Danske Invest
Outlook for Q4
2016

Investor brief

All eyes on the US – we have capped risk

We have no significant expectations for global equity markets in Q4 – either positive or negative – and therefore have a neutral weighting on global equities. Not least the upcoming US presidential election and an expected US rate hike in December have capped our risk appetite for the final three months of the year.

- Neutral risk-weighting on global equities
- Uncertainty due to US presidential election and potential rate hike
- European growth to slow slightly

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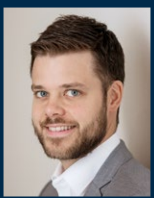
All eyes on the US – we have capped risk

There appear to be few events in Q4 that could stimulate global equity markets positively. We expect growth in Europe to slow slightly, though Chinese growth should prove surprisingly resilient, while the US outlook is heavily dependent on the outcome of the presidential election and a potential interest rate hike. Given these scenarios, we have a neutral weighting on equities and a cautious stance on risk. In other words, the share of equities in our portfolios is at its expected long-term level and we are wary of investing in higher risk assets like equities and corporate bonds. We were more positive earlier in the year and had an overweight of US equities.



By Jan Holst Hansen, chief analyst at Danske Invest

A BRIEF RECAP:

Brexit volatility easing

Volatility in the wake of the UK Brexit vote has eased and the global equity market has slowly regained lost ground. Central banks were very much the focus of attention in Q3, with both the Bank of Japan (BoJ) and the Bank of England (BoE) easing monetary policy. The BoE cut interest rates and reintroduced loan programmes to the financial sector, while the BoJ set a 0% target for the yield on 10-year government bonds going forward. In contrast, the European Central Bank (ECB) disappointed. Many had expected the ECB to ease further, but these expectations were not met.

Mixed data from the US

Market expectations of a rate hike from the US central bank, the Fed, were already waning and indeed the Fed let rates remain unchanged. US economic data were slightly mixed in Q3 and disappointed on several fronts at the end of the quarter. Extremely low government rates and yields increased investor demand for excess return, which has helped risk assets like corporate bonds, equities and emerging market bonds. Overall, the global equity market ended the quarter slightly up.

LOOKING AHEAD:

An election and a rate hike

The US will grab much of the attention in the final quarter of the year, with two major events lined up – the presidential election and a long-awaited rate hike, though that could potentially be postponed again. Hillary Clinton winning would mean continuity, while a win for Donald Trump would stoke global uncertainty. The news-flow in the run-up to the election could also affect the market negatively, especially if the probability of a Trump win increases. We estimate that any negative fallout on the equity market from a Trump win would be met by a Fed determined to do all in its power to restore calm, including cancelling a potential December rate hike. Whatever negative impact there might be would be more keenly felt in the US than by global equity markets, while we expect a Clinton win would be moderately positive for US equities. Given this scenario, we have decided not to take on any more risk ahead of the election.

Flat outlook for global equities

In Europe, we expect the positive effects in Q3 of lower oil prices and a cheaper EUR to fade and the economy to slow in an environment with few potentially positive events for the equity market. In the emerging markets, we expect China – perhaps surprisingly – will be able to sustain growth levels due to further government stimulation. Many emerging market nations have benefited from more stable local currencies and firmer equity prices, but we expect equity markets to level off in Q4. Overall we see little opportunity for significant growth in global equity markets during the final three months of the year.

USA:

Growth picking up

Q3 ended on a surprising note in the US, as business confidence in both the service and manufacturing sector fell significantly in August. The decline was unexpected and we can find no reasonable explanation other than the fall came in the wake of some very sharp – and perhaps slightly exaggerated – increases the previous month. Hence, business confidence may simply have corrected towards reality in August. At the end of Q3, the US economy was growing by less than 2%. Looking ahead to Q4, we expect the economy will pick up again and return to annual growth rates of between 2% and

▸▸ 2.5%. We see the US housing market, in particular, strengthening on the back of robust underlying demand – plus the banks have become more willing to lend.

Contradictory trends
We expect to see both a stronger labour market and rising inflation as the quarter progresses and hence a rate hike, although certain events could of course push a rate hike further into the future. We do not expect a rate hike would have any great impact on the markets, as the Fed would be careful to signal that future rate hikes should unfold at a very modest pace. With gently accelerating economic growth on the one hand and a rate hike and uncertainty over the presidential election on the other, Q4 will see contradictory trends pulling in opposite directions,

> *Hillary Clinton winning would mean continuity, while a win for Donald Trump would stoke global uncertainty.*

which is also why we forecast US equities to remain flat overall for the quarter.

EUROPE::
Favourable influences will fade
Europe could in many ways be described as a growth miracle in 2015 and H1 2016. While other parts of the global economy have been struggling, Europe has experienced decent economic growth throughout the period, with a helping hand from lower oil prices, a cheaper EUR and a bank system that is beginning to lend again. However, we estimate these favourable influences will begin to fade in Q4, though we expect the ECB's accommodative monetary policy will continue, albeit not at the same level.

Growth set to slow
With respect to monetary policy, we do not expect the ECB to deliver a rate cut in Q4 but rather to adjust its asset purchase programme to include buybacks of bonds in southern Europe. The move could have a slightly positive effect on European equities, as southern Europe continues to face problems, so bond market support would be positive for risk appetite in general. However, this must be seen against our expectation of European growth slowing in the final quarter of the year. Europe's ▸▸

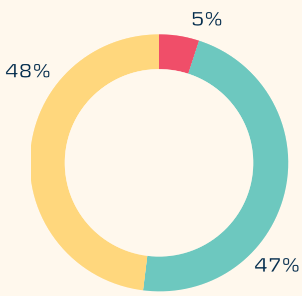
ALLOKERINGS SCORECARD

Current expectations on various asset classes on a scale from -3 (negative) to +3 (positive)[1]	Outlook (-3 -2 -1 0 +1 +2 +3)	Conviction (1-5)
Equity, developed markets	0	2
Equity, global emerging markets	0	3
Global inflation-linked bonds	0	2
EU short bonds	0	4
EU long bonds	0	2
EU investment grade bonds	+1	2
EU high-yield bonds	+2	2
US high-yield bonds	0	2
EU senior bank loans	+2	2
US senior bank loans	+1	3
Emerging market debt (HC)	0	2
Emerging market debt (LC)	+1	3

	Outlook (-3 -2 -1 0 +1 +2 +3)	Bias
Market risk (3 mth.)[3]	+1	Up
Risk appetite	0	Neutral

GLOBAL MACROECONOMIC OUTLOOK

Most likely macroeconomic development over a 6-month horizon.*



RECESSION
5% (negative and falling growth)

RECOVERY
0% (negative growth, but turnaround under way)

EXPANSION
47% (positive and accelerating growth)

SLOWDOWN
48% (growth is positive, but slowing)

▸▸ economy is currently growing at 1.5%, but we expect this to decline to around 1.0% over the quarter. All in all, that means we do not expect to see any particularly positive developments in the European equity market.

EMERGING MARKETS:

Focus on the Fed and China

Emerging markets will face two major global risk factors going into Q4. The first is whether the Fed will hike interest rates, while number two is how the Chinese economy develops going forward. EM equity markets have had a fantastic year so far, in part because the countries have managed to stabilise their currencies. When emerging market currencies strengthen, companies' earnings are boosted, and this has been a welcome positive effect after many years of headwinds.

However, the FX tailwind is a one-off effect and we do not expect emerging market currencies to continue strengthening. We therefore look for stability in Q4 rather than a further period of firming currencies. While a US rate hike often has negative consequences for emerging markets, in part because of the subsequently stronger dollar, we expect the impact will be limited by clear signals from the Fed that future rate hikes will be made at a very modest pace. That should mean stability rather than pronounced increases in the equity market.

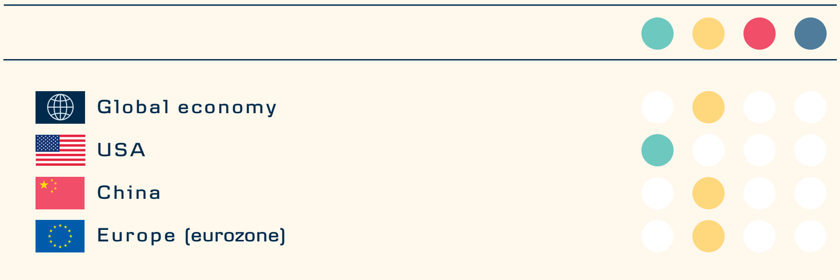
Growth levels sustained

Turning to China, the authorities have set a growth target we expect they will diligently pursue. If the economy disappoints, the government will enact further fiscal stimulation, and if the economy does not disappoint, stimulation will ease. We therefore expect the Chinese economy to remain on an even keel in Q4 and thus achieve the stated growth target of around 6.5% for the year. Hence, the growth outlook for China is quite undramatic , neither positive nor negative in the final quarter of the year. This also fits with what we expect of developments in much of the rest of the world – though with the notable exception of the US presidential election as a potentially dramatic climax.

> *Europe could in many ways be described as a growth miracle in 2015 and H1 2016.*

CURRENT MACRO BAROMETER

Danske Invest's Macro Barometer describes the current strength of the global economy and the economies of the US, Europe and China. Danske Invest regularly uses the Macro Barometer as a guide for asset allocation – in other words, how investments should be divided between equities, bonds and corporate bonds. The Macro Barometer differentiates between whether the economy is in recession or expansion (growth) and between whether growth is accelerating or slowing. This then gives four possible phases in all for a particular economy at a particular time.



EXPANSION – positive and accelerating growth. Equities and corporate bonds typically perform best, while rising yields hit the return on bonds.

SLOWDOWN – growth is positive, but slowing. It is not clear which asset will perform best in this phase. Themes and trends play a greater role than normal for market developments.

RECESSION – negative and falling growth. Government and mortgage bonds typically outperform equities.

RECOVERY – negative growth, but a turnaround is under way. Equities and corporate bonds typically perform best, but as yields are still falling, bonds also do well.