Q2 2018

QUARTERLY OUTLOOK

By #**SAXO**STRATS

SAXO GROUP

Q2 2018

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THE END OF
A CYCLE LIKE NO OTHER

BY STEEN JAKOBSEN

We are nearing the end of the largest monetary policy experiment of all time, and ascendant nationalism, staggering inequality, and a widespread loss of hope among the younger generation are among its varied fruit. The good news? Things only change when they absolutely must.

"When you reach the end of your rope, tie a knot and hang on" – Franklin D. Roosevelt

In our Q1 report we pointed to bubbles in the financial markets as a theme; for Q2, we want to alert investors to the fact that we are at the end of a cycle like no other.

We are nearing the end of the biggest monetary experiment in history, when central banks replaced politicians as decision-makers. Their maintaining of low- and negative interest rate policies and quantitative easing for far longer than the normal business cycle would dictate was necessary kept markets in a good mood, but with the unfortunate side effect of killing the market-based economy.

Q1's brief volatility spasms notwithstanding, today's capital markets are in a zombie-like state, with low volatility and extreme valuations in all assets with no net increase in growth and productivity, and a massive increase in inequality.

While this monetary misallocation bought markets some time, it concurrently increased the interdependency between markets and countries in a globalised economy. Federal Reserve easing did more to stimulate emerging markets than the US itself, and China became the main engine of growth, "saving" the world in 2008 by expanding credit and stimulus at an unprecedented pace and consequently carrying the world through the low in 2009 into 2010.

The benefits from the globalised system and particularly from the central bank's asset-pumping response accrued near-entirely to the already wealthy, while the average economic participant lost out.

This is the process that drove the advent of Brexit and Trump.

So now we have our first great new showdown since the Cold War, which saw the victory of capitalism over communism. Now comes the fight between nationalism and globalism. Nationalism is winning big, as country by country the outlook is turning inwards, with an increase in placing the blame on external forces from immigrants to the real and imagined misbehaviour of trade partners. Talk of trade policy and protectionism is now labelled "trade wars".

THE BENEFITS FROM THE GLOBALISED SYSTEM AND PARTICULARLY FROM THE CENTRAL BANK'S ASSET-PUMPING RESPONSE ACCRUED NEAR-ENTIRELY TO THE ALREADY WEALTHY, WHILE THE AVERAGE ECONOMIC PARTICIPANT LOST OUT

THE END OF
A CYCLE LIKE NO OTHER

That brings us to our theme: that this cycle is like no other. So many prior attempts at understanding our situation look back towards the last handful of recessions and even the global financial crisis for lessons.

DARE WE CLAIM THAT THIS TIME IS DIFFERENT?

In our view, the implications of a global trade war and the world possibly having reached peak globalism have super-cycle implications. On the interest rate front and due to the excess of central bank policy, we are likely about to see the end of the 35-year downward trend in interest rates, the price of money. This has enormous implications, as the world has amassed $237 trillion of debt with little growth to show for it. The next round of policies won't simply be more of the same from central banks, as they will suddenly find politicians seizing the reins of control.

At the same time, we have seen an information technology revolution in which technology companies have become monopolies of a size not seen since the 19th century, with their dominance of the market and downright scary data-gathering capacity more powerful than that of governments.

As investors, we celebrate the FANGs (Facebook, Amazon, Netflix, Google) due to their returns, but we forget in the process that their profits are mainly created through monopolistic practices that kill growth and productivity and end up as a big tax on consumers. We should be protecting markets and market-based allocation, but we've instead allowed these companies to run amok.

This is now changing with the European initiative to both enforce GDPR, the General Data Protection Regulation, and the 4% turnover tax applied to technology companies. This will reprice technology, as (at a bare minimum) growth is now taxed higher with more spending needed on data protection, which is not "sales" but costs. Technology represents 25% of the US stock market – any time in history when one sector has reached this level it "mean reverts" back lower.

The last sector to reach this level was banking, and we easily see much of what happened to banking transferring to technology: more regulation, more oversight, and less profit.

THE IMPLICATIONS OF A GLOBAL TRADE WAR AND THE WORLD POSSIBLY HAVING REACHED PEAK GLOBALISM HAVE SUPER-CYCLE IMPLICATIONS

With the technology sector facing headwinds the economy will have a tough time expanding. The consumer is maxed out in terms of credit: as Saxo Bank head of macro strategy Christopher Dembik writes, the saving rate is tanking and so is the forward-looking credit impulse, which still leaves us thinking that market is way too bullish on top line potential for growth and overall profit.

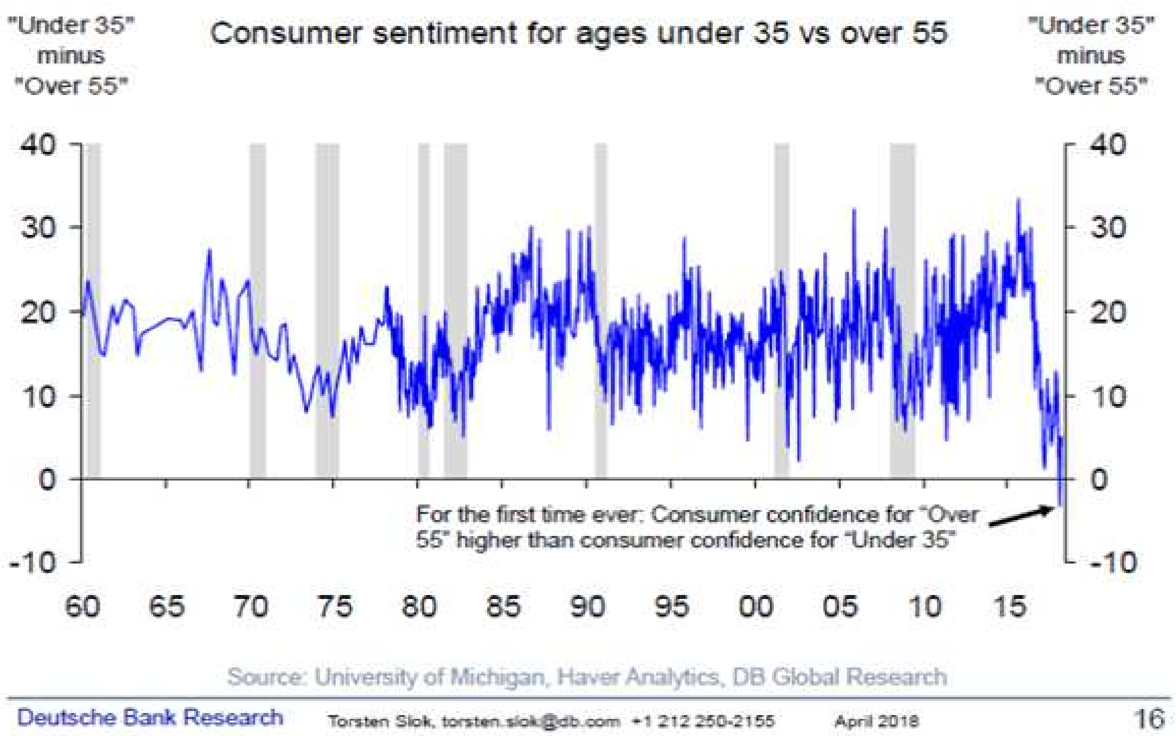
What we are forecasting is that technology will move from app-creation and data harvesting to becoming compliant with new data regulations – again, a cost. The US economy will get no big upside from the tax cut; housing prices have already dropped 15-20% in New York and inflation still will not materialise as net lending demand, or the velocity of money, continues to be depressed and will soon enter negative territory.

The geopolitical scene will be driven by nationalistic agendas, meaning less and more expensive trade and – in the worst outcome – a world split into China versus the US, with the rest of the world having to decide which side to join.

THE END OF
A CYCLE LIKE NO OTHER

For yet another angle on how this cycle is different from anything in recent or even distant memory, see the chart below (courtesy of my fellow Dane Torsten Sløk of Deutsche Bank in New York), which I deem to be the most negative I have ever seen.

YOUNG GENERATION HAS ALWAYS BEEN MORE OPTIMISTIC THAN THE OLD GENERATION: BUT NOT ANYMORE



Please explain to me how a 35-year-old can be less optimistic about the future than a 55-year-old! It defies logic, nature, and reasoning. It is a case of young people feeling the pain of the present economic reality: it's hard to find a decent job and or even interview for a job when you need a PhD to start with. The young are increasingly indebted by education costs and priced out of getting onto the house ownership ladder. Beyond that, the technology they grew up with is not liberating them, but containing them or merely providing pointless distractions in the social media space.

This is one chart not to be ignored, as this has never happened before. Not in recession, not during the oil crisis, not even during the Great Financial Crisis.

Macro changes, and changes overall, are always a product of policy mistakes. There have been so many mistakes made in this cycle of infinite money printing and debt accumulation with no reforms.

THE END OF A CYCLE LIKE NO OTHER

We have allowed the market-based economy to be replaced by interventionist central bank policy, a defeat of the globalist agenda, close to no discussion on how to solve inequality, the creation of most unhappy youth in modern history, and we permitted monopolies to develop in the few growth sectors that perform – often only at the cost of others.

This isn't to say that there are no choices or that there is no hope. As the late Stephen Hawking once remarked: "I have noticed that people who believe everything is predestined and can't be changed still look before they cross the road".

We are at that road. We need to look, but we also need to accept this is the end of a cycle like no other and the future will not be an extension of the recent past. We are in a rapidly changing landscape where the world risks dividing into new spheres of influence led by China and the US, where we could be headed for a "tech sector winter" as needed regulations and compliance are initiated, and where the youth – fortunately – will decide the outcome in numbers, in votes, and in action.

I am satisfied to leave my future in the hands of the bright and unhappy youth, as change only comes when needed... and that time is now.

Please enjoy this excellent report from my colleagues who are even sharper than usual.

CHANGE ONLY COMES WHEN NEEDED...
AND THAT TIME IS NOW.

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.

EQUITY BURNOUT?

BY PETER GARNRY

Equities are under pressure on many fronts, ranging from a potential trade war to disappointing macro numbers and technology regulation. Caution is critical in such an environment and portfolio diversification and defensive choices therefore make sense.

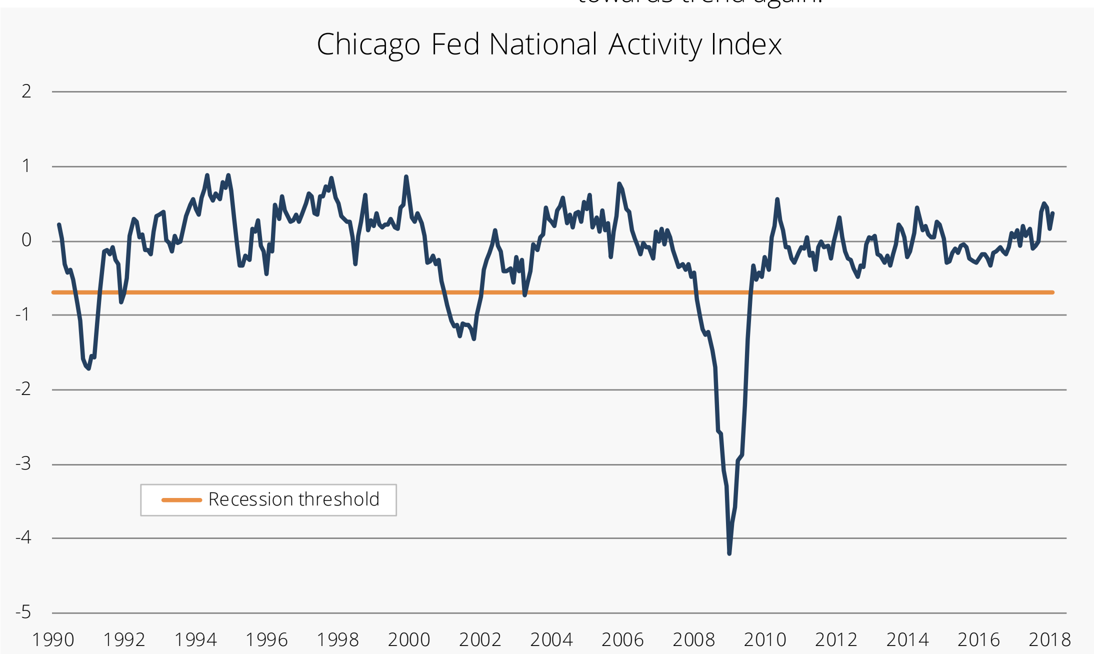
The first quarter had everything. From the strongest start to a year in decades to the biggest one-day move in the VIX index during the past 10 years, revealing that selling volatility was the most overcrowded trade in financial markets, financial markets saw all manner of drama.

Heading into 2018, inflation expectations were pushing rates higher and lifting the Federal Reserve's confidence in its communicated rate trajectory, but disappointing numbers ultimately punctured this certainty, leaving inflation as the biggest modern economic puzzle. Technology had its first major market hiccough in years as the Facebook data scandal erupted, shocking investors with the prospect that company usage of personal data faces heavy regulation. Moreover, the US and China seem to be on a collision course over trade that could jeopardise global growth.

The G10 countries have gone from their best macro prints against expectations since Q2 2010 to what is almost their worst performance since 2013. The most urgent question for all investors now is whether equities are burning out and how to address risk reduction.

FUNDAMENTALS VERSUS OUTLOOK

The battleground in Q2 will be fundamentals against outlook. The Q1 earnings season is going to be strong with profits up 10% globally, having ridden the tailwind from a global economy that has arguably been quite good over the past six months. As of February, the Chicago Fed National Activity Index indicated US economic activity is firmly above the historical trend. But these readings are already stale news and the market is way past all that… given recent weakness it would not be a surprise to see the CFNAI to come down towards trend again.



SOURCE: BLOOMBERG AND SAXO BANK

EQUITY BURNOUT?

Investors' attention is on both a potential trade war and recent macro data disappointments. These two major forces will cast a shadow on a Q1 earnings season that will deliver but fail to bolster investor confidence. Our dynamic asset allocation has gone moderately defensive in February and as a result we remain negative on equities as the risk-reward ratio seems low at this point. We recommend investors to be overweight defensive sectors such as health care and consumer staples, as well as interest rate-sensitive sectors including utilities and telecomsm as rate expectations could take a hit in Q2 while markets digest the changing landscape.

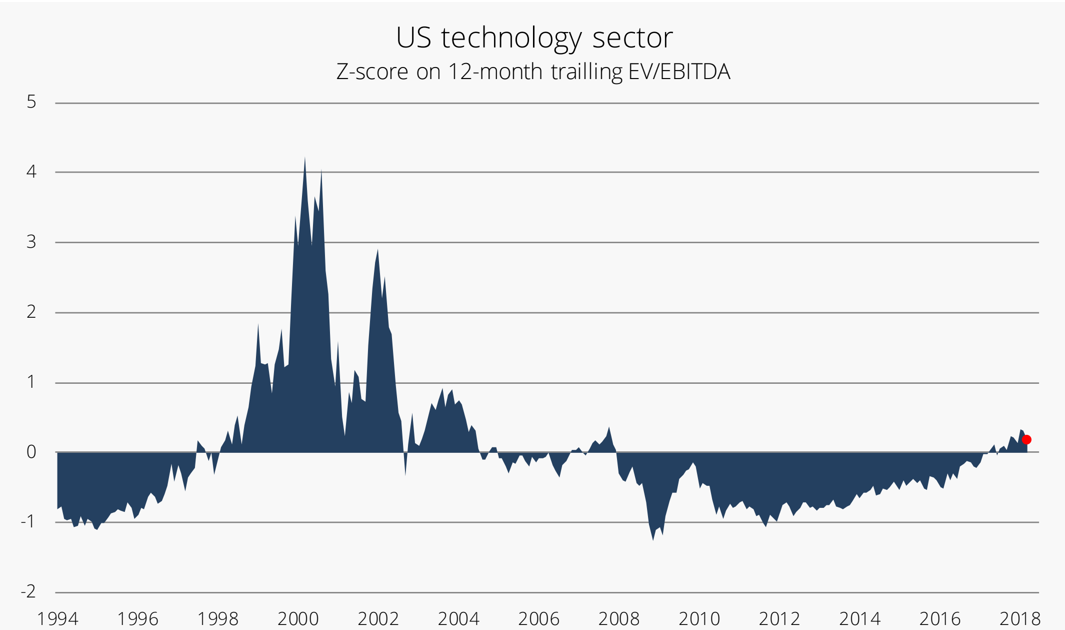
SILICON VALLEY'S WAKE-UP CALL

The US technology sector fell with the general equity market in February, losing almost 11% in two weeks, but the thirst for growth ultimately saw investors bid up technology stocks again, taking the sector to a new all-time-high in mid-March. However, the data scandal at Facebook triggered a fresh round of selling amplified by President Trump's negative comments about Amazon which spooked investors and sparked fears that Amazon may soon be regulated.

> INVESTORS SHOULD BEGIN DECREASING EXPOSURE TO HIGH LEVERAGE NON-FINANCIAL CORPORATIONS

Despite these setbacks in Q1, the three industry groups comprising the global technology sector are all in the top five of the best performing industry groups in Q1. Only seven out of 24 industry groups rose in global equity markets in Q1.

This illustrates the strength of the technology sector. In terms of valuation, the US technology sector trades only 8% above its historical average since 1994 whereas the S&P 500 is valued 21% above the average. US technology is valued 22% above the S&P 500 as of March 2018 but this premium seems reasonable given that the sector has delivered 8.3% annualised profit growth since 1994 compared to 4.7% in the S&P 500. One thing is history; another is the outlook for technology.



SOURCE: BLOOMBERG AND SAXO BANK

EQUITY BURNOUT?

The past 15 years have been unique as people have loosened up about privacy. Basically, people have traded their personal information for free internet services at Google, Facebook, Twitter, and LinkedIn, and signed terms and conditions at Apple and Amazon allowing a wide range of uses for our personal data. The pendulum is likely to swing back over time, increasing people's interest in data privacy.

Facebook's data scandal has become the public picture of what is wrong with technology firms using personal data. However, the European Union has long pursued an active role of reining in dominant US technology companies, fining Facebook for incorrect disclosure on the WhatsApp deal; going after Apple's lack of taxes paid in Europe (Apple settled at $15.4 billion in December 2017); fining Google a record $2.7bn in the first antitrust case and fining Amazon €250 million over tax issues. Other countries are watching Europe and considering implementing a tough stance against technology companies, especially those using personal data.

Our prediction is that the EU's General Data Protection Regulation (GDPR) effective as of May 25, 2018, and an upcoming technology tax on revenue to offset tax arbitrage through transfer pricing represent the start of a wider crackdown on, and regulation of, dominant technology companies. Other countries will follow and it will have an impact in the longer term on profitability. The GDPR is effectively the end of the internet's grand bargain as put forward by the Harvard Business Review. We are not negative long-term on technology but our prediction is that successful technology companies will increasingly be those that create technological solutions without using personal data; this could mean battery technology, robotics, and/or automation solutions. Our advice to investors is to avoid large technology companies using vast amounts of personal data and go for smaller, niche tech-sector firms.

INVEST IN LONG-TERM TRENDS

The usual research and commentary on global equities circles around regions and industries. On top of this, mega cap stocks such as Apple and Amazon get disproportionate attention as the free-float market capitalisation-weighted equity indices rule the investing world. But the biggest issues with the current way of looking at equity markets are that it ignores the high cross-correlation due to globalisation and misses the important 'mega trends' in society.
In 2018 we are directing more of our research towards equity themes as these are easier to crystallise for clients but also easier to link to real, societal changes. In the fast-evolving ETF industry, several providers are creating new and interesting ETFs covering emerging equity themes previously only accessible to sophisticated investors. It is our ambition in 2018 to deliver ideas and insights about the important themes that will shape our society over the coming decades. According to our preliminary research, the strongest equity themes in Q2 are battery technology, pharma breakthroughs, e-commerce, US energy infrastructure, and cyber security. These themes have the potential to deliver relative alpha in Q2. In the other spectru, we find the least attractive themes: US technology, travel & leisure, India, Vietnam, and buyback achievers.

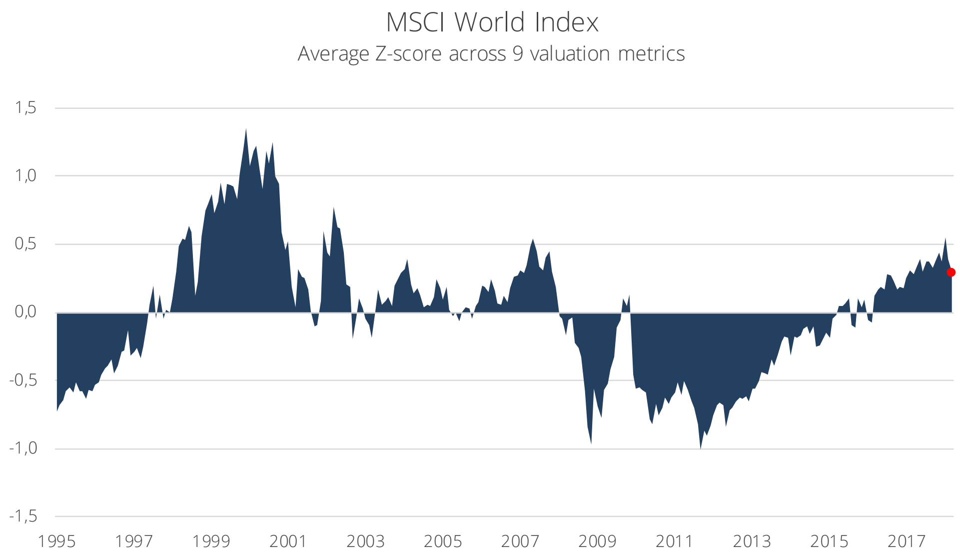
WE RECOMMEND INVESTORS TO BE OVERWEIGHT DEFENSIVE SECTORS SUCH AS HEALTH CARE AND CONSUMER STAPLES

EQUITY BURNOUT?

RISK-REWARD RATIO LOOKS UNATTRACTIVE

Nine years into the global expansion several trends are colliding simultaneously. The US and China are on a collision course in terms of trade policy, and multilateral institutions are under attack, threatening to stall corporate investment and slow down the economy.

Geopolitical risks are rising in the Middle East with tensions between the US and Russia on the rise. Increased regulation of technology companies could impact investor sentiment as well. On top of all this, the Fed is still signalling that it will continue to hike rates, increasing the price of financing. This means that investors should begin decreasing exposure to high leverage non-financial corporations.



SOURCE: BLOOMBERG AND SAXO BANK

With the MSCI World Index valued above the average and multiple key macro risks on the horizon, the risk-reward ratio is no longer all that attractive for equities on a two-year horizon. Global rates have risen, thereby improving the alternative to equities. With a recession likely coming with the next two years, the outlook does not support an aggressive stance and overweight position in equities.

Portfolios should be more balanced and tilted towards defensive industries in the portfolio's equity exposure. On a longer term horizon of five to seven years, equities will likely do better than bonds unless the world falls into a prolonged deflationary low-growth period.

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 US DOLLAR IS A TIME BOMB UNDER THE MARKET

AND THE FUSE IS BURNING FASTER

BY JOHN J HARDY

Ten years after the start of the global financial crisis, President Trump has turbocharged the search for a replacement for the US dollar as the world's chief reserve currency with his total abandonment of fiscal discipline at what could prove the tail end of the US recovery. The USD is destined for pronounced weakness in purchasing power as reserve status begins to slip away – now sooner than before. But the real devil is in the detail of how we get there.

> WE ARE NEARING THE BEGINNING OF THE ENDGAME FOR THE USD'S ROLE IN THE GLOBAL ECONOMY

The so-called "Triffin Dilemma" is named after Belgian-American economist Robert Triffin and is based on his criticism of the use of the dollar as the global standard under the post-World War II Bretton Woods exchange rate regime. The dilemma outlines the inevitable instability when a national currency acts as the chief global reserve currency and is required to run constant large deficits. Those deficits, in turn, eventually risk undermining trust in the value of that currency.

The US dollar is of course exhibit one in any analysis of the Triffin Dilemma, and the de-pegging of USD from gold back in 1971 was just Chapter One of what has proven an ongoing saga in the dollar's status as the chief global reserve currency. As we look to the rest of 2018 and beyond, we suspect we are nearing the beginning of the endgame for the USD's role in the global economy.

We'll fast forward through the petrodollar and Asian mercantilist policies that propped up the USD's purchasing power from the 1970s and until the early 2000s. It wasn't until the arrival of the global financial crisis in 2008-09 that the increasing dysfunctionality of the dollar-based global financial system was really laid bare. The collapse in global asset prices triggered a massive scramble for liquidity in the global financial system due to the contagion of panic deleveraging. With so many of the world's assets and short-term funding denominated in US dollars, the Federal Reserve was forced to bail out not only US financial system, but the entire global financial system as it opened up enormous swap lines to provide USD liquidity to foreign central banks. This was not only true for the major economies in Asia and Europe, but remained the case even as far afield as Brazil and New Zealand. This tsunami of liquidity provision succeeded in bailing out the global financial system without addressing the fundamental weakness of the system and its reliance on the power of the Fed to save the system.

Then ironically, the subsequent easy monetary policy from the Fed, chiefly aimed at healing the wounded US economy, had the unintended consequence of supercharging a new credit bubble in emerging markets around the world who enjoyed relatively clean sovereign balance sheets and their real economies weren't as hard hit by the financial crisis as developed markets. In short, borrowers in emerging markets were more than happy to borrow "free" global money (US dollars) at virtually no interest to fund new activities.

By 2011, the Fed-induced easy money bubble was beginning to slow in emerging markets, and in 2013, that bubble begin unwinding in an ugly way, a process that culminated in late 2015 and early 2016 as the Fed first warned that it was set to reduce quantitative easing purchases in 2013 and then stopped doing so entirely by the end of 2014.

It was clear in hindsight that most of the entire boom-bust cycle was precipitated by the Fed, central bank of the world's global reserve currency. When the Fed tightened policy starting in late 2013, the supply of printed US dollars started drying up and the USD exchange rate went increasingly vertical. Many forget just how bad a year 2015 actually was for global asset prices, particularly in emerging markets, and it was the lucky timing of the European Central Bank's extreme QE starting in early 2015 and China's eventual massive stimulus starting later that year that likely kept the world from dipping into recession.

But now, most of the policy punchbowls around the world have been removed or are nearly empty. China's growth priorities are changing to priorities centred on the standard of living for everyone, as well as environmental policy, and Beijing also faces the onerous task of addressing its own credit bubble. The Fed, meanwhile, continues to tighten policy and supposedly intends to shrink its balance sheet at an accelerating pace. Elsewhere, the ECB has promised to cease expanding its asset purchases entirely by late this year. Only the Bank of Japan continues to drag its heels, though it has also tapered its rate of asset purchases over the past year.

THE FINANCIAL WORLD RISKS ANOTHER LIQUIDITY CRISIS LINKED TO THE US DOLLAR IF WE SEE ANOTHER FINANCIAL PANIC OR TURN IN THE GLOBAL CREDIT CYCLE

The removal of global policy stimulus has naturally come about as the world economy finally managed a couple of quarters of synchronised growth in 2017. But our view is that this growth is tenuous and very late-cycle, particularly in China and the US, as the credit cycle has already turned. And the next challenges for markets are just around the corner…

Aside from the ongoing withdrawal of central bank accommodation and gathering recession risks, Q1 saw the Trump administration add two very volatile compounds to an already unstable global financial system framework that will bring forward its day of reckoning.

First, the escalation of US protectionist rhetoric, most pointedly aimed at China, sets in motion a whole host of potential responses from the Chinese side. Undoubtedly, among these will be an effort by China to reduce the sway that the US dollar holds over global trade and financial markets.

Already back in 2009, China's redoubtable central banker Zhou Xiaochuan opined that it was precisely the US dollar-driven Triffin dilemma that drove the severity of the global financial crisis. Some even argue that Q1's launch of a yuan-based oil contract is a cornerstone effort in supplanting, or at least rivaling, the petrodollar with a petroyuan in global trade, something made more plausible by the fact that China is now the world's largest oil importer, overtaking the US. As well, one has to imagine that among the long-term goals of China's One Belt, One Road strategy and its creation and connection of trading hubs across Asia and into Europe and Africa will be a more China-centred, or at least China-influenced, unit of value.

Second, Trump's freshly minted tax regime has guaranteed unprecedented new fiscal shortfalls during an expansionary phase of the US growth cycle – as much as a trillion USD for the next budget year already. The US actually dipping into a recession over the next 12 to 18 months (as we suggest) is an underappreciated risk, tax cuts notwithstanding; the fiscal gap will stretch beyond even the extremes seen during the financial crisis of near 12% of GDP.

THE US DOLLAR IS A TIME BOMB UNDER THE MARKET AND THE FUSE IS BURNING FASTER

As the US runs a large current account deficit, it will have to fund that deficit with foreign capital – likely at a far lower USD value. Providing added urgency to the search for an alternative to the USD is the need to devalue the world's stock of USD-denominated debt – which has only increased by leaps and bounds in the offshore USD system that got global finances in such a pickle back in 2008-09. Last September, the Bank for International Settlements estimated that there was a net $25 trillion in USD-denominated debts and derivatives in the offshore financial system. The world can ill afford another USD funding mishap, one that has already partially been set in motion by Trump's corporate tax cuts, which are encouraging US corporations to repatriate hundreds of billions of USD from outside the US and draining liquidity from the offshore USD system. This, possibly combined with the Fed's quantitative tightening, has seen the worst spike in USD Libor spreads versus the Fed's official policy rate since the global financial crisis.

So what is the path from here for the greenback, and what can possibly replace it? All paths lead to a lower dollar eventually, with the traditional basic fundamentals (late-cycle US economy and ugly current account shortfall) the most glaringly obvious negatives for the US dollar.

On that basis, USDJPY to 90 and EURUSD to 1.35 look like no-brainer calls. But the Triffin dilemma vastly complicates the short- to medium-term path towards that eventual longer-term devaluation as the USD at some point loses some or all of its reserve status. Left to its own devices, the financial world risks another liquidity crisis linked to the US dollar if we see another financial panic or turn in the global credit cycle.

The hope may be that the problem with the USD was so acute and obvious the last time around in 2008-09 that plans are likely in place to deal with another round of more of the same. But this time around, addressing the USD problem must transcend the Fed and could possibly involve the International Monetary Fund in coordination with multiple other global central banks in addition to the Fed.

Some new reserve asset will have to be at the centre of that new system – some have argued for a Special Drawing Right, a gold-backed SDR or similar. Otherwise, a new USD crisis could overwhelm the financial system without a coordinated response, risking a mass of defaults, unprecedented exchange rate volatility and a Balkanisation of the global financial system with no single reserve asset and division of the world into spheres of influence.

The open question is whether global elites can move to short circuit the inevitable USD crisis in launching such a monumental reconfiguring of the global financial system without the permission/consent/direction of political authorities in countries with democratic leaders.

In democracies, for better or worse, and as the global financial crisis and the EU sovereign debt crisis showed, the crisis comes before the solution.

> THE USD IS DESTINED FOR PRONOUNCED WEAKNESS IN PURCHASING POWER

THE US DOLLAR IS A TIME BOMB UNDER THE MARKET AND THE FUSE IS BURNING FASTER

CURRENCY OUTLOOK BRIEFS

Our main FX feature this quarter makes it clear that our chief focus for coming quarters is on the fate of the US dollar, but below we offer a few thoughts on specific currencies.

EUR – the market is well positioned for further euro strength as speculators are quite long. Further upside in EURUSD may prove a bit of a grind and may require a correction first?

JPY – short-term directional uncertainty, but eventually, either the interest rate cycle heads higher and the BoJ has to shift policy or a pick-up in risk aversion sees the usual JPY safe haven bid, so win-win for the longer term.

GBP – Brexit developments must arrive soon for a credible "soft Brexit" scenario required to see sterling revaluing to the upside versus the euro, our preferred scenario. While the EU elite has taken a harsh negotiating tactic, national politicians across the EU may assert their more rational UK-friendly stance (particularly from a EU common defense perspective!).

CHF – a gentle further unwinding of its overvaluation the generally preferred trajectory, with new strength only arriving when the EU faces a recession and renewal of existential risks somewhere over the horizon.

AUD – encouraging for the Aussie that China wants to maintain its currency's strength, but China is likely undergoing a change of growth focus that will prove less commodity intensive and the end of the Australian housing bubble lies somewhere ahead once the credit cycle Down Under eventually turns. The path of least resistance for the Aussie is to the downside.

CAD – may prove an ongoing range trade versus the greenback. Anything below 1.2000 in USDCAD looks too cheap in our book, as oil prices are the dear end already at $70 per barrel and Canada faces its own housing bubble deleveraging event, with incipient signs already in evidence. Prefer CAD against AUD and NZD, however.

SEK – Sweden has likely achieved peak economic growth with a policy rate of -0.5% and active QE – what are the policy options when the inevitable recession arrives in the foreseeable future and NIRP/QE is the Riksbank's starting point? Yes the krona is cheap – but for very good reasons.

NOK – a range trade versus the euro, perhaps, though Norway faces some risk from lower oil prices if global growth hits the skids later this year and Norway faces its own housing bubble overhang.

EM CURRENCIES

CNY – despite the clear overvaluation in the CNY on a CPI-adjusted basis, China apparently wants to maintain a strong currency policy, perhaps looking to force the needed devaluation adjustments beyond its borders.

RUB – ruble volatility is back with the latest rounds of oligarch-aimed sanctions that have seen international investors jettisoning Russian assets of all stripes. Assuming that Russian access to foreign investors isn't entirely closed off by future sanctions, the ruble will eventually be a bargain as Russian authorities have a history of administering harsh medicine to maintain stability.

TRY – the lira is one to watch for the remainder of 2018 as President Erdogan has been sending all of the wrong signals and wants to stimulate growth with money that he increasingly won't find arriving from foreign investors. The Turkish economy and its large external debt exposures require strong capital inflows for stability. A loss of confidence is a distinct risk and could spell a Turkish default and broader EM contagion.

MXN – we're torn here: the peso has done well considering the drumbeat of threats from Trump protectionism. But a weak global growth outlook will do the currency and its rather export reliant economy no favours

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.

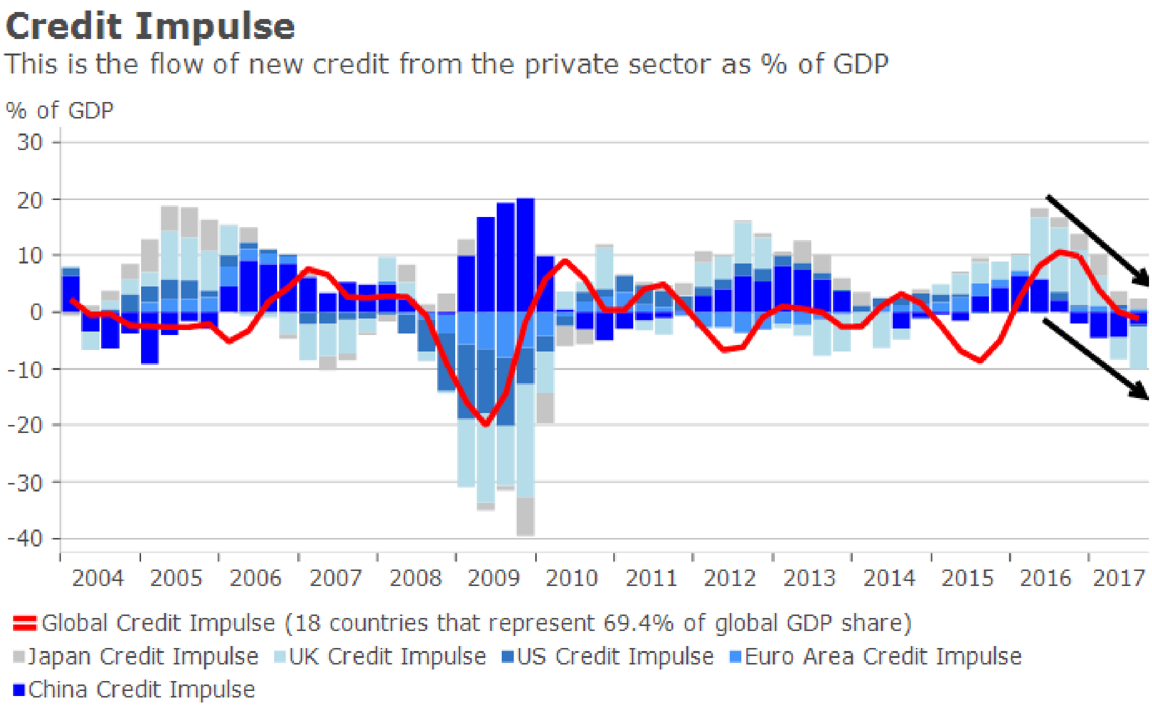
RECESSION – THE EVIDENCE PILES UP

BY CHRISTOPHER DEMBIK

Economic indicators ranging from Saxo Bank's proprietary credit impulse to the yield curve and credit card delinquencies all point in a single direction – the US is heading for recession.

At the end of last year, the consensus eagerly embraced the "synchronised global growth" narrative and no one dared question the strength of the United States economy. Optimism prevailed among the financial community. As we enter the second quarter of 2018, the hopes of synchronised growth are vanishing quickly as the global economy suffers a loss of momentum (global PMI has plunged to a 16-month low) and warning signs of an imminent slowdown are popping up in the US.

CREDIT IMPULSE IS HEADING SOUTH



SOURCE: MACROBOND, SAXO BANK RESEARCH & STRATEGY

Explanation: To calculate Credit Impulse, we use the variation of the stock of loans held by the non-financial private sector (Nonfinancial Corporations and Households & NPISH) on a quarterly basis and we calculate a second derivative which is finally expressed as percentage of GDP. The Saxo Bank Global Credit Impulse is based on 18 countries that represent 69.4% of global GDP share (adjusted for purchasing power parity). It is updated on a quarterly frequency in order to avoid too many adjustments. The index is GDP weighted and it is built using GDP in current prices from the IMF's WEO in order to have access to forecasts and since all data are expressed in USD.

RECESSION
– THE EVIDENCE PILES UP

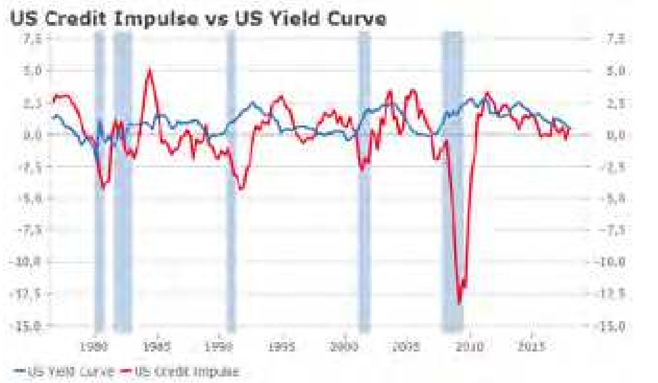
Since mid-2017, our favourite leading indicator, the credit impulse (which represents the flow of new credit from the private sector as a percentage of GDP) has entered the risk zone. Credit impulse (total and main countries) is heading south, driven by China and the United States that weigh roughly 1/3 of our global index. Our most updated data indicate that the US credit impulse was running at only 0.4% of GDP in Q4'17 (after entering into contraction in Q3) and that the Chinese credit impulse has been following a sharp downward trend since the end of 2016, running at minus 2.1% of GDP in Q3'17.

Based on up-to-date domestic nonfinancial loans data, such as C&I loans in the US, there is every reason to believe that the sluggish momentum will remain in place in both China and the US on the back of deleveraging and monetary policy normalisation.

In a highly leveraged economy like the US, credit is a key determinant of growth. Lower credit generation is expected to translate into lower demand and lower private investment in the coming quarters. There is a high 0.70 correlation (out of one) between US credit impulse and private fixed investment and a significant 0.60 correlation between credit impulse and final domestic demand.
So far, there has been no sign that Trump's tax cuts could mitigate the negative effect of a lower credit impulse by lifting companies' investment spending plans. In the last NFIB survey, the proportion of respondents planning to increase capital spending even decreased to 26%, which seems to indicate that there is more to consider than tax alone when running a business.

THE SPECTRE OF RECESSION LOOMS

The main risk for investors is the increasing mismatch between the optimistic view of the market that considers the risk of recession as being less than 10% and what recession indicators are saying about the economy. These indicators suggest that the US is at the end of the business cycle – which is not much of a surprise – and hint that recession is just around the corner and Trump's economic policy does not seem able to avert it.



SOURCE: MACROBOND, SAXO BANK RESEARCH & STRATEGY

The most watched indicator is the persistent flattening of the yield curve (currently at 46 basis points). A yield curve inversion combined with a negative credit impulse has predicted the last five recessions.

SOURCE: MACROBOND, SAXO BANK RESEARCH & STRATEGY

Over the past decades, another reliable indicator has been the contraction in C&I loans and leases which has predicted the last three recessions. Over the course of 2017, C&I loans and leases have sharply decreased to reach the low level of 1.2% (year-on-year) in Q4.

RECESSION
– THE EVIDENCE PILES UP

Industrial Production: Nondurable Goods: Pulp, Paper & Paperboard Mills, Index [rebase 2012=100]

SOURCE: MACROBOND, SAXO BANK RESEARCH & STRATEGY

US Consumer Confidence Index vs Recession

SOURCE: MACROBOND, SAXO BANK RESEARCH & STRATEGY

Even unconventional indicators are sending warning signs. Product sales by paper and paperboard mills, which reflect the evolution of sales and therefore give a signal about the future evolution of production, have been falling since the beginning of the year. Although this indicator is certainly less reliable than in the past due to the digitalisation of the economy, there is still an obvious correlation with the economic cycle.

REMEMBER THE 'STRONG CONSUMER'?

Many are increasingly aware of these alarming signals but they often try to minimise their impact by pointing to the "strong US consumer" and the fact that consumer confidence is at its highest level since the end of 2000.

Even though we agree that history does not always repeat itself, it is interesting to note that historically, such levels of consumer confidence have been followed by recession and a lost decade. This is too much of a coincidence, is it not?

> INDICATORS SUGGEST THAT RECESSION IS JUST AROUND THE CORNER AND TRUMP'S ECONOMIC POLICY DOES NOT SEEM ABLE TO AVERT IT

US consumer confidence has returned to a high level but households' financial situation remains gloomy. Household debt is at a new record of $13 trillion and the most fragile households are starting to face serious difficulties due to higher interest rates and tightening credit conditions. Delinquencies have increased considerably over the past few months, especially in subprime auto loans where serious delinquencies have reached 'Lehman moment' proportions, as well as in credit cards.

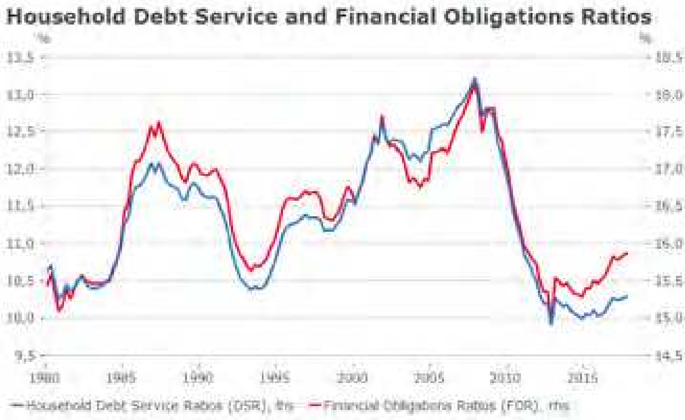
Delinquency Rate On Credit Card Loans, Banks Not Among The 100 Largest In Size (By Assets)

SOURCE: MACROBOND, SAXO BANK RESEARCH & STRATEGY

The delinquency rate on credit card loans among small banks has sharply risen in less than two years to return to its GFC peak at 5.55% in Q4'17. Although the share of small banks in the outstanding credit card total has considerably decreased since 2008, the evolution of this indicator is a bad sign that tells us a lot about the financial situation of the most fragile US households.

RECESSION
– THE EVIDENCE PILES UP

SOURCE: MACROBOND, SAXO BANK RESEARCH & STRATEGY



SOURCE: MACROBOND, SAXO BANK RESEARCH & STRATEGY

The US is a low-savings economy. In the wake of the financial crisis, however, the personal savings rate has temporarily recovered to reach a peak since 1984 at 11% before collapsing as fast as it rose to 3.4%. This decrease can be explained by structural factors – the US consumer saves little – but also by cyclical factors, as low interest rates offer little incentive to save, especially in low-risk assets. As we know, saving is all about preparing for the unexpected and, based on the evolution of US leading indicators, everything suggests that the worst is ahead for the US economy.

However, the situation is not as dark as we might think. US households are not as ill-prepared as in 2007/08. Household debt and financial obligations as a share of disposable personal income remain well below their pre-crisis levels, at 10.2% and 15.8% respectively in Q4'17, which suggests that the effects of the next recession could be less severe than in 2008 for households. The main uncertainty concerns the evolution of interest rates: if they continue to increase, so will debt payments.

> SERIOUS DELINQUENCIES IN SUBPRIME AUTO LOANS HAVE REACHED 'LEHMAN MOMENT' PROPORTIONS

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.

TACTICAL ASSET ALLOCATION IN ECONOMIC CYCLES

BY ANDERS NYSTEEN

As this current economic cycle draws towards its close, preserving capital becomes an increasingly important metric. But how to achieve this? One method is tactical asset allocation and the key to success here is to identify the asset classes which relatively outperform during the different periods of an economic cycle.

In portfolio management, asset allocation policy is an "overwhelmingly dominant" contributor to the variance in the total return, according to Brinson et al.[1] Active investment decisions and market timing do not on average improve performance as the activity is a zero-sum game minus trading costs. However, the difference in the annual performance of the active strategies was more than 600 basis points, illustrating a significant upside if active investing can be successfully implemented.

One strategy is to construct a framework in which portfolio weights deviate from the asset allocation policy throughout the economic cycle, also called tactical asset allocation. The key to success in tactical asset allocation is to identify the asset classes which relatively outperform during the different periods of an economic cycle. One approach is provided by R. David Ranson[2], in which the drivers of an economic cycle are boiled down to two indicators:

- The yearly change in Baa-Aaa corporate bond spreads which describes the financial risk in the market. Expanding credit spreads indicate increased economic uncertainty which often increases the demand for stable, safe-haven investments such as government bonds and gold.
- The yearly change in the price of gold signals currency depreciation risk which occurs when the debt of governments becomes alarmingly high through massive fiscal spending. Rapidly rising energy prices forcing headline inflation have also increased the price of gold in the past as inflation deflates the value of fiat currencies.

Based on these two indicators, basic economic scenarios are created by considering if the yearly change in the spreads and gold price is either positive, close to zero, or negative – see the coloured sectors in Figure 1. Using data since 1969, Ranson shows how specific asset classes outperform in the different scenarios. The upper part of Figure 1 contains the safe-haven assets that perform well when markets become more uncertain, in contrast to the risky assets in the lower part. Similarly, the left-hand side contains "soft" assets that are vulnerable to inflation, in contrast to the "hard" assets in the right-hand side that are boosted by inflation.

SAXO BANK'S FORECAST IS THAT CREDIT SPREADS WILL WIDEN AND THE YEARLY CHANGE IN GOLD PRICES WILL STAY POSITIVE

TACTICAL ASSET ALLOCATION
IN ECONOMIC CYCLES

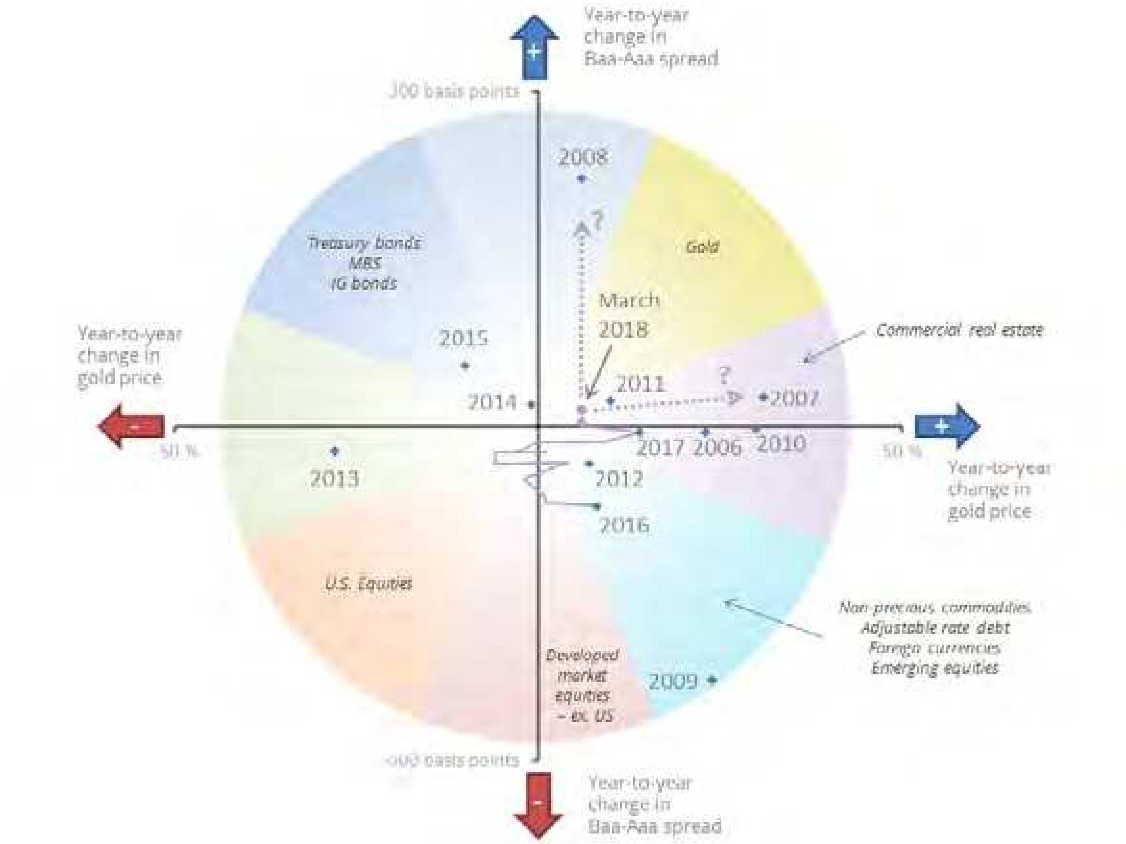


Figure 1: Favoured asset classes in the different scenarios, indicated by the coloured sectors – including the assets that outperform in the scenario. The coordinate system maps the yearly change in the Baa-Aaa spread and in the price of gold, and each diamond bullet is the end-year value. Since end-2016, the monthly indicator values are directly mapped out with the purple arrows. Source: Bloomberg. The figure is based on an illustration in R. D. Ranson's "Some Empirical Foundations for Tactical Asset Allocation"[2].

A LARGER FOCUS ON DIVERSIFICATION USING NON-TRADITIONAL INVESTMENTS

To illustrate how the two indicators have developed over the last decade, the past end-year values are included in Figure 1. They are consistent with the evolution of the recent economic environment. The global financial crisis led to a large widening of credit spreads in 2008, followed by a narrowing during the equity upturn in 2009 as credit markets began functioning again.

The large decrease in the gold price in 2013 is aligned with 2013 being the best performing year for US equities since the financial crisis. Lower gold prices in 2013 signalled that market participants were less worried about the financial system and the impact from high debt levels as easy monetary policies backstopped Europe.

TACTICAL ASSET ALLOCATION
IN ECONOMIC CYCLES

The monthly values of the indicators are specifically mapped out since December 2016 in Figure 1. In mid-2017, the indicators are in the lower left corner, aligned with the superior performance of the US equity market during 2017. The credit spread has changed from contracting to slightly expanding, indicating a move towards an inflationary slowdown. The last data point in March 2018 lies close to the centre – in the "neutral" zone – where no asset class is expected to outperform. This underlines the importance of not only having a portfolio with "soft" assets from the left-hand side, but to be prepared for sudden market changes with a more diversified portfolio including some of the "hard" assets from the right-hand side such as commodities, real estate, and emerging market exposure.

With the current slightly negative credit impulse and highly indebted financial system, minor events could trigger increased uncertainty in the market, leading to a further expansion of the corporate spreads. A potential trade war between the US and China could increase the risk premium in credit markets. This would trigger a slowdown in the economy as companies would face higher financing costs.

Saxo Bank's forecast is that credit spreads will widen and the yearly change in gold prices will stay positive... However, the consensus is looking for credit spreads to remain low and not expanding much while inflation will pick up.

[1] G. P. Brinson, B. D. Singer, and G. L. Beebower, "Determinants of Portfolio Performance", Financial Analysts Journal, 1991, 47:3, 40-48
[2] R. D. Ranson, "Some Empirical Foundations for Tactical Asset Allocation", The Journal of Wealth Management, Oct 2016, 19 (3) 62-74.

IT IS IMPORTANT TO BE PREPARED FOR SUDDEN MARKET CHANGES WITH A MORE DIVERSIFIED PORTFOLIO

ANDERS NYSTEEN, QUANTITATIVE ANALYST

Anders Nysteen joined Saxo Bank in 2016 in the Quantitative Strategies group, and his primary focus is on developing mathematical trading strategies and asset allocation models. Anders has a degree in Physics and Nanotechnology from the Technical University of Denmark and holds a Ph.D. in Quantum Photonics.

COMMODITIES
GO THEIR SEPARATE WAYS

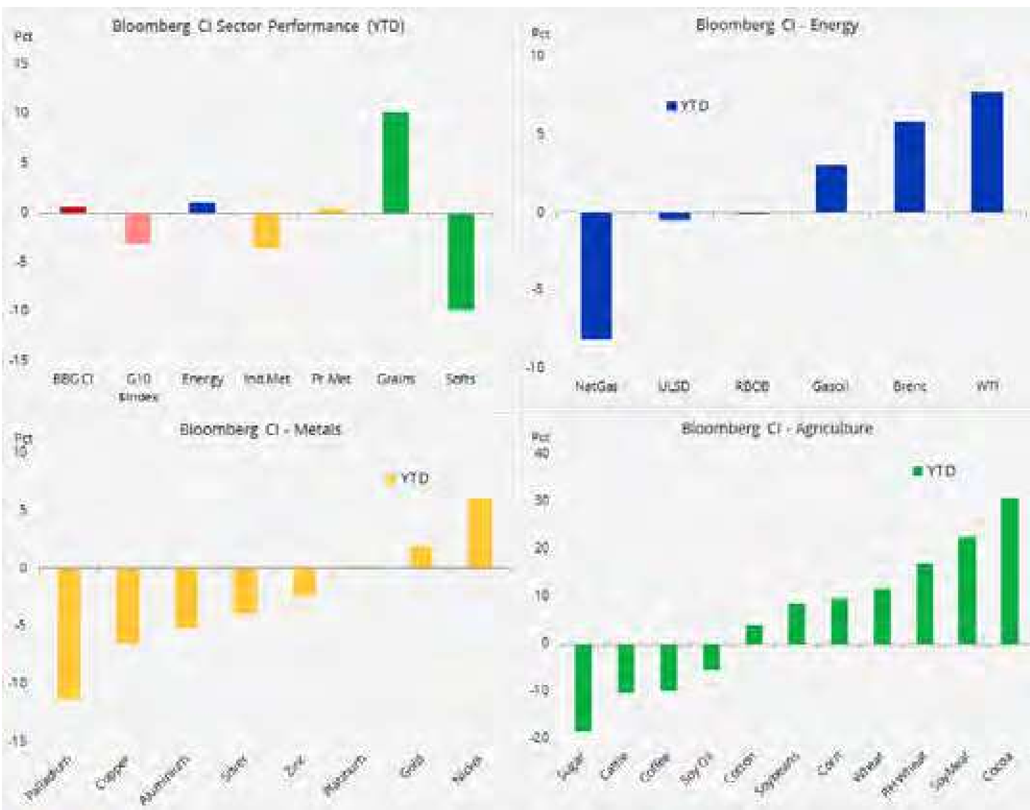
BY OLE HANSEN

The turbulent turn that geopolitics took in recent weeks has had a severe impact on commodities. But while crude oil and gold benefitted from these tensions, industrial metals suffered on the outlook to lower economic growth. The agriculture sector, meanwhile, was ruled by the weather.

Commodities got off to a strong start in 2018 but have since come under heavy pressure as rising trade tensions threatened to further undermine already slowing economic growth momentum. The focus on a commodity-supportive rise in inflation has also faded with current and forward projections not showing much sign of a pickup in global price pressure.

Against these developments we are facing multiple sources of geopolitical risk including Russia and the West on opposing sides in Syria, as well as Iran against Saudi Arabia and the US. While increasing the level of uncertainty, these simmering tensions have also been providing some underlying support for crude oil and, to a certain extent, gold. For this reason, these two commodities are among the very few cyclical commodities currently showing a plus on the year.

Given our worries about the outlook for global growth and inflation potentially not meeting expectations, we are turning our attention to the non-cyclical agriculture sector, which has underperformed almost against all other asset classes for several years.



SOURCE: BLOOMBERG AND SAXO BANK

COMMODITIES
GO THEIR SEPARATE WAYS

Crude oil has settled into a wide trading range following the second-half surge in 2017. Robust supply growth from non-Opec producers, not least from US shale, has kept the market close to balance despite the Opec+ group's continued successful agreement to curb production. While non-Opec supply for 2018 has continued to be revised higher, global demand growth has remained stable at around 1.6 million barrels/day.

Multiple events could impact this delicate balance, hence the difficulty in projection prices much further out than a couple of months at this stage. The current build-up in trade tensions between the US and China, the world's two biggest consumers, could potentially impact the demand side. More importantly, the spat in Syria and as well as President Trump's decision in May on whether to step away from the Iran nuclear deal and reintroduce sanctions, could impact the supply side.

The recent appointments of several hawks to his inner circle, not least the appointment of John Bolton as national security advisor, have increased the risk of the US applying fresh sanctions against Iran. These would likely reduce the country's ability to produce and export crude oil at the current rate.

Other sources of support are the continued deterioration in the outlook for Venezuela's ability to maintain production, as well as emerging signs of US shale oil producers struggling to meet growth expectations due to pipeline constraints.

These are some of the reasons why hedge funds continue to believe strongly in higher prices as they entertain a combined net-long in WTI and Brent crude oil of more than one billion barrels. The downside risk of such a one-sided position was last seen in late January when the flow of price supportive news paused. The 10% correction that followed can easily occur again, especially if market attention turns from supply disruptions to the risk of lower demand growth.

We expect to see Brent crude remain mostly stuck within the established $10 range with tough US-Russia tensions and US sanctions against Iran potentially giving it a temporary boost towards $75/b. Geopolitical risk spikes can be vicious but tend to lack longevity. Unless supply is threatened, such spikes could add extra non-Opec barrels while potentially raising growth and demand risk. Given the risk of additional disruptions and Opec's success in curbing production we raise our year-end call on Brent crude by seven dollars to $67/b and WTI crude by five to $62/b.

CRUDE OIL AND GOLD ARE AMONG THE VERY FEW CYCLICAL COMMODITIES CURRENTLY SHOWING A PLUS ON THE YEAR

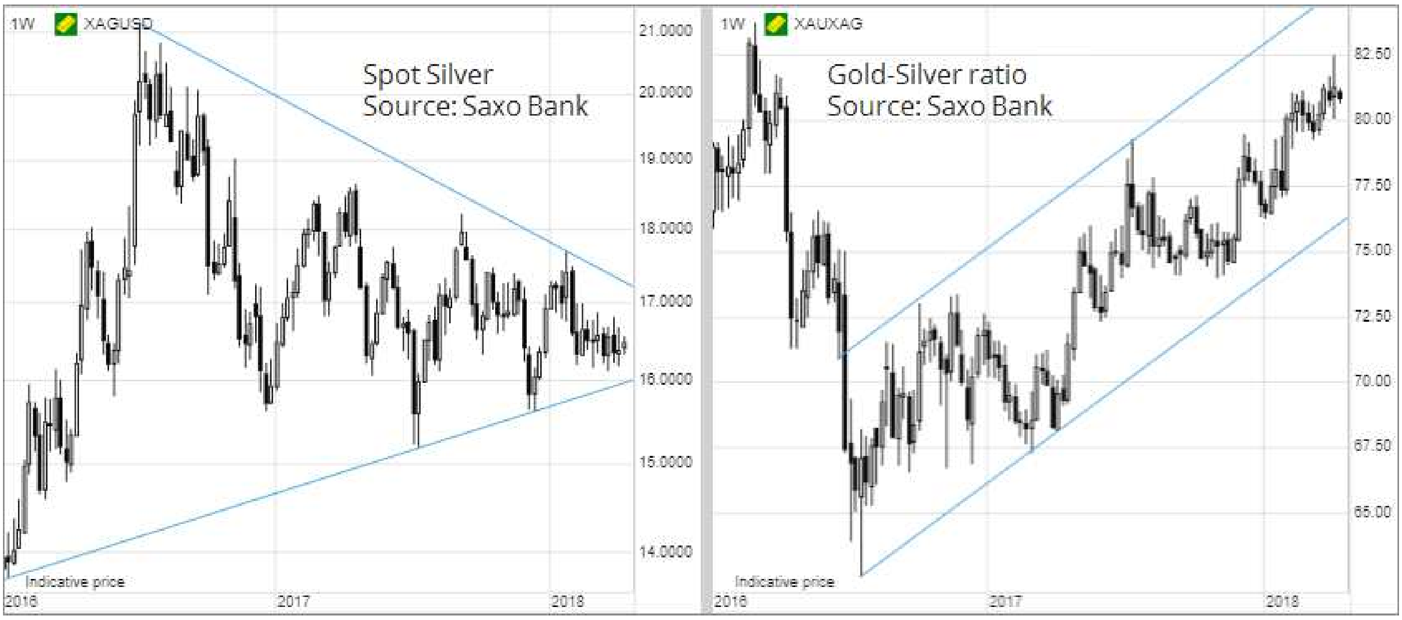
COMMODITIES
GO THEIR SEPARATE WAYS

Gold is one of a few metals that has managed to hold onto a positive return this year. However, after several failed attempts to break through the $20 band of resistance above $1,355/oz, many investors have for now adopted a wait-and-see approach. Despite the fading focus on inflation, which was a key driver at the beginning of the year, we believe that investors will continue to seek diversification and protection against trade and geopolitical tensions as well as increased volatility across global stock markets.

Recent history does tell us that the impact of geopolitical risks and events tends to be transitory unless they lead to a significant change in the economic outlook.

An escalated trade war could be a situation where growth is negatively impacted. That could lend support to precious metals as the speed of future US rate hikes slow and bond yields reverse lower.

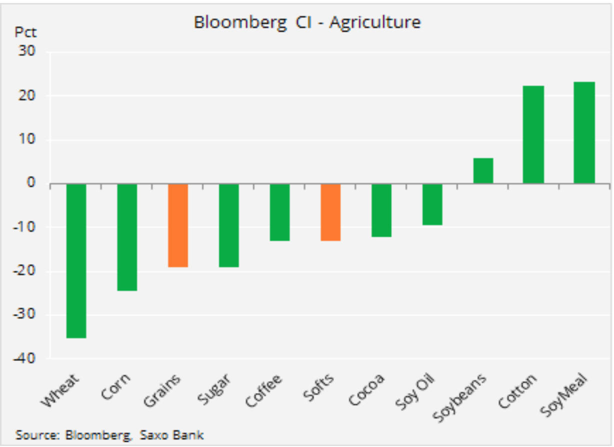
On that basis we maintain a bullish stance on gold above $1,280/oz and view a break above $1,375/oz opening up for a move towards $1,480/oz. Silver has the potential for making a comeback based on continued support for gold. This is because hedge funds hold a record and now squeezable short due to the lack of lower price action to support, as well as the fact that compared to gold, silver is relatively cheap with the gold-silver ratio trading near a two-year high.



INVESTORS WILL CONTINUE TO SEE SAFETY IN GOLD

COMMODITIES
GO THEIR SEPARATE WAYS

The grain sector, including corn, wheat and soybeans, has enjoyed a strong beginning to 2018 with rising weather premiums triggering a scramble among hedge funds to cover what at the beginning of the year was a combined record short position.



SOURCE: SAXO BANK

The rising weather premium was triggered by extreme heat in the Southern Hemisphere and extreme cold and drought across the northern one.

This has ensured a battle between high stock levels left over from recent bumper crop years versus a very uncertain production outlook. The second quarter in the US will be pivotal with planting intentions to a certain extent being driven by weather and the relative price between the different crops.

The three-year performance of key agriculture futures including roll cost:

	YTD	1-year	3-year	5-year
BBG CI	0.6	4.1	-9.6	-33.4
Energy	0.9	5.1	-27.2	-58.4
Ind.Met	-3.3	18.6	15.2	-4.0
Pr.Met	0.5	1.9	5.6	-24.5
Grains	10.4	-1.0	-19.0	-40.1
Softs	-9.5	-18.3	-13.2	-38.9

SOURCE: BLOOMBERG COMMODITY INDEX, SAXO BANK

An additional and very important focus during the coming months will be the ongoing trade war rhetoric between China and the US. As a retaliatory measure against the US' proposed tariffs on Chinese imports, China, in a tit-for-tat move, threatened to hike import taxes on a range of US products, including soybeans, whose price slumped 5% before recovering.
China is the world's biggest buyer of US soybeans but once the dust settles it is very unlikely that the US and China can live without each other, as other major exporters – especially in South America – are unable to meet China's fast-rising demand. Last year, Brazil already supplied half of China's soybean imports, with the US shipping around one-third or 33 million tons valued at $12 billion. The short-term impact of unrealised tariffs could actually support US soybeans due to their relative cheapness to Brazilian beans.
The combination of a potential challenging planting season (the first since 2014), rising energy costs, a weaker dollar, hedge funds rebuilding long positions, and not least the non-cyclical credentials of agriculture products could see this sector return to life following years of underperformance.

There are multiple ways of getting exposure to the agriculture sector. Individual products can be bought and sold either through futures, CFDs or ETFs. Given the volatility often seen we favour a broad-based approach through ETFs tracking a specific sector or the agriculture space as a whole.

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.

A REGIME CHANGE
LOWER IN AUD

BY KAY VAN-PETERSEN

The APAC region's demographic health means a rosy outlook over the longer-term, but policy divergence could spell a pronounced decline in the Australian dollar over Q2 and beyond.

> FOR THE FIRST TIME IN OVER A DECADE, US BONDS YIELD MORE THAN THEIR AUSTRALIAN COUSINS

In the long term, Asia's enviable demographics see the APAC region enjoying some of the best returns across asset classes compared to its global peers. Not only does the populous region have more economic "chips on the table" in weighted terms, but it also has more time to place those chips, employ its strategies, and – perhaps most importantly – make mistakes.

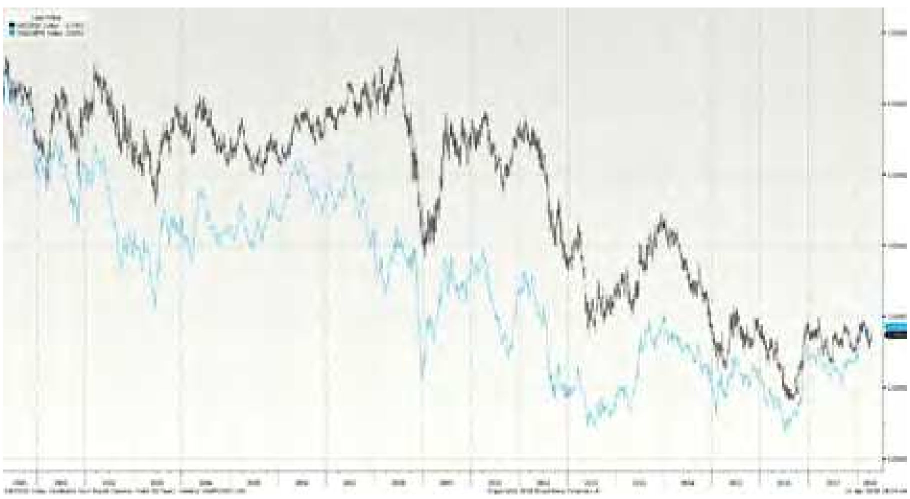
While 2018 earnings growth for China and Japan are forecast at 15% and 13% respectively, falling well short of the 25% expected by the consensus in the US, the trend still bodes well for APAC given that the US trend will dictate Asian risk sentiment levels in the near-term.

The overall theme of rising credit conditions and normalisation is set to continue, we already saw this at the start of the year with the surprise rate hike from Malaysia (South Korea towards end of last year) and it's a trend we can expect to continue, with the likes of Indonesia potentially set to hike at some point this year.

We are, however, seeing a lag in interest rate-driven regime changes and nowhere is this more apparent than in the AUD and NZD pairs. It is for this reason that we expect the second quarter of 2018 to see a protracted decline in the AUD, with an ultimate Q3-early Q4 target of 0.70-0.73 in AUDUSD.

A REGIME-CHANGE IN AUD

For the first time in nearly 20 years, we see a yield differential between the Reserve Bank of Australia and the Federal Reserve that actually favours the Fed. At present, the Federal Funds rate sits at 1.75% versus the RBA's 1.50% – a 25 basis point premium towards the Fed, USD, and US assets versus their Australian counterparts.



A REGIME CHANGE
LOWER IN AUD

Policy divergence between the Fed and other central banks is projected to increase as well, particularly given the likelihood of another Fed rate hike on June 13. The RBA, by contrast, has been in neutral-to-dovish mode for well over 18 months and this is unlikely to change. After all, Australia is an economy flush with high levels of consumer debt, a fragile and over-extended property market, stretched bank balance sheets, and the risk that comes with not having endured recession in more than 25 years.

Remember the traditional argument for holding Australian debt? The "highest-yielding AAA developed market sovereign" narrative? It no longer applies. For the first time in over a decade, US bonds yield more than their Australian cousins. This is a regime-change event wherein a traditional carry currency that used to be funded by the sale of US dollars is reversing its role and potentially becoming a funding currency for the USD carry trade.

With the market expecting a total of three 2018 rate hikes for the US and none for the RBA, this year could see the central bank spread between the two countries widen to 0.75%.

This view of a protracted decline in AUD echoes the risks identified by Saxo Bank chief economist Steen Jakobsen, who sees the likelihood of recession nearing 60%, versus the consensus 10%, on the warning notes being issued by credit impulse. Australia is the highest-leveraged country to global growth and China overall, hence any slowdown would materially impact AUD.

The best cure for recessions and bear markets is to maintain a cross-asset allocation, as this not only dampens volatility but ends up giving higher adjusted returns.

AUSTRALIA IS THE HIGHEST-LEVERAGED COUNTRY TO GLOBAL GROWTH AND CHINA OVERALL, HENCE ANY SLOWDOWN WOULD MATERIALLY IMPACT AUD

KAY VAN-PETERSEN, GLOBAL MARCO 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.

TIME FOR BONDS
TO JOIN THE VOLATILITY PARTY

BY ALTHEA SPINOZZI

We are witnessing a gradual degradation of corporate credits, and an increase in bond market volatility appears likely over the coming months.

The first quarter of 2018 has been quite entertaining. Not only we have seen volatility picking up for the first time in years, but the Trump administration has given us plenty of reasons to stay up into the wee hours of the night reconsidering the risks and effects of new policies within what remains a globalised financial market.

Equity traders had all the fun, while in the fixed income space the uncertainty that characterised Q1 kept bond yields subdued. The real question is how much longer 10-year US Treasury yields can trade below the key psychological level of 3%?

It will be hard for 10-year Treasuries to keep trading around 2.80% with the Federal Reserve seeming confident about the future and focused on a tightening path. It also seems that it will prove necessary for the Treasury to keep increasing bond issues for fiscal deficit funding, adding further upward pressure to yields. Additionally, US yields could see more pressure still if China reduces Treasury purchases in the event of a trade war.

With the Congressional Budget Office now saying that the US deficit will rise above $1 trillion by 2020 (two years sooner than expected) and warning of dangerous implications such as a sudden increase in interest rates, reduced policy flexibility and ultimately even a financial crisis, we cannot help but stay cautious.

We believe that in Q2 we will see intensifying signs of distress in the corporate space which may provoke confined periods of volatility, but a more severe sell-off will not happen until the end of the year.

SIGNALS OF DISTRESS

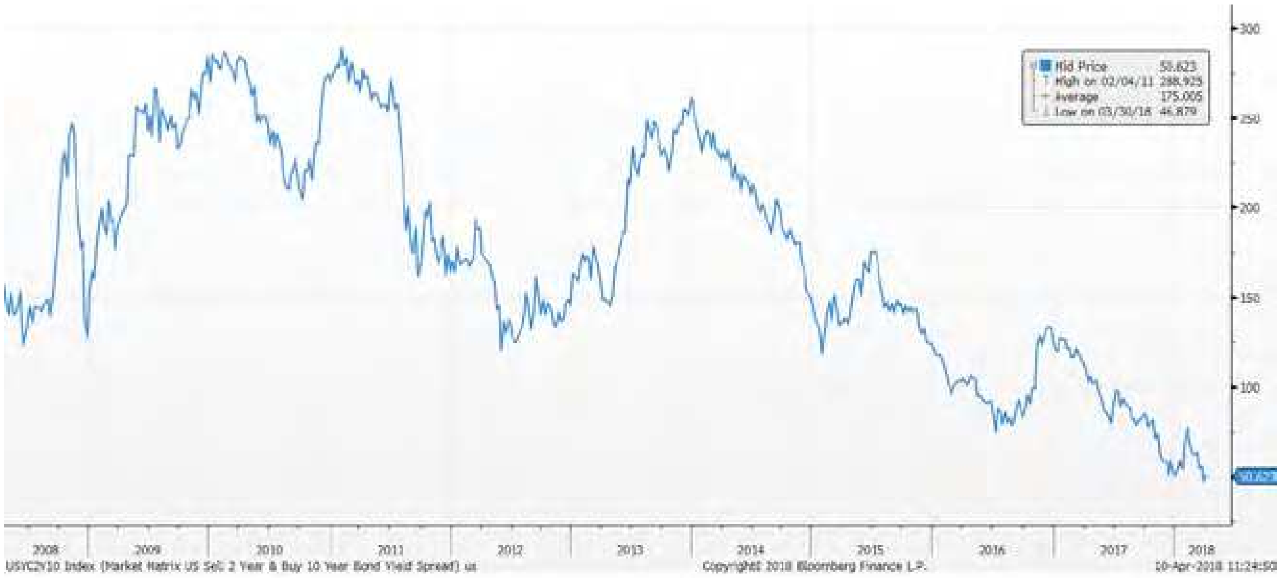
Starting with the US yield curve, we can see that even though Treasury yields have been pushed up by a tighter Fed, the curve is slightly flatter compared to the beginning of the year, and the spread between US 10- and two-year yields is at its lowest since 2007. This can be explained by the fact that while the Fed increases short-term rates, there continues to be buying pressure on the long end.

At the same time, with the US Treasury issuing more and more bonds in order to fund its fiscal deficit, there is a sharp decline in scarcity value of Treasuries – a trend that we haven't been used to seeing in a decade.

INVESTORS SHOULD BE WORRIED THAT LOWER INVESTMENT GRADE US CORPORATE BONDS ARE ACTUALLY WIDENING FASTER THAN HIGH-YIELD US CORPORATE BONDS

TIME FOR BONDS
TO JOIN THE VOLATILITY PARTY

10-YEAR/TWO-YEAR SPREAD:



SOURCE: BLOOMBERG

It is important to note that a flatter yield curve doesn't necessarily constitute a problem. However, if other credit indicators also start to sour, the situation could worsen faster than expected.

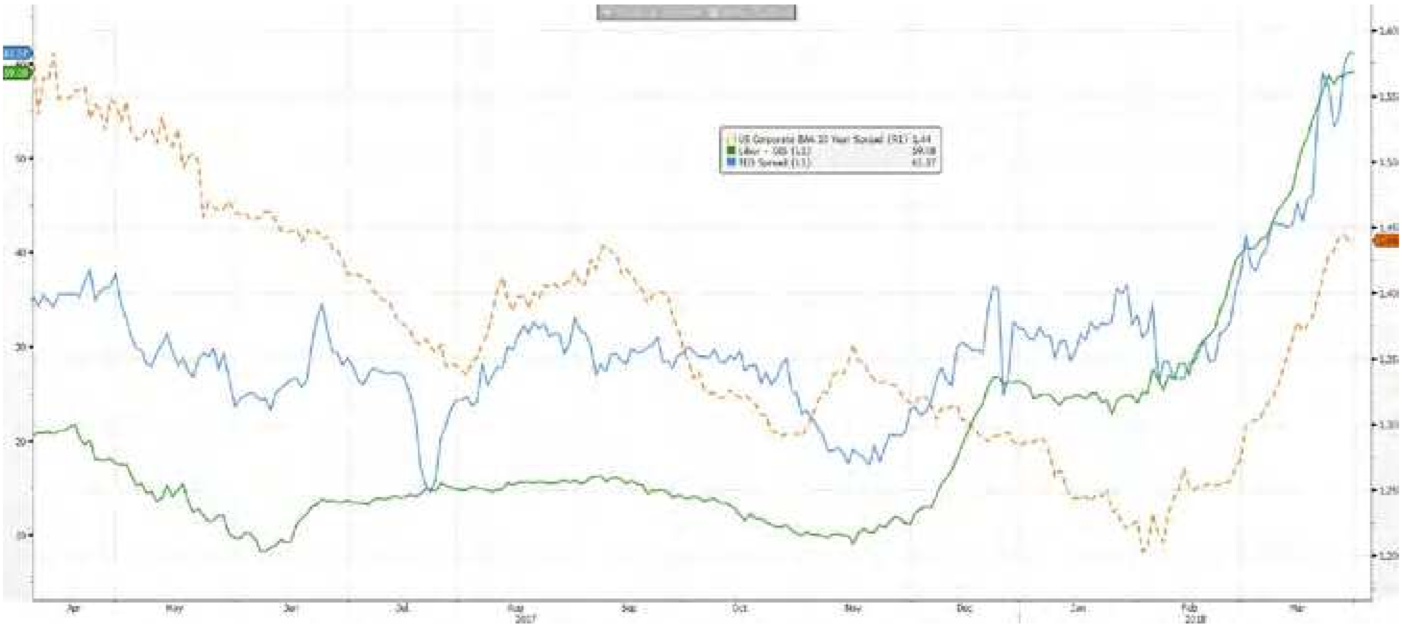
The Libor-OIS spread has touched new highs since 2009 and bonds will thus see new pressure. Many have undervalued the recent upward trend of the Libor-OIS spread, pointing to the fact that it could represent a primarily technical signal (caused most probably by Fed tightening measures and the pickup up in Treasury issuance), but we believe that a widening of the Libor-OIS spread has a more profound meaning and clearly indicates a rise in funding costs.

Rising funding costs combined with a continuously flattening yield curve can quickly become a liquidity trap for lower-rated, capital-intensive businesses.

Most alarmingly, the Libor-OIS spread is not the only credit spread to have widened. As we can see on the chart below, Q1 saw the TED spread and the BBB/Baa corporate spread widen in the US as well. As credit spreads trend upwards, it is safe to believe that Q2 will see a further deterioration in credit spreads, provoking a possible sell-off when the investors start to feel more nervous about risky assets.

TIME FOR BONDS
TO JOIN THE VOLATILITY PARTY

10-YEAR/TWO-YEAR SPREAD:

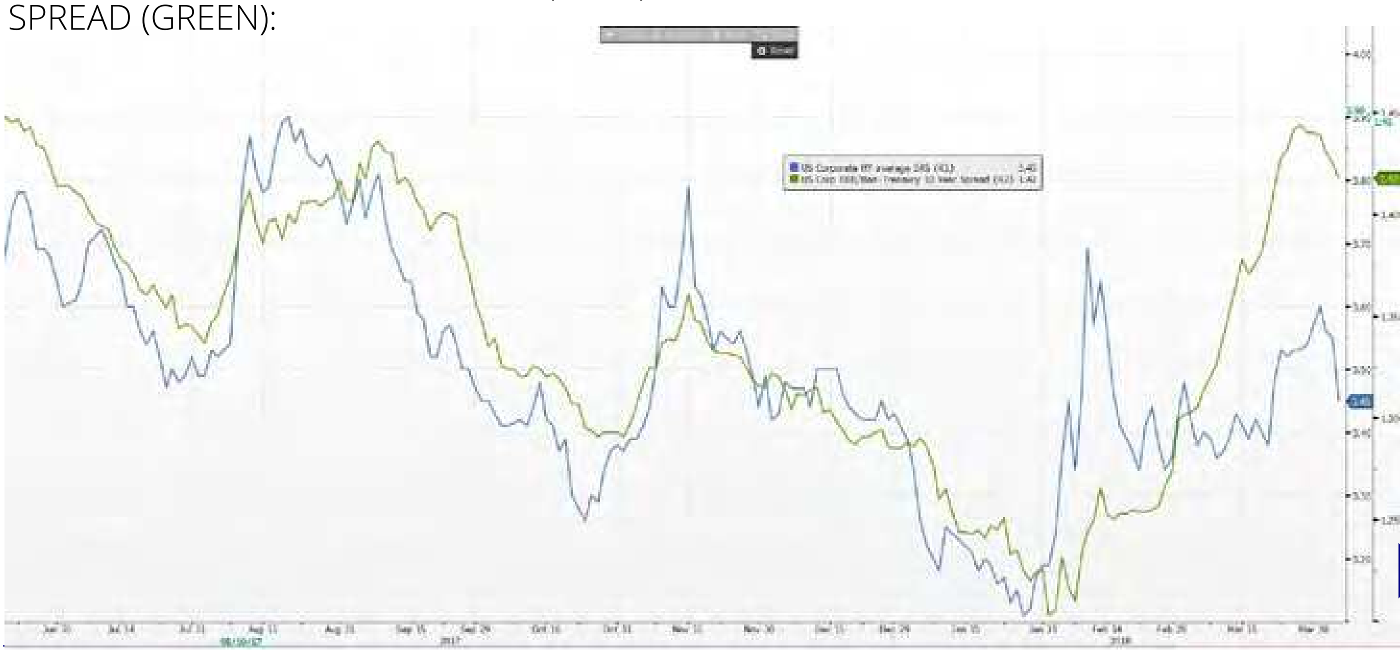


SOURCE: BLOOMBERG

The chart above reveals another important point: corporate bonds within the lower investment grade space (BBB/Baa) are widening surprisingly fast. The chart below combines investment grade versus high-yield spreads, and illustrates that the former are widening faster than the latter.

Investors should be concerned about this trend, as it is a clear sign that valuations are too tight according to the rising risk.

US CORPORATE HY AVERAGE OAS (BLUE), US CORP BBB/BAA-10-YEAR TREASURY SPREAD (GREEN):



SOURCE: BLOOMBERG

TIME FOR BONDS
TO JOIN THE VOLATILITY PARTY

The reason for the accentuated widening of lower investment grade spreads lies in the decline of credit quality in this space. At the moment, BBB- rated bonds – the lowest investment grade rating – account for approximately half of the IG market, and the average leverage of companies in this rating category has increased threefold compared to two years ago.

This has happened as companies have lined up to take advantage of favourable market conditions by issuing more bonds or refinancing existing debt. To make things worse, merger-and-acquisition activity has picked up lately, meaning that IG companies looking to acquire or merge with weaker market participants now would face higher leverage than investors accounted for, provoking an increase of yields in this space.

A good example here is the planned acquisition of AETNA by CVS. Last month, the big pharma retailer released a $40 billion multi-tranche issue to finance the acquisition. Investors, however, soon realised that the overall leverage of the group would rise over 4x, and thus felt entitled to more yield.

RISKS AND OPPORTUNITIES

It is therefore clear that Q2 will see more weakness affecting the bond market, and that any negative news may serve as a catalyst to provoke a sell-off within the bond space.
This should not deter investors as it is in uncertain moments like this that we can take advantage of the market and find exciting opportunities.

We believe that in a volatile environment characterised by rising interest rates, the following products could prove to be the riskiest:

- Weaker emerging markets: In the past few years, emerging markets have issued more and more hard currency debt. Although the USD has been losing value since the beginning of 2017, the Fed is on course to tighten monetary policy and this should support a stronger dollar in the long run. Tighter monetary policy will also lead to an increase in yields, which combined with a stronger dollar can cause considerable outflows in already highly leveraged economies. Another reason for weakness in this space is the rising trade tension between the US and its trading partners. This will make developing economies exporting to the US even more sensitive to other factors such as commodity prices.
- BBB- rated bonds: As mentioned above, companies in this space have increasingly become leveraged compared to higher graded names. As interest rates are rising, we can expect further volatility within BBB- bonds while higher graded bonds should tighten as they are perceived as being safer.
- Contingent convertibles: These instruments are the most sensitive to volatility and credit degradation. Although they have returned +35% since mid-2014, they are performing poorly year-to-date due to several factors including increasing interest rates and the high volatility in the equity market that provoked a modest sell-off of riskier credit names. With credit conditions worsening (i.e. the rising Libor-OIS spread and the flattening of the yield curve) we can expect this asset class to suffer bigger losses.

THE PROBLEM IS THE SIZE OF THE BOND MARKET COMPARED TO THE MARKETPLACE OVERALL

TIME FOR BONDS TO JOIN THE VOLATILITY PARTY

On the other hand, we can find interesting opportunities in:

- Blue-chip bonds: This is the classic trade. When volatility rises, buying safe assets guarantees better returns. We believe that bonds of blue-chip companies may serve this function better than Treasuries because, as we explained above, the latter are under pressure due to the Fed tightening and the necessity of the Treasury issuing more bonds to double up its borrowings and pay for the growing budget deficit. Also, blue-chip corporates can be more resilient to "Trumpolitics" given that the majority of these companies maintain global operations.
- Short-term, high-yield bonds: Although weaker credits are normally the first to suffer from rising interest rates, we believe that interesting opportunities can be still found within short-term, high-yield bonds. Defaults are still at historic low levels and looking at maturities up to three years, investors can find still risk-reward opportunities that would enable them to lock in yield for a specific period.
- Retail sector: We believe that Q2 will remain characterised by late-cycle pressures which consist of an overheated but still growing economy and a gradual rise of inflation. In this environment, retailers should benefit from higher profit margins with consumers likely to spend more as they are still benefitting from economic growth and still-high equity markets.

We believe that investors' focus will remain on inflation and the supply/demand of Treasuries, and any surprise in these data may cause volatility within the sovereign space.

However, this will most likely not cause a sell-off in the corporate space until the 10-year Treasury yield hits the 3% psychological level or there is a more significant sell-off within the equity market. Although there is an obvious deterioration of credits, this may not be a good enough reason for investors to sell riskier assets as they know that central banks are distorting markets' behavior like never before.

In Q2 we will see increased, yet limited, episodes of volatility which will provide investors with a window of opportunity in which to carefully select risk ahead of the stormier waters to come. It is time to acknowledge that we are entering an environment of rising interest rates and that this will not affect bonds equally.

This is why it is important to look beyond the mainstream for opportunities, keeping one eye fixed on diversification.

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.

ARE CRYPTOCURRENCIES ENTERING A NEW CYCLE?

BY JACOB POUNCEY

Cryptocurrencies fell back to earth with a bang in the first months of this year, having enjoyed exponential growth in 2017. The situation remains fragile, given the outlook to increased regulation and social media advertising bans. That said, we can't rule out the possibility of a comeback.

If 2017 was the party year for cryptocurrencies, then Q1 of 2018 was the hangover with Bitcoin losing 52% of its value.

The steep losses have driven industry consolidation. The rush to market was badly timed and a number of crypto asset hedge funds, exchanges, and ICOs have shut down already.

The market has seen several acquisitions of crypto exchanges from financial firms such as Goldman Sachs-backed Circle acquiring Poloniex, Monex Group acquiring Coincheck, and Yahoo Japan buying a 40% stake in BitARG Exchange Tokyo.

Increasing regulations are still on the horizon as the G20 and other countries are aiming for specifications by the end of the year.

An additional headwind has been numerous social media platforms including Google and Facebook prohibiting the marketing of ICOs.

Finally, from a macro perspective, the era of loose credit seems to be closing and geopolitical tension is rising.

> THE STEEP LOSSES OF Q1 HAVE DRIVEN INDUSTRY CONSOLIDATION

In addition to the possible increase in regulations leading to further declines in the short term, the continued sell-off of large blocks of cryptocurrency, such as the Bitcoin cache of the MtGox trustee, could result in continued selling pressure across the market. However, several events could serve as springboards for a cryptocurrency bull market in Q2, whether it is through fundamental drivers, or it is just a self-fulfilling prophecy.

ARE CRYPTOCURRENCIES ENTERING A NEW CYCLE?

If there is a significant pullback in the equity markets, there will be an inflow of money into uncorrelated assets, or assets that lie outside the reach of the traditional financial system in which cryptocurrencies are a potential alternative. Historically, many of the blue chip cryptocurrencies have seen price increases in the face of global uncertainty and risk-off events such as Brexit, the election of President Trump, and the North Korean missile tests.

The inflow of institutional capital to the cryptocurrency market due to the increase in regulation and investor protection could lead cryptocurrencies to a positive quarter.

In my opinion, we will eventually see the end of the current, negative cryptocurrency cycle, as many of the weak hands have been shaken out by the bear market and the remaining investors are on the ready to latch onto any good news after the bad start this year.

> SEVERAL EVENTS COULD SERVE AS A SPRINGBOARD FOR A CRYPTOCURRENCY BULL MARKET IN Q2

JACOB POUNCEY, CRYPTO ANALYST

Jacob Pouncey first joined Saxo in 2017 as their go-to crypto guy. He has followed the cryptocurrency and blockchain space since 2013. Jacob focuses on delivering in-depth crypto market analysis. He has a deep understanding of the technology and fundamentals that drive the Crypto Asset space.
Jacob tends to focus on medium and long-term indicators for market analysis.

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