Nordea View

December 2018: Sell on strength

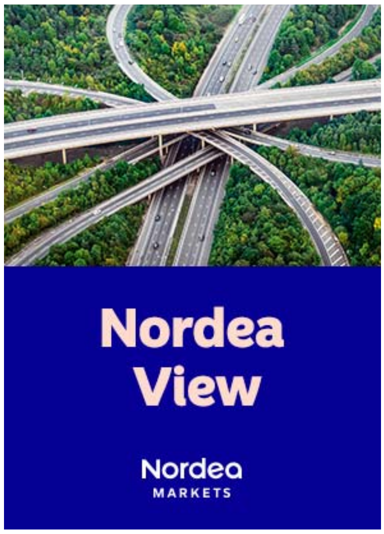
Nordea Markets - Analysts
Mikael Sarwe
Head of Market Strategy
mikael.sarwe@nordea.com

Carl Grapenfelt
Head of Market Research
carl.grapenfelt@nordea.com

Martin Enlund
Chief FX Strategist
martin.enlund@nordea.com

Arvid Böhm
Head of Equity Strategy, Market Strategy
arvid.bohm@nordea.com

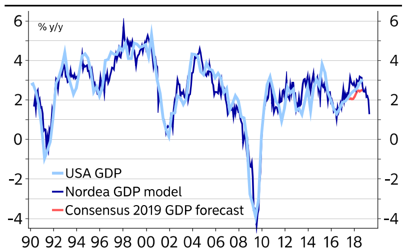
We stick to our medium-term negative view on risky assets. Expectations for profit margins are too high, given slower growth and rising wage costs. Our earnings revision indicators are starting to turn negative. Positioning is overweight risky assets globally and profit-neutral equity valuation measures more elevated than during the 2015-16 setback. P/E levels could be challenged more by current interest rate levels and tightening central bank liquidity. Our broad GDP indicators are sending signals that our rather bleak macro scenario could be too optimistic, spelling more trouble for 2019-20 EPS estimates. We do not expect a global recession though, due to low global real short rates and fiscal stimuli. Short term, equities have been starved of good news, so the tariff postponement might help trigger a bounce, which we would advise to sell into.



Strategy view: The times they are a-changin'
We continue to advocate for a value-based investment style owing to the attractiveness of relative valuation, which our new study of the global market demonstrates. Given the clear evidence that value traits offered defensive characteristics during the latest turmoil, we believe style rotation should have further to run. Although we see less upside risk in bond yields, we demonstrate that a worsening growth outlook should also lead to contraction of multiples and bring reduced valuation differences. It does suggest that high quality and growth traits should not be ignored though, and so we argue that GARP and reasonably priced quality should more firmly take the baton from momentum.

Themes heading into 2019
Markets into 2019: Scouting for support
When seeking support for a risk appetite recovery, we look at the series of events that led us to expect negative returns in equities. Hard evidence of or fundamental support for a recovery is still lacking and we expect the sluggish market trends to linger for some time. Credit spreads should trade higher and equity returns remain in negative territory. Valuation metrics and risk premiums have not yet reached levels that can absorb headwinds from the soft top-line growth, squeezed margins and higher interest rates. We do, however, see early indications of a potential tide change during 2019, possibly by late Q2.

US GROWTH OUTLOOK DETERIORATES

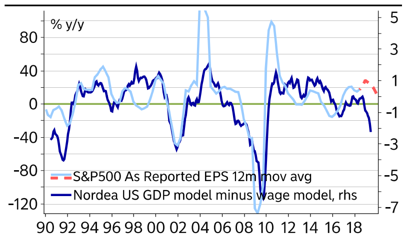


Source: Macrobond and Nordea

FX into 2019: Dollar stronger for longer
We have expected the dollar to weaken around the turn of the year, based on US core inflation disappointments, lower US growth expectations and a turnaround in central bank liquidity, while politics have been expected to become a more neutral driver. Only core inflation has been truly well-behaved, which is why we think a turn towards a weaker dollar is likely to occur later and be of less significance than before. This is not good news for risky assets.

Political risks into 2019
Political risks will remain elevated. Europe is heading for parliamentary elections that could result in EU-sceptic parties more able to set the agenda, while China may face a surge in US tariffs, and a deeply split US Congress is heading towards debt-ceiling negotiations, to name but a few risks.

EPS GROWTH COULD TURN NEGATIVE



Source: Macrobond and Nordea

EM equities into 2019: Remove underweights
The derailing performance of emerging markets (EM) risky assets was an early canary that prompted our defensive stance this year. Since the peak, EM equities have lost some 20% in local currencies. Their relative valuation appeal versus developed markets, based on EV/sales at multi-year lows, should not be ignored despite lingering estimate risks. The underperformance now appears to have troughed and we argue that positioning should be neutralised.

Macro strategy: Times they are a-changin'

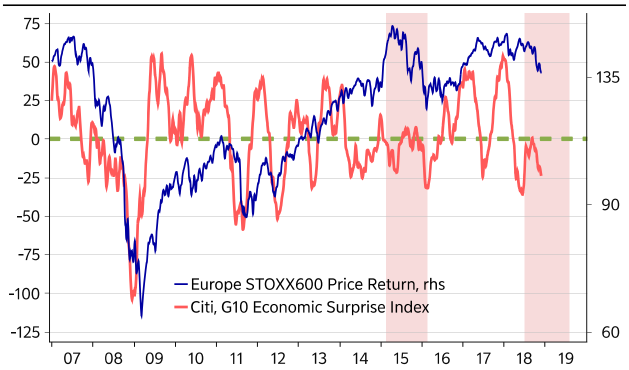
We stick to our negative view on risky assets. Expectations for profit margins are still too high due to slower global growth and rising wage costs. Positioning globally is still overweight risky assets and profit-neutral valuation measures remain more elevated than during the 2015-16 setback. P/E levels could be challenged more by current interest rates and tightening central bank liquidity conditions. Also, our broad leading GDP indicators are warning of a more negative outlook, which means that downside risks to earnings growth have increased.

Equity and credit markets have started to correct, but expectations are still too rosy

We still find evidence that our negative tilt to risky assets, which we have advocated since mid-May, remains valid. Both equity and credit markets have started to correct, but not enough to bring expectations back in line with our macro and profit margin outlook. The main reasons for the defensive view are intact, even though there have been some interesting changes to the backdrop since our latest Nordea View in mid-October.

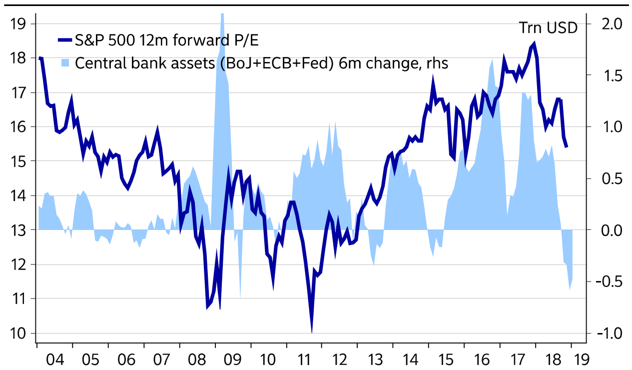
The manufacturing slowdown we have envisaged is likely to continue for the major part of 2019 as stimulus effects ebb. Central bank liquidity, important for both growth and asset valuations, has started to contract. The period with negative macro surprises should thus continue in 2019. As we have stated in earlier editions, we think the slowdown will be on a par with the 2015-16 experience, although for slightly different reasons, when equity markets fell some 17-23% top to bottom. Negative surprises and less liquidity also spell higher volatility than between early 2016 and 2017.

MACRO SURPRISES AND EQUITY MARKET



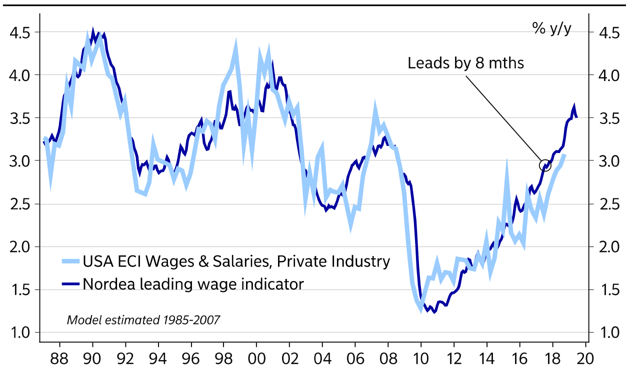
Source: Macrobond and Nordea

FORWARD P/E AND QUANTITATIVE TIGHTENING



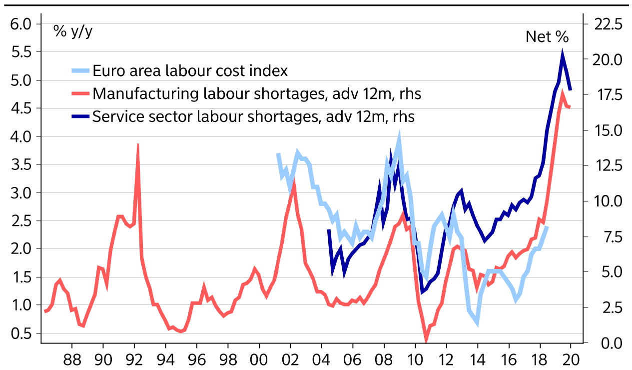
Source: Macrobond and Nordea

US WAGE COSTS SHOULD HEAD HIGHER



Source: Macrobond and Nordea

EURO AREA LABOUR SHORTAGE IS AT A RECORD HIGH

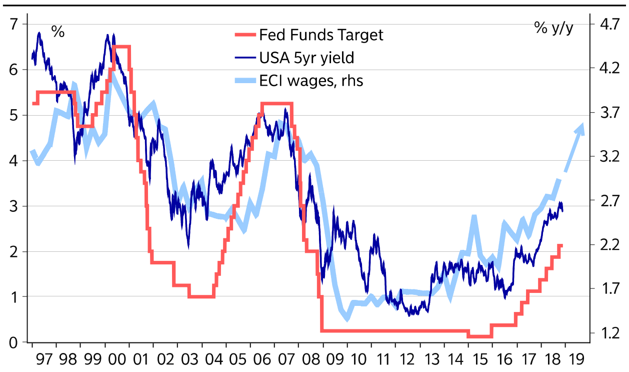


Source: Macrobond and Nordea

Slower growth and higher wage costs speak for downward revision to profit margin expectations

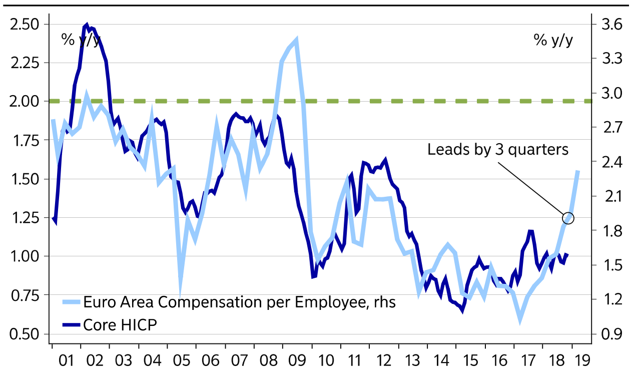
Record-high profit margin expectations have been shaved somewhat, but more is needed given our slowdown and rising wage cost scenario. Even higher wage cost increases in 2019, both in the US and Euro area (see 'Inflation at an inflection point 2.0'), would mean that interest rates should not fall back the way they did in 2015-16 and central banks are unlikely to shower the markets with liquidity as back then; quite the contrary, in fact. Those were very important reasons behind the kick-starting of the global economy and equity markets bottoming again in mid-2016. Also, current interest rate levels justify lower forward P/E levels than investors have grown accustomed to in the past four years. Downside risks to EPS forecasts have also increased recently and slower growth per se usually goes hand in hand with lower forward P/Es.

INTEREST RATES AND WAGES TREND TOGETHER



Source: Macrobond and Nordea

HIGHER CORE INFLATION IN EURO AREA IN 2019



Source: Macrobond and Nordea

Downside risks to our growth scenario have increased

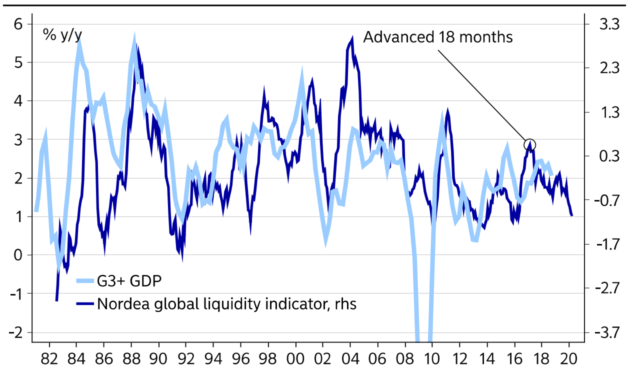
We still do not believe this is a broad recession scenario, due to low short real rates and fiscal policy stimuli, and so we do not envisage a market crash scenario. Previously, we have also pointed to a benign capex trend as a balancing factor, but currently we are less convinced in the cyclical part of that story. Even though we do not anticipate a recession, we have to admit that our leading GDP indicators have dropped markedly recently. The risk of a clearly more negative broad growth outlook than our official forecasts has increased.

Our leading US GDP indicator has quickly dropped below 1.5%

There are four interesting negative changes in the backdrop since our latest Nordea View**. First,** the manufacturing slowdown, where we have pencilled in 0% y/y growth in OECD industrial production at the end of 2018, seems to have been a canary in the coalmine for a more broad-based GDP slowdown. In the US, the positive fiscal policy impulse in 2018 will gradually peter out and be replaced by the negative effects of tighter monetary policy; both from higher interest rates and a reduction of Fed's balance sheet. It takes about 1.5 years for monetary policy tightening to bite into the economy and our conviction about ISM moving to 50 by mid-2019 has been strengthened.

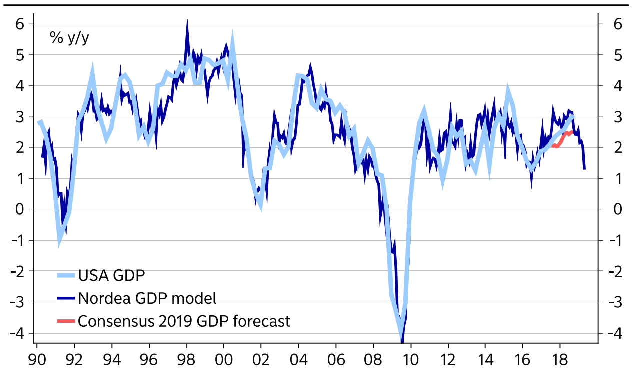
It could even be that our leading indicator warns that the GDP slowdown we have been expecting in 2020 could already be seen in 2019. Currently, our GDP indicator, which consists of 12 variables, points to GDP growth of below 1.5% in mid-2019, markedly below current consensus forecasts. Housing, capex, monetary and financial indicators are all contributing to this slowdown, while the labour market remains a positive force.

G3 GDP AND CENTRAL BANK LIQUIDITY



Source: Macrobond and Nordea

LARGE DROP IN LEADING US GDP INDICATOR



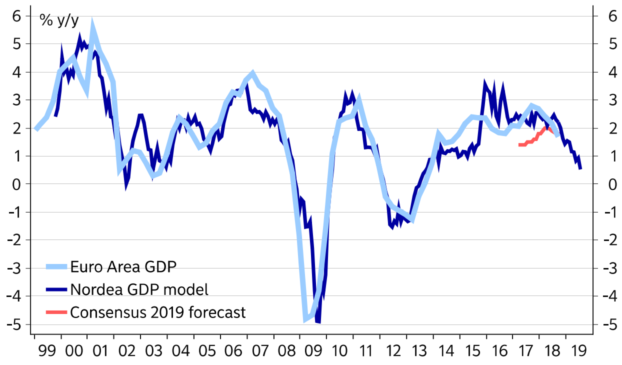
Source: Macrobond and Nordea

Euro-area GDP growth could drop below 1%

In the Euro area, our broad leading GDP indicator looks even worse, indicating a risk of growth below 1% in 2019 (ECB's forecast is 1.8%). The indicator points to a bigger slowdown than our 2015-16 roadmap. The ECB will likely have the delicate monetary policy problem of balancing higher wage and core inflation with much lower growth in 2019. There is an obvious risk that due to Draghi's strange promise of doing nothing until after the summer 2019, the ECB has already missed the opportunity to build any interest rate buffer ahead of the slowdown.

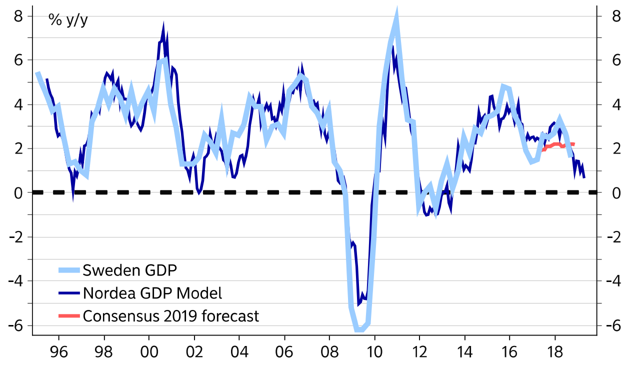
That said, models are models and timing is not always that exact, but the historical accuracy is so solid that it is fair to say that the risk to our "benign" global slowdown scenario clearly is on the downside.

RISK FOR MUCH LOWER EURO-AREA GROWTH



Source: Macrobond and Nordea

SWEDISH GDP GROWTH IS SLOWING

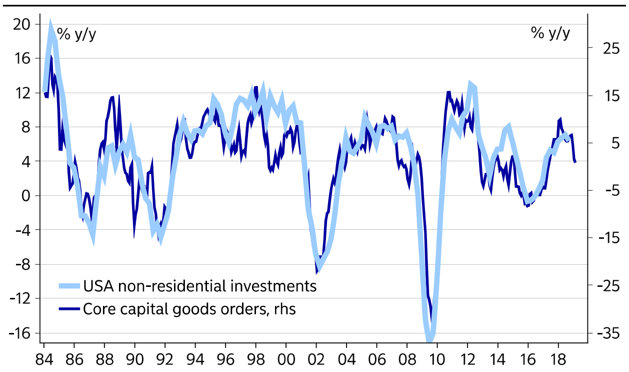


Source: Macrobond and Nordea

Global capital goods orders signal a capex slowdown

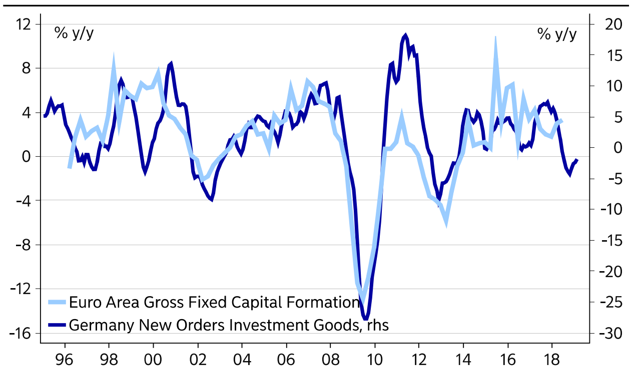
Second, the positive capex story seems to be taking a cyclical hit. The ongoing trade war discussions are not helping either and we have earlier pointed to the risk that boards might postpone structurally sound investments as an effect. That now seems to be happening. Core capital goods orders have started to signal a capex slowdown in the developed world.

US CAPEX GROWTH SCENARIO CHALLENGED



Source: Macrobond and Nordea

CYCLICAL HEADWINDS FOR EURO-AREA INVESTMENTS



Source: Macrobond and Nordea

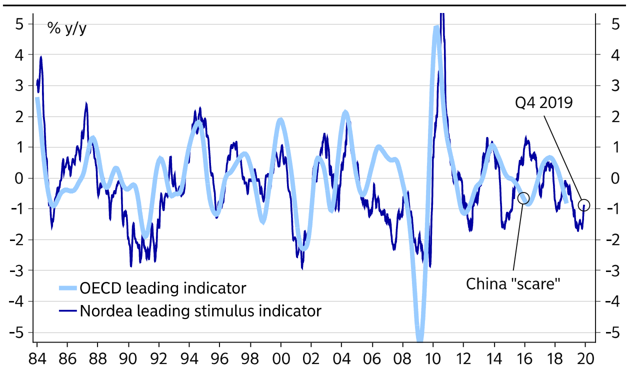
Falling oil prices have short-term negative growth implications

Third, oil prices have dropped. Until October, rising oil prices had been a positive difference from the 2015-16 slowdown. That conclusion is now being challenged. To be fair, falling oil prices are not purely negative; they have negative short-term production and oil investment effects on global growth, but medium-term positive effects due to the world still being a net user of oil. A falling oil price is thus one reason why our longer leading stimulus indicator has started to trough and turn upwards, but markets will need to react to the short-term negative effect first. That said, if the recent speculation that Russia/Saudi Arabia will push through production cuts at the OPEC meeting turns out to be correct, this would put a floor on oil prices for the time being.

Credit spreads have continued to widen

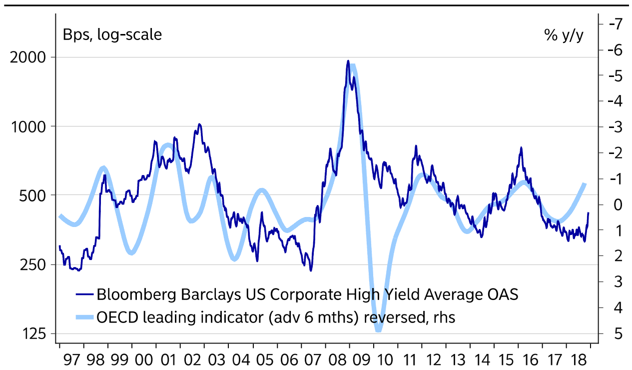
And **fourth**, credit spreads have been under upward pressure in Europe all year long but there are now also clear indications of the US following suit. In other words, for the first time, US high yield markets are starting to confirm our US slowdown scenario. Note also that credit spreads usually move exponentially with the business cycle; as the growth outlook deteriorates, the negative effect on credit spreads amplifies.

TROUGH FOR THE OECD LEADING INDICATOR IN Q3 2019?



Source: Macrobond and Nordea

CREDIT SPREADS HAVE WIDENED IN THE US RECENTLY



Source: Macrobond and Nordea

Hard to tell if Chinese stimulus efforts will be successful

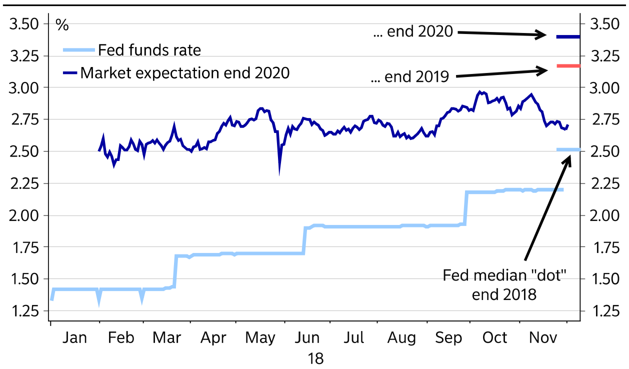
But aren't there any positive changes at all in the backdrop? Well, maybe a few. The Chinese situation is hard to interpret, but the authorities clearly continue to signal that they will do whatever it takes to keep growth on the right track. Tax cuts and other measures could help, but the efficiency might be debated since it could end up in savings. The credit-driven, state-owned enterprises' solution to the 2015-16 China growth scare had a more direct impact, but it is not a viable option this time. Chinese business surveys have also, if anything, taken a beating even after stimulus measures were announced. Domestics seem to doubt the potentially positive stimulus effects, maybe because of the trade war and tariff hike threats heading in to 2019.

The market is only discounting slightly more than one Fed hike until the spring

The other potential positive change could be the Fed outlook. Powell's recent statements have, on the surface, sounded much softer than the August-October hawkish tone of being far below the neutral rate and needing to counteract financial imbalances/too high asset valuation levels. Falling oil prices and the strong USD also point to inflation dropping back down for a period. Admittedly, we are confused by Powell's wild rhetoric swings, but the fixed income markets have reacted by slashing the expected rate path to below 2.5% by March 2019, to be compared with the current effective funds rate of 2.2%; ie less than 30 bp worth of hikes and less than the Fed dot plot.

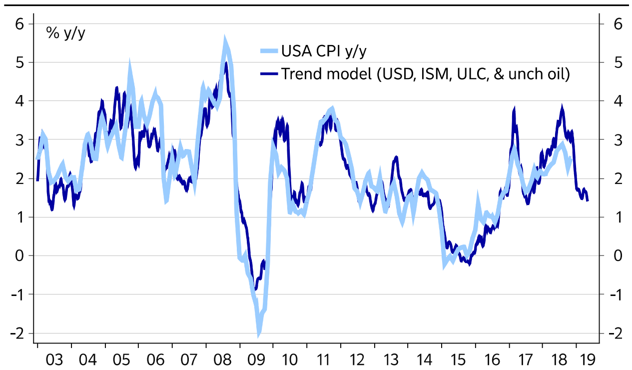
Powell's new statement was more accurately that the policy rate is "just below" the bottom of the relatively broad range for the neutral rate (2.5-3.5%), so it's fully possible that markets have over-interpreted his words and we still have further to go to neutral. Of course, our GDP indicator for the US increases the risk of a more protracted pause further out, but at the same time wage growth should grind higher, making it hard for the Fed to become very dovish. Even in the case of a somewhat more pronounced slowdown scenario, we currently have a hard time believing the Fed will deliver fewer hikes than the market is discounting. For interest rates more generally there is also a continuous increase in bond supply putting an additional floor under US longer rates.

ONLY TWO MORE FED HIKES DISCOUNTED BY END 2020



Source: Macrobond and Nordea

USD AND OIL PRICES SHOULD PUSH DOWN INFLATION



Source: Macrobond and Nordea

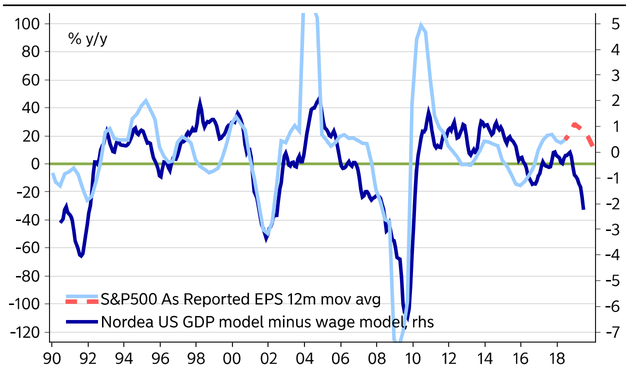
The tariff postponement could trigger a knee-jerk bounce for equities, despite it not being a solution to the problem

Any positive surprise on the trade war front, be it US/China or US/Europe, would probably trigger a knee-jerk reaction by equities that are currently technically oversold and starved of good news. The three-month delay to the tariff hike after the G20 meeting could certainly be viewed as such, although we would remind investors that this is a postponement and not a solution to the quite extensive US demands. Moreover, we believe that the underlying negative macro trend would be intact even with better news on the trade war front.

US EPS growth could be negative in 2019

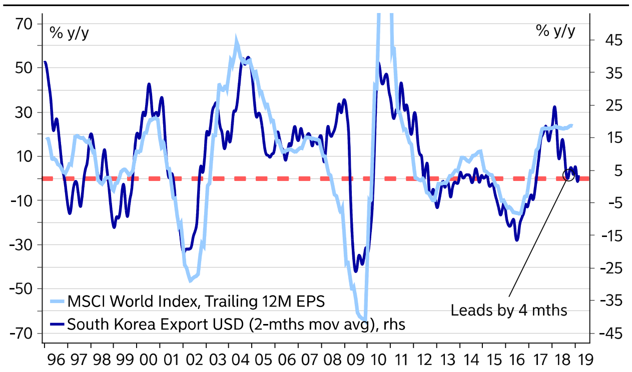
Turning to the risk on/risk off conclusions, we still believe global investors are overweight both equities and credits, and should want to reduce those positions in our macro scenario. The profit margin squeeze we are expecting is unlikely to be counteracted by positive top-line surprises, as it was in the US for most of 2018. In fact, if we combine our leading US GDP and wage indicators, a picture emerges that warns of negative EPS growth in 2019, compared with the current +10% expectation. Even though interest rates might not rise as much as we forecast, the E in the P/E ratios should be challenged more than we originally thought.

SLOWER GROWTH/HIGHER WAGES SPELL EPS PROBLEM



Source: Macrobond and Nordea

SOUTH KOREAN EXPORTS AND GLOBAL EPS GROWTH



Source: Macrobond and Nordea

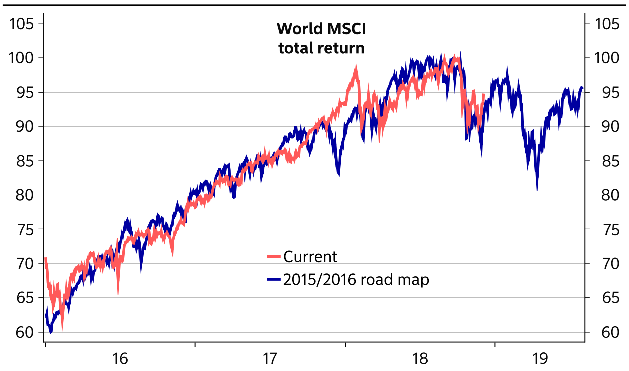
Markets are signalling more risk aversion and cyclical doubts than in the Jan/Feb selloff

As we pointed to in October, markets are also indicating more risk aversion, liquidity worries, cyclical doubts and, in general, changed leadership compared to the January/February sell-off. Credit spreads are widening more broadly, small caps are underperforming large caps, cyclicals are underperforming defensives and, for the first time, value stocks have started to outperform growth stocks. All this follows the game plan we have been writing about since mid-May and partly resembles the run-up to the 2015-16 sharp equity market correction.

We stick to our 6-9 month negative view on risky assets

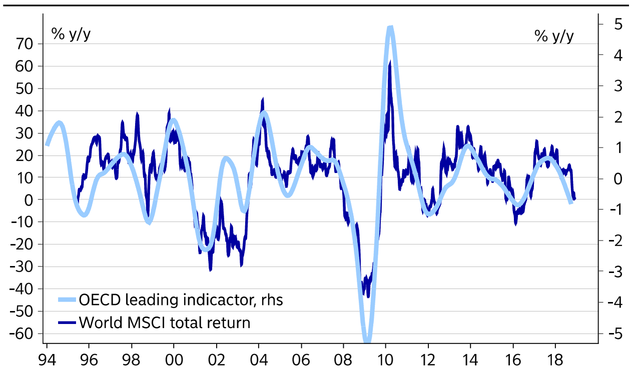
All in all, we stick to our medium-term negative view on risky assets. Expectations are too high on the business cycle and profit margins, positioning globally still overweight risky assets, profit-neutral valuation measures are still more elevated than at the 2015-16 setback and, if anything, downside risks to EPS growth have increased. Even though we acknowledge that there has been a global "Santa Claus" rally in December for 12 of the last 15 years and oversold equity markets together with the recent US/China news and Fed signals could trigger something similar now, we believe there will be a better entry point in six to nine months' time to go long the equity market again.

2015-16 EQUITIES ROADMAP STILL VALID



Source: Macrobond and Nordea

EQUITY MARKET TREND SHOULD CONTINUE DOWN IN 2019



Source: Macrobond and Nordea

This section has been produced by Nordea Research's non-independent Research unit.

Equities: Estimate trends signal tough times

Our revision indicators have worsened materially, bolstering our conviction that they will be in negative territory during most of 2019. We cannot square the prevailing consensus forecasts, which see accelerating margin improvement despite rising wage pressure and downside risks, with our already pretty muted macro scenario. Given recent evidence of the US outperformance stalling, we reiterate our belief that US stocks are set to underperform based on relative valuation, revision and positioning arguments.

Estimate revision momentum is waning...

We have witnessed a marked weakening of revision momentum utilising our revision indicators. Sales momentum is waning and although the latest reading is neutral in the US and Europe (negative in Asia), the speed of the second derivative and prevailing macro trends suggest that we are likely to be in negative territory during Q1 2019. This issue is compounded by the re-acceleration in profitability that consensus forecasters expect.

...slowing growth, rising wage pressure and overoptimistic margin forecasts make us call material downside risk to 2019-20 forecasts

Since May, we have warned about the earnings risks the market is facing in 2019: slower growth, wage cost pressure, rising interest costs and over-optimistic margin forecasts. As we see downside risk to our original, rather muted macro scenario, we are growing in conviction that 2019 should witness material estimate downgrades. We would not rule out that we will see negative y/y EPS growth next year.

We see clear evidence that analysts have started the margin adjustment process, but believe it has further to go.

We are also growing in conviction as we already detect clear evidence that the analyst collective has started to shave its 2018-19 margin outlook, with both our median and aggregated 12-month forward margin charts rolling over. In addition, the share of companies globally with improving EBIT margins in 2018 is the worst seen since 2012. Although it is too early to dissect 2020 forecasts, our first glance suggests that they are beyond exuberant. Unless the analyst collective really takes care of estimates in the coming six months, we could see a prolonged period of estimate weakness.

Given the earnings risks we foresee, we advise against focusing too much on earnings-based valuation

Valuations have contracted quite materially (approximately three P/E units), but we advise not putting too much emphasis on profit multiples, given the estimate risk we foresee. We would rather point out that levels are still rather elevated based on profit-neutral multiples such as EV/sales and P/BV. We consequently remain in the multiples contraction camp and foresee further contraction. We do acknowledge, however, that the next leg should come from slower global growth rather than markedly higher interest rates.

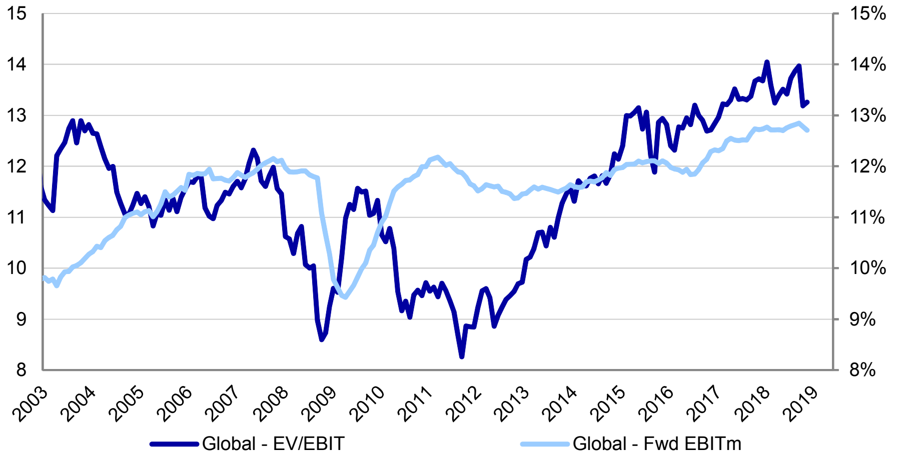
Recent trend suggests that our October call to underweight US stocks could be materialising

We also reiterate that the valuation discrepancy between the US and other markets has not been this great since 2003-04, which continues to speak in favour of underweighting the US. In addition, although we detect US earnings momentum stalling, we still doubt that the full FX effect of the strength in the dollar index has been fully captured. If we are right in this assessment, it will be very hard for the US to outperform the rest of the world from a relative revision standpoint, eliminating the argument that has helped US stocks extend their outperformance ahead of the latest market turmoil. In fact, the US equity market has underperformed slightly over the past six weeks. Additionally, global positioning remains tilted towards risky US assets, so we continue to see three solid arguments for US underperformance, namely relative valuation, revision and positioning.

We are still paying high multiples in a historical context for great earnings, despite the recent correction

A double whammy (multiples and margins) could still be on the cards

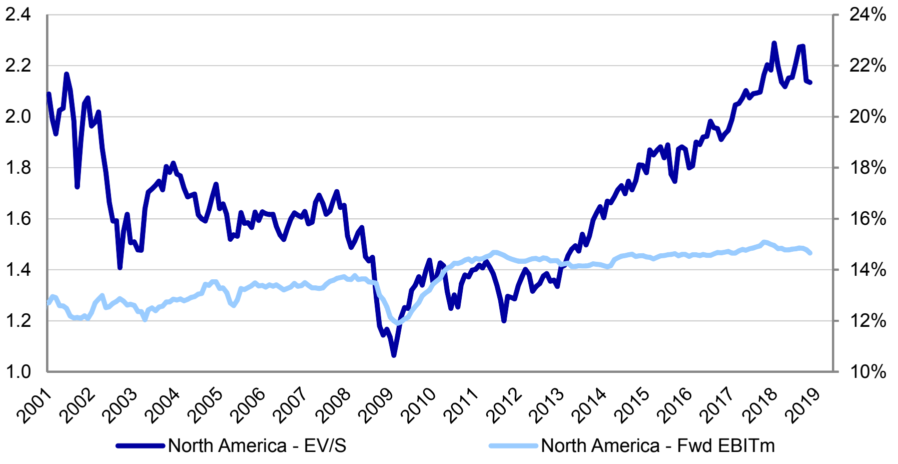
EV/EBIT VS MARGINS (AGGREGATED) – STOXX GLOBAL 1800



Source: FactSet and Nordea

EV/sales could still fall quite far in the US, next stop 1.8x perhaps

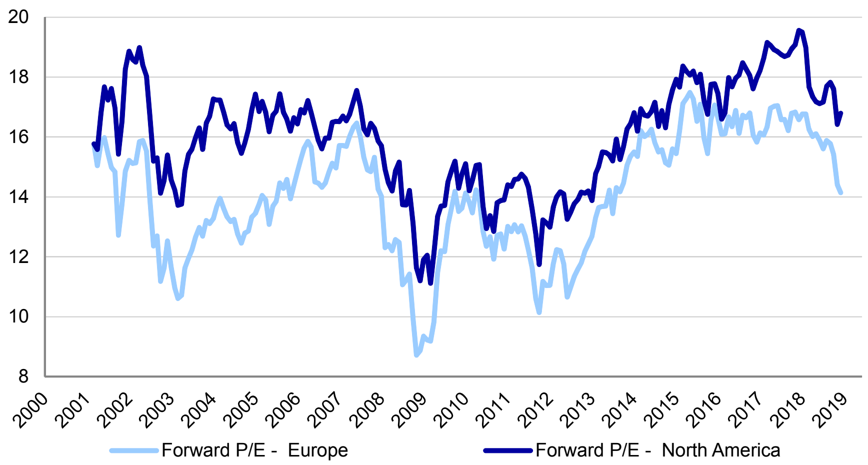
EV/SALES VS MARGINS (AGGREGATED) - STOXX NORTH AMERICA 600



Source: FactSet and Nordea

Median P/E multiples not that alarming after having contracted three units, but beware of the estimate risk

MEDIAN P/E – STOXX EUROPE 600 AND NORTH AMERICA 600

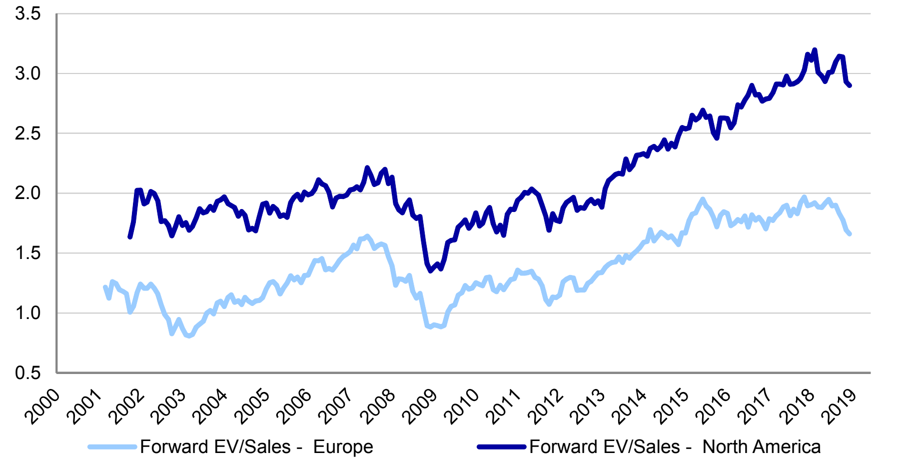


Source: FactSet and Nordea

In the US, EV/EBIT multiples are decoupling versus Europe to the greatest degree since 2003-04

Even though Europe should weather the storm better we note that the correction has "only" got us back to the 2007 peak.

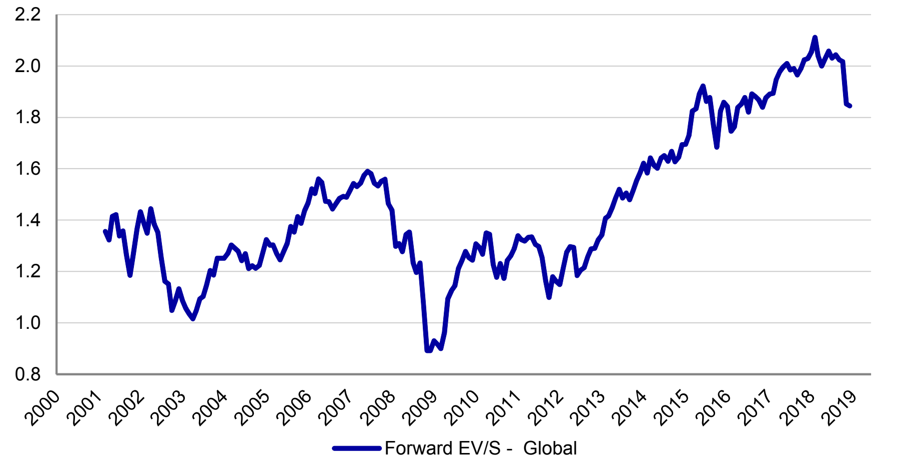
MEDIAN EV/SALES – STOXX EUROPE 600 AND STOXX NORTH AMERICA 600



Source: FactSet and Nordea

The median company remains pricey on EV/sales, especially if margins start declining

MEDIAN EV/SALES - STOXX GLOBAL 1800

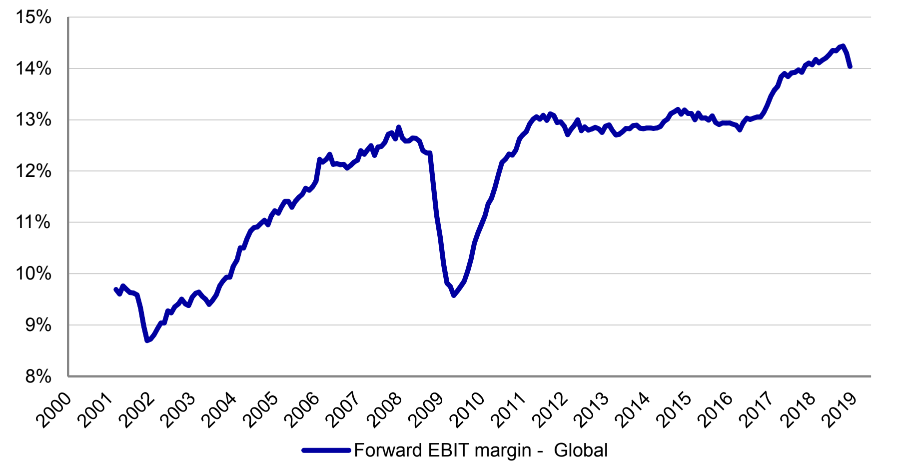


Source: FactSet and Nordea

Following the Q3 reporting season, we are getting the first signs that margin forecasts are being moderated.

We argue that we are not done yet

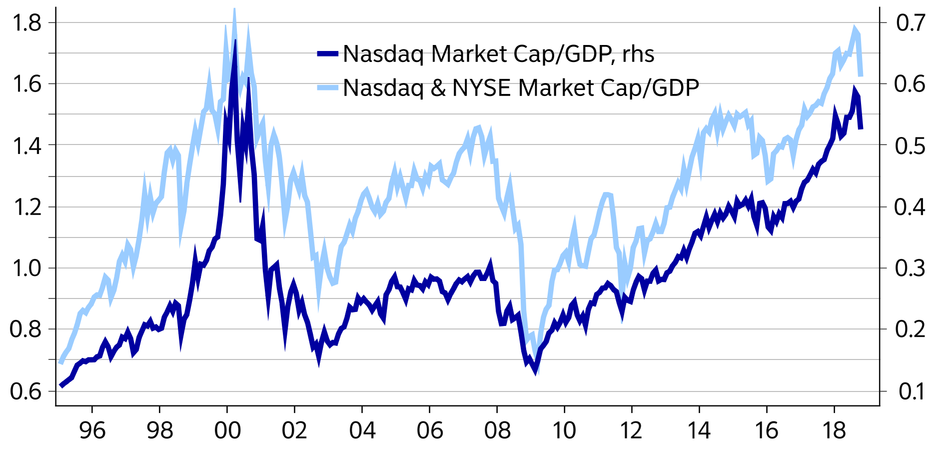
MEDIAN EBIT MARGIN – STOXX GLOBAL 1800



Source: FactSet and Nordea

A macro strategist's best chart for valuation tells the same story as an EV/sales chart

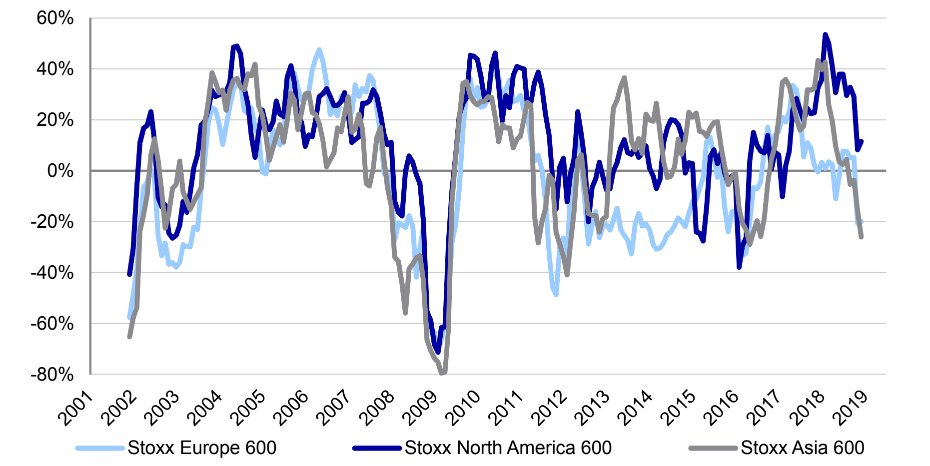
MARKET CAP/GDP BACK AT DOT-COM BUBBLE LEVELS



Source: Macrobond and Nordea

Asia and Europe in negative territory while the US barely keeping its head above water still

OUR EPS REVISIONS INDICATOR - EUROPE, NORTH AMERICA AND ASIA

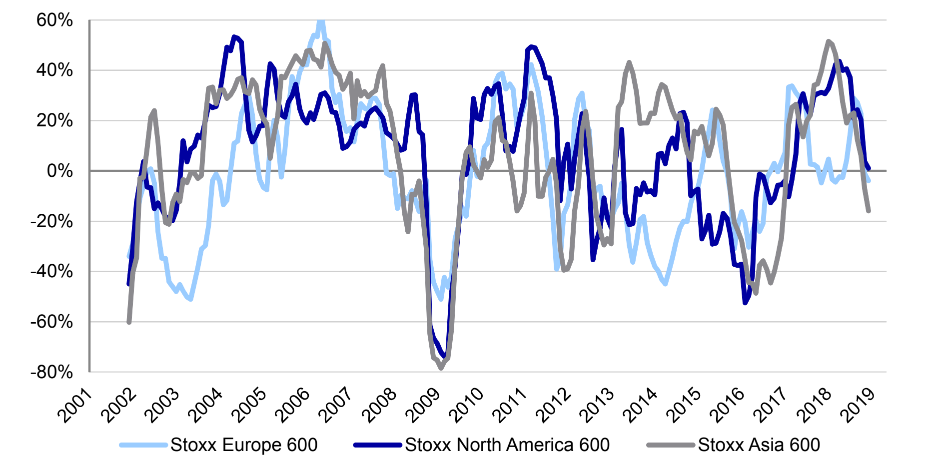


Source: FactSet and Nordea

Sales momentum is no longer positive in any of our three core regions.

If our macro scenario plays out you should expect this indicator to mimic the 2015/16 scenario

OUR SALES REVISION INDICATOR - EUROPE, NORTH AMERICA AND ASIA

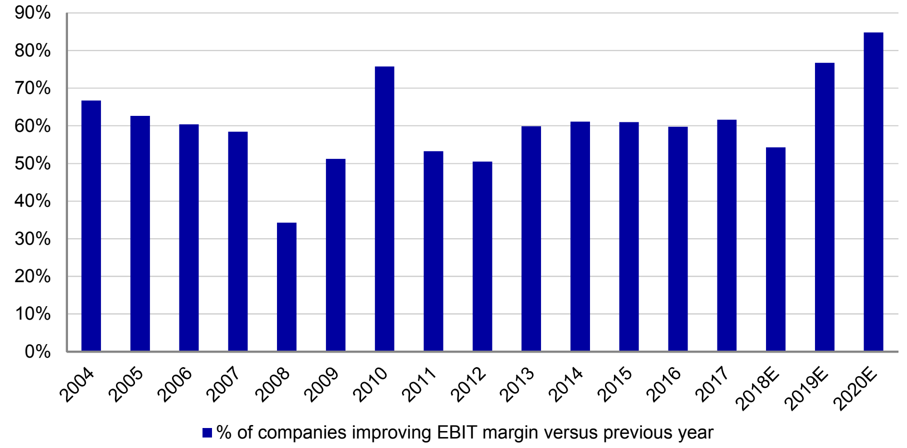


Source: FactSet and Nordea estimates

STOXX 1800:
2018 is expected to post the worst share of margin improvements since 2012

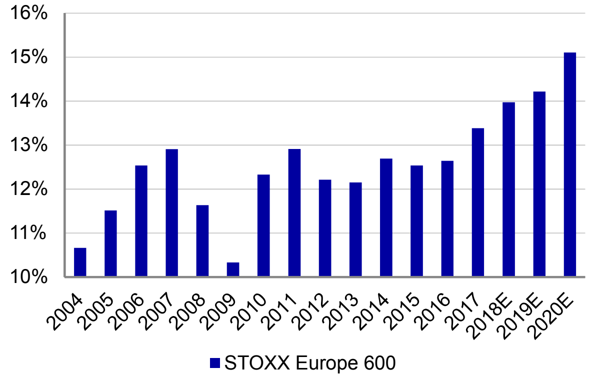
Although it is too early to focus on 2020 we note that those expectations are beyond exuberant

SHARE OF STOXX 1800 COMPANIES EXPECTED TO IMPROVE EBIT MARGINS



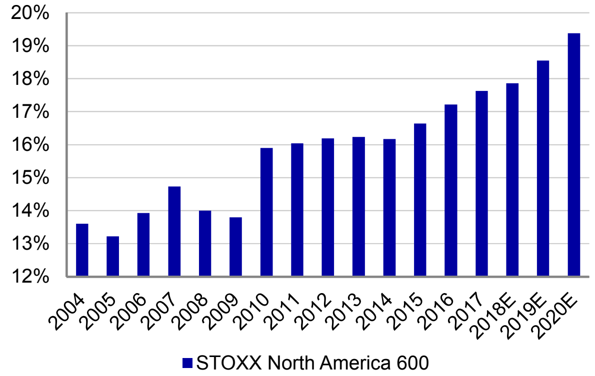
Source: FactSet and Nordea

MEDIAN EBIT MARGIN - STOXX EUROPE 600



Source: FactSet and Nordea

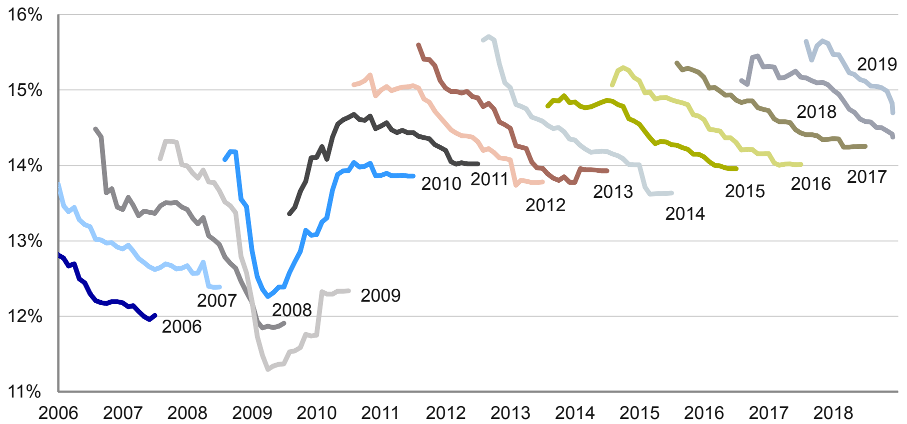
MEDIAN EBIT MARGIN - STOXX NORTH AMERICA 600



Source: FactSet and Nordea

2019 margin forecasts now coming under pressure in the US

MARGIN EXPECTATIONS OVER TIME - STOXX NORTH AMERICA 600



Source: FactSet and Nordea

This section has been produced by the Nordea Markets Independent Research unit.

Equities: Style analysis cements a value bias

We steadfastly continue to advocate for a value-based investment style owing to the attractiveness of relative valuation, which a new study of the global universe demonstrates. With clear evidence that value traits offered defensive characteristics during the latest turmoil, we are confident that the current relative performance has further legs. Even though we see less upside risk in bond yields, we demonstrate that a worsening growth outlook should also lead to general multiple contraction and bring about smaller valuation differences. It does, however, suggest that high quality and growth traits should not be ignored and we thus argue for GARP and reasonably priced quality traits to return to the fray. Lastly, we would also expect earnings uncertainty to increase further during 2019, with early signs that it is starting to put a dent in the earnings momentum style, which has enjoyed remarkable alpha in recent years.

Valuation protected the downside in the recent market turmoil

Looking at the style development during the recent market turmoil, we take comfort in clear signs that valuation appears to have acted as a defensive attribute, just as we argued in previous editions. We are especially intrigued by the value comeback in the US, which has outperformed growth (MSCI definition) by around to 8% over the past two months. In Europe the recovery has been ongoing a bit longer and although value has also worked in Europe over the past two months, it has not accelerated in the same fashion.

There is further mean-reversion logic to value extending relative gains given the extreme valuation differential between the cheap and the expensive ends of global stocks

In this report we dig deeper into our global universe (STOXX 1800) to demonstrate that the gap between the cheap and expensive ends of the equity market has rarely been this wide. Our analysis demonstrates that the gap is close to 18-year extremes regardless of whether you apply earnings multiples (P/E, EV/EBITDA) or profit neutral multiples (EV/sales, P/BV). Interestingly, similar conclusions can be drawn if you analyse the 75th versus 25th percentile instead of the 10th versus 90th percentile. This strengthens our conviction that the relative value recovery that we are witnessing has further legs, especially for the most expensive part of the equity market, which implicitly has the highest growth expectations.

The upside risk in bond yields may have been reduced but a worsening growth outlook also indicates multiple contraction and compression

Even though we still see some upside for long-dated bond yields, we acknowledge that the risk of central banks lowering their rate paths has increased. As an example, the fixed income market is already factoring in “only” two more rate hikes from the FED, compared with the dot plot suggesting at least three during the next 12 months. This has clear implications for our Gordon (growth)-inspired P/E matrix.

We have been arguing that we are moving from right to left and that we are embarking on a multiple contraction and compression journey (reduced valuation differences) as the cost of capital is on the rise. We now want to remind investors that a lower growth path also leads to valuation contraction and compression and we are therefore not ready to abandon our conclusion that valuations will become much more important in stock picking in the foreseeable future. If interest rates settle around today's levels in the US, it does however suggest to us that investors should also attempt to identify growth at a reasonable price (GARP).

It is also worth mentioning that value recoveries rarely stop after 6% outperformance (MSCI World value versus growth). They tend to continue well beyond 10%. In conclusion, we feel very comfortable in still advocating a value bias based on relative valuation attraction, further valuation compression and, as value recoveries often extend past at least 10%, outperformance relative to growth. Lastly, given more than ten years of underperformance, we see a value recovery extending beyond the recoveries seen over the past ten years.

We see rising earnings uncertainty, which should make investors think twice about chasing momentum regardless of the price of the security

Over the past six months, we have argued that earnings uncertainty should increase owing to higher rates, rising costs (labour in particular) and a slowing global economy. If you believe this will materialise, there is one potential key consequence for earnings revision momentum for investors. If there is greater uncertainty around the mean of the consensus, then revisions around that mean should theoretically matter less. This is why we continue to argue that it could be perilous to rely solely on momentum. We also see some evidence that earnings revision momentum has stopped working in Europe, with our "upgrade strategy" underperforming almost 5% since September.

Previously, it was not uncommon that value and high-quality traits outperformed in unison – Over the past three years it has hardly happened, but recent signs suggest that we could be at an inflection point

We have previously illustrated (based on European mid-small cap data) that we have come through a rather unusual period, where classic fundamental analysis has been out of favour and momentum, be it growth acceleration, price and/or estimate changes, has taken the upper hand. In this report we also demonstrate that it was actually quite common that value and high-quality traits offered outperformance in tandem between 2001 and 2007. We can also demonstrate that over the past three years we have not had a single occurrence of simultaneous value and quality outperformance on a rolling six-month basis. Recently, we are actually seeing tentative signs that both value and quality traits are outperforming in tandem, and hence it is an early sign that our thesis may be playing out.

Given the valuation of our value/quality hybrid in Europe at the vicinity of relative historical lows (30% discount) and our belief that slower growth and rising cost pressure should make earnings forecasts more uncertain, we find it likely that the signs we are seeing now may be sustained. We thus see good odds that fundamentals will bounce back again with a vengeance. This is yet another argument to complement our valuation focus with both high-quality and GARP attributes.

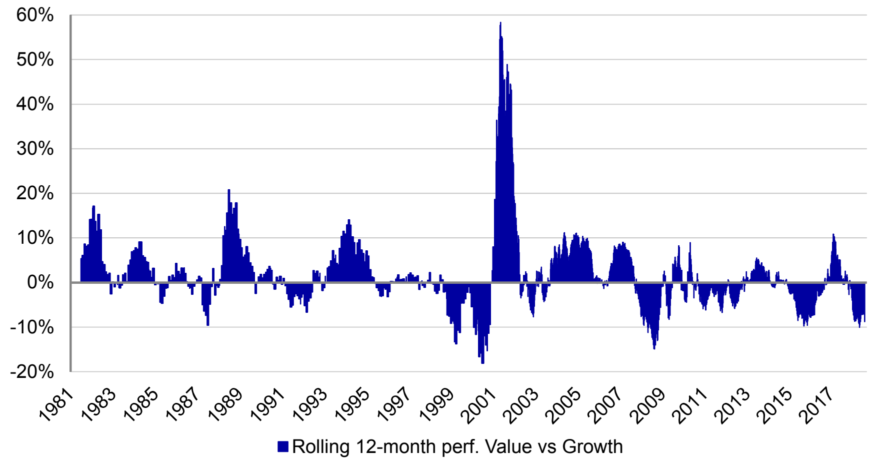
Recent weeks have seen a really strong value comeback

VALUE IS MAKING A GLOBAL COMEBACK AS IT HAS STARTED TO OUTPERFORM GROWTH

Source: FactSet and Nordea

Historically, we have seen value runs extend well beyond 10% outperformance

ROLLING 12-MONTH RELATIVE PERFORMANCE OF VALUE VS GROWTH



Source: FactSet and Nordea

Gordon inspired P/E matrix

Moving downwards on growth also shifts multiples down and valuation multiples tend to compress when comparing a market or a company delivering excess growth

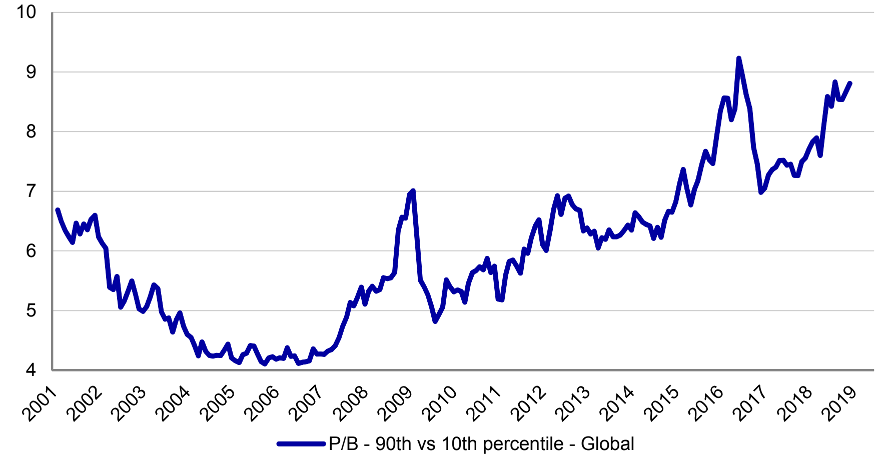
GORDON GROWTH: IMPACT ON VALUATION OF CHANGING DISCOUNT AND/OR GROWTH RATE

		Discount Factor (Cost of equity)								
		9.0%	8.5%	8.0%	7.5%	7.0%	6.5%	6.0%	5.5%	5.0%
Growth (g)	3.5%	13.6	15.0	16.7	18.8	21.4	25.0	30.0	37.5	50.0
	3.0%	12.5	13.6	15.0	16.7	18.8	21.4	25.0	30.0	37.5
	2.5%	11.5	12.5	13.6	15.0	16.7	18.8	21.4	25.0	30.0
	2.0%	10.7	11.5	12.5	13.6	15.0	16.7	18.8	21.4	25.0
	1.5%	10.0	10.7	11.5	12.5	13.6	15.0	16.7	18.8	21.4

Source: Nordea estimates

The relative P/BV spread between expensive and cheap stocks is staggering, suggesting that the value run of late has further legs

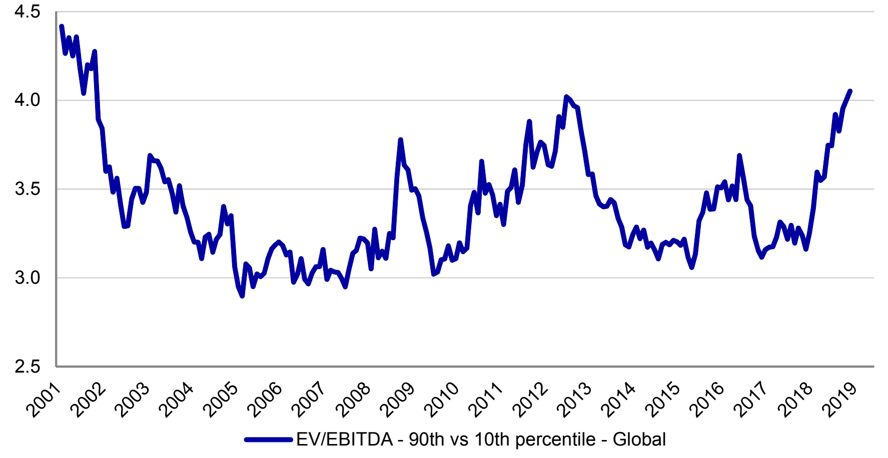
MEDIAN P/B – 90TH VS 10TH PERCENTILE IN STOXX GLOBAL 1800



Source: FactSet and Nordea

The relative EV/EBITDA differential is back at 4x; historically we have moved down toward 3x, which would suggest 25% underperformance for the most expensive end.

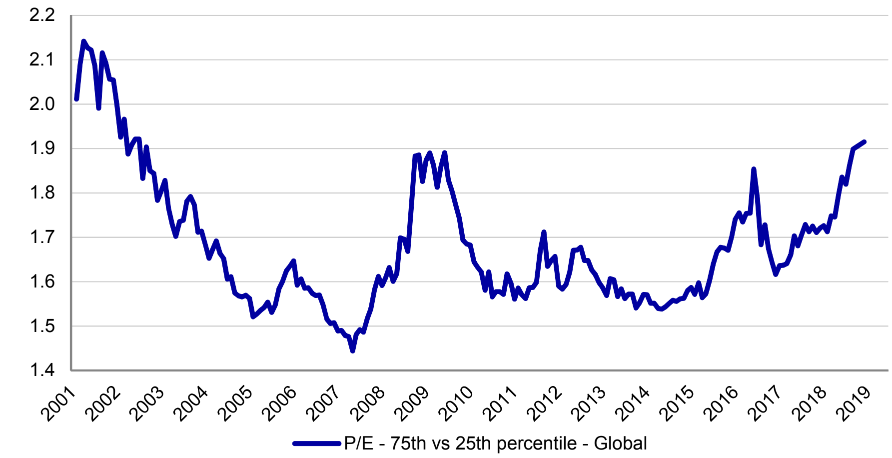
MEDIAN EV/EBITDA – 90TH VS 10TH PERCENTILE IN STOXX GLOBAL 1800



Source: FactSet and Nordea

Even when comparing the 75th versus the 25th percentile we detect material differences versus the historical range, suggesting that the breadth of the cheap versus expensive (implicitly high growth) is quite extreme.

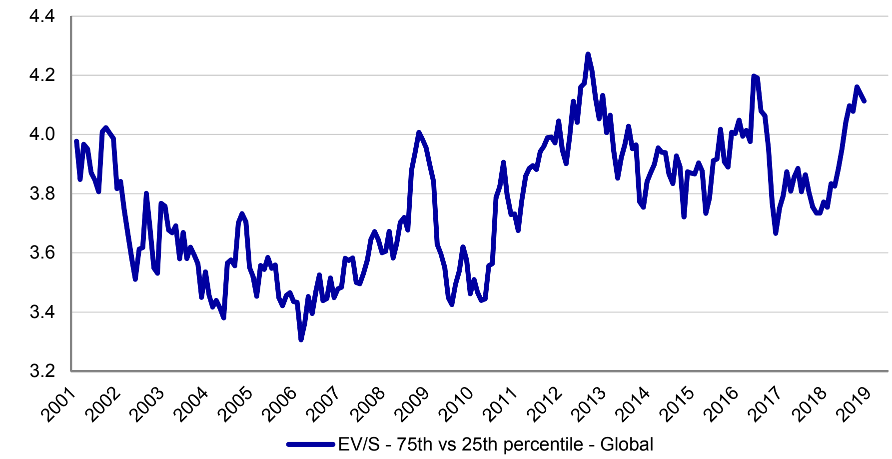
MEDIAN P/E – 75TH VS 25TH PERCENTILE IN STOXX GLOBAL 1800



Source: FactSet and Nordea

When you are above 4x on this spread you have been well rewarded going long cheap and short expensive traits.

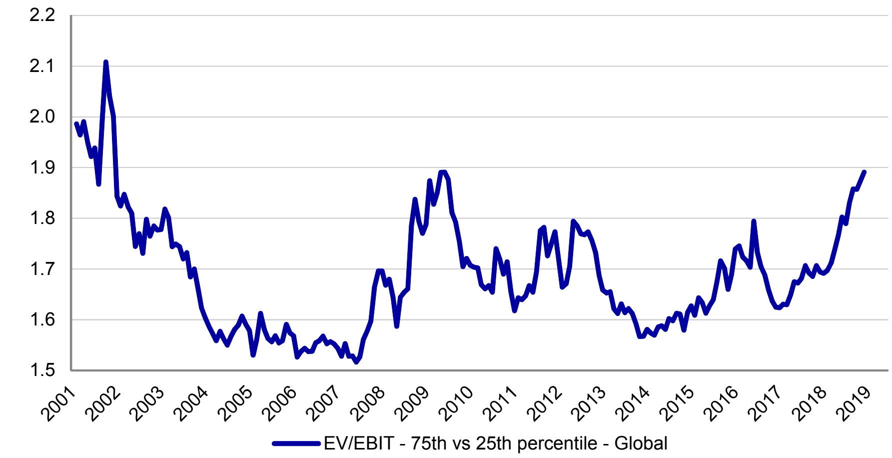
MEDIAN EV/S – 75TH VS 25TH PERCENTILE IN STOXX GLOBAL 1800



Source: FactSet and Nordea

EV/EBIT differentials are not quite as extreme as they were post the dot-com bubble bursting...

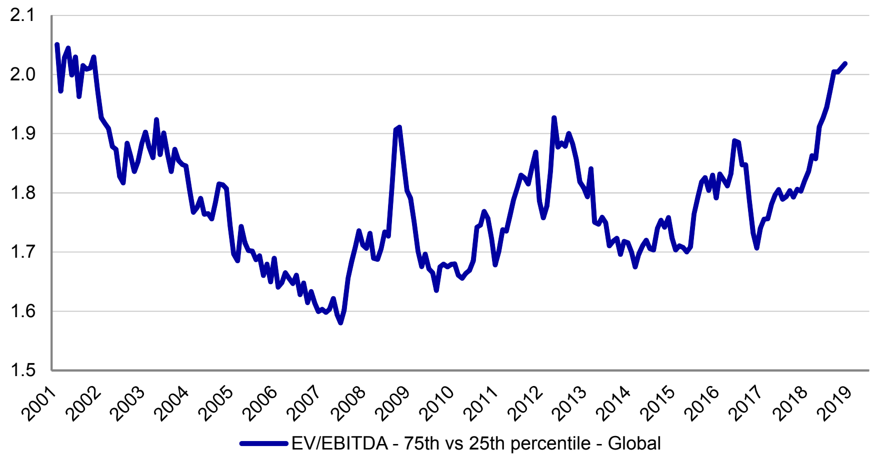
MEDIAN EV/EBIT – 75TH VS 25TH PERCENTILE IN STOXX GLOBAL 1800



Source: FactSet and Nordea

...but based on EV/EBITDA we are back at multi-year highs

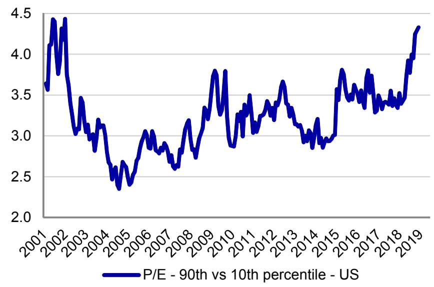
MEDIAN EV/EBITDA – 75TH VS 25TH PERCENTILE IN STOXX GLOBAL 1800



Source: FactSet and Nordea

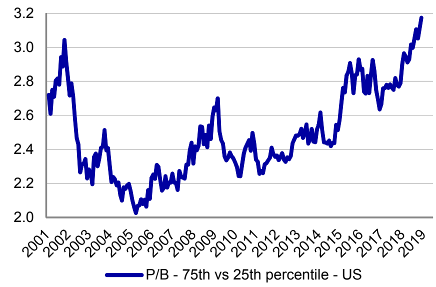
In the US market this is also quite extreme...

MEDIAN P/E 90TH VS 10TH P. – US



Source: Company data and Nordea estimates

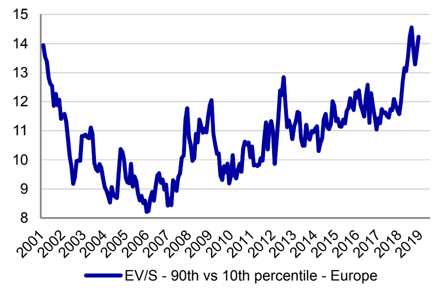
MEDIAN P/B – 75TH VS 25TH P. – US



Source: Company data and Nordea estimates

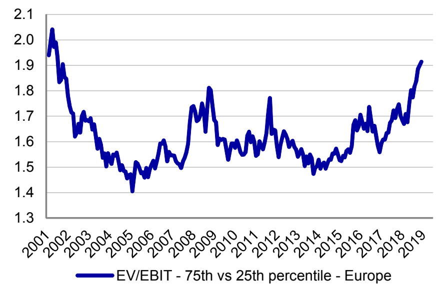
...and don't forget Europe....

MEDIAN EV/S – 90TH VS 10TH P. – EUROPE



Source: FactSet and Nordea

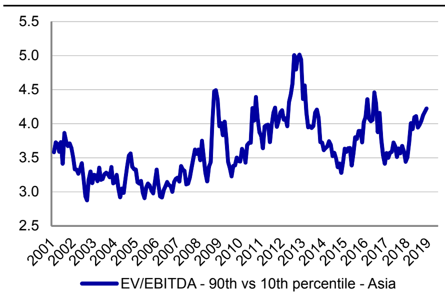
MEDIAN EV/EBIT – 75TH VS 25TH P. – EUROPE



Source: FactSet and Nordea

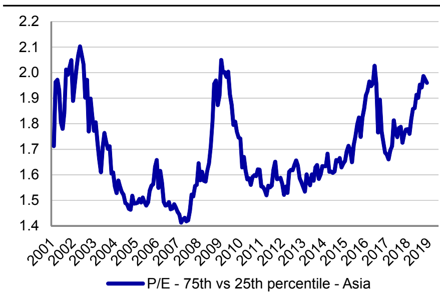
...or Asia - confirming that avoiding value traits has been a clear trend

MEDIAN EV/EBITDA – 90TH VS 10TH P. – ASIA



Source: FactSet and Nordea

MEDIAN P/E 75TH VS 25TH P. – ASIA



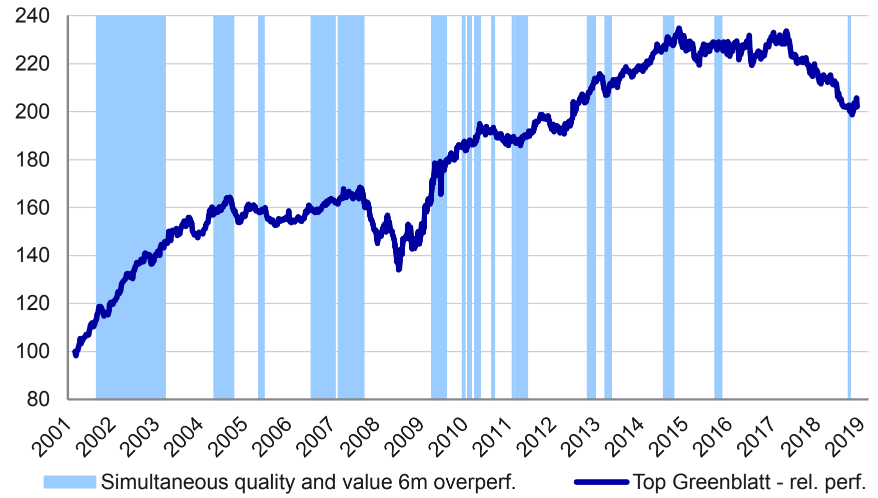
Source: FactSet and Nordea

Shaded areas show value and quality traits outperforming in tandem, which in 2001-07 was quite common

Over the past three years we have not had a single data point with value and quality working simultaneously

Recent evidence suggests that things are changing and our bet would be that the recent trend shift will continue

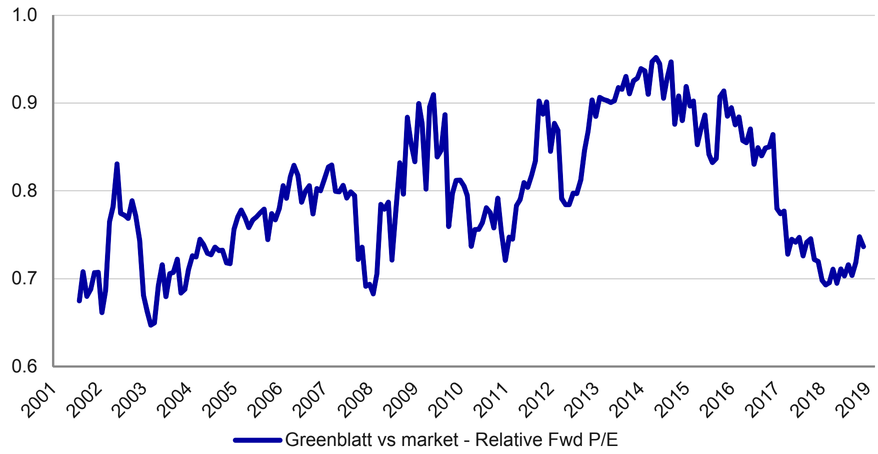
QUALITY AND VALUE TRAITS SHOULD COME BACK IN VOGUE



Source: FactSet and Nordea

The relative value appeal of our value/quality hybrid suggests solid risk/reward in focusing on fundamentals instead of momentum

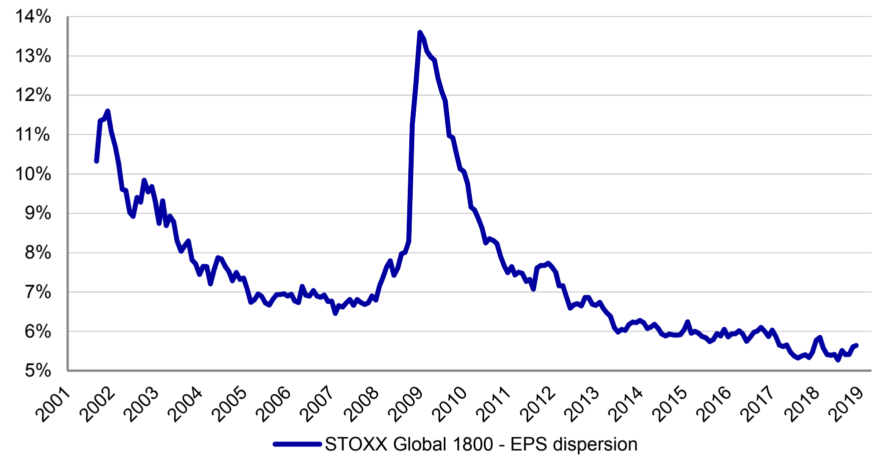
GREENBLATT STYLE STILL AT A SUBSTANTIAL DISCOUNT BUT HAS SHOWN RECENT UPTICK



Source: FactSet and Nordea

The analyst collective is still exhibiting a historically low spread on EPS estimates but we believe that we are past the trough and that dispersion will increase going forward

EPS DISPERSION STILL AT HISTORIC LOWS BUT HAS STARTED ITS RISE



Source: FactSet and Nordea

This section has been produced by the Nordea Markets Independent Research unit.

Markets into 2019: Scouting for support

When seeking support for a risk appetite recovery, we look at the series of events that led us to expect negative returns in equities. We conclude that hard evidence or fundamental support for a recovery is still lacking and therefore expect the sluggish market trends to linger for some time. We expect credit spreads to trade higher and equity returns to remain in negative territory. Valuation metrics and risk premiums have not yet reached levels that can absorb continued headwinds from soft top-line growth, squeezed margins and rising interest rates. We do, however, see early indications of a tide change during 2019 – possibly by late Q2 – if the pricing of emerging market assets once again proves to be a good guide.

A string of events has led us to expect markets to derail from the positive trend

Throughout 2018, we have witnessed a change in investor behaviour, detected through changes in the pricing of financial assets, which have painted a picture of an increasing loss of risk appetite. Credit spreads started to rise at the beginning of the year, up from compressed levels last seen in 2007. Shortly thereafter, demand for emerging market (EM) assets started to fade and EM currencies depreciated. EM equity markets started to trade lower after two solid years on an upward trend. As investors sought to reduce risk further by scaling back on liquidity constraints and moving to 'size', we saw small cap stocks starting to underperform large cap stocks. Finally, as investors started to move away from cyclical exposure and towards more defensive trades, we argued the risk of a flat-out sell-off was imminent.

Waning support from the forward-looking business cycle is core to markets needing to adjust expectations

As discussed earlier, the underlying factor that explains the reduced demand for risk is a slowing business cycle, triggered by less support from expansionary monetary policies. Therefore, to determine when the current sluggish market trends will end and eventually turn more positive, we should closely watch for changes in monetary policy and the direction of the business cycle. As explained in the macro section, there is little evidence of a trough in the expected cycle for 2019. Consistently tight labour markets also suggest we will see rising wage pressure which, with some lag, could indicate rising inflation rates and hence less accommodative monetary policy.

Markets should trough well ahead of any real cycle support

As markets normally expand in a more orderly fashion and correct themselves more harshly and abruptly, we can reasonably expect more sluggish macroeconomic support to be discounted by the market well ahead of any turning point in the real cycle. When risk premiums have improved enough to incorporate a typical cycle downturn, investors start venturing further out on the risk curve again.

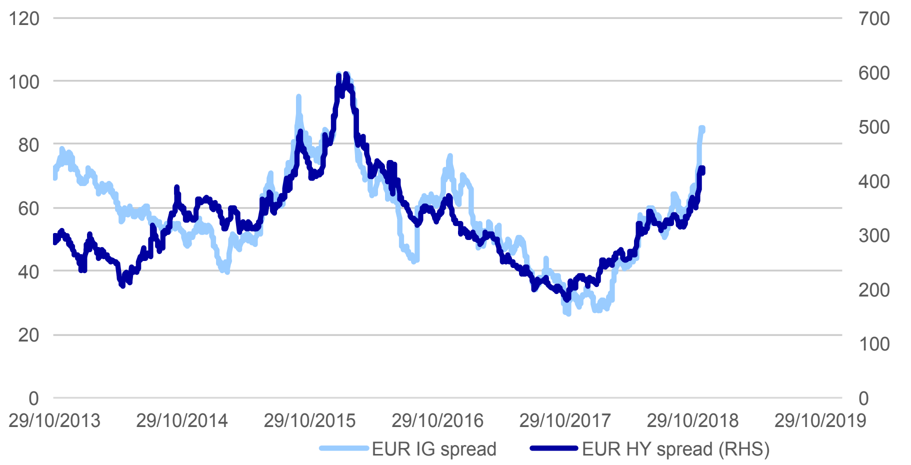
High yield spreads appear to have come halfway

The European high yield (HY) bond spread has risen ~200 bp this year and is trading at around 415 bp. The investment grade (IG) corporate bond spread has more than doubled to almost 85 bp. If we assume this current business cycle downswing is similar to 2015-16, HY could see a peak at 600 bp and IG at around 100 bp. Judging by the fast pace of the current trend, IG could reach 100 bp by Q2 next year, while HY could take until Q3 to reach 600 bp.

Even after more than a 200 bp rise in EUR HY spreads, another 200 bp looks likely

IG bond spreads appear closer to their peak

EUR HIGH YIELD AND INVESTMENT GRADE BOND SPREADS AIMING FOR 2015 PEAK

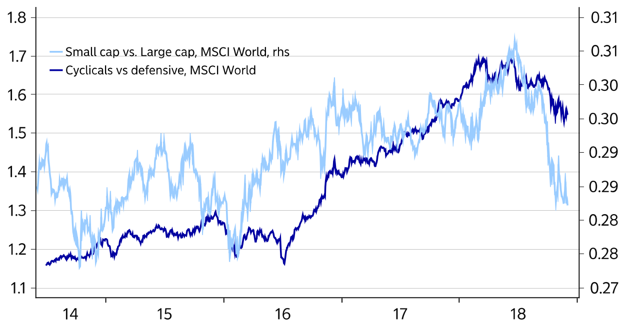


Source: Bloomberg and Nordea

Defensive 'size' has been a protective trade so far

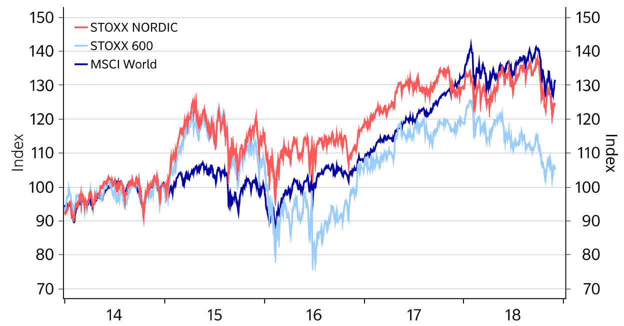
So far, markets have traded both the MSCI World defensives versus cyclicals index ratio and the small cap versus large cap index ratio some 10% lower. This is almost exactly the same as the relative performances that the markets experienced back in 2015. However, equity markets have done much less in absolute terms. The MSCI World index is only down around 10% from its October peak, while Europe including the Nordics is down only a little more. In 2015-16, these markets contracted by 17-23% before troughing (in early 2016).

INVESTORS SHIFTING TO SIZE AND DEFENSIVES



Source: Macrobond and Nordea

MARKETS ARE HALFWAY TO A 2015-16 CORRECTION



Source: Macrobond and Nordea

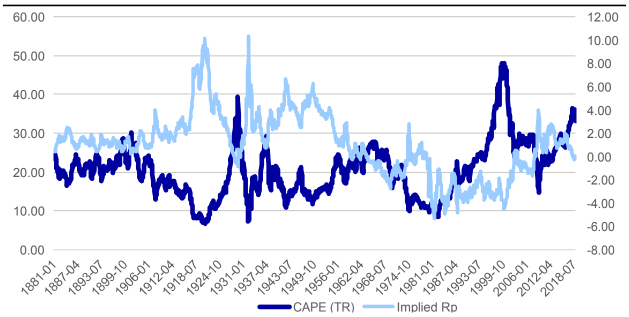
Fundamental support for risk is still lacking

Although some relative trades appear to have removed and possibly rebalanced some markets' internal risk premiums, our calculations do not suggest that the overall market risk compensations have found equilibrium or trough levels yet.

All else being equal, (US) equities need close to a 20% contraction to re-establish long-term supportive valuation

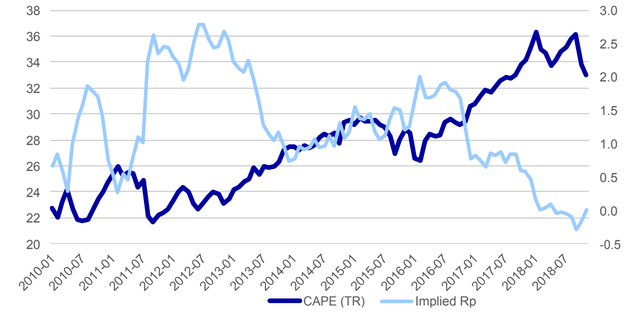
Based on Shiller data, the newly introduced total return CAPE valuation data, we believe that equity markets are still expensive. The S&P500 trades at a CAPE (TR) of 33x, down from 36x in September 2018. The average since the 'beginning of time', ie 1881, is 20x. Although we are not suggesting that a long-dated average is less correct, a more 'modern' average could prove to be more accurate for gauging the shorter-term outlook. We note that the average CAPE (TR) since 2010 has been 28x, indicating that the market is still trading at an 18% premium. In the 2015-16 correction, this same metric troughed in February 2016, at 26x, when the implied market premium had been removed. Imputing a constant cyclical-adjusted real earnings growth rate at 8% for 2019, we calculate that the CAPE (TR) multiple would reach 31x, still indicating an 11% premium. This therefore suggests that further downside risk remains, especially without any support from leading indicators for a rebound in the business cycle.

LONG-TERM REAL RP IS 1%, CURRENTLY IT IS ZERO



Source: Shiller Data and Nordea

MIND THE GAP BETWEEN CAPE AND IMPLIED RISK PREMIUM



Source: Shiller data and Nordea

Actually, based on CAPE TR metrics, compensation for taking on risk is currently zero

However, what the above does not reveal is the risk compensation investors can expect. Based on the same Shiller data, the long-dated (1881-2017) implied earnings yield (EY=1/CAPE (TR)) has been 5.6%. It shrinks to 3.7% when calculating the EY starting in 2010. Using the same data source for long-term interest rates as a benchmark for the risk-free rate return (Rf), we calculate the historical risk premium (Rp) at 1 pp starting from 1881 and at 1.3 pp starting from 2010. The current level, based on the same input variables, is zero. For the market to return to a mean Rp of 1.3 pp, keeping all else equal, we believe that the CAPE (TR) needs to contract to 23x. Should the Rp mean be restated in the market via the Rf, we argue that US ten-year bonds would need to be repriced to a yield of 1.7%, keeping all else equal. They currently yield just above 3%.

Even a less hawkish monetary policy assumption would most likely not be enough

Looking at 2019, adding another year of 8% cyclical-adjusted profit growth (implying a CAPE (TR) of 30x and an even split between EY and Rf adjustments to restate the market risk premium, US ten-year bond yields would need to slide 50 bp and the S&P500 slip another 12%. If this sounds challenging, it could be worth remembering that as the market troughed in 2016, the implied Rp was 2 pp, 70 bp above the 2010 mean.

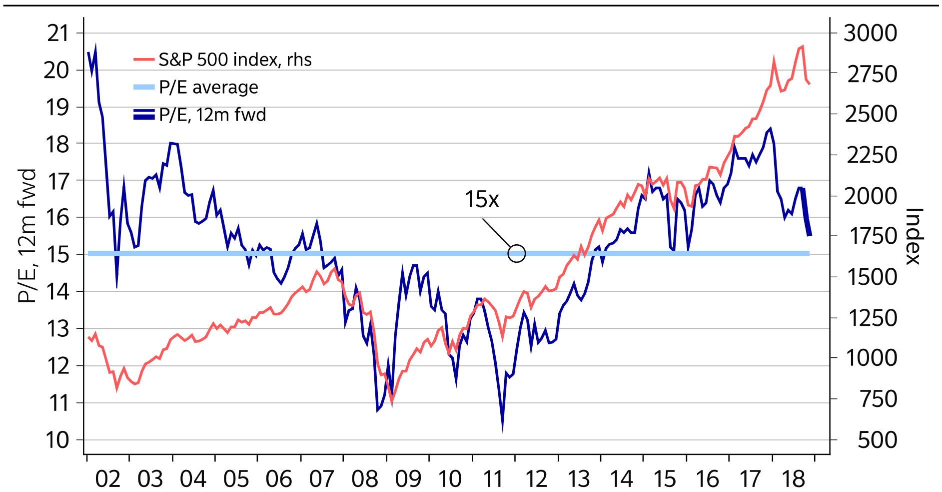
Leaving the trailing and cyclical-adjusted data used above and turning to more commonly used forward-looking data, the conclusions are similar.

Using forward-looking metrics, we arrive at a very similar conclusion

The average US 12-month forward-looking P/E outlook, based on Standard & Poor's consensus figures, is 15.5x. The average since 2002 is 15x. The outlook incorporates 10% earnings growth. The implied premium (current versus mean valuation) is 3%. Should 2015-16 prove to be of relevance in gauging the market downturn, the forward-looking P/E ratio would drop to 15.1x. A similar contraction, and assuming an unchanged earnings outlook, would hence need prices to contract by 3%. As we conclude in our macro outlook: given also the elevated profit margin expectations, current earnings estimates are certainly at risk, and the possibility of negative profit growth in 2019 should not be excluded. If we assume zero profit growth, the implied P/E (12-month forward looking) is currently 16.7x; ie suggesting an 11% premium valuation to mean.

A 'visible' 3% premium to a 'modern' equilibrium could hide an implied 11% premium

US STOCKS TRADING AT A 3% PREMIUM TO AVERAGE VALUATION SINCE 2002



Source: Macrobond and Nordea

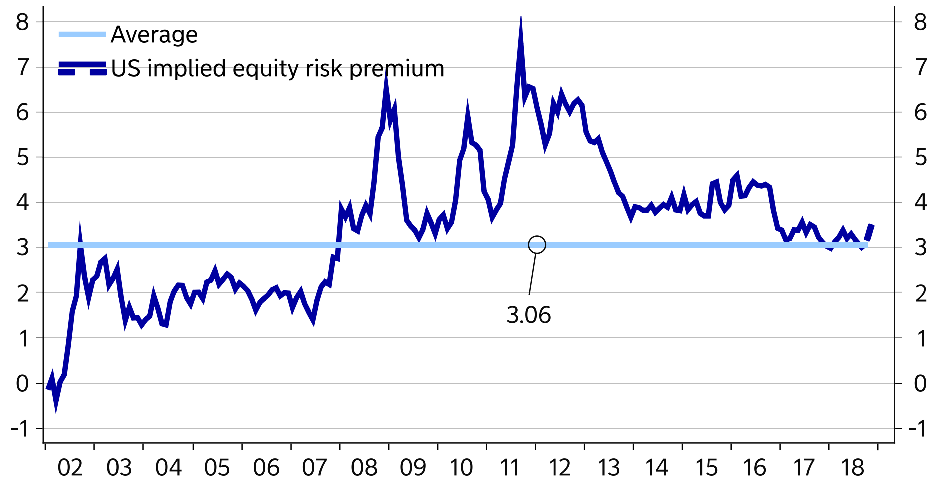
Although implied forward-looking risk compensation could arguably be normal, things are not normal

Turning to the Rp, the 'need' for further market adjustments is not as straightforward as it might first appear. Over the same period, the implied equity risk premium, now based on a forward-looking earnings metric, would be 3.1 pp. The market is currently priced at 3.5 pp, suggesting that the market is being somewhat overcompensated for taking on equity risk: 40 bp, equivalent to 13% extra compensation. However, should profits not grow in 2019, the market is at par with the historical mean. This implies that the US equity market is priced at roughly double the expected return compared with a ten-year US bond yield. If the experiences of 2015-16 prove relevant again, one could argue that compensation for risk is too low at present, as the implied risk premium was about 100 bp higher back then.

Setting the absolute level aside and instead focusing on the change in the implied Rp, a 50 bp rise occurred from the peak to the trough to stabilise the market in 2015-16. A similar reaction today would suggest a Rp of 3.5 pp. Keeping all else equal, for every unit of negative profit revision, the S&P 500 would need to move in tandem; ie removing the expected 10% profit rise in 2019, the S&P 500 would need to slip another 7-8%. Alternatively, the ten-year bond yield would need to drop 50 bp to 2.5%. Furthermore, and although equilibrium analyses are good to gauge longer-term risk/reward, it is worth remembering that markets seldom trade at estimated equilibriums. Over time the market usually either over- or undershoots.

Since 2002, US investors have on average traded stocks at an Rp of 3.1%, the same as they believe they are currently doing

US IMPLIED RISK PREMIUM ON FORWARD-LOOKING EARNINGS YIELD HAS NORMALISED



Source: Macrobond and Nordea

Adding to a sluggish business cycle outlook, other macro events are weighing on the markets as well

As described in our policy events outlook, we could argue that risk premiums need not only to normalise but also to expand beyond the mean, not only to incorporate the risk of the cycle but also other macroeconomic risks pressuring businesses and their P&Ls. The Italian budget for 2019 has not been approved by the EU Commission. The Brexit deal has still not passed through the UK parliament, raising concerns about the readiness of the UK to implement it by the deadline on 29 March 2019. The US/China trade conflict is a source for sub-optimal resource allocation. With the US running a mounting budget deficit, the debt ceiling discussion could be back on the table again, possibly in early Q2 next year, but now with a split Congress.

The main challenge, however, is what still appears to be overly lofty earnings growth rate expectations

We would also need to incorporate the challenges we identify for the earnings outlook. Consensus expectations for 9% earnings growth in 2019 (MSCI World, Bloomberg) rest on the assumption that a clear majority of the listed companies will improve margins next year, suggesting that the median margin will reach unprecedented highs. With growth momentum slowing, wages on the rise and capacity utilisation already high – which is capping productivity growth – we reason that profit growth expectations remain too lofty as margins are set to be squeezed.

All in all, we could be halfway through rebalancing the markets

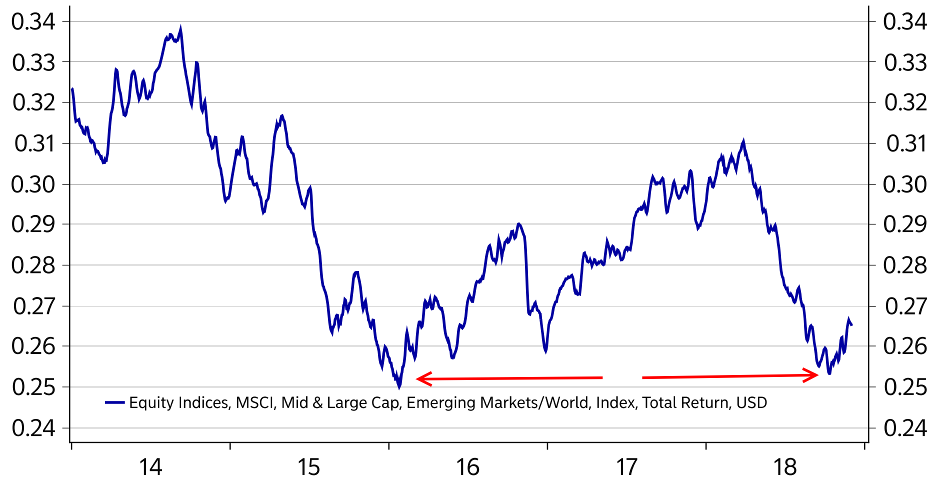
We would therefore need the general equity markets to trade at close to 10% lower before we could argue for some fundamental stabilisation. We equally believe that credit spreads should rise further, more for HY than for IG. Long-dated bonds should also be expected to trade somewhat lower (higher yields), as the Federal Reserve is expected to hike policy rates in December. The markets has curbed their expectations of a FOMC rate hike decision to only two of the coming 12 months, including one in December 2018. If anything we believe the risk to this outlook is to the upside.

EM equities were one of the first asset classes to slip; after a 25% slump, their underperformance has stopped

However, one major asset class that has traded more negatively than most others in 2018 has been emerging markets (EM). EM equities are down 25% (in USD) from the peak in March 2018, vastly underperforming the rest of the world. They were one of the first fallen canaries in our coalmine, detecting the change in risk appetite this year. The relative performance versus the rest of the world has taken the return index ratio back to the trough following the market correction in 2015-16. The underperformance seems to have halted recently, possibly once again proving to be an early signal of a wider, global market trend, albeit this time for a stabilisation and potential recovery in demand for riskier assets.

Has one of the canaries in our theoretical coal mine started singing again?

AFTER A 25% SLUMP EM/WORLD EQUITY RATIO BACK AT 2015-16 TROUGH



Source: Macrobond and Nordea

Following our analysis, we conclude that from an absolute return perspective, it is probably still too early to invest in EM equities. It is equally possible that relative to the rest of the world, EM equities have already borne the brunt of the current market adjustment need. We therefore recommend removing underweight positions in EM equity risk. We discuss our view on EM in greater detail later in this report.

This section has been produced by Nordea Research's Independent Research unit.

Dollar stronger for longer

We were expecting the dollar to weaken around the turn of the year, based on US core inflation disappointments, lower US growth expectations, and a turnaround in central bank liquidity, with politics becoming a more neutral driver. However, only core inflation has been truly well-behaved, which is why we believe a weakening of the dollar is likely both to occur later and to be of less significance than before. This is not good news for risky assets.

A string of events led us to expect markets to derail from the positive trend

The dollar-o-meter is a way of trying to structure four drivers of the USD. It comprises the core inflation outlook, the growth outlook, monetary policy and politics. Early in 2018, all these drivers were set to turn supportive for the USD. We were expecting most of the drivers to turn around and the dollar to weaken around the turn of the year, but we now postpone our expectation of substantial dollar weakness into 2019.

Core inflation outlook

Core inflation has turned against the dollar

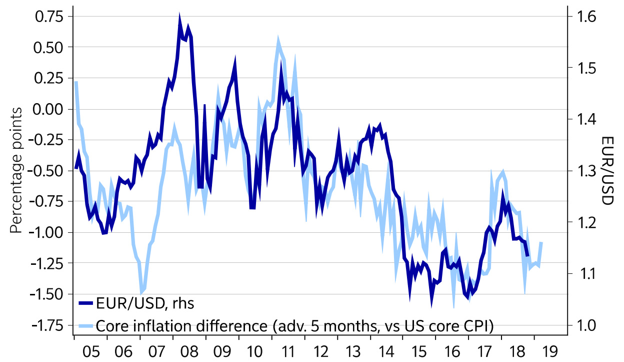
Early this autumn, we argued that US core inflation would soon disappoint because of weak ULC growth and adverse currency effects, which would turn one tailwind for the dollar into a headwind. At roughly the same time, Euro-area core inflation would move higher due to base effects. Of the four drivers in the dollar-o-meter, the core inflation spread has been the most well-behaved recently.

While Euro-area core inflation has not picked up, US core inflation has indeed disappointed three times in a row. For the same reasons as before, we still see downside risks to US core inflation, while Euro-area core inflation still looks ripe for a pickup.

The core inflation spread has signalled turning points in the dollar over the past decade and implies dollar weakness starting sometime in Q1 2019

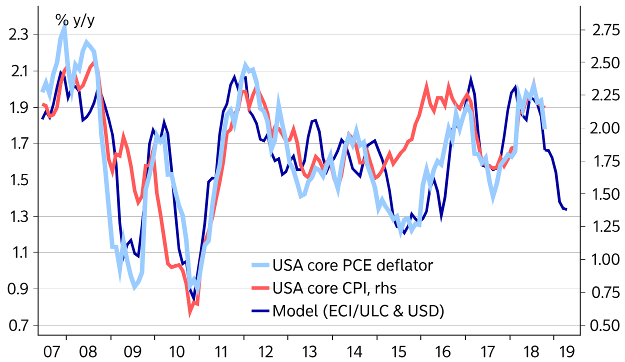
The core inflation spread has been good at signalling turning points in the dollar over the past decade and implies dollar weakness, at least temporarily, starting sometime in Q1 2019. The first part of the dollar-o-meter has thus turned against the dollar and is likely to move further against the dollar in the coming months.

CORE INFLATION HELPFUL IN PREDICTING TURNING POINTS



Source: Macrobond and Nordea

US CORE INFLATION STILL RIPE FOR SETBACKS



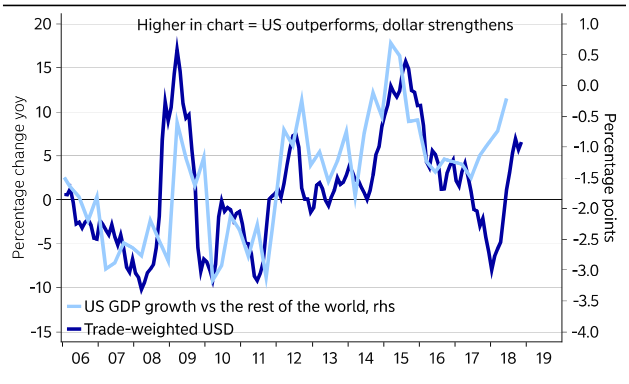
Source: Macrobond and Nordea

The growth outlook

Owing to both US strength and the weakness elsewhere, the trade-weighted USD has performed admirably

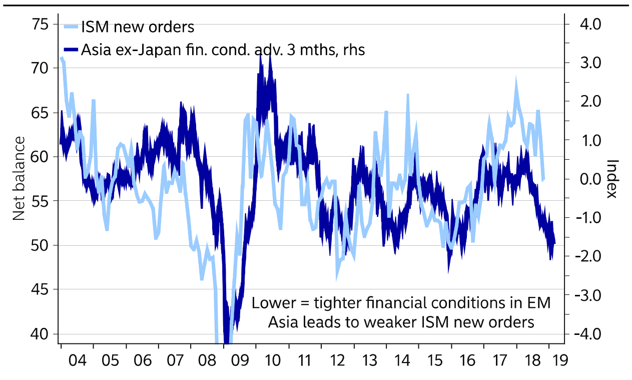
The second part of the dollar-o-meter, growth expectations, has continued to favour the USD. The US has been a safe haven this year, offering strong economic performance in contrast to both the Euro area and many emerging markets. Owing to both US strength and weakness elsewhere, the trade-weighted USD has performed admirably. We were expecting US data disappointments to outweigh Euro-area data disappointments late this year, which would then reduce the tailwinds for the dollar. This now looks more doubtful.

US OUTPERFORMANCE HAS BEEN HELPFUL FOR THE USD



Source: Macrobond and Nordea

EM TURMOIL HAS STARTED TO SPILL BACK TO THE US

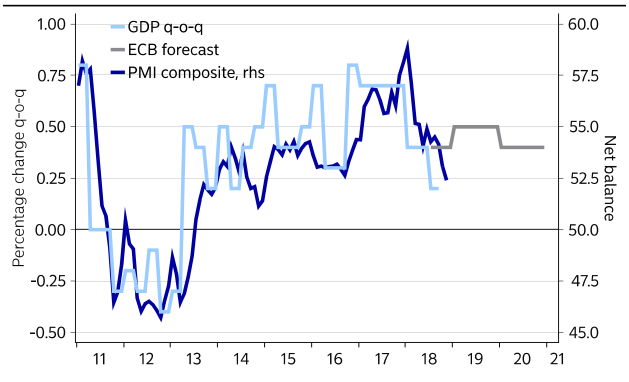


Source: Macrobond and Nordea

Deterioration in ISM new orders likely reflects tighter financial conditions in Asia spilling back to the US

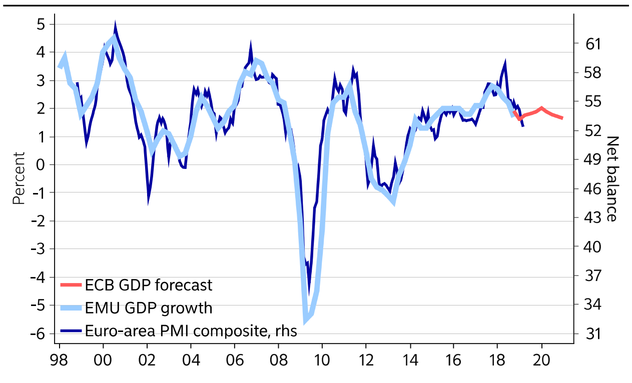
We see signs that this year's emerging market turmoil, triggered by a hawkish Federal Reserve and Trump's trade war, is spilling back to the US. For instance, the recent weakness in US durable goods orders, ISM new orders, and German export orders likely reflects tighter financial conditions in Asia spilling back to the US and the Euro area.

EURO-AREA PMI SURPRISINGLY SOFT



Source: Macrobond, ECB and Nordea

ECB NEEDS PMI TO RISE TO MATCH ITS GROWTH FORECASTS



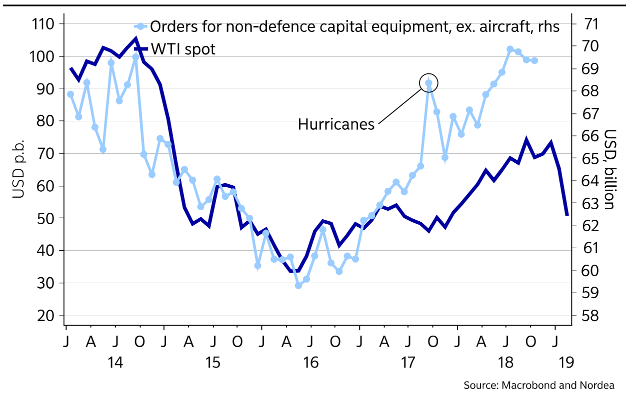
Source: Macrobond, ECB and Nordea

PMI composite at these levels suggests growth may have dipped below its potential, and far below the ECB's expectation

Euro-area sentiment indicators have shown surprising weakness. This might reflect the fact that the Euro area is more sensitive to various global headwinds than the US. While the US likewise has to deal with trade frictions, financial market volatility and EM vulnerabilities, the Euro area is also being asymmetrically impacted by the Brexit process, the Italian budget standoff, a credit crunch in Turkey, and new emission measurement procedures.

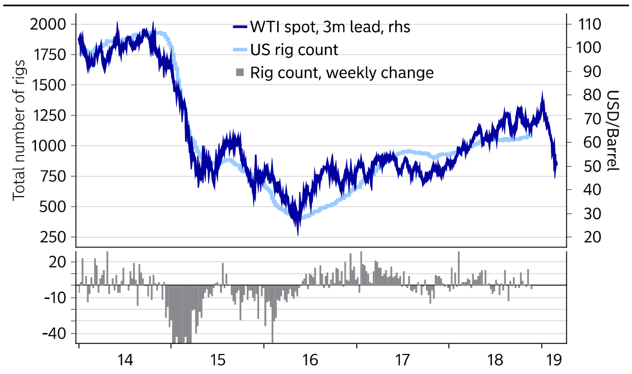
The PMI composite at these levels suggests growth has dipped to or below its potential, in line with the GDP outcome for the third quarter, but significantly below the ECB's expectation.

OIL PRICE PLUNGE ADDS A HEADWIND TO US CAPEX



Source: Macrobond and Nordea

OIL RIGS MIGHT BE TAKEN OFFLINE IN 2019

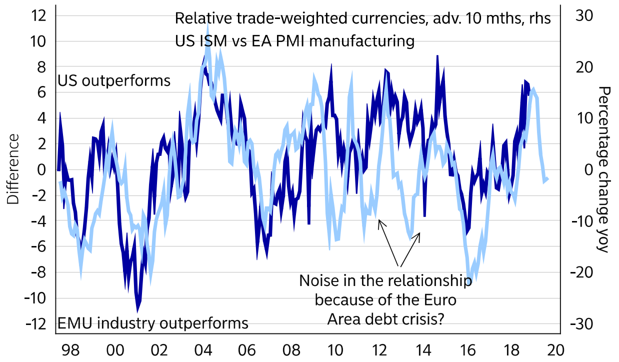


Source: Macrobond and Nordea

The gap between ISM manufacturing and Euro-area PMI manufacturing should narrow substantially over the next six months

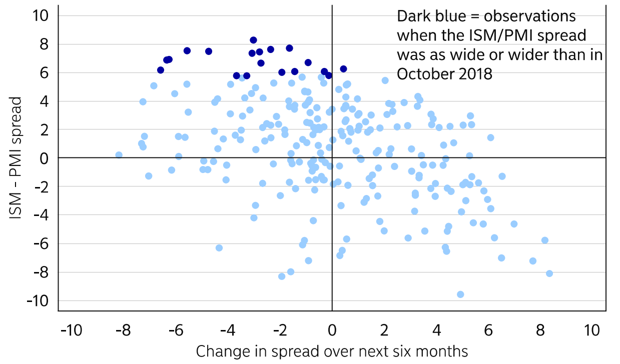
We expect further weakness in leading indicators in both the Euro area and the US, as outlined in the macro strategy chapter. ISM should move to 50 by mid-2019. The recent plunge in oil prices, if persistent, adds larger headwind to the US than to the Euro area, which should help to level the playing field somewhat. The hefty disappointment in the regional Dallas Fed survey was a first sign. The recent strength of the trade-weighted dollar suggests the gap between ISM manufacturing and Euro-area PMI manufacturing could narrow substantially over the next six months.

STRONGER DOLLAR TO WEIGH ON US ACTIVITY



Source: Macrobond and Nordea

ISM/PMI SPREAD USUALLY NARROWS WHEN THIS WIDE



Source: Macrobond and Nordea

Indeed, the ISM/PMI spread almost always narrows when as wide as today. If some of the temporary factors (such as the effect from emission measurement effects) depressing Euro-area activity wanes, then PMI should see some supported versus ISM in relative terms.

We have become less confident that growth will become a positive driver for the EUR/USD in H1 2019

At this juncture, growth expectations still need to be revised downwards for the Euro area but not so much for the US. This leaves the USD underpinned in the near term. Looking at 2019, we still believe growth may become a positive driver for the EUR/USD, but our confidence is waning. The Euro area may be much more sensitive than the US to various global headwinds.

Monetary policy

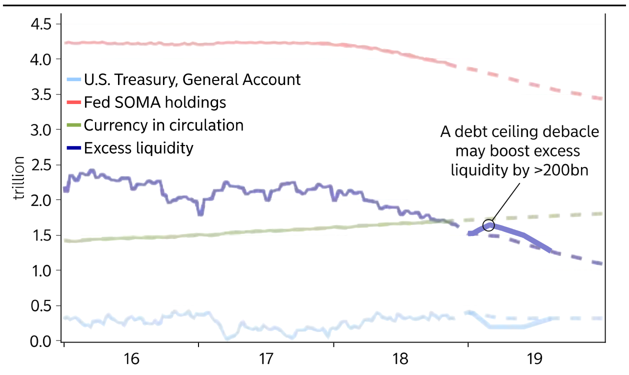
The Fed is surely on autopilot for another rate hike in December, and the March meeting looks softly priced

Since early in 2018, the Fed has been underpinning the dollar both in terms of vanilla monetary policy (nominal rates) and via unconventional measures (such as the shrinking of its balance sheet). The Fed is surely on autopilot for another rate hike in December, and the March meeting looks too softly priced. This is good news for the USD. A sudden surge in US excess liquidity in the first couple of months of 2019 would have the potential to undermine the dollar, however.

More excess dollars in early 2019 implies a risk of a weaker dollar

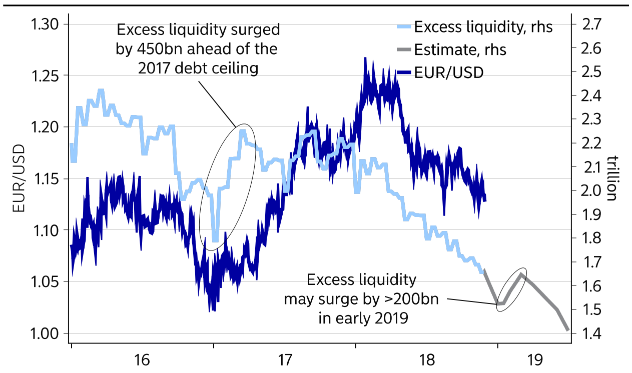
The debt ceiling likely comes into force again on 2 March 2019. From that point, the US Treasury is not allowed to have excess dollars on its cash account at the Federal Reserve. The Treasury will need to reduce its cash holdings. This will push at least USD 200bn in excess dollars into the private banking sector, temporarily overshadowing the negative effects on liquidity from the shrinking of the Fed's balance sheet. While the effect is roughly half that seen in early 2017, more excess dollars nonetheless implies a risk of a weaker dollar.

DEBT CEILING TO PUSH DOLLARS INTO THE SYSTEM



Source: Macrobond and Nordea estimates

DEBT CEILING WILL NOT BE NOT DOLLAR-POSITIVE



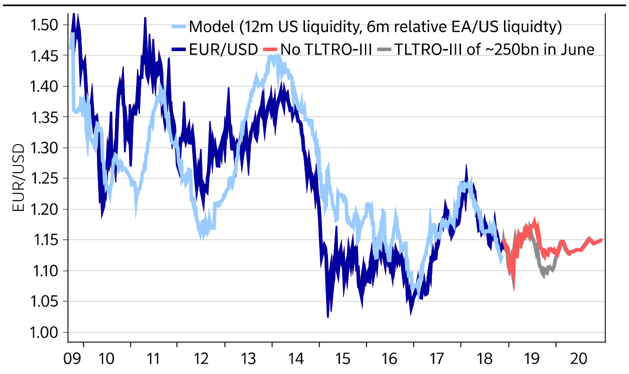
Source: Macrobond and Nordea estimates

Relative central bank liquidity has favoured the USD in 2018 but will turn negative in H1 2019

At the same time, the ECB is set to stop its asset purchase programme at the end of this year suggesting negative implications for excess liquidity in the Euro area's banking system. Moreover, when the programme has ended, TLTRO repayments means that the ECB's balance sheet may start shrinking. This could be positive for the EUR, not only due to a changed flow environment, but also for its psychological impact. Modelling EUR/USD by liquidity measures alone suggests a bounce from 1.10 to 1.18 during H1 2019, and only a somewhat lower peak if ECB launches another TLTRO.

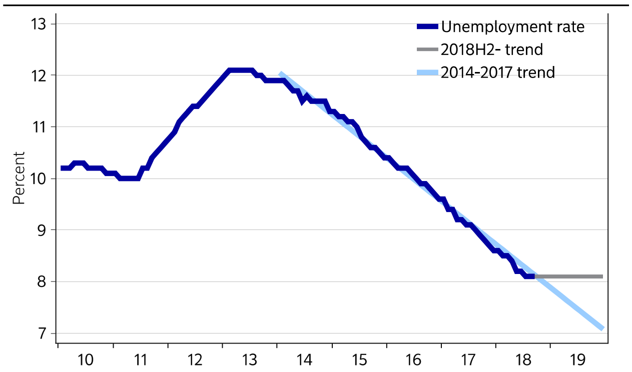
All in all, relative central bank liquidity has favoured the USD in 2018 but this will turn negative in H1 2019.

LIQUIDITY INDICATES HIGHER EURUSD IN H1 2019...



Source: Macrobond and Nordea estimates

...BUT EURO-AREA UNEMPLOYMENT NO LONGER DROPPING



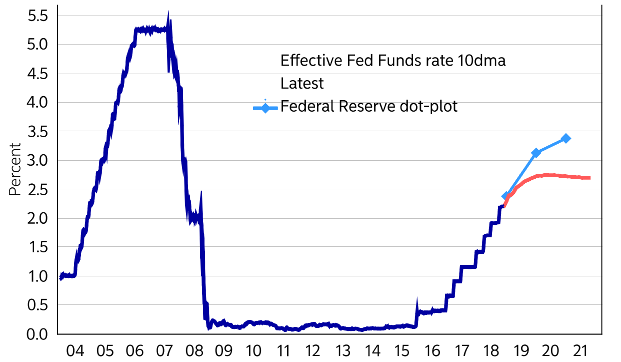
Source: Macrobond and Nordea

The ECB is at risk of ending up in a tricky spot in 2019

The ECB is at risk of ending up in a tricky spot later in 2019 if growth continues to weaken though. The Euro area's unemployment rate has stopped dropping in recent months, during a period with surprisingly weak GDP growth. And if growth weakens further, unemployment might even start rising in 2019. This would not be an environment in which the ECB could stop worrying as much about inflation, even though wage growth is likely to rise further, and so it may want to postpone its planned rate hikes.

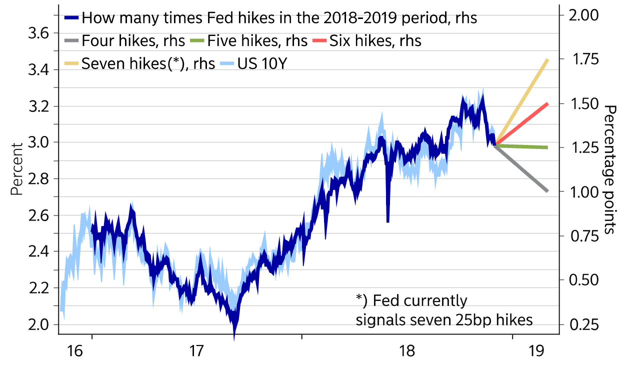
In the near term, the ECB is highly unlikely to draw such far-reaching conclusions. It might flag downside risks to growth but is likely to cross its fingers and hope for a growth rebound as we head into 2019.

MARKET ALREADY PRICING IN A PAUSE FROM THE FED



Source: Macrobond and Nordea

DROP IN 10Y YIELD ALSO CONSISTENT WITH EARLY PAUSE



Source: Macrobond and Nordea

Despite our downbeat views on global macro strategy, we do not foresee an earlier Fed pause than is currently priced in

The Fed has sounded more worried about the growth situation recently, acknowledging that not everything may be all right across the globe. As a result, the market is now pricing in a pause in the rate hiking cycle by the spring of 2019, after a delivery of two more 25 bp rate hikes.

Despite our downbeat views on global macro strategy, we do not foresee an earlier Fed pause than is currently priced in**,** and hence little to undermine the USD from an interest rates perspective. If the Fed were to signal a pause in the hiking cycle already after the December hike, it would definitely undermine the USD, especially versus emerging markets.

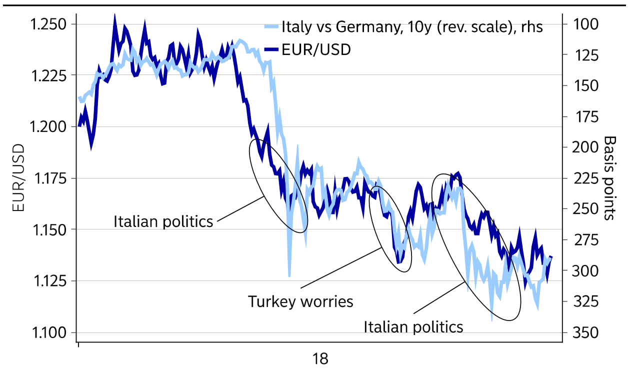
Relative liquidity still favours a turn higher in EUR/USD in H1 2019

In our eyes, the relative central bank outlook has become less clear-cut, particularly as a result of a disappointing Euro area. If global activity does disappoint further, it risks becoming a larger issue for the ECB than for the Fed, given their different starting points. For all that, we still judge that relative liquidity favours a turn higher in EUR/USD in the first half of 2019.

Politics and political uncertainty

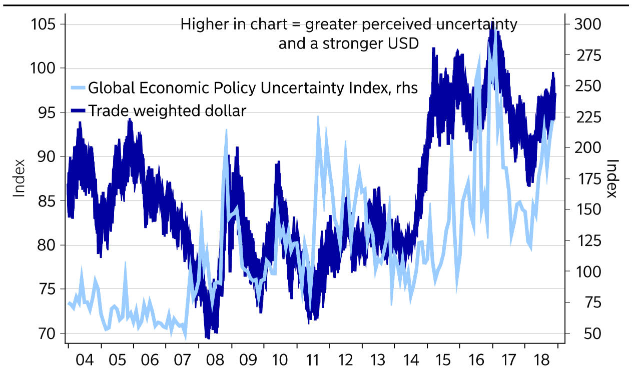
Market participants have had to worry about Brexit, the Italy-EU budget standoff, Turkey, and the trade war this year. This list differs markedly from what they believed they would be worrying about at the start of the year, namely the awaited special report on Russia from special counsellor Mueller and/or an impeachment of the US President, both of which have been missing in action. As a consequence, political developments have largely provided tailwinds for the dollar.

EUR/USD IMPACTED BY ITALIAN POLITICS IN 2018...



Source: Macrobond and Nordea

...BUT UNCERTAINTY HAS BEEN GOOD NEWS FOR THE USD



Source: Macrobond and Nordea

If the budding theme of a ceasefire in the trade war were to bear lasting fruit, it would constitute bad news for the USD

While US politics will be centre stage during parts of 2019 (such as during what might be tough debt ceiling negotiations in the summer), we expect European politics to be perceived as more troublesome than US politics, with focal points ranging from Brexit, to Italy and on to the EU parliamentary election (see separate article).

If the budding theme of a ceasefire in the trade war were to bear lasting fruit, it would constitute good news for growth beyond the US and bad news for the USD. Substantial progress appears unlikely, however.

All in all, political risks have clearly been adding positively to the dollar-o-meter this year and will remain a positive driver of the USD. US domestic politics may be able to offset some of Europe's worries.

Bringing it all together

A turnaround towards a weaker dollar look likely later than expected before, and to be less significant than before – this is not good news for risky assets

Core inflation has turned against the dollar and will continue to do so. Growth expectations are yet to turn against it, but still seem likely to weigh on the dollar in H1 2019.

Monetary policy looks helpful for the dollar, but the central bank liquidity story still suggests dollar weakness in H1 2019.

Politics, which we judged was becoming a neutral or negative driver for the USD, is now, we believe, a neutral or positive driver.

We had anticipated all four factors to start favouring EUR/USD upside right about now, but we are now down to three: core inflation, growth and central bank liquidity. And of these three, we are less confident about both growth and central banks. All in all, a turnaround towards a weaker dollar looks likely to happen later than we previously expected and to be less significant than before. This is not good news for risky assets.

This section has been produced by Nordea Research's non-independent Research unit.

Political risks going into 2019

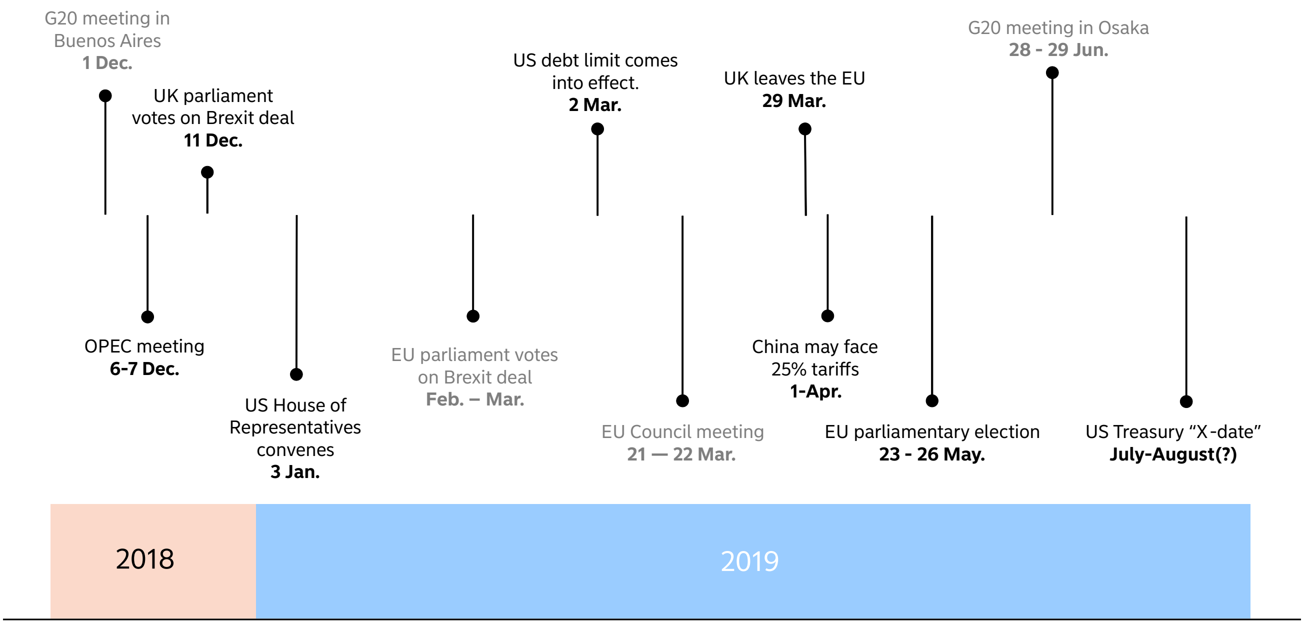
Political risks will remain elevated going into next year. Europe is heading towards parliamentary elections that could result in EU-sceptical parties more able to set the agenda. China may face a surge in US tariffs, and a deeply split US Congress is heading towards debt ceiling negotiations, to name but a few risks.

Political risks have become prevalent

Ten years ago, politics only rarely impacted developed markets noticeably, but with the global financial crisis, the Euro-area debt crisis, the Brexit referendum and President Trump's win, this is clearly no longer the case. Political risks have become prevalent.

There are indeed several political drivers looking into 2019, ranging from the ongoing trade war to European politics. Here, we outline a few of the likely talking points of H1 2019.

TIMELINE FOR SELECTED POLITICAL EVENTS



Grey text implies events of lesser importance.
Source: Nordea

Lower oil prices rewrite the outlook for headline inflation, and increase downside risks to capex

6-7 December: OPEC+ meeting

The recent drop in oil prices has prompted demands for production cuts from the OPEC + group, the 25-nation alliance of oil produces also including Russia. At the current oil price, Saudi Arabia may need to either engage in fiscal consolidation or to sell dollars to fund ongoing concerns. It should come as no surprise that Saudi Arabia seems keen on arranging production cuts. The calculation for Russia may be different: while oil prices are good news for the state's coffers and would buy Putin goodwill with a key US ally in the Middle East, high fuel prices will squeeze Russian consumers and risk prompting protests. The group meets on 6-7 December.

Why it matters: lower oil prices rewrite the outlook for headline inflation, and increase downside risks to capex in for instance the US. Pressure on oil-exporters currency pegs might also reignite if oil prices fall further.

Republicans reportedly fear the Democrats may seek to turn the White House into a "24/7 legal defence operation"

3 January: US Congress convenes

The newly elected US Congress convenes for the first time on 3 January. The Republicans reportedly fear that the Democrats may seek to turn the White House into a "24/7 legal defence operation".

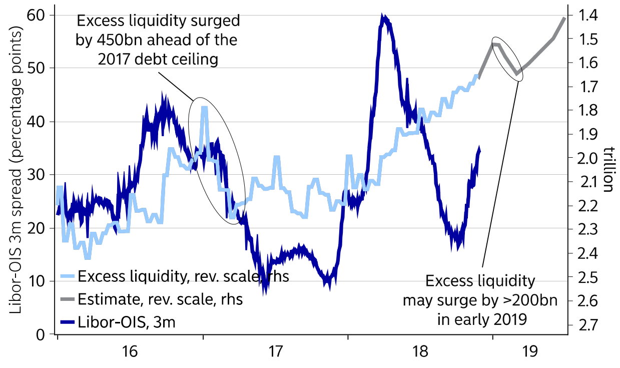
Why does this matter? The split in Congress likely reduces the scope for fiscal stimulus and reforms, while boosting the likelihood of both political turmoil and a harsh debt ceiling standoff (and potentially a government shutdown).

DEMOCRATS MAY TRY TO TURN THE WHITE HOUSE INTO A LEGAL DEFENCE OPERATION

President Trump's tax returns
Trump family businesses — and whether they comply with the Constitution's emoluments
Trump's dealings with Russia, including the president's preparation for his meeting with
The payment to Stephanie Clifford — a.k.a. Stormy Daniels
James Comey's firing
Trump's firing of U.S. attorneys
Trump's proposed transgender ban for the military
Treasury Secretary Steven Mnuchin's business dealings
White House staff's personal email use
Cabinet secretary travel, office expenses, and other misused perks
Discussion of classified information at Mar-a-Lago
Jared Kushner's ethics law compliance
Dismissal of members of the EPA board of scientific counselors
The travel ban
Family separation policy
Hurricane response in Puerto Rico
Election security and hacking attempts
White House security clearances

Source: Axios

US DEBT LIMIT MAY WEIGH ON LIBOR RATES



Source: Macrobond and Nordea estimates

2 March: US debt limit comes into effect

The US Treasury will need to reduce its cash buffer, which will increase excess liquidity in the US banking system

Beyond 2 March, the US Treasury will no longer be allowed to accumulate debt.

Why does this matter? The US Treasury will not be allowed to keep excess cash on its general account at the Federal Reserve from this date. The US Treasury will need to reduce its cash buffer, which will increase excess liquidity in the US banking system. This might spill over to lower Libor rates and a weaker dollar.

29 March: The UK to leave the EU

Brexit risks are far from over. Prime Minister Theresa May faces a tough challenge getting the deal through the UK parliament, with an elevated risk of a snap election. A turbulent "no deal Brexit" remains a tail risk.

Why does this matter? Elevated uncertainty, as long as it lasts, constitutes bad news for UK investment demand and makes for a volatile GBP. Even if the Brexit deal is passed, unresolved issues will continue to characterise UK domestic politics.

1 April: Chinese tariff surge

Higher tariffs generally pose downside risks to Chinese activity in 2019

More important still is the trade war, with Chinese/US relations in focus. We see the temporary ceasefire and 90-day negotiating window decided at the G20 meeting as more or less status quo (ie China has not given in). 90 days is a very short period to strike as an extensive deal as this one, and on 1 April, tariffs on USD 200bn worth of Chinese exports to the US may more than double, from 10% to 25%.

Why does this matter? Global trade may have been buoyed by corporations' pre-loading trade activity ahead of a potential tariff surge and it might weaken in 2019 as a result. Higher tariffs generally pose downside risks to Chinese activity in early 2019 as well as upside risk to the USDCNY. If the CNY weakens further, no matter the reason, it is likely to spill over negatively to other currencies in Asia and consequently push the USD stronger in trade-weighted terms. And vice versa, any more substantial ceasefire in the trade war would diminish economic-political uncertainty, constituting relatively good news for growth outside of the US, but bad news for US inflation and, by extension, also bad news for the trade-weighted USD.

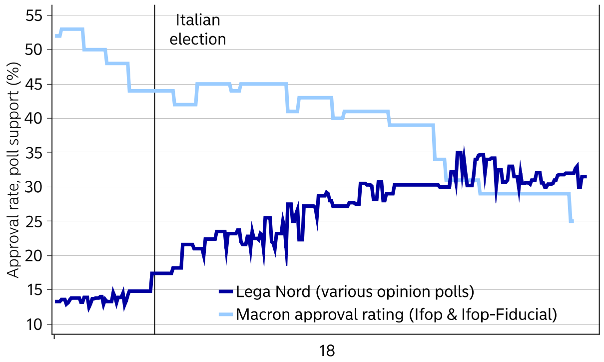
23-26 May: EU parliamentary elections

Investors stayed away from French bonds ahead of the French presidential election of 2017

The European parliamentary elections on 23-26 May will receive plenty of attention next year: how will EU-sceptic parties fare? As a possible indicator, we can consider the collapsed approval rating of France's pro-EU President Macron with the surging support for Salvini's EU-sceptic Lega Nord party in Italy since the Italian election. While pro-EU powers will do their utmost to prevent a likely growing EU-sceptic bloc from gaining any meaningful power, the election may serve as a reminder of the many fissures in both the Euro area and the EU.

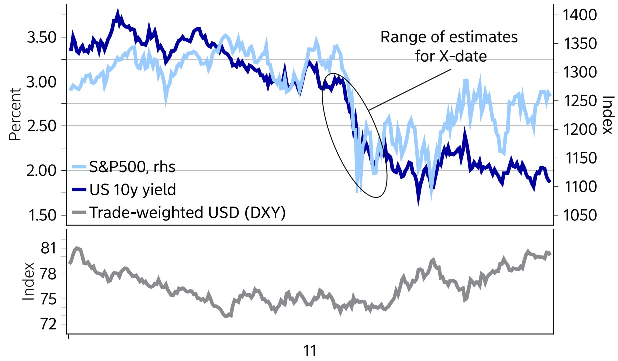
Why does this matter? While it might seem far-fetched to expect this election to influence markets significantly, the same could have been said ahead of the French presidential election in 2017, ahead of which investors stayed away from the EUR as well as from French bonds.

MACRON'S APPROVAL CRASHING, SALVINI'S RISING



Source: Macrobond and Nordea

DEBT CEILING NEGOTIATION OF 2011 A TURBULENT TIME



Source: Macrobond and Nordea

July-August: US Treasury "X-date"

As the X-date draws near, the market may get increasingly nervous about a potential default by the US Treasury

Despite the US debt limit likely coming into effect in March, the US Treasury will be able to meet the US's running concerns for several months via "special measures", buying time for Congress to reach a new deal. Some time after this period, beyond the X-date, the US Treasury risks defaulting on its obligation.

The new composition of Congress (more fiscal conservatives on the Republican side), and a lame-duck President keen on building a wall, amidst a general pickup in political polarisation, could pave the way for harsh negotiations.

Why does this matter? A more lasting and severe shutdown of the federal government would be negative news for US demand growth as it would represent a form of fiscal austerity. As the X-date draws near, the market may get increasingly nervous about a potential default by the US Treasury, which could send shockwaves across the global financial system.

This section has been produced by Nordea Research's non-independent Research unit.

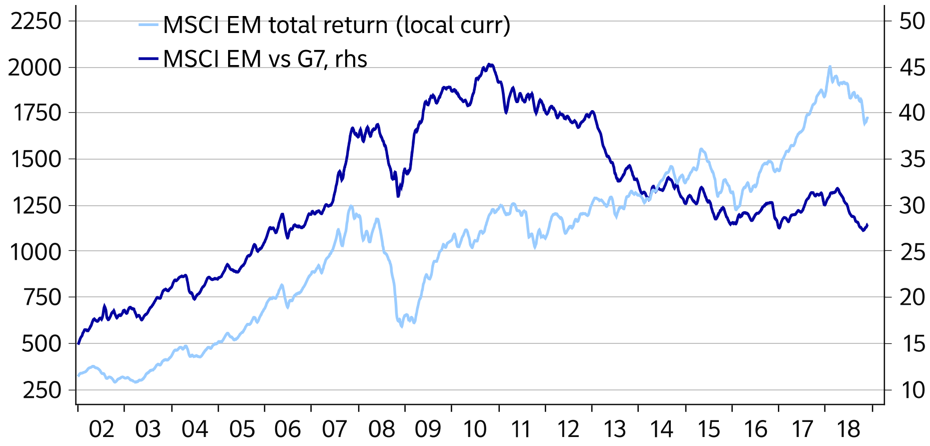
EM into 2019: Remove underweights

The derailing performance of EM risky assets was one of the early canaries that led us to our defensive stance this year. Since the January 2018 peak, EM equities have lost some 20% in local currencies. At first, the tumble was in tandem with the rest of the world. However, starting in late March, EM equities lost traction on their own, and up until October the relative loss was 16%. The underperformance now appears to have troughed and we argue that positioning should be neutralised.

The EM/DM (G7) performance ratio looks to have troughed at the same point at which the outperformance kicked off at the start of 2017; a year-long trend that led EM equities to outperform by 20%, as they increased by close to 45%. In the recent turmoil, EM equities have sheltered their value better than DM. Does this mark a good entry point back into EM exposure? To regain a more solid footing on EM versus DM, we examine the development over a longer period.

Following a horrendous performance for most of 2018, EM equities have been managing the current turmoil better recently

EM EQUITIES DERAILED WELL AHEAD OF DM WHILE DOING BETTER RECENTLY

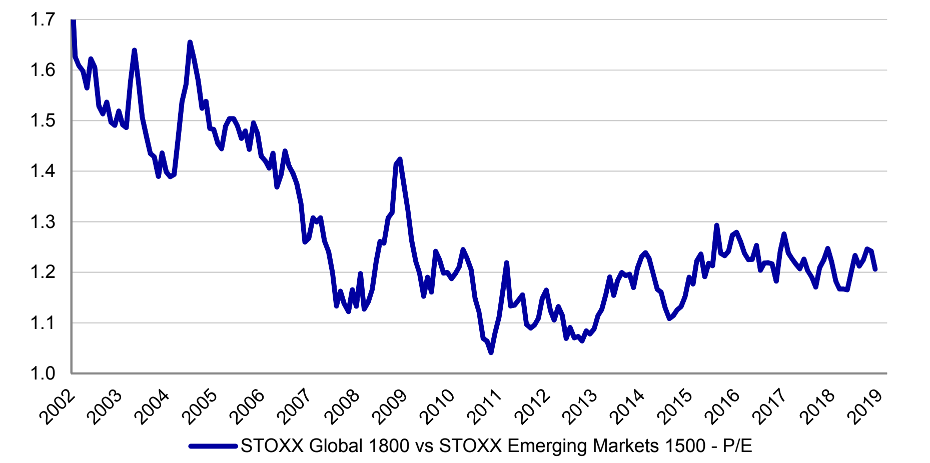


Source: Macrobond and Nordea

We note fundamental support for part of the EM discount

At first glance, developed markets trade at a 20% premium on forward-looking price earnings ratios. But this masks the fact that the earnings trend (margins in particular) has been much stronger in developed markets. In fact, the relative margin differential has remained rather constant, with margins around 10% higher for developed markets since 2014.

DM TRADING AT 20% P/E PREMIUM TO EM (RELATIVE MEDIAN)

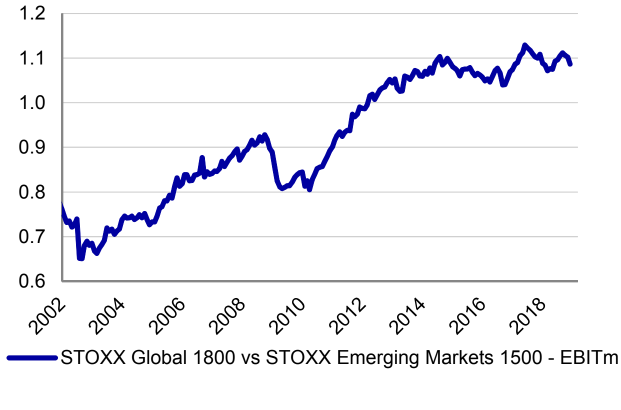


Source: FactSet and Nordea

DM's EV/sales premium to EM suggests a change

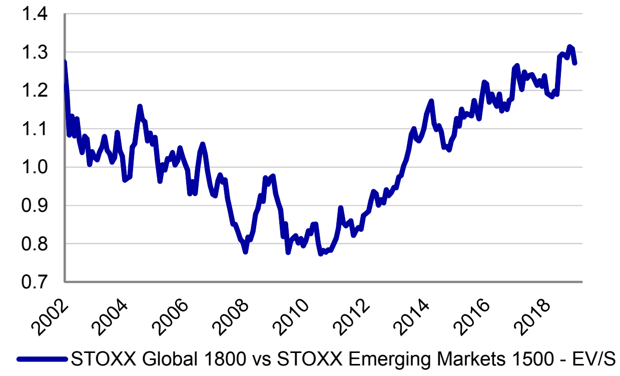
This is the highest margin premium in our 17-year dataset. We therefore examine the EV/sales premium, which reveals that we are back at previous peaks of around 25-30%, which we last saw in 2001. These relative levels have historically acted as a solid guide for EM outperforming DM.

DM MEDIAN MARGINS ARE AT RECORD-HIGH RELATIVE TO EM



Source: FactSet and Nordea

RELATIVE MEDIAN EV/S MULTIPLE SUGGESTS TURNING POINT

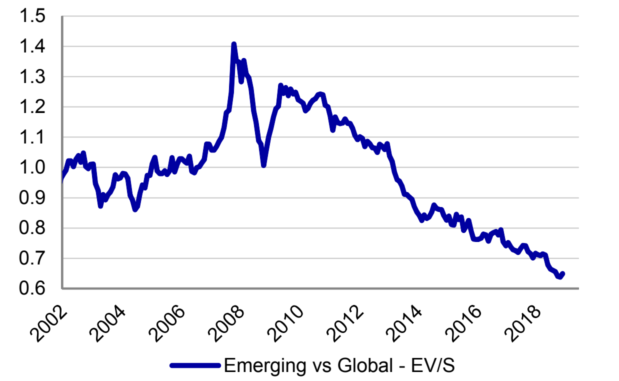


Source: FactSet and Nordea

Although not yet hitting historical troughs, the implied EV/EBIT discount is at a 10-year high

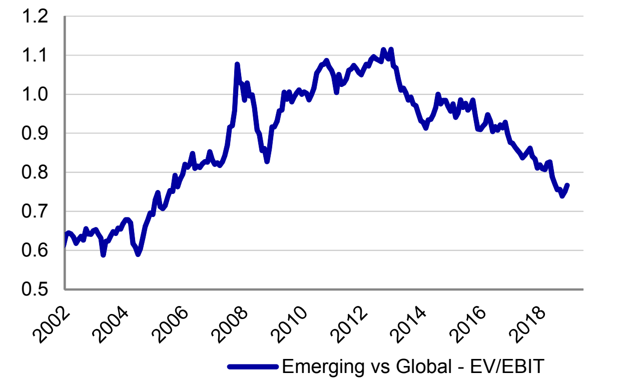
When examining aggregated data, we can conclude that the EV/EBIT discount is at a 10-year high of around 25%, although the discount plummeted to around 40% in 2003/04 and even slightly higher after the dotcom bubble burst. We are also astounded that we are at 20-year high discount on EV/sales, with EM offering a whopping 35% discount versus developed markets. Relative margins had a negative trajectory between 2002 and 2016, but we note with interest that margins have remained rather stable in the past couple of years

RELATIVE AGGREGATED FWD EV/S



Source: FactSet and Nordea

RELATIVE AGGREGATED FWD EV/EBIT



Source: FactSet and Nordea

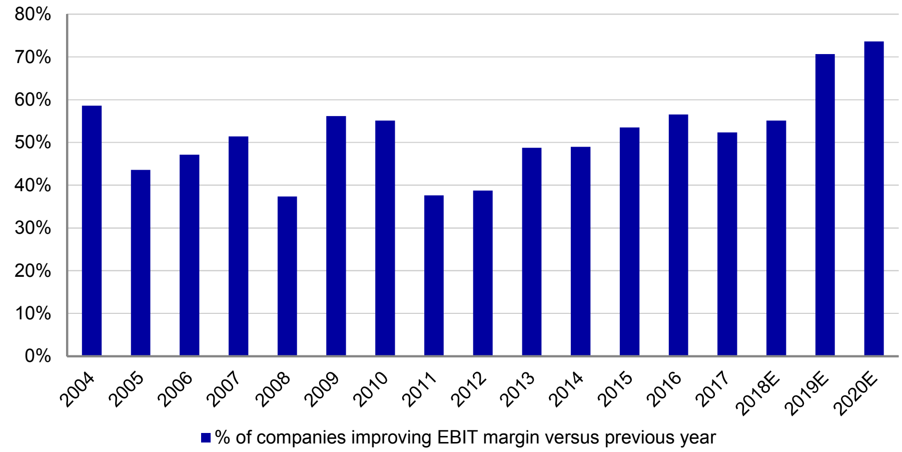
Less lofty expectations for EM margins

When we apply our earnings indicators to the STOXX Global EM universe, we discover that the prevailing consensus expects relatively fewer EM companies (versus DM) to improve EBIT margins. However, we are not comfortable with the vast improvements expected between 2018 and 2020 given our view of slowing global growth and mounting wage pressure. Our revision indicators also reveal that EM is already in downgrade territory.

Not out of the woods yet...

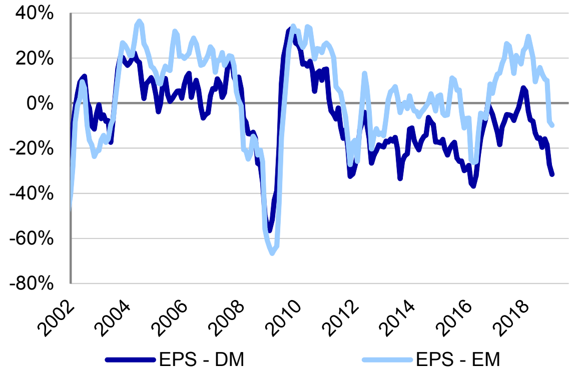
On balance, we are quite attracted to the relative valuation setup for emerging markets versus their developed counterparts. We conclude that it is hard to decipher whether the earnings risks are lower. On the one hand we note the rather rapid wage growth in EM, but on the other hand expectations are slightly less exuberant. On balance, we believe the relative revisions versus DM should hence be rather neutral.

CONSENSUS TOO OPTIMISTIC ON EM MARGIN IMPROVEMENTS, BUT LESS SO THAN FOR DM



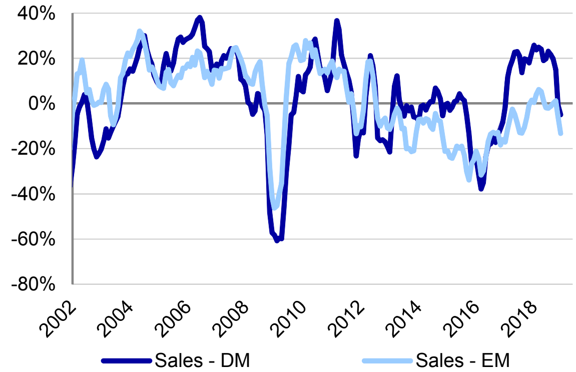
Source: FactSet and Nordea

EPS REVISION INDICATOR - DEVELOPED AND EMERGING



Source: FactSet and Nordea

SALES REVISION INDICATOR - DEVELOPED AND EMERGING



Source: FactSet and Nordea

...but we advocate a normalising positioning

The key trigger for a reversal of fortunes, in our minds, would be a trend reversal in the US Dollar Index, which – according to our dollar-o-meter – should materialise towards the end of Q1 2019. Given the timing uncertainty, we recommend reducing EM underweights. We suggest waiting for the turn of the US Dollar Index before implementing an outright overweight position, however.

This section has been produced by Nordea Research's Independent Research unit.

Disclaimer

Nordea Markets is the commercial name for Nordea's international capital markets operation.

The information provided herein is intended for background information only and for the sole use of the intended recipient. The views and other information provided herein are the current views of Nordea Markets as of the date of this document and are subject to change without notice. This notice is not an exhaustive description of the described product or the risks related to it, and it should not be relied on as such, nor is it a substitute for the judgement of the recipient.

This report should be considered marketing material as the macro and FX sections have not been produced in accordance with the regulations designed to promote the independence of investment research and it is not subject to any legal prohibition on dealing ahead of the dissemination of the report. The information provided herein is not intended to constitute and does not constitute investment advice nor is the information intended as an offer or solicitation for the purchase or sale of any financial instrument. The information contained herein has no regard to the specific investment objectives, the financial situation or particular needs of any particular recipient. Relevant and specific professional advice should always be obtained before making any investment or credit decision. It is important to note that past performance is not indicative of future results.

Completion date: 3 December 2018, 22:42 CET

Nordea Bank Abp

Nordea Markets Division, Research
Visiting address:
Aleksis Kiven katu 7, Helsinki
FI-00020 Nordea
Finland
Tel: +358 9 1651
Fax: +358 9 165 59710
Reg. no.: 2858394-9
Satamaradankatu 5
Helsinki

Nordea Bank Abp, filial i Sverige

Nordea Markets Division, Research
Visiting address:
Smålandsgatan 17
SE-105 71 Stockholm
Sweden
Tel: +46 8 614 7000
Fax: +46 8 534 911 60

Nordea Danmark, Filial af Nordea Bank Abp, Finland

Nordea Markets Division, Research
Visiting address:
Grønjordsvej 10
DK-2300 Copenhagen S
Denmark
Tel: +45 3333 3333
Fax: +45 3333 1520

Nordea Bank Abp, filial i Norge

Nordea Markets Division, Research
Visiting address:
Essendropsgate 7
N-0107 Oslo
Norway
Tel: +47 2248 5000
Fax: +47 2256 8650