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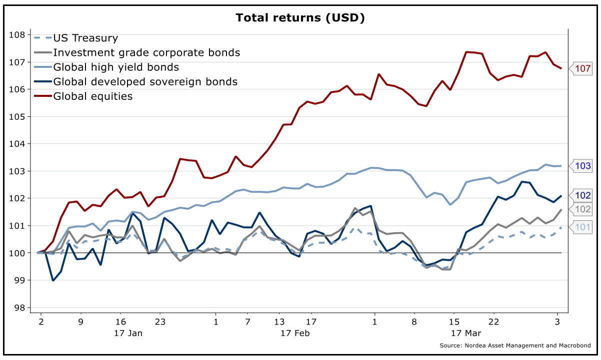
Great Expectations—little room for error

In Q1, strong growth indicators resulted in an impressive rally in risk assets, betting on higher growth and inflation. At the same time, core government bonds showed decent returns as well, implicitly questioning the sustainability of the rally. So, who will be right, equities or bonds? This is the key question for the rest of 2017.

Three factors point towards bonds winning the argument: Risk assets already price a heroic rebound in global growth, reflation is likely to peak and monetary conditions are tightening. Absent new positive drivers emerging, the air is getting thinner for risk assets. Risk assets performed strongly in the first quarter of 2017 (see figure 1), driven by a stunning run of positive macroeconomic data surprises. Confidence and growth indicators roared ahead, signalling a synchronised global recovery. Nevertheless, hard data categories (consumption, labour markets etc.) aren't beating expectations as much, and lag behind soft data (surveys, opinion polls etc.). So far, investors are clearly giving soft data the benefit of the doubt by shrugging off central bank tightening, lofty valuations and elevated policy uncertainty.

Figure 1: Asset returns. On track for a risk-friendly H1 – but bonds are holding up well, *despite* central bank tightening. Something's got to give?



How sustainable is the rally? Caution is warranted

At the current juncture, the obvious question to ask is how sustainable this rally is. In order to assess this, take a closer look at the key driver behind the rally year to date –the impressive positive surprises in confidence surveys and the likes. One could argue that surveys simply precede the hard data. After all, these indicators normally should be leading the data pack in order to warrant their label. In the US, growth indicators are currently signalling GDP growth in the range of 3.5-4%, up from 2.1% in Q4. If these signals hold true, we probably ain't seen nothing yet in terms of equity returns. To be clear, this is not undoable.

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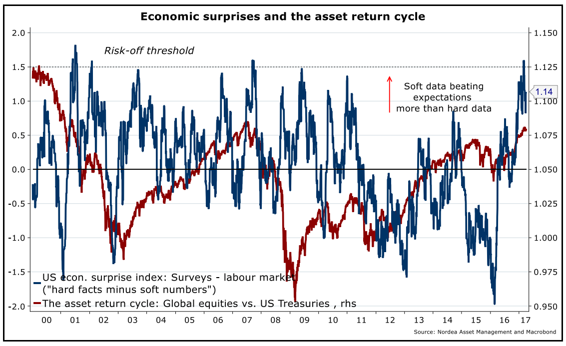
But reality doesn't paint such a rosy picture: there is an extreme discrepancy between soft data, which heavily beats expectations, and hard data, which is more in line with expectations. In the first quarter, this "surprise gap" has been at levels only witnessed twice, namely in 2001 and 2007 (see figure 2). In both cases, equities were either in or at the beginning of a bigger correction. This is not to say that equity investors should run for the hills because the surprise gap is flashing a "sell" signal, especially given the limited history of data available. But this underlines the fact that positive data surprises driving markets higher might not be a reassuring sign. From a macro perspective, caution is warranted regarding the sustainability of the rally in risk assets. Extrapolating Q1market trends into the rest of the year is a dangerous strategy.

Figure 2: The "surprise gap" between hard and soft data at extremes – could be a bullish signal, but caution is warranted.



Strong equities, strong bonds – who's right?

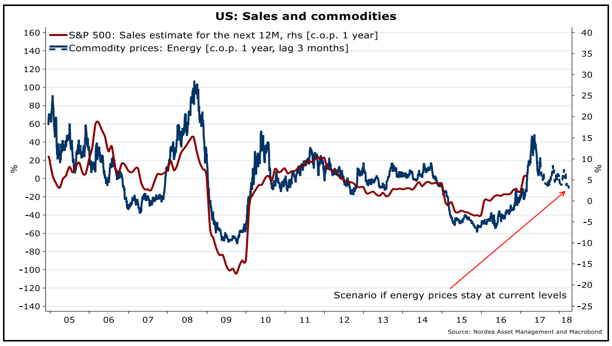
So far so good regarding the macro picture, but what is the market telling us? On the one hand, global equities returned 7% in the first quarter. This performance was driven by hopes for the aforementioned macro surprises translating into stronger growth and moderately higher inflation - the reflation trade as we know it. At the other end of the risk spectrum, core government bonds also showed decent returns in the first quarter. In a risk-on market with central banks tightening, one would expect the opposite reaction in bond markets. In addition, fixed income market's inflation expectations are actually down slightly year-to-date. So what is the bond market signalling? Unlike the post-Lehman years, this is not a question of central banks lifting all boats. G3 central banks are on a tightening course, marking a global monetary regime shift. In the wake of this, the positive returns in core government bonds are even more striking. This "conundrum" of diverging market patterns is most likely due to bond markets questioning the sustainability of reflation dynamics – and therefore the sustainability of the rally in risk assets.

When squaring the divergent market patterns with the overall macro picture, it boils down to a question of who's right at the end - equities or bonds. Bonds are likely to win the argument, as the reflation-induced rally faces three significant hurdles.

Looking ahead: Three headwinds to risk assets

First, the reflation hype is expected to run further out of steam as commodity prices stabilise and base effects begin to drag down headline inflation globally. This will also impact corporate earnings negatively. Half of US earnings growth in Q4 2016 was caused by the energy sector's rebound (see figure 3).

Figure 3: Peak reflation. The inflation boost from commodities is fading - the risk of earnings disappointments rising.



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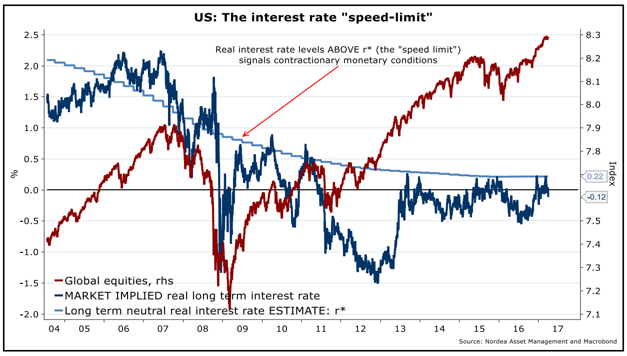
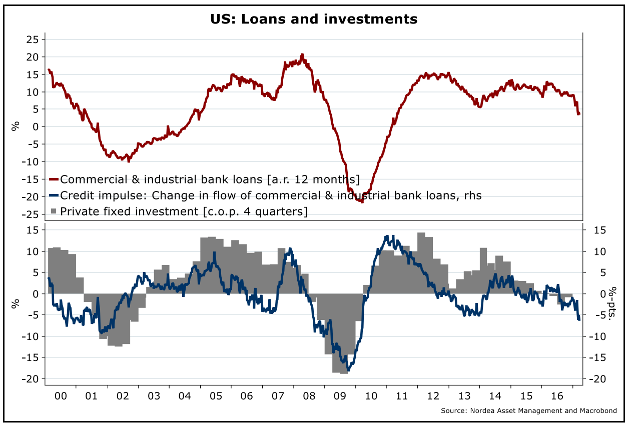
Secondly, the dominance of easy monetary policy is coming to an end, as all G3 central banks are tightening. Meanwhile, the interest rate "speed limit" (the neutral real interest rate) is low due to low growth potential. For the US, this means significant rate increases will not be required going forward to drive the actual real interest rate into the restrictive area, i.e. above the neutral rate (see figure 4). As the graph also illustrates, more often than not, this has caused a correction in risk assets in the post-Lehman low growth environment.

Figure 4: Real interest rate close to the "speed limit"- *monetary conditions tightening globally.* Implication: even small rate increases have significant impacts.



A global weakening of credit growth over recent months is an early warning (see figure 5): Monetary tightening already has a negative impact, despite low interest rates in *absolute* terms. This trend of tightening monetary conditions is likely to continue, deteriorating the macro risk balance in H2. Could fiscal dominance compensate for this? To the contrary – opening the fiscal spending spigots in the US would force the Fed to hike interest rates more than expected, since the economy is running at close to full capacity. This would bring forward the end of the 8-year old equity bull market. In that sense, the hurdles Trumponomics currently faces in the Congress aren't that bad.

Figure 5: The credit channel. Loan growth and credit impulse weakening. *No signs of animal spirits.*



Last but not least, risk assets are already pricing a heroic growth comeback, basically expecting global GDP growth to rebound to levels seen before the Great Financial Crisis (see figure 6). This is not unachievable, but a lot of stars have to align for these expectations to be met. The bar for further upside surprises is undoubtedly high. Risk-rewards favour betting against this scenario, in our view.

Figure 6: Mr. Market's growth expectations. Pre-Lehman growth levels seem to be in the price – high bar for further upside surprises. ***Deflating great expectations in H2?***

2017: A story about two halves
So both the macroeconomic picture as well as diverging market patterns are putting a big question mark behind the sustainability of the rally in risk assets. Bond markets scepticism is justified in the midst of peak reflation, monetary tightening and potential growth disappointments caused by overly optimistic growth expectations should all weigh on risk appetite in the second half of 2017.

The bottom line: absent any political shock (read: Le Pen victory), risk assets might have a bit further to run in the short term. But bumpier roads lie ahead. Risk-reward should therefore be tilted towards developed marked government bonds in the second half of the year. Still, a shallow tightening path in the US is limiting the downside in equities. In the same vein, a more bullish scenario could materialise if monetary conditions would ease from here. On the negative side, fiscal policy is a wild card, potentially forcing the Fed to over-tighten, bringing us closer to the end of the cycle.

About Nordea Asset Management
Nordea Asset Management (NAM, AuM 217 bn EUR*), is part of the Nordea Group, the largest financial services group in Northern Europe (AuM 323 bn EUR*). NAM offers European and global investors exposure to a broad set of investment funds. We serve a wide range of clients and distributors which include banks, asset managers, independent financial advisors and insurance companies.

Nordea Asset Management has a presence in Cologne, Copenhagen, Frankfurt, Helsinki, London, Luxembourg, Madrid, Milan, New York, Oslo, Paris, Sao Paulo, Singapore, Stockholm, Vienna and Zurich. Nordea's local presence goes hand in hand with the objective of being accessible and offering the best service to clients.

Nordea's success is based on a sustainable and unique multi-boutique approach that combines the expertise of specialised internal boutiques with exclusive external competences allowing us to deliver alpha in a stable way for the benefit of our clients. NAM solutions cover all asset classes from fixed income and equity to multi asset solutions, and manage local and European as well as US, global and emerging market products.

**Source: Nordea, 31.12.2016*

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