21 September 2018

Week ahead – The "Powell-put" is far out of the money

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Vigorous inflation pressure is on its way in the Euro area, at least according to Mr Draghi. Jerome Powell on the other hand kept 10yr treasury yields from breaking 3.11%, while he continues to warn that the Fed put is deeply out of the money.

The otherwise positive vibrations from the past two to three weeks have taken a slight pause towards the latter part of this week, **while the overall story that US assets are outperforming the rest of the world is showing tentative signs of metal fatigue.** Thus far in September only the German DAX (of the three big countries with huge trade surpluses against US) has underperformed S&P 500 in USD terms.

Are we past the peak in the US outperformance story as we prewarned more than a month ago? (Week ahead: Is it time to question the US outperformance?). **We think so.**

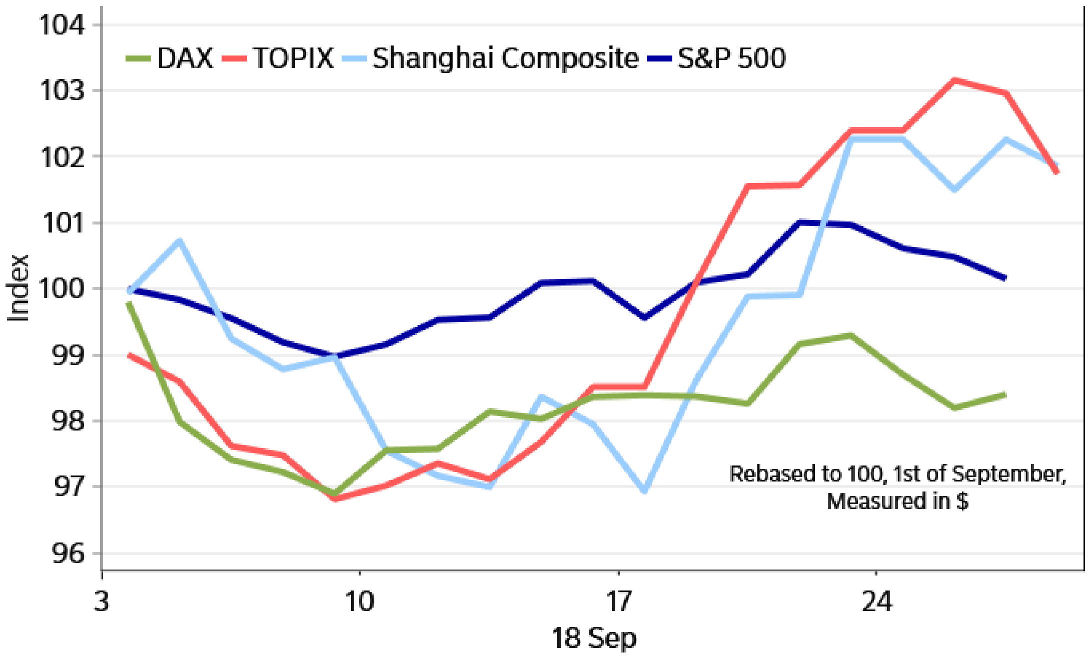
One reason behind the relatively weaker S&P 500 performance is likely that earnings estimates are being revised lower ahead of the Q3 reporting season. We argued months ago that EPS estimates in the US would eventually need to be lowered (FX weekly: Dollar to provide headwinds for earnings estimates), as the dollar had picked up materially from its lows early this year, and this would reasonably impact revenues. If 50% of revenues stems from abroad (for the S&P500 index), then a 5% stronger dollar could trigger a 2.5% cut to revenues/EPS. **The strong USD is now finally starting to show up in the S&P 500 - EPS estimates.** More will come from this story.

Vigorous inflation must mean a vigorous EUR

When Draghi **expects a relatively vigorous pick-up in underlying inflation** then markets move and so they did after his speech in the European parliament earlier this week. Even if there are no new short-term policy signals in this upbeat statement on underlying inflation it matters for markets and especially for the time frame that is beyond the ECB's current forward guidance (markets have added roughly 10 bp to the EURIBOR curve over the next two years the past seven to ten days). There is still a large threshold to be crossed before the market will start to speculate that the ECB will hike before the current forward guidance *that rates will be on hold until after the summer of 2019.*

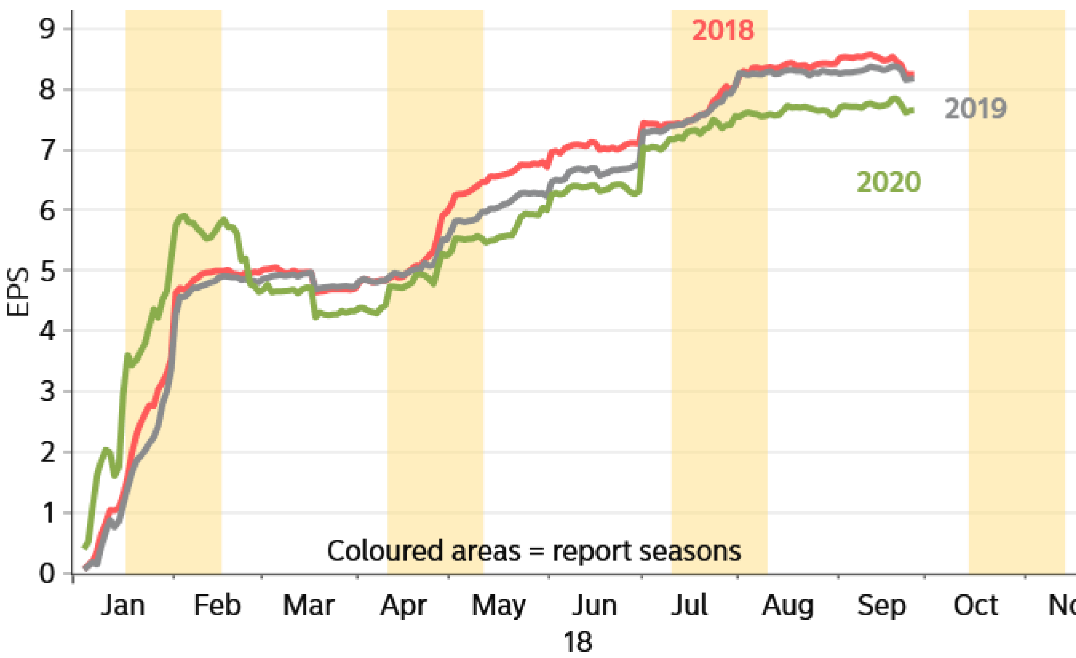
In the meanwhile, higher core inflation in the Euro area will matter for longer rates (5yr+) and likely also the EUR. **Because higher core inflation is on the cards in the Euro area (also despite today's surprising core inflation miss at 0.9%) – we agree with that.**

Chart 1: Early signs of an end to the US outperformance story?



Source: Nordea Markets and Macrobond

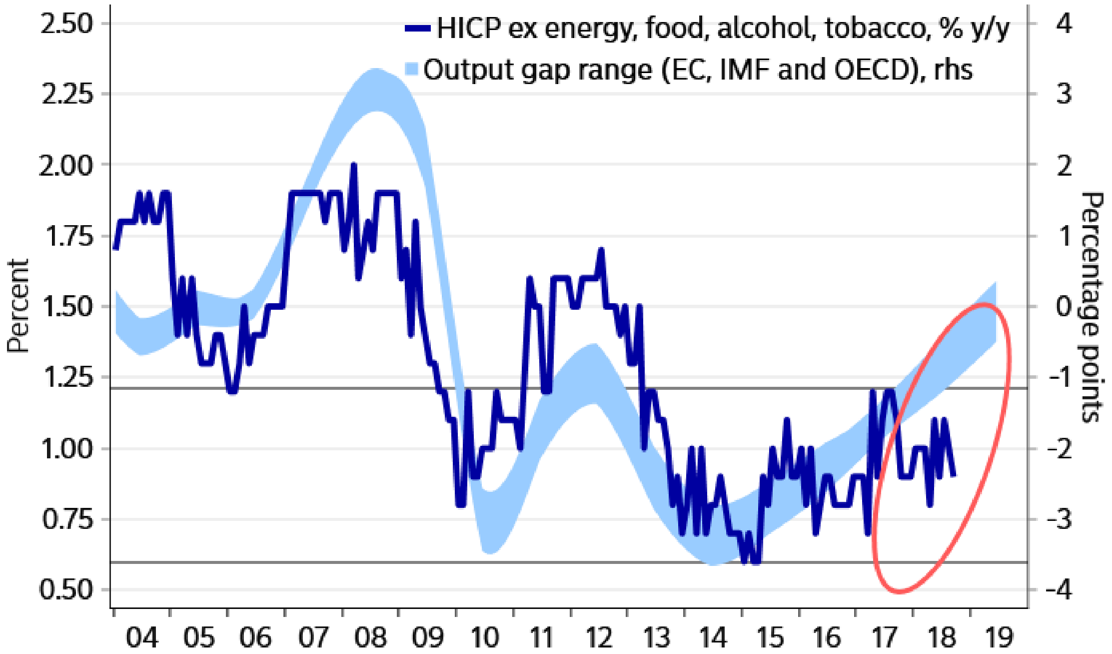
Chart 2: The USD is starting to take its toll on forward estimates of earnings-per-share in US



Source: Nordea Markets and Macrobond

Should markets start to price in a substantial probability of an ECB hike before the summer of 2019, **we would seek to fade such moves by receiving the very short-end again**, as we consider it very unlikely that Draghi will step away from his current "promises". **Given today's core inflation miss, this is though an outside scenario currently, even despite Draghis upbeat comments this week.**

Chart 3: Euro-area core inflation should reach 1.5% soon if it catches up with the output gap



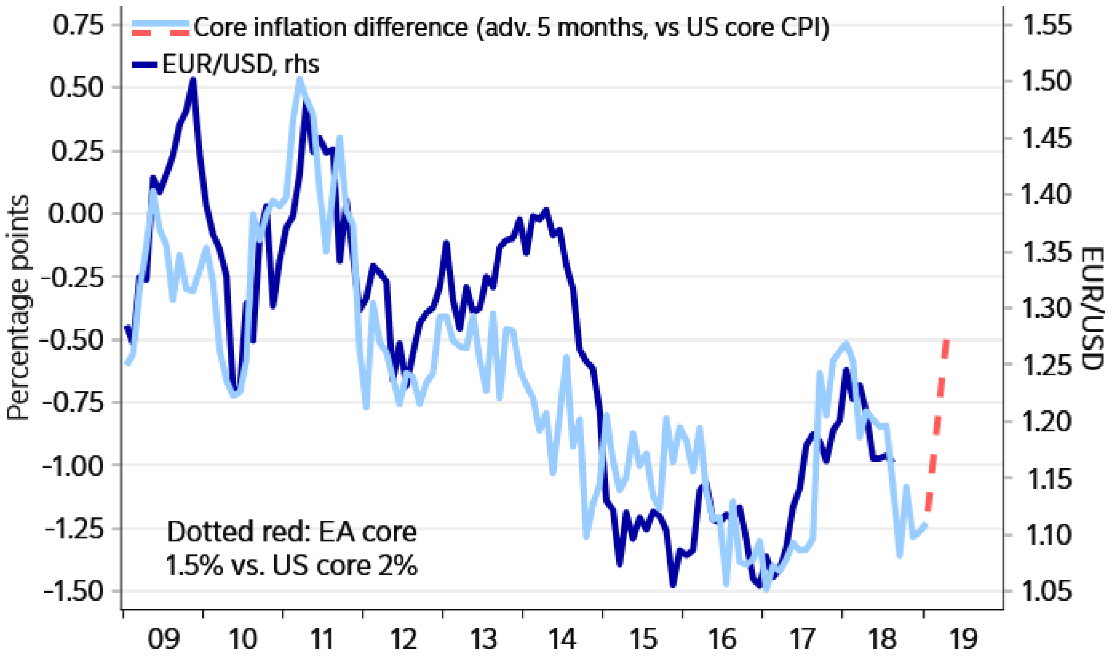
Source: Nordea Markets and Macrobond

On a relative basis, **the higher core inflation that we expect in the Euro area is one argument why we deem that the USD barometer versus the EUR will turn ice-cold in November/December at the latest.** Should Euro-area core inflation move to 1.5% over the next few months (not unthinkable) and US core inflation ease a little in the meantime (Week ahead – US goldilocks reincarnated?), **it could mean a swift move higher in EUR/USD (see chart 4).**

However, the big elephant in the EUR room is still Italy and the unorthodox M5S/League administration. Recently, Luigi Di Maio, leader of M5S, has stepped up his rhetoric markedly. "*If you are siding with the market (betting against Italian government bonds), you are against the Italian people"* is a slightly loose interpretation of his remarks in La Stampa this week. **We are not far from "Erdoganish" rhetorical territory.**

The key dates in the Italian budget process are the following (see below), despite yesterday's news that the League/M5S have agreed on a 2.4% deficit (more than the 1.6-1.9% Finance Minister Giovanni Tria targeted). There are still risks of a setback of the political order within the Euro zone and **you should not rule out that the technocrat Finance Minister Giovanni Tria at some point throws in the towel.** A scenario that will lead to renewed market worries concerning Italy.

Chart 4: A break higher in Euro-area core inflation could lead EUR/USD swiftly higher



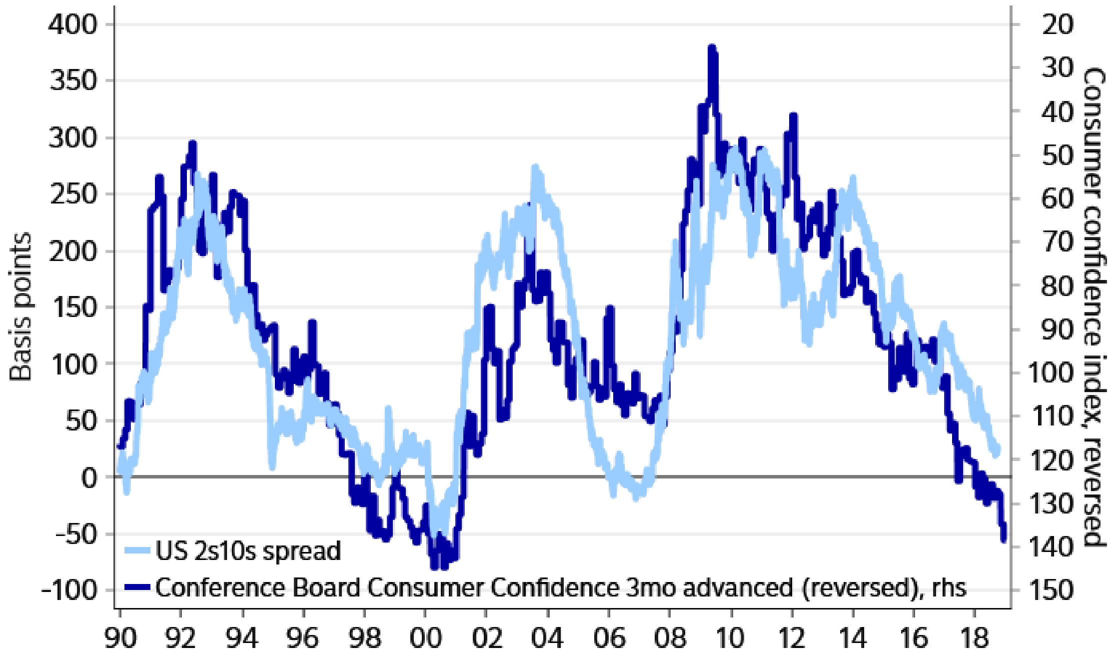
Source: Nordea Markets and Macrobond

Illustration 1: Italy's budget timeline – don't rule out an Italy-German stand-off just yet

US consumers are partying like it's 99, while Chair Powell continues to mention financial excesses

And while the first tentative signs of a weaker US outperformance story are emerging, US key figures continue to deliver. This week, US consumer confidence rose to tremendous levels close to 140. The further pick-up in US consumer confidence is not a sign to cheer for the medium-term, though. **Super strong consumer confidence could basically be interpreted as a very positive output gap.** Over the next quarters this should add to the flattening pressure on the USD curve (see chart 5).

Chart 5: US consumer confidence at whopping 138.4. All good then? Well ... (note reversed right axis)



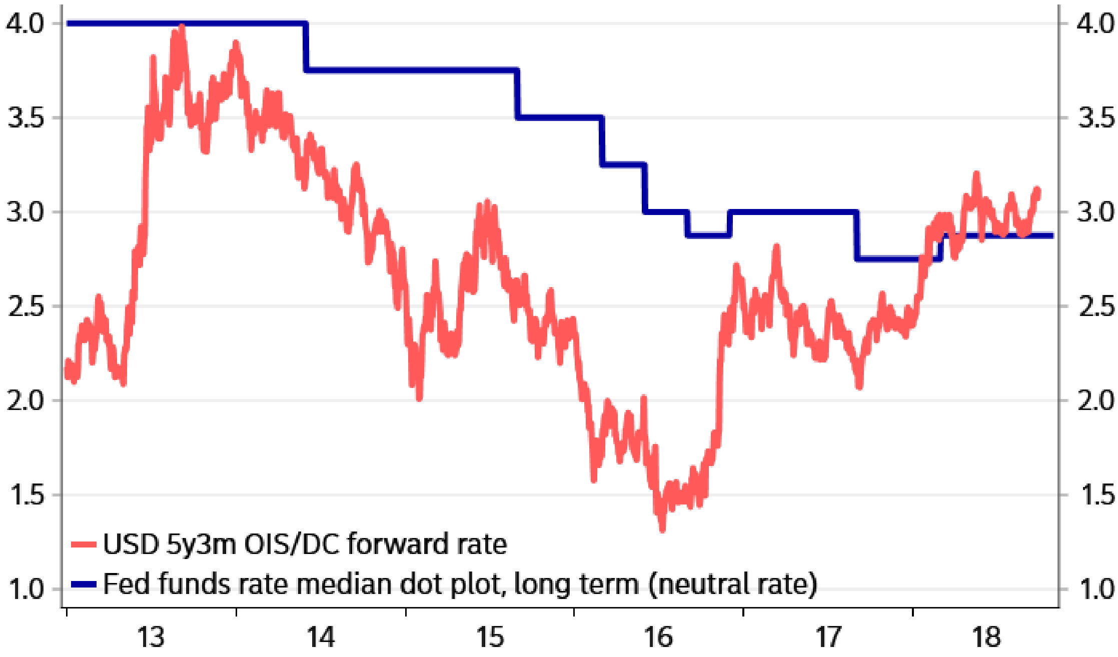
Source: Macrobond and Nordea

Jerome Powell and the FOMC also did their part in re-flattening the US yield curve this week, as the 25 bp hike and a roughly unchanged dot plot came in short of market expectations. The market had seemingly geared up for an upwards revision of the long-term median dot (the neutral rate / r*), judged by the 5y3m OIS/DC forward rate. **Usually the "neutral rate" works as a kind of ceiling for short-rate expectations five years from now.**

However, we don't think that the Fed presented any new signals regarding the future path of interest rates (Fed Watch: No new signals from Fed).

Chair Powell, on the other hand, continues down his *Jackson Hole* road by hinting that equity market valuations are stretched, saying *"some assets prices are in the upper reaches of historic ranges" and "we'd react to a significant and lasting market correction"*. To us, that is a sign that **the "Powell put" has a strike level that is deeper out-of-the-money** than the old Yellen/Bernanke/Greenspan puts.

Chart 6: The market had hoped "for more" on the long-term median in the dot plot



Source: Nordea Markets and Macrobond

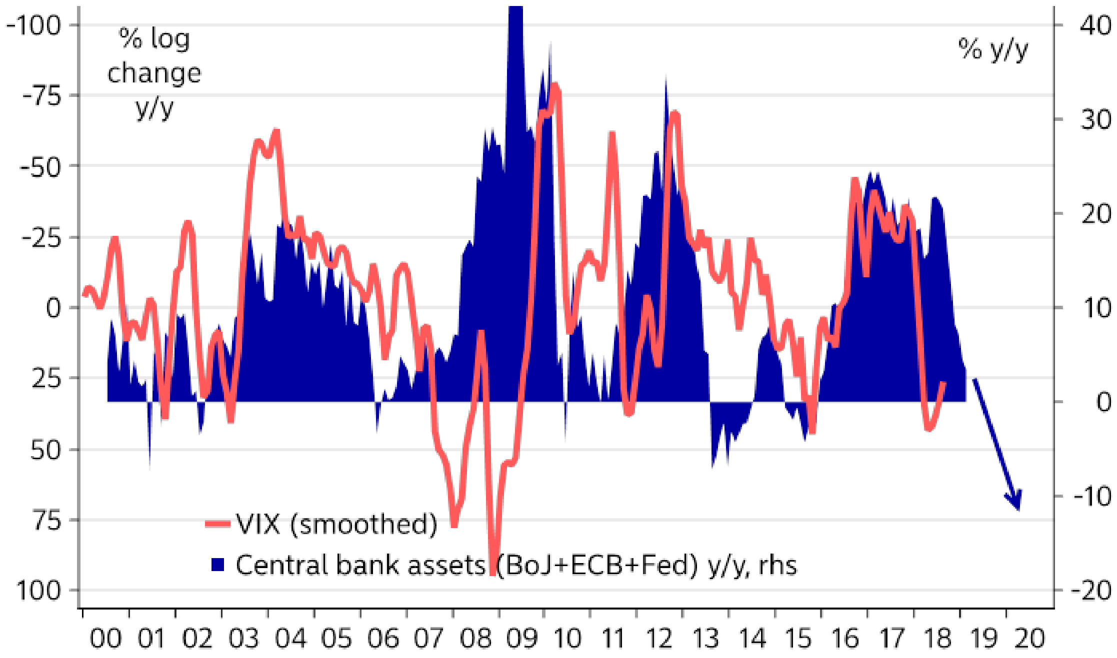
In the meanwhile cross-asset volatility looks cheap again ...

Despite signs of major central banks turning more hawkish on asset valuations, cross-asset volatility remains depressed after the short-lived, but dramatic spike we saw in February/March this year.

Especially the less benign central bank balance sheet policies that we have ahead of us is a warning signal that volatility is bound to increase again. On aggregate BoJ, ECB and Fed will likely hold less assets pr. month in 2019. This is a major change of environment (compared to the QE era), which will also tend to alleviate the price cushion of risky assets slowly but surely as private risk takers are gradually lured inwards on the risk curve, as the Fed leaves a portion of the safest part of the risk curve "up for grabs" when they shrink their bond portfolio (without other central banks making up for it).

On top of the central bank balance sheet policies, we see (at least) six further arguments why the pricing of volatility looks complacent (Seven reasons why cross-asset volatility is (too) low).

Chart 7: When CB balance sheets shrink on aggregate, usually volatility increases (note the reversed left axis)



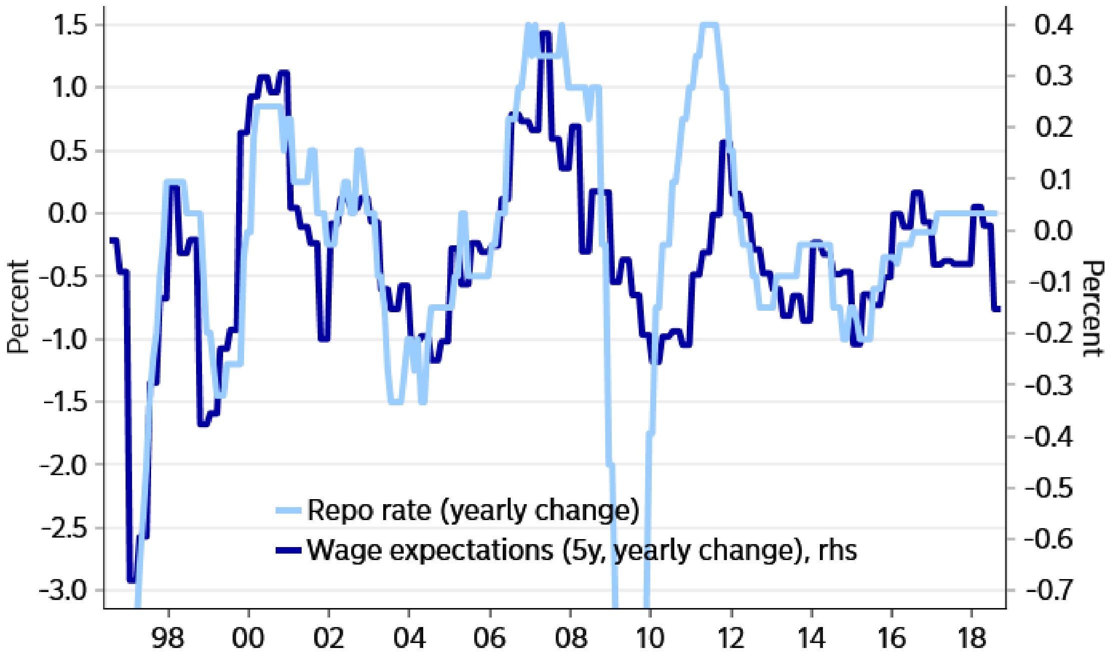
Source: Nordea Markets and Macrobond

Scandinavia: Service inflation is the "Janssonizer"

The most important news out of Scandinavia this week was the hints about future Riksbank monetary policy that we got from the public appearance of Deputy Governor Per Jansson in London Tuesday evening. Overall, we judge that those remarks had a slightly dovish twist, with Jansson saying that a hike will come in December or February (in line with recent Riksbank communication)**, but that the underlying trend in inflation is worrying and needs to change.** He further said that without higher service inflation it will be difficult to hike and that things can go very wrong in terms of FX rates given the impact that a firmer exchange rate can have in a small, open economy – **ie he sounded an awful lot like his usual dovish self.**

The hike in December hence hinges on a rebound in service inflation (a rebound that is likely to come). We expect a kind of one-and-done hike in December, but it will be an odd hike by historical standards from the Riksbank, as it will likely come alongside weaker wage expectations year on year (see chart 8). **Not a usual Riksbank cocktail.**

Chart 8: Lower wage expectations and a repo rate hike in December? Not a usual Riksbank cocktail



Source: Nordea Markets and Macrobond

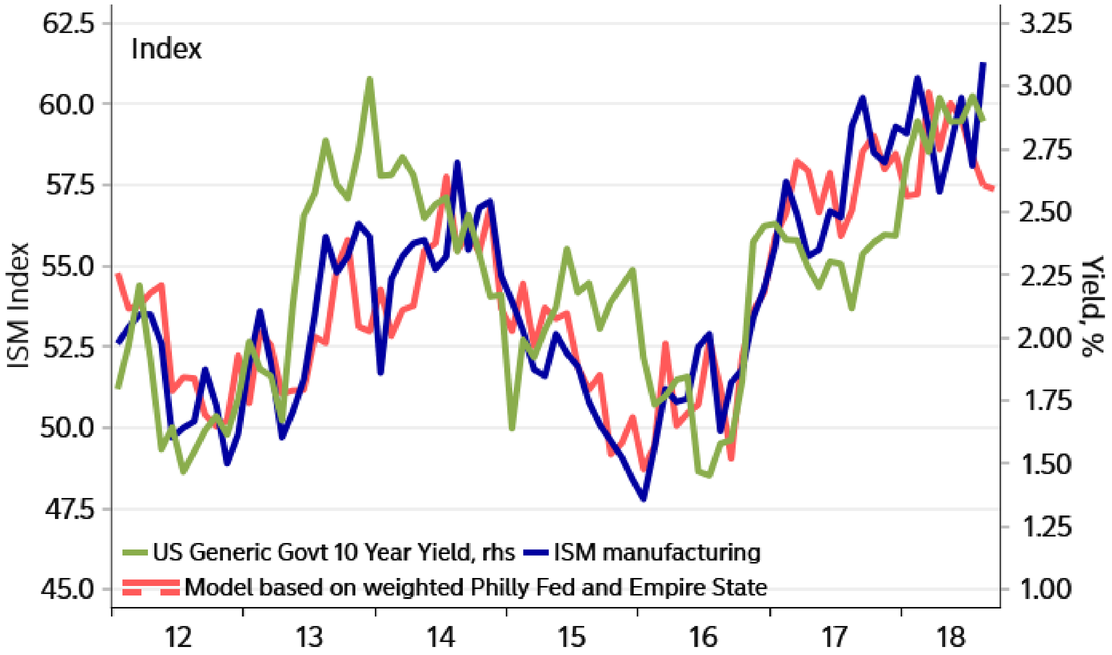
What is most important in the week ahead?

Monday kicks off with important temperature checks from the manufacturing sector with PMIs from Sweden, Norway and US (ISM). We expect a correction lower in ISM manufacturing in September. The August print always looked like an outlier and the model based on Philly Fed and Empire State regional indices puts ISM at 57.5 (way below consensus at 60.5).

Recently the 10yr treasury yield (and to a certain extent cyclical equities) have been partying like they were the ISM index. We judge that regional surveys are "truer" than ISM currently, which should limit the short-term upside for both 10yr treasury yields and cyclical equities.

From Sweden the monthly wage growth data are out Monday as well. If wage increases remain low, it will be even more difficult for the Riksbank to stabilise inflation at the 2% target. We expect a moderate 2.7% yearly wage growth. **Also remember that the Swedish Manufacturing PMI (out Monday) is maybe THE best indicator for the European manufacturing PMI three months later.** Currently the Swedish PMI continues to send negative signals for the Euro-area outlook.

Chart 9: The 10yr treasury yield is almost partying like it's ISM

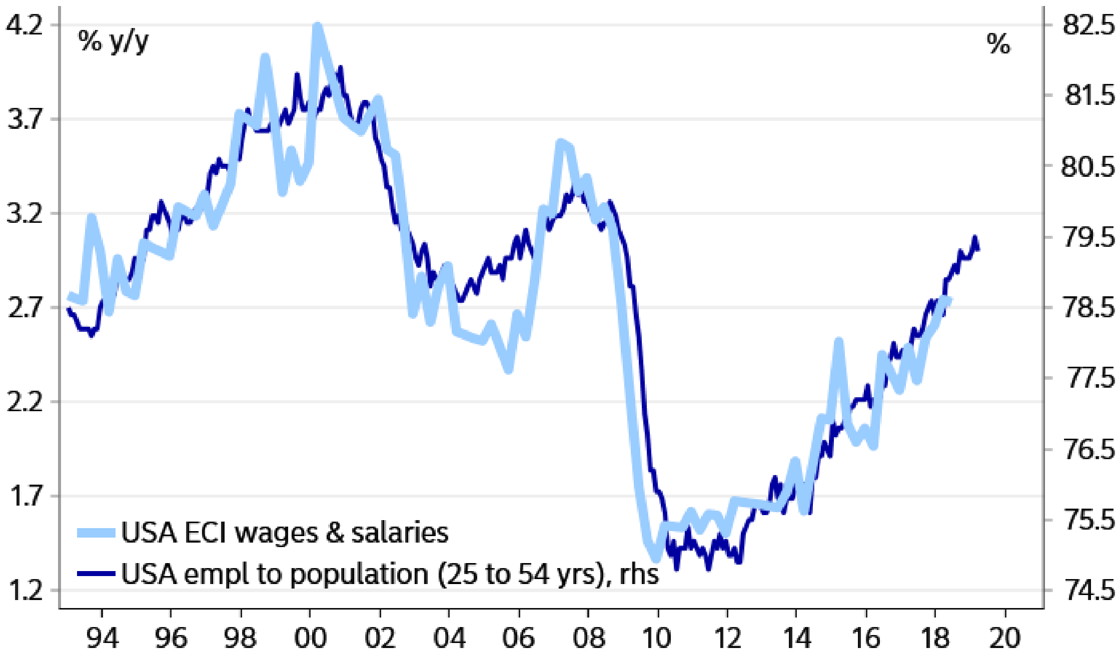


Source: Nordea Markets and Macrobond

Otherwise the US job report next Friday will be one of the main events of the week. Even though we sound a little stuck on repeat, we will continue to say that the wage growth component is the focal point to watch in the job report. Those who have followed Nordea Research in recent quarters should know by now that we continue to see upside risks to US wage growth. A trend that will keep the Fed in quarterly hiking mood at least another three to four quarters.

Otherwise, watch out for Chair Powell's speech Wednesday evening. Any further focus on financial excesses/asset valuations from Powell should be interpreted hawkishly.

Chart 10: Increasing US wage growth should be no surprise to those who followed Nordea's research



Source: Nordea Markets and Macrobond

Editorial by Senior Global Strategist, Andreas Steno Larsen

Key research pieces over the past week:

FX weekly: Twin deficit scare #2? (23 September)

FX month-end indicator: Buy SEK or EUR versus JPY (25 September)

Sweden: PM forced to step down – what's next? (25 September)

Fed Watch: No new signals from Fed (26 September)

ECB Watch: Good news for Germany, bad news for Italy (26 September)

Seven reasons why cross-asset volatility is (too) low (27 September)

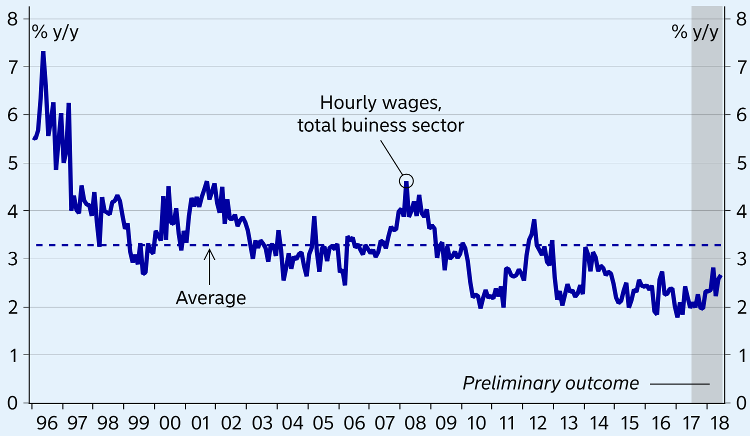
Table 1: Main releases to watch

Date	Key figure	Nordea	Consensus	Last
01-Oct	NO: PMI (index, sa)		54.5	60.5
01-Oct	SE: PMI, Manufacturing		57.0	52.5
01-Oct	US: ISM, manufacturing		60.5	61.3
01-Oct	SE: Wage increases (y/y), Swedish National Mediation Office	2.7%		2.6%
03-Oct	US: Fed's Powell speaks in Washington			
05-Oct	US: Nonfarm payrolls (absolute change m/m)		188k	201k

Monday

Today is filled with important manufacturing PMI numbers from the UK, Sweden, Norway and the US (ISM). Final estimates are also due from Germany and the entire Euro area. In China, markets are closed today and the rest of the week because of National Day. The Fed's Kashkari (dove, non-voter), Bostic (dove, voter) and Rosengren (neutral/hawk, non-voter) will speak during the day.

Monday, 01/10/2018				Nordea	Consensus	Previous
07:00	IN	PMI, manufacturing	Sep			51.7
08:00	DE	Retail sales (m/m)	Aug		0.4%	-0.4%
08:00	RU	PMI, manufacturing	Sep			48.9
08:30	SE	PMI, manufacturing	Sep		57.0	52.5
09:00	NO	PMI (index, sa)	Sep		54.5	60.5
09:30	**SE**	**Wage increases (y/y), Swedish National Mediation Office**		**2.7%**		**2.6%**



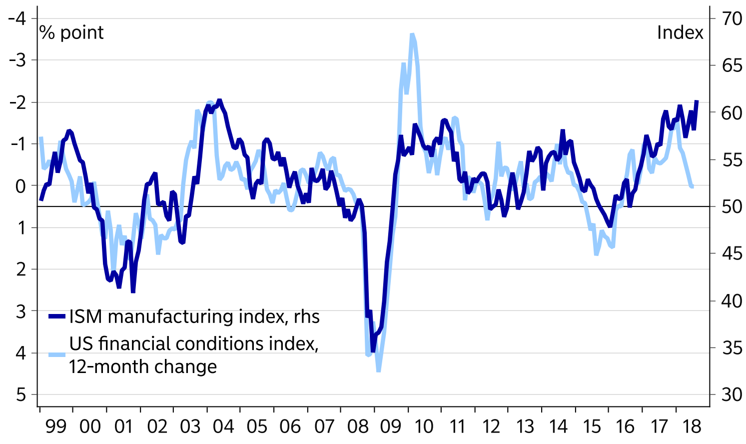
Source: Macrobond and Nordea

Inflation is the focal point for the Riksbank, but wages are almost as important. If wage increases remain low, it will be even more difficult to stabilise inflation at the 2% target. We expect wage growth to edge up to 2.7% y/y in July, thus higher than the 2.6% recorded for June. The somewhat higher pay rises are due to base effects, as wages dipped last summer, but also due to an upward trend in the business sector. It is still a long way off before wage increases are high enough for the Riksbank to relax about domestic inflation.

By Torbjörn Isaksson

				Nordea	Consensus	Previous
09:55	DE	PMI manufacturing (final)	Sep		53.7	55.9
10:00	EU	PMI, manufacturing (final)	Sep		53.3	54.6
10:30	GB	PMI, manufacturing	Sep		53.8	52.8
11:00	DK	PMI survey	Sep			59.1
11:00	EU	Unemployment rate	Aug		8.2%	8.2%
15:02	US	Fed's Bostic Speaks on Economic Development				
15:45	US	Markit manufacturing PMI (final)	Sep		55.6	54.7
16:00	US	Construction spending (m/m)	Aug		0.4%	0.1%

Monday, 01/10/2018 (continued)				Nordea	Consensus	Previous
16:00	**US**	**ISM, manufacturing**	**Sep**		**60.5**	**61.3**



Source: Nordea and Macrobond

We expect a correction lower in ISM manufacturing in September. The index surprised significantly to the upside in August, reaching the highest level since 2004. A rapid rise in the sub-index for new orders compared with a month earlier even pointed to positive ISM readings in the near term. However, we expect the ISM to correct gradually lower as the global manufacturing sector slows and tighter financial conditions in the US take their toll. Since 2010, the ISM has surprised most positively in Aug, Sep and Oct.

By Anders Svendsen

16:00	US	ISM, new orders	Sep			65.1
16:00	US	ISM, prices paid	Sep		70.8	72.1
17:00	US	Fed's Kashkari speaks in Minnetonka, Minnesota				
18:15	US	Fed's Rosengren Speaks on the U.S. Outlook and Monetary Policy				

Tuesday

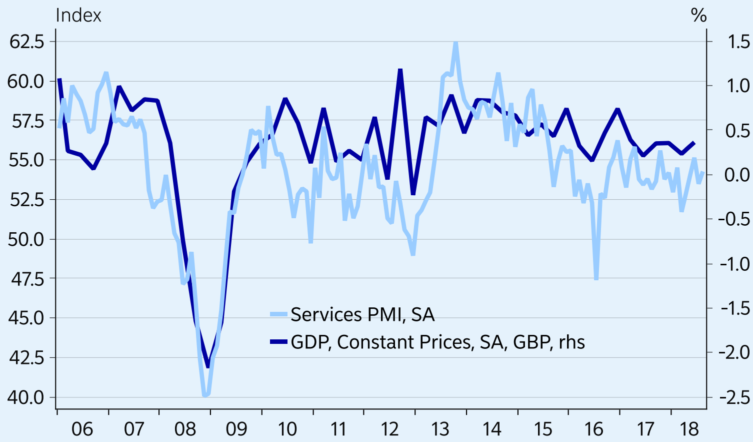
The day kicks off with the RBA's interest rate decision. In the UK, Nationwide HPI house price data and construction PMI are released. The Fed's Powell (neutral, voter) and Quarles (neutral, voter) will give speeches.

Tuesday, 02/10/2018				Nordea	Consensus	Previous
06:30	AU	RBA announces interest rates (cash rate target)	Oct	1.50%	1.50%	1.50%
08:00	GB	House prices, nationwide (m/m, sa)	Sep		0.2%	-0.5%
08:00	GB	House prices, nationwide (y/y, nsa)	Sep		1.9%	2.0%
09:30	SE	Registration of vehicles (y/y)	Sep			-17.9%
09:30	SE	Unemployment, Labour Force survey (AKU)	Q2			
10:30	GB	PMI, construction	Sep		52.6	52.9
16:00	DK	Foreign currency reserves (DKKbn)	Sep			467.9
16:00	US	Fed's Quarles Testifies to Senate Banking Committee				
18:00	US	Fed's Chairman Powell Speaks at NABE Conference in Boston				
23:00	US	Vehicle sales, domestic	Sep			13.1
23:00	US	Vehicle sales, total	Sep		16.8	16.7

Wednesday

Both German and Chinese markets are closed today. On the data front, markets will look out for service PMIs from Russia, Sweden and the UK and final service and composite PMIs from Germany and the Euro area. In the US, the ISM non-manufacturing reading is released along with the private ADP job report, while FOMC members Evans (dove, non-voter), Barkin (neutral, voter) and Mester (hawk, voter) will give speeches during the day. In the EM space, we expect the Polish central bank to keep its policy rate on hold.

Wednesday, 03/10/2018				Nordea	Consensus	Previous
08:00	RO	BNR announces interest rates	Oct		2.50%	2.50%
08:00	RU	PMI, services	Sep			53.3
08:30	SE	PMI, service sector	Sep			57.1
09:00	TR	CPI (y/y)	Sep			17.9%
09:55	DE	PMI composite (final)	Sep		55.3	55.6
09:55	DE	PMI services (final)	Sep		56.5	55.0
10:00	EU	PMI, composite (final)	Sep		54.2	54.5
10:00	EU	PMI, services (final)	Sep		54.7	54.4
10:30	GB	PMI, composite	Sep			54.2
10:30	**GB**	**PMI, services**	**Sep**		**53.9**	**54.3**



Source: Nordea and Macrobond

Both the services and composite PMIs accelerated as well as surprised to the upside in August. Thus, the latest figures boosted the outlook for Q3 growth, consistent with GDP growth of 0.4% q/q. Business activity was supported by an increase in incoming new work. However, due to the ongoing Brexit uncertainties, business optimism about the year ahead sank to the lowest level since March, while business expectations across all three sectors (services, manufacturing and construction) plummeted to the lowest levels since the EU referendum in 2016. Given the sour business outlook reported in August and the increasing tensions between the UK and the EU, we expect a decline in the September numbers compared to August. Read about our Brexit view here.

By Morten Lund

11:00	EU	Retail sales (m/m)	Aug		0.2%	-0.2%
11:00	NO	House prices EFF (m/m, sa)	Sep			
11:00	SE	SNDO to auction bonds				
12:10	PL	NBP announces interest rates (Base rate)	Oct	1.50%	1.50%	1.50%
12:30	US	Fed's Evans Speaks in London				
13:00	US	Mortgage applications, MBA	Sep			2.9%
14:05	US	Fed's Barkin Speaks at Economic Conference in West Virginia				
14:15	US	Employment, ADP (absolute change m/m)	Sep		185k	163k
15:45	US	Markit composite PMI (final)	Sep		54.7	53.4
15:45	US	Markit services PMI (final)	Sep		52.9	54.8
16:00	US	ISM, non-manufacturing, composite	Sep		58.3	58.5
20:00	US	Fed's Brainard speaks in Chicago about Payment System				
20:15	US	Fed's Mester Speaks at Community Banking Conference				
22:00	US	Fed's Powell speaks in Washington				

Thursday

Today is very light on the data front. The Mexican central bank announces its interest rate decision while the Fed's Quarles (neutral, voter) and ECB's Nowotny (neutral) will give speeches.

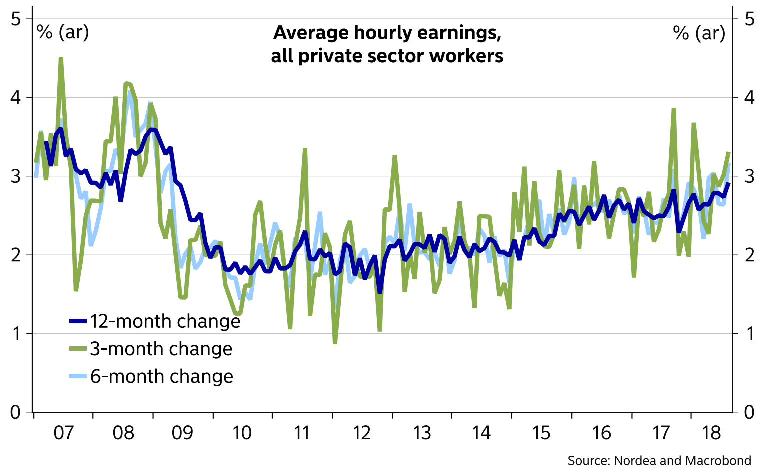
Thursday, 04/10/2018				Nordea	Consensus	Previous
	EU	ECB's Nowotny speaks				
06:00	SE	House prices, Mäklarstatistik (y/y)				
13:30	US	Challenger job cuts (y/y)	Sep			13.7%
14:30	US	Durable goods orders (m/m)	Aug			
14:30	US	Durable goods orders, ex transportation (m/m)	Aug			
14:30	US	Jobless claims, continuing	Sep		1669k	1661k
14:30	US	Jobless claims, initial	Sep		206k	214k
15:15	US	Fed's Quarles Speaks at Community Banking Conference				
16:00	US	Factory orders (m/m)	Aug		0.9%	-0.8%
16:00	US	Factory orders, ex transportation (m/m)	Aug			0.2%
20:00	MX	Banxico announces interest rates		7.75%	7.75%	7.75%

Friday

All eyes will be on the US job report today. In Europe, the UK Halifax House Price Index is released and in the EM space, the Indian central bank announces its interest rate decision.

Friday, 05/10/2018				Nordea	Consensus	Previous
06:30	IN	RBI announces interest rate (Repurchase Rate)	Oct	6.50%	6.75%	6.50%
08:00	DK	Industrial production (m/m, sa)	Aug			1.4%
08:00	DE	Factory orders (m/m)	Aug		0.0%	-0.9%
09:00	GB	House prices, Halifax (m/m)	Sep			0.1%
09:00	GB	House prices, Halifax (y/y, 3mma)	Sep			3.7%
09:30	SE	Central Government Debt	Sep			
09:30	SE	Industrial orders (y/y)	Aug			9.4%
09:30	SE	Industrial production (m/m)	Aug			-2.2%
09:30	SE	Industrial production (y/y)	Aug			2.3%
09:30	SE	Private service sector production (m/m)	Aug			
09:30	SE	Private service sector production (y/y)	Aug			0.1%
09:30	SE	Total business sector production (m/m)	Aug			-0.9%
09:30	SE	Total business sector production (y/y)	Aug			1.8%
11:35	EU	ECB's Klaas Knot Speaks at Student Conference in Groningen				

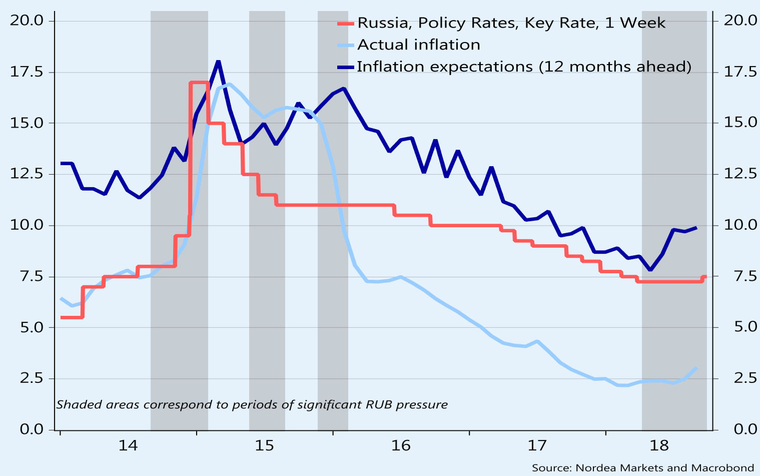
Friday, 05/10/2018 (continued)				Nordea	Consensus	Previous
13:30	US	**Nonfarm payrolls (absolute change m/m)**	**Sep**		**188k**	**201k**



We expect nonfarm payrolls to remain around the average pace of 200k increase per month. Barring a major surprise in payrolls, we believe average hourly earnings will get more attention after the surprisingly strong increase of 0.4% m/m in August. Consensus expectations hold for another strong increase of 0.3% m/m in September, which compares with 3.0% y/y. The broader measure of unemployment, U6, also surprised positively in August with a drop to 7.4%, which – if sustained at that level – would be another solid sign of the strength in the labour market.

By Anders Svendsen

14:00	RU	**CPI (y/y)**	**Sep**	**3.3%**		**3.1%**



The key numbers for Russia this week are September inflation and inflation expectations. Inflation will continue to accelerate on the back of a weaker RUB, higher gasoline prices and approaching VAT hike. We expect it to reach 3.3% in September, gradually returning to the 4% target. Inflation expectations may well exceed 10% for the first time since July 2017. Against this backdrop one more key rate hike by the end of the year cannot be ruled out.

By Tatiana Evdokimova

14:30	US	Average weekly hours	Sep		34.5	34.5
14:30	US	Hourly earnings, average (y/y)	Sep			2.9%
14:30	US	Labour force participation rate	Sep			62.7%
14:30	US	Trade balance	Aug		-50.0bn	-50.1bn
14:30	US	Unemployment rate	Sep		3.8%	3.9%
18:40	US	Fed's Bostic Speaks at Financial Literacy conference				
21:00	US	Consumer credit	Aug		15.0bn	16.6bn

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