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SAXO BANK PRESENTS

OUTRAGEOUS PREDICTIONS

For **2017**

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STRANGER THAN FICTION

Steen Jakobsen / CIO

The biggest challenge for the crop of Outrageous Predictions this year is to follow up from the 'surprises' of Brexit and the election of Donald Trump as US President. It seems sometimes 'life' or 'reality' beats even the most outrageous calls.

This selection of calls continues our tradition of provoking conversation on what might surprise or shock the investment return in the year ahead.

Let me, as always, stress this is not Saxo Bank Research/Strats 'official' outlook for 2017, it is the events and market moves we deem outliers with huge potential for upsetting the always-in-place complacent consensus.

It is simply our attempt to get you to think out of the box. The fact a few of our calls tend to be right is either random, a matter of not being outrageous enough or simply luck. We do not see ourselves as the market Oracle of Delphi, rather we believe in the old saying: To be forewarned is better than...

Disclaimer aside, how does the following selection resonate with an overall theme?

The common thread if any would be 'desperate time, call for desperate actions'. As 2016 turns into 2017, central banks may be about to give up on QE and negative interest rates, but they are far from being done on intervention and distorting the allocation of capital and the price of money.

Helicopter money through the back or even the front door seems more and more likely, as the Bank of Japan focuses on steeper yield curves and fixing 10-year Japanese government bonds, which by itself frees the Japanese government from any accountability of fiscal deficits. Effectively, it is step one towards firing the rotary blades of the helicopter.



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The election calendar has the good people of the Netherlands, France and Germany going to the polls, but projected social-contract breakdown-driven outcomes for those elections is of course almost mainstream these days. What if 2017 marks the year when Brexit gives way to Bretun as the UK and the EU reconcile their differences?



In my research, I have pointed out inflation could surprise due to the rise of Chinese PPI. China has been the main driver in the reduction in global inflation, but it has now moved into positive for the first time in six years, but maybe the real surprise is again Bank of Japan not only reaching its 2% inflation target but overshooting it in an exercise where ceasing to buy JGBs from banks makes the direct link to the economy more direct and catapults the inflation to 3% plus.

The big outside trade for 2017, this year's version of our very bullish call on emerging markets and Brazil from 2016, could be to go long Italian banks. Is there not a real risk that the weak position of German banks could force Germany to issue European wide carpet support for bank union and direct capital into banks in a world where the cost of capital has only been - going higher, effectively shutting out the ability to raise capital and buy time?

In France, Francois Fillon has emerged as the Conservative presidential election nominee and could reignite the German-French coordination of pro-Europe policies. With a Thatcherite mandate, he is more German than French in his economic policy, with a belief in smaller government, fiscal discipline and less intervention.

Is a European Government bond issuance, the real political bomb in 2017? Change happens in times of crisis and if the political fabric is Europe is not under attack after

Brexit and a major shift to populist parties in all elections, when will it be? Europe's willingness to change as a consequence of the populist backlash could be a very real prospect.

The real 'positive surprise' though would be for China to exceed growth expectations - we call for 8% growth in China based not on intervention but the gradual release of productivity. China did the manufacturing adjustment, now it turns towards technology. The vertical integration, technology, into the global economy after the horizontal, globalisation, has reached its limits.

China's starting point is roughly 20% productivity of the US - in other words if China continues to open capital accounts and create more competition domestically and in state-owned enterprises, it may actually provide the much needed growth push to the rest of the world, where a recession light in the US remains one of my main non-outrageous calls.

For now, though enjoy the full ten ideas which we hope will create some debate, and, as ever, we more than welcome your push back.

One final rule of thumb from my experience with doing Outrageous Predictions is that the one idea you 'hate' the most has a tendency to come through. Let's face it -- no one wanted to buy emerging-market Brazil last year.

Finally, I hope you will enjoy the Outrageous Predictions as much as we enjoy doing them - it is a special time of year and I would like to wish you and your family a great holiday season and a happy new year.



CHINA GDP SWELLS TO 8% - SHCOMP TO 5,000

Peter Garnry / Head of Equity strategy



China shocks the globe for an 8% rise in GDP and a jump in the Shanghai Composite Index to 5,000

With the consensus betting on China to slow down further, the broader point of China's massive government firepower and willingness to use it is overlooked.

China's current slowdown is predictable due to elevated investment levels of around 50% of GDP while total debt has swollen to an unsustainable 237% of GDP.

China understands that it has reached the end of the road of its manufacturing and infrastructure growth phase and now has to rely on a private sector driven economy that incentivises innovation and a more open economy.

Through massive stimulus from fiscal and monetary policies, and opening up capital markets even more, the country successfully steers a transition to consumption-intensive growth surpassing current expectations and reaching 8% growth in 2017.

Even more interestingly, the old positive correlation between Chinese growth and commodity markets is gone as the resurgence in growth comes from the service sector, which is already the largest sector in China at 48% of GDP.

Euphoria over private consumption driving growth higher sees China's stock market gripped by wide-scale speculation and the Shanghai Composite Index doubles from its 2016 lows, surpassing the 5,000 level briefly reached in 2015.



DESPERATE FED FOLLOWS BOJ LEAD TO FIX 10-YEAR TREASURIES AT 1.5%

Simon Fasdal / Head of Fixed Income trading



Desperate Federal Reserve forced to fix runaway US 10-year Treasuries yields to 1.5% in twist on Bank of Japan policy

As dollar and US interest rates rise in increasingly painful fashion in 2017 in anticipation of Trump-initiated tax cuts and fiscal stimulus, the Federal Reserve feels forced to step in and provide a backstop to avoid a trainwreck in global asset prices and the global economy. The Fed eventually fixes the 10-year yield at 1.50% and the USD tanks, if only after reaching new lofty heights.

When former Fed chief Ben Bernanke mentioned the small word “taper” in May 2013, he sparked a financial thunderstorm that not only took 10-year US Treasury yields to 3%, but created a global selloff, especially in emerging markets (EMBI down 12%), but also global equity markets (MSCI world down 8%) as well as EM currencies. Early 2017, it is clear that the combination of a Trump testosterone driven fiscal policy and upward surprises in global inflation (oil drops have played its role in inflation equation) brings 10-year US yields on course to hit 3%, causing panic that this could have a devastating effect on the global asset bubble. While it can handle a lot, yields too high, too fast could prove a bridge too far.

Furthermore to add to the problems, technologically-synchronised financial markets coupled with portfolio risk models, react to the same problem, in the same manner, at the same time, threatening a trigger of a global selloff, as it becomes clearer that larger parts of financial assets have become co-dependent on continued central bank nursing. At the same time, the problem for the Fed is that it is only yields and some inflation that are rising. Domestic growth has become weaker and a global wash out in financial markets could introduce a stagflation scenario which is unwanted by the Fed.

On the verge of disaster, the Fed copy pastes the Bank of Japan’s yield curve control strategy, but from a different angle, by fixing the 10-year Government yield at 1.5 %. Effectively, it’s the introduction of QE4, later known as QE Endless.

The result is seen promptly as the selloff in global equity and bond markets stops, emerging markets assets do an about turn, and global bond markets enjoy their largest weekly gains in seven years. Critics indicate the risk for an even larger bubble when the impact of an extremely loose fiscal policy combined with Fed chair Janet Yellen’s momentary speed blindness emerge, but the voices are lost in the roar of yet another central-bank infused QE rally.



HIGH-YIELD DEFAULT RATE EXCEEDS 25%

Steen Jakobsen / CIO



High-yielding bond default rate spirals to 25% from less than an average 4% as QE and ZIRP strategy failures come home to roost

The long-term average default rates for high-yielding bonds is 3.77%, jumping respectively during the US recessions of 1990, 2000 and 2009 to 16%, 10% and 12%. In 2017, however, we see default rates as high as 25%.

The chief driver of a higher default rate is the detonation of the long duration bomb that was manufactured by central banks' relentless zero interest rate policy and quantitative easing strategies since the global financial crisis.

Next year heralds a dramatic reversal in yields after 2016's final sprint lower in bond yields as we switch from monetary policy acting alone to a focus on fiscal stimulus. Donald Trump and Theresa May will bring fiscal stimulus, real inflation and higher yields and the European Union will need to do similar to avoid populist uprisings across the continent as we face a bonanza of EU elections next year.

A pullback from the reach for yield will see interest rates rise further globally, excluding Japan. This means yield curves steepen dramatically and the shaky trillions of corporate debt are in a world of hurt.

Not only do the lowest grade debt issuers run into trouble when their current bonds mature and they face refinancing, but the gravest threat is from investors fleeing for the exits as they rotate out of bond funds, further aggravating the spread widening and impossibility of refinancing for low grade debt.

The default rate spikes to an unprecedented 25%. But it won't be all bad, as a high corporate default rate is actually a healthy development for the economy, a much needed creative destruction as Joseph Schumpeter would have put it: – putting out of business the inefficient, unproductive actors in the economy who have had a free ride for too long and allowing a reallocation of capital to those who deserve it.



BREXIT NEVER HAPPENS AS THE UK BREMAINS

John J Hardy / Head of Forex strategy



The EU seeks rapprochement with the UK cutting deals on immigration and financial services to engineer a 'Bremain' and send EURGBP to 0.7300

The global populist uprising evident in the Brexit referendum, Donald Trump victory and Italian referendum disciplines the EU leadership into a new, more cooperative stance, both internally and towards the UK.

As the negotiations drag on, the EU realises that it is stronger with the UK under its umbrella than without, and indicates a willingness to make a key concession or two on immigration and the UK's financial services under its existing special status within the EU. By the time the Article 50 invocation vote is put before Parliament, it is turned down in favour of the new deal that goes far beyond former prime minister David Cameron's original treaty change requests.

The much anticipated Brexit thus yields to a Bremain as the UK is kept within the EU's orbit. The sigh of relief from huge foreign holders of capital in the UK worried about its future sees a massive lifting of sterling hedges and strong reweighting by financial services firms back into the pound.

The Bank of England hikes rates back to 0.50% to play a bit of catch-up with the US Federal Reserve and EURGBP plummets to 0.7300. We choose 0.7300 as the market tips its hat at the 1973 entry of the UK into the EEC.



DOCTOR COPPER CATCHES A COLD

Ole S Hansen / Head of Commodity strategy



Copper endures a nasty correction in 2017 to \$1.25/lb as a more sober assessment of Trump's ability to deliver on spending pledges emerges

Copper was one of the clear commodity winners following Donald Trump's surprise election as president of the US. The metal raced higher on the expectation that his pledge to spend billions of dollars on rebuilding America would trigger a demand bonanza – something copper had been missing increasingly following the Chinese investment boom immediately after the great financial crisis in 2009.

Into 2017, the market will begin to realise that the new president will struggle to deliver the promised investments and the expected increase in copper demand fails to materialise. Faced with growing discontent at home, he will turn up the volume on protectionism and the introduction of trade barriers will spell trouble for emerging markets as well as Europe.

Global growth will start weakening while China's demand for industrial metals will slow. That's because this time around, China's growth is not about wasteful infrastructure building, but about consumption growth. Lower copper prices also become self-perpetuating as copper inventories from copper's "financialisation" years in China flood the market.

Once HG Copper breaches a trend-line support, going back all the way to 2002 at \$2/lb, the floodgates open and a wave of speculative selling (especially out of China) helps send copper down to the 2009 financial-crisis low at \$1.25/lb.



HUGE GAINS FOR BITCOIN AS THE CRYPTOCURRENCIES RISE

Kay Van-Petersen / Global Macro Strategist



A Trump spending binge propels dollar sky high forcing emerging-markets to seek alternatives, creating ideal conditions for Bitcoin to test \$2,000

The Trump regime pulls out all the stops and jumps on a fiscal spending binge, further increasing the circa \$20 trillion of US national debt and in the process, potentially tripling the current US budget deficit from approximately \$600 billion to \$1.2-1.8trn, or some 6-10% of the US's current \$18.6trn economy.

This causes US growth and inflation to sky rocket, forcing the Federal Reserve to accelerate its hikes and the USD dollar to hit the moon.

This creates a domino effect in emerging markets and China in particular, leading people globally to look for alternative forms of currencies and payment systems not tied to central banks that have exhausted monetary policies or crony governments that are in full financial repression mode nor transaction systems that are long overdue for a revolution.

Cryptocurrencies are here to stay given the history of booms and busts in fiat money and debt excesses. Bitcoin as the face of cryptocurrencies benefits from this chaos.

Emerging market powers eager to move away from being tied to the monetary policy of the US and the banking system as well as to adopt the block chain as a payment system prove willing adherents as they adjust to zero interest rates and the decrease in systematic risk.

If the banking system as well as sovereigns such as Russia and China move to accept Bitcoin as a partial alternative to the USD and the traditional banking and payment system, then we could see Bitcoin easily triple over the next year going from the current \$700 level to +\$2,100 as the block-chains decentralised system, an inability to dilute the finite supply of bitcoins as well as low to no transaction costs gains more traction and acceptance globally.



US HEALTHCARE REFORM TRIGGERS SECTOR PANIC

Peter Garnry / Head of Equity strategy



The inflated bubble in the US healthcare system will be popped by sweeping reforms for a 50% fall in selected stocks

Markets live through bubbles and the US political system has inflated a new one in the US healthcare system.

Insulin drug prices are up 700% after inflation since 1996 and continue to rise. The same insulin drug is around seven times more expensive in the US compared to France.

This is of course the gross price as the large excess price is offset by private health insurance policies which are again tapping into government budgets through the many bills governing the US healthcare system.

Doctors earn about five times more than the average patient, which is around three times higher than in comparable western countries, partly explaining the high administration costs of running hospitals in the US.

Healthcare expenditure is around 17% of GDP compared to the world average of 10% and an increasing share of the US population cannot pay for its medical bills.

The initial relief rally in healthcare stocks just after Trump's victory will quickly fade in 2017 as investors realise that his administration will not go easy on the healthcare system but will instead launch sweeping reforms of the unproductive and expensive US healthcare system.

The Health Care Select Sector SPDR Fund ETF will plunge 50% to \$35, ending the most spectacular bull market in US equities since the financial crisis.



DESPITE TRUMP, MEXICAN PESO SOARS ESPECIALLY AGAINST CAD

John J Hardy / Head of Forex strategy



"Mexico's peso may look like the fall guy in a Trump world, but once reality settles in, it will rebound with CAD in particular buckling"

The market has drastically overestimated Donald Trump's true intention or even ability to crack down on trade with Mexico, allowing the beaten-down peso to surge, especially as Trump's stimulus is seen as a boon to Mexico's economy, which is highly dependent on US demand.

Meanwhile, the US' neighbour to the north suffers as higher interest rates initiate a credit crunch in one of the world's most overleveraged private sectors. Canadian banks buckle under, forcing the Bank of Canada into quantitative easing mode and injecting capital into the financial system in order to stave off a crisis and to keep the semblance of a healthy credit channel into the economy.

Canada's housing market becomes an albatross around the economy's neck after having been a chief driver of economic growth since the global financial crisis. Additionally, CAD underperforms as Canada enjoys far less of the US' growth resurgence than it would have in the past because of the longstanding hollowing out of Canada's manufacturing base transformation from globalisation and the years of an excessively strong currency.

CADMXN corrects as much as 30% from 2016 highs.

ITALIANS BANKS BEST PERFORMING EQUITY ASSET

Steen Jakobsen / CIO



"Italian banks rally more than 100% as the ECB implements extraordinary too-big-to-fail bank measures"

Italian banks outperform the EU banking sector and all other equity classes as the EU instructs the European Central Bank to issue a guarantee for all of the too-big-to-fail European banks.

Ironically, Italian banks, saddled with heavy non-performing loans in a stagnant, domestic economy, are thrown a lifeline due not to local consideration, but to a crumbling German banking industry.

German banks have been caught in a negative spiral because of the weight of negative interest rates and too-flat yield curves. In 2017, the banks suddenly can't access the market for additional capital as the spike in global yield represents a prohibitive rise in the cost of capital and aggravates counterparty risk as the major banks don't feel they can trust their interbank counterparts. In the EU framework, a German bank bailout inevitably means an EU bank bailout, and not a moment too soon for beleaguered Italian banks.

The new guarantee makes it possible for the banking system to recapitalise and a European Bad Debt bank, EBDB, is established, based on the Swedish bank bail-out of the early 1990s and the Saving & Loan rescue in the US in the late 1980s, to clean up EU bank balance sheets and get bank credit mechanism working again.

Italian bank stocks rally more than 100%.



EU STIMULATES GROWTH THROUGH MUTUAL EURO BONDS

Christopher Dembik / Economist



A move away from austerity towards Keynesian-style stimulus is underpinned by EU mutual bonds issue to the tune of €1 trillion

The populist uprising evident in 2016's Brexit referendum and Donald Trump's victory in the US spreads to Europe as Matteo Renzi's referendum confirms the rise in anti-establishment sentiment and the Dutch election sees dramatic success for Geert Wilder's PVV.

Facing a completely new political landscape in Europe, traditional political parties have a change of heart and acknowledge that they have not done enough to revive the economy and abandon their austerity programmes. After a difficult start, the Juncker plan is on the right track but its total amount of €630 billion over six years is far from sufficient.

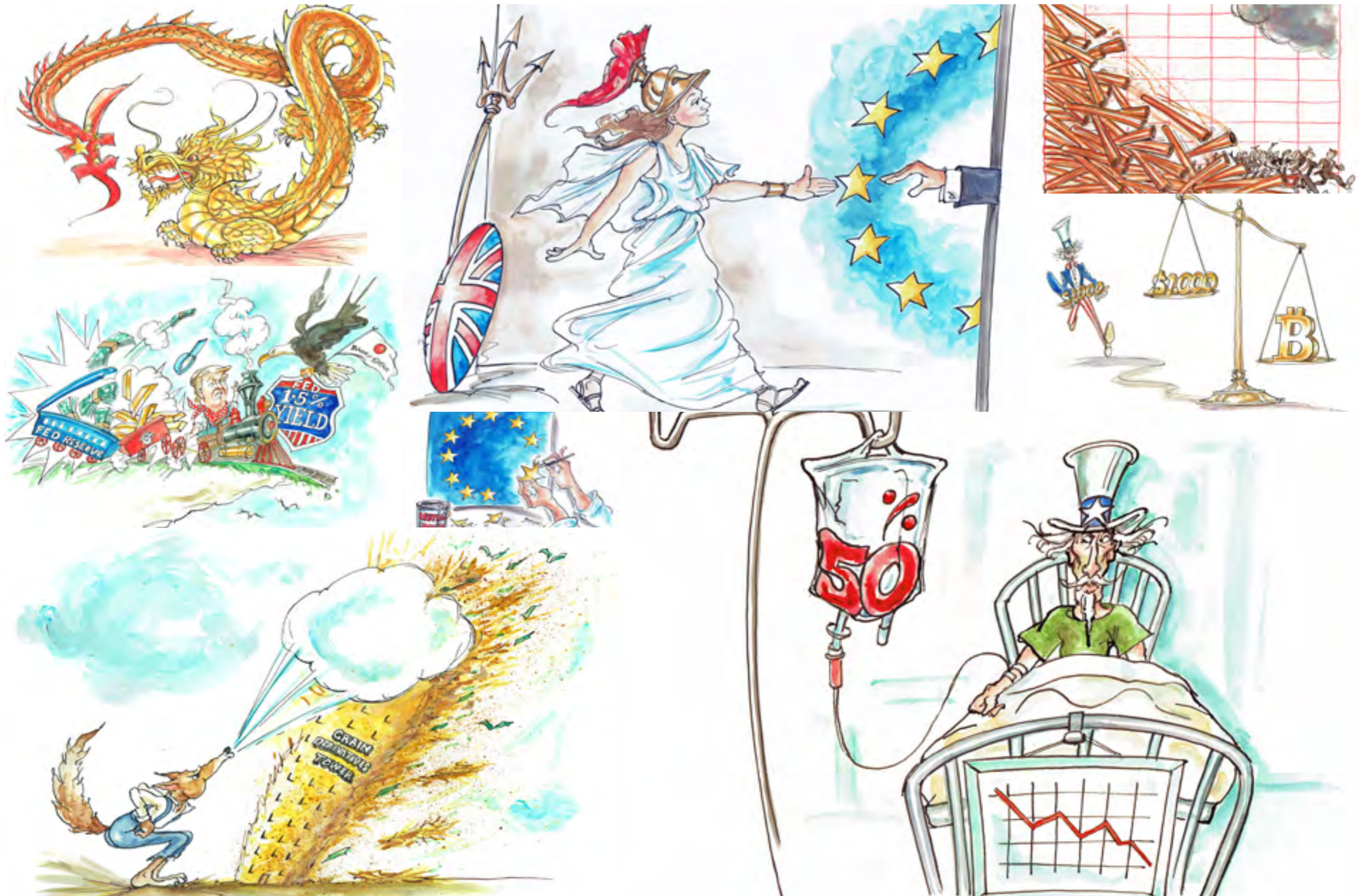
More and more countries consider the adequate answer to the economic and political crisis is to launch more ambitious Keynesian-styled measures inspired by the successful experiences of UK prime minister Neville Chamberlain and US president Franklin Roosevelt in the aftermath of the 1929 crisis.

Such a stimulus plan provides a large economic bang for the buck and significantly boosts growth. However, the benefit for countries following that road is likely to be diluted by an increase in imports if the plan is not coordinated at the European level.

In order to avoid this scenario, EU leaders announce an enormous issuance of mutual EU bonds, at first geared towards €1 trillion in infrastructure projects that reinforces the economic integration of the region and attracts massive amounts of capital inflows from investors regaining confidence in the future of the EU.



Illustrations by Chris Burke





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