equities and bonds spread across many different regions, sectors and securities.

While life as an investor may appear easy and carefree during the good times, investors must remain true to their strategy and maintain the

right allocation between equities and bonds. That includes regularly selling off equities in a bull market so the proportion of equities in a portfolio does not come at the expense of bonds, with the portfolio's 'bond buffer' subsequently becoming too small. This helps investors regularly capture the extra return and at the same time reduce the risk of nasty surprises when the market turns.

3. What now for China after the all-important party congress?

The third important question for 2018 is what will happen in China. At the all-important party congress in October, President Xi Jinping wrote himself into the history books as the most powerful leader China has seen since Mao Zedong and sent a clear signal to the rest of the world – not least the US. Xi announced the time had come for China to assume a central role in international affairs and that the country would become a leading global power by 2050.

China is no different to the rest of the world, and Chinese politicians need to legitimise themselves. Since 1973 the central pillar for this has been economic development. Structural factors have put a cap on this crusade, as China has grown and matured and so naturally its potential growth rate has slowed. China's challenge now is to achieve the structurally correct mix of growth to create sustained progress and development. Xi has dubbed the country's latest central strategy a new era of socialism with Chinese characteristics. This is the Chinese version of populism, and the concerns it has raised in the US are hardly surpris- ►►

► ing. For us as investors this means geopolitical risk will increase. China's self confidence as a superpower could raise tensions with respect to Taiwan and the South China Sea, where the US also has political interests.

The Trump administration is busy isolating itself trade-wise, while China is focused on expanding its trade relations

via the One Belt One Road project - popularly known as the new Silk Road. In addition, China is beginning to deploy its economic power via informal sanctions against Japan, South Korea, Vietnam and Taiwan, among others, to achieve political goals in the region. Informal as well as formal relations will bind Asia ever more closely together, and

the greater that mutual dependency becomes the greater the risk of tension between the US and China.

Important anniversary on the horizon
Economically, we see China as a significant risk factor in 2018. We expect economic growth to continue to slow down in China and come in at 6.3% ►►



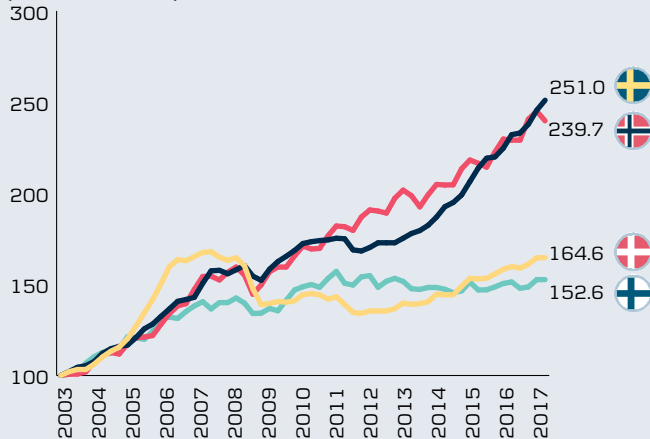
Stockholm has experienced huge house price increases since the start of the millennium - with increases higher than economic growth would justify

Nordic house prices

Sweden and Norway have experienced the most pronounced increases in house prices across the Nordics, both when looking at nominal price increases and price increases relative to economic growth (GDP) - with prices rising significantly more than growth would justify. The graphs also show how Denmark experienced a housing bubble in the years leading up to the financial crisis - the bubble burst during the period 2007-2011.

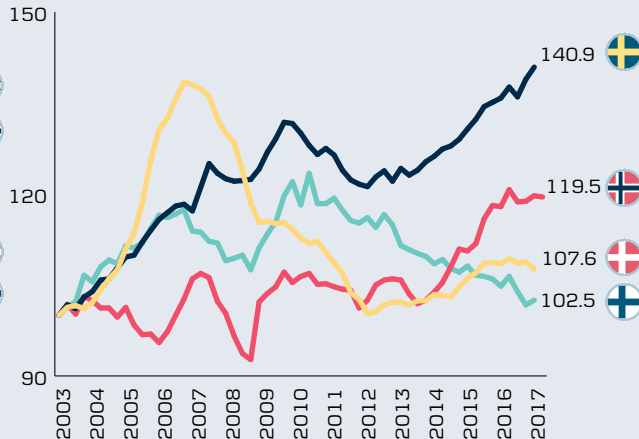
House prices

Index
(01.01.2003 = 100)



House prices relative to GDP growth

Index
(01.01.2003 = 100)



Source: Macrobond. Data for single family dwellings from 01.01.2003 to 01.07.2017, though for Denmark and Finland only until 01.04.2017. The same applies to data for house prices relative to GDP in Sweden.

►► in 2018. That of course still represents strong growth and does not in itself worry us. However, in the shorter term the financial markets are very much driven by investors' perception of events, so data potentially indicating that China is slowing too quickly could create short-term turmoil in the financial markets.

However, the Chinese authorities have a lot at stake in the next few years. On 23 July 2021 the Communist Party can celebrate its 100-year anniversary, and we cannot imagine the top politicians are interested in that day being

accompanied by an economic crisis or even disappointing growth, which may prompt the authorities to launch initiatives supportive of growth and stability. China's ambition of doubling GDP per inhabitant between 2010 and 2020 remains intact, with China requiring average annual growth of 6.3% in 2018-2020 to reach its target. However, we would not be surprised if the authorities aim even higher so they can celebrate an economic triumph alongside the Communist Party's anniversary in 2021.

Credit growth has to be reined in
Another clear message from the party congress was that the authorities want to slow credit growth and foster financial stability via increased regulation in order to avoid a systemic crisis. As mentioned earlier, Chinese credit growth, which is concentrated in the private sector, constitutes one of the biggest risks in the coming year. However, the authorities are fully aware of the risks and should be able to steer clear of a crisis with a suitable tightening strategy that avoids a sudden lending freeze. Striking the right balance will be difficult and involves not choking growth in sectors that are expanding, while doing nothing would likely result in several

banks becoming insolvent in 2018. The proportion of distressed loans is rising, while state-owned companies are struggling with profitability and also have the highest levels of debt.

That being said, we should stress that China is capable of solving this problem itself. Government debt is modest and several economists have estimated a recapitalisation of the banks would increase government debt by around 45 percentage points to roughly 80% of GDP. That is high compared to other emerging market countries, but similar to the strongest developed economies (Germany is around 70% and the US around 100%). All in all, we do not expect a financial crisis in China in 2018, but even the slightest indication of things going wrong would stoke speculation and fears of a crisis that in turn could trigger a major correction in global equity markets.

Anti-pollution initiatives may be a drag on growth
Another important reform issue that in the short term will be a drag on economic growth and corporate profitability is pollution. During his party congress speech President Xi confirmed through his vision of a 'Beautiful China' that environmental challenges need to be ►►

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the dynamics that drive the financial markets and investors have not changed. This is still all about people.



Chinese metropolises, here Beijing, are struggling with high levels of pollution. The authorities have declared war on the problem, but this could dampen economic growth.



Muhammad bin Salman was named the new crown prince of Saudi-Arabia in June, which has led to reforms – such as women being allowed to drive – but also power struggles. If the power struggles and political turmoil in Saudi Arabia escalate, they could at worst have consequences for the country's large oil production.

►► resolved. Moreover, the government has gone all in on sustainability, and going forward will focus on developing the technical sector in such areas as electric cars, solar and wind energy and robots, etc. Finally, we expect the reform of state-owned enterprises (SOE) to continue, with an unchanged focus on reducing overcapacity in certain sectors (such as steel), reinforcing governance structures and making SOEs more profitable. All are necessary reforms that will ensure long-term productivity and progress. We are positive overall on China in the long term and have an overweight of Chinese equities relative to the other emerging markets.

4. Which current or potential geopolitical conflicts could hit us?

We see considerable political risk here on the threshold of 2018. However, geopolitical conflicts typically do not have long-lasting negative effects on the financial markets, as they rarely trigger major or sustained economic setbacks. That being said, temporary negative shocks can spill over into the real

10

million barrels of oil – that is how much Saudi Arabia produces every day in round figures, which equates to around one eighth of global production. Only Russia produces a similar amount.

economy and cause growth slowdowns via declining consumer and business confidence, though this is more the exception than the rule.

Nevertheless, that does not mean investors can afford to ignore geopolitics. Wars and conflicts fuel uncertainty among investors, which they hate.

New geopolitical conflicts can arise suddenly and unexpectedly, while others can escalate rapidly. In our opinion, investors should keep a particular eye on the following two hotspots in the coming year.

NORTH KOREA: The media's focus on North Korea has faded, but North Korea is a simmering and unresolved conflict. We have no idea whether the situation will end in a war or not, but the US has probably never been closer to wanting to topple the North Korean regime.

The moment North Korea points a missile at US territory, Donald Trump will be forced to make a decision: to wait and see how far the missile travels, to shoot down the missile, or to prevent it being launched. He is presumably not keen on the first option, while the remaining two mean we could wake up one day with the US militarily engaged on the Korean peninsula and a dramatically escalated conflict.

Furthermore, the North Korean crisis could potentially open the door to a conflict between the US and China. This would be driven by the missile threat against US territory, for if Donald Trump assesses that a missile is on its way he would be forced to react. China is interested in a stable North Korea, as the economic and human cost of toppling the regime or of the US carrying out military action would be immense and create more of a problem for China than the US.

MIDDLE EAST: Just as Xi Jinping is in



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the process of cementing his power in China, Saudi King Salman bin Abdulaziz bin Saud has also started in Saudi Arabia. The arrest of numerous prominent leaders has been the most important political development in the country since 1975, and these arrests were not about corruption, but about power – power for crown-prince Muhammad bin Salman, who has recently encountered considerable dissent in connection with his decisions on Qatar, Iran and Yemen.

Recent events have revealed an upsurge in political instability in Saudi Arabia, and that makes investors nervous. Since the crisis involving the boycotting of Qatar by several Arabian countries erupted in May, the price of default insurance in the Middle Eastern countries via credit default swaps has risen and has not fallen again.

Escalating conflicts in the Middle East – particularly those involving Saudi Arabia – could potentially affect the oil price and have a negative knock-on effect in the financial markets. However, we have difficulty seeing how the current political instability should affect oil production in Saudi Arabia, unless the instability develops into some form of civil war in the country.

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.

Danske Bank A/S
Holmens Kanal 2-12
1092 Copenhagen K

Phone +45 33 44 00 00
CVR no. 61 12 62 28
danskebank.com