



Danske Bank Asset Management
Quarterly House View Q3 2018
INSTITUTIONAL

Investors underestimate the strength of the global upswing

While the economy has entered the late-cycle phase of the upswing, we still see an extended period of economic growth and rising equity prices ahead of us.



The risk of a hard landing for the Chinese economy has, in our view, diminished, making emerging market equities – and not least Asian equities – attractive.

Late-cycle tailwind for European and emerging market equities

While the economy has entered the late-cycle phase of the upswing, we still expect equity prices to experience tailwinds, not least in Europe and the emerging markets. Many investors are excessively negative on market developments, in our view.

We had a positive stance on both economic growth and equity markets going into 2018 and our expectations have not changed – even given the political chaos in Italy and Donald Trump's trade

war that is currently creating uncertainty in the financial markets. Neither the macroeconomic data nor corporate earnings point to an imminent economic recession.

However, investors do not entirely agree with us. Looking at the financial markets, we must conclude that a majority of investors apparently see the next recession brewing. Despite the expansion progressing steadily and a stellar US earnings season, investors have been reluctant to take on additional risk since the correction in February.

Investor reluctance explained
The reluctance of investors probably has several explanations:

- First, we are now in the tenth year of the US upswing, making it the second longest since World War 2. Hence, we are heading for new heights, which in itself makes many investors aware – and indeed nervous – that the end could soon be nigh. Moreover, equity markets have historically peaked around six months before the economy



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We expect that investors will by now have adjusted to an environment of rising US interest rates and increased volatility – and have moved on from the price falls experienced earlier this year.

Expected return from global equities of

10-12%

over the coming 12 months in local currency.



Overweight in equities



Underweight in bonds

turns. So if you are among those expecting a recession in 2019, then now is logically the time to start trimming back your investments.

- Second, some of the economic data have begun to dip, particularly the all-important business confidence indicators, but also others, including US retail sales. Naturally, this reinforces awareness that the upswing

will not continue indefinitely, and as always the financial markets react negatively when the data disappoint expectations.

- Last but not least, despite the decline in recent weeks US yields have shot up in 2018 and the yield curve - in other words, the difference between short and long yields - has flattened. Historically, a flattening

of the yield curve has been the best indicator of an upcoming recession, so this has of course been noted by investors.

From recovery to overheating

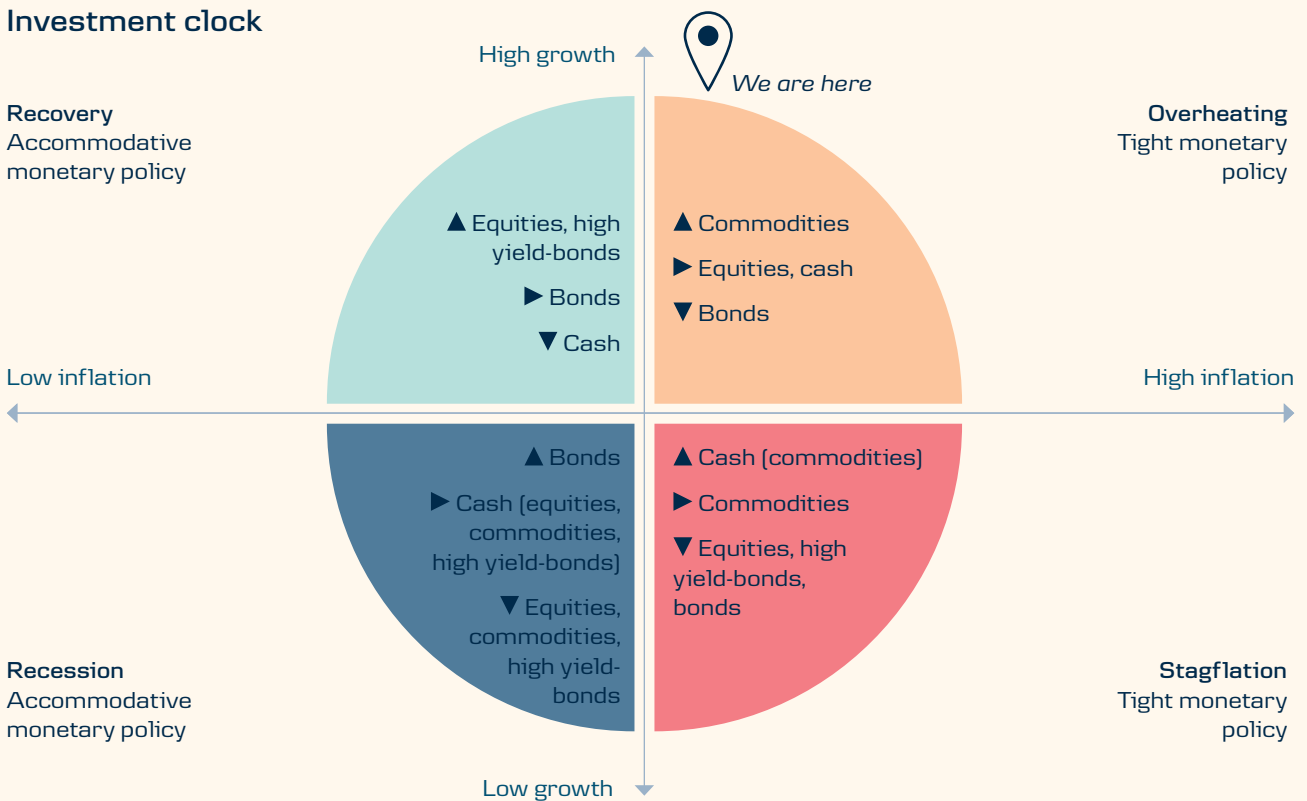
We fully agree with investors that the global upswing has matured and that we are currently in the late-cycle phase (see figure), also known as overheating. An economic upswing can be ▶▶

Where the economy is now

At Danske Bank we work with the so-called investment clock, which shows the various phases of the economy and the asset classes that are typically attractive to be exposed to during these phases. An economic upswing

can be divided into the two phases of recovery and overheating, and our estimation is that we are currently in the early stages of overheating.

Investment clock



Large emerging market economies like Russia and Brazil are benefiting from rising commodity prices, including rising oil prices.



divided into two phases – the recovery period and overheating, respectively. The gear shift apparent in economic growth and monetary policy over recent months suggests we have moved into the overheating phase.

The recovery period is characterised by accelerating economic growth, but we left this phase behind us in 2017. In addition, global monetary policy appears to be more on a tightening than an easing course, while the labour market is tight. Furthermore, companies are running at full or near full capacity and

are increasingly reporting capacity limitations – all of which are typical indicators of overheating.

However, we would beg to differ with investors who believe we are approaching the end of this phase. On the contrary, our view is that everything points to the economy only being at the start of the late-cycle phase. We are still enjoying solid economic growth rates above the long-term trend in all major economies, and we expect this will continue for the rest of 2018 and into 2019.

The positive signs

There are several reasons why we do not expect an imminent end to the current economic upswing, which we assess can continue for a couple more years:

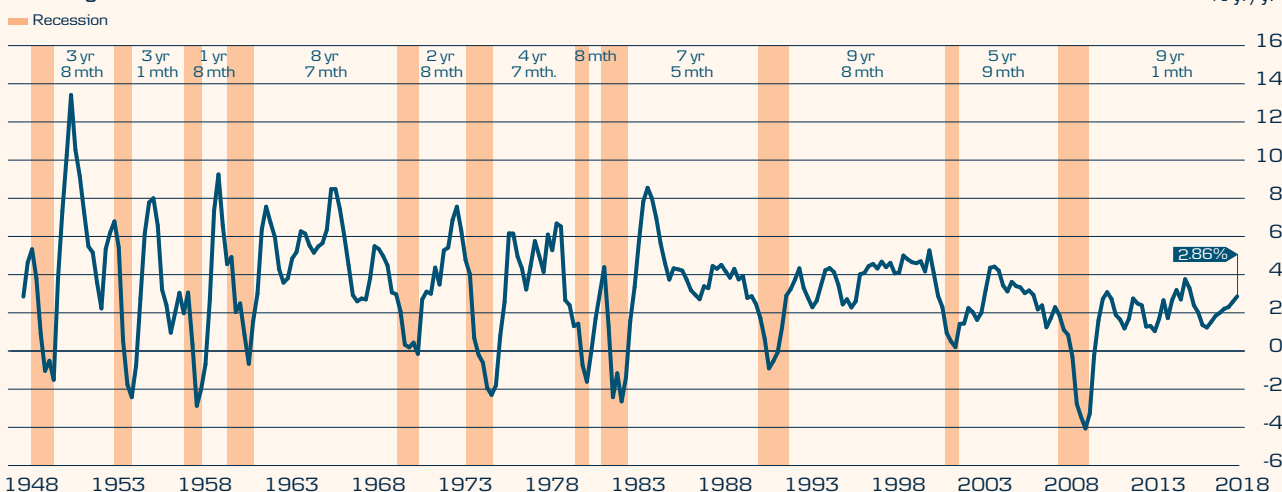
YIELD CURVE IS STILL IN SAFE TERRITORY: The flatter US yield curve is indeed a sign that we are in an advanced stage of the economic cycle. However, the flattening can continue for some considerable time, and it is only when the curve inverts – in other words, short yields become higher than



Upswing nudging record

The current US upswing is the second longest since World War 2. The upswing passed the 9-year mark in May to move into its 10th year. Only the 1991-2001 upswing has lasted longer – 9 years and 8 months.

US GDP growth



Source: Macrobond, 01.01.1948-01.01.2018. (The length of the current upswing has been extrapolated to May 2018)



The lack of inflation is the main indicator for the economy being in the early stages of the overheating phase rather than nearing the end.

long yields - that a recession occurs, historically speaking. Moreover, even when the curve has inverted, it has taken an average of 27 months before the US slides into a full-blown recession.

Hence: we need not fear a flat yield curve, but rather an inverted yield curve

- and at present there is no sign of an imminent inversion. The fed funds rate, the key policy rate of the US central bank, the Fed, currently stands at 1.75%, while the long 10Y US Treasury yield is currently at 2.85%. Danske Bank expects a further three rate hikes at most from the Fed this year, so even after that there will still be a sizeable gap between long and short yields if comparing to the current 10Y yield.

BUSINESS CONFIDENCE STILL HIGH DESPITE FALL: The decline in business confidence over the past few months is a natural consequence of growth no longer accelerating. But note that the confidence indicators are turning down from some extremely high levels and are most likely simply in the process of finding a level that is more consistent with current economic developments.

On business confidence indexes, 50 marks the dividing line between growth and contraction. As long as the confi-

dence indicators remain above 52 and the downturn is gradual, we would not be concerned. Significant falls could fuel uncertainty, but the uncertainty should be temporary if the indicators remain above 52.

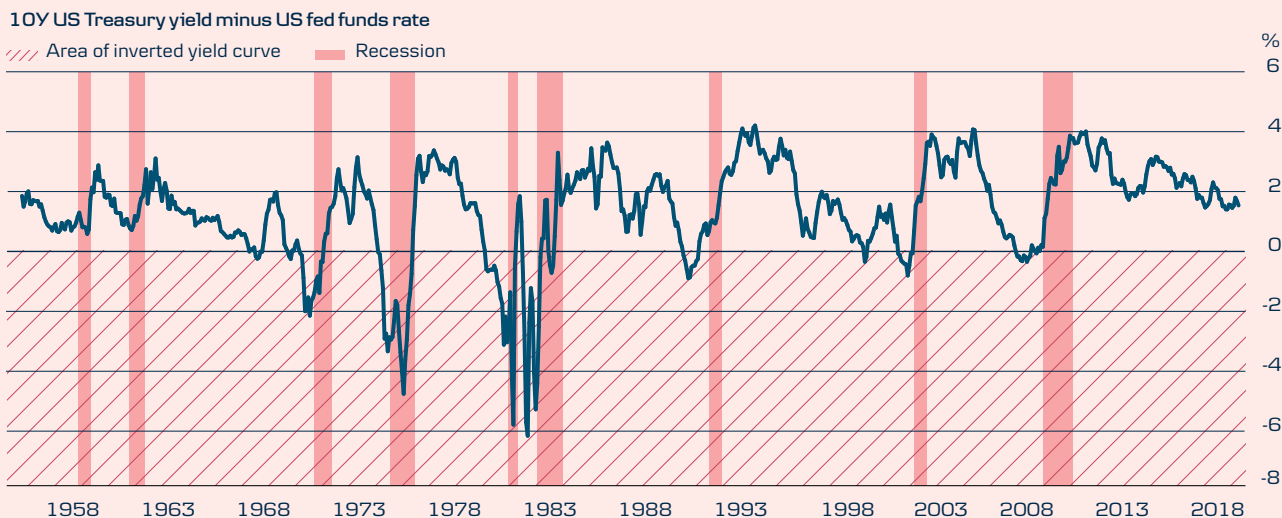
Negative wage-price spiral held in check

LOW INFLATION STILL DOMINANT: However, in our view, the lack of inflation is the main indicator for the economy being in the early stages of the overheating phase rather than nearing the end.

The end of an economic upswing is typically characterised by a shortage of labour and a level of production that cannot keep up with demand, which results in upward wage and price pressures. In a nutshell, the price of inputs into the production chain rises and these higher production costs are passed on to consumers in the form of price increases. But we have not reached this stage yet. ▶▶

No red flag from yield spread

Long yields are normally higher than short yields. Historically, the yield curve inverting, i.e. short yields becoming higher than long yields, has heralded a recession in the US. Looking at the spread between the long 10Y US Treasury yield and the short US fed funds rate, however, we are still far from an inversion.



Source: Macrobond, 01.07.1954-01.04.2018



The stronger USD will increase the competitiveness of, for example, European and Asian exporters.

Wage growth is picking up but still restrained, while technological advances are helping to keep costs down. E-trading, for example, has made the world smaller. Goods that can be traded across borders are subject to massive price competition, and so long as we wage earners do not experience generally rising living costs we are not so insistent about wage increases. This is presumably helping to keep the negative wage-price spiral in check.

That being said, inflation has been rising in recent months in the US, which is furthest advanced in the economic cycle. US inflation is hovering around the central bank inflation target, while inflation is much less apparent in both Europe and Japan. The sedate path of inflation means central banks can take things easy, which is precisely what the Fed is doing - and also what the ECB will very probably do.

Our current allocation

Given that the global economy is in the early stages of the late-cycle phase and still being supported by fiscal stimuli, we continue to see further potential in the equity market. Hence, we are continuing to overweight equities and underweight bonds.

The strong labour market means consumption is well supported, and the same holds true for corporate investment. The outlook for corporate earnings remains robust - even though earnings growth will peak this year as the effects of the US tax reform gradually fade. We would also note that the recently concluded reporting season managed to deliver upside surprises despite already very high expectations. Finally, analysts are beginning to revise

earnings expectations higher, which is very unusual at this time of year, but promising for the equity market going forward.

We therefore expect that investors will by now have adjusted to an environment of rising US interest rates and increased volatility - and have moved on from the price falls experienced earlier this year. In our view, this should pave the way for investors to once again focus on the potential remaining in the upswing.

More specifically, we are expecting a return of 10-12% (in local currency) from global equities in the coming 12 months. We are overweighting Europe and emerging markets.

We are carefully tracking the firming of the US dollar (USD) and the rise in the price of oil, which has though retreated somewhat again recently. The former is a hindrance for US exporters, while many emerging market nations have noticed that financing their dollar-denominated debt has become more expensive. Hence, countries running large current account deficits will be the most vulnerable to a strengthening USD.

In contrast, the stronger USD will increase the competitiveness of, for example, European and Asian exporters. Rising oil prices and a stronger dollar are good for oil producers, whose income in local currency will rise, though expensive oil could potentially dampen private consumption, as a larger proportion of our disposable income will have to be spent on filling up the car, etc.



Given that the global economy is in the early stages of the late-cycle phase and still being supported by fiscal stimuli, we continue to see further potential in the equity market.

The two most attractive regions

Danske Bank currently has an overweight in Europe and emerging markets.

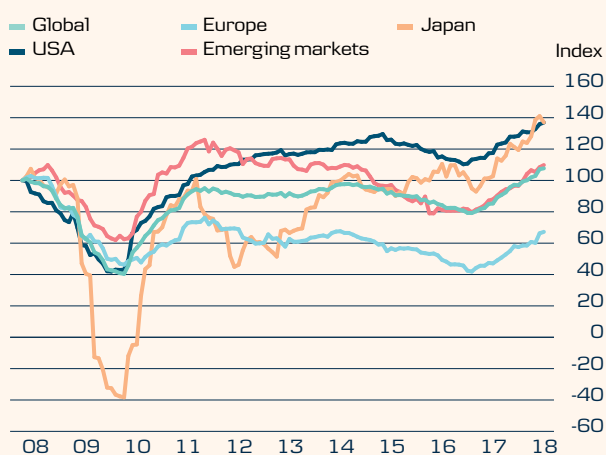
EUROPE:

Room for further growth

Europe is lagging behind the US in the economic cycle and is the only major economy where the unemployment rate is close to the long-term average, whereas both Japan and the US have unemployment rates that are close to record lows. Europe is also behind the US and Japan in terms of the corporate earnings cycle, which is why we see a relatively greater potential for earnings in Europe, assuming the upswing continues - which we do.

Across developed markets Europe is the only region where EPS - earnings per share - is not at a 10-year high [see figure below]. On the contrary, EPS here is 30% lower than 10 years ago, while the other regions are more than 35% higher. European valuations are also more favourable, relatively speaking, while European monetary policy should continue to provide a tailwind for some time yet compared to the US.

EPS (earnings per share) growth since 2008



Source: Macrobond, 01.01.2008-01.04.2018, MSCI-index, IMI, 12-month moving average EPS.

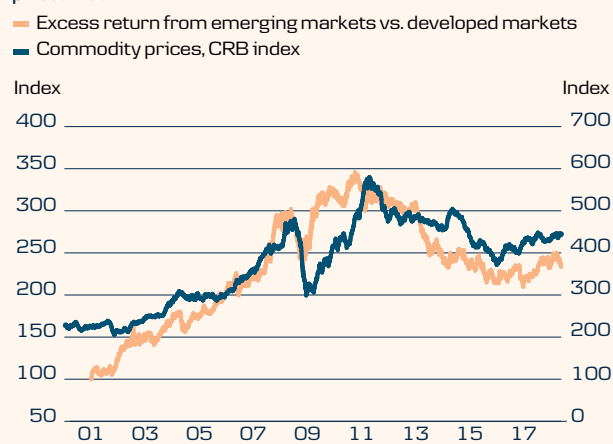
EMERGING MARKETS:

Chinese growth is underestimated

Emerging markets are benefiting from the global upswing due to their high level of exports and commodity-heavy equity markets. Brazil and Russia have emerged from deep recessions and we see a diminishing risk of a pronounced growth slowdown in China, which in our estimation has not been reflected in securities prices.

The Chinese authorities have proven they can still balance economic policy, and the major risks facing the economy are being addressed - including private sector debt levels and imbalances in the property market. We still expect growth in China to slow, but the risk of a hard landing has eased, making Asia attractive. Like Europe, emerging markets are lagging in the earnings cycle, so if the upswing continues, emerging markets should, in our opinion, outperform global equities in the late-cycle phase of the upswing due to increasing exports and growing domestic demand.

Emerging markets have generated more return when commodity prices rise



Source: Macrobond, 01.01.2000-22.05.2018, relative performance for emerging market equities vs. developed markets calculated as growth in MSCI Emerging Markets Mid & Large Cap (Large, Mid & Small Cap) relative to MSCI World, IMI.

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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