Q1 2019

QUARTERLY OUTLOOK

By #SAXOSTRATS

SAXO GROUP

Q1 2019

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BEWARE
THE GLOBAL POLICY PANIC

BY STEEN JAKOBSEN

The worst December for global equity markets in more than a generation has set up a risk that policymakers overcorrect and scramble to bring back the policy punch bowl that they tried to remove in 2018. Indeed, a policy panic could see a major market low as soon as the first quarter of this year.

After traveling extensively in the fourth quarter of 2018, I am convinced that the world is one or at most two quarters away from a global policy panic, signs of which have already emerged in the first days of 2019. What would this look like? Policymakers throwing everything they can at an economy that is sinking fast and still reeling from the mistakes of the last decade, exactly six months after those same policymakers said the crisis was over.

As 2019 gets under way, Europe is sliding back into recession despite a negative European Central Bank policy rate, and Germany and its marquee names suddenly look like far greater risks than Italy's populist government. Australia is a mess, both politically and economically, as the royal commission has left banks tightening their lending standards in an economy that is at least 50% driven by housing.

Strains in the US credit market reached a crescendo in the first trading days of 2019, as Barclay's high-yield spread climbed more than 500 basis points above US Treasuries. This combined with a bear-market run in equities from the September highs saw US Federal Reserve chief Jerome Powell trotting out the latest version of the Fed in an interview where he shared the stage with his two bubble-blowing predecessors. There was plenty of egg on Powell's face as his promise to "listen to the market" came barely two weeks after he put on a hawkish show at the December 20 Federal Open Market Committee meeting.

So the Fed is already slamming on the brakes as the flows from corporate repatriation run dry and high-risk issuers have not been able to auction debt. Clearly, the Fed has already gone too far as its policy normalisation, including the blistering $50 billion/month of quantitative tightening and not just the rate hikes, kills the massive financial engineering game that drove so much of the past decade's unsustainable US corporate profitability growth.

> AS 2019 GETS UNDER WAY, EUROPE IS SLIDING BACK INTO RECESSION DESPITE A NEGATIVE ECB POLICY RATE

China is still contemplating its next stimulus – tax cuts, mortgage subsidies, a stronger renminbi – and is wondering how to proceed towards its 100-year anniversary in 2049 with its 2025 plan now pushed back to 2035. In India, the rupee still looks shaky after a freefall in the third quarter, and the central bank of India has lost independence. Japan registered negative nominal GDP growth in Q3 – nominal growth – despite the ramping up of spending for the 2020 Olympics in Tokyo.

The UK, meanwhile, has suffered the biggest credit impulse contraction of any country, leaving the first half of next year a major risk for UK assets.

BEWARE
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The chief drivers of the above were the Four Horsemen we identified over the previous couple of quarters that pressured global markets and increasingly dented the economy as well:

- The rising price of global money from the Fed's tightening and contagion into higher risk spreads.
- The declining quantity of money due not only to the Fed's tightening, but also due to the tapering of balancesheet growth from the Bank of Japan and European Central Bank.
- Reversal of globalisation as the US and China face off over trade.
- Ramp-up in global oil prices before the recent decline, which was made especially painful by USD outperformance.

Since the global financial crisis, the business cycle has been suspended, and replaced by only a credit cycle. Credit, credit and more credit crowded out productivity and inflated asset prices while doing little for the real economy and driving the worst inequality in generations. The mis-pricing of money and credit has also driven a terrible misallocation of capital and kept unproductive zombie debtors alive for too long.

The mood in Europe, Middle East, Africa and Asia is the worst I have seen in recent memory – including the conditions leading into 2008. There is, however, a new sense of urgency everywhere, and the classic response of "it could be worse" is now being replaced by frank questions about what to do next and how bad the trade war and populism can get. A status check tells us that the situation is bad and will get worse if nothing changes. Looking ahead of the curve, however, we need to ask what might change the dynamic?

The price of money is the easy fix: the market has already largely reversed the Fed's anticipated tightening, and the entire US yield curve – so important as the Fed controls the price of global money – has dropped sharply. This offers little more than psychological support; the price of money is the least potent of the Horsemen as the proximity of the zero-bound weakens the monetary transmission potential of lower rates. Outside the US, there is even less interest-rate policy room to work with in most cases.

The most important factor is the quantity of money, and even if all the major central banks opened their taps now, the boost to economic activity wouldn't really be felt until around Q3 of this year. The transmission of the credit impulse into the economy, in other words, takes at least nine months and often longer depending on a country's debt levels. But for renewed growth in the quantity of money, the Fed will need to reverse QT, a shift that would bring a fresh bout of market distress akin to what we saw in December.

One bright spot for the new year is that the price of energy in USD terms plummeted back to 2017 levels in Q4, though it remains very volatile. Still, it will take some time for this fresh stimulus to be felt after the highest prices since 2014 were registered a mere three months ago – particularly for emerging market currencies, which were likewise very weak at the time. Energy could remain lower, but Opec and non-Opec producers alike will try to keep the $50/barrel price floor in place for Brent.

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THE MOST IMPORTANT FACTOR IS THE QUANTITY OF MONEY, AND EVEN IF ALL THE MAJOR CENTRAL BANKS OPENED THEIR TAPS NOW, THE BOOST TO ECONOMIC ACTIVITY WOULDN'T REALLY BE FELT UNTIL AROUND Q3

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In Q1, a combination of the Fed pausing and signalling a climb-down from QT with China continuing to drive the CNY stronger toward 6.50 or better versus the USD could help. China can pay the price of a 5% stronger currency as it reduces the burden on state-owned enterprises' USD-denominated debt and could power a massive boost in resolving the trade impasse. At the same time, a strong policy move like this from China with a weaker USD backdrop could drive a considerable relative revival in EM assets.

Finally, on the reversal of globalisation: there is no clear long-term solution here, but the global economy is suffering, global markets are shaken after a terrible 2018, and China will do all it can for stability. The hunt for a solution is fully engaged, and the odds of one appearing are rising fast. In our view, a solution needs to show itself before February 5, the Chinese New Year – this is a top priority for both sides in the US-China trade dispute. The alternative is simply too dire.

After Chinese New Year, we will see powerful support for the Chinese economy – it is needed, and it will come. Nonetheless, beware of incoming turbulence as the policy response everywhere is reactive rather than predictive and may come a bit too late. This means that Q1 is the riskiest period, and this is where the cyclical low in assets and the economic cycle will come. Q1 may see a significant market low for this part of the cycle.

That being said, early 2019 could merely mark the start of the cycle or the early innings of the next cycle of intervention. 2020 is more likely to prove the real year of change. That would fit the political cycle, and it might take an even bigger scare for central banks and politicians to get their acts together – unfortunately.

Welcome to the Grand Finale of extend-and-pretend, the worst monetary experiment in history.

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.

EQUITIES ENTER THEIR **FINAL ACT**

BY PETER GARNRY

After the dramatic plunge in equity markets at the end of 2018, investors should keep a defensive stance and seek low volatility as the risk-reward ratio for 2019 looks bad. Japanese stocks could rebound if China succeeds in stimulating its economy and reaches a trade deal with the US.

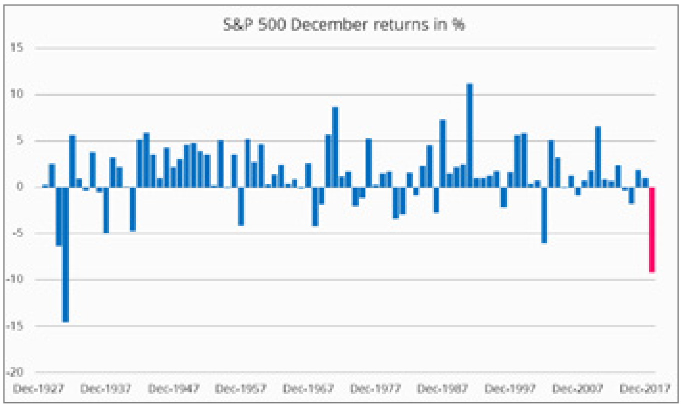
OUR MAIN MESSAGE FOR INVESTORS IS TO STAY DEFENSIVE, FAVOURING MINIMUM VOLATILITY FACTOR OVER PURE EQUITY EXPOSURE

Last year was spectacular, starting with peak euphoria and ending with violent December drama of a type not witnessed since 1931. There were several culprits, but the stand-off between the US and China, together with a relatively hawkish Federal Open Market Committee decision in December – seen by many market participants as a policy mistake – were likely the two biggest drivers.

Our main message for investors is to stay defensive, favouring minimum volatility factor over pure equity exposure. Japanese equities are a potentially interesting rebound case if China manages to stimulate its economy into growth and strike a deal with the US on trade issues. In addition, we highlight long-term constraints on economic growth and warn about emerging-market exposure.

IGNORING DECEMBER COULD BE COSTLY

The S&P 500 declined 9.2% in December, which is a rare event. If markets were normally distributed, which they are not, it would translate into a 1.8 sigma move, and a loss of this magnitude or more would not happen more than 3.5% of the time. All information is in the tails with the rest just being noise. Ignoring the decline in December would be a grave mistake. Even Federal Reserve chair Jerome Powell acknowledged in an early January interview that he and his colleagues are indeed taking market signals seriously.



SOURCE: BLOOMBERG AND SAXO BANK

What do the history books tell us about such large declines? The steepest December drop ever in the S&P 500 happened in 1931 and was followed by an additional 45% decline over the following six months. Another sharp fall in December 1930 was followed by very negative performance during 1931. Similarly, a slide in December 1937 led to a series of declines before sentiment changed and transformed 1938 into a year of gains. The 6% decline in December 2002 signalled the beginning of a weak three-month period before equities switched into fierce rally mode.

EQUITIES ENTER THEIR **FINAL ACT**

The three-month future return, after a month with a decline of 8% or more, has historically been substantially positive, with an average gain of 2.7%. But the positive expectation comes with great risk in the form of a 20.1% standard deviation. Whatever direction equity markets take from here – which depends on many factors such as the Fed, US-China relations and China's response to its economic slowdown – the path will be very volatile.

Traders and investors need to be prepared and more active than usual as US equities could easily be up or down by 20% or more over the next three to six months.

Our main thesis, presented in our Q4 2018 Outlook, remains unchanged: equities and the current expansion are entering their final act, so risk-reward is not attractive. We still believe that equities should be part of investors' asset allocation, but with a low weighting of around 30%, and exposure should be mainly in defensive sectors (consumer staples and healthcare) and minimum-volatility stocks.

JAPANESE EQUITIES ARE OUR TOP TACTICAL PLAY IN Q1

Our new relative equity market model, introduced in early December, identifies Japan as the most attractive market on a relative basis. Japanese equities were hit hard in the fourth quarter, down 17.5% in JPY terms as Japan is an export-driven economy that has much to lose from the US-China trade war.

While it was a brutal quarter for Japanese equities, the momentum relative to other equity markets over the past 12 months is still high. Combined with a low valuation relative to historical terms, the Japanese equity market offers an attractive risk-reward ratio, especially if China manages to engineer a rebound in its economy and seal a deal with the US across market access, trade issues and intellectual property rights.

Mainland Chinese equities remain underweight in our model together with other emerging markets such as India and South Africa.

Market	Mkt Cap (USD bn.)	% of ACWI	12M RET	Valuation	Momentum	View
Japan	3,069	7.5	-13.1	Low	High	Overweight
Hong Kong	486	1.2	-8.2	Low	High	Overweight
Australia	873	2.1	-9.7	Low	High	Overweight
Norway	96	0.2	-3.4	Medium	High	Overweight
Sweden	343	0.8	-12.1	Low	Medium	Overweight
Brazil	389	1.0	8.8	High	High	Overweight
United States	22,304	54.5	-3.5	High	High	Overweight
Netherlands	430	1.0	-12.8	Medium	Medium	Overweight
Singapore	171	0.4	-9.5	Medium	Medium	Neutral
Spain	396	1.0	-12.8	Low	Low	Neutral
United Kingdom	2,152	5.3	-12.8	Low	Low	Neutral
South Korea	647	1.6	-25.6	Low	Low	Neutral
France	1,387	3.4	-12.1	Medium	Medium	Neutral
Germany	1,125	2.7	-20.1	Low	Low	Neutral
Finland	134	0.3	0.1	High	High	Neutral
Taiwan	521	1.3	-12.9	Medium	Medium	Neutral
Canada	1,227	3.0	-14.4	Medium	Medium	Underweight
Switzerland	1,105	2.7	-6.8	High	High	Underweight
Italy	290	0.7	-15.1	Medium	Low	Underweight
Belgium	122	0.3	-24.3	Medium	Low	Underweight
India	446	1.1	-8.4	High	Medium	Underweight
Denmark	225	0.5	-12.6	High	Medium	Underweight
China	1,449	3.5	-19.5	High	Low	Underweight
South Africa	308	0.8	-22.2	High	Low	Underweight

SOURCE: BLOOMBERG, SAXO BANK

* VALUATION IS MEASURED AGAINST THE INDEX ITSELF OVER A FIVE YEAR PERIOD

** MOMENTUM IS MEASURED ON THE RESPECTIVE MSCI INDEX IN USD

EQUITIES ENTER THEIR **FINAL ACT**

US equities were expensive and unattractive as we wrote our Q4 Outlook, but the 14% decline in the fourth quarter has reduced the z-score on the S&P 500's valuation from 0.72 in September to 0.10 in December. At this level, US equities have obviously become more attractive, with an expected 10-year annualised return of 5.8% and a predicted worst-case at around 2%. While investors have been accustomed to high equity returns over the past 30 years, this may change soon as the global economy will be constrained across multiple dimensions, which we will explain later in this equity outlook.

VALUE BEAT GROWTH IN Q4 – WHAT NOW?

Our Q4 Outlook highlighted value stocks as the preferred factor tilt (minimum is still preferred overall) over growth as higher interest rates discount future cashflows proportionally more, leading to downside pressure on assets with high duration. This includes equities in general, but more so for growth stocks that derive most of their present value from cashflows beyond the immediate five-year horizon. US value stocks were down 10.8% in Q4, compared with a decline of 16.6% for growth stocks, so value stocks delivered 5.8 percentage points of outperformance.

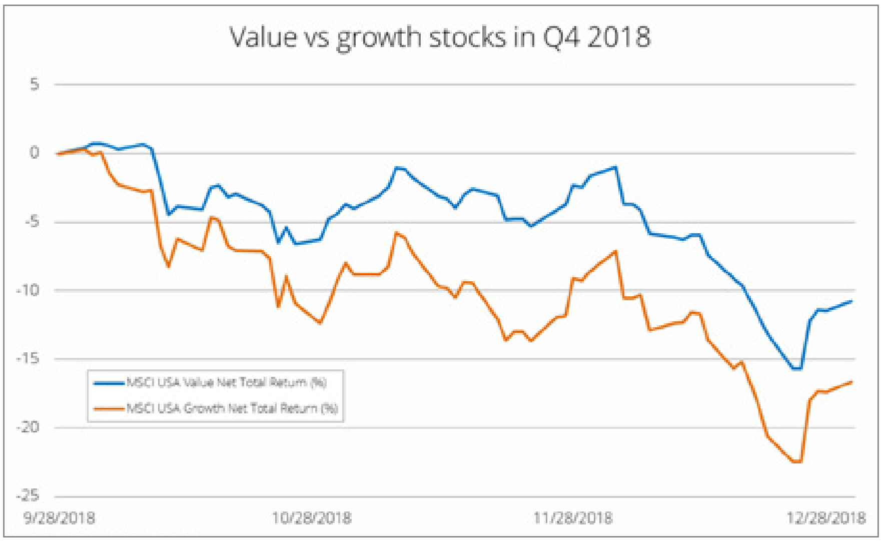
The tilt towards value stocks was based on higher interest-rate expectations driven by the Fed's communicated trajectory. However, given the slowdown in Chinese growth and the Fed's likely lower path for interest rates in 2019, the big case for value stocks may already be over. We maintain that the best factor to be exposed to is minimum volatility.

CONSTRAINTS HOLDING BACK ECONOMIC GROWTH

Investors should try to come to peace with the fact that long-term return expectations for equities are now likely lower than they have been since 1945. Equity valuations are not excessive; they reflect a continuation of the earnings growth trend. But what if the global economy is running on the final fumes of globalisation, the most recent fuel to have carried the economy forwards? In the long term, we observe multiple constraints for the global economy, and ultimately the global investor, with the following list not being exhaustive.

LOW PRODUCTIVITY

Persistently lower productivity growth is one of the greatest puzzles in modern economic theory. This constrains economic growth as productivity is its main



SOURCE: BLOOMBERG AND SAXO BANK

EQUITIES ENTER THEIR **FINAL ACT**

INVESTORS HAVE BEEN ACCUSTOMED TO HIGH EQUITY RETURNS IN THE PAST 30 YEARS, BUT THIS MAY CHANGE SOON

engine. We side with the hypothesis that it comes down to debt saturation as well as combined industry concentration that are stopping productivity from rising.

DEMOGRAPHICS
Population growth has been one of main engines of growth for centuries. Across Europe, China and Japan, demographics will become a negative constraint for nominal growth. For large welfare states, negative demographics come with even larger risks as pension liabilities could become a systemic risk.

RISING HEALTHCARE COSTS
Healthcare costs are rising in almost every country. In the US, health expenditure has risen from 5% of GDP in 1960 to a projected 20% of GDP in 2020. This is essentially a tax on consumers and the economy that diverts resources from other problems. Excessive drug prices are largely driven by their patent protection, leading to excess profit.

DEBT CYCLE
The world was saturated in debt after the Second World War, and a long period of deleveraging began, ending only in the early 1970s. Since then, debt-to-GDP has exploded with only few periods of deleveraging – the latest being in the years after the great financial crisis in 2008; according to the Institute of International Finance, global debt to GDP now stands at around 325%. Excess debt creates hidden risks and exposes the economy to severe tail risks. The world has essentially borrowed growth from the future.

DEGLOBALISATION
The escalating rivalry between the US and China started after the US became preoccupied for over a decade by the Middle East in the wake of the terrorist attacks in 2001. As China is not converging with Western values in terms of a globalised market economy, deeper integration is at risk. Nationalism is on the rise, driven by many factors, including wealth inequality and the downside effects of globalisation. Any meaningful degree of deglobalisation will be a constraint on global growth.

INEQUALITY
The world has returned to its second Gilded Age, with high income and wealth inequality changing political dynamics. Nationalism and populism are on the rise. Consequently, taxes on capital and income could rise, thereby constraining growth. With big political change comes uncertainty, which is likely to lower confidence and future equity returns.

EQUITIES ENTER THEIR **FINAL ACT**

BE WARY OF EMERGING MARKETS

In our previous Equity Outlook, we highlighted emerging markets as potential outperformance candidates, particularly Chinese equities. In the fourth quarter, Chinese equities were down 10.7% compared with a drop of 13.4%in the MSCI World Index (global equities). Other EMs contributed positively to performance, and the MSCI Emerging Market Index was only down 7.5%, delivering a 5.9 percentage point outperformance over developed market equities.

While it is tempting to remain positive towards EM, there are more paths to a negative outcome than positive. In the best-case scenario, China manages to kick-start its economy, pulling the global economy and EM countries out of the mud. However, we see signs of credit transmission being broken in China, so China's ability to stimulate the economy, as it has done several times since 2007, is severely constrained.

In a worst-case scenario, the US economy stays strong, luring the Fed to keep hiking interest rates and disregarding market signals from abroad. In this scenario, we see tremendous stress for EM economies reliant on USD funding for their growth.

OUR VIEW

We remain defensive on equities as the risk-reward ratio for 2019 looks bad. Short term, we could see a rally if China succeeds in its stimulus of the economy and the country strikes a deal with the US on trade. Our equity model has Japanese equities as its top conviction on a relative basis. EMs look fragile, and only Brazil is favoured in our equity market model, so in general we recommend investors either to underweight or stay out of this space. A potential option play on an industry level is call options on semiconductors, which will likely rebound if China and the US reach a deal.

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.

THE FED BLINKED, BUT THE PATH TO A WEAKER USD MAY BE ROCKY

BY JOHN J HARDY

The Fed is slowly coming around to the reality that its own tightening regime and a strong US dollar are increasingly incompatible with financial stability, and it kicked off 2019 with a loudly dovish downshift in its rhetoric. But it may take some time for the Fed to execute a full reversal of its tightening course, and the lack of bright spots elsewhere in the global economy as the year gets under way may mean that the path to a persistently weaker USD is a rocky one in 2019.

> THE DIRECTION CHANGE FROM THE FED TOWARDS THE END OF THE YEAR IS A FIRST KEY STEP IN WHAT COULD PROVE A DRUNKEN STAGGER TOWARDS A WEAKER USD

The last quarter of 2018 was clearly the worst quarter of what many have touted as a downright *annus horribilis* for global asset markets. Equity markets suffered their worst December in modern market history on concerns that weakening global growth, a tight Federal Reserve, poor USD liquidity and a US-China trade war all spell doom for the global economy.

Even outside of equities, returns were weak, and no asset class put in a strong performance for the calendar year – one of the worst cross-asset market performances in decades. Currencies finished the year with generally low volatility as the USD was caught in the crossfire of conflicting themes and China's heavy hand in support of a CNY floor muted activity. Still, the very tail end of the year saw a last-minute melt-up in the JPY after the December 20 Federal Open Market Committee and Bank of Japan meetings and subsequent risk deleveraging.

The mood brightened in the first week of 2019 when Fed chair Jerome Powell pivoted from his tone-deaf performance at the December 20 FOMC press conference and made clear that the Fed is listening to the signals that the market is sending, even as he praised the strength of the US economy and argued that the barrage of Treasury issuance (made worse by the Fed's balance sheet reductions, or quantitative tightening) was not a key part of the market turbulence.

Powell will continue to listen to markets in 2019. He is rightly seen as a different breed from his more academically oriented predecessors, often stressing that financial stability risks are the most likely source of the next crisis, not overheating wages and inflation. That means he will be happy to resume hiking rates if the markets and data permit, and will only pause or reverse at a sufficiently high pain threshold.

Still, the direction change from the Fed towards the end of the year is a first key step in what could prove a drunken stagger towards a weaker USD, and one that will gain momentum once the Fed is forced into a full reverse by a weakening US economy in the coming quarters. The tricky bit is that markets appreciate liquidity in tough times, and the US dollar and US Treasury debt are the most liquid of instruments in times of market volatility. So, if we are headed for a further downdraft in global asset markets on concerns about the US and global growth outlook (and

THE FED BLINKED, BUT THE PATH TO A WEAKER USD MAY BE ROCKY

importantly, the earnings outlook), the USD may rally steeply at times, just as it did during the global financial crisis even as the Fed chopped rates towards zero and launched its first round of QE.

Looking beyond the dollar, the most important question across the major currencies is clearly China's intentions for the renminbi as it faces tremendous pressure to devalue. We're somewhat torn on what China will choose to do with its currency. When Brent oil was trading well above $80/ barrel just a few months ago, it was easy to argue, as we did, that China would prefer to maintain a floor for its exchange rate, if nothing else to ensure that it could afford its enormous oil import bill. But after the hefty drop in energy prices, China has more leeway to allow a weaker renminbi, even if it will likely continue to keep a floor under the currency at least so long as trade talks with the US continue as proof of good faith. In general, China may be unwilling to devalue the renminbi dramatically against the USD, and it could even rise together with other currencies versus the USD once the greenback rolls over later this year.

As China continues to pursue its deleveraging, now apparently offset slightly by new attempts at stimulus as 2019 gets under way, the one imperative will be to keep nominal growth of China's economy advancing rapidly to avoid a deflationary dynamic, particularly in housing.

The greatest gift to China's policy flexibility in that regard would be a US economy that rolls over and requires a more profound shift in the Fed's stance and outright easing, thus improving the global USD liquidity that is critical for funding too much of the world's debt. The entire world's financial system, China included, remains far too vulnerable to USD liquidity shocks, and the next crisis will inevitably bring a more serious effort to develop an international reserve currency.

CURRENCY OUTLOOK BRIEFS

In our last Quarterly Outlook, we argued that the quickest route to a US dollar reversal was through further rises in US yields and the USD: "The US dollar and US rates can only rise so far from here before something – or rather more things – break." US yields were the first to break down with Treasuries serving as a safe haven as equity markets sold off heavily last quarter. At the end of the quarter, the USD finally weakened as the Fed was seen feeling around for the strike price of the Powell put. A few thoughts on the major and emerging-market currencies in Q1:

USD – TURNING, BUT HOW QUICKLY? 2019 is getting under way with a weaker US dollar as the Fed appears to have finally realised that its policy mix and guidance were already beyond what the market can bear. The risk for USD bears is that the market over-celebrates the Fed's turn, which is so far just a deceleration. A further calming of financial conditions and a continued spike in US wages could even see the Fed making one last hike in March, but in general we think that the Fed is done for the cycle. The question now is the time from the last hike to the first cut – whether to interest rates or to the pace of QT.

EUR – SIDELINED FOR NOW. Last quarter we tried to wax positive on the euro as we sensed that the curtains have closed on the age of austerity and that the European Union is nearing the moment when fiscal expansion will return. Indeed, the yellow vest protesters in France have thrown French president Emmanuel Macron's budget discipline to the winds even if Italy has backed down this time around in its showdown with the EU over its budget. Our fear now, however, is that the concerns about the rise of populism that weighed on the euro at the beginning of 2017 ahead of key elections have returned and could dog the euro before EU parliamentary elections in May. Will EU leaders pull their message together and open the fiscal window before those elections? It's doubtful, as EU political leaders seem unable to move until a crisis is in full swing. Furthermore, Brexit weighs at the margins, and the euro could continue to fail to strengthen.

THE FED BLINKED, BUT THE PATH TO A WEAKER USD **MAY BE ROCKY**

JPY – ANOTHER LEG HIGHER AND THE NEXT WAVE OF BOJ POLICY? The JPY dragon was finally awoken by a tardy response to the wave of risk deleveraging that washed over global markets in Q4, and as the long end of the US yield curve was smashed back from whence it came. Japan's economy faces an ugly outlook into 2019, as Japan is a large current account surplus country and its economy fell into negative growth in Q3 just as the currency was set to revalue higher coming into 2019. The Kuroda BoJ may be the first global central bank to innovate the next round of unconventional policy, which could potentially be some version of debt monetisation and/or enabling fiscal projects that force money into the economy through wage boosts or similar. Q1 is too early for this, though, and there's more upside than downside risk in broad terms for the yen until then.

GBP – ARTICLE 50 DEADLINE TO COME AND GO WITH NO END TO BREXIT IN SIGHT? The March 29 Article 50 deadline is rapidly approaching, and we're none the wiser on where Brexit is headed. Assuming the likely failure of UK prime minister Theresa May's ill-fated deal, Britain is potentially headed towards a no-deal Brexit that becomes a "semi-deal" Brexit hammered out over the coming months after a significant delay beyond the Article 50 deadline on March 29. Even a second referendum would likely take us beyond the deadline. In any case, sterling may remain bottled up for most of the quarter before eventual significant two-way potential.

CHF – TOO STRONG, BUT FOR A REASON. Market volatility and the risk that we don't get a firm conclusion on where Brexit is headed in Q1 could keep a bid in place under the Swiss franc. In Q2, the EU parliamentary elections in May and concerns over the populist uprising are existential risks while the EU's leadership dithers and could continue to drive CHF resilience as well.

CAD, AUD AND NZD – DIVERGING PATHS. AUD and NZD will feel the gravity from a stable renminbi, which has helped prevent more extensive downside for the Aussie on what looks like an Australian housing bubble in full unwind as 2019 gets under way. The bursting of that bubble next year could threaten Australia with its first recession since the early 1990s. AUD may escape more aggravated downside if China keeps the renminbi stable and commodity prices in check. Meanwhile, the CAD faces housing-bubble risks of its own, as well as risks linked to the collapse in crude oil prices next year. Canadian prime minister Justin Trudeau has just rolled out a carbon tax that could also weigh on growth at the margin, though he is likely to do everything in his power to juice the economy ahead of federal elections in October.

NOK AND SEK – TOO LONG NEGLECTED. The Scandies' comeback we anticipated was derailed by a collapse in crude oil prices in the case of NOK, and by a weakening European economy and weak risk appetite in SEK. SEK did offer resilience over the last few months but couldn't engineer a more notable break higher against the euro even as European Central Bank tightening appears permanently off the table and the Riksbank managed to carry out its first rate hike in over seven years in December. Still, we prefer SEK strength relative to the euro. Meanwhile, for the coming year, NOK could outperform SEK on an eventual global reflation theme driven by China.

THE FED BLINKED, BUT THE PATH TO A WEAKER USD **MAY BE ROCKY**

EM CURRENCIES – CHEAPER US DOLLAR VERSUS GLOBAL GROWTH PROSPECTS. EM currencies put on a show of strength in the fourth quarter – not so much in absolute terms, but most certainly relative to the very ugly backdrop of worsening financial conditions and a meltdown in equity markets. Given our global growth concerns for early 2019, we wouldn't expect notable strength on the risk of USD funding issues and credit spread widening risks, but for forward growth potential, EM economies are strongly preferred. For now, we prefer a stance of fading excessive weakness rather than anticipating trending strength in early 2019.

> BEYOND THE US DOLLAR, THE MOST IMPORTANT QUESTION ACROSS THE MAJOR CURRENCIES IS WHAT CHINA'S INTENTIONS ARE FOR THE RENMINBI

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.

THAT **SINKING** FEELING

BY CHRISTOPHER DEMBIK

The global credit impulse is falling again, mainly in developed-market economies and due largely to the normalisation of monetary policy. The message from the slower credit impulse is that growth and domestic demand are headed for a slowdown, unless the world's largest economies launch a massive coordinated intervention in 2019.

Global credit impulse — the second derivative of global credit growth and a major driver of economic activity — is falling again, running at 3.5% of GDP versus 5.9% in the previous quarter. Currently, half of the countries in our sample, representing 69.4% of global GDP, have experienced a deceleration in credit impulse.

With some notable exceptions such as the US, Japan and the UK, lower credit impulse is mostly observed in developed markets while emerging markets experience a significant increase in the flow of new credit. Higher credit impulse in EM countries can be interpreted as a direct consequence of the measures taken to support economic activity to face ongoing headwinds (lower liquidity, higher USD funding costs and deteriorated financing conditions).

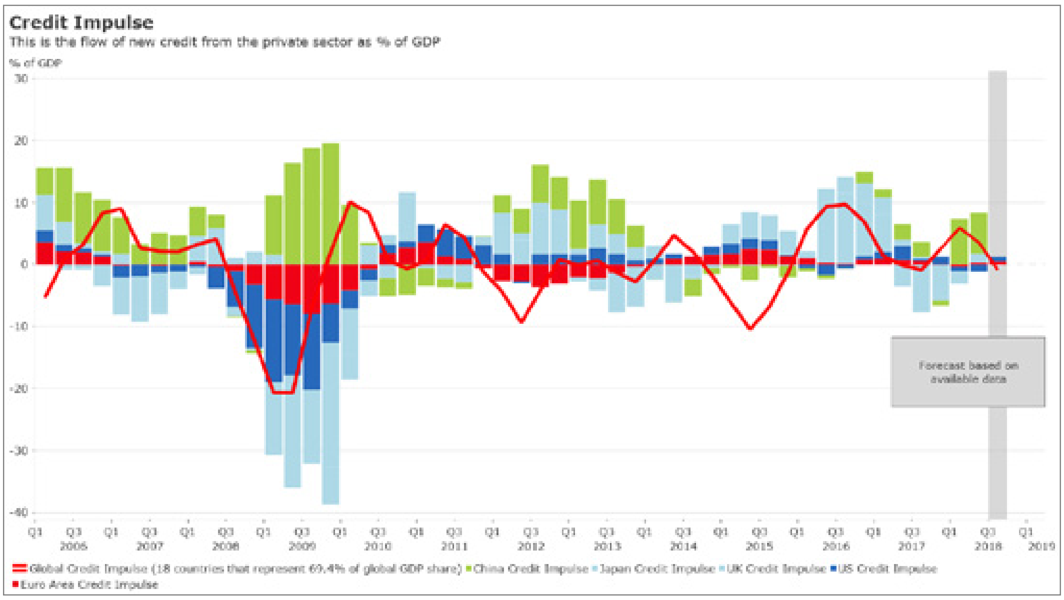
By contrast, the more negative trend observed in DM countries is largely due to the normalisation of monetary policy. In the euro area, credit impulse is still subdued and close to zero, indicating that a new and more restrictive credit cycle has just begun. The message from the global credit impulse is basically that growth and domestic demand, which is highly correlated to credit impulse, are doomed to decelerate, unless a massive coordinated intervention of the world's largest economies occurs in 2019.

CHINA, THE GLOBAL CREDIT ENGINE

Like in the previous quarter, China is the main positive contributor to global credit impulse. Excluding China, the global credit impulse would come close to zero. China's stimulus represents 34% of global growth, which is equivalent to the combined contributions of the US and the Eurozone, and about 70% of Asian EM manufacturing growth. China's credit impulse has been revised upward, at 7.4% of GDP in the previous quarter, the highest level since 2013, and is currently slightly lower at 6.6% of GDP.

We expect that credit impulse will remain strong in coming quarters as China's focus is moving towards greater economic support to mitigate the impact of trade war. A large-scale fiscal and monetary stimulus is probably off the table given policymakers' worry about yuan stability. However, the likelihood of new market-opening policies, including tariff cuts on more goods and a cut in banks' reserve requirement ratio, is high in the first quarter of 2019.

THAT **SINKING** FEELING



SOURCE:
MACROBOND, SAXO BANK
RESEARCH & STRATEGY

COUNTRY-BY-COUNTRY: WHERE ARE WE HEADING?

In the appendix, we show updated data for the credit impulse for our sample of 18 countries. In this edition, we focus on four countries: the UK, the US, Australia and Japan.

UK DOWNSIDE RISKS REMAIN HIGH

The UK's credit impulse has been one of the lowest in the DM countries, but it has recently returned to positive territory. However, the impulse is too little and too late to be optimistic about the UK economy in 2019. Growth is expected to decelerate further, though remain above potential. All the other leading indicators also point to downside risks as Brexit anxiety is mounting.

The UK OECD leading indicator, which is designed to anticipate turning points in the economy six to nine months ahead, fell in October for the fifteenth straight month. The year-on-year rate started the year at minus 0.6%; it now stands at -1.34% – quite a swing over 10 months! In addition, new car registrations, which are viewed as a leading indicator of the wider economy in the UK, have been tracking downwards since 2016, driven by falling consumer confidence. Over the period, new car registrations fell to 2.3 million from 2.7 million – a stunning drop of 15% in just 20 months. The downward trend has accelerated in recent months as the perspective of a no-deal Brexit increased.

Though the risk of recession is limited in 2019, our view for the UK economy is very negative since all the possible post-Brexit scenarios will be worse than staying in the European Union.

US ECONOMY SET TO DECELERATE

As noted earlier, the US credit impulse has rebounded to 0.7% of GDP versus -1.1% of GDP in the previous quarter. This acceleration can be partially explained by strong demand in commercial and industrial loans and leases since the beginning of 2018 and confidence in the economy expressed by strong private investment and linked to Trump's tax reform.

However, these factors will not last long and credit impulse along with GDP growth are expected to decline.

THAT **SINKING** FEELING

Our US GDP forecast is below consensus, at 1.9% this year. The acceleration of the slowdown in the housing market – a reliable harbinger of the overall economy – and the slope of the yield curve suggest the economy is not as strong as the US administration believes.

Digging into the data, it appears that fear of higher interest rates is one of US households' main concerns. Although it has not yet had a visible impact on consumption – consumer confidence is at a high point – it will negatively affect retail sales and credit flows sooner or later. We are already starting to see weak spots, such as the drop in restaurant sales since last summer, that indicate the US consumer is not in such good shape as it may seem. Bearish signs for the US economy are accumulating and will eventually push the Federal Reserve to pause monetary policy for at least Q1 2019 and even longer if the global economic momentum, led by China, does not improve.

AUSTRALIA IN THE CROSSHAIRS

Australia's credit impulse is still in contraction, at -1.9% of GDP, and has been since Q3 2016. The country offset the global financial crisis faster than any other DM country by accumulating public and household debt at a fast pace and because credit contraction was smaller than in the US and followed a period of stronger credit expansion, with the credit impulse reaching a high of 6.8% of GDP before the crisis.

But debt-fuelled growth cannot last forever, and it's now time for the payback. 2019 will be a year full of dangers for the Australian economy as it will face the repercussions of China's slowdown, and it will probably have to deal with more restrictive lending conditions following the recommendations of the royal commission's report (due on February 1, 2019), which could add price pressure in the country's property binge.

In many cities, such as Sydney and Melbourne, mortgage repayments are above the risk zone (30% of average earnings). Any acceleration in the fall of real estate prices could put many Australian households in trouble, forcing the Reserve Bank of Australia to step in to prop up prices, eventually through quantitative easing.

JAPAN HEADING FOR A SLOWDOWN

Japan's credit impulse has been in negative territory since the end of 2017, and it is just now slightly back in expansion phase, at only 0.07% of GDP. This drop followed a two-year period of strong credit growth that started in 2016 and that helped to support the economy, through private investment and consumption, until now.

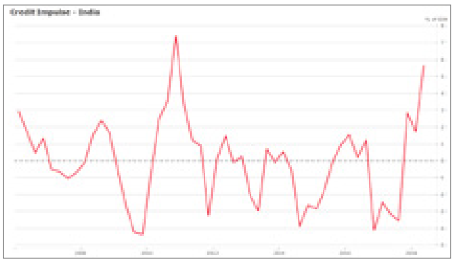
Over the past years, in the context of a strong yen, Japan became less dependent on foreign demand, which should help mitigate the impact of the US-led trade war in the future. But now that the flow of new credit is drying up, we should expect lower growth in 2019 and 2020.

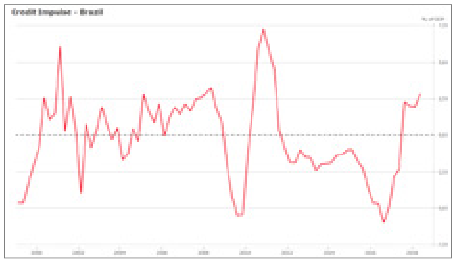
Growth deceleration will also be furthered by the planned October 2019 consumer tax hike. But, like with previous hikes, the risk to growth is likely to be ephemeral and mostly noticeable in the third quarter of 2019. Last, but not least, there is not much to expect from the Bank of Japan this year as it should stay on hold since reflation is nowhere in sight.

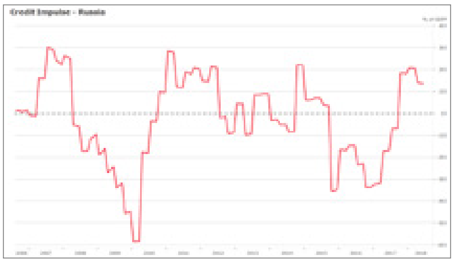
> BEARISH SIGNS FOR THE US ECONOMY ARE ACCUMULATING AND WILL EVENTUALLY PUSH THE FEDERAL RESERVE TO PAUSE MONETARY POLICY FOR AT LEAST Q1 2019 AND EVEN LONGER

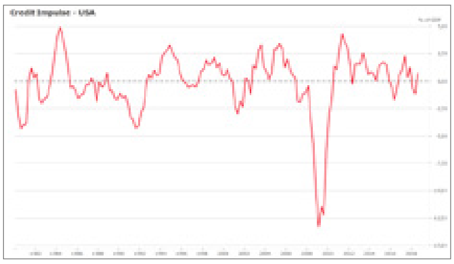
THAT **SINKING** FEELING

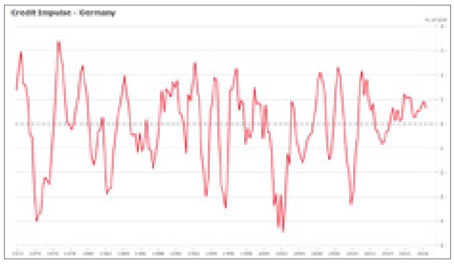
CHINA IS THE MAIN POSITIVE CONTRIBUTOR TO GLOBAL CREDIT IMPULSE

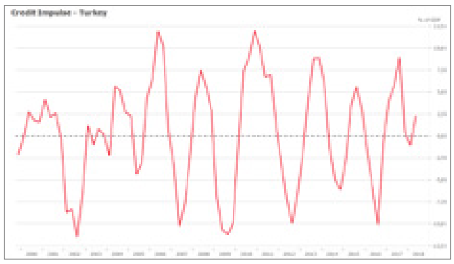












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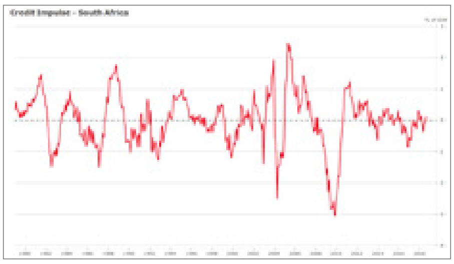
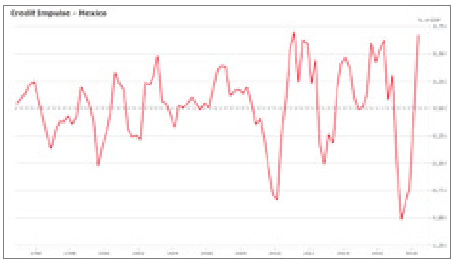




CHRISTOPHER DEMBIK, HEAD OF MACRO ANALYSIS

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.

GETTING DEFENSIVE ON AUSTRALIA

BY ELEANOR CREAGH

"Lucky" Australia's luck may be running out and China's economic slowdown only adds to the country's woes, giving investors good reason to take a cautious stance. Going into the first quarter, we are focused on wealth preservation and a defensive risk allocation. Against the backdrop of falling house prices and tightening credit, the central bank's next move could be a cut rather than a hike.

After the previous quarter's mayhem, there is no shortage of concern heading into 2019. Although it is hard to pick a single culprit for the Q4 sell-off, arguably the most important is the culmination of several factors leading to tightening of global liquidity, but others include:

- The shift from quantitative easing to quantitative tightening as central bank balance sheets shrink and drain liquidity – a task never achieved on such a scale by any central bank in history.
- Decelerating global growth with the narrative of "synchronised global growth" now firmly switched to a synchronised global slowdown.
- Seizures in corporate credit markets.
- The rising price of money, with the question being whether the Fed is simply tweaking its message or balking and pausing on rate hikes.

> THE RISKS ARE MOUNTING, AND THE AUSTRALIAN ECONOMY HAS RUN OUT OF STEAM OVER THE LAST SIX MONTHS, AS EVIDENCED IN THE THIRD-QUARTER 2018 GDP REPORT

Add to the melting pot we see trade wars reversing decades of economic globalisation, rising geopolitical uncertainty and the resurgence of nationalism with whispers of civil insurrection. This combined with a continued undermining of international frameworks and supine political institutions, and we have a host of challenges that will only serve to heighten volatility in 2019.

However, the last quarter's pessimism seems to have evaporated, and equities are off to a positive start in the new year as the US Federal Reserve has flipped to capitulation mode, counselling a wait-and-see approach to policy adjustments. While glimmers of a trade deal surface and China announces further policy easing, a bounce is warranted. But despite the U-turn from Fed policymakers and investor sentiment alike, it remains likely that panic capitulation still lies ahead, and it would be premature to sound the all-clear.

A rally off the back of any quantifiable trade deal would be called into question as the earnings cycle turns and it becomes clear that a cyclical peak in corporate profits has passed, with forward earnings guidance trending lower. Further vulnerability to such a rally could stem from incoming real economic indicators (global PMIs, manufacturing ISM, et cetera) highlighting deterioration in global growth, not to mention if any one of the aforementioned risks rears its ugly head. Then policymakers' pirouettes will need to become more than

GETTING DEFENSIVE ON AUSTRALIA

just rhetoric, and a trade *détente* won't save the turning cycle. Markets will remain choppy and volatile, and for now it seems more likely than not that the December lows will be retested.

Australia has been recession-free since the early 1990s, but it seems the country's luck may be drying up. Investors in Australia face a raft of domestic problems in addition to the myriad global troubles. The deceleration in the housing market is gaining pace, and a potential change of leadership brings uncertainty with federal elections due to be held by May 2019. Opinion polls indicate a Labour government is increasingly likely. This brings an element of policy uncertainty, with proposals to restrict negative gearing, cap private health insurance premium increases and abolish cash rebates when franking credits are greater than the taxes paid. Throw into this mix China's slowing growth momentum, and the outlook for the Aussie market this year should also be viewed with a degree of caution.

Heading into the first quarter of 2019, we focus on wealth preservation and playing defence with a conservative allocation to risk assets unless global policymakers capitulate and move to boost liquidity. Based purely on where we are in the current economic cycle, the risk-reward ratio for equity investment is skewed to the downside, while investors can secure an almost 2-3% return over the year in Treasuries. The second half of 2019 could be different if we see the global economic slowdown lead policymakers towards stimulus in a bid to catch the dip. A few months ago, this scenario seemed far-fetched, but recent messages from the Fed indicate a more flexible policy approach and that a pause in QT could be in the pipeline if deemed necessary.

In terms of ASX 200 sector performance, there is scope for returns from high-quality stocks in the healthcare sector, with defensive, quality cashflows adding resilience to portfolios. In volatile times, another way to slice and dice the equity market and add defensiveness to a portfolio is to look at style/factor exposure rather than sectors. We look to maintain exposure to low beta/minimum volatility and quality in terms of factor exposure as an indirect portfolio hedge, while staying clear of momentum and high beta factor exposure. We also look to bond proxy stocks in the year ahead to provide reliable cashflows and predictable returns adding to portfolio defence.

CHINA TROUBLES

We expect growth stabilisation to be a top policy priority for China this year – with fiscal and momentary stimulus playing key roles – so the mining sector in Australia could benefit if infrastructure spending is ramped up. However, be aware that stimulus measures will take several more months to feed through to the real economy. Recent Chinese data suggest the economy has not yet bottomed out, and early 2019 could see data deteriorating and a deeper slowdown before easing policies take effect.

Almost every Chinese indicator in the last few months has come in below expectations, most significantly November's industrial production and December's manufacturing PMIs. Although deleveraging plans have fallen by the wayside, local governments are expediting new bond issuance and the reserve requirement ratio has been cut for a fifth time in a year, these new stimulus measures fall on a weaker economy saturated with debt where the marginal impact of such measures will be less than in previous episodes of stimulus. The scale of the stimulus package is also still falling short of the previous 2008-09 and 2014-15 packages. For Beijing's growth targets to be met, larger stimulus measures cannot be avoided.

If, as we have long predicted, China pursues a growth-at-all-costs strategy, resisting economic slowdown and kicking the can on financial stability, and implements the large stimulus package needed to counteract slowing growth momentum, then the second half of this year

GETTING DEFENSIVE
ON AUSTRALIA

could look different as growth would eventually be stabilised. But larger stimulus or not, it is unlikely China will resume its role as the global growth wunderkind. At this stage, a "Shanghai Accord 2.0" seems unlikely, and markets will have to look elsewhere for a lifeline.

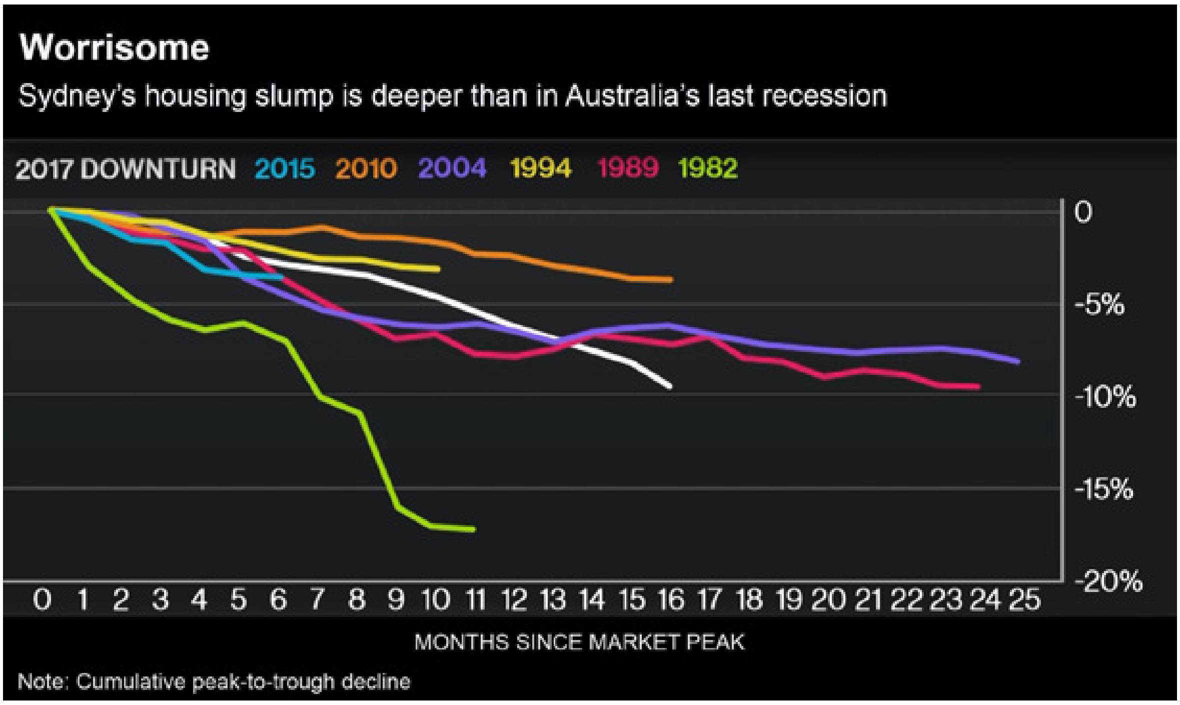
Chinese policymakers are also focusing on quality over quantity in terms of economic growth and switching from an export-driven economy to a consumption/ domestic demand-led economic growth model. Further stimulus measures are likely to focus primarily on boosting domestic demand as opposed to increased infrastructure spending, meaning the marginal benefit to Australian commodity exporters could be less than in previous bouts of stimulus.

We are cautious of Australian banks. Although the 9-11% gross dividend yield provides valuation support, it is difficult to see a catalyst for a broad sector upgrade. While the decline of the East Coast housing market continues to gather pace, the banks will remain victims to offshore selling and earnings headwinds will persist given their leverage to the housing market. If we see a Labour government, the proposed changes to franking credits will also weigh on valuations in 2019.

AUSSIE HOUSING MARKET

The latest statistics show that declines in the property market are gaining pace, with the CoreLogic December home value index down 1.1% month-on-month. The housing market is struggling, and weekly auction clearance rates continue to deteriorate, pointing to further declines ahead.

The epicentre of the housing market downturn is in Sydney where an 11.1% drop in prices since the peak in July 2017 is outpacing the declines seen in the late 1980s during the last recession.



SOURCE: CORELOGIC INC., BLOOMBERG

GETTING DEFENSIVE ON AUSTRALIA

> THE RBA EXPECTS THAT A STRENGTHENING LABOUR MARKET WILL OFFSET THE POTENTIAL HIT TO CONSUMPTION FROM DECLINING HOUSE PRICES, THUS SECURING A SOFT LANDING FOR THE AUSTRALIAN ECONOMY

Looking forward into 2019, it is likely that the East Coast housing market will continue to slide as credit conditions continue to tighten with the banks' self-regulating, thus weighing on the growth outlook for the year ahead. Banks will continue to tighten credit standards and serviceability measures in the wake of the banking royal commission. Tougher credit checks and verification of borrower income and expenses are in full swing already.

The Australian economy is now in reasonable health, growing at a steady pace with benign levels of inflation at 1.8%, consistently below the Reserve Bank of Australia's target band of 2-3%. According to RBA deputy governor Guy Debelle, the country is in "uncharted territory" as house prices are falling while the labour market is strengthening, and unemployment rests at a modest 5.1%. The RBA expects that a strengthening labour market will offset the potential hit to consumption from declining house prices, thus securing a soft landing for the Australian economy.

The RBA is, however, becoming anxious that lending standards have tightened significantly, and that continued credit constriction may add fuel to the fire. RBA governor Philip Lowe met with the heads of Australia's big four banks last month to warn against an over-restriction of credit inflicting harm on the economy. But the royal commission's final report is due to be submitted in February 2019, and it is highly unlikely that credit standards will be loosened in the run-up to this event.

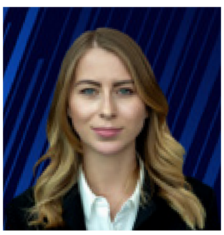
The RBA is treading a fine line after the banking royal commission exposed decades of bad behaviour by the banks, which has led to tighter lending standards, and the epic build-up of debt on household balance sheets from the property binge threatens long-term financial stability. But the hit to households and the economy from a housing market crash would be dire. Nevertheless, it could be argued that the unwinding of credit excesses is needed to reset the economy and fix the problems rather than keep inflating asset price bubbles.

The risks to the downside would become more severe if unemployment were to rise amid a hit to domestic growth, an exogenous shock, or if banks further tighten lending standards, resulting in lower loan supply and higher loan costs. A self-perpetuating feedback loop could then ensue as prices fall further and the loan supply remains tight, mortgage stress rises, and defaults rise particularly for those with less equity in their homes. Vulnerable borrowers could then no longer afford their mortgages and would be forced to sell their homes. A rise in unemployment would further perpetuate that vicious circle as those who lose their jobs would be forced to sell, sending prices spiralling further downwards. If this scenario were to unfold, the RBA would have no choice but to cut the cash rate and, depending on the severity of the slowdown, implement QE – a scenario outlined by Debelle in his December speech.

The recent strength in the labour market may offset the negative wealth effect and fall in consumer spending precipitated by the sliding housing market – at least that is what the RBA is relying on. But the risks are mounting, and the Australian economy has run out of steam over the last six months, as evidenced in the third-quarter 2018 GDP report where annual growth slowed to 2.8% from 3.1%. Household spending stumbled in the Q3 GDP report as well, weighing on growth. Household spending growth slowed to 0.3% in Q3 from 0.9% in Q2, against a declining household savings ratio. As house prices fall, heavily indebted households feel less comfortable with running down their savings and will trim spending, especially if wages are stagnant. Eventually, consumption takes a hit.

In light of these developments, the RBA will likely need to lower its optimistic 3.5% annualised growth forecast for 2019 in its February update as the economy continues to lose momentum.

The markets have also lost faith in the RBA's stoic narrative that the next move in its cash rate will be up, and they have started to price in the growing chance of a rate cut over the past few weeks. Given the uncertain global backdrop and concerns about the domestic economy, it seems likely that the RBA cash rate will not increase anytime soon, and the risk that the bank's next move is a cut is ever increasing.



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.

GOLD REGAINS **SAFE HAVEN STATUS**

BY OLE HANSEN

With turmoil on every side, gold has re-emerged as a preferred safe haven with further upside. Meanwhile, prospects for a further recovery in oil seem limited by signs of slowing global growth.

The direction of commodities in the early part of 2019 will continue to be influenced by decisions taken in Washington and by central banks last year. The economic fallout from US president Donald Trump's trade war with China is beginning to be felt. Quantitative tightening by the US Federal Reserve and an end to quantitative easing by the European Central Bank have begun to remove some of the liquidity that a heavily indebted world needs to support demand for riskier assets.

Gold, which recorded its best month in two years in December, has re-emerged as a safe haven amid the turmoil elsewhere. A drop in US 10-year bond yields to a near one-year low, reduced expectations for further rate hikes, a dollar that has stopped rising and, not least, the turmoil in global stocks have all supported renewed demand for gold as well as silver, given its historical cheapness to gold.

While a trade deal between the US and China could help counteract the current risk aversion, the end-of-cycle market dynamics and the risk of recession combined with the continued unwinding of a decade-long sugar rush of central banks' liquidity injections will create formidable headwinds throughout the year. In this environment, we see upside to precious metals, pockets of opportunity in industrial metals and limited upside to oil as supply outstrips demand through most of the year.

Depressed prices across several key commodities and tightening fundamentals in others may still attract some buyers. In addition, support could emerge in response to a weaker US dollar, China stepping up its efforts to support its economy and, not least, the potential policy panic from central banks mentioned by Steen Jakobsen in his introduction.

GOLD AND SILVER

As the aforementioned themes roll over into 2019, we expect to see continued demand for gold as investors once again seek tail-end protection against increased volatility and uncertainty across other asset classes. Hedge funds only turned long gold in early

> WE SEE UPSIDE TO PRECIOUS METALS, POCKETS OF OPPORTUNITIES IN INDUSTRIAL METALS AND LIMITED UPSIDE TO OIL AS SUPPLY OUTSTRIPS DEMAND THROUGH MOST OF THE YEAR

GOLD REGAINS **SAFE HAVEN STATUS**

December after having traded it from the short side for six months. This pickup in demand together with a continued accumulation from long-term investors through exchange-traded funds should provide enough support for gold to break higher towards the key area of resistance between $1,360 and $1,375/oz where consecutive highs were set between 2016 and 2018.

A friendly investment environment for precious metals should see silver, despite its link to industrial metals, regain some of its lost ground against gold. From an historically cheap level above 80, the gold-silver ratio, which measures the value of gold in ounces of silver, could turn lower towards the five-year average at 74, a 10% outperformance. Based on this assumption, we forecast an end-of-year price for gold at $1,350/oz and silver at $18/oz.

We would categorise the gold forecast as being relatively conservative. Please note that a break above $1,375/oz, the 2016 high, could signal additional strength towards $1,480/oz, the halfway mark of the 2011 to 2015 sell-off.

SOURCE: BLOOMBERG AND SAXO BANK

CRUDE OIL

Forecasting a price level, let alone the direction, of crude oil has not been getting any easier after a brutal end to 2018. The risk of a spike to $100/barrel at the beginning of October was followed by a collapse in Brent crude oil to $50/b just before year-end.

The moving parts in crude oil are many, both on the supply and the demand sides. Adding to this an increased degree of political interference, courtesy of President Trump and others, and it is no wonder that uncertainty is elevated as 2019 begins. Oil producers can support the price by cutting supply, but with global growth being called into question, they have been left struggling to respond to the recent collapse.

It is, however, our view that crude oil will recover further than what has already been achieved in early January. On the demand side, the market is already pricing in a sharp deterioration in global growth, and this has created the "risk" of a positive surprise. The Opec+ accord to cut production by 1.2 million barrels/day from January and six months forward will help stabilise the market. Additional support could be provided by the US signalling its unwillingness to extend further the waivers that back in November allowed eight countries to keep buying oil from Iran.

US production, meanwhile, remains a key point of interest as it was last year's production surge together with the aforementioned waivers that helped reverse the bullish sentiment in the market. US shale oil production growth is likely to slow following the price slump but if the 2014 - 2016 selloff is anything to go by, it could take somewhere between three and six months before

> FORECASTING A PRICE LEVEL, LET ALONE THE DIRECTION OF CRUDE OIL, HAS NOT BEEN GETTING ANY EASIER

GOLD REGAINS **SAFE HAVEN STATUS**

the impact becomes visible in the data, which for now, despite having stabilised into year-end, continue to show year-on-year growth close to 2 million b/d.

During the first quarter, we see WTI crude oil averaging just above $50/b as it settles into a $45/b to $55/b range while awaiting further developments on the trade front, as well as weekly US rig count data serving as a future guide to production and the Opec+ group potentially delivering the agreed production cut. Brent crude is likely to have already found a bottom at the key $50/b psychological and technical level, and we see it averaging $60/b as it settles into a $55/b to $65/b range.

COPPER

After the initial sell-off when the trade war erupted last June, copper spent the rest of the year within a range while taking a whole host of market-unfriendly news on the chin. Although fundamentals have started to improve, as seen in available stocks and the outlook for tightening supply, the headline risks associated with trade wars and weaker economic data have kept it locked.

An eventual de-escalation of the US-China trade war and further Chinese policy easing combined with a relatively tight supply outlook should, in our view, provide the support copper needs to yield a positive return in 2019. From its current level around $2.65/lb, we see high-grade copper during the first half of 2019 making a return to $3/lb, the equivalent of $6,600/tonne for LME Copper.

Needless to say, the biggest risk to this assumption remains the recessionary risks that could affect both housing activity and car sales. The Chinese car market suffered its steepest monthly decline in six years last month, resulting in the first annual decline in three decades.

CRUDE OIL	
UPSIDE	DOWNSIDE
Geopolitical instability and sanctions cut supply by more than expected	Trade wars and EM slowdown reduce demand growth outlook
Shale oil production growth slows on rising cost pressures and bottlenecks in the delivery chain	USD continues its ascent as global growth slows and trade tariffs bite
US-China trade war de-escalates	US extends relief for buyers of Iranian crude oil beyond March
Opec+ announces even bigger cuts than the already agreed 1.2 million b/d	

PRECIOUS METALS	
UPSIDE	DOWNSIDE
US growth slowdown triggers renewed dollar weakness	USD stays bid on continued central bank divergence
Mispriced financial and geopolitical risks boost demand for precious metal as a portfolio diversifier and hedge	People's Bank of China allows the renminbi to weaken above $7
Improved technical and/or fundamental outlook forces a strong buy reaction from underinvested funds	A solution to the US-China trade war sparks a massive risk-on move other assets

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.

THE JAPAN EXPERIMENT: **ABENOMICS OR ABYSMALNOMICS?**

BY KAY VAN-PETERSEN

Has Abenomics been a success, or has it been a dismal failure for Japan? The answer to that question is likely to determine markets' attitude towards the country as an investment opportunity.

Every day is historic in its own way, yet from financial markets' perspective, the monetary policy cocktail that was produced in response to the 2008 financial crisis has brought us to the heart of uncharted territory in the largest financial experiment the world has ever seen. During this period, the world's leading central banks, including the US Federal Reserve and its counterparts in the Eurozone, Switzerland, Sweden and the UK, undertook unconventional asset purchasing to bring interest rates to unprecedented lows.

While we have laughed at some of the unintended consequences of the monetary policy responses to the great financial crisis (such as being paid to take out a mortgage in Denmark), the truth is that capital markets, the cost of capital and the way our financial system functions have never been more synthetic.

Global debt has gone from around $175 trillion to over $250 trillion – it just does not feel like it because interest rates are still lower than before the crisis. While we have seen the Fed shift from quantitative easing to quantitative tightening, and the European Central Bank start the process with a projected move to QT by mid-2019, the Bank of Japan has in many ways been the most extreme of the world's major central banks.

It has kept its policy rate at minus 0.10% since its surprise move to negative rates in early 2016, which was not at all well received by the markets. It has continued to buy Japanese government bonds and is now the biggest holder of them. It has also added equity ETF purchases over the last few years – an area that almost all central banks have avoided, with the notable exception of the Swiss National Bank, which holds billions of dollars in Apple shares that are now down by over one-third from the highs of last year.

> IN A WORLD OF MONETARY POLICY EXPERIMENTS, JAPAN IS ON SPEED

The key question now for many people watching Japan is: has Abenomics – of which the BoJ has been a pillar – been a success or a failure for Japan, and what can we expect for 2019? Let's consider this both from bullish and bearish perspectives; as is generally the case, the truth lies somewhere in between.

So let's look at two different scenarios.

DOOM, GLOOM AND DARK THUNDERCLOUDS: JAPAN, THE BOJ AND ABENOMICS ARE A JOKE

We are entering the seventh year since prime minister Shinzo Abe took office in 2012 and fostered his then-famous, now infamous, "three arrows" of Abenomics:

- Fiscal expansion
- Monetary easing
- Structural reform

THE JAPAN EXPERIMENT: **ABENOMICS OR ABYSMALNOMICS?**

With the objective of shaking Japan out of its zombie trance and multi-year deflationary environment, the idea was to stimulate sustainable growth that would benefit average citizens. Yet the mark to market on this has been far from great. Overall, it's been just more of the same three arrows – monetary easing that has been tried and tweaked multiple times. The result is the BoJ's balance sheet at $5.1 trillion (or JPY 552 trillion, at a 108 FX rate) as of December 2018, according to the BoJ's website. This is equal to about 100% of the estimated $5.1 trillion Japanese economy in 2018 and more than 100% of the 2017 GDP figure of $4.8 trillion.

To put that in context, everyone goes crazy when they think of the Fed's balance sheet of about $4.5 trillion, yet that is "only" about 21% of the US's $21 trillion economy. For the Eurozone and the ECB, that ratio is more like 40%; for Japan we are talking 100%. So, in a world of monetary policy experiments, Japan is on speed.

Japan's total government debt-to-GDP ratio is over 250%, a situation that is clearly not sustainable given the country's demographics and growth. Third-quarter 2018 GDP figures were worse than expected at -2.5% against an expected -2.0%, which also included a revision of second-quarter 2018 growth to 2.8% after a -1.3% contraction in the first quarter. This is not an economic success.

Japanese corporate governance, while improved, is still abysmal. Remember the outright fraud and mismanagement at the likes of Olympus, Toshiba, Fujifilm and Takata – where, to my knowledge, no senior executives went to jail, even in the case of Takata where people, including Americans, died because of faulty airbags made in Japan.

ALTHOUGH DEBT LEVELS ARE FAR FROM SUSTAINABLE, ALMOST ALL OF THE DEBT IN JAPAN IS IN YEN AND HELD BY THE GOVERNMENT OR JAPANESE COMPANIES AND CITIZENS

At the same time, Renault-Nissan's Carlos Ghosn (a foreigner) is now in jail for tweaking his pay – no doubt a poorly constructed and even more poorly executed strategy to keep Nissan from fully merging with Renault. This is not even apples and oranges, it's more like gold and manure, and we're likely to see the story told in a book and possibly a movie someday. The point is we are far from a level playing field in the Japanese corporate landscape. Shareholder and fiduciary rights are still at the back of the line.

The demographics are abysmal, with more adult diapers being sold than baby diapers. Last year the net decrease in Japan's population accelerated to close to 370,000, bringing the population to 126 million. By 2050 the population is expected to have shrunk to just 108 million – that's in just 31 years. The median age in Japan is around 47.3, compared with a world average of 30.4; for context the EU's median age is about 43, while the US median is 38 and the Philippines has a median age of about 24. In fact, according to the CIA Factbook from 2017, there is only one country with a median age higher than Japan, and that's the billionaire playground of Monaco at 53.1.

At the same time, Japan as an export nation faces a double whammy with its trade to China and the Eurozone. Both these regions are experiencing an economic slowdown that is showing no signs of ending yet, leading to less demand for Japanese goods. Additionally, China is climbing the value chain in production – especially in cars, machinery, automation, robotics and artificial intelligence – that minimises future market share and revenue for what was previously an uncrowded area for Japanese companies.

On top of it all, Japan still needs to work out a trade deal with the US on its autos, and US tariffs on Japanese exports could have dire consequences for the Abe administration, especially after such robust global growth in 2018.

THE JAPAN EXPERIMENT: **ABENOMICS OR ABYSMALNOMICS?**

On the political side, there is no real opposition to check Abe's Liberal Democratic Party. The consumption tax is coming up for review in October 2019, however, which had dire consequences last time it was passed in 2012.

BOOM, BUTTERFLIES AND SUNSHINE: ABENOMICS WORKS, JAPAN OFFERS COMPELLING OPPORTUNITIES TO INVEST

In this scenario, Abenomics is working, and things are far from stale in the land of the rising sun, with evidence of wage growth recently at 2.0% year-on-year against an expected 1.2%. The unemployment rate of 2.4% is a multi-decade low since the early '90s, with a trend of more full-time jobs coming online that will only increase the pressure on wages and inflation to rise.

While Japan has entered a recent soft patch in economic data terms, inflation (most recently with the core figure at 0.9%, like the Eurozone's 1.0%) continues to be positive – an Herculean feat for a country that was pretty much in deflation territory for decades. Furthermore, Abe has much stronger relations with US president Donald Trump, so reaching a trade deal between the US and Japan is easier than between the US and China, especially as intellectual property and technological theft is not an issue. It should be possible to start formal trade talks between Japan and the US in mid-January. Trump needs an easy win given the troubles he faces with the government shutdown, uncertainty around a US-Chinese deal and his continued loss of supporters.

Is Japan a country of xenophobes? Not so fast. The government recently passed a bill that would allow more immigrants into the country as it recognises that Japan's demographic problems cannot be solved organically, and too many jobs are going unfilled. For the first time ever, a bill has been approved for 250,000 five-year work visas for unskilled workers. The change of perception in culture and Japanese society as a whole is accelerating, and many businesses would not be able to run without foreign workers.

Although debt levels are far from sustainable, almost all the debt in Japan is in yen and held by the government or Japanese companies and citizens, which should make any debt restructuring, defaults or haircuts easier to manage in the future. That is a much different situation than that of, say, an emerging market country whose debt is in USD while revenue and earnings are in domestic currency.

Japanese equities offer compelling opportunities, and not just on the fact that the Nikkei is down about 20% from the 24,448 highs of October 2018; many companies are sitting on a lot of cash. From a valuation perspective, one year forward price/earnings ratios are at a modest 13.0x without adjusting the price for cash on hand. The price/cashflow is about 8.0x, against 10.0x for the S&P 500, while the price/book also offers value at 1.4x, compared with 2.6x for the S&P 500.

A dividend yield on the index of 2.2% is not too shabby either (the S&P 500 is at 2.4%), especially when 10-year Japanese government bonds are yielding close to 0.0% and the front end of the curve is negative yielding.

Japan will host the 2020 Olympics, which should leave the fiscal spending side well-supported. Abe's leadership and his LDP have continued to solidify (his term of office lasts until 2021), which makes the case for long-term structural change that much more credible, as there is virtually no political risk to his administration, unlike the elections faced by political leaders in India this year and in the US in 2020.

Japan's demographics are a positive, not a negative, factor. Because of its shrinking and much older population base, Japan has become a pioneer in healthcare and robotics. These are competitive edges that the country can export to the rest of the world. Over the coming decades, Europe and places like China will also start running into demographic challenges, including a shortage of workers, as well as needing care for their seniors (for instance, the median age in Germany is just a touch lower than Japan's 47.3, at 47.1).

THE JAPAN EXPERIMENT: **ABENOMICS OR ABYSMALNOMICS?**

So Japanese healthcare and, more importantly, robotics are likely to be multi-decade long investment themes.

In the robotics segment, the likes of FANUC Corp [6954], Omron Corp [6645] and Nabtesco Corp [6268] could be worth further research and due diligence by investors, especially as these three names have sold off by 50-60% over the last year from their January 2018 highs.

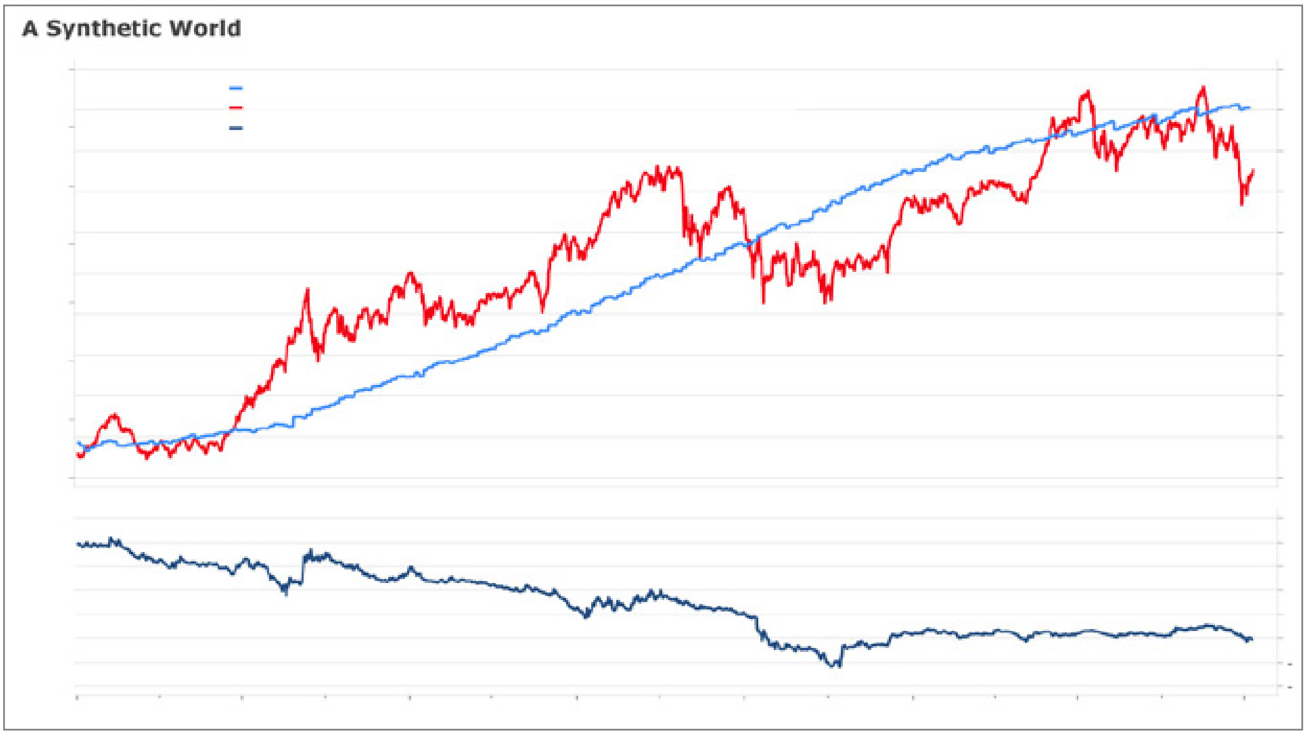


CHART: A SYNTHETIC WORLD, WHERE THE BOJ BALANCE SHEET EXPANSION (WHITE LINE) CORRELATES WITH GAINS IN JAPANESE EQUITIES (RED LINE) AND A DECLINE IN JGB YIELDS (BLUE LINE)

KAY VAN-PETERSEN, GLOBAL MACRO STRATEGIST

Kay Van-Petersen joined Saxo Bank in 2014 as a Global Macro Strategist, based in Singapore. He focuses on delivering strategies and analyses across asset classes based on monetary & fiscal policies, global geopolitical landscapes as well as other macroeconomic fundamentals. He also takes into account market sentiment, technical and momentum factors, and corporate bonds with attractive risk and return.

BONDS SHINE
IN BABY BEAR MARKET

BY ALTHEA SPINOZZI

The biggest driver in the bond markets in 2019 will be a slowdown in the global economy combined with high political and economic uncertainty, which will lead many investors to flee to safety and to favour sovereign debt that has already undergone tightening, such as US Treasuries.

If you thought 2018 was a hell of a ride, then you should really be worried about 2019. The year is starting with a slowing global economy. Signs of distress have begun to emerge not only in emerging markets, but also in several pockets of corporates in developed economies due to headline risk provoked by the US-China trade confrontation and political uncertainty in the euro area. Amid this chaos, central banks are left powerless, trying to support a tired economy that is approaching the end of the economic cycle and dangerously pointing towards a recession.

2019 will be a year of profound changes, so we believe that investors should take urgent measures to preserve capital and prepare for a downturn. They should look at the bond market as a way to diversify their equity portfolios and use bonds as a buffer against market volatility.

Positioning is crucial.

In sovereigns, we prefer safe haven assets, such as 10-year Treasuries and 10-year bunds. In the US, we also like short-term Treasuries with maturities up to two years, which could be a sensible place to park money while the economic cycle ends and the economy heads towards recession, providing an opportunity to reinvest proceeds at a later stage once better prospects emerge.

In the US corporate world, we like short maturities up to three years, with a preference for high-quality investment-grade corporates offering at least 150 basis points over Treasuries, so that real yield would not be eroded in the unlikely event that inflation continues to rise. We also believe that opportunities still exist in the high-yield corporate world, but investors should be careful not to jump into a liquidity trap and should select names carefully. In both high-yield and investment-grade names, we prefer the defensive sectors, while we dislike capital-intensive sectors that we believe will undergo radical changes as liquidity dries up.

Finally, EMs will continue to be volatile, but opportunities can still be found selectively. We believe that China can offer good opportunities, especially after the repricing of these assets in 2018, as the government stays focused on supporting the economy and implementing reforms that will ultimately further develop, and create security within, the Chinese financial market.

SOVEREIGNS

Like last year, the performance of sovereign debt all around the world will remain dependent on political headlines and central banks' monetary policies. But unlike 2018, the biggest driver will be a slowdown in the global economy. This means that political and economic uncertainty will remain high in 2019, causing many investors to flee to safety and prefer sovereigns that

> INVESTORS SHOULD TAKE URGENT MEASURES TO PRESERVE CAPITAL AND PREPARE FOR A DOWNTURN

BONDS SHINE
IN BABY BEAR MARKET

have already undergone a tightening process, such as US Treasuries.

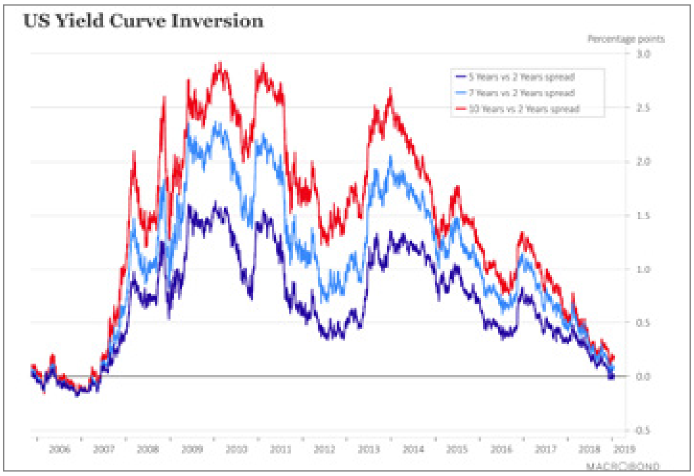
In the US, the year is getting started with an inverted yield curve in the short part of the curve, while the long part of the curve is undergoing a slow and painful flattening. This has left investors wondering about the distance to recession, which looks closer and closer.

The main driver for US Treasury performance this year will be the US' economic performance. We expect the Federal Reserve to refrain from raising rates in 2019 due to concerns over the economy, while Treasury issuance will remain high amid the Fed's balance sheet normalisation. Domestic and foreign demand will continue to be high due to weak global growth, and most of the demand will concentrate on the longer part of the yield curve, in the 10-year and 30-year maturities. This will lead the yield curve to flatten further, with 10-year Treasuries trading well below 3% for at least the first quarter. We might see the 10-year Treasury softening from the current level if the US reaches a trade deal with China, but we still expect it to trade around 3% as concerns over the economy will intensify.

Positioning depends on the particular needs of the investor. If the investor is looking to flee to safety as volatility increases to create a cushion against bleeding equities, the 10-year Treasury would serve this purpose. Otherwise, if investors are looking to park money while the economic cycle ends and a recession begins, short-term maturities up to two years are the most feasible, especially in light of lower inflation expectations.

Things look very different in Europe, where not only is the European Central Bank facing growth problems again, but political risk in Italy, France and Germany remains very high. The market expects the ECB to raise interest rates after the summer for the first time since 2011, but we believe this will prove impossible as the economic slowdown becomes a major challenge for the euro area as well. Because the ECB has played all its monetary policy cards in the past few years, and it has not yet started tightening, we can expect exchange-rate policy to be the only instrument available to the ECB – i.e. keeping the euro low to stimulate the economy.

Looking more specifically at various rates in the European Union, we remain negative on Italian BTPS and French OATS, while we continue to be positive on German bunds given their safe haven status. Although the clash between the new Italian government and the EU seems to be resolved, we believe there are still many reasons to fear that the situation will destabilise again as the two deputy prime ministers, Matteo Salvini and Luigi Di Maio, fight to implement their political policies within the deficit boundaries agreed with the EU. Italian newspapers are forecasting new elections as soon as spring 2019, before the European Parliament elections. As if that wasn't enough bad news, the Northern League, whose rhetoric has been the most euro-unfriendly so far, seems to be leading in the polls.



BONDS SHINE
IN BABY BEAR MARKET

CORPORATE BONDS

We believe that 2019 is all about bonds. The bottom in the equity market has not yet been reached, and that should push investors into safer assets. In a baby bear market where uncertainty becomes the norm, the only way to sleep at night is to choose quality, and bonds can provide that and give interesting returns, especially when cherry-picking across several sectors and durations.

However, it is important that investors realise that the credit spread widening that began in 2018 will likely continue in 2019, because of the large refinancing burden that corporates face now that interest rates have increased.

In the past few years, many corporates that were unable to access bank lending have been serviced by collateralised loan obligations; now that interest rates are higher and volatility has increased in the equity market, however, these vehicles are clearly destined for repricing. This means that firms that have relied on that sort of financing will suddenly be locked out of the market and corporate defaults will spike, causing more volatility in an already very fragile situation.

THE BOTTOM IN THE EQUITY MARKET HAS NOT YET BEEN REACHED, AND THAT SHOULD PUSH INVESTORS INTO SAFER ASSETS

Nonetheless, we believe that US credits will outperform Treasuries as upside for further tightening in Treasuries from current levels is very unlikely. Furthermore, although credit spreads are certain to widen, if an investor chooses solid names offering a good pick-up over the US Treasury curve and stays invested in short maturities up to three years, we believe that these instruments will provide a nice buffer in a diversified portfolio. Even if inflation increases, we believe that returns of corporate bonds with a good pick-up over Treasuries will not be eroded and will serve as a buffer as the equity market remains volatile.

The widening of credit spreads will depend mostly on investors' risk perception and the economic cycle. Whille high-yield credit spreads tend to widen faster than investment-grade credit spreads when the market sentiment is risk-off, IG credit spreads tend to widen faster in the final stage of the economic cycle preceding a recession. The key question at this point is how long we have until recession arrives.

Given this, we believe it is important to stay short duration and be invested in maturities up to three years maximum; such bonds would be less sensitive to market volatility, and investors can wait for the bond to mature in case credit spreads widen severely.

In the corporate credit space, we dislike capital-intensive sectors such as real estate, automobiles, manufacturing and the transportation sector, including railways and airlines.

We remain positive towards defensive sectors, such as healthcare – one of the few sectors that performed well in 2018 – and industrials excepting natural resources companies.

BONDS SHINE
IN BABY BEAR MARKET

For financials, things are getting more and more complicated as the US yield curve continues to flatten, pointing towards an inversion. But we still believe there are good opportunities in this space, especially when looking at senior unsecured bonds with short-term maturities. It is important, however, to select better-rated and liquid names and avoid smaller banks amid the risk of a global slowdown.

EMERGING MARKETS

Emerging markets remain the most discussed opportunity and threat. Last year brought a significant repricing of these assets, and the average yield of EM bonds is currently near a nine-year high.

Therefore, investors are now starting to look at this space with interest, thinking that if central banks become more accommodative amid a global slowdown, maybe some of the most resilient EM bonds will recover as well.

We believe this may be true. But, like everything else in this market, it is important to select risk in order to avoid bad surprises.

We see Latin America as one of the areas exposed to the biggest risk. Not only is Argentina still struggling with a currency crisis, but this year has brought new presidents to Mexico and Brazil, which could be a game-changer for the region.

Although the obstacles between Mexico and the US seem to have been overcome, one should not forget that Andres Manuel Lopez Obrador (known as 'AMLO'), who took office in December 2018, is a left-leaning populist who favours social reforms over economic ones. Already in November, when he cancelled the construction of a new international airport in Mexico City, he showed that he does not care about the economic consequences of his actions, and this should alarm investors.

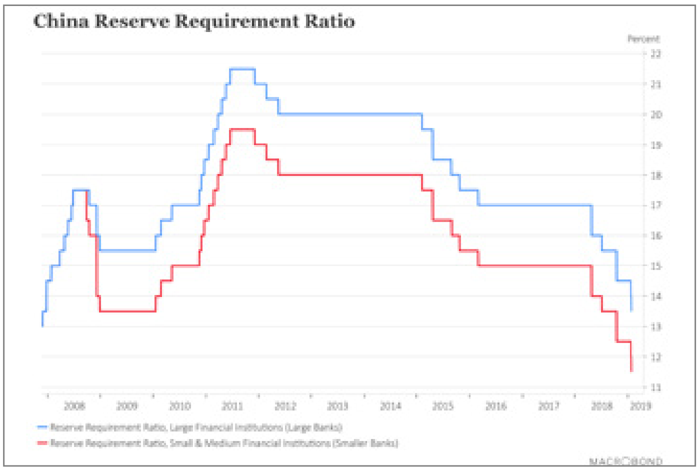
One of the most controversial points in AMLO's campaign concerns the energy reforms he wants to implement: AMLO sees Mexico as an an energy-independent country, and he pledged to end oil exports and stop gasoline imports from the US. Not only would this have devastating effects on Mexico's state-controlled petroleum giant, Pemex, but it could even intensify unwanted confrontation with US president Donald Trump.

BONDS SHINE
IN BABY BEAR MARKET

Similarly, even though Jair Bolsonaro in Brazil was welcomed as a market-friendly new leader, we believe he will not live up to market expectations. International investors expect Bolsonaro to implement structural changes, particularly pension reforms, to keep the country from borrowing money to pay public-sector employees and retirees. However, it is easy for the market to forget that Bolsonaro was not elected on the strength of his economic agenda, but rather due to disdain for the corruption within his rival Workers' Party. It would not be surprising if Bolsonaro gave priority to other reforms before touching the hot potato of pension reform, and that could mean significant delays in the much-awaited economic reform.

In Africa too, risks remain high from an economic point of view, especially concerning the elevated issuance of debt in hard currencies by these countries in the past few years. Another destabiliser could be the general elections in South Africa in May and presidential elections in Nigeria in February. These are the region's two biggest economies, and they will be instrumental in shaping the political and economic patterns in sub-Saharan Africa. This region will be the most vulnerable to an economic slowdown, so risk allocation should be extremely selective.

We remain positive on China. Although trade-war worries are still running high and the economy is slowing down, the Chinese government is focused on implementing the necessary supportive reforms. During the Central Economic Work Conference held on December 19-21, China's representative talked about "countercyclical adjustment", with the government ready to intervene with tax cuts and prudent monetary policies. As a consequence, we have seen the People's Bank of China cutting the reserve requirement ratio by 1% at the beginning of the year. Not only is the central bank extremely supportive now, but the country is concentrating on improving property policies, advancing manufacturing and implementing reforms of state-owned enterprises, which will be instrumental in boosting fair competition with privatively owned businesses.



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.

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