TradingFloor·com Insights

Quarterly Outlook

Q3 · 2013

Waiting for reality to hit

STEEN JAKOBSEN, Chief Economist

“The next peak in economic cycles and assets will come in 2017, so enjoy it while it lasts”

SAXO BANK

Welcome to Saxo Bank and TradingFloor.com's Insights Q3 Outlook.

In this issue, we feature a range of differing opinions from our analysts.

At Saxo Bank, we have embraced the concept of freedom of speech and therefore do not pursue one centrally dictated market view. Instead, our analysts are encouraged to voice their differing opinions on a wide range of global topics and news and how it impacts their areas of speciality, which includes commodities, equities, forex and macroeconomic insights.

From Steen Jacobsen's "Waiting for reality to hit" analysis, in which he writes the third quarter will mark the end of the "extend-and-pretend mentality", to John Hardy's "The calm before the storm" commentary on global forex markets, we believe the variety and depth of our Q3 report will give you insightful guidance to help you make informed decisions about your investments.

Freedom of speech is an important tenet of Saxo Bank and our Insights Quarterly Outlook is a reflection of that. We hope you enjoy reading it as much as we did.

Kim Fournais
Co-founder and CEO of Saxo Bank

Lars Seier Christensen
Co-founder and CEO of Saxo Bank

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CONNECT WITH LARS:

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Waiting for reality to hit

The third quarter is looking good for assets, but it will also mark the end of the extend-and-pretend mentality.

by STEEN JAKOBSEN, Chief Economist

The stock market continued to rally in the second quarter and early into the third, going full steam ahead and defying the law of gravity and investment sanity. But will we see anything new for the rest of the third quarter? Or is waiting for a return to reality and normalisation, similar to Samuel Beckett's characters Vladimir and Estragon, just like waiting in vain for Godot?

In today's world, the "Godot" we are waiting for is the wake-up call – the reforms needed to get the world economy back to normal, where the fuel for robust markets is not easy money, zero interest rates and negative real rates, but rather, innovation, real risk-taking and, equally important, real loss-taking. This is something we have not seen in earnest since before Alan Greenspan, the previous US Federal Reserve chairman. The high-probability scenario from here is one in which we hit new highs in the third quarter for stock markets – in the order of 1,750 or even 1,800 for the US S&P 500 Index. This is based on the tailwinds of managed earnings and a US Fed that is reluctant to end the easy money despite the obvious need to do so. Ironically, continued sluggish growth figures out of the US and core Europe, while not perfect conditions for the economy, seem to be ideal for the ongoing equity market rally because this keeps the wake-up call on hold.

But make no mistake: What I have called the "Bermuda Triangle" of economics (low growth, high stock markets and high unemployment) is not a sustainable reality. It's an illusion and one that will become increasingly painful to extricate ourselves from the longer we continue to believe that it is real. The market backdrop in Q3 has nothing to do with economic fundamentals, but has much to do with whether politicians will continue to be able to buy time like they've been doing since 2008. Their loyal brothers in arms since 2008 have been the central banks, even if this year has seen the first rumblings – mostly from the US Fed, if somewhat fitfully – that quantitative easing (QE) cannot last forever and a normalisation will eventually be necessary. Indeed, the Bank for International Settlements, which some might call the central bank of central banks, even recently warned in no diplomatic terms that the concept of "as much as it takes" monetary policy had its limits and actually, if performed continuously, would hurt the ability and incentive structure of reforms.

In other words, the risk is that central banks increasingly find their own actions questionable and that, in itself, should be a

"The third quarter could be where even the slowest of investors get hooked on the stock market and its ability to climb the wall of worry, even if the driver is a tailwind of central bank puts and a supporting cast of politicians only too willing to delay any real reform."

dire warning for investors as they have been the main driver taking asset markets to such heights by aggressively mispricing the price of money and, therefore, the price of risk since the global financial crisis struck.

The combination of disbelief that the party will ever end and ongoing sluggish economic conditions suggests a belief that the central banks will not alter the status quo. But the issue remains that the Fed continues to talk up a tapering of its asset purchases as it can't maintain emergency conditions forever. The timing of a withdrawal of liquidity, given the economic backdrop, does, however, look awkward.

US growth projection for the first half of 2013 is par for the course at 1.7 percent. Our forward-looking indicators don't see any improvement or worsening, so we expect 2 percent growth for the full year after 2.2 percent in 2012. The slowdown this year is a product of tax-code adjustments and fiscal spending cuts at the margin, as well as a world economy on the ropes and a weaker US consumer (or, rather, one with less disposable income to spend).

The third quarter could be where even the slowest of investors get hooked on the stock market and its ability to climb the wall of worry, even if the driver is a tailwind of central bank puts and a supporting cast of politicians only too willing to delay any real reform. And why should politicians talk real reform when a wake-up call means short-term pain, which translates into guaranteed defeat at the next election.

This inability to reconcile what's needed (reform) with what is actually being done (buying time) is now in its final phase. This is the blow-off phase in which the remaining pockets of market participants who actually behave according to fundamentals give up, while central bankers and politicians begin to feel confident that their inaction might just work, even as the real economy refuses to reignite.

We believe Q3 could actually be a major pivot point. It could be the beginning of the end of excessively easy money and a turning point towards the slow withdrawal of QE (after a false start of the same in Q2), as well as the end of the belief that real growth can return without reforms. Ironically, even as QE is slowed, it could also be the starting point towards an all-time low in interest rates in 2014, when the final bill comes due.

In other words, we do not see a bubble yet in fixed income, but still see high probabilities of new lows in yields in 2014. We can't expect a recovery as long as small- and medium-

Watch Steen talk about waiting for reality to hit...

sized enterprises (SMEs) – 80 percent of the economy – are struggling to innovate and create new jobs. Therein lies the problem: The 20 percent of the economy made up of the exchange-listed companies and quasi state-owned banks are not the innovators or job creators. They do not need to be. They buy their competitors and the strong up-and-comers. You only have to look at the tech sector, in which brand names such as Google, Yahoo and Microsoft continue to pay a massive premium for "the next big thing".

The key event, the one we have waited for all year, is the German election on September 22, not so much because we are unsure of the outcome as it's Chancellor Angela Merkel's election to lose (which she won't). Rather, this election is about how the new German government and parliament shape Germany's EU policy. Europe remains "overbanked" with undercapitalised banks, an issue that ultimately needs to be resolved on an EU level before we will see credit flowing again in Europe. Keeping inefficient banks alive via European Central Bank life support is not helping the SMEs, or, in other words, 80 percent of the economy that really could benefit from easier credit.

We are preparing ourselves for a significant slowdown in the EU in the fourth quarter, which is now back-loaded with events that will be difficult to keep under control: Greece's non-compliance with Troika demands; Portugal's political instability combined with its deteriorating fundamentals; the restrictive recession in Ireland and both Italy and France giving lip service to real reforms rather than taking the medicine that needs taking. And then there's the political scandal in Spain that has reached all the way to the top of the current government. Europe will have to stop pretending very soon.

Again, Q3 looks to be good for assets, but also the end of the extend-and-pretend mentality. The next peak in economic cycles and assets will come in 2017, so enjoy it while it lasts.

Plain sailing

Tapering may have caused equities some pain in the second quarter, but the market was quick to factor in a likely end to quantitative easing. But fears of another shock to the system, at least from this angle, look groundless.

by PETER GARNRY, Head of Equity Strategy

Quantitative easing (QE) is about to be scaled back because US private employment seems to be improving and the fiscal deficit as a percentage of nominal GDP is rapidly shrinking. Of course, we all know that the mere mention of QE tapering, driven by the US Federal Reserve, was enough to send equities scurrying for cover in the second quarter. But should we necessarily take it as read that the third quarter will be the same?

The looming slowdown in QE does represent a relative tightening of monetary policy, but we should not forget that the policy is still very accommodative. Looking back at previous interest rate hikes from the Fed, the equity market normally weakens in the first one to three months. But history only gives half the truth as QE tapering is not comparable to normal interest rate hikes. The equity market has already discounted the projected slow pace of QE tapering as the US economy is still not expanding at trend growth. With global equities having recouped the initial shock and with the discount now in place, trouble ahead is more likely to come from the political noise emanating from the German elections on September 22, the US debt ceiling or a new confidence dip in Europe's government bond markets. Otherwise, equities will continue to discount an improving global economy.

Overall, global equity markets are still trading below their historical average valuation and we expect a gradual reversion to the average valuation over the coming years. The dividend yield in developed market equity indices remains historically high at 3.4 percent. On that basis, we maintain the view that global equities will be higher over the next 12 months. In a rising growth environment with benign inflationary pressure,

"With global equities having recouped the initial shock and with the discount now in place, trouble ahead is more likely to come from the political noise emanating from the September German elections, US debt ceiling or a new confidence dip in Europe's government bond markets."

equities are among the most attractive asset classes. Our developed equity market ranking model, which takes value and momentum factors into account, is currently signalling that the Netherlands, Germany and France are the most undervalued markets on a relative basis. At the other end of the spectrum, our model is negative on New Zealand, Australia and Switzerland. The ranking is relative, so whether the equity market rises or falls, we expect the model's top three equity markets to outperform its bottom three.

Corporate bond spreads are good for filtering out the noise in equity markets, thus helping to identify risky and calm periods. The corporate bond spread is currently 103 basis points, up substantially following the factoring in of QE tapering. The increase in the credit spread seems to have stopped for now

"In a rising growth environment with benign inflationary pressure, equities are among the most attractive asset classes."

and is at levels that correspond with low drawdowns if they happen in the third quarter.

US stocks feel the heat

US equities peaked in valuation terms on a weekly basis on May 17 at 14.8 x 12-month forward earnings per share, which is the highest level since March 2010. With the S&P 500 trading close to all-time highs, it is a fair question to ask if US equities are overheating. However, before going into detail, it is important to note that the US equity market is not in a bubble state when observing the Tobin Q ratio, which is published by the Fed every quarter.

Many elements are contributing to the strength in US equities. The housing market is improving despite recent weakness due to rising mortgage rates, oil and gas production is growing fast, automobile sales are increasing (about 18 percent upside exists if auto sales jump to normal levels) and overall inflation pressure remains subdued.

While many factors are increasingly brightening the outlook for the US economy and the S&P 500, the third quarter could see minor setbacks centred on the debt ceiling debate, Germany's election or a European peripheral bond market, such as Portugal.

As the US government's drag on the economy fades a bit in the second half and the private sector likely accelerates, we expect to see rising equity markets towards the end of the year. Our year-end target for the S&P 500 is 1,750 based on 1.7 percent growth in 12-month forward earnings per share to 117.0 and a 12-month forward multiple of 15 times, which is not unusual at this point in the business cycle and with the current outlook. The global economy, however, does not justify a forward earnings multiple above 15 times, but that may be the case in 2014.

Draghi's magic wand

European equities are broadly our most favoured equity markets on a relative basis going into the latter part of the year, driven by benign valuation and good price momentum. Our preferred equity markets are the Netherlands, Germany, France, Ireland, Norway and Belgium.

Ever since European Central Bank president Mario Draghi pledged to do "whatever it takes" to save the euro, government bond yields and credit spreads have come down in tandem with rising equity markets and improving surveys on confidence. European banks have also increased their tier-one capital over the years, stabilising the financial system somewhat. Nevertheless, European banks still remain the continent's Achilles' heel. Following six quarters of negative growth, the real-time GDP tracker eurocoin is now close to zero and with July's good PMI figures from Europe, it may turn positive, which indicates that positive GDP growth may return to the euro area later this year.

With positive economic growth returning to the euro area and growth projected to be 1 percent in 2014 and 1.3 percent in 2015, in combination with a relatively low 12-month forward earnings multiple of 12.6 times, we are positive on European equities on a relative basis over the next 12 months.

Watch Peter talk about plain sailing for equities...

The two worst-performing industry groups in Europe this year have been energy and materials, which have been driven by a weak global demand outlook and overcapacity issues. Strikes and demand for wage increases in many African countries have also had a negative impact on materials stocks. We expect energy and materials stocks to represent a good tactical and contrarian opportunity later this year as economic growth picks up. Consensus price targets for the two industry groups are also about 10 percent to 20 percent higher than current prices, indicating that sell-side analysts believe the current valuation does not reflect the long-term prospects, and we agree.

Abenomically speaking

Going into the second quarter, we hesitated about being long on Japanese stocks as we said they were significantly overvalued relative to other developed equity markets. The momentum effects, however, were stronger than we expected and the Nikkei 225 Index climbed an additional 26.1 percent to its quarterly closing high of 15,627 on May 22.

Then on May 23, the Nikkei 225 Index experienced a 9.2 percent decline from its intraday high to its close. This was likely triggered by the weaker-than-expected HSBC flash PMI manufacturing for China and exacerbated by margin calls and general profit-taking. In the following two weeks, the Nikkei 225 index fell almost 20 percent, virtually erasing the quarter's gains.

The question is whether the price action in Japanese stocks so far has been a speculative event or Abenomics is, in fact, setting the stage for a secular bull market. The weaker JPY has increased exports by 16.5 percent since November 2012 and confidence among households has surged to the highest levels since 2007. Tokyo department store sales are up 9.4 percent year-over-year as of June, the highest level since 1990 if the spikes following earthquakes are removed. It indeed looks like Abenomics and the Bank of Japan's new monetary policy to reflate the economy is working so far.

The fiscal 2015 consensus earnings estimate on the Nikkei 225 Index is up 24.4 percent since the beginning of the year, reflecting increasing expectations for Japanese companies. Consensus estimates for GDP growth in 2013 have increased

"The question is whether the price action in Japanese stocks so far has been a speculative event or Abenomics is, in fact, setting the stage for a secular bull market in Japanese stocks."

from 0.7 percent to 1.8 percent since December, while 2014 estimates are 1.4 percent, up from 1 percent, and a reflection of the growing confidence in the government's new economic policy.

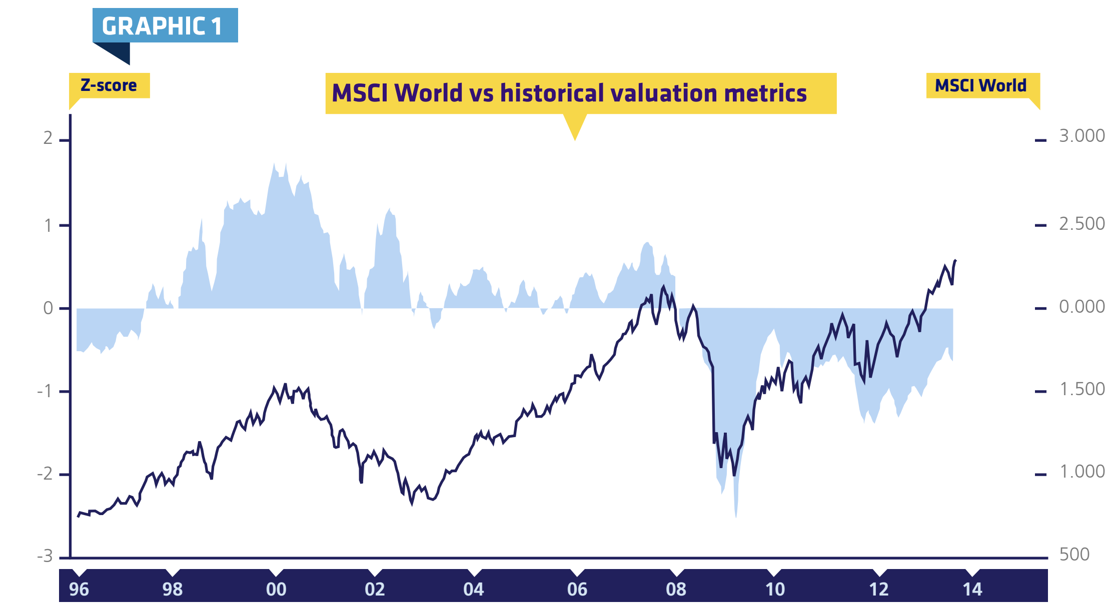
Given the acceptance of the G20 countries on Japan's current policies, including a "thumbs up" from the International Monetary Fund, the new policies are likely to continue. In addition, Japan has its strongest government in many years after the decisive win by Prime Minister Shinzo Abe's ruling coalition in the recent upper house election. The building blocks for a better future for Japan seem to be in place.

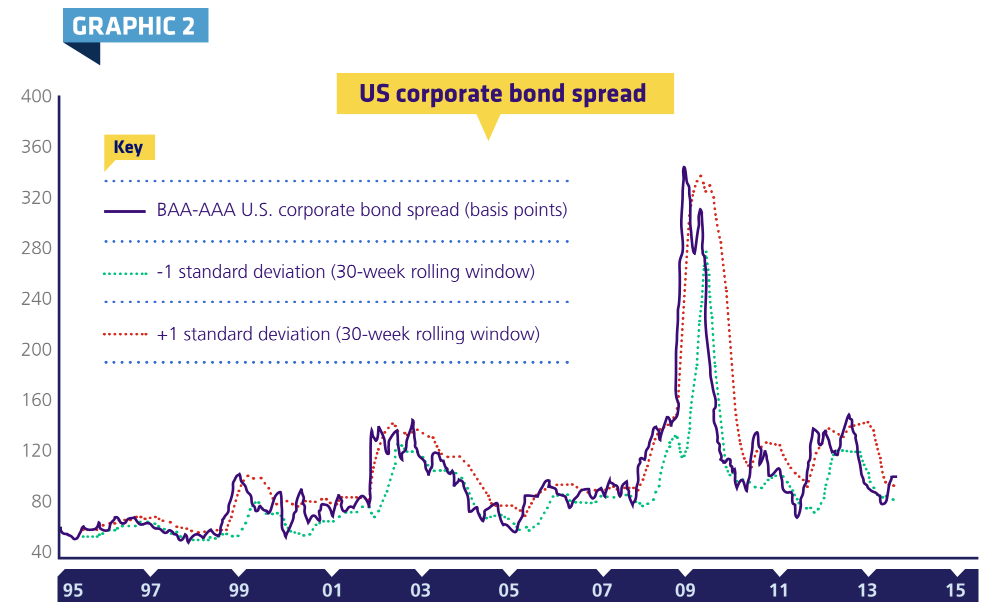
Despite improving fundamentals, the Nikkei 225 index is trading at the highest forward multiples among developed equity indices at 16.3 x fiscal 2015 earnings combined with slowing momentum relative to other developed equity markets. This has recently pushed Japanese stocks to our model's least favourite equity market.

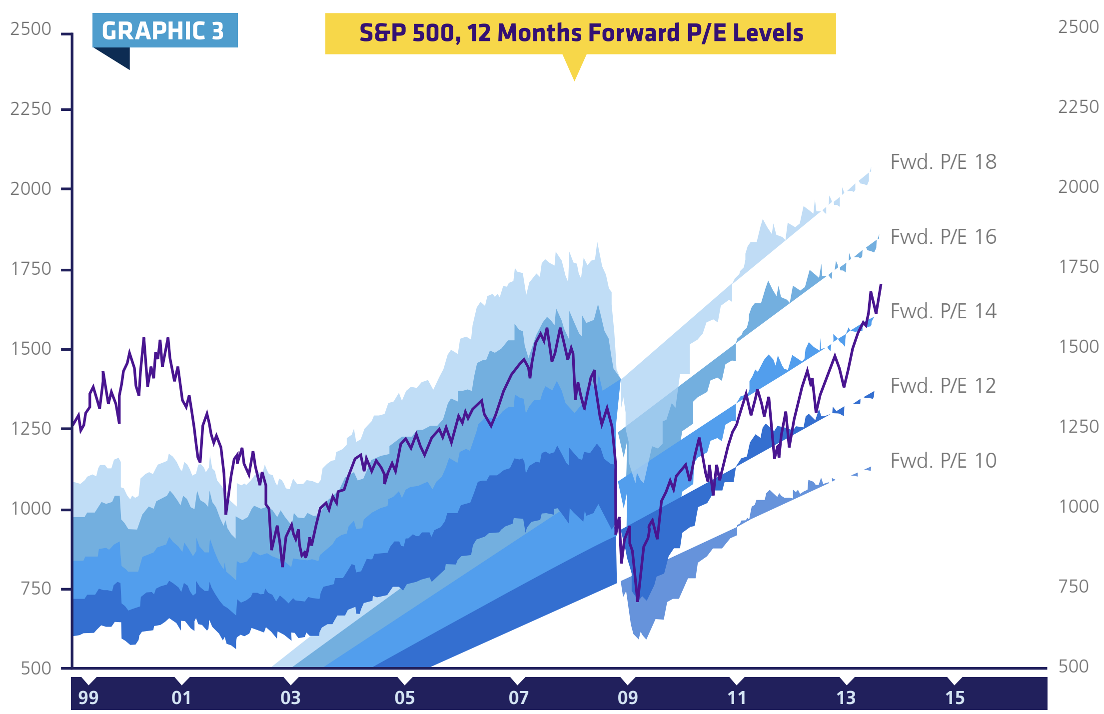
Calmer waters

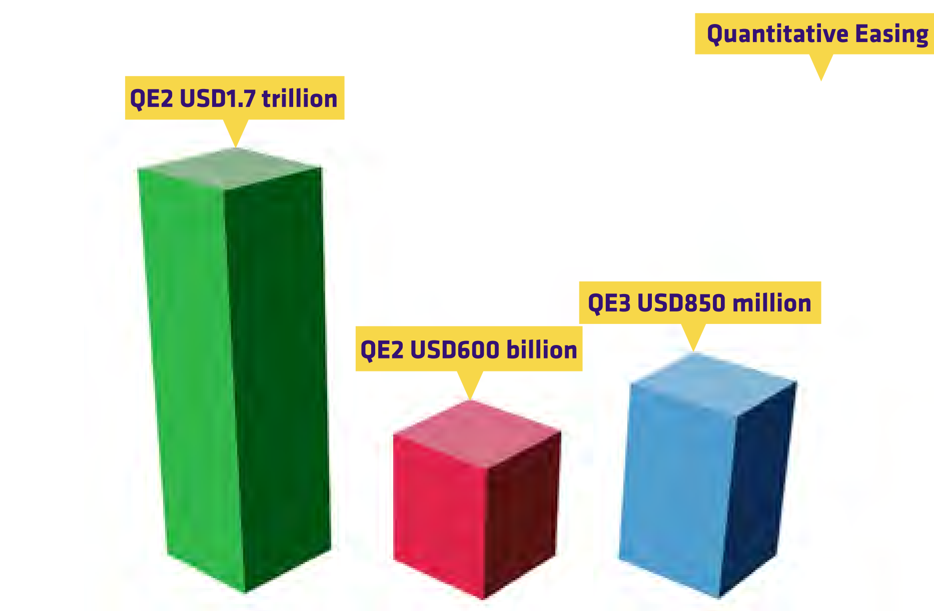
The third quarter could be a much more stable quarter for equities relative to the choppy waters of Q2. Geopolitical shocks notwithstanding, equities have already factored in the likelihood of an end to QE.

Q2 rolled with that particular punch and came back somewhat bloodied but not bowed. Whatever shocks hit home in Q3, it's unlikely that the talk or even the implementation of QE tapering will be at the heart of it. Look elsewhere for the trigger.









Launched:	Nov 08	Nov 10	Sep 12
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Graphic 1, Graphic 2, Graphic 3 Source: Bloomberg, Saxo Bank

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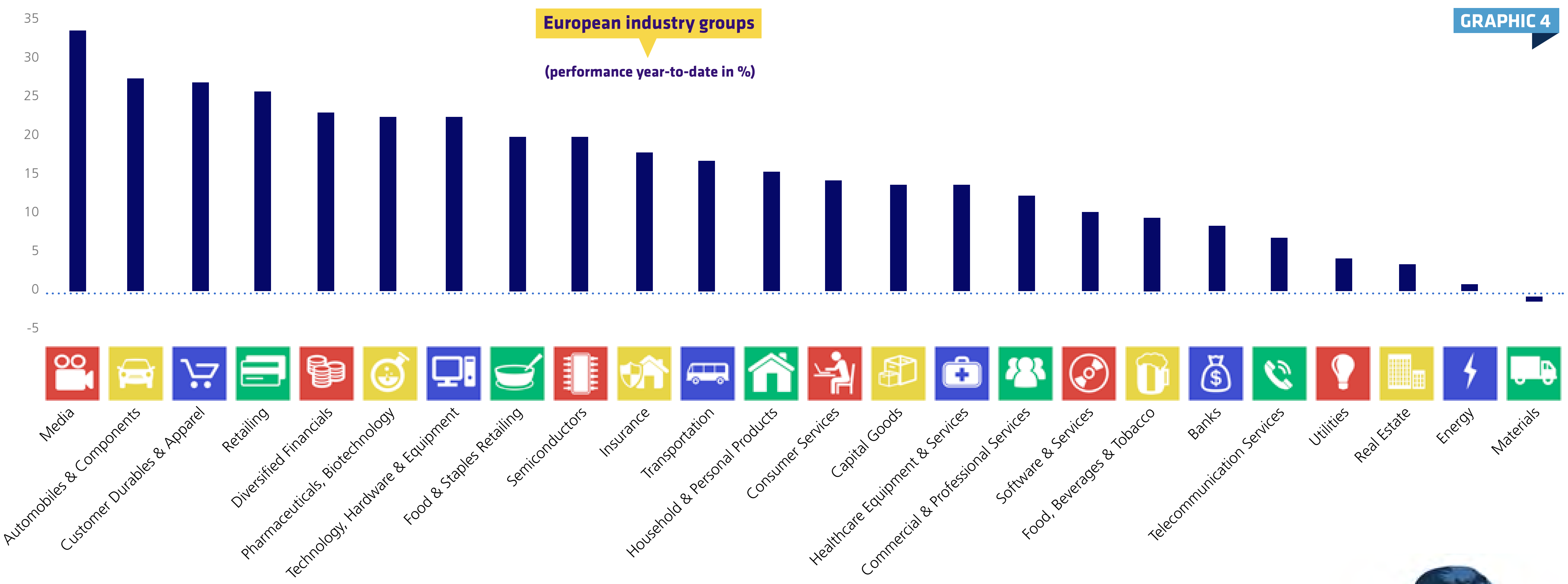
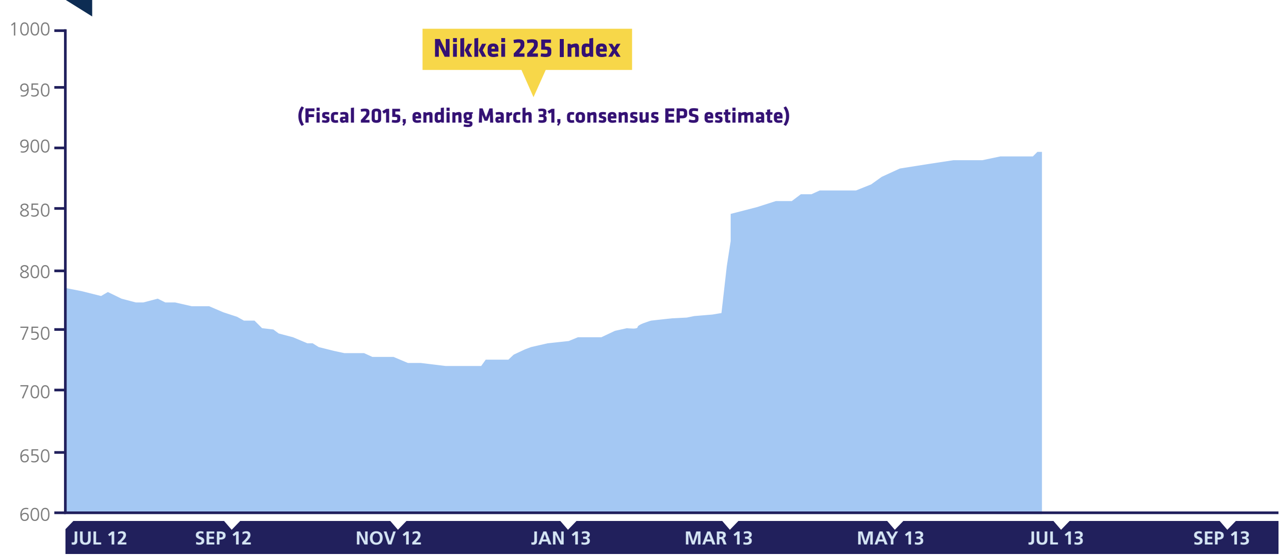
GRAPHIC 4



GRAPHIC 5



Graphic 4, Graphic 5 Source: Bloomberg, Saxo Bank

Within our mandate, the ECB is ready to do whatever it takes to preserve the euro.

And believe me, it will be enough.

There are short-term challenges, to say the least.

Mario Draghi, ECB president
July 2012

CONNECT WITH PETER:

The calm before the storm

The withdrawal from quantitative easing in the US, a new Fed chairman on the way and the looming German elections could see a dramatic return of volatility by year-end.

by JOHN J. HARDY, Head of FX Strategy

"From here, the set-up looks like a win/win for the US dollar."

In the second quarter, I looked for the narrow rise in volatility to begin to broaden and result in more USD strength, a wild ride for the JPY and commodity dollar weakness as the main themes. I give myself a score of seven out of 10 on that front – we saw more USD strength in Q2, although with some indecisiveness as I discuss below. As for commodity dollar weakness, the AUD collapsed in Q2, while the CAD and NZD moves were more fitful. Meanwhile, the ride for the JPY was, at most, bumpy rather than the wild I expected.

The headline for the third and fourth quarters is "USD to send a clearer message". The idea here is that after the solid pull higher for the greenback early this year, Q2 and early Q3 have seen the currency beset with wild indecision. The market is fretting about the US Federal Reserve's awkward attempts at communicating its intention to slow its quantitative easing (QE) purchases, which have clearly created distortions in asset markets. In Q3 and beyond, I am looking for the US dollar to send a clearer message on its intent to rally as the Fed asset purchase taper arrives on schedule, even while the market continues to fret about the prospects for US and global growth.

Our main theme going into Q2 was "Trees still don't grow into the sky", a pointed reference to ongoing complacency across markets and still very low volatility, which I suggested could only rise. Volatility did indeed rise in Q2, but has collapsed again going into Q3. I suspect this is a false signal – a possible quiet before the storm. With the coming withdrawal – no matter how gentle – from QE in the US, a new Fed chairman on the way and German elections in late September, more far-sighted investors might consider the prospects for a dramatic return of volatility well ahead of year-end.

USD rally to get back on track

The market has been in an absolute fit on what to do with the USD since mid-May. Since then, mixed US economic data has partially derailed the anticipation of a Fed exit and stopped the juggernaut of the USDJPY rise in its tracks. From here, the set-up looks like a win/win for the USD. Either the US recovery continues on schedule and the US leads the world in anticipating a rate-tightening cycle (I give this lower odds) or we get a weaker US economy, but a Fed that nonetheless must signal a slowing of asset purchases due to the continued distortions caused by QE. This would leave the Fed relatively less dovish than other central banks. Don't forget, we also have a leadership change at the Fed on tap, which can only enhance uncertainty – and anyone but Janet Yellen, currently the leading contender for the job, would trigger dramatic uncertainty.

"The eventual solution for Europe is likely to include some elements of euro-weakening devaluation."

Reality awaits the EUR after German election

EUR was one of the strongest currencies among the G10 in Q2 and is trading close to two-year highs versus an evenly weighted basket of the rest of the G10. The European Central Bank's (ECB) theoretical outright monetary transactions backstop has maintained confidence in peripheral debt despite a spate of mini scares. At the same time, the ECB is unable to effectively fight the currency wars with the methods available to the Fed and the Bank of Japan (BoJ). The EUR has defaulted to the strong side, also helped by a growing EU current account surplus with the rest of the world due to feeble domestic demand – particularly at the periphery. Going forward, the prospects for the EUR will be defined after the September 22 German election, when Germany and Europe and the ECB will have to sit down and figure out how to recapitalise the banking sector. We could get a bit more EUR resilience, but the eventual solution for Europe is likely to include some elements of EUR-weakening devaluation.

Two-way risks for JPY

Most of Q2 was about BoJ damage control to the chaotic reaction in markets once the stunning scale of its new QE programme became clear in early April. This included an enormous acceleration in bond market volatility and a 20 percent freefall in stocks, admittedly after a rally exceeding 75 percent last autumn. In the near term, bond volatility may be controllable by the BoJ if major sovereign bond markets settle down elsewhere as expected. But the longer-term fiscal headaches are the eternal question for Japan. As well, will Prime Minister Shinzo Abe move to focus on the constitutional issues he is most passionate about now that he has cemented his power base at the July upper house elections (more JPY bearish)? Or will he focus instead on the much-needed structural reforms, such as labour market flexibility and the fiscal predicament (more JPY bullish)? That 2 percent inflation target for Japan looks a long way off… and if it does come, the risk is that it will be the wrong kind of inflation. The JPY may eventually weaken, but significant consolidation can't be ruled out if the market agrees that the QE approach doesn't work and begins to look at what will come next.

Carney changes the BoE tune

We can expect the Mark Carney-led Bank of England (BoE) to be more about transparency and a loud broadcasting of intent compared with the style under former governor Mervyn King, when the bank rarely released policy statements even on the days of its interest rate/asset purchase decisions. We can also expect the UK economy to mean revert at some point from its recent show of strength and for the market to eventually remember the scary twin deficit picture for the UK, which has failed to improve despite years of a weaker currency. There's no easy way out for the UK; GBPUSD is the favourite way to look for a weaker pound.

Visibility could release EURCHF from the floor magnet

CHF pulled back towards the lower part of its range versus the EUR as the EU situation remains more than tenuous and nervous ahead of the German election, and as carry trades came under some pressure during parts of Q2 and were sideways at best. The Swiss National Bank (SNB) seems passive as well. I expect the time is getting ripe in Q3 for the CHF to finally start to peel further away from the 1.20 floor. Almost any scenario after the German election, as long as it offers strong visibility on the future of the EU and its banking system, would help. In addition, the SNB might jump into the fray as CHF is now close to its most expensive level in more than 18 months.

Commodity dollars a mixed bag

AUD has been singled out among the commodity dollars for the most weakness since mid-Q2. With such widespread consensus that it is the currency to short with heavy positioning, it may face less downside risk than the most overvalued of the three commodity dollars, the NZD, in which mean reversion of the economy relative to the rest of the world is inevitable. Any broader weakening of risk appetite will also see the currency's strength fade rapidly due to liquidity issues. The CAD may be somewhere in the middle, but certainly looks overvalued given the coming hangover as the credit cycle in Canada peaks.

A rollercoaster ride for the Scandies

NOK has been on a rollercoaster ride in recent months as Norges Bank built up a straw man of hawkish rate expectations, only to douse those expectations with a dovish about-face at its June meeting. This caught the market completely off guard and sent the currency over a cliff. Still, I expect NOK to be a middle-of-the-road performer, while SEK is vastly overvalued and is traditionally a pro-cyclical currency. Look for it to peak and switch to weakness if major equity markets do the same, not to mention the general overvaluation headwinds for the SEK. Furthermore, an ugly post-housing bubble economy awaits Sweden.

"The ideas for this quarter play on a variety of themes."

Watch John talk about the calm before the storm...

Benchmark forecasts

Currency Pair	3 months	6 months	12 months
EURUSD	1.25	1.19	1.15
USDJPY	98	102	110
EURJPY	123	120	125
GBPUSD	1.46	1.44	1.40
EURGBP	0.86	0.82	0.82
EURCHF	1.25	1.27	1.30
USDCHF	1.00	1.07	1.13
AUDUSD	0.86	0.80	0.75
USDCAD	1.07	1.10	1.15
NZDUSD	0.75	0.70	0.64
EURSEK	8.90	9.25	9.00
EURNOK	8.00	8.25	8.00

CONNECT WITH JOHN:

Trading themes in the third quarter

The ideas for this quarter play on a variety of themes and are hopefully not overly correlated. Our Q2 ideas were everything from home runs (long GBP, NOK and EUR vs AUD) to flatliners (long USDCHF).

Long USD versus EUR and CAD: It's time for CAD to move far, far away from parity – another 1.0600 break could send this one flying. The EURUSD trade may take time to develop.

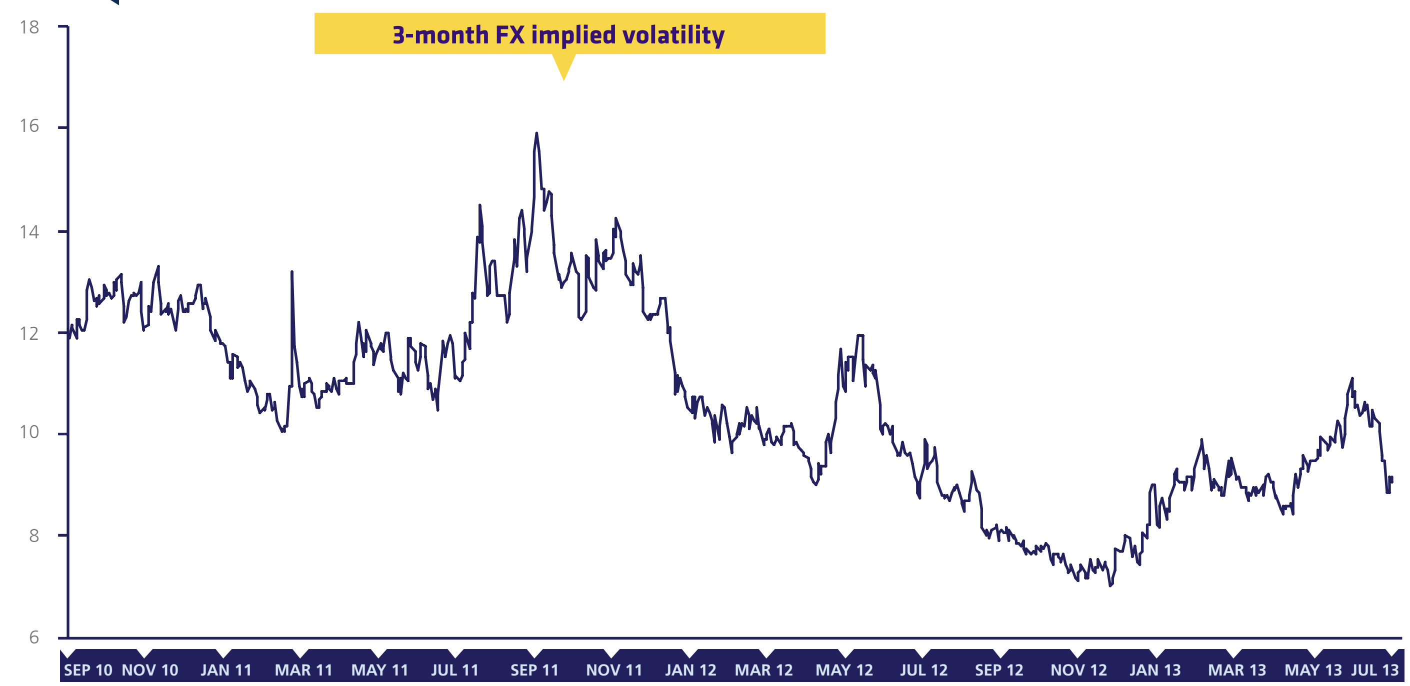
Short NZD versus CAD and NOK: The kiwi's strength has become excessive – all economies eventually mean revert to the rest of the world and the potential for a risk-off market late in Q3 would hurt the high-flying illiquid NZD.

Short CHFJPY: SNB activism has more potential after the German election and we're likely to find more EU visibility thereafter as well. Even if carry trades return to popularity, the CHF has some catching up to do.

Long GBPAUD on dips: A repeat from the last time around, but the Reserve Bank of Australia has more cutting to do, while the UK could continue to putter along. Still, 1.600 might be a better area to try the long side than the 1.6500 in late July.

Short SEK versus NOK and G7: This means shorting one unit of SEK versus NOK and one unit of SEK versus an evenly weighted basket of USD, EUR, JPY, USD, AUD, CAD and CHF. This is about the overvaluation of SEK. TF

GRAPHIC 1



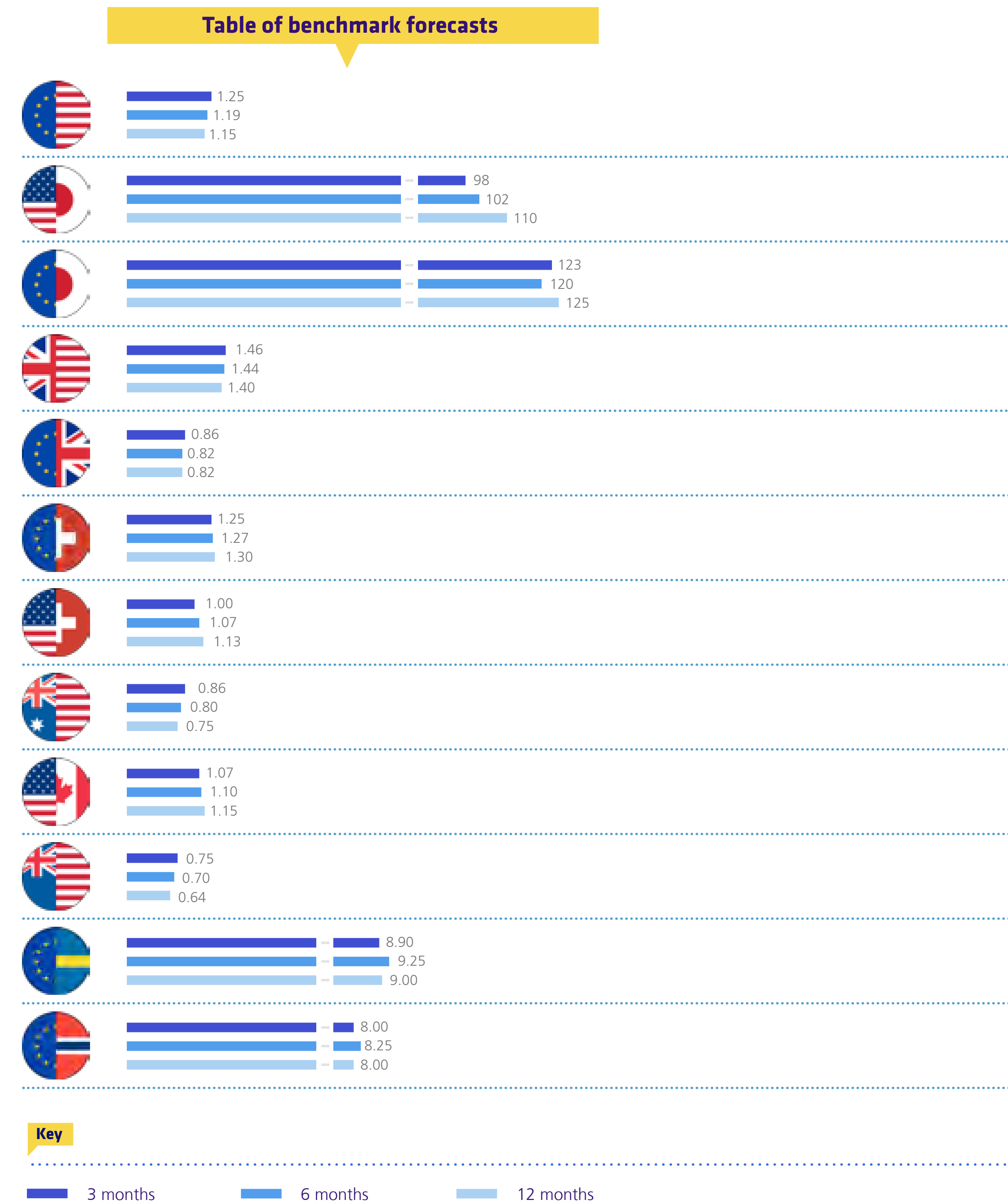
GRAPHIC 2

Graphic 1, Graphic 2, Graphic 3 Source: Bloomberg, Saxo Bank

I will make an all-out effort to pull Japan's economy out of deflation.

Haruhiko Kuroda,
Governor of the Bank of Japan
April 2013

GRAPHIC 3



CONNECT WITH JOHN:

More of the same

US fiscal drag will remain sizeable in the second half of this year and will keep growth lower than developments in the private sector suggest.

by MADS KOEFOED, Head of Macro Strategy

Watch Mads talk about an economy stuck in gear...

The second quarter of 2013 was marked by dismal global economic growth driven by the world's two largest economies: the US and China. The period also saw the Bank of Japan (BoJ) initiate its long-awaited quantitative easing (QE) programme. Indeed, the only surprise about the second quarter was how little attention was paid to the Eurozone – even considering the Cyprus debacle in March and the rate cut in May. Instead, the BoJ's QE programme, concerns about QE tapering by the US Federal Reserve and the lack of action from the People's Bank of China in the face of slowing economic activity drove headlines. And while we expect the quarter to mark the low point this year in terms of growth, the improvement in the third quarter will be minor, leaving ample room for central banks and politicians to set the agenda. Economic growth this year, at 2 percent, will be more or less on par with last year's 2.1 percent before accelerating to 2.7 percent in 2014.

Fiscal drag keeps US growth trapped below trend

The strength of the US labour market, which has added 202,000 non-farm payrolls on average in each of the first six months, is rather impressive considering that sequestration was initiated earlier this year and that the drag exerted on the US economy from declining public spending is continuing. But the US is not out of the fiscal-drag woods yet for a couple of reasons. First, defence spending, which is down 12.6 percent since the Q3 2010 peak and down 3.1 percent in H1 this year alone. This will continue to decline in the second half of the year. And second, the projection for public spending by the Congressional Budget Office for the full year supports the notion of further cuts, including those due to sequestration. Therefore, we expect the fiscal drag to remain sizable in the second half of the year and keep growth lower than developments in the private sector suggest.

But the fiscal drag is not all negative. The public deficit has narrowed to 4.2 percent of GDP in the first quarter from a peak of 10.1 percent in Q4 2009. Even under relatively conservative assumptions about nominal GDP and the federal budget deficit, it should end the year at less than 3.5 percent. Given our expectations about further cuts to federal spending in coming quarters, this deficit-to-GDP projection looks probable.

Our overall case for the US this year is a story of more of the same. Given modest growth in GDP in the first quarter, we have lowered our GDP forecast for this year to 1.6 percent, slightly below the 1.8 percent consensus forecast and well below the 2.8 percent recorded in 2012. We still expect a return to stronger growth next year, when the fiscal drag will fade. The housing recovery still has legs and will continue to contribute directly through residential investment and indirectly through higher home prices, which will lift people out of negative equity and increase purchasing power.

Eurozone supertanker turning slowly but surely

The Eurozone has been in recession for the better part of two years and output is down 1.5 percent through Q1. There are tentative signs, however, that the recession is coming to an end when looking at it from quarter to quarter. Survey data, whether it is PMI or ESI, are painting a much less dark picture of the immediate outlook compared with just a quarter ago. Indeed, in July the PMI Composite crawled above the 50 threshold, which separates expansion and contraction, for the first time since January 2012. Furthermore, the drag from austerity measures, which have regrettably mostly centred on tax hikes, should fade somewhat and lessen the pressure on the purchasing power of households. That said, the turnaround will be slow due to the abundance of excess capacity in the economy – both in terms of machinery and not least the more than 19 million unemployed. Wage growth will, therefore, be muted and will keep a lid on consumption growth. Hence, we only expect a modest recovery in 2014.

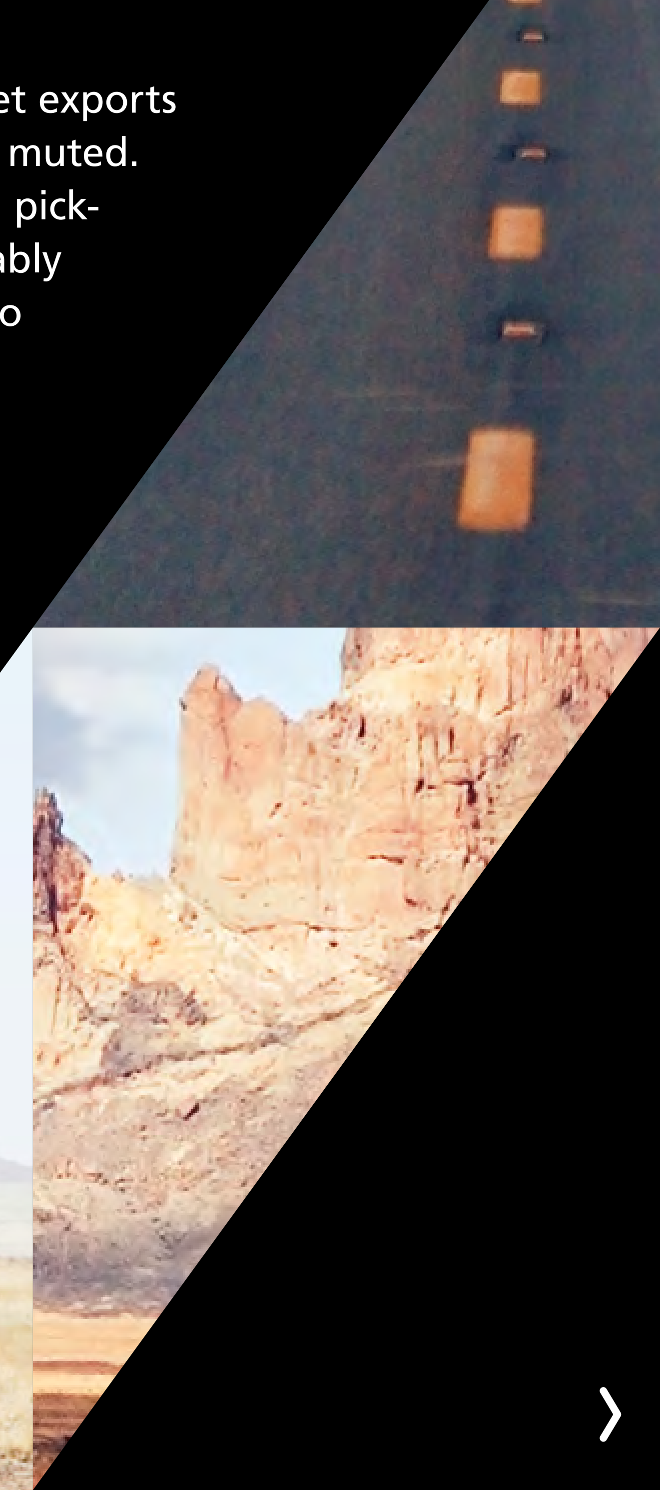
In terms of yearly GDP growth rates, the story is bleaker as this year's growth has a poor starting point due to the large drop in Q4 2012 of 0.6 percent quarter-on-quarter. We believe the Eurozone economy is on track to post even larger negative growth of 0.8 percent compared with the decline of 0.5 percent in 2012.

"Net exports and investment have driven a large part of China's growth in recent years, but global trade is currently muted. Given the weakness of European and US consumers – relatively speaking – not much bodes for a sharp pick-up in foreign goods this side of New Year."

China's struggle to maintain its growth rate

The Chinese economy has decelerated in 2013 as global trade growth lost momentum and the government was less forthcoming with stimuli than expected. Indeed, neither the new Chinese leadership under Premier Li Keqiang nor the People's Bank of China have done much to arrest the weakness. Economic growth has slowed to 1.6 percent quarter-on-quarter in Q1 and 1.7 percent in Q2, both of which are below the average of 2011 and 2012. In the second quarter, the year-on-year growth rate even fell to the leadership's target of 7.5 percent from 7.7 percent in the first quarter.

The outlook for the second half is only a bit brighter and the reasons are both structural and cyclical. Net exports and investment have driven a large part of China's growth in recent years, but global trade is currently muted. Given the weakness of European and US consumers – relatively speaking – not much bodes for a sharp pick-up in foreign goods this side of New Year. Furthermore, the level of investment in China is unsustainably high and must come down substantially in the coming decade if the world's second-largest economy is to experience a successful transition into a developed economy. This transformation will take time and will certainly not be without bumps. In addition, the post-global recession growth in China has relied on leverage to a great extent. The debt-to-GDP ratio has increased by 56 percentage points in the five years to 2012 and now stands at close to 210 percent. All of this suggests to us that China will see its growth rate decline steadily over the next 10 years to about 5 percent.



In the nearer term, however, growth should be higher and a small uptick in the second half is on the cards. Not least if the biggest importer of Chinese goods, the euro area, performs better than the growth rate of -0.1 percent quarter-on-quarter we have currently pencilled in for Q3 and Q4. Furthermore, even if the new Chinese leadership has not engaged in any large-scale stimulus, smaller steps will be taken. Programmes similar to those for less-developed urban areas, which were announced in late June, can be expected, including, for example, transport upgrades of railroads. This is a subtler way of stimulating the economy, but is nevertheless driven by exactly that desire. Given these smaller initiatives and the fact that the government is clearly concerned about slowing economic growth, it leaves an expectation that growth will remain quite high in 2013 and 2014, at 7.3 percent and 7.8 percent respectively. However, it will, nevertheless, be far below the levels seen in (late) 2009 to 2011.

Table 1

Growth of GDP in % for 2012, 2013* and 2014*

-0.5
-0.8
0.7

Strong German households will aid consumption while Italy and Spain are slowly seeing the results of reforms. The worst in terms of austerity could be behind us.

The failure to be more decisive will result in sub-par growth in France in the coming years. Spain may still require a bailout package should social unrest increase.

7.8
7.3
7.8

Urban redevelopment and new similar programmes will help stimulate the economy.

Tighter monetary and fiscal policies and a heightened focus on rebalancing the economy by the new administration will contribute to weaker growth both this year and next. Investment still accounts for too large a share of economic growth.

2.0
1.8
1.3

A new investment incentives programme is expected in autumn fuelling spending on capital equipment. A corporate tax cut is also a possibility, but more likely in 2014.

A higher consumption tax will likely be implemented in 2014, which will curtail domestic consumption.

0.3
1.1
1.6

Government and central bank policies remain supportive, including support for housing.

Further cuts to the public budget as targets are missed.

2.1
1.6
2.8

The labour and housing sectors continue to recover, which stimulates private consumption and housing investment and repairs of household balance sheets.

The fiscal drag is expected to continue throughout the year before fading in 2014.

2.1
2.0
2.7

Fiscal consolidation in lower gear, which will aid growth in developed economies. Exports from developing economies to gain from fading austerity in the euro area, stronger US consumer.

Global trade growth has been weaker than expected and the pick-up is expected to be small in the second half of 2013.

Key

GDP Growth 2012 | GDP Growth 2013 | GDP Growth 2014 | Upsides | Downsides

*Note: GDP (gross domestic product) is real, inflation-adjusted, year-on-year changes in percent. 2012 is actual, while 2013 and 2014 are forecasts.

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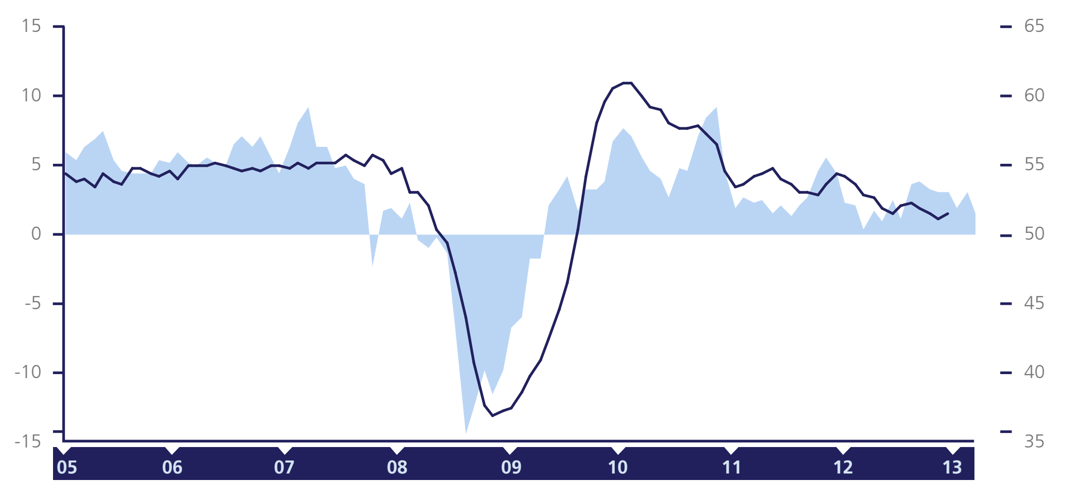
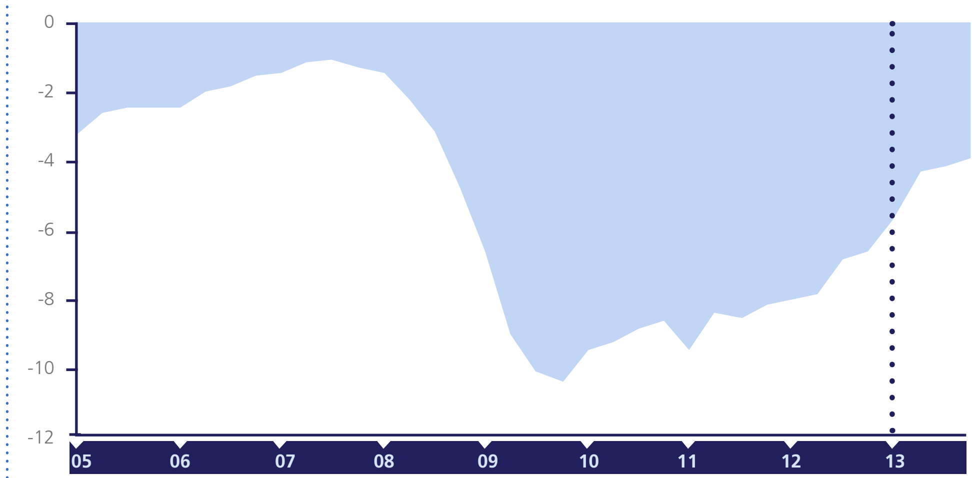
GRAPHIC 1

Global PMI manufacturing vs Global Industrial production



GRAPHIC 2

Federal budget deficit or surplus



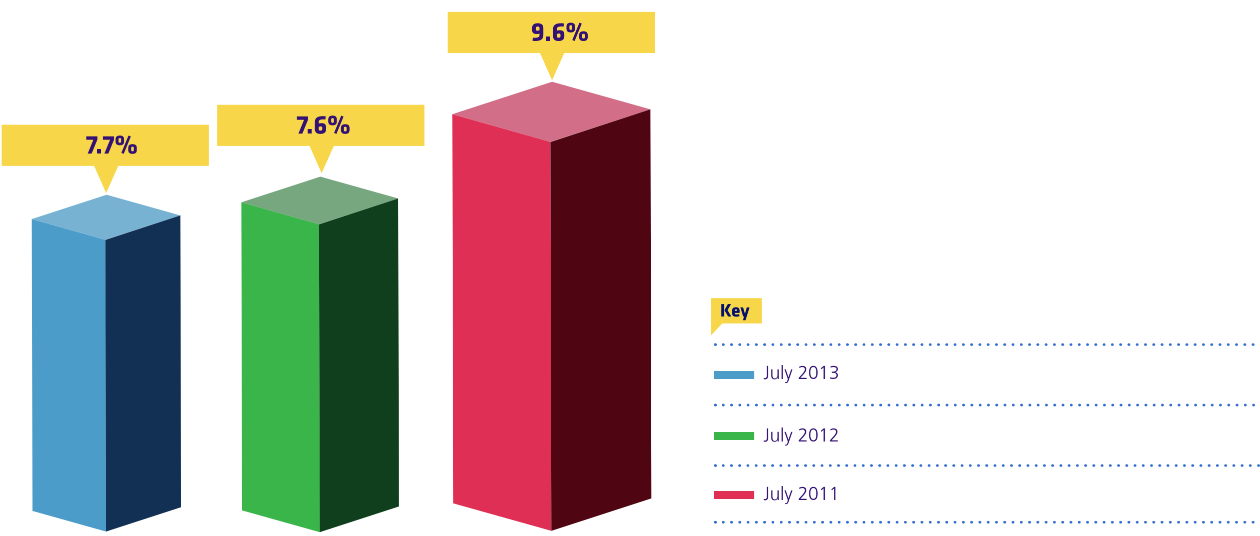
“

China's economic growth is on a steady track.

China has the conditions and the capability to reach the major goals the Chinese government set for economic growth this year.

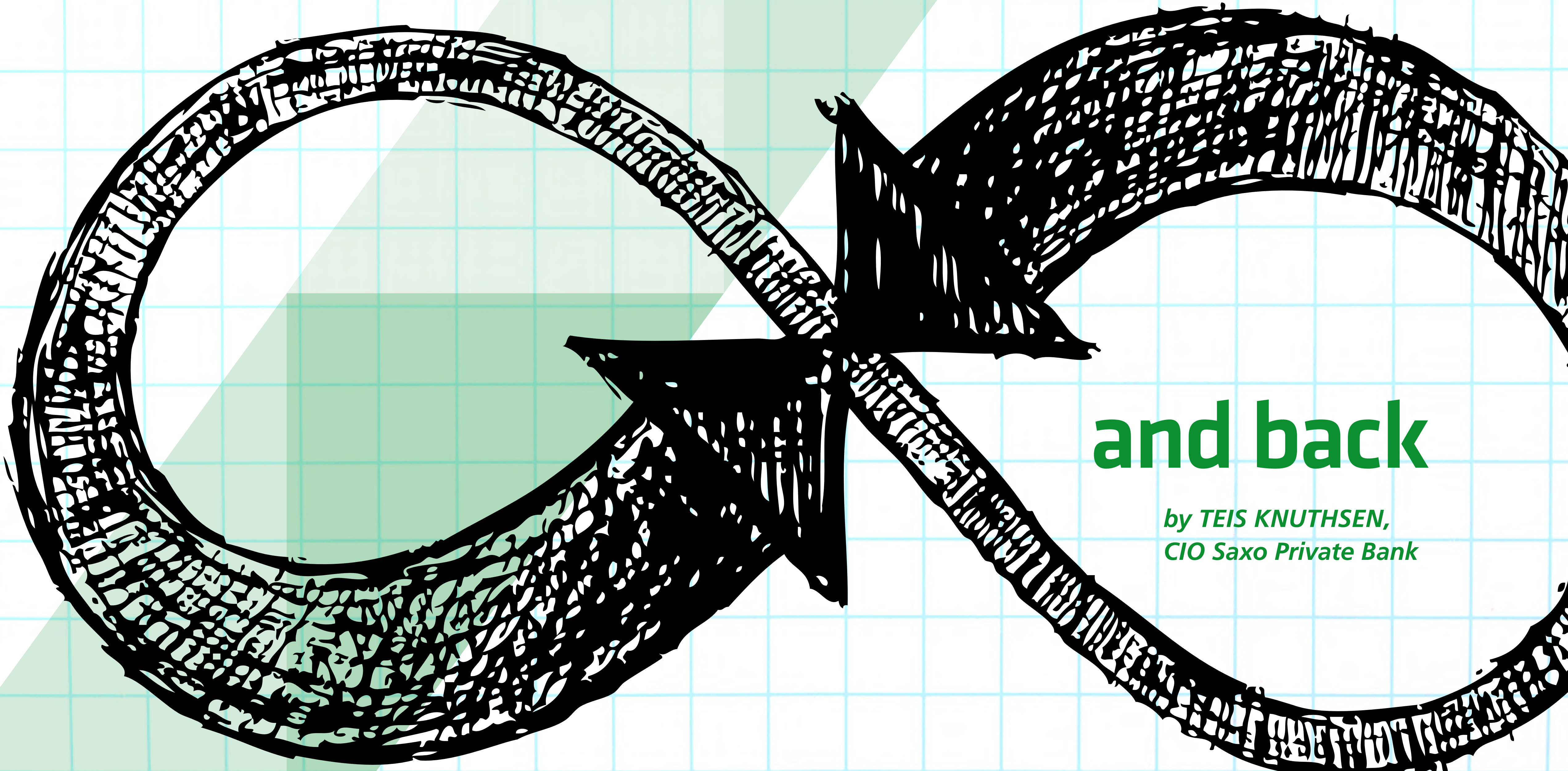
Li Keqiang, Premier of China
June 29, 2012

China Q2 GDP



CONNECT WITH MADS:

QE to infinity



and back

by TEIS KNUTHSEN,
CIO Saxo Private Bank

With the US Federal Reserve's quantitative easing bonanza coming to an end, it's time to face a new reality.

The past few months have seen a reality check on earlier market expectations of quantitative easing (QE) infinity – the idea that quantitative monetary easing by major central banks would go on forever, allowing us to lean back and enjoy an everlasting carry trade. Instead, US Federal Reserve chairman Ben Bernanke decided to teach markets a new word – tapering.

News that the Fed would taper or gradually reduce its monthly bond purchases under QE3 did not go down well with financial markets in May and June. Interest rates rose across the board, equity markets fell and the segments of global financial markets that perhaps had benefitted the most from a search for yield, particularly high yield and emerging market bonds, all fell sharply. The price of gold, long supported by the idea that central banks could be undermining the paper-based fiat money system, also continued its descent.

But let's back up a bit and revisit what US monetary policy is trying to achieve. The federal funds target rate fell to its current low of just 0.25 percent in December 2008. With that, the Fed had effectively reached zero-bound, or the ability to impact economic activity through traditional channels. In trying to support the economy further and facilitate a balanced repair sheet for households and financial institutions, the Fed embarked on a series of quantitative easing programmes: QE1, QE2, operation twist and – since September 2012 – QE3. Under QE3, the Fed has been buying a record amount of bonds worth USD 85 billion per month, or more than USD 1 trillion a year.

Side effects

By most accounts, US monetary policy has contributed not just to an economic recovery, but also to a more expedient restructuring of the financial sector than we have seen in Europe, or what we saw in Japan in the 1990s. However, an aggressive monetary policy is not without adverse side effects and as the economy recovers, it is natural for the Fed to consider terminating the QE programme. Further, in light of a significant improvement of the US budget position and hence a reduction of the bond issuance, a lowering of the Fed

"An aggressive monetary policy is not without adverse side effects, and as the economy recovers, it is natural for the Fed to consider terminating the QE programme."

purchases seems entirely appropriate. Finally, unlike prior to the financial crisis, responsibility for regulation of the banking and financial sector now lies with the Fed and it cannot to the same extent ignore signs of "irrational exuberance" in financial markets. So, back to the present. From numerous Fed comments since the initial warning on May 22, there is a fair degree of certainty that a reduction in the monthly bond purchases will commence this year and will end altogether

"If the Fed is right in its forecast of a sustainable recovery, there is no reason to expect a persistent decline in equity markets, where continued economic progress and earnings growth will be key in terms of making the most recent period just another correction."

sometime in the first half of 2014. For bond markets, the most likely result will be a gradual rise in yields. However, as long as the funds rate is anchored at just 0.25 percent and with core inflation close to 50-year lows, a rapid rise in yields seems unlikely.

But when is the federal funds rate likely to rise? The Fed has conditioned a rise in rates on a decline in unemployment to 6.5 percent (currently at 7.4 percent) and a rise in inflation to 2 percent (currently, core PCE is just 1.05 percent). Of the two, the target for unemployment is more likely to be reached, whereas inflation is set to remain very low. We think the first rate hike will be delayed to 2015. Currently, federal funds futures price a rate hike of close to 75 basis points by end-2015. Implied probabilities now have a more than 40 percent chance in favour of a rate hike as early as December 2014. In short, markets seem well prepared for monetary policy changes.

Arguably, the greatest impact will be away from government bond markets. For instance, each QE programme has coincided with persistent gains in equity prices, just as the periods between the QE programmes have seen stock market declines. If the Fed is right in its forecast of a sustainable recovery, there is no reason to expect a persistent decline in equity markets, where continued economic progress and earnings growth will be key in terms of making the most recent period just another correction. Nonetheless, turning off the QE autopilot must be expected to influence relationships between sectors and to reduce expected returns. A tapering of QE may also spell trouble for the asset classes that have seen the largest capital inflows in recent years, particularly corporate and emerging market bonds.

Europe's stable outlook

In Europe, the outlook for monetary policy is stable. We expect the European Central Bank (ECB) to keep policy rates at record low levels for the foreseeable future, with a bias towards further rate cuts. We also think the ECB will continue to explore other avenues through which to ease liquidity conditions in an attempt to support an economic recovery, counter the contractive impact from fiscal policy and facilitate a further balance sheet repair. In contrast to the US, much has been achieved in Europe from a verbal commitment to do "whatever it takes". While the outright monetary transactions programme designed to keep market tensions in check has been brought into question in Germany, we expect the commitment to intervene in peripheral bond markets to remain. More specifically, we see the ECB going down two different routes. We can see a new round of very long-term repo operations designed to anchor interest rates, as well as changes to collateral and haircut rules. Negative deposit rates are a possibility, but will probably be dependent on a rise in EUR's value. The other route involves asset purchases, including asset-backed securities to facilitate increased lending to small- and medium-sized enterprises (SMEs). Further out, there is still a banking union to deal with, although little will move here until after the German election.

Watch Teis talk about QE to infinity and back...

Abe's gamble

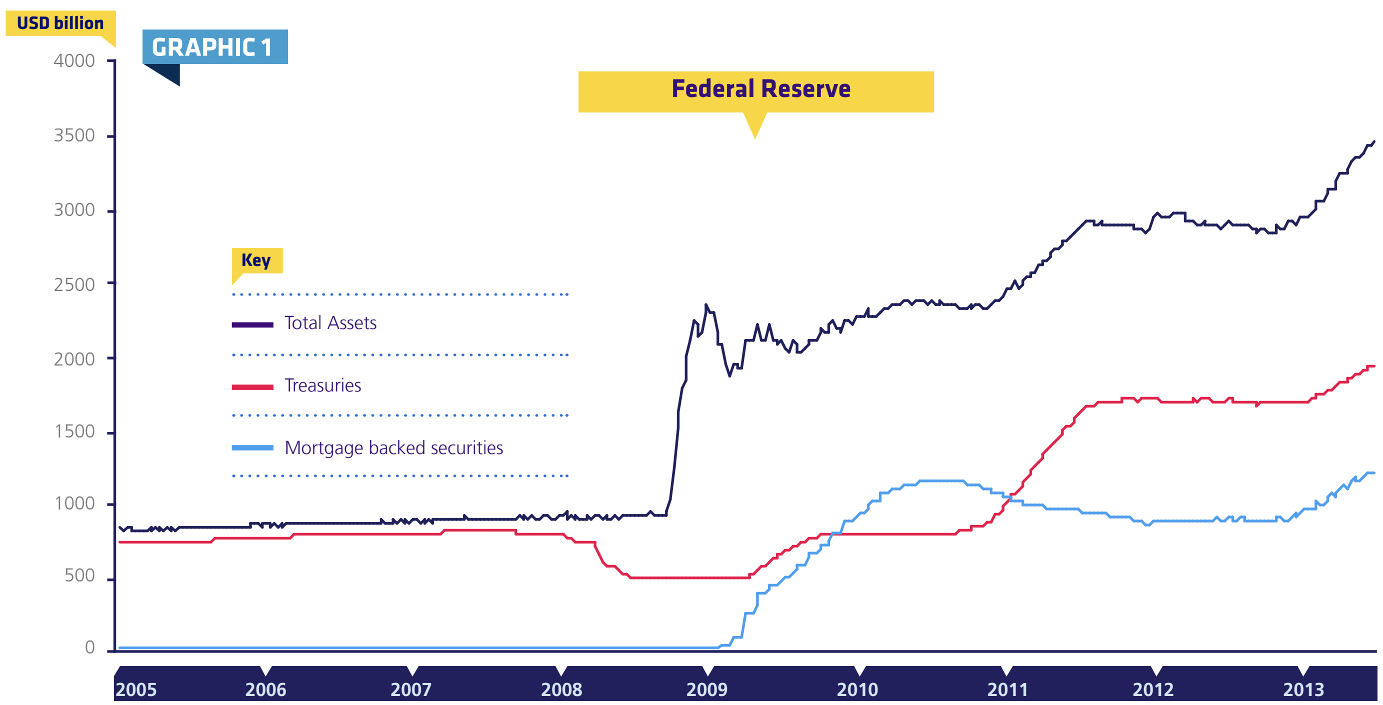
The Fed may be thinking about taking the foot off the monetary gas pedal, but the Bank of Japan (BoJ) has put the pedal to the metal this year. A change in policy by the least independent of the G3 central banks was already pre-announced by incoming Prime Minister Shinzo Abe last year. Under the leadership of the new BoJ governor Haruhiko Kuroda, the central bank said in April it would be doubling its monthly bond purchases to JPY 7.5 trillion, equal to 70 percent of government bond issuance and effectively doubling money supply in two years. Kuroda also pledged to achieve a 2 percent inflation target within two years, ending years of deflation.

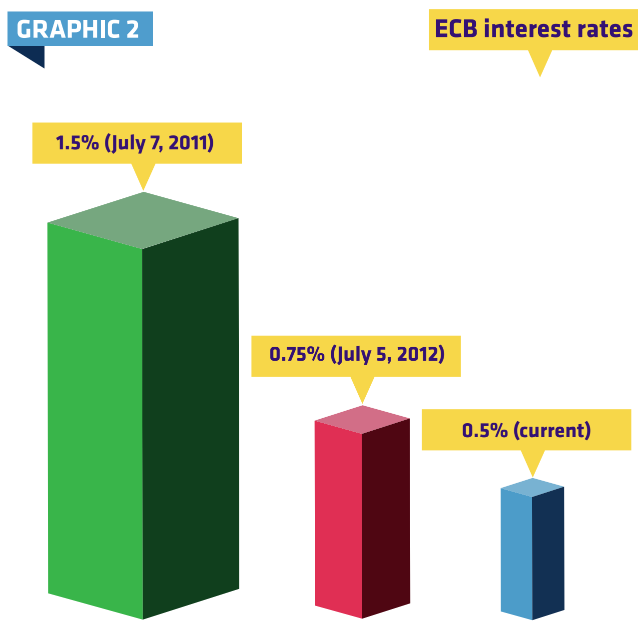
The BoJ's new strategy is nothing if not radical. A sharp rise in break-even inflation rates and a decline in the value of the JPY suggested early on that the policy was seen as credible.

"The BoJ is essentially running printing presses to finance budget deficits, thus increasing the risk of hyperinflation."

Combined with an easing of fiscal policy and structural reforms, Japan appears more dedicated to lifting economic activity than it has for years. Whether it will work is another matter. The bank has experimented with QE since 2001, so far with little success. The BoJ is essentially running printing presses to finance budget deficits, thus increasing the risk of hyperinflation. Currently, however, the Japanese economy is moving in the right direction. Overall, monetary policy is set to remain extremely accommodative in the coming years.

Global monetary policy has undergone substantial changes since the financial crisis and the great recession. In truth, major central banks are experimenting with monetary policy on a scale not seen in generations. It is difficult to argue that aggressive easing has resulted in higher activity levels, but at the same time it is probably true that we would have been worse off without the interventions. So far, there is little evidence that the expansion of the money base is resulting in inflation. What we do know, however, is that central bank intervention is making price discovery in financial markets difficult, to the point that it can be hard to know what the fair value of interest rates and equity markets would be if central banks stepped back. That thought caused turmoil in markets during May and June. It seems clear that G3 central bank policy will begin to diverge in the coming year. The Fed is an early mover and while it will begin to lower its asset purchases this year, it will, together with the ECB and BoJ, keep policy rates at record lows well into 2015. TF

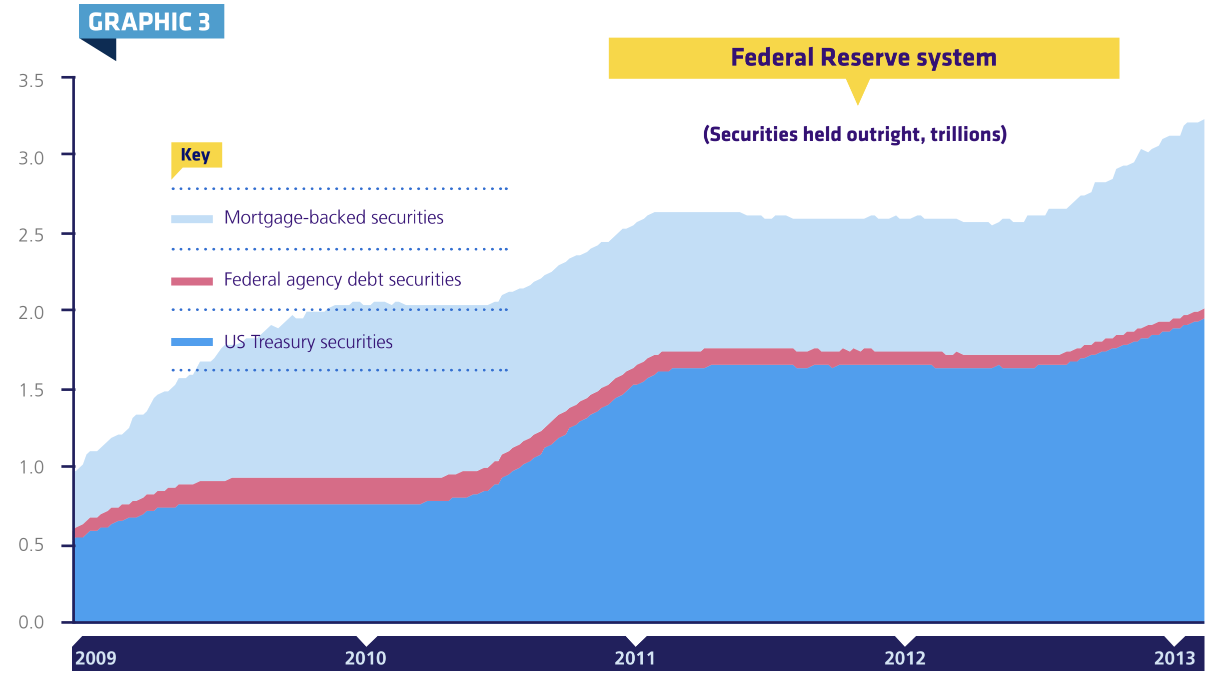


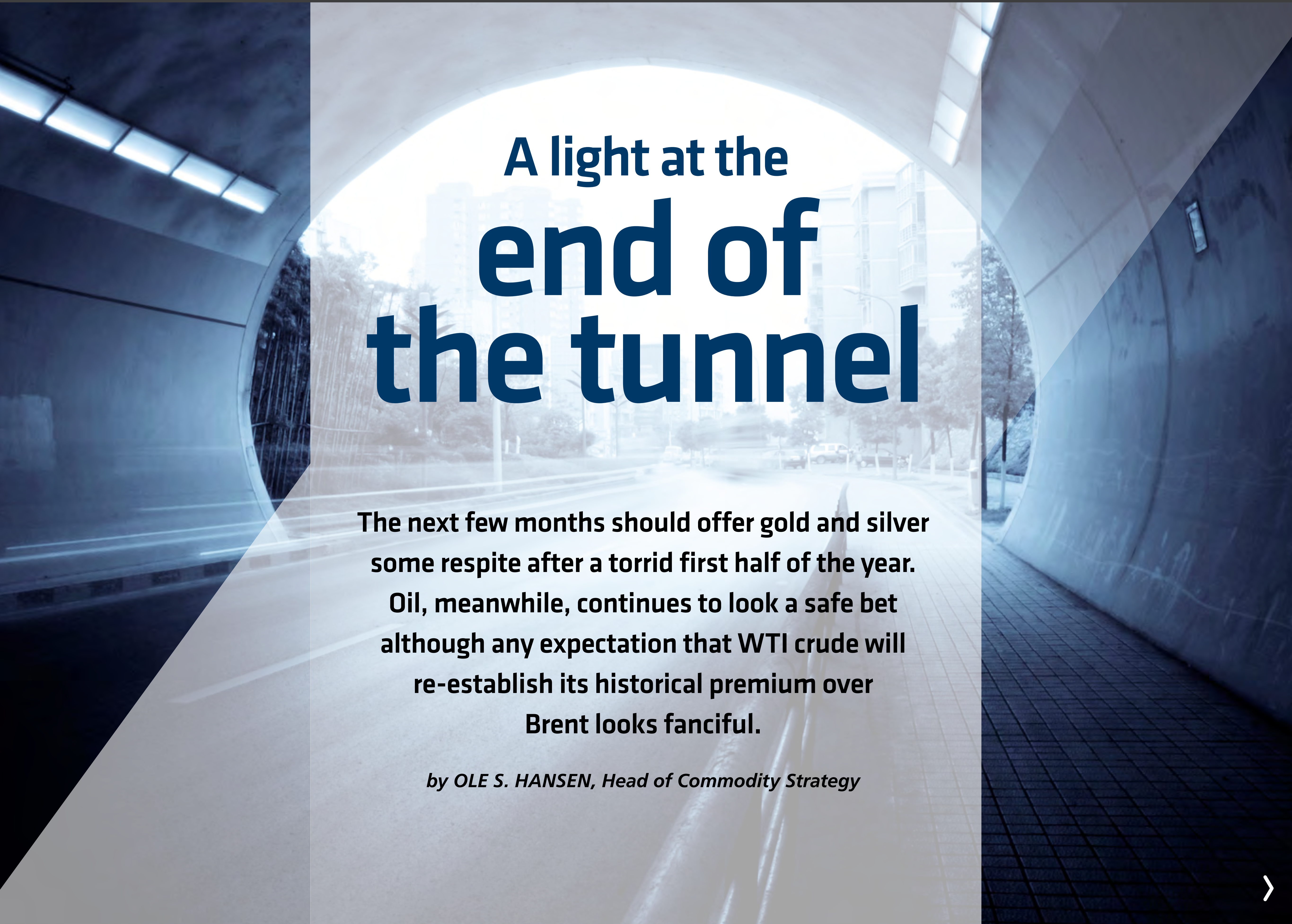


Overly long phases of low interest rates carry risks, that is undisputed.

It can lead to a misallocation of capital.

Joerg Asmussen, ECB executive board
July 15, 2013





A light at the end of the tunnel

The next few months should offer gold and silver some respite after a torrid first half of the year. Oil, meanwhile, continues to look a safe bet although any expectation that WTI crude will re-establish its historical premium over Brent looks fanciful.

by OLE S. HANSEN, Head of Commodity Strategy

A changing outlook for supply and demand fundamentals has been creating some major headwinds for commodities so far this year. After several years of breathtaking demand growth, led by emerging economies and rising commodity prices, the subsequent rise in production of several key commodities at a time of slowing demand is hitting home.

Optimal growth conditions across Europe and the US have perhaps seen this trend most pronounced in the agriculture sector, leading the price of coming crops to fall on an anticipated increase in supply this autumn following last year's drought.

On the economic front, disappointing Chinese growth and increased speculation as to when the US Federal Reserve will exit quantitative easing have resulted in heavy losses on both industrial and precious metals. Industrial metals markets are better balanced now than they have been for years, but while focus has been on slowing demand at a time of rising supply, demand disruptions can be a recurring theme that will support prices. We see limited downside risk from here.

The energy sector has seen natural gas prices retreat as a milder US summer has reduced demand at a time of continued strong production of shale gas, while oil markets are looking in very good shape. The main theme in recent weeks has been the normalisation of the price relation between global benchmark Brent crude and the US-produced WTI crude. However, all is still not well with multiple geopolitical hotspots offering speculative investors an incentive to remain long. Although we do not expect it, negative growth developments in China and in the US have the potential for offering the greatest downside risk.

"The main theme in recent weeks has been the normalisation of the price relation between global benchmark Brent crude and US produced WTI crude."

Crude oil support

Global oil fundamentals look likely to keep prices stable over the coming months. Since April, the price action on Brent crude has remained below the average price over the past two years at USD 110 per barrel. Ample supply at a time of slowing activity in emerging economies, especially China, has further removed the risk of supply chokes, which, on balance, points towards continued rangebound market conditions over the coming months. But a geopolitical event cannot be ruled out and this, together with a seasonal pick-up in refinery demand following a heavy maintenance season, has seen the price recover. Speculative investors have raised their bullish bets to record highs on both WTI and Brent crude. This situation, seen on a number of occasions in recent years, provides the biggest downside risk as any change in sentiment – potentially combined with a stronger dollar – could see bouts of long liquidation and ultimately result in lower prices.

The US oil market has finally managed to solve its infrastructure problems resulting from increased production from shale oil

Watch Ole talk about the light at the end of the tunnel...

and oil sand over the past few years. The bottleneck of oil inventories at Cushing, Oklahoma, the delivery point for WTI crude, triggered a huge dislocation between Brent and WTI, with the price difference reaching USD 23 per barrel less than six months ago. Increased pipeline and rail capacity from the US production areas and Cushing has seen the discount to Brent removed during July as landlocked oil finally began to flow out to coast-based refineries at a time of strong seasonal demand for gasoline.

Going forward, we see limited possibility for WTI to regain its historical premium to Brent and see the latter moving back towards a premium of about USD 5, reflecting the cost of transportation. Refineries are already running at their highest capacity utilisation in eight years. The continued strong flow of oil carries the risk of moving the bottleneck from inland to the coast as refineries will struggle to keep up with demand.

Such a situation could force the price of WTI down to attract demand at the expense of imported crude oil such as Brent.

Turning to the international stage, the outlook for supply and demand looks the healthiest it's been for a number of years. Demand growth will slow primarily on the back of a trend towards retrenchment in emerging markets, while supply from countries such as the US, Canada and Brazil will continue to grow. This leaves Opec in the middle with ample amounts of spare capacity, which should help to limit the upside potentials from any (smaller) supply disruption.

Brent should remain rangebound at USD 100-114 per barrel, with the highest price most likely to be witnessed during the early part of the coming period. The risk of revisiting the USD 100 per barrel level will increase as we move towards the final quarter of 2013 and into 2014. Random, stubborn supply outages, together with ongoing geopolitical concerns, will support prices in the near term, while elevated speculative positioning in both crude oils is a cause for concern as any worsening outlook for US and/or Chinese growth may trigger long liquidation.

Precious metals retrenching

Both precious metals remain stuck at the bottom of the performance table, with silver having lost more than one third and gold more than one fifth of their respective values during the past seven months. A multi-year rally, which saw gold make positive returns 12 years in a row, has well and truly come to an end. The buzz now is whether the sell-off has further legs to stand on.

"At the beginning of the year, gold was still regarded as a potential strong performer in 2013, according to most analysts. The sharp reversal that followed caught most off guard, resulting in some painful losses and lack of appetite to re-enter the market."

The exodus, especially out of gold, by institutional investors has been quite aggressive, accelerating in April after it had initially begun last October. There has been a 25 percent reduction in total holdings in exchange-traded products (ETPs; Bloomberg) and hedge funds had reduced their net-long exposure by 84 percent before the July price bounce. At the beginning of the year, gold was still regarded as a potential strong performer in 2013, according to most analysts. The sharp reversal that followed caught most off guard, resulting in some painful losses and lack of appetite to re-enter the market.

The pressure on precious metals from this institutional investor exodus has been driven by a turn in the US interest rate cycle, which has seen rising real yields due to falling bond prices at a time of a subdued inflation outlook. Investors have sought and found better opportunities elsewhere, especially in stocks, with the S&P 500 currently showing an 18 percent return on the year. Going forward, several obstacles still exist as a favourable growth outlook, especially in developed economies, which will continue to attract investors to equities.

We favour the USD to perform well in the months ahead, not least due to the expectation that US growth potential exceeds that of the euro area and elsewhere. This poses some additional downside risk to precious metals. Supporting gold is the fact that most of the selling has probably been seen already, which leaves the price in a better position to react to market-friendly news. Such news could be a postponement or reduced tapering by the US Federal Reserve, a revision to current interest rate projections and not least the fact that mine supply may begin to reduce should the price fall and stay below USD 1,200 for a prolonged period of time. The NYSE

Gold Bugs Index – a basket of major gold mining companies – is down more than 40 percent this year, indicating the considerable pressure these companies are under to maintain profitability.

We see the potential for gold to reach USD 1,450 per ounce over the coming months. Physical demand, especially from Asia, and Central Bank demand from emerging economies remains robust, while the reduction in paper demand through ETPs has almost stopped. This leaves the potential for some investors to decide to take advantage of lower prices, especially if opportunities in other asset classes prove harder to find. However, any renewed weakness carries the risk of a move to USD 1,090, which would represent a 50 percent retracement of the rally seen over the past 12 years.

Taking stock

Geopolitical issues notwithstanding or some other unforeseen shock to the market, the commodities sector looks set for a relatively benign near-term future. Gold and silver should stage a mild recovery, while oil looks as stable as it has at any time for a number of years. Agricultural commodity prices will fall, but in a manner entirely consistent with the rise in supply. Exciting it may not be, but sometimes an asset class could do with a bit of breathing space. After the volatility endured by the likes of gold and silver in the first half of 2013, we don't think there will be too many investors who would not welcome that. TF

Commodities	
Upside risks	**Downside risks**
Geopolitical events/worries	China's growth continues to slow
Strikes/labour disputes in key production areas	Lack of credit for commodity transactions
Weaker dollar	Major stock market correction
Production cuts as cost floors are broken	Excessive speculative positioning
Rising marginal production costs	Production has caught up with demand, resulting in inventory builds

Energy	
Upside risks	**Downside risks**
Oil producers need high prices to finance rising government spending	Excessive speculative positioning running at a record high on both Brent and WTI crude
Geopolitical tensions: Iran, Iraq, Libya, Sudan, Syria and Egypt	Non-Opec supply growth continuing to surprise
New production techniques such as shale oil and deep-water leads to higher production cost	Surging US shale production reducing imports
Stronger-than-expected pick-up in global growth	Faltering Asian demand from China, South Korea and Japan causing destocking

Precious Metals	
Upside risks	**Downside risks**
Euro area debt crisis escalates once again	Rising bond yields
US growth slows – delayed tapering	Subdued inflation outlook
Strong physical demand from central banks and retail	Rising growth expectations
Cost pressures on miners requiring higher prices	Continued long liquidation from exchange-traded products
Rising inflation expectations	A stronger dollar

GRAPHIC 1

Gold and US real rates

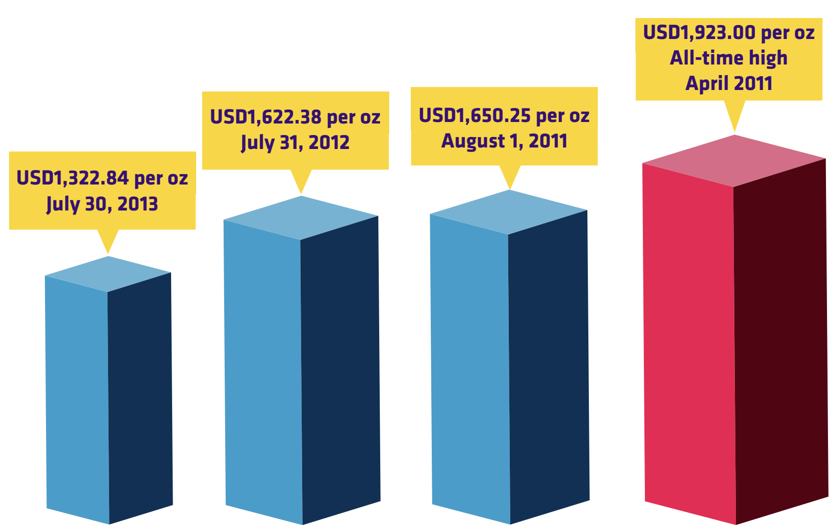
Key

Spot gold

5-year US real rates, right, inverse

Source: Bloomberg, Saxo Bank

GRAPHIC 2



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Ole Hansen, Head of Commodity Strategy at Saxo Bank
July 2013

CONNECT WITH OLE:

What impact will the outcome of the German election have on the fourth quarter? Stay tuned for our Insights Q4 Outlook, out in October.

SAXO BANK