The global fiscal panic

Q3 2019

QUARTERLY OUTLOOK

By #SAXOSTRATS

Q3 2019

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The global fiscal panic

By Steen Jakobsen

Central banks' response to the looming economic slowdown and trade war has been panic cutting of interest rates and signalling of new extremes of easing, while politicians are warming to the idea of Modern Monetary Theory. Our model indicates that the low point in the economic cycles lies in the third quarter for China, and in the first to second quarter for the US, UK and Europe. Furthermore, we could be headed for a massive repeat of the 1970s global supply shock.

Looking ahead to the rest of 2019, central banks are concerned about inflation, the voters about the environment and inequality, and business about the global supply disruption caused by the trade war, which some might call a war for technological supremacy.

The central banks' policy response has been the predictable panic cutting of interest rates and guiding policy to new extremes of easing, while politicians are warming to the idea of Modern Monetary Theory as an intellectual backdrop to the fiscal expansion they will initiate as global growth falters further. Meanwhile, companies globally are scrambling to make sense of the trade war, Brexit and the disintermediation of a multilateral system in a world where environmental costs are about to explode, driven by consumer concerns and a wave of Green politicians getting into the political driving seats.

What does that mean for us investors?

We, Saxo's strategy team, have learned through trial and error that the best way to forecast involves anticipating policy responses and to combine them with an analysis of the credit impulse.

The credit impulse – the growth or contraction of credit supply into the economy – explains economic activity nine months forward with an "r2" of .60; or, in layman's terms, 60% of the economic activity nine months in the future is given already now. The credit impulses globally continue to indicate that the economic low point is ahead of us, not behind us. Our model indicates that it lies in the third quarter for China, and in the first to second quarter for the US, UK and Europe.

The lower policy rates will not help, as we have pointed out several times using our Four Horsemen theme. The price of money is only a derivative of the quantity of money. And currently, the change in the quantity of money, explained via the credit impulse, remains sluggish, which means that the current central bank effort to change the price of money will only create a short-term sugar high. The analogy we use is that the size of the credit cake is unchanged to smaller, while a piece of cake will now get a bit cheaper. This, of course, leaves only a marginal transmission to the real economy.

> **"We believe the next logical step will be a massive increase in fiscal spending as national budget talks get under way in October-November"**

And once the central banks burn through the last bits of available policy headroom, policymakers will look for further policy initiatives as the rate cutting and restarting of quantitative easing will not be enough. We believe the next logical step will be a massive increase in fiscal spending as national budget talks get under way in October-November. This fiscal expansion will be aimed at infrastructure, environment and inequality.

The global fiscal panic

Some countries, especially Germany, the US and Latin America, are in desperate need of infrastructure improvement. The McKinsey Global Institute's Bridging Global Infrastructure Gaps report says that the world needs to spend 3.8% of GDP annually, or an average of $3.3 trillion a year. Emerging markets (the high-growth countries) account for 60% of that need. Right now, they estimate we are 11% short of that, or $350 billion per year. This is not including additional investment required to meet the UN Sustainable Development Goals.

A global push to expand fiscal spending and run larger budget deficits, while global interest rates are set at zero or below, while the globalisation benefit on inflation is structurally disappearing due to trade tensions and general globalisation fatigue, sets up a scenario reminiscent of the 1970s: Big government, trade troubles (back then the US vs. Japan), supply constraints (the Opec crisis), changing market models (the shift away from the gold standard), inflation, the opening of the US-China relationship, and — who knows? — maybe even bad hair. This may seem an outrageous prediction, but the structural forces keeping inflation low have disappeared.

Austere fiscal policy (excluding the US) globally has had a negative impact on inflation expectations; the rock-bottom interest-rate policy is per definition anti-inflationary as it reduces the velocity of money, and globalisation was also deflationary.

> **"A perfect storm is brewing that will turn the tide back toward inflationary outcomes"**

Remember globalisation worked to reduce prices as China and emerging-market countries started producing goods with their cheaper labour forces. This made all products cheaper, which benefitted consumers, and that in turn reduced saving, which increased deficits, which reduced growth and that way circled back to even lower rates and inflation.

Today globalisation has reached its maximum, even without the trade spat. China produces everything, so the "making things cheaper" process has run out of room. Add to that the potential trade war and massive focus on the environmental impact of all facets of consumption, from plastics to packaging, airline and sea transport pollution, and, with central banks wrongly focused on excessively low inflation, you get a perfect storm brewing that will turn the tide back toward inflationary outcomes. From anti-globalisation, higher unit cost of production due to environmental considerations, a fiscal push into infrastructure and shoring up injured global supply chains — all that creates a massive repeat of the 1970s global supply shock.

The shock this time will come sometime after the global fiscal expansion set to arrive in the third and fourth quarter. In this situation, the markets that stand to benefit the most will be commodities and real resources, infrastructure plays, wages and gold.

By the summer of 2020 – one year from now – we will have seen the end of any belief in monetary policy moving the needle, and will be witnessing extravagant spending driving inflation to levels beyond anyone's expectations, just a couple of quarters after inflation, once again, has been pronounced dead.

Steen Jakobsen, Chief Economist & CIO

Steen Jakobsen first joined Saxo Bank in 2000 and has served as both Chief Economist and Chief Investment Officer since 2009. He focuses on delivering asset allocation strategies and analysis of the overall macroeconomic and political landscape as defined by fundamentals, market sentiment and technical developments in the charts.

@Steen_jakobsen

Global equities show the biggest disconnect since 2007

By Peter Garnry

Equities are defying gravity and continue to rise, despite a persistent decline in global leading indicators, which historically has pointed to underperformance by stocks versus bonds. Investors are buying the Fed put and betting on low inflation, stable growth and avoidance of another major crisis. This is foolish, and we strongly recommend that investors stay underweight in equities, especially the value trap of European stocks.

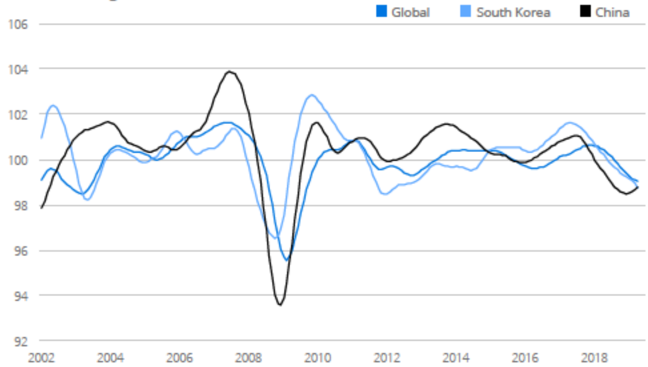
Society has reached an important inflection point on several fronts which will have profound implications for global equities and investors. We have reached the end of globalisation as we have known it since the early 1980s. Large imbalances can be seen across the environment, income distribution, credit and the global supply chain.

Investors are buying the Fed put

The OECD's leading indicators on the global economy are still declining with April's numbers marking the 17th consecutive monthly decline. The global economy is at its weakest point since July 2008 and the probability of a recession is still elevated and not fully reflected in equity valuations. South Korea, one of the world's economies most tuned to globalisation, is showing significant weakness with its leading indicators declining for 23 straight months in April, and to levels not seen since early 2012. The South Korean economy has historically been one of the best indicators for the global economy, so we expect more pain to come in the second half of the year.

The only major economy that has turned positive among the OECD's leading indicators is China. This is not a big surprise, given the recent major improvement in the credit impulse, although it is still negative. But China's improved industrial sector is driven by a major national push from the government and is likely driving domestic demand more than global demand. Meanwhile, the country's car sales (which serve as a proxy for the consumer sector) remain weaker than at the bottom of the financial crisis, highlighting elevated uncertainty among Chinese consumers. In fact, May data shows that sales growth weakened again.

OECD Leading Indicators

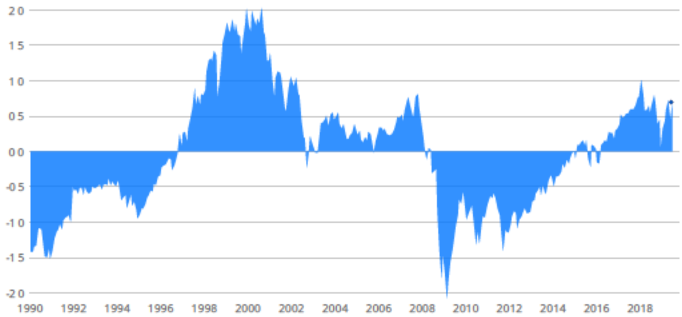


SOURCE: BLOOMBERG AND SAXO BANK

Added to the current economic realities is stagnant profit growth among global companies, an escalating technology war between the US and China, likely higher input costs for companies due to "green policies" and an increasing attack on inequality, which will lead to higher wage growth and, therefore, dent companies' profit margins. How do investors reconcile all these risks with high equity valuations?

Global equities show the biggest disconnect since 2007

Historically, equities have done worse than bonds when global leading indicators have been below trend and declining (also called the recessionary phase), but this time equities have defied gravity and continued their ascent. The only sensible explanation is that investors are buying the Fed put and betting on low inflation, stable growth, no financial crisis and that a global supply chain shock from the current US trade policy can be avoided. This is both foolish and dangerous for investors, and investors who agree in this view could consider an overweight in bonds and underweight in equities. Most important for equity investors is to steer clear of the value trap called European stocks.



SOURCE: BLOOMBERG AND SAXO BANK

“History has often showed a final bullish move in equities despite clear evidence of an incoming recession. This is exactly what we are witnessing today.”

The probability of recession is much higher than what global equities are currently reflecting, with the yield curve and leading indicators sending the strongest warning signals to investors. But history has often shown a final bullish move in equities despite clear evidence of an incoming recession. This is exactly what we are witnessing today. The Fed put is used as an excuse to buy equities as it presumably increases the equity risk premium. But history shows that the first rate-cut is often a reliable signal that a recession is coming which reduces short-term cash flows and raises return expectations as investors become more risk-adverse. The short term is not correctly discounted in equities, based on our forecast, but it is the long-term expectations that we believe make the disconnect between equities and reality the biggest.

Historically pro-cyclical countries, such as South Korea, Brazil, South Africa, Australia, the US and Hong Kong, have delivered the best returns when the economy has been in a recessionary phase. In terms of sectors, this means overweight information technology, communication services, consumer staples and real estate.

Equities reflect unheard-of confidence

Equity valuations reflect the present value of future cash flows which is primarily a function of current cash flows, growth expectations and the discount rate. This naturally leads to considerations of cash-flow generation in both the short and long term. With equity valuations at their current level, investors are showing confidence in short-term cash flows not declining materially, hence a bet on no recession, and on stable long-term growth. This belief is best reflected in US equities which are back to elevated valuation levels characteristic of late-cycle behaviour.

Long-term profit growth expectations are likely too high. As the pendulum swings back from globalisation, inequality, the environmental degradation and debt saturation, companies (especially technology companies) will likely face more regulation, higher taxation related to carbon emissions, higher labour costs and more local production due to rising nationalism. These factors will act as headwinds for companies, though some of it can be offset by increased fiscal spending driving up nominal growth. But this policy trajectory points to much higher inflation, on top of higher inflation from a less global supply chain, which will ultimately be the inflation tax that companies faced in the 1970s.

Global equities show the biggest disconnect since 2007

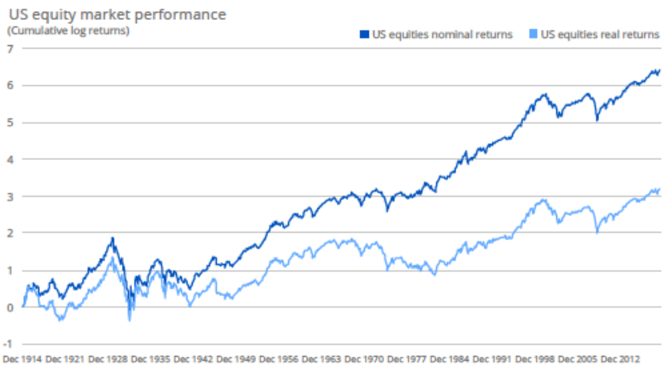
Input costs will rise dramatically

Companies have enjoyed a remarkable expansion in profit margins during the great globalisation starting in the early 1980s. Driven by lower funding costs, weaker labour unions, weak anti-trust regulation, digitalisation and lower input costs from historically low commodity prices and cheap labour in Asia, global companies — and especially US companies — sit on the fattest profit margins in recent history.

As policymakers will soon find out, the current monetary policy has little power to restore economic growth at a debt-cycle peak, so they will quickly move to the next natural extension of policy moves called Modern Monetary Theory — a tighter linking of fiscal and monetary policies. Governments will likely be forced to increase spending dramatically to close the infrastructure gap, but also to deal with the transformation of society to lower the impact on the environment from economic activity and finally to address the issue of inequality.

> **“We expect the next 10 years to be the most difficult for investors to navigate”**

The consequence of significantly higher fiscal spending is likely higher commodity prices and higher inflation. The inflation component will also get a boost from the global supply chain being rolled back to a more local arrangement due to the breakdown of the multilateral trade framework initiated by the Trump administration. These factors will drive up input costs for companies, pushing profit margins back towards their long-term average. Higher inflation will be the most damaging factor for equity investors, as the 1970s showed: equity investors had a negative real return in 1969-1982.



SOURCE: BLOOMBERG AND SAXO BANK

Investors face large structural breaks, low expected returns across most asset classes and increased volatility, as the volatility compression brought about by monetary policies since 2008 will likely end with higher volatility restoring symmetry in the risk-payoff structure. In other words, we expect the next 10 years to be the most difficult for investors to navigate and to deal a big blow to passive investing as well. There has probably not been, in recent time, a better starting point for active investing, as the one-way street of monetary policy and globalisation that benefitted passive investing has ended. The structural breaks ahead will also be difficult for computer models to handle, restoring humans as a critical element in the investing process.

Peter Garnry, Head of Equity Strategy

Peter Garnry joined Saxo Bank in 2010 and is the Head of Equity Strategy. In 2016 he became responsible for the Quantitative Strategies team, which focuses on how to apply computer models to financial markets. He produces trading strategies and analyses of the equity markets as well as individual company stocks, applying advanced statistics and models to beat the market.

@PeterGarnry

It's finally time for the USD to weaken

By John J. Hardy

The US Federal Reserve is playing catch-up with market expectations for rate cuts. But if we see further signs of a US growth slowdown from here, the Fed will quickly axe rates to the effective zero bound and could even restart quantitative easing before year-end. But it's not just a dovish Fed that will see the USD turning lower in the second half of 2019.

Historically, US Federal Reserve easing cycles have coincided with a strong dollar as global deleveraging prompts the global financial markets to scramble for USD funding. This time around, we may have already seen the maximum potential for USD strength early in the Fed's shift to a more dovish stance, and the USD looks set to weaken if the Fed keeps delivering powerful easing and the rest of the world wakes up to the potential for fiscal policy options.

The most remarkable development in currencies over the first several months of 2019 was the resilience of the US dollar despite the whiplash-inducing reversal in Fed expectations, from hawkish in late to December to dovish and then more dovish with each subsequent Fed appearance in 2019. This shows how far the Fed overreached during the later phase of the tightening cycle in 2018. Kicking off the view to the third quarter and beyond, at the June 19 Federal Open Market Committee meeting, the market felt that it got the signal from the Fed it needed to continue pricing for aggressive further easing.

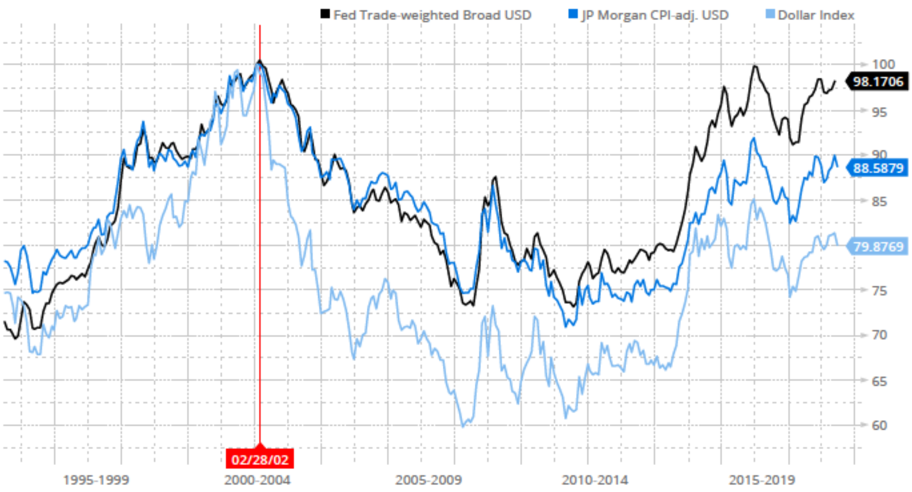
> **"The most remarkable development in currencies over the first several months of 2019 was the resilience of the US dollar"**

And given the risks of a growth slowdown in the US already baked into the cake, from the weak credit impulse to the rolling off of the impact of Trump's tax reforms, we should expect clearer signs of a weaker US economy to emerge.

As the second quarter draws to a close, one sign that the Fed is still playing catch-up is the still rather flat yield curve, where the two-ten slope has yet to steepen notably even after the market had already priced the next 100 basis points of easing for the coming 12 months. The market is far too cautious in that regard. If we see material signs of weakening in the third quarter, the Fed will chop to the effective zero bound at a breath-taking clip and could even restart quantitative easing before year-end.

It's finally time for the USD to weaken

How strong is the US dollar?
The Fed's measure is strongest



SOURCE: BLOOMBERG

***How strong is the US dollar?** The dollar is strong, but how strong certainly depends on which measure is used for perspective. The chart above shows three measures of the US dollar, all indexed to 100 in February 2002, the month that all three measures reached their highest reading in the last 30+ years. The most important for Fed policy from here should clearly be the Fed's own measure, shown on the chart in black, which neared those multi-decade highs in early 2016 and was a clear driver of Janet Yellen's dovish pivot in that time frame. A stronger USD from here is anathema for the Fed as it would frustrate progress toward its "symmetrical inflation target". Besides, a stronger USD is politically toxic for the Trump administration. From here, the Fed and Trump will throw everything they can to cap the US dollar.*

For the second half of 2019 we will be looking for a transition to a weaker US dollar as the Fed is set to deliver strong easing. And if it doesn't, it will be so rapidly disciplined by the market that it will be forced into so doing. (That was what the December market meltdown and subsequent implicit Fed mea culpa was about, let's recall.) But as Steen Jakobsen writes in the introduction to this outlook, Fed rate cuts and restarting the same old QE playbook are pushing on a policy string. The next and more powerful policy drug is fiscal, a Modern Monetary Theory framework of proper fiscal helicopter money spending, not the pointless purchase of safe treasury assets that drives savers out the risk-taking curve. Whether the US can make a quick transition to MMT will depend on whether US President Donald Trump is able to make a truce with the Democratic House of Representatives, both in general and on ceasing and desisting on impeachment efforts. An ugly standoff could slow the transition to a weaker USD.

"The USD looks set to weaken if the Fed keeps delivering powerful easing"

The collapsing rate outlook from the Fed and its willingness to bring back the policy punchbowl will make the rest of the world look less bad, though there are residual risks that any ugly episodes of general market deleveraging could drive bouts of USD (and, maybe even more so, EUR and JPY) strength against the most vulnerable currencies, the Turkish lira, for example. Elsewhere, the world doesn't look great, but the lack of room to move further on the monetary-policy front will encourage a more rapid transition to fiscal policy options. Surely countries like Australia, where the market is already projecting that the Reserve Bank of Australia will take the policy rate below 1.00% later this year, can learn the lesson that has been so glaring over the last ten years. Zero interest-rate policy, negative interest-rate policy and quantitative easing are a swamp from which policymakers will never emerge if those are their only policy options.

And while a shift to MMT and a fiscal approach in the US is potentially highly negative for the USD, as the US already has the world's largest deficit, it could be positive for other currencies where capital has been fleeing due to punitive low interest rates and where austerity has kept monetary growth very low. The starting point is very different, after all, with the US already with an annual trillion-dollar budget deficit run-rate that will only yawn wider while other countries have run surpluses in recent years.

Take a country like Sweden, which has a seemingly permanent current account surplus and has seen its currency in a negative spiral since the 2013 highs as rates were taken to deeply negative levels to avoid deflation. The combination of easy monetary policy and tight fiscal policy in recent years is a poisonous cocktail for a currency. By opening

It's finally time for the USD to weaken

up for fiscal stimulus, perhaps combined with supply-side tax cuts, Sweden would see capital both stay at home and rush back home to invest. Besides, the country needs to invest in housing and other infrastructure to accommodate its massive influx of immigrants and refugees in recent years.

Most refreshingly for currency trades, the second half of this year brings the likelihood of a multi-speed world in which some policymakers are slow to see the light while others forge aggressively ahead. Policy divergence is often a powerful market mover, so we could also see an end to the incredibly low volatility in FX that has marked the last couple of quarters. And that dynamism in exchange rates will, in some cases, also serve to hasten the next policy response – especially in Japan. In short, buckle up, because things are about to get interesting again.

Select currency comments

USD – the Fed appears set to deliver powerful easing; it just needs to remain powerful enough to outpace the offshore USD liquidity risks that can develop during risk deleveraging events. A deglobalising world, the US' increasing weaponisation of the USD and its power over the global financial system, together with President Trump's tilt away from multilateral international institutions will have the world scrambling to reduce exposure to the greenback.

EUR – the European Union is in most need of a switch to an MMT framework if the whole stumbling EU project is to avoid existential strain, especially Italian deputy prime minister Matteo Salvini's mini-BOT alternative currency scheme. The EU stands to gain the most, both economically and in exchange-rate terms, from a more generous fiscal response, and even if the next European Central Bank president is the German Jens Weidmann, he has declared that Outright Monetary Transactions (essentially MMT) is a valid policy option (and declared legal by the key EU courts.)

JPY – strengthening pressures have appeared as US yields collapse. Watch for Bank of Japan governor Haruhiko Kuroda and prime minister Shinzo Abe to bring out the next policy bazooka if USDJPY threatens below 100.00.

CHF – a switch to a fiscal approach in Europe could slow the Swiss franc's ascent, but certainly we can also expect the Swiss National Bank to push back hard if the trade-weighted franc rises from here.

GBP – we are constructive on sterling for the medium term. It is cheap, the country has moved away from its austerity posture, and in the end, we expect common sense to prevail and that prime minister Boris Johnson and the EU agree on a "managed Brexit," perhaps with a year or more to hammer out a trade deal after the October 31 exit date.

Smaller DM currencies – some downside risks here as all five G10 smalls have housing bubbles to contend with, but the starting point is already generally low. SEK looks one of the cheapest, while AUD could suffer some further broad weakness before bottoming out as Australia's housing bubble risks a major dent to the banking system and consumption, though its much stronger current account fundamentals are already softening the downside risks.

EM – the surplus countries exposed to China may suffer short term, but China tends to lead the global economy, so these could pivot back to strength first as China's economy bottoms first and begins to rise again. The bellwether is the Korean won. Elsewhere, the vulnerable EM countries that run current account deficits will need to hope that the Fed easing remains powerful enough to offset risks from foreign-denominated debt loads.

John Hardy, Head of FX Strategy

John Hardy joined Saxo Bank in 2002 and has been Head of FX Strategy since October 2007. He focuses on delivering strategies and analyses in the currency market as defined by fundamentals, changes in macroeconomic themes, and technical developments.

@Johnjhardy

Commodities are set to benefit

By Ole Hansen

The global fiscal panic, which is likely to result in governments spending money they don't have, has the potential to drive a boom in commodities, not least gold as inflation looks likely to come roaring back. And a weaker US dollar could give gold and commodities overall the boost that has been lacking in recent years.

The global fiscal panic that we expect to unfold over the coming quarters will drive additional gains across several key commodities. Gold seems best positioned to benefit from a renewed race to the bottom in central bank rates and bond yields, while the risk of a renewed currency war could weaken the US dollar, another positive factor for commodities.

> **"We see Brent crude oil struggling to recover much beyond $70/b during the coming months"**

Steen Jakobsen highlighted the risks that renewed monetary policy easing might be unable to move the needle and deliver the sought-after boost to global growth. As a result, we are likely to see a shift towards global fiscal expansion with a focus on infrastructure, environment and inequality. One of the sectors standing to benefit the most from the increased spending of money that governments don't have is commodities, not least gold as inflation is likely to come roaring back just a couple of quarters after it had been pronounced dead.

Five years of range-bound gold trading look set to come to an end over the coming months as the yellow metal takes aim at $1,483/oz, the 50% reversal of the 2011 to 2015 sell-off. Driving the initial move higher are expectations that global central banks will cut rates to spur growth, which has proven increasingly difficult to achieve with trade wars disrupting global supply chains. The US-led slump in bond yields was another major driver behind gold reasserting its role —not least considering how in Europe an even bigger amount of outstanding bonds has moved into negative yield territory. Why is this important for gold? Because it removes the opportunity cost of holding a non-coupon or non-dividend asset such as gold.

SOURCE: BARCLAYS, BLOOMBERG, SAXO BANK

Commodities are set to benefit

While US Federal Reserve easing cycles in the past have coincided with a strong dollar, we may already have seen the maximum potential for USD strength early in the Fed's shift, according to John Hardy, our FX strategist. On that basis, we ask if it is finally time for the USD to weaken? That would give gold and commodities in general the tailwind that has been missing in recent years.

The biggest risk to our scenario of rising commodity prices is the potential for a major trade deal between the US and China reducing the markets' expectations for how much US rates will have to fall. However, looking at the data, we find that credit impulses globally continue to indicate that the economic low point is ahead of us, not behind us.

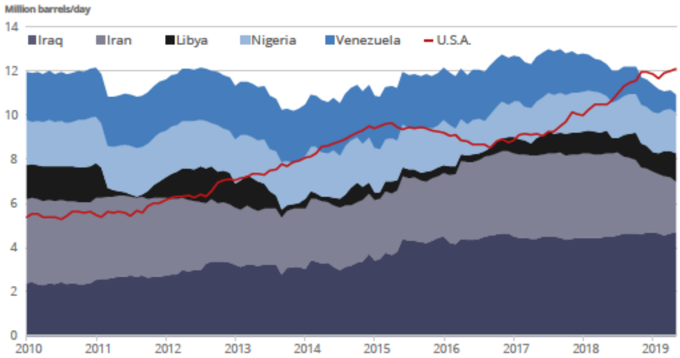
With silver trading at a 26-year low relative to gold, we see some additional upside, not least due to investors having preferred to trade silver from the short side for a while. The goldilocks scenario that could kick life back into silver would be a weaker dollar, low yields and the mentioned increased focus on fiscal spending.

In copper, we may already have seen the low point around $2.60/lb in high grade and $5,750/tonne in LME. Looking ahead, support will be driven by supply constraints offsetting current demand worries before a pickup in demand occurs. We expect that infrastructure spending and the move towards copper-intensive electrification will only continue to accelerate as the public increasingly calls for action to combat climate change and pollution.

Crude oil's gyrations during the past six months look set to persist, with multiple drivers creating a very difficult market to navigate. Lower growth leading to a visible reduction in global demand for crude oil was the main theme that helped drive crude oil down to $50/barrel (WTI) and $60/b (Brent) during the past quarter.

To prevent further losses, we expect that Opec and Russia will reaffirm their commitments to keeping oil production capped for the remainder of the year. Additional support should be provided by the continued risk to production from the so-called fragile five, the improved risk appetite from the expected cut in US interest rates, a weaker dollar and, not least, heightened geopolitical risks related to the Middle East. Despite all of these, the risk to global growth remains a major headwind, and barring any escalation in the Middle East, we find the upside risk limited to $70/b in the coming months.

Oil Production: Opec's Fragile Five versus U.S.



SOURCE: BLOOMBERG, SAXO BANK

Agriculture commodities will be keeping a close eye on the clouds (or lack of them) in the sky. The problems that farmers in Europe and the Black Sea region faced last year due to drought have moved to the US this past quarter. Torrential rain and flooding have sharply reduced the prospect for US corn production, while the quality of wheat has also been called into question. Soybeans, while also rallying, have struggled to gain momentum amid the trade war and the outbreak of African swine fewer reducing demand from China.

> **"Five years of range-bound gold trading has come to an end"**

Farmers outside the US, especially in South America, are expected to take advantage of rising prices to produce at will into 2020. The short-term direction of US crop prices however will be determined by weather developments in the US and Europe. On that basis we see prices supported over the coming months.

Ole Hansen, Head of Commodity Strategy

Ole Hansen joined Saxo Bank in 2008 and has been Head of Commodity Strategy since 2010. He focuses on delivering strategies and analyses of the global commodity markets defined by fundamentals, market sentiment and technical developments.

@Ole_S_hansen

Fiscal policy to the rescue in the Eurozone

By Christopher Dembik

Growth in the Eurozone could be derailed in the coming quarters, and such a slowdown would trigger a new phase of expansionist fiscal policy. The size and the effectiveness of the next round of stimulus, however, remain uncertain, and some European governments will have little incentive to act.

In coming months, Eurozone growth could slow more sharply than commonly expected. We can identify six main risk factors that could negatively affect growth:

- A tariff shock hitting the European manufacturing sector, especially the German automotive industry that represents about 14% of German GDP, if there is no agreement between the US and the European Union on auto imports by December 11.
- The lasting consequences of the economic slowdown in China and the credit crunch in Turkey which have already hurt German exports since the end of 2018.
- Pessimism among EU consumers, leading them to save.
- The likelihood of a no-deal Brexit on October 31.
- Higher risk of recession in the US in 2020.
- Rising tensions between the US and Iran in the oil-strategic routes of the Strait of Hormuz that could lead to disruptions in the global oil market.

> **"The ECB could resort to a new round of quantitative easing, in case of an economic downturn or de-anchoring of inflation expectations, as early as 2020"**

If one or more of these risks materialises, which is more than likely in our view, growth in the Eurozone would be at risk of derailing, which would push policymakers to intervene to support demand and investment. We believe that the conditions are already in place for fiscal stimulus in the euro area for the following reasons:

Interest rates are structurally extremely low. In other words, the cost of debt is low so it reduces the urgency to reduce debt. Recently, for the first time ever, the 10-year government bond interest rates of Austria, France and Sweden have fallen below zero. For some Eurozone countries, up to 88% of the total outstanding public debt is with negative yields for maturity up to 2032. This is the new normal in the Eurozone. Consequently, in major European countries, the

Fiscal policy to the rescue in the Eurozone

cost of debt is totally manageable. Based on the latest OECD data, net government interest payments as a percentage of GDP are close to historically low levels, at 3.5% in Italy, 1.5% in France and 0.6% in Germany, and are expected to decrease further for most of them in coming years.

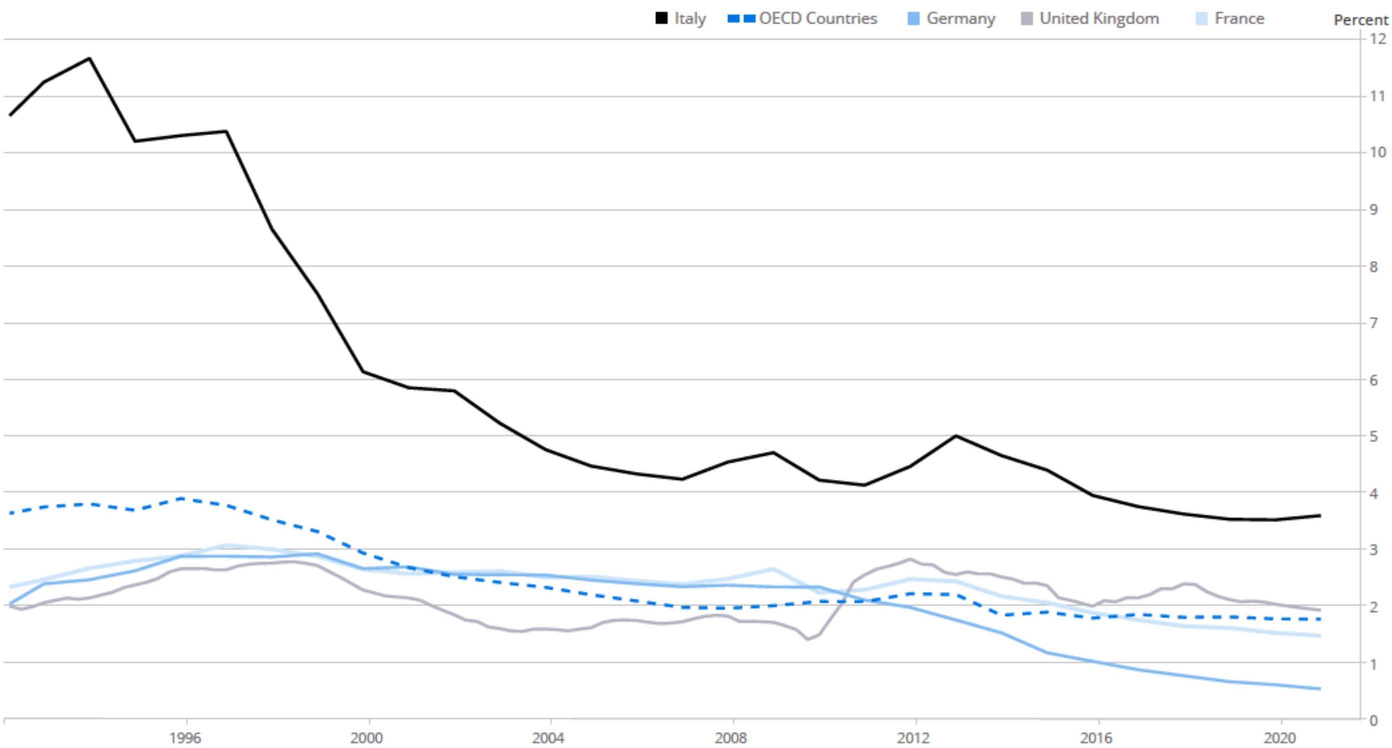
There is little room left for monetary policy. The European Central Bank is confined to the zero lower bound, which means that lower rates have less positive effect than in the past, as they are already very low or negative. The ECB could resort to a new round of quantitative easing, in case of an economic downturn or de-anchoring of inflation expectations as early as 2020, but to be effective, it will need to wield a more massive bazooka than in 2015, and the effects are still uncertain. What we know with more certainty is that QE tends to be associated with negative distributional effects (exacerbation of wealth inequality) that can only be mitigated by fiscal redistribution.

Over the past few years, the economic literature and prominent scholars have paved the way for expansionist fiscal policy. In the US, Modern Monetary Theory proposes to finance a Green New Deal and full employment by increasing the deficit and using the central bank to pay off debt by printing more money. MMT is attracting more and more attention in Europe, including among populist parties, but also beyond, and will certainly be part of the conversation in upcoming elections.

Investment to finance clean energy transition is gaining strong support among European citizens, as shown by the victory of Green parties in the latest EU parliamentary elections.

Fiscal stimulus will likely be oriented towards the future, to finance investments in infrastructure, education and clean energy transition, and will imply a need to revisit fiscal golden rules. We believe a pragmatic coalition could emerge at the EU level between populist and more mainstream political parties to reform the 3% of GDP deficit limit and exclude productive investment from deficit calculations.

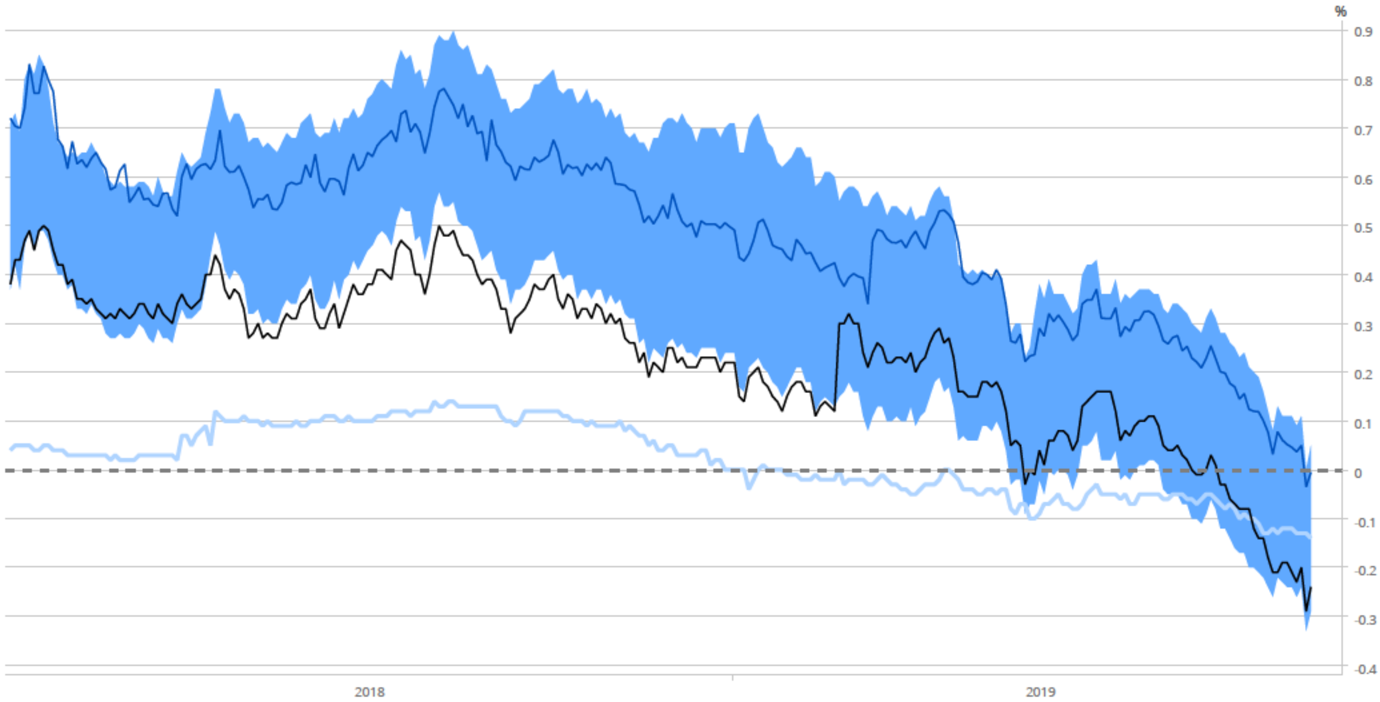
Net government interest payments as % of GDP



SOURCE: MACROBOND, SAXO BANK RESEARCH & STRATEGY

Fiscal policy to the rescue in the Eurozone

Negative yields are the new normal
10-year government bond yield



SOURCE: MACROBOND, SAXO BANK RESEARCH & STRATEGY

> **A pragmatic coalition could emerge at the EU level between populist and more mainstream political parties to reform the 3% of GDP deficit limit**

The likely growth slowdown in the euro area in the coming quarters will be the trigger for this new phase of expansionist fiscal policy.

However, uncertainty remains as to the scale and the implementation of the stimulus. If it is up to member countries, the stimulus is likely to be under-supplied as many governments will have little incentive to do much. Europe will face the same free-rider problem as in the past, with countries patiently waiting to benefit from the stimulus policies of their neighbours. The ideal scheme would be that of coordinated fiscal expansion through fiscal agreement or a proper common budget incorporating counter-cyclical mechanisms. That would involve highly sensitive political concessions, especially on risk-sharing, and high execution risk, but this would be the most efficient way for the Eurozone to avert an upcoming economic downturn.

Christopher Dembik, Head of Macro Analysis

Christopher Dembik joined Saxo Bank in 2014 and has been the Head of Macro Analysis since 2016. He focuses on delivering analysis of monetary policies and macroeconomic developments globally as defined by fundamentals, market sentiment and technical analysis.

@Dembik_Chris

Global policy panic to boost bonds

By Althea Spinozzi

European government bonds have rallied powerfully since the end of 2018, with periphery issuers, such as Greece, benefiting the most. European sovereign debt valuations are likely to be well supported throughout the summer, and a further rally could be ahead if the unfolding economic slowdown triggers a new loosening of monetary policy.

Central banks are rushing again to ease economic conditions. It is now clear that an economic downturn is inevitable, but will loose monetary policies succeed in saving the world again this time? We believe that central banks' policies may not be enough this time around, but in the meantime, investors have plenty of time to decide where to invest. The fixed-income market provides a great opportunity to investors to ride the rally that comes with loosening of monetary policies, while taking less exposure to volatility than in the equity market as recession kicks in. It is important to consider risk wisely and choose quality over higher returns.

> **"Overall, we are positive on European sovereigns, except for Italy"**

European sovereigns: The rally will last through the summer with help from a dovish ECB, but an economic recovery is unlikely

We believe that European sovereign debt valuations will continue to be supported throughout the summer, and they may tighten a little further as monetary policies remain extremely dovish. European Central Bank president Mario Draghi's last speech made clear that the ECB is ready to increase monetary stimulus if the economy does not improve. At this point, not only inflation is disappointing, but the data show weakness in the biggest EU economy, Germany, as economic sentiment plummeted in June, while uncertainty over US foreign policy is weighing on economic forecasts. European sovereigns have rallied powerfully since the end of 2018. Periphery sovereigns benefited the most, with Greek 10-year yields falling 2 points, to 2.5% from 4.6%, since November last year. The drop in Greek sovereign yields was followed by Portuguese sovereign yields falling 1.4 points, to 0.55%, since November last year, while Italian and Spanish 10-year sovereign yields fell one point.

We believe that once sovereign prices stabilise, the bonds will hold their value throughout the summer, and another rally could be right around the corner if more dovish statements come out of central banks. Spanish and Portuguese sovereigns are now trading below 1%, but, given the countries'

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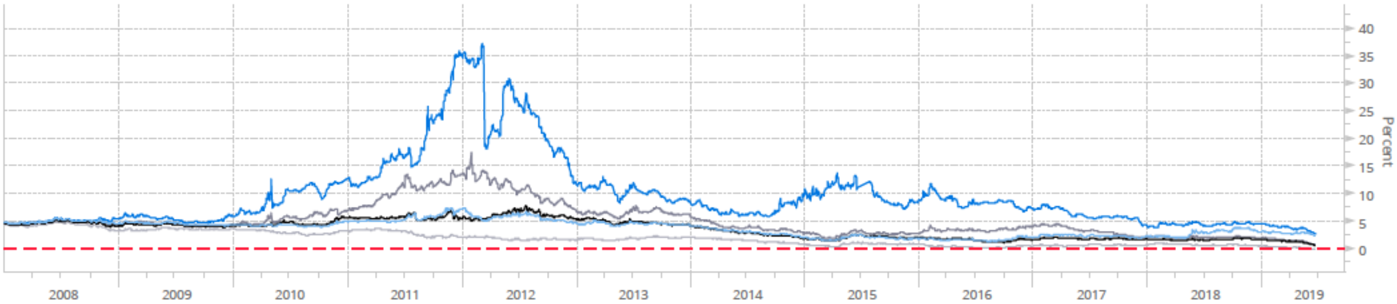
significant economic improvements in the past few years, we can expect them to be less vulnerable to external factors than other sovereigns, such as Italy. In the case of Italian sovereigns, we believe that the rally is overdone, and that BTPs should price lower because the country's weak economic data and populist policies are clearly going to go against the EU indications and further destabilise the economy. While the value of Italian BTPs can continue to be supported throughout the summer, we believe that volatility will increase as autumn approaches and the 2020 budget talks begin.

Overall, we are positive on European sovereigns, except for Italy, as we believe that a sell-off of Italian bonds may materialise in autumn this year as national budget talks get started.

European bond yields: a new low point



SOURCE: BLOOMBERG

US Treasuries: Fed policies and trade war to keep yields low for longer

We believe the market is too dovish in pricing three US interest rate cuts this year, starting in July. The Federal Reserve just finished hiking rates four times last December, reaching a "comfortable" level at the moment. Unless there are clear signs of distress or economic downturn, the Fed will not rush to cut interest rates, because then it would be unable to use the interest-rate tool when it most needs it. We expect, however, that the Fed will deliver one interest rate cut as the economy is clearly heading towards a downturn, and the Fed will also need to mitigate the effects of an escalation of trade war if it persists.

If the Fed does not deliver, it would be a huge disappointment to the market and could lead to a correction that might cause the US yield curve to invert suddenly as rate-cut projections change on the short end of the yield curve, pushing it upwards, while the longer part of the curve would be slower to widen as fears of an escalation of trade war would keep attracting safe-haven seekers.

US Treasuries Rally

SOURCE: BLOOMBERG

Global policy panic to boost bonds

Corporate debt: yields are falling but risks remains high

European and US corporate bonds have been rallying since the beginning of the year, reaching levels previously seen at the end of 2016, at a time when economic conditions were robust and well before the Fed and the ECB started to talk about raising interest rates. Now the economic backdrop is weaker amid slowing growth and escalation of trade war, so it is hard to justify low yields on corporate bonds. The real issue is that prices continue to rise, pushed up only by indications that central banks are ready to stimulate the economy further. Although there has been an obvious deterioration in the quality of corporate debt, investors' buying frenzy is pushing companies to seize the opportunity and issue more debt, thereby increasing overall leverage and putting more pressure on an already tired economy ready to tilt towards recession.

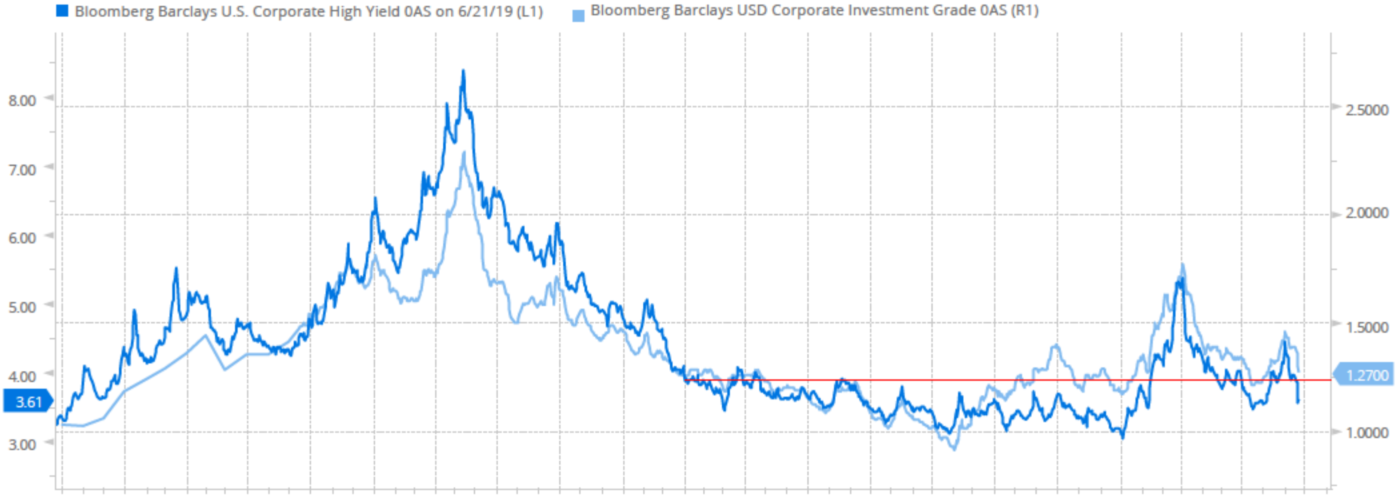
In Europe, bond sales in the primary market have fared particularly well this year, with 2019 bond issuance up 9% from 2016 and 3% from 2017, according to Bloomberg data. If the market keeps trading at current levels, or if it rallies further, we expect to see more issuance taking place, especially in high yield, as companies take advantage of low interest rates to refinance existing debt, while investors are pushed towards higher-yielding credits as yields get squeezed.

Similarly, it is clear that the rally in US corporate bonds has been driven merely by the market's expectations that the Fed will cut rates, while ignoring underlying economic conditions. So, the biggest risk that corporate bondholders face now is that the Fed does not deliver, which would cause a sell-off, especially among lower-rated credits.

Therefore, we believe that investors should remain cautious and look at investment-grade corporates and carefully select higher-rated junk issuances.

Although in the short term the positive market trend caused by loose monetary policies supports corporate bonds prices, both in the US and Europe, we believe that the long-term effects of such a trend will have serious consequences for the market and that, once a recession starts, many investors will find themselves trapped in lower-rated securities and suffer severe losses. Although in the short term, junk bonds may present an opportunity, in the long term, we prefer better-quality names.

Corporate US spreads tightest in 2 years



SOURCE: BLOOMBERG

Global policy panic to boost bonds

UK bond market: Still at the mercy of Brexit

Since the resignation of British prime minister Theresa May last month, we have seen 10-year gilt yields inevitably fall below 1%, exactly as was seen in 2016 after the Brexit referendum. The message that the bond market is sending is clear: things are going to get worse before they get any better. This has serious implications for investors with sterling as a base currency as it means that they need to pay up for good-quality assets, but if they venture into the junk space, yields are so high that they may be irresistible. The average yield offered by sterling high-yield issuances is around 6% across maturities, while the average yield offered by investment-grade sterling bonds is only around 2%. The biggest problem with high-yield corporate names, however, is that it is still unclear how Brexit will affect their operations, and a large majority of them do not have any Brexit plan in place. With a trade war also looming on the horizon, it is obvious why investors are steering away from lower-rated bonds. Unfortunately, we do not believe that the situation will change until there are clearer indications of where Brexit is going. So, also in this case, investors should be cautious and prefer higher-grade names over junk.

> **“Another rally could be right around the corner if more dovish statements come out of central banks”**

10-year gilt yields lowest since Brexit vote

SOURCE: BLOOMBERG

Althea Spinozzi, Fixed Income Specialist

Althea Spinozzi is a sales trader at Saxo Bank, and specialises in fixed income products within the global sales team. Spinozzi joined Saxo Bank in 2017 and maintains an active approach in bond trading focusing on maximising total return. Because of her background in leveraged debt, she is particularly focused on high yield and corporate bonds with attractive risk and return.

@Altheaspinozzi

Monetary madness in the 'miracle' economy

By Eleanor Creagh

With the global economic outlook weakening and the Australian economy losing momentum, the Reserve Bank of Australia already in June began what is likely to be a series of cuts to its cash rate, which will probably land at 0.5% next year or even by year-end. Easier monetary policy will be required to deal with labour-market slack, weakness in the housing sector and falling consumption.

Faced with a tumultuous political environment, Brexit woes, trade tensions, new battle lines on the front of global technology dominance and a slowing Chinese economy, businesses around the world are losing confidence, and global growth is ailing. This is apparent particularly when viewed through the prism of trade and manufacturing. The uncertainty paralyses decision-making at multinational companies, burdens capex intentions and forces supply chains to be unravelled to reduce risk as businesses are unsure of the regime under which they will operate in the coming years.

Against this backdrop, US Federal Reserve chief Jerome Powell, no longer set to wean stocks of their addiction to easy monetary policy, has surrendered for a second time in a bid to bolster confidence. And the question is no longer if the Fed is prepared to act, but rather by how much. So a domino effect is in motion. As the global outlook weakens, central banks are faltering in their resolve. Both the Fed and the European Central Bank, which not long ago talked of raising rates, are now ready and willing to race to rock bottom. The Reserve Bank of Australia has already begun to tread down this treacherous path, having delivered in June the first in what will be a series of cuts to the cash rate, which is likely to land at 0.5% in 2020. The risk to this view is to the downside, and the cash rate could reach that level by year-end.

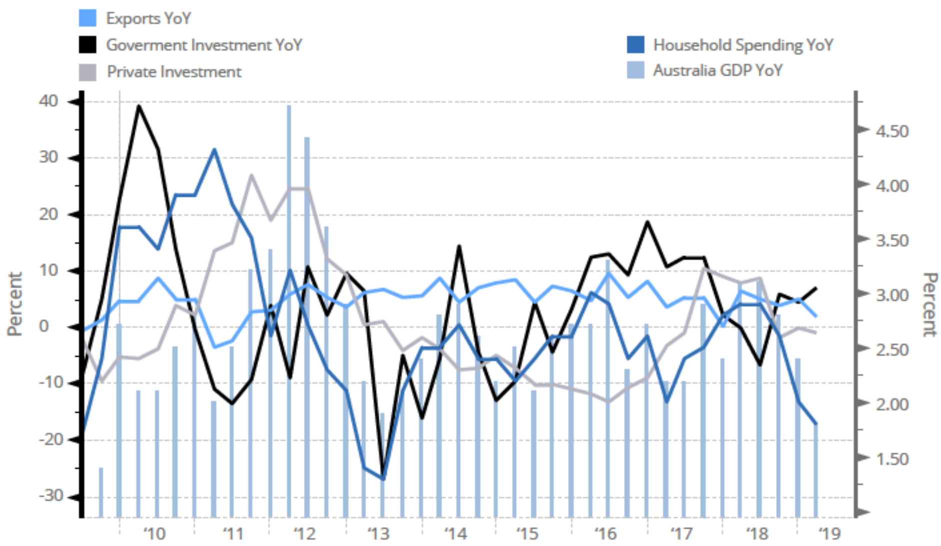
> **"Australia's near 30-year recession-free run, the envy of central bankers around the globe, is now at risk"**

Australia's near 30-year recession-free run, the envy of central bankers around the globe, is now at risk as economic malaise grips. The "wonder, down under" that escaped zero interest-rate policy, negative interest-rate policy and quantitative easing has not managed to vanquish the business cycle and will not be so lucky this time around.

In Australia, easier monetary policy will be required given the sizeable spare capacity remaining in the economy which continues to lose momentum and is running well below potential. The weakness is likely to lead to a further rise in unemployment and persistent disinflationary pressures, even

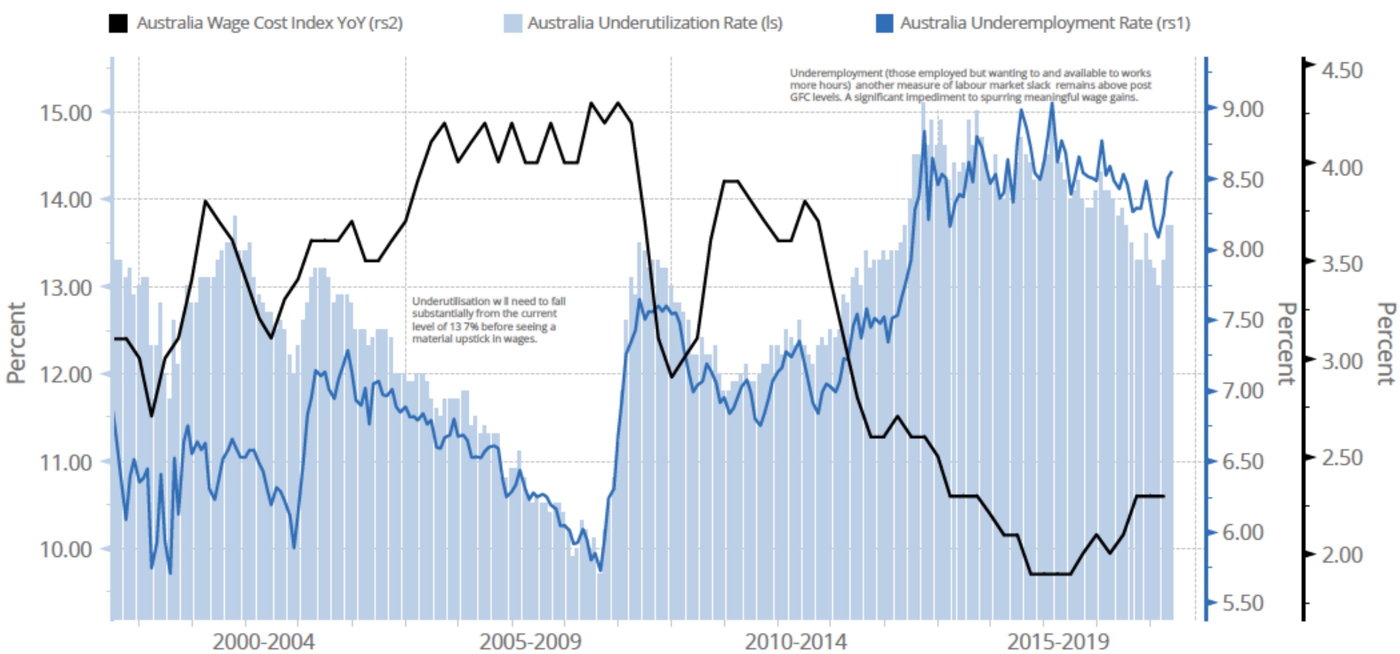
Monetary madness in the 'miracle' economy

before a potential global shock appears. Remember, trade is just a sideshow for the unfolding rivalry between the 20th century's superpower and the would-be hegemon of the 21st century's bid for supremacy. And, while a trade deal could still be reached with China, Europe could easily be next in the firing line. But perhaps the main unknown here is US President Donald Trump's calculation of what will score points with his voters, which could turn on a dime.



SOURCE: BLOOMBERG

Australia's March quarter national accounts confirmed that the slowdown seen in the second half of 2018 has extended into 2019, with weakness in the housing sector and falling consumption key concerns. Labour-market slack, as measured by both unemployment and underemployment, needs to fall substantially before wages can rise. This significant spare capacity in the job market will be a major impediment before stagnating real wages reverse their course and relieve the pressure on debt-laden households. That would be critical for an economy where household consumption accounts for almost 60% of GDP. The RBA is communicating that unemployment now needs to fall below 4.5%, and even lower if overseas experience is anything to go by, before inflation would pick up. So, there is significant work to be done with unemployment currently sitting at 5.2%, well above the full-employment level needed to spur wage gains and inflationary pressures.



SOURCE: BLOOMBERG

Monetary madness in the 'miracle' economy

Combine stagnant wage growth, labour-market slack and an economy heavily reliant on private consumption, and you have an ugly cocktail for sub-trend economic growth. With the case to cut rates having been made, why wait? The RBA has materially shifted its assessment of the labour market and the degree of spare capacity that remains, so there is little to gain from holding off until August. So, next up is the bank's July meeting, and one more cut is likely by November. The RBA has few options, especially considering the limited scope for banks to pass on further rate cuts as the official cash rate creeps towards the zero lower bound. Furthermore, the prospect that the Fed will cut rates goes against what the RBA has identified as a critical policy lever to stimulate the economy: the exchange rate. So, get ready for lower yields.

terms of policy stimulus. Don't forget that in the previous four cutting cycles the RBA delivered an average of 300 basis points of easing. But, as Steen Jakobsen points out in his introduction to this outlook, the cost of capital is just one small piece of the puzzle, and, with interest rates already at historic lows, arguably not the main factor hindering economic growth.

In the current low-rate environment and for the foreseeable future, fiscal policy therefore has a far more active role to play. So, what is the bigger problem? Governments shirking their responsibilities to focus on infighting instead of policy reform. Monetary stimulus is ineffective for the challenges we face, and bureaucrats in Canberra must have realistic expectations about what central banks can achieve to stimulate the economy.

expanding the productive capacity and potential output of the Australian economy — something the RBA has long bemoaned, and now more vocally than ever. But the newly elected treasurer Josh Frydenberg seems completely unperturbed by these challenges, and instead is determined to retain political capital and become the first treasurer to deliver a surplus in over a decade. Unfortunately, if the current slowdown persists and the credit impulse is right in indicating the economic low point remains ahead, Frydenberg may have no choice. After all, the credit cycle leads the economic cycle.

Where there is a policy power vacuum, the RBA must be ready to step in and do the heavy lifting in case of an enduring threat to growth and employment. Although the RBA hopes it will not need to resort to unorthodox measures, once the conventional policy toolkit has been exhausted (which is already close), the RBA would probably turn to quantitative easing if the economic outlook were to deteriorate further. Asset purchase programmes could take several forms, depending on the objective. Or, given that the RBA has a last-mover advantage, it could skip ineffective QE and retool asset purchases to go straight to "helicopter money" or infrastructure spending, in keeping with the global fiscal panic. However, such a move would likely require an economic crisis to unfold.

"Once the conventional policy toolkit has been exhausted, the RBA would probably turn to quantitative easing"

After three cuts by November, the RBA is likely to pause to assess the outlook, while remaining locked and loaded if conditions warrant further action. A fourth rate cut in play for 2020 would take the cash rate down to 0.5% which is likely the effective lower bound. One problem is that the RBA is up against the law of diminishing marginal returns in

Monetary policy will never replace sound economic policy. So, rather than relying on central bankers to clean up the mess, the government must deliver productivity-enhancing reforms, infrastructure spending and other fiscal measures to restore confidence and start a self-sustaining recovery in economic growth. It needs to do that while


@Eleanor_Creagh

Eleanor Creagh, market strategist

Eleanor Creagh joined Saxo Bank in 2018 and serves as the bank's Australian Market Strategist, responsible for creating, implementing, and monitoring equity strategies and research for traders and investors, as well as developing quantitative models and customised mathematical frameworks for institutional clients. Eleanor holds a double major in Finance and Economics from the University of Sydney.

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