SAXO BANK

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Quarterly Outlook

Q2 · 2014

Europe: Make or break

STEEN JAKOBSEN, Chief Economist

"Germany's flirtation with recession by the end of the year could prove more detrimental than the European Parliamentary elections as the market's attention is elsewhere."

Welcome to Saxo Bank and TradingFloor.com's Insights 2014 Q2 Outlook

In every sense, this is Europe's make-or-break quarter.

America's recovery, despite the awful winter it has endured, looks fair, and Asia's rebalancing effort, while pertinent, is an ongoing theme through 2014. For this quarter, at least, Europe is where it is at.

Pivotal European Parliamentary elections in May are likely to deliver a kick in the teeth for pro-European proponents. The very real possibility of EU sceptics making up the biggest bloc in the European Parliament ought to force a rethink on the whole experiment and, in particular, the fundamental flaws that run through the common currency.

But, given Brussels' predilection to follow its own path in these matters, no such rethink is likely.

It may not ultimately matter. Eurozone growth engine Germany is already showing signs that it could be following beleaguered France towards recession. Meanwhile, an apparent improvement in the Club Med economies is nothing more than a transfer of their chronic problems to Europe's core.

And then there is Ukraine. Russia's intervention on the Crimea Peninsula is the proverbial spanner in the works that casts a deep shadow over the continent. Europe's short-sighted energy strategy has left it uncomfortably dependent on its vast neighbour and the threat of sanctions is only likely to see Moscow dig its heels in deeper.

We've entered the danger zone. The repercussions are likely to be far-reaching and difficult to predict. However it unfolds, Europe will pay a price. The only imponderable is how profound that price may be.

Kim Fournais
Co-founder and CEO of Saxo Bank

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State of flux

Europe faces its biggest electoral challenge in May and if Brussels listens to voters, it could mark a decisive turning point for the failing EU experiment. But there are fears that the opportunity will slip through its hands.

by STEEN JAKOBSEN, Chief Economist

The "State of flux" headline has been used before. Each time it is deployed, pessimists are surprised by how politicians and their mandarins appear to create yet another plan for keeping the European experiment alive. Our *Q2 Insights Quarterly Outlook* is neither predicting the end of the euro nor the EU. Rather, it is forecasting that Europe could face its biggest electoral challenge in the quarter since the 1970s and a severe slowdown in growth.

At worst, a massive push back to the concept of more Europe is what is needed from Brussels as many voters see politicians lacking in focus on the priorities necessary for real change.

The gap between Europe's voters and their EU-friendly politicians has never been bigger. Across Europe, the polls indicate that any party that is EU hostile will have substantial support. The EU-sceptic parties could even make up the biggest overall bloc in the European Parliament after the elections on May 22.

Watch Steen talk about his Q2 forecast

Turning ugly

How did we get to this point? A united Europe as a concept is, by and large, universally accepted by most voters. Most people get the idea of a United States of Europe, as borne out of Winston Churchill's speech in Zurich after WWII. Europe can offer stellar credentials in terms of keeping its member states out of war, but any model needs an economic foundation that is sound and long term. It's here that things start to turn ugly for the EU.

History shows us that even the most primitive of monetary unions can ultimately fail when it gets tough economically. Many European countries have not yet reached their 2007 GDP levels and unemployment remains stubbornly high. Meanwhile, Europe's biggest customers – Asia and the US – are having a hard time sustaining momentum despite the fact that we in the developed world are enjoying the easiest monetary policy in history.

For voters to blame all our economic problems on the EU is, of course, misplaced. Nevertheless, that is what could happen in May. The EU Parliamentary elections are often used to register a "protest" vote. This means that the minor parties may collect more votes than they otherwise would. Strategists from France's Front National and the UK Independence Party are smiling right now. The polls are friendly and improving month by month.

Can support for minor parties hinder Europe? No, not at all. Too much political capital is tied up in the system and the economic model. However, it will cause concern and may even mean a few years of reduced "innovation" and "more Europe" talk from Brussels.

False starts

What will test Europe in Q2 is a European economy that has had an abundance of false starts. The outlook through the rest of 2014 is likely to see below consensus growth in Asia, Europe and the US. By the end of Q2, the growth data will probably force the US Federal Reserve to stop its tapering. The European Central Bank will be concerned about deflation and a lack of growth that is forcing it to engage in open quantitative easing and yet another set of unconventional measures.

Germany's flirtation with recession by the end of the year could prove more detrimental than the European Parliamentary elections as the market's attention is elsewhere. The market may be more concerned about France, but while Europe stabilises, there is an internal rotation going on where the Club Med's unit labour cost is improving while core Europe (France, Netherland, Belgium and Germany) is eroding.

Spain, Portugal and Greece doing better is not necessarily good for all of Europe as it's really a transfer of problems from Club Med to France and soon Germany.

Europe is not better off overall, but the weaker countries are showing signs that their respective domestic devaluations are working.

As for Europe's customers, the global market is also under pressure. Asia is no longer overinvesting, which means fewer exports will be going east. Russia is close to zero on both growth and a current account surplus, from levels of 5 percent to 7 percent and 5 percent to 10 percent growth, respectively, before the crisis. Russia remains the world's third-largest luxury goods market. And who sells mainly luxury goods? Correct. France and Germany. Q2 is likely to see the early signs of this slowdown in exports.

Fragile Eight

The lead lag, meanwhile, from policy decisions taken in Asia in the autumn is six to nine months, meaning the full impact starts now and will weigh down exports in Q4. A similar picture can be seen in Latin America. The "Fragile Five" (South Africa, Brazil, India, Indonesia and Turkey) have, over the winter, become the "Fragile Eight" with the inclusion of Argentina, Russia and Chile. In 2012, the "Fragile Eight" plus China made up more than 70 percent of global growth. These same countries are now in the process of rebalancing and guiding their currencies weaker to regain their footing. This is what "state of flux" refers to.

The world is healing, absolutely, but too many countries and economies are trying to do the same thing simultaneously. The only known conclusion to be gleaned from this is that growth will weaken structurally and cyclically.

"Europe can offer stellar credentials in terms of keeping its member states out of war, but any model needs an economic foundation that is sound and long term. It's here that things start to turn ugly for the EU."

When both point downwards, we'll end up with a quarter and a year that should be seen as a down payment in reforms. Such a rebalancing should leave the world more deleveraged, more balanced in current account trends and a state in which small- and medium-sized companies will again be given their proper role as the key drivers of innovation and growth.

Illustrating the desperate need to focus on long-term reforms is best accomplished by noting this Conference Board chart, taken from a report on productivity called *2014 Productivity Brief – Key Findings*.

The chart shows the "innovation and technology" trends of the global market. The lines in this chart measure our potential future growth as productivity over time determines the rise in a society's standard of living. Emerging markets have seen a sizeable drop in net positive contribution to growth and the mature economies are about to go negative. We have been so focused on saving the world, the banks and the political system that we have underinvested in people, education, infrastructure, innovation and technology.

Full circle

These are policy choices comprised of difficult decisions that need to be taken and sold to the voters. I think voters can and will deal with any scenario unless they feel they are being cheated. That's where we come full circle to the start.

The European Parliamentary elections may show the politicians that the voters feel betrayed. By June, the politicians need to decide whether or not to ignore the results – the most likely outcome – or face up to getting involved in redefining Europe in the mould of what the voters believe in the most: themselves.

You can have too much of a good thing, as the saying goes. Q2 will prove that through a growth slowdown, pressure will be put on Germany, China and even the US. The state of flux is here, but the good news is that, as a definition, it offers hope: "A state of uncertainty about what should be done preceding the establishment of a new direction of action."

It will not be the European Parliamentary elections that make or break the EU, but how the policymakers and their trusted mandarins respond to the slowdown and subsequent rebalancing of the world.

"We have been so focused on saving the world, the banks and the political system that we have underinvested in people, education, infrastructure, innovation and technology."

This leaves me with a few key points on investments for 2014:

Fixed income

Core government bonds will be the only asset that is up Q1 2014 versus Q1 2015 (rebalancing and lack of productivity).

Foreign exchange

EURUSD will peak at about 1.4000/1.4050 and then turn down to 1.2500 (the ECB should get active on deflation over the summer). USDJPY could see 95.00 on a VAT hike and initial signs of Abenomics failing. The "Fragile Eight" will drop another 5 percent.

Commodities

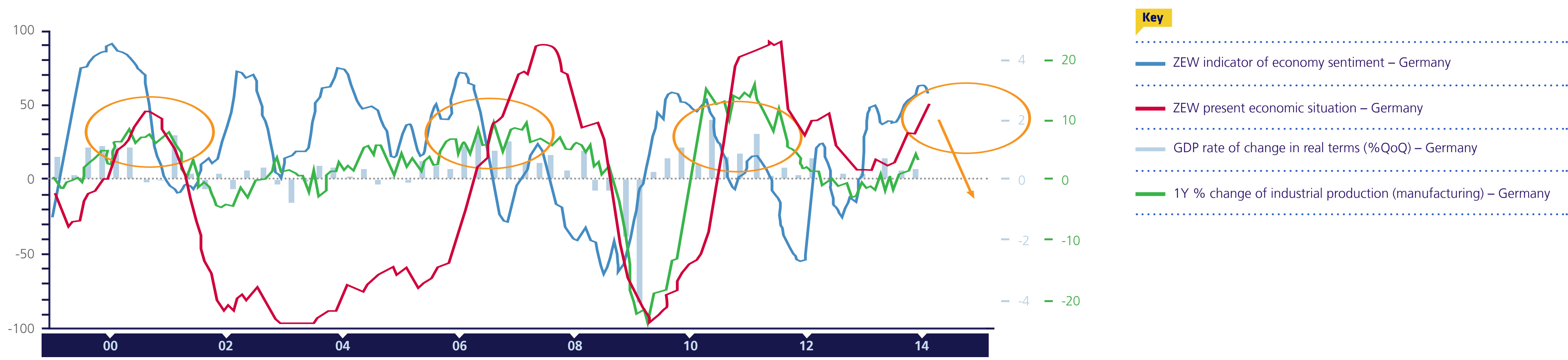
Commodities will do well through Q2 as real rates will drop, but it's a fall slated for H1 2015. Will take profit in Q3 2014.

Equity

Equity will peak at about 1,900/1,950, then a 30 percent correction. Equities are the only asset not yet hurt by the changing economic cycle. TF

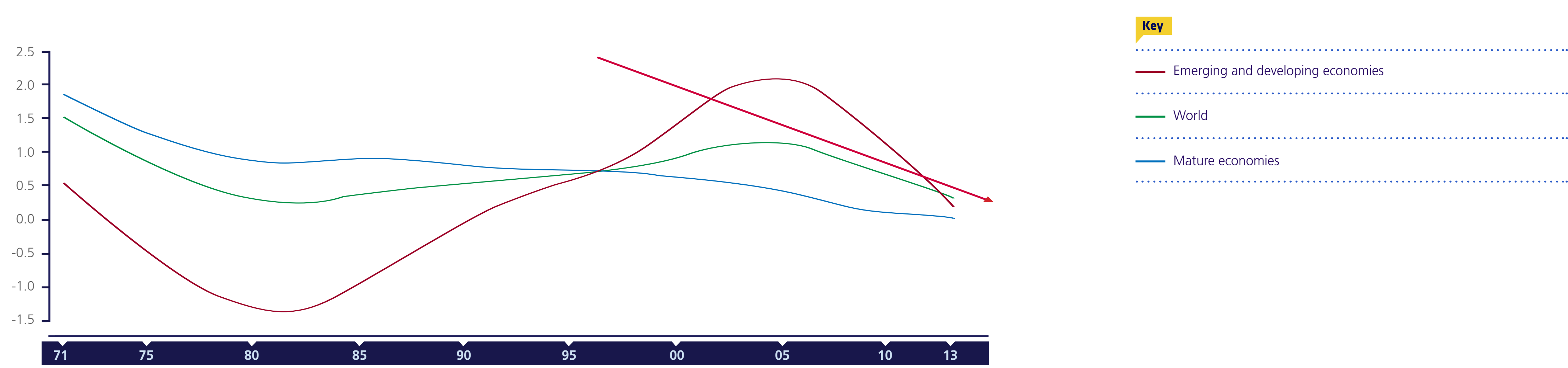
GRAPHIC 1

Current economic situation – Germany



GRAPHIC 2

Trend growth of total factor productivity



Sources: ThomsonReuters Datastream, The Conference Board *Total Economy Database* ™, January 2014

Strength in numbers

The global economy may not be in a stellar growth mode, but there is every sign that a recalibrated engine is shifting into a higher gear. Even Russia, albeit with the potential for disaster from the Ukraine crisis, could make a significant contribution.

by MADS KOEFOED, Head of Macro Strategy

"A key risk to our outlook is the magnitude of economic sanctions – and potential for escalation – between Russia and the western countries over Ukraine."

Is the global economy really struggling? Emerging market turmoil and a mediocre start to the year in the US and China, the world's two largest economies, might suggest so. However, a closer look reveals a global economy that is doing quite well, supported by a lessening in fiscal drag and private sector deleveraging in developed economies. The onus is much more on developed economies to lead the way than has been the case in recent years. But that should be within their compass, so expect global economic growth to rise to 2.8 percent this year from 1.7 percent in 2013.

Russian economy strong enough

The Russian economy was hampered by lower commodity prices last year, with GDP posting growth of just 1.3 percent compared with 3.4 percent in 2012. Brent crude oil prices hit a yearly average of 108.70 USD/barrel from 111.60 USD/barrel in 2012, a 2.6 percent decline. The Dow Jones UBS Commodity Index also dropped by 7.5 percent. What's more, we see risks to oil prices skewed to the downside this year (see our Commodity Outlook), with a base scenario of 105 USD/barrel and a rather stale outlook for commodities in general.

But commodities were just one part of the slowdown story. Consumer spending suffered alongside investment last year and sentiment only worsened as the reality set in post-Winter Olympics. Industrial production is flat year-on-year and growth in household consumption slowed to less than 4 percent. Furthermore, external demand was weak last year as key trading partners, including the euro area, saw little growth, while little progress has been made on reforms to limit corruption and boost competitiveness in parts of the economy.

Considering our modest outlook for commodity prices this year, why do we then forecast a pick-up in growth in an economy heavily dependent on commodities?

First, downward pressure from commodities will lessen and agriculture actually has upside risk. Second, while domestic consumption growth will likely stay subdued, investment should benefit from large-scale state projects. Third, demand from abroad should strengthen as the recovery in Europe gains a solid footing.

Needless to say then, a key risk to our outlook is the magnitude of economic sanctions – and potential for escalation – between Russia and the West over Ukraine. Europe and Russia are interdependent in trading terms, notably energy, up for a slight increase in growth to 1.6 percent this year from 1.3 percent.

US to overcome harsh winter

The US economy has had a disappointing start to the year, if only because expectations were so much higher. Dire weather may have left a mark on economic activity, but should not shoulder all of the blame. Inventory accumulation and subdued investment growth have also weighed on growth, as has continued fiscal restraint.

Public spending is down no less than 5.6 percent on a quarterly annualised basis on the fourth quarter of last year.

The labour market has had a subdued start to the year, with net job creation running at just 129,000 on a three-month basis through to February.

In comparison, no less than 194,000 non-farm payrolls were added on average per month in 2013, only a little shy of what is typical during an expansion.

However, the unemployment rate maintained a steady downward trend to end 2013 at 6.7 percent as employment climbed 1 percent, while labour force participation hit a multi-decade low in December of 62.8 percent compared with 63.6 percent a year earlier.

The "easy" unemployment rate gains in recent years on the back of a shrinking labour force will probably not be repeated going forward. Indeed, the labour force participation rate may well hold more or less steady throughout the year as job prospects increase and fuel a desire to return to the workforce. Hence, further declines in the unemployment rate will mainly come about as a result of employment growth and be less pronounced in size than what we witnessed last year.

Sharp increases in mortgage rates in the spring of 2013, coupled with rising house prices, saw the housing market screech to a halt in the second half of 2013. New home sales averaged 415,000 per month in that period (annualised), down from 445,000 in the first six months, while annual sales growth is close to flat following nearly two years at plus 10 percent. Growth in sales of existing homes is outright negative thanks to being bogged down by a reduction in distressed sales. Despite these facts, housing in the broader picture did well enough in 2013. Indeed, new home sales rose 16.6 percent from 2012 and prices continued north, bolstering household balance sheets.

The US economy could accelerate to close to 3 percent this year on the back of private consumption and investment. Housing, albeit to a lesser extent than recent years, will also help to drive the economy forward. Furthermore, the drag from the public sector will be close to and perhaps even zero. In 2013, the public sector saw spending drop by 2.3 percent, with federal spending down 5.2 percent. President Barack Obama: the public sector slayer. Who would have thought?

"The US economy could accelerate to close to 3 percent this year on the back of private consumption and investment. Housing, albeit to a lesser extent than recent years, will also help to drive the economy forward."

Year-long spring in the euro area

The recovery in the euro area is ongoing, with growth expected to rise to 1 percent this year following a contraction of 0.4 percent in 2013. Consumers may still feel hard hit by austerity, but the impact to the economy is lessening whether you look at the private or public sector. Deleveraging still has far to go and will ensure a subdued recovery not just this year, but into 2015. But there is no denying that prospects are better than they have been in a long time.

Unemployment has finally peaked and should start to decline meaningfully later in the year, wages are rising in real terms and there is substantially less pressure on peripherals. Public sector spending should, therefore, rise faster than last year's 0.4 percent.

The pace of structural reforms remains inadequate in several member states, including France and Italy, but it will not be an issue in the short term where calm markets and better economic data preside.

Hence, growth is expected to proceed at a steady if unimpressive rate of 0.2 percent to 0.3 percent per quarter and 1 percent for the full year. The current bout of disinflation running through the euro area is partly temporary and partly structural in nature.

With downward pressure from energy prices subsiding, it should accelerate later this year from an annual pace of 0.7 percent in February. But that will, in all probability, not be enough for the European Central Bank, which is bound to take further policy steps to speed up inflation.

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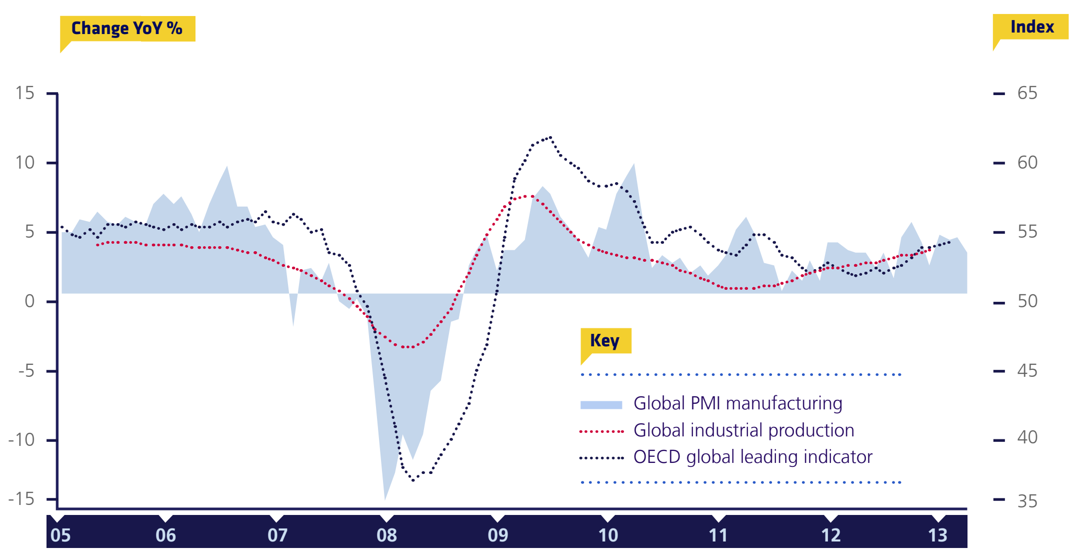
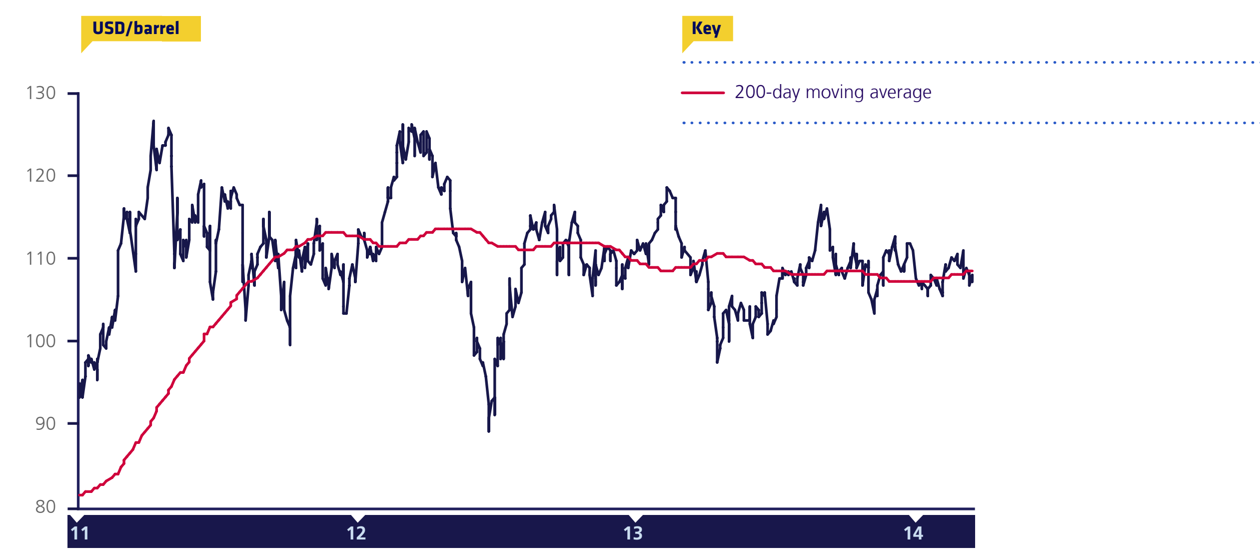
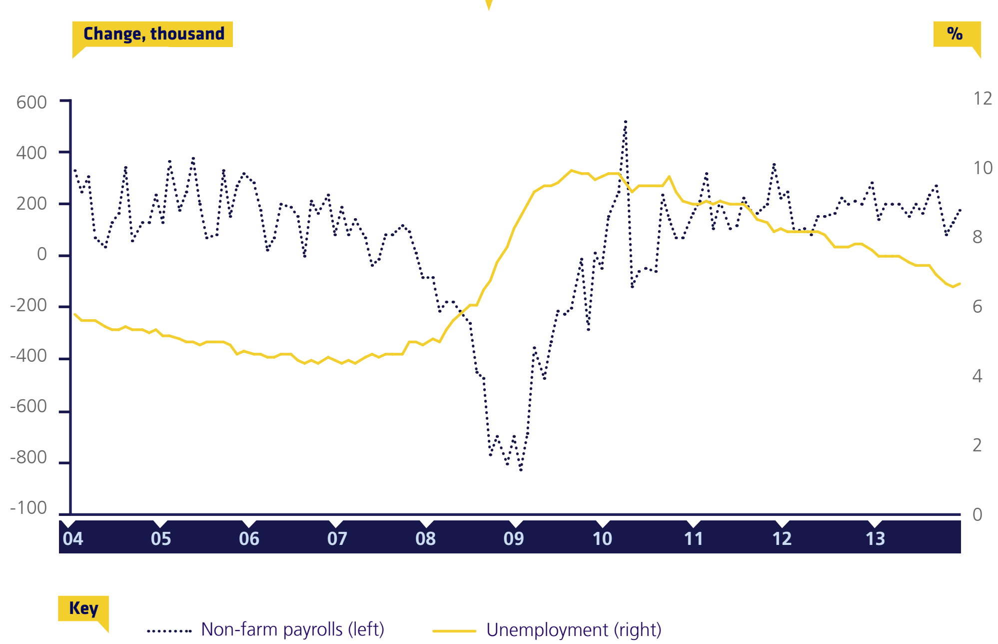
GRAPHIC 1 **Global PMI manufacturing vs global industrial production**



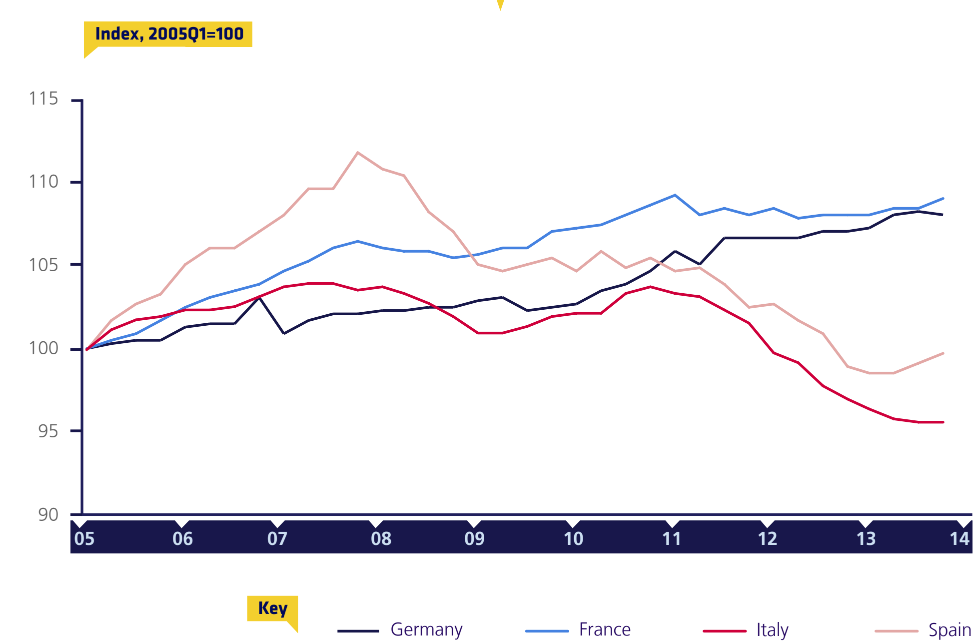
GRAPHIC 2 **Brent crude oil**



GRAPHIC 3 **US labour market**



GRAPHIC 4 **Household consumption**



Sources: Bloomberg, Saxo Bank

Table 1

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

-0.7
-0.4
1.0

Austerity measures fade, boosting both private and public spending.

Structural reforms still lacking. Geopolitical tensions with Russia may hamper growth.

7.7
7.7
7.3

More stimulus probable as the leadership responds to the downshift in economic activity.

Concerns about credit growth will see authorities refrain from stimulus.

1.5
1.5
1.4

More fiscal stimulus may be introduced as the government remains wary of an economic slowdown.

Higher consumption tax will curtail domestic consumption.

0.3
1.8
2.6

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

Housing sector slows down materially.

2.8
1.9
2.8

Consumer in a strong position to drive growth.

A sharper-than-expected slowdown in the housing sector and more fiscal cutbacks.

2.1
2.0
2.8

Less fiscal austerity and a stronger consumer to drive growth in advanced economies. Stimulus in emerging markets.

Rate hikes in emerging markets and geo-political tensions.

2.8
1.6
1.3

Stronger foreign trade and little to no downward pressure from commodity prices.

Lower Brent crude oil prices will weigh heavily on the Russian economy.

Key

GDP growth 2012 | GDP growth 2013 | GDP growth 2014 | Upsides | Downsides

*Note: GDP is real, inflation-adjusted, year-on-year changes in percent. 2012 is realised, while 2013 and 2014 are forecasts.

Dollar looks to spring

The USD appears ready to leave behind its winter doldrums, while the EUR could be in for a tougher quarter. But Russia's intervention in Ukraine could scupper markets if the crisis escalates.

by JOHN J. HARDY, Head of FX Strategy

The end of the first quarter saw a more hawkish Federal Open Market Committee meeting than expected, signalling that the US Federal Reserve will consistently unwind policy accommodation if the economy continues to improve. The Fed may even have to move its guidance further forward than it did at the March meeting if signs broaden that high unemployment is more structural than cyclical. Evidence is already accumulating that this is the case. Then again, Fed guidance will only be worth anything if the economy springs back to life after the recovery was clearly affected, if to an unknown degree, by the worst winter weather in a generation.

Watch John talk about his Q2 forecast

USD winter ends, EUR tops out

Overall, I expect the greenback to jump back on the rally track in Q2 as we look for tapering to stay on track for at least the next two meetings. The caveat is that US economic data improves strongly for the April and May data cycles. But even if the US recovery falters, it may not prove particularly bad for the dollar as a weak economy would likely be something that occurs in the context of even worse economic performance elsewhere (think China and Europe, in particular) and the Fed will be slower to turn its policy guidance around than other central banks.

"Even if the US recovery falters, it may not prove particularly bad for the dollar as a weak economy would likely be something that occurs in the context of even worse economic performance elsewhere."

This quarter could see the end of the euro's rally from its mid-2012 base as 1.4000 proves a bridge too far in EURUSD and the European Central Bank finally moves firmly towards accommodation as the European recovery falters and disinflation risks slowly edge towards deflation. The EUR forecasts below don't even consider the potential rise in the now almost non-existent EU stability tail risk.

A weaker economy in Q2 and beyond, if realised, could sorely test that complacency, as could the political disruption from the EU Parliamentary elections in May because EU-sceptic parties are storming higher in the polls. Broadly speaking, the euro may be a middle-of-the pack currency as long as the EU tail risk is kept at bay as bouts of poor risk appetite tend to support the most liquid currencies, such as the G3, against emerging markets and the G10 smalls.

JPY's speed bump, GBP's slack

The yen has been generally firmer as the market was unimpressed with the lack of Bank of Japan (BoJ) policy dynamism. And risk appetite – particularly in Japanese stocks – weakened significantly during Q1. In Q2, market disenchantment with Abenomics (really Kurodanomics) will filter through to the economy.

So far, import prices have risen, while the hoped for export gains are hard to spot and consumer confidence in Japan is collapsing, although business confidence is hanging in there. The weakness in some of the data could deepen as some demand may have been brought forward by the sales tax rise from April 1. The ongoing risk of further global consolidation in risk appetite could also see a very resilient JPY, with impressive spikes at times that diverge far from the forecasts as heavy JPY short positions are unwound.

Still, the long-term structural fundamentals – including a further erosion of the current account, ageing demographics and the disastrous fiscal picture, as well as the risk of capital flight if investors and companies look abroad for investments and acquisitions – will eventually drive the yen weaker.

So the quarter may provide opportunities to trade for a strong JPY and invest for a weaker one.

A stronger JPY is also precisely what could provoke the next policy move as failure or a stronger yen is not an option. And the next policy move could be a coordinated one, one with more involvement from the fiscal side – most dramatically if Prime Minister Shinzo Abe opts for overt monetary financing, effectively printing money to spend rather than the BoJ printing money to buy assets. Is that the endgame for all QE countries?

Meanwhile, the big argument at the Bank of England (BoE) is the degree of “slack” in the economy and how it can signal its intentions towards hiking rates.

BoE governor Mark Carney is on the slightly more dovish end of the spectrum of the output gap debate. It will be up to the incoming data to drive sterling from a rate expectation perspective and the currency may edge higher against the euro, but considerably lower against the dollar.

Even if the economy remains resilient and the market pulls the BoE interest rate path trajectory forward and higher, the market has been ignoring the ugly structural current account shortfall for too long and sterling won't shine amid uncertainty in global asset markets.

CHF muscle, NZD gravity pull

Feeble CHF sell-off attempts in recent quarters gave way in Q1 to a bout of weak risk appetite and a pause in the JPY carry trade to hit its strongest since late 2012. Odds are we will see little on the policy front and EURCHF could remain suppressed by geopolitical risks and possibly sideways asset markets over the coming months.

However, the price risks for EURCHF are dramatically asymmetrical from here, with potential upside from the Swiss National Bank rattling its cage if already weakening Swiss data declines further. Finally, if the ECB is seen moving towards QE, this could further erode the CHF safe-haven trade.

Q1 saw the AUD downtrend transitioning into a sideways consolidation, even as China's slowdown saw big price drops in some of the important hard commodities Australia exports to the mainland, such as iron ore. Positioning and a less dovish Reserve Bank of Australia stance were supportive after a number of positive data surprises, but unemployment set a new 10-year high in Q1.

"Whether the Ukraine crisis remains confined to financial sanctions or shifts more worryingly to actual trade sanctions, the main currency at risk would be the rouble."

Look for a reassertion of the AUD downtrend as Australia is inevitably pro-cyclical and exposed to China's long-term restructuring process.

Meanwhile, the NZD rally found even more rocket fuel to burn as the Reserve Bank of New Zealand (RBNZ) shrugged off the currency's marked strength by becoming the first G10 central bank to hike rates since 2011. The bank actually upped its guidance on growth as well and the market couldn't get enough kiwis on board. I look for mean reversion of kiwi strength over the balance of this year – a single country can't remain an outlier forever and the forward rate expectations for the RBNZ mean the kiwi is priced for perfection, especially if we witness bouts of widespread risk appetite.

Of the three commodity dollars, I'm looking for the CAD to be the more resilient (less weak) this year, even as the Bank of Canada's (BoC) guidance is neutral to dovish. That's because of its exposure to the US economy and it is now far more fairly priced relative to its commodity dollar peers.

The Scandies rode a dovish outlook wave for the Riksbank and Norges Bank to rise in Q1. Since then, the outlook for Norges Bank suggests more hawkishness, while Riksbank has been more stable, suggesting NOKSEK likely put in a major cycle low in Q1.

From here, expect relative firmness in NOK to SEK because the latter is very pro-cyclically correlated with Europe, where grave challenges await that make SEK a high beta bet on European relative economic performance and perhaps even risk appetite.

Ukraine factor

Any further escalation of the conflict in Ukraine between Russia and the EU/US will almost certainly be financial rather than military. Let's hope so.

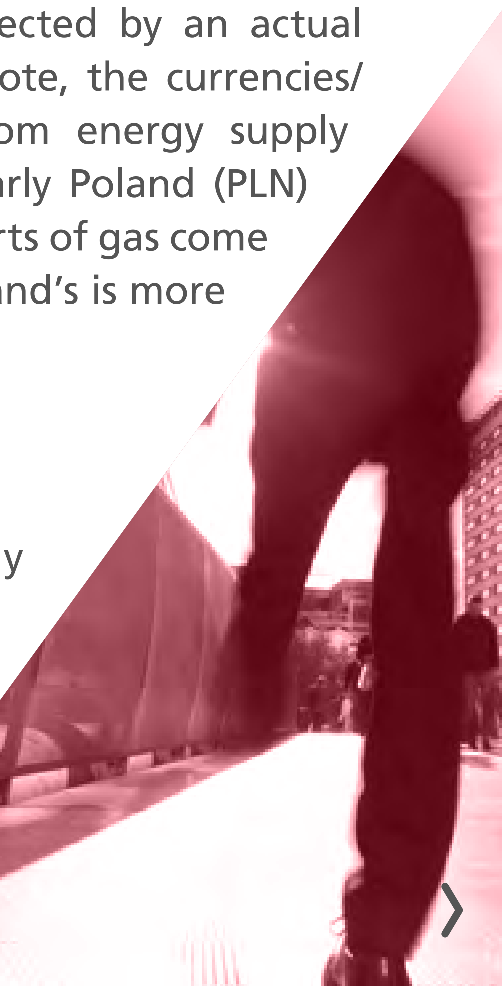
Whether the Ukraine crisis remains confined to financial sanctions or, more worryingly, shifts to actual trade sanctions, the main currency at risk would be the rouble, although significant further weakening would require an escalation of the conflict.

Of the G10 currencies, GBP could be threatened from a financial/capital flow angle due to UK banks' exposure to Russian loans and capital account flows.

Meanwhile, EUR is only likely to be affected by an actual disruption of energy supplies. On that note, the currencies/economies most significantly at risk from energy supply disruptions are that of the CEE, particularly Poland (PLN) and the Czech Republic (CZK). Czech imports of gas come in at 80 percent of total demand and Poland's is more than 50 percent.

Trading themes in Q2

The overwhelming theme is generally one of mean reversion. Q2 will see many of the very well-established and long-in-the-tooth trends disrupted and reversed.



Long JPY through options

Implied volatilities are low and the world refuses to hear or see evil. Shorting the JPY has been one of the global consensus trades that are not working out, meaning big correction potential in the near term even as the longer-term direction is down. EURJPY 3 Month Puts are one way to trade for JPY upside.

Short EURUSD and long USDSEK

It's time for the USD to make a stand against the major European currencies. The SEK has been too strong as a high beta play on the European economic recovery and tends to be positively correlated with risk appetite, which could face challenges in Q2.

Long EURCHF through options

The implied volatilities are quite cheap relative to the potential for the pair to finally get moving over the next quarter or two. Six-month, out-of-the-money calls may be the way to go and could be partially financed with at-the-money Puts.

Short AUDCAD

The Aussie is overachieving relative to the Canadian dollar, especially with the ongoing risks that are underappreciated going into Q2, which stem from slackening Chinese import demand. TF

Benchmark forecasts

Currency pair	3 months	6 months	12 months
EURUSD	1.32	1.25	1.18
USDJPY	102	106	110
EURJPY	135	133	130
GBPUSD	1.60	1.55	1.50
EURGBP	0.82	0.81	0.79
EURCHF	1.23	1.25	1.25
USDCHF	0.93	1.00	1.06
AUDUSD	0.86	0.80	0.75
USDCAD	1.15	1.20	1.22
NZDUSD	0.80	0.73	0.67
EURSEK	9.10	9.35	9.10
EURNOK	8.50	8.50	8.20

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GRAPHIC 1

NZDCAD

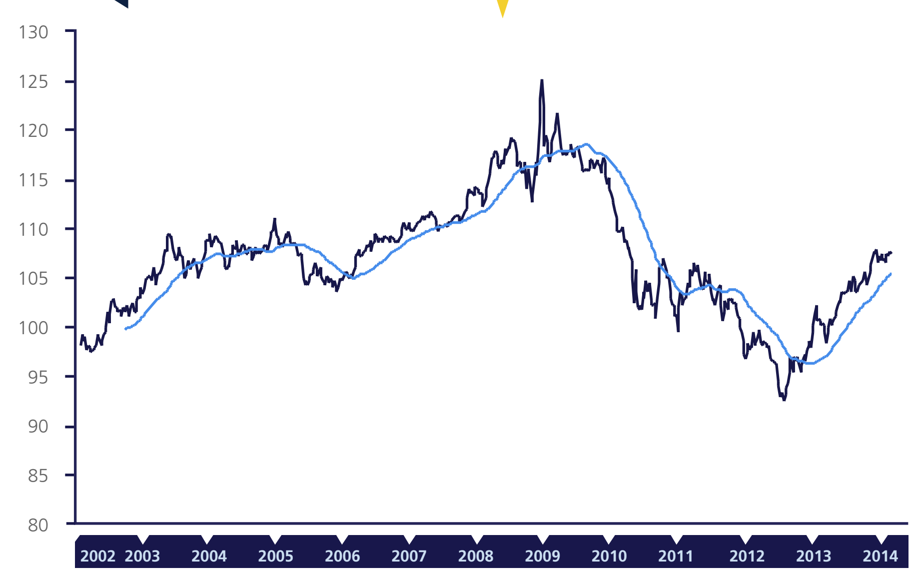
NZDCAD

NZDCAD is one of the all-time mean-reversion candidates as the BoC's neutral to dovish rate guidance amid weak Canadian numbers contrasts with the RBNZ's upgraded forecasts amid strong domestic economic data.

The remarkable divergence will strongly mean revert, likely starting in Q2.

GRAPHIC 2

EUR vs the rest of the G10



Key

EUR vs G10

200-day moving average

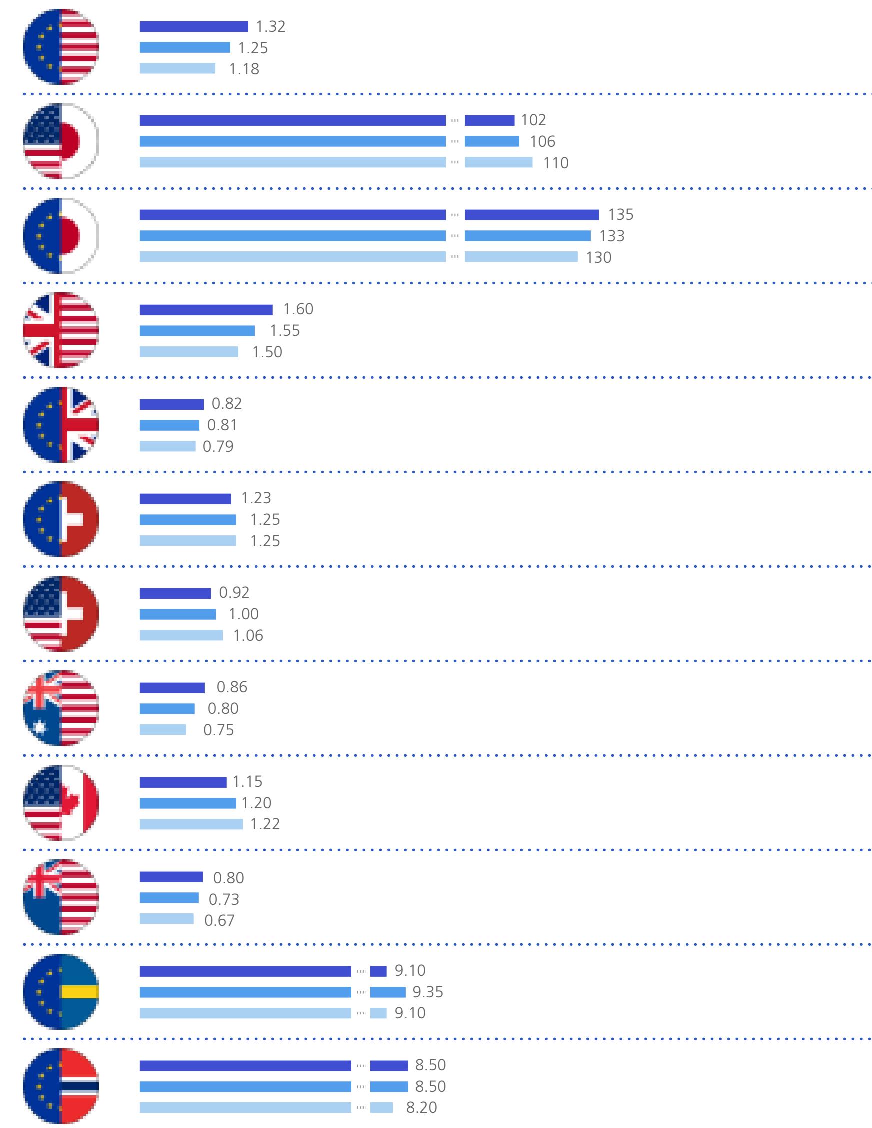
EUR vs the rest of the G10
(indexed and evenly weighted)

The euro has now officially come full circle, or mean reverted, from the period of extreme strength during the global financial boom and then extreme weakness during the worst of the EU crisis. From here, look for a weaker euro.

Sources: Bloomberg, Saxo Bank

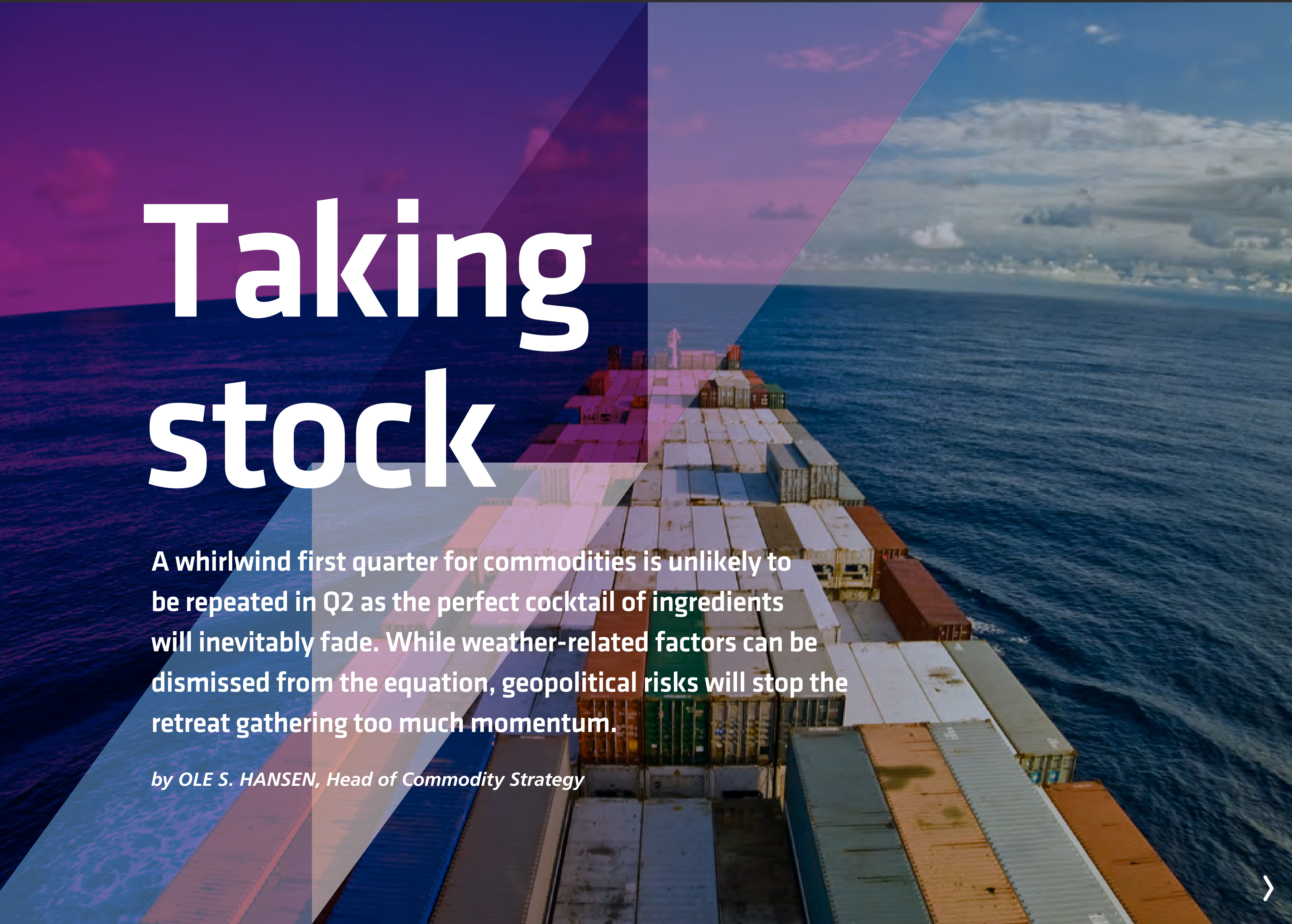
GRAPHIC 3

Table of benchmark forecasts



Key

3 months | 6 months | 12 months



Taking stock

A whirlwind first quarter for commodities is unlikely to be repeated in Q2 as the perfect cocktail of ingredients will inevitably fade. While weather-related factors can be dismissed from the equation, geopolitical risks will stop the retreat gathering too much momentum.

by OLE S. HANSEN, Head of Commodity Strategy

Commodities have delivered a surprisingly strong beginning to 2014 following three consecutive years of underperformance relative to equities. But this strong performance has not been consistent across the different sectors.

While energy and industrial metals were held back on continued concerns over the demand outlook in China, traders went on a buying spree in precious metals and, in particular, the agriculture sector.

> *"Gold has been one of the big surprises so far this year as it first found support from strong physical demand out of Asia and then from geopolitical factors as the crisis in Ukraine unfolded."*

Gold has been one of the big surprises so far this year after first finding support from strong physical demand out of Asia and then from geopolitical factors as the crisis in Ukraine unfolded. The agriculture sector, however, has led the field as adverse weather in both North and South America once again raised worries about the outlook for supply of commodities, from coffee and sugar to corn and wheat.

Elevated risk appetite poses near-term threat

It is doubtful whether the second quarter will produce similar strong returns as growth and demand-dependent commodities, such as energy and industrial metals, are expected to lag once again. Precious metals may struggle to build on the gains from the first quarter as some of the key drivers begin to fade. Hedge funds are holding the biggest combined net-long position across 24 US-traded commodities on record, not least due to a very strong rise in bullish bets within the agriculture and energy sectors. Out of 24 commodities, a negative view is only held on copper and any upset or changing outlook could have a major negative impact on some of these individual commodities. Most at risk could be WTI crude, natural gas, gold, corn, coffee and cattle.

Energy: slowing demand offset by geopolitical risks

The boost to the energy sector until early March is unlikely to be repeated as we move into Q2. The US witnessed a very cold winter during January, which raised demand for products and helped to keep refinery demand unseasonably high. At the same time, the improved pipeline infrastructure from the US Midwest to the Mexican Gulf reduced the bottleneck at Cushing, Oklahoma, and this helped to narrow the discount between WTI and Brent crude, the two global benchmarks. As the discount began to contract, speculative investor interest in WTI crude rose to a record high. This elevated interest may now, barring any renewed geopolitical tension, pose a downside risk as we enter a period of lower seasonal demand.

Supply outages from key Opec producers, such as Iran, Libya and Nigeria, are running at historical highs. Combining this with additional non-Opec disruptions in South Sudan and the North Sea has led to a much tighter global balance than might have been expected. If it had not been for the continued rise in non-Opec production, especially in the US and Canada, increased volatility and higher prices could have become the norm.

A pick-up in Opec production either from a return of Libyan oil or reduced sanctions against Iran is not expected to have a major impact as the increased production would go towards rebuilding OECD inventories, while any signs of price weakness will be met by reduced Saudi Arabian production. A reduction from Saudi Arabia below 9 million barrels per day would raise the amount of available spare capacity from the world's most flexible producer and ensure continued price stability.

Over the coming quarter, oil traders will be keeping an eye on several issues. China, the world's biggest importer of oil, saw a dramatic reduction in February imports from a record in January. If this trend continues, demand growth may have to be revised lower. The hope of reaching a comprehensive agreement between Iran and the West over its nuclear intentions may have suffered a setback considering the breakdown in relations between Russia and the US over Ukraine. Iran has been exporting more than allowed under western sanctions for the past four months and this increases the risk of a crackdown if Washington feels economic pressure is being relaxed too quickly.

Russia's involvement in helping to bring the Syrian conflict to a close may also have suffered a setback and potentially destabilising the situation in Iraq further, not least considering the upcoming elections this month. Libya's oil production remains disrupted and it looks like turning into a chronic situation as a weak government fails to deal with rebels who have been disrupting supplies since last August.

Plenty of ongoing geopolitical risks will continue to keep oil markets supported and speculative investors from relinquishing their overall bullish exposure to the market. On balance, however, we continue to expect the average price of Brent

Energy	
Upside risks	**Downside risks**
Breakdown in relations between Russia and the West	Increased global supply from rising non-Opec production
Geopolitics keeps Libyan and Iranian oil flows reduced	Excessive net-long investor positioning
Rising demand growth from DM as economic growth accelerates	Reduced demand from US refineries during maintenance season
High demand from OECD countries as inventories are rebuilt	Slower-than-expected demand growth from emerging economies such as China

crude to move lower towards 105 USD/barrel, but see limited downside risks below 100 USD/barrel and view double-digit prices as a strategic buying opportunity. The spread between Brent and WTI crude will continue to exhibit periods of raised volatility. In the near term, the spread may widen as less oil is pushed towards the Gulf of Mexico as refinery demand slows during maintenance.

But as Cushing empties, the spread should continue to narrow unless the result is the creation of a new bottleneck on the Gulf coast as fresh supplies struggle to find a home.

Precious metals: as good as it gets – for now

Gold defied most analysts' expectations at the beginning of the year, when it kicked off a strong rally. This was initially supported by strong physical demand from China, followed by winter-driven weakness in the US economy and finally

Watch Ole talk about his Q2 forecast

safe-haven demand as the crisis in Ukraine escalated. We were cautiously optimistic at the beginning of 2014 on the assumption that most of those who wanted to exit gold had already done so at the end of 2013, but still expected some headwind being created by the announced tapering in the US. As it turned out, the focus shifted elsewhere and gold took off.

Looking ahead, the risk to gold is now increasingly skewed to the downside as some of those key positive drivers, including the weaker dollar, will eventually fade. That will leave little room to the upside as the US economy continues to improve and expectations for the normalisation of interest rates move closer. Near term, the unsettling developments in Ukraine and the uncertainty about what happens next will continue to add a risk premium and keep a hand under gold, but as the situation eventually normalises, lower prices look more likely.

Investment flows have been positive, but mostly from tactical traders in the futures market. Meanwhile, holdings in exchange-traded products have stabilised, but remain almost unchanged this year despite the strong price rally in the first quarter. Physical buying interest remains very price sensitive, with the strong demand witnessed below 1,300 USD/oz during January fading once it broke higher.

"Buying precious metals at this stage requires a great a deal of stamina, patience and deep pockets."

Hedge funds increased their net-long futures position to the highest since December 2012 and, while this looks supportive on paper, the numbers point towards an increase that will be primarily driven by short covering rather than new buying.

We maintain our view that 2014 will be a year of consolidation following a dramatic sell-off last year. On that basis, we see limited upside above 1,450 USD/oz, while support at about 1,200 USD/oz should prevent gold flirting with a new multi-year low.

Agriculture: extreme bullish sentiment poses a risk

The agriculture sector is always notoriously difficult to forecast as so much depends on climate developments across the globe. As we enter Q2, the focus will switch back to the US from South America as farmers prepare to get back into their fields.

The annual battle of acreage will be followed closely as it helps to set the direction for new crops. There is also a raised risk that the weather phenomenon El Niño will return later in the year and it carries the risk of roiling agriculture markets as farmers have to deal either with drought or too much rain.

Global inventories of key crops, such as soybeans, corn and wheat, remain elevated. But general brisk export demand and a troubled South American soybean harvest – together with worries about Black Sea supplies of wheat and corn later this year – created a positive environment in Q1.

Another strong summer of production across the northern hemisphere, especially for soybeans, is currently priced in with the new crop trading at a 17 percent discount to last year's crop.

This leaves the risk skewed to the upside should weather developments not turn out as expected.

Commodities	
Upside risks	**Downside risks**
Geopolitical events/worries	China's growth not picking up speed
Adverse weather after "perfect" 2013	A stronger dollar and higher interest rates
Rising manufacturing activity filters into higher demand for raw materials	EM countries adjusting to lower growth and lower demand
Strikes/labour disputes in key production areas	Accelerating production catching up with demand

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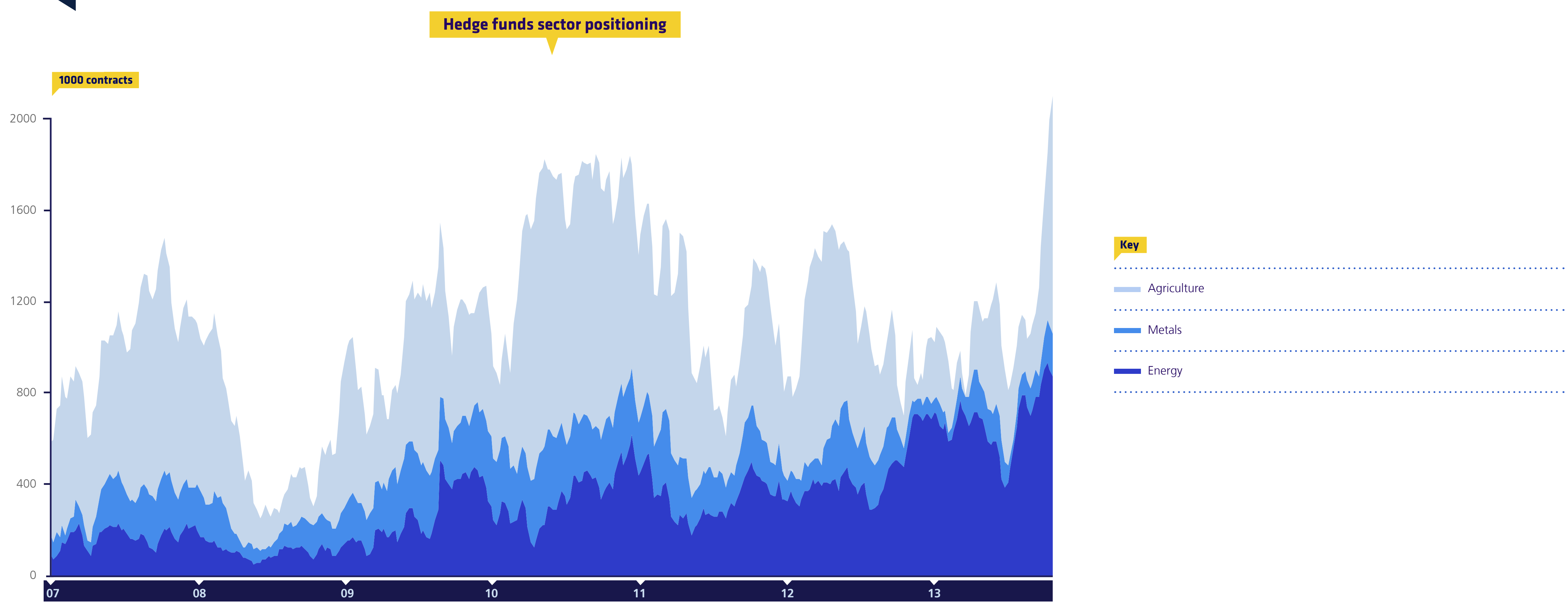
GRAPHIC 1



Sources: Bloomberg, Saxo Bank

Paradise for stock pickers

While the equities party is far from over, investors will increasingly have to make specific country, sector and stock bets to outperform.

by PETER GARNRY, Head of Equity Strategy

Global equities were flat in the first quarter following a 5.5 percent drawdown at the end of January on the back of multiple risk drivers from capital outflows in emerging markets, soft macro data and declining interest rates.

US equities have again been some of the best relative performers in developed markets, but are running out of rocket fuel from expanding valuation multiples – unless, of course, equity markets enter a full-blown bubble state.

With US equities being fairly valued, returns going forward will be more closely aligned with underlying growth in revenue and profit and, as a result, the returns from 2013 will not be coming back.

As US equities have about 50 percent weight in the MSCI All Country World Index, the lower expected returns from US equities will be a drag on global performance. The party is not over, but investors will increasingly have to make specific country, sector and stock bets to outperform. Over the past year, we have been positive on European equities, especially the cyclical sectors.

This view is coming to an end despite being relatively cheaper than US equities and expectations that the euro area will improve. In our view, most core European equity markets are now fairly valued and, as such, a broad bet on Europe is no longer sufficient to outperform. European banks are offering specific risks that are preferred in our hunt for alpha stocks.

Despite the European Central Bank's asset quality review looming on the horizon, European banks are up 12 percent this year, making them the best-performing industry. We expect European banks to continue to perform well, with at least 25 percent upside from current levels. As the deleveraging matures and the euro area economy improves, banks will obtain cheaper financing and see more flexible loan conditions on top of increasing capital market activity. These trends, in addition to balance sheet clean-ups, will slowly push valuations back to 2010 levels.

"Investors selling emerging market equities across the board will be making a big mistake."

Watch Peter talk about his Q2 forecast

Russian equities are incredibly cheap

The political trajectory in Ukraine and Russia's subsequent intervention in Crimea led to a pure panic sell-out, with Russian equities down 18 percent. While our timing was not perfect, we made a bullish call on Russian equities on the morning of March 4 based on the assumption that the conflict would escalate into a military or trade war. The trade dependencies are too high between the European Union and Russia, so a pragmatic solution is likely to be the endgame.

Buying what nobody else wants is, most of the time, a good strategy. Think of early 2009, when the world was shell-shocked, or late 2011 during the euro meltdown. The investors who dared to buy Egyptian equities in late 2011 during the parliamentary elections following the bloody revolution would have doubled their investment – measured in USD – in a little more than two years.

Russian equities are by far the cheapest market in the world measured on almost any valuation metric (see table). For instance, investors are only paying three times the 12-month expected cash flow from operations. These valuations would make sense if expectations were off by a universe or default risk was rising fast, but none of these are the case.

On the contrary, the country's economic indicators are relatively good compared with, say, the euro area.

"We expect European banks to continue to perform well, with at least 25 percent upside from current levels."

If Russian equities are to stage a comeback, there is a good chance that the RUB will strengthen. Moreover, foreign capital should come back, which will add further to the return measured in either EUR or USD.

The party is over in Greece

Greek equities are up 180 percent since the election in May 2012 and most forward-looking indicators are signalling that the economy is finally approaching the light at the end of the tunnel. However, the party in equities is over, with the current valuation reflecting expectations that far exceed what is realistic.

The expected return on equity from most publicly traded Greek companies is still very low and far from covering the cost of equity, which is sizable and reflects the substantial investment risk that still exists in Greece. Hence, it does not make any sense that Greek equities are valued above South Korean and Israeli equities (see chart). Greek equities are among the most expensive equity markets, together with those of the Philippines and Indonesia.

Going into the second quarter, we are negative on Greek equities. Our view is that the ASE Index should trade at about the 1,000 level, which is 25 percent lower than current levels.

Emerging market equities are not equal

Investors selling emerging-market equities across the board will be making a big mistake. This market segment is far from homogeneous and investors are selling underperforming assets with high-dividend yields and low valuations in exchange for pricier assets in the developed world.

Divergence between weaker and stronger emerging market (EM) countries has widened considerably over the past year to such an extent that the stronger countries, such as the Philippines, Indonesia and Mexico, are now so overvalued that we cannot justify it any longer despite their macro outlook. Instead, EM countries such as Russia, South Korea, China (H-Shares) and the Czech Republic are increasingly looking undervalued and present a basket we would buy despite the ongoing issues in Crimea and the EM slowdown.

The biggest misconception floating around is that the world needs a new commodity boom for emerging markets to perform. While it would certainly benefit some emerging market countries, such as Brazil, Chile and Russia, most emerging market countries are slowly drifting into being more consumption-driven due to the growing middle class.

Investors who want to be selective in emerging market equities should buy companies with exposure to domestic consumer markets.

Our 2014 calls so far

Below are our top picks for 2014 that we presented in our *Q1 Insights Quarterly Outlook*. We have looked at their performance and so far, four out of six have performed better than their benchmark index. Most notable is Roche, up 7.5 percent as healthcare stocks have continued to outperform the market.

Our worst-performing pick so far is General Electric, down 9 percent. This is despite the company having announced the initial public offering (IPO) of its North American retail finance division, which we thought would be the positive catalyst on top of an expanding global economy. As the year progresses, we expect the market to reward GE for its decision to IPO the retail finance division as it will free up capital and shrink the balance sheet. TF

Top picks in 2014

Table 1

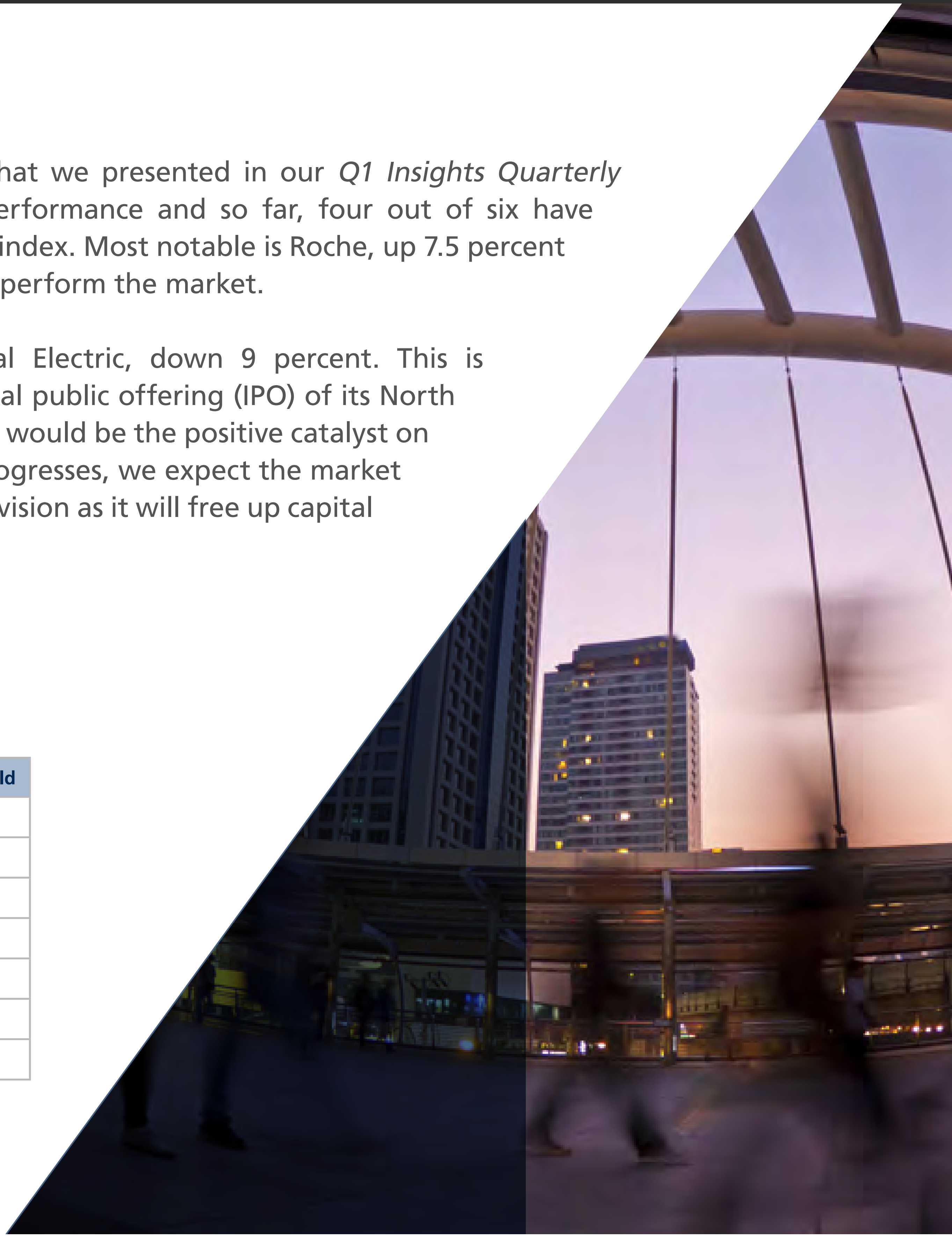
Name	P/E	YTD (%)
General Electric	14.7	-9.0
Qualcomm	14.3	3.9
Microsoft	13.7	5.8
Airbus	15.5	-8.0
Roche	16.8	7.5
BNP Paribas	10.6	-0.5

* P/E is based on 12-month forward EPS, YTD is in local currency

Russian equities are cheap

Table 2

Metric	MICEX	MSCI World
P/E	4.8	15.2
P/CF	3.0	9.9
Div. Yld.	5.3	2.6
P/B	-	2.0
P/S	0.6	1.3
EV/EBITDA	3.1	9.4
Volatility	16.8	7.5



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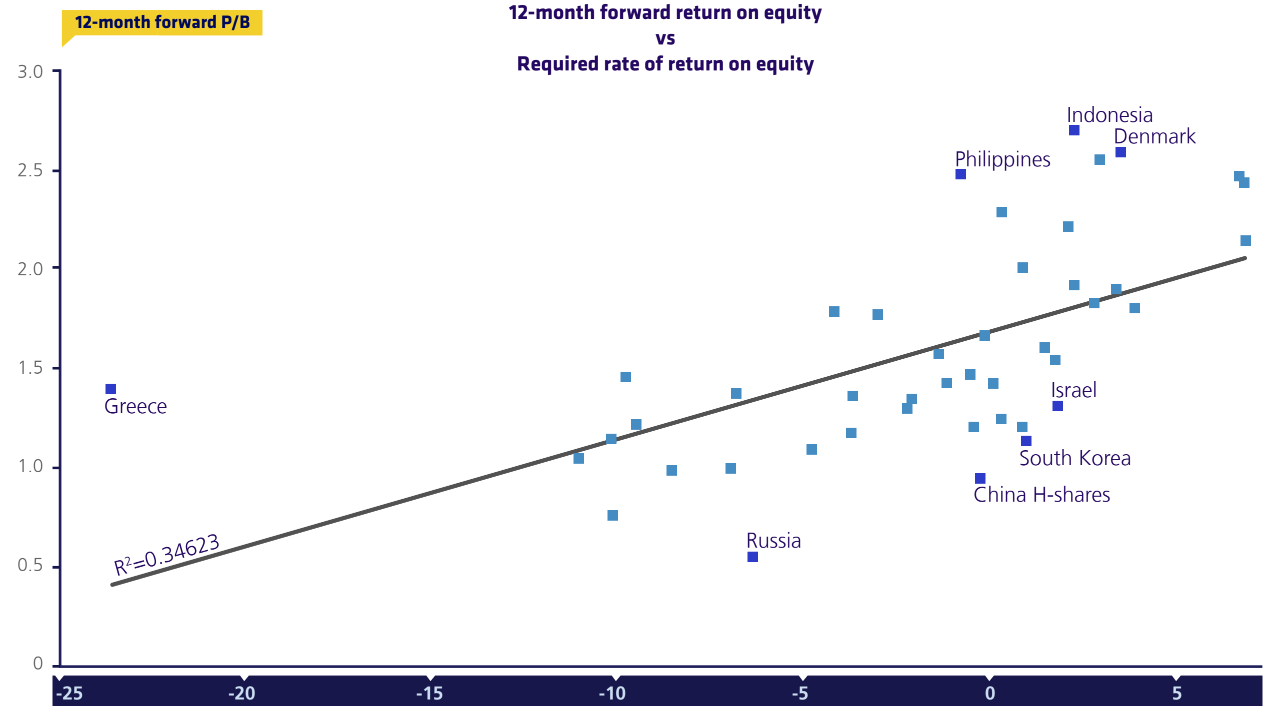
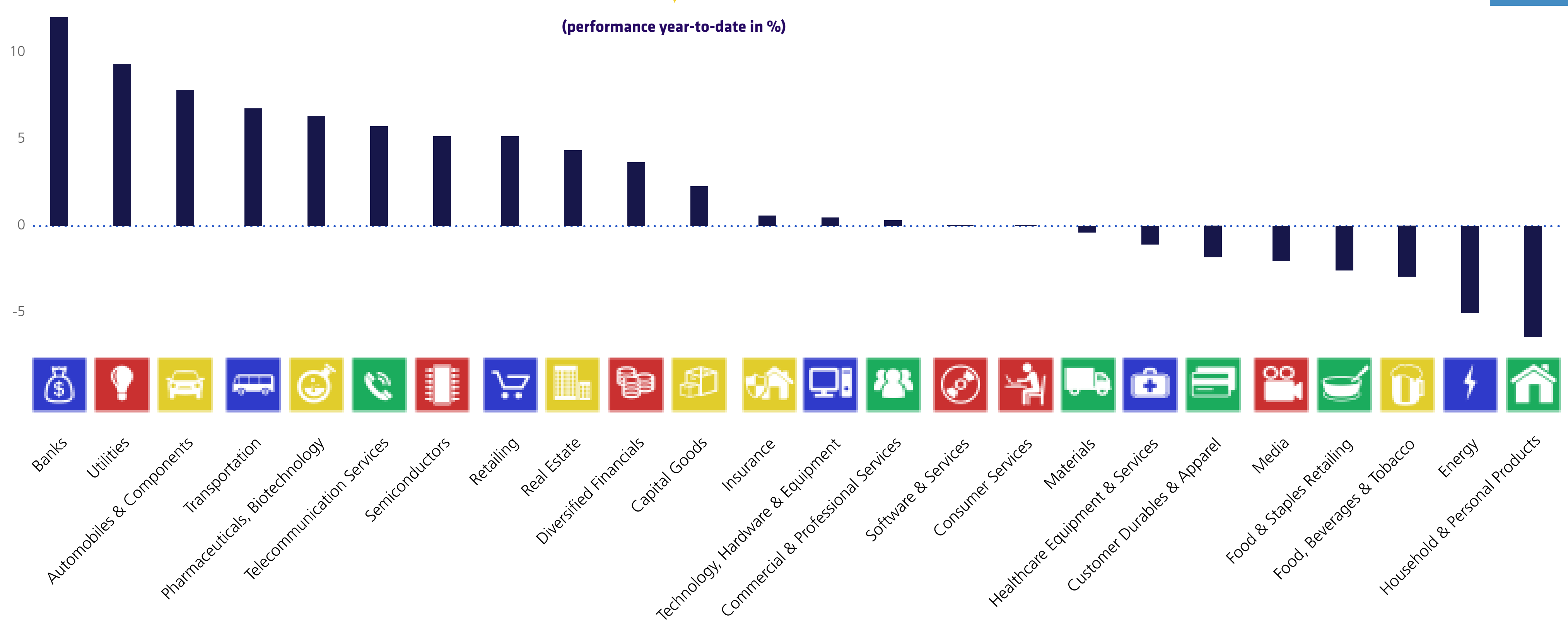
GRAPHIC 1

Developed and emerging market equity indices



European industry groups

GRAPHIC 2



Sources: Bloomberg, Saxo Bank

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