

December Economic Update: Avoiding Hard Choices

Early signs suggest that 2019 will see lower global growth. Markets have recently been unsettled by US monetary tightening, trade protectionism, unseasonal weather and emerging market troubles. But looking ahead, there are potential upside surprises as well. Read more in our latest economic update

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US: As good as it gets?

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Source: Shutterstock
Fed Chair, Jerome Powell

Strong economy, for now

Ten years on from the global financial crisis and it is safe to say that the US has come out in a far stronger position than most other major economies. Output is up 23% from the 2009 trough, while there are over 20 million more people in work. Inflation is broadly consistent with the Federal Reserve's mandate, interest rates have been increased, the central bank's balance sheet is being run down and the dollar is in the ascendancy. 2018 has been a particularly good year, with the US economy likely expanding at the fastest rate for 13 years and the unemployment rate falling to a 49-year low. The key question for markets, as underlined by recent equity weakness, is how long can this continue?

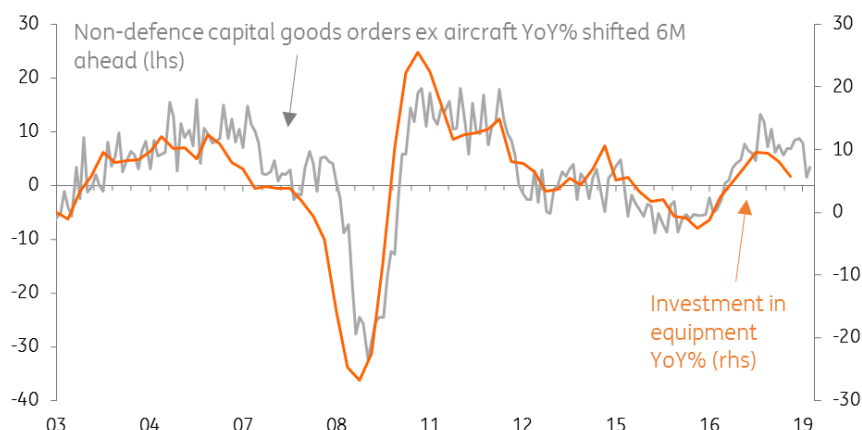
In the near-term, the story remains very positive. There is broad-based momentum in the economy with huge tax cuts providing additional thrust. Given this environment, the Federal Reserve chose to raise its policy rate corridor in each of the first three quarters of the year with another rate rise looking highly probable in December. After all, the economy is booming, inflation is at or above the 2% target on all the key measures and the jobs market is finally generating wage pressures.

Growth momentum remains strong with the Federal Reserve set to raise rates again in December

However, the US economy will face increasing headwinds in 2019 as the lagged effects of higher interest rates and a stronger dollar act as a brake on activity. The support from the fiscal stimulus will also gradually fade, with the split Congress mid-term election results limiting the chances of additional significant tax cuts or spending increases. Then there is the weaker global growth outlook, with Europe and Asia seeing clear signs of slowdown. Intensifying trade protectionism could exacerbate the softening trend.

Recent Federal Reserve comments have acknowledged these external risks, although officials, in general, remain broadly upbeat on the domestic US story. Still, we see some signals that are potentially troubling. The housing market has been the most notable area of softness, which is understandable given 30Y mortgage rates are close to 5.2% right now – the highest for eight years. Home builder confidence has fallen quite significantly this year while the number of transactions has fallen gradually over the past 18 months. This suggests that construction activity will be a drag on growth in 2019.

Investment slowdown underway



Source: Macrobond

Some positive signs

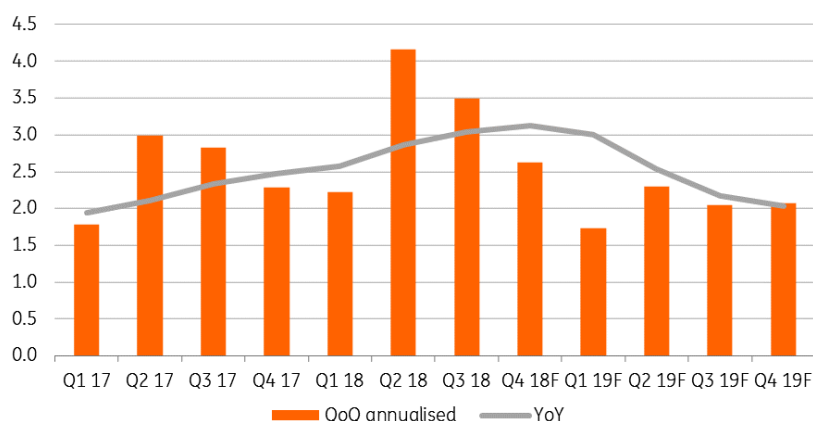
Furthermore, corporation tax cuts do not appear to have yielded the results in terms of domestic investment that President Trump had been hoping for. We are already seeing some signs of softness in durable goods orders, which as the second chart shows, tends to lead investment spending. Instead, a significant amount of those tax cuts appears to have been used to fund share buybacks and special dividends. Additionally, the recent bout of equity market weakness isn't going to be helpful for business sentiment with regards to investment programmes.

That said, it is important to point out that there are positives. Wage growth has broken above 3% year-on-year and we think there is more upside ahead given the tightness of the labour market. Indeed, the NFIB survey suggests that companies are finding it increasingly difficult to find labour

and are consequently increasing compensation while the Federal Reserve has noted greater competition on benefit packages including healthcare, vacation days and signing bonuses. If we are right and wages continue rising, this will support consumption while adding to medium-term inflation pressures.

Moreover, the \$30 drop in the oil price since the start of October could be viewed as another mini-stimulus for the consumer. It certainly leaves drivers with more money in their pockets after they fill up on gasoline.

US GDP & forecasts (%)



Source: Macrobond, ING

Outlook for Fed policy

Back in September, the Federal Reserve withdrew its assessment that monetary policy was “accommodative” and the latest comments from Fed Chair Jay Powell suggest the central bank is “closing in” on neutral policy. The criticisms of the Federal Reserve policy stance by President Trump, combined with what appears to be a toning down in Powell’s comments regarding the monetary policy stance (back in November the Fed had suggested the US was a “long way” from neutral), mean that markets are only pricing in two rate hikes by the end of 2019.

However, we remain some way off policy being labelled “restrictive”. On balance, we think growth will slow to around 2.4% in 2019, but inflation will likely persist above target for much of the year thanks to those wage increases and the prospect of higher imported costs caused by an escalation of protectionist measures. As such, we expect interest rate rises to continue in 2019, but we favour three 25 basis point rate rises in 2019 versus four in 2018.

The risks for 2019 seem skewed to the downside

As for the risks for 2019, they seem skewed to the downside. We are not optimistic on a near-term thawing of trade tensions given that China seems to be digging in with a three-pronged strategy of fiscal stimulus, looser monetary policy and a weaker yuan. That doesn’t suggest China is about to come to the negotiating table and offer the concessions President Trump desires on trade access and intellectual property rights. Indeed, tariffs on Chinese imports are likely to be raised and

broadened in 2019.

Moreover, should relations worsen markedly we fear that China could use the US's deteriorating fiscal position and the fact the Federal Reserve is running down its balance sheet as a way of fighting back against the US administration. China holds 20% of US Treasuries, and while it won't sell those Treasuries, it could choose not to turn up at future Treasury auctions. Given China is typically such a huge buyer, this could mean a failed auction. The result could be a spike in yields, which would have ramifications for US equities and by extension, the US economy. Domestically, tensions could remain high on Capitol Hill. The Democrat sweep of the House of Representatives means that President Trump's legislative agenda is likely curtailed and there will be a risk of government shutdowns as legislators battle over the budget and potentially the debt ceiling. However, the President could try to forge a grand bargain with the Democrats in an effort to get an infrastructure budget through. While it seems unlikely at the moment it is not beyond the realm of possibility as he seeks re-election in 2020. Such an outcome would be a positive surprise and support growth and employment in coming years.

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Eurozone: Diminishing expectations

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More political uncertainty

Things have been moving on the political front in Europe. A deal on Brexit has been reached, though its approval in the UK parliament is not yet guaranteed, meaning that uncertainty could still linger in the run-up to 29 March 2019 and the turbulence of a hard Brexit can still not be dismissed entirely.

In the eurozone, French President Emmanuel Macron and German Chancellor Angela Merkel have taken the surprising step to follow-up on previous agreements and establish a eurozone budget. This could be a major step forward to solidify the structure of the eurozone. However, when looking at the details, the intention seems more important than the substance, because what is on the table now so far lacks the muscle to smooth asymmetric shocks within the bloc. On top of that, a number of member states, the so-called New Hanseatic League, under informal leadership of the Netherlands, are eager to block any European initiative that has the faintest whiff of debt mutualisation in it.

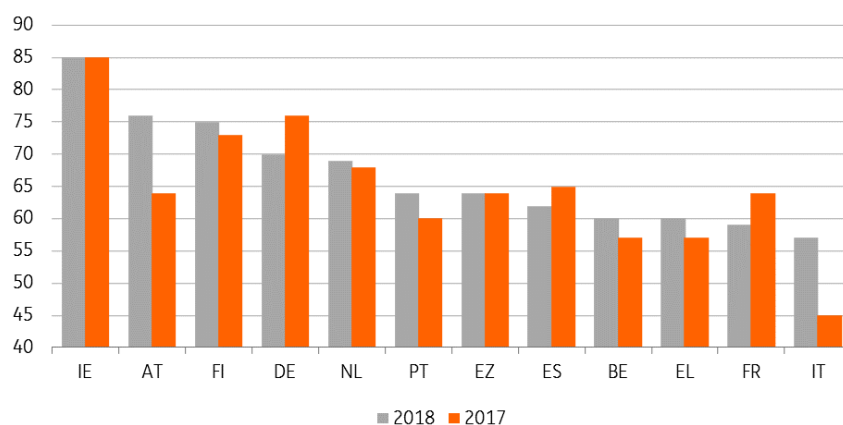
So in the short run, the promised further deepening of eurozone integration will remain limited to making the European Stability Mechanism (ESM) a financial backstop for bank resolutions and probably a very tiny, though symbolic, eurozone budget. The latter will be larded with good intentions but with little commitment to finalising a banking union, morphing the ESM into a

European Monetary Fund, eurozone revenues or pooling of debt. As a consequence, the solidity of the Monetary Union could be tested again, once economic growth falters.

In the meantime, there is a new episode in the Italian story. After looking at the Italian budget plans the European Commission concluded that “the debt criterion ...should be considered as not complied with, and that a debt-based Excessive Deficit Procedure is thus warranted”. This will have to be approved by the Council, probably in January. After this time, Italy will have between three and six months to put corrective measures in place. This means that a judgment on Italy’s efforts may not be made until after the European elections, and even then, a final judgement is not strictly necessary.

Fortunately, the Italian government has realised that higher bond yields are now also seeping through into bank lending rates. In talks with the European Commission, the Italian government has suggested that there is no urgency to implement all of its plans immediately. The conciliatory tone might push bond yields down somewhat although this doesn’t alter the fact that most of the government’s measures will do little to improve Italy’s growth potential. Another piece of comfort for the markets is the fact that in the latest Eurobarometer (survey taken in October), support for the euro in Italy actually increased by a whopping 12 percentage points to stand at 57% (against 30% detractors).

Having the euro is a good thing for my country



Source: Eurobarometer

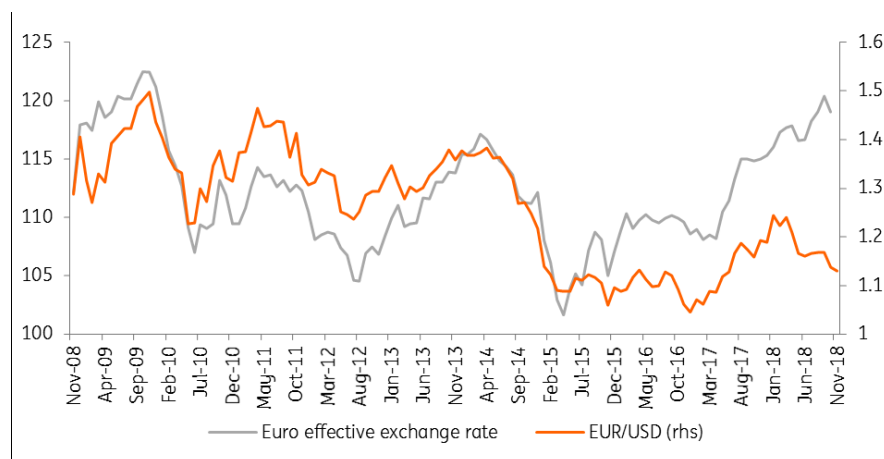
Slowdown continues

Meanwhile, the economic slowdown in the eurozone continues. The composite PMI dropped to an almost four-year low in November, from 53.1 to 52.4. Forward-looking indicators like new orders don’t herald a strong rebound. Weakening export orders, across both industry and services, are a testament to the fact that the eurozone is quite sensitive to the growth slowdown in the emerging world. Europe’s biggest economy Germany was hit by the new emissions standards in the third quarter, creating severe production problems in the automotive industry, and the country is not necessarily going to see a V-shaped rebound in the fourth quarter. The Ifo index actually dropped for the third consecutive month in November, with both the current assessment and the expectations components losing momentum.

The good news is that the recent significant drop in energy prices will be a boon for both

consumers and businesses. So the fourth quarter could see growth pick up a bit after a very weak third quarter, but we wouldn't get overexcited. While ECB President Mario Draghi is still putting on a brave face, the minutes of the October meeting of the Governing Council revealed that some members had their doubts about the growth outlook. We believe that the staff projections, now pencilling in 1.8% and 1.7% GDP growth for 2019 and 2020, respectively, will inevitably be revised down at the next forecast round in December. Our own forecast now stands at 1.4% and 1.3% for 2019 and 2020, respectively, while we slightly lowered our 2018 forecast to 1.9% on the back of a weaker-than-expected growth rebound in the fourth quarter.

Euro exchange rate: stronger than you think



Source: Thomson Reuters Datastream

Outlook for inflation and policy

The slower growth picture begs the question to what extent inflation will pick up. Lower oil prices will have some downward impact on headline inflation in the months ahead. Due to the tightness in the labour market, wages are starting to rise, which could ultimately drive core inflation higher. However, the ECB notes that up until now, businesses have absorbed most of the increase in input costs with narrower profit margins. It remains to be seen whether they will be able to restore margins, as pricing power could be hurt by both slower growth and competition from the emerging world, which may benefit from depreciated currencies. We have revised our headline inflation forecast downwards to 1.6% for 2019 and 1.7% for 2020 and still think that the ECB's expected pick-up in core inflation to 1.8% in 2020 is too optimistic.

All of this means that the 'normalisation' of the ECB's monetary policy is going to be a long and winding road. For the time being, we still think that the ECB will bring the deposit rate to 0% by the end of the first quarter of 2020. But that's all we expect for now and if some of the adverse risks materialise, we might end up with no rate change at all over the next two years. If the Italian economy remains lacklustre (we're forecasting only 0.9% growth in 2019) and Italian bond yields remain high, we believe the ECB will launch a new round of targeted longer-term refinancing operations (TLTRO) to avoid a tightening of monetary conditions in the peninsula.

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UK: Three Brexit questions for 2019

The immediate question for the UK in 2019 will be whether the government can gain approval for its Brexit deal. A defeat seems highly likely in December,...



Source: Shutterstock

For the UK, 2019 looks set to be a year of two very uncertain parts. The most pressing question before March is whether Parliament will get behind a plan to avoid the economically risky 'no deal' scenario. If that happens - and ultimately we still think a fudge can be found - then focus will turn to starting trade talks. We'll take a look at these issues in turn.

1 Can the Prime Minister persuade Parliament to back her deal?

In short, the answer looks increasingly like 'no'. Parliament will get a vote on the Brexit deal agreed with the EU on 11 December, and as things stand, the widespread scepticism within the House of Commons means it's hard to see Theresa May finding enough support to back her deal. Focus is now switching to what might happen if May is indeed defeated - and we think there are five main possibilities.

Firstly, it seems fairly probable that there would be an attempt by the opposition to force a general election. This would require two-thirds of MPs to vote in favour of a no-confidence motion in the government. For this to succeed, it would require a number of Conservative MPs to back it - and

that seems like a tall order.

The second possibility - a second referendum - could face similar hurdles. It's hard to imagine a Conservative Prime Minister triggering one, but it could come about if a 'People's vote' amendment were to be introduced in Parliament. In this case, a simple majority of MPs would need to vote in favour of it. But while a handful of Conservative MPs would likely back a referendum, it would require most Labour MPs to back it, too. Despite some prominent Labour figures talking up the chances, given that many represent staunch Leave-supporting constituencies, it's not immediately clear whether a majority would actively back a second vote.

Even if there's no election or referendum, we may still see a Conservative leadership challenge. This has of course been mooted several times over the past few months, but thus far the threshold of 48 MPs required to trigger a no-confidence vote in the leader hasn't been met. That might change in the aftermath of a defeat on Brexit in Parliament, although even if there is a vote, there's no guarantee the Prime Minister would lose. It's also possible that Theresa May feels obliged to stand down if she is defeated on such a fundamental policy issue, although our feeling is that her preference is to see this through.

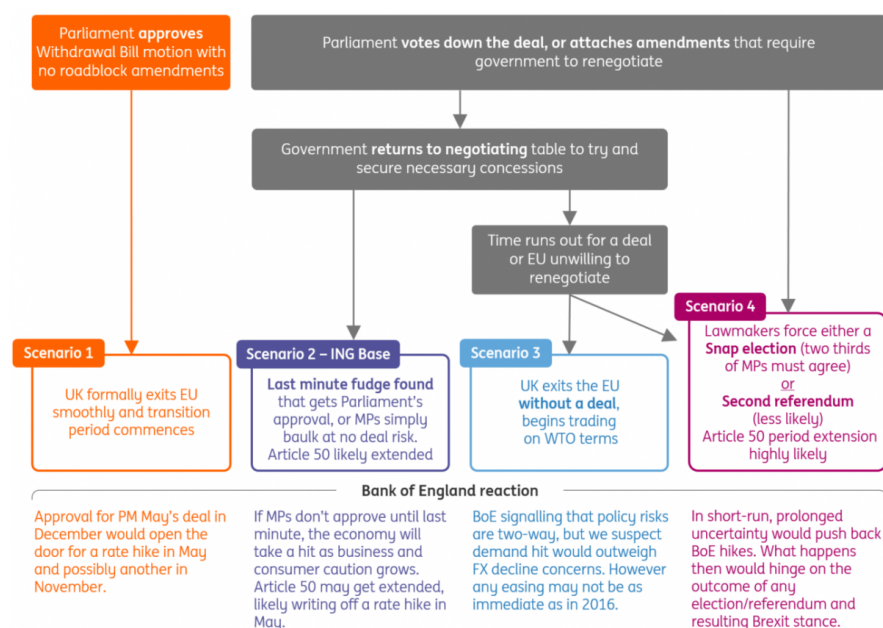
It all comes back to whether Theresa May can find a way to get her deal through Parliament second time around

Assuming we're right on all of the above, then it all comes back to whether Theresa May can find a way to get her deal through Parliament second time around. This will be challenging, not least because the EU will not be in the mood to renegotiate on the key withdrawal issues. That said, Brussels may be open to tinkering on the non-binding political declaration which sets out a vague roadmap for a future trade deal.

In the end, the response of the Labour Party may prove key. For instance, if Labour were to introduce an amendment in Parliament, pushing for a commitment to permanent membership of the customs union, there's a chance they could gather enough support in the House of Commons to force the government's hand.

In this case, Theresa May would be forced to return to the EU and try to work this into the political declaration on trade. There's no guarantee this would be successful, and of course the more extreme Brexit-supporters in the Conservative Party would be deeply concerned. But such a move may be enough to win support of the main opposition party in a second vote, which could be sufficient to gain approval for a deal in Parliament.

Four Brexit scenarios for 2019



Source: ING

2 What happens if 'no deal' is avoided?

Having said all of the above, nobody really knows for sure how – or if – Theresa May will succeed over the next few months. But assuming she prevails and the UK leaves the EU on 29 March – or later if article 50 has to be extended – then the 21-month transition period will kick in. The goal is to agree a new trading relationship by the end of this period in December 2020, although we feel this is highly unlikely to be long enough.

Trade deals take time – remember the EU-Canada agreement took roughly seven years to negotiate. The domestic debate on the best Brexit path is also far from over, and it could be quite some time before a clear strategy is established. It's also worth remembering that the EU side may also become more disunited. So far, the remaining 27 member states have been closely aligned on mutually-important issues such as money and citizens' rights. But trade talks open the door to a range of potential sticking points – the recent disagreements on Gibraltar may be a taste of what is to come.

Implementation will also take time. Hiring new customs and border officials often takes upwards of two to three years, given the likely volume of staff required and the need for training and extensive security checks, while the necessary physical infrastructure and associated IT systems will also be time-intensive to set-up.

We therefore think the transition period will ultimately need to be extended – subject to fresh EU budget contributions from the UK – taking us much closer to the next scheduled election in 2022.

3 What about growth and the Bank of England?

If the UK exits with a deal, then the economy may regain some poise, with hiring and investment likely gaining a little more momentum. But as mentioned above, it could be many years before the true Brexit implications emerge for specific sectors, companies and individuals, which will keep a

cloud of uncertainty over the outlook in 2019 and beyond. We expect this to limit growth next year to 1.6%, although we do anticipate further Bank of England rate hikes as policymakers seek to offset higher wage growth.

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China: Rough seas in 2019

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Escalation of the trade dispute is the key risk to China in 2019

2019 will be a difficult year for China in terms of economic growth and the increasingly tricky political relationships with its trading partners.

An escalation in trade tensions is the key risk to China in 2019 – and this seems like the most probable scenario. This will hurt exporters, manufacturing and logistics services, therefore slowing economic growth directly.

Indirectly, the bilateral trade conflict between China and the US has resulted in multilateral trade and investment disputes. This is exacerbated by international voices blaming the Belt and Road Initiative as a debt pile-up exercise for poorer economies. It has become more difficult to maintain existing relationships with trade and investment partners. The recent APEC meeting showed these economies having difficulties positioning themselves between China and the US.

Sizeable fiscal stimulus and looser monetary policy will see only a moderate slowdown next year

Having said that, we are not too worried about the economic growth rate. We expect GDP growth to slow to 6.3% in 2019 from 6.6% in 2018.

This moderate slowdown in growth reflects our projection of fiscal stimulus worth between CNY 9-10 trillion from late 2018 to 2020, averaging about CNY 4 trillion each year. The size of this stimulus is comparable with that of 2009-2011's CNY 4 trillion, taking into account that nominal GDP has grown by 2.3 times between 2009 and 2018 to CNY88.6 trillion (rolling four quarters to 3Q18).

Manufacturing PMI approaching 50 and below



Source: Bloomberg, ING

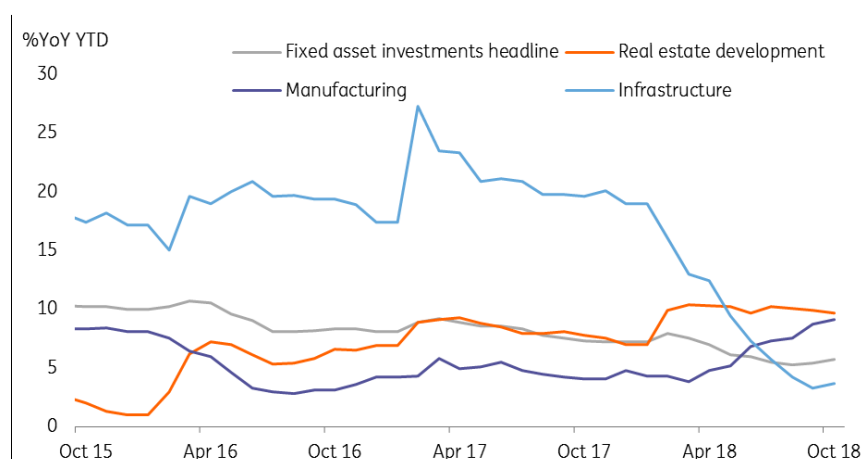
GDP won't rise proportionally to the fiscal money spent

This fiscal boost will take the form of tax cuts (salary tax cuts and more export tax rebates), creation of capital pools for advanced technology R&D, the creation of liquidity pools for small private companies, and infrastructure projects. We'd emphasise that fiscal spending on infrastructure projects may not reflect the same scale of increase in fixed-asset investments. This is because some of the money will be used for repayment of debt from local government financial vehicles (LGFVs) that finance infrastructure investments. Put simply, fiscal money spent will not result in a proportional increase in GDP. This also reflects the fact that the debt problem in China has yet to be solved.

Moderately loose monetary policy to support small private firms

We expect monetary policy to provide support to the economy, mainly to small private firms. Liquidity injections via cuts in the reserve requirement ratio (RRR) are necessary to keep private firms running. Again, some of this money will be used for debt repayments. To lower the interest burden when risk premiums should be rising, we expect the central bank (PBoC) to also cut its seven-day reverse repo policy rate twice (in [1Q19](#) and [3Q19](#)).

Infrastructure investments have increased in Oct18



Source: Bloomberg, ING

Housing market restrictions will be relaxed to support growth

Restrictions on the housing market could be relaxed, as the government won't want another drag on the economy during the ongoing trade dispute, and the housing market could support construction activity.

USD/CNH crossing the 7.0 handle is a high probability scenario

We forecast the USD/CNY and USD/CNH will reach 7.30 by the end of 2019 from 7.00 by the end of 2018, as the trade conflict escalates.

Unlikely scenario: Resolution to trade conflict, what would happen?

In the unlikely event that China and the US agree to withdraw tariffs altogether, the Chinese government would focus again on reducing the economy's debt pile. This could prove just as difficult as facing a trade war. The deleveraging reform has been shelved since the middle of 2018 because the government has had to focus on combating the trade dispute. Within these few months, debt has piled up quickly within local governments, and LGFVs have made a comeback. It would take another few years (just like 2016 to mid-2018) to reduce debts of LGFVs, not to mention state-owned and privately-owned enterprises that receive liquidity for survival. In this scenario, GDP growth would be around 6.5%, depending on how fast the government wants to clean up debts. If the trade conflict were to end, the yuan would likely appreciate against the dollar to 6.50 by the end of 2019.

Japan: Ready to bounce back

Economic growth in Japan contracted in the third quarter, hit by extensive damage from typhoon Jebi. But the doors are now open for a fourth-quarter...



Source: Pexels

Jebi wreaks havoc on 3Q18 GDP figures

Typhoon Jebi made landfall over Shikoku and then the Kansai region of South Eastern Japan on 4 September, before tracking North West in the direction of Taiwan and Far East Russia. Jebi was estimated by one source as being the most powerful storm on the surface of the planet so far in 2018. It was the most intense tropical cyclone to hit Japan since Typhoon Yancy in 1993.

At peak intensity, Jebi was a Category 5 super Typhoon, with sustained wind speeds of 195km/h, and gusts of 280km/h.

Extensive capital losses and infrastructure damage caused a September slump

Damage from the typhoon was extensive. Flooding and winds wreaked havoc with infrastructure. Roads airports, bridges and ports were wrecked. Private residential property damage was extensive. Hundreds of cars were picked up and tossed to destruction by the winds. Not surprisingly, many businesses suffered capital losses, and many others were shut as staff were unable to reach them. Total insured losses for the economy have been estimated at between JPY340 and JPY620 billion (up to about 0.1% of GDP). But according to some estimates, uninsured agricultural damage may have been up to ten times as large, with other uninsured losses probably

of a similar magnitude.

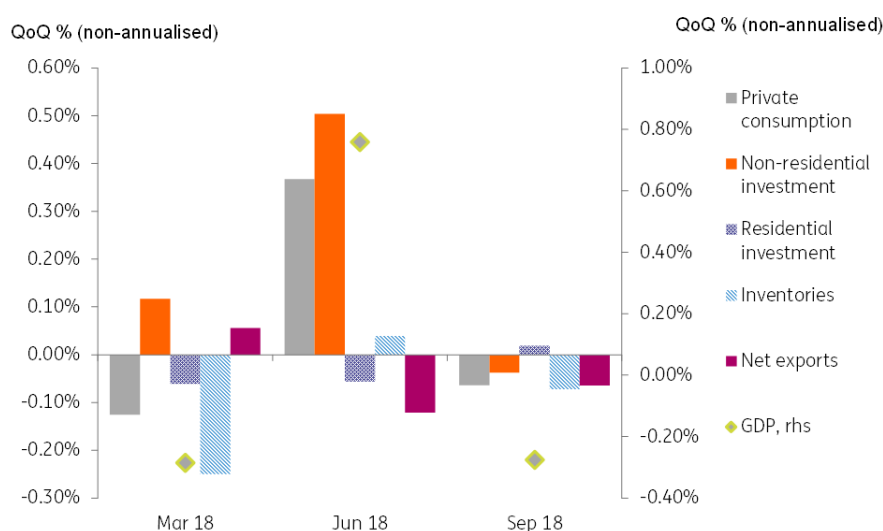
GDP contracted 0.3% QoQ in 3Q18

Our forecasts for third quarter GDP prior to Jebi had been quite strong, at about 2.2% (quarter-on-quarter annualised). Initial indications were that the economy had weathered the Typhoon well. But data released just prior to the GDP figures showed this was not the case. Private household spending dropped very sharply. Business investment was also badly hit, as were exports (though so too were imports). Nonetheless, we still thought there would be some offset in terms of an unintended inventory build as activity that should have happened didn't. The official GDP figures released suggested oddly that this did not happen – possibly inventories were damaged / lost in the Typhoon. The net result was a 0.3% quarterly GDP contraction or -1.1% QoQ in seasonally adjusted annualised terms.

But Japan will bounce back, with stronger growth in 4Q18 and 1Q19...

The common pattern with a natural disaster hitting an economy is real time economic disruption, followed in subsequent quarters by a bounce back, as clean-up spurs activity that would not ordinarily have happened, bolstered also by replacement of damaged capital and infrastructure. The net result on GDP is often (though not always, depending on the extent of infrastructure damage) positive. We imagine that this will be the case this time round too, and have nudged up our 4Q18 and 1Q19 GDP estimates, in response providing a little lift to the 2019 annual growth estimate, which now stands at a healthy 1.7%.

GDP gets wrecked by Typhoon Jebi



Source: CEIC, ING

Inflation spikes should also be limited by oil price declines

Near-term inflation in Japan could also be affected, in particular, agricultural damage should push up headline inflation rates as fresh food prices in Japan and across the Asia region spike higher. But against this, we also have to factor in the much sharper falls in oil prices that have coincided with this event, and which will mitigate against some of this food price increase. In the very short-term,

this may limit the quarterly impact on headline inflation rates. And core rates are likely to remain subdued at close to their current 0.4% year-on-year rate.

The BoJ will find it harder to make any near-term progress towards a taper

None of the above makes it easier for the Bank of Japan to further its attempt to follow the ECB and begin a taper of its own with respect to asset purchasing and bond yield targeting. 10Y JGB yields are back smack on their 0.1% target, and there is no sense that further taper progress is possible near-term. This is not helped, of course, by the macro and political difficulties being faced in the eurozone right now, which limit progress that can be made there, and which therefore deprives the BoJ of a screen for its own intentions.

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FX: Patiently waiting on the peak

As 2019 progresses, expect to hear more about a Fed pause. US market interest rates typically turn lower before the top in the Fed cycle. And if...



Source: ING

It is too early to call a top in the dollar. The Fed is now in the realm of late-cycle tightening and should deliver four more hikes. Dollar hedging costs will remain extremely expensive and, barring a US-centric shock, we would expect to see marginal new dollar highs against the euro and the Japanese yen over the next six months.

As 2019 progresses, expect a bearish dollar narrative to develop. US rates should be coming off their highs by the end of the year and as US growth converges lower on the rest of the world, expect investors to rotate out of US asset markets. A search for alternative sources of stimulus may also see the White House favour a weaker dollar.

Europe has been a big disappointment in 2018. Though sluggish growth has been blamed on a relentless stream of 'one-off factors', it is hard to see a significant pick-up in activity next year. EUR/USD will struggle to make it above 1.20 as the ECB barely lifts rates off the floor. European Parliamentary elections in May will also be in focus.

A lower EUR/USD in the early part of the year is typically not good news for CE4 currencies. The good news is that the Hungarian forint and Polish zloty are already undervalued, while the market's favourite villain – the Romanian leu – is too expensive to sell. The Czech koruna should hold gains.

On Brexit, UK parliamentary approval of the Withdrawal Agreement may not be seen until

February. Even if the deal is passed, 2019 is unlikely to look pretty as both the UK and the EU struggle to define what the ultimate relationship should look like. Expect the pound to continue to trade on volatility levels more common in emerging markets.

For EM, the gales blowing out of the US look set to continue through early 2019. Add in declining world trade volumes and rising late-cycle volatility and the EM environment looks challenged. But EM currencies have already discounted a lot of bad news. If they can survive the first half, modest rallies should be seen later in the year.

Within the EM space, we see China's renminbi steadily weakening all year as the economy adjusts to the US trade agenda. Our USD/CNY target is 7.30. In theory, a softer environment for crude oil prices in 2019 – we see Brent trading more in the US\$60/bbl area than the US\$70/bbl area – should be good for Asia. Assuming the Indian rupee can survive elections in May, central bank tightening in 2H19 should allow the currency to take advantage of the softer dollar story.

The big beasts of Latam, Brazil's real and the Mexican peso, will continue to see substantial volatility as investors adjust to the new political reality. Argentina aside, better external accounts, low inflation and faster GDP growth suggest more resilience in the region. However, Brazil's ability to pass fiscal legislation will very much set the tone early next year.

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Rates: Why EU angst is prompting talk of topping out

European politics, namely Brexit and the dispute between Italy and the EU, is keeping a lid on US 10-year rates. Though we may not have seen market rates...



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Peak US 10-year rates?

We identify some diverging issues in play when it comes to core rates. First, our model for US 10-year rates continues to pitch fair value at between 3.4% and 3.9%. But second, some technical indicators are describing the 3.25% level hit by the US 10-year as the structural peak. In addition, the richening of the 5-year area of the curve that started about three weeks ago has historically been an end-of-rates-hike-cycle lead indicator.

The Fed isn't done hiking yet. Are they seeing something we're not?

However, there are two outstanding issues that warrant caution. First the Fed is not done yet. As long as the Fed is hiking, there will be the residual fear that the central bank is seeing something that we do not. Second, our model for the 10-year pitches fair value at 3.4% to 3.9% but we have not even entered the bottom end of that range. We're not far off it, but still not there yet. Bottom line, contemporaneous macro factors remain robust.

That 3.4% to 3.9% range is based off an assumption that the neutral policy rate in the US is between 2% and 2.5%. We add to that our calculation of how far market rates should be above normal right now based on how far the average current data readings deviate from normality. That is currently running at about 140 basis points. Hence the aforementioned range. For this to change, activity data needs to slow, considerably.

Reasons for low European rates is also containing those in the US

That said, we doubt that the top end of that range can be seriously entertained given the elevated risks in emerging markets. Also there is a massive focus on Europe, with Brexit on the horizon, and a focus on Italy's spat with the EU. This is fine provided it remains a spat, but very sinister if it extends to the limits (Quitaly). These factors are keeping core European rates down, and by extension containing US rates too.

EU angst elevated as row with Italy set to persist into 2019

And we come full circle here as this also filters into ECB policy. A muted uptick in rates is on the horizon. Domestic stresses are one factor. Another is the likelihood that the US is slowing (by 2020) just as the ECB could have had an ambition to hike. We still view 1% as the ultimate target, but that is now some way off. The German 10-year yield back at 36 basis points is behaving as a deutschemark proxy again, in part discounting a Quitaly.

It looks like the row between the EU and Italy persists into 2019. An excessive deficit procedure is a risk, but this does not have much teeth. No country has even been fined, even though there have been nearly 40 such procedures in the past, and Hungary was on such a procedure for nine years (came out in 2011). There is a vacuum here within which the populist government can operate, maintaining elevated angst.

Bulk of rises in long-end rates can be pretty much ruled out - from a US perspective

For the US 10-year to break back above 3.25%, a significant calming of jitters in Europe is needed, and every negative twist in the Brexit mess adds oxygen to the Italian populist government finger-pointing at Europe. The same goes for ambitions to get the German 10-year yield back into the 0.5% to 0.75% range. That needs a political calming. The 36 basis points is not reflective of macroeconomics but of an EU/euro existential discussion.

We may not have seen the peak in market rates yet but the bulk of the rises in long-end rates are likely behind us from a US perspective. The same goes for the Fed; a few more hikes to deliver, but the peak is much closer now. Meanwhile, the ECB is staring at the headlights of a car being driven by EU antagonists, while Angela Merkel fades quietly into the background. Add to that wobbles in global risk assets, and the recipe is there for core rates containment at a minimum, at least for as long as this combination persists.

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