Bundles | 7 September 2018

Global Economic Update: Peak Trump?

In our monthly economic outlook, we examine the turmoil in emerging markets exacerbated by a strong dollar, rising US borrowing costs and fears of a trade war. We also delve into Europe's troubles, with Italian politics in focus and mounting Brexit risks. Will US markets and the dollar continue to strengthen against this backdrop or are we past the peak?

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FX: Peak Trump?

The strong dollar and aggressive protectionism continues to ask major questions of vulnerable Emerging Markets. This narrative looks set to extend into the November US mid-terms. Add in the Italian budgetary position and EUR/USD should stay under pressure over coming months. The wild card here, however, is President Trump's desire for a weaker dollar

President Trump has played his hand well

President Trump has played his hand well. After a relatively quiet first year in office, the protectionism characterising his second year has been launched from a position of strength. Here the $1.5 trillion fiscal stimulus agreed at that start of the year has provided a strong tail-wind to the economy. The tax break on repatriated profits has also provided direct support to the US stock market – and the dollar.

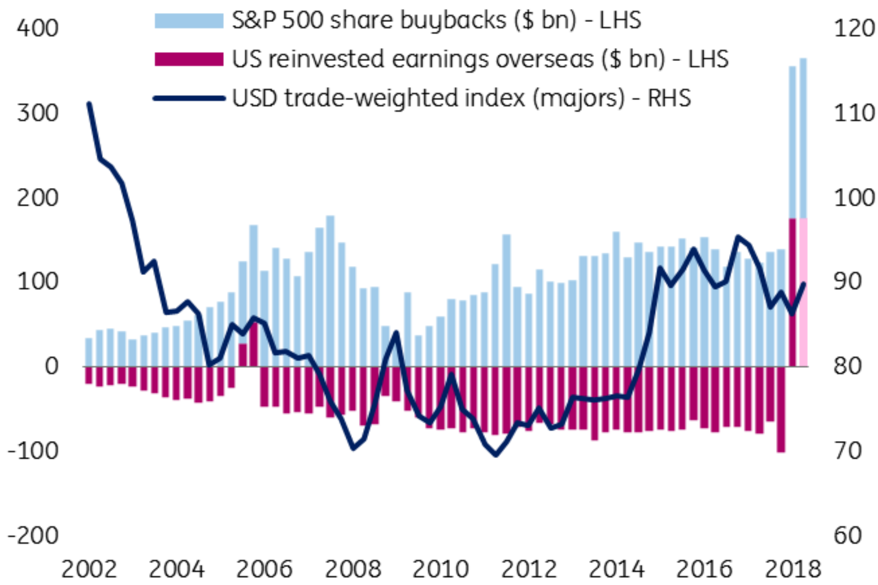
Whether US mid-term elections clip Trump's wings remains to be seen, but we suspect we will see Peak Trump over coming months. That aggressive protectionism should be reflected in the dollar pressing new highs against vulnerable EM currencies and perhaps some marginal new lows in EUR/USD - aided by uncertainty around the Italian budget.

Were Trump's trade position to turn more conciliatory after the mid-terms and, as we forecast, the ECB to progress with monetary normalisation through 2019, then we should see EUR/USD recovering towards the 1.25 area. At some point as well, US twin deficits will catch up with the dollar – although this may not be a story until late 2019.

$175 billion of US overseas earnings were repatriated in 1Q18

Returning to the subject of the US tax cut, US Balance of Payment data shows an enormous $175 billion of US overseas earnings being repatriated back to the US in 1Q18. That helped finance the $180 billion of share buybacks of S&P 500 stocks that quarter. 2Q18 data shows another $190 billion of share buybacks occurred suggesting that corporate repatriation was still a major factor. These amounts dwarf the peak $50 billion per quarter repatriated under the Homeland Invest Act in 2005.

Massive repatriation of US corporate profits



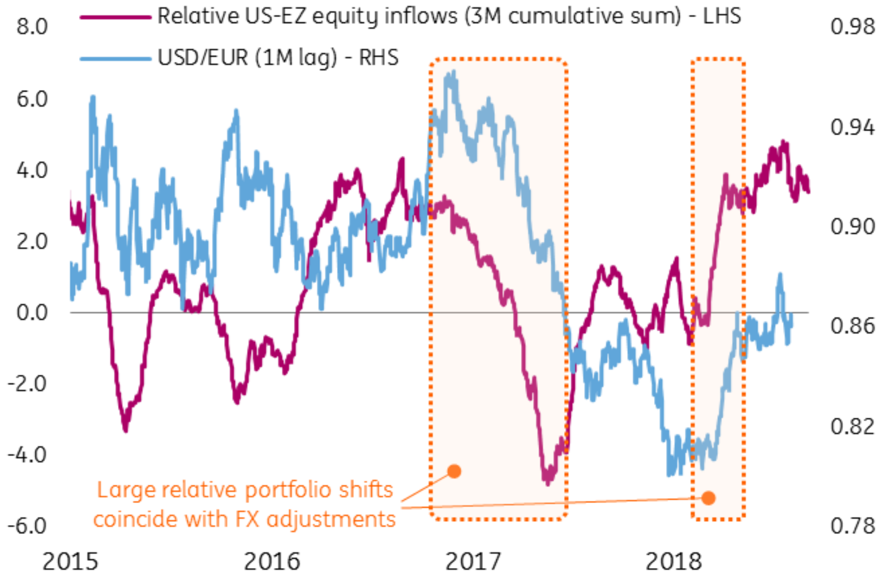
Source: ING, US Bureau of Economic Analysis

Rising US rates, a stronger dollar and firming energy prices create perfect storm for EM

The tax cut has undoubtedly strengthened the dollar and asked severe questions of countries struggling with sovereign debt (Argentina) or subject to political sanctions (China, Russia and Turkey). And the unlucky combination of rising US rates, a stronger dollar and firming energy prices have proved a perfect storm for the likes of India.

Beyond the future of protectionism, an important question is whether US corporates are drip-feeding overseas earnings back into the US economy or whether the bulk of the activity has been seen already? We're looking into this closely, but suspect that since the repatriation is open-ended, the flows may well be front-loaded – effectively translating into front-loaded dollar strength. Early signs that President Trump is becoming more serious about the need for a weaker dollar should limit its strength as well in 4Q18.

US equities insulated during US protectionism



Source: ING, Bloomberg

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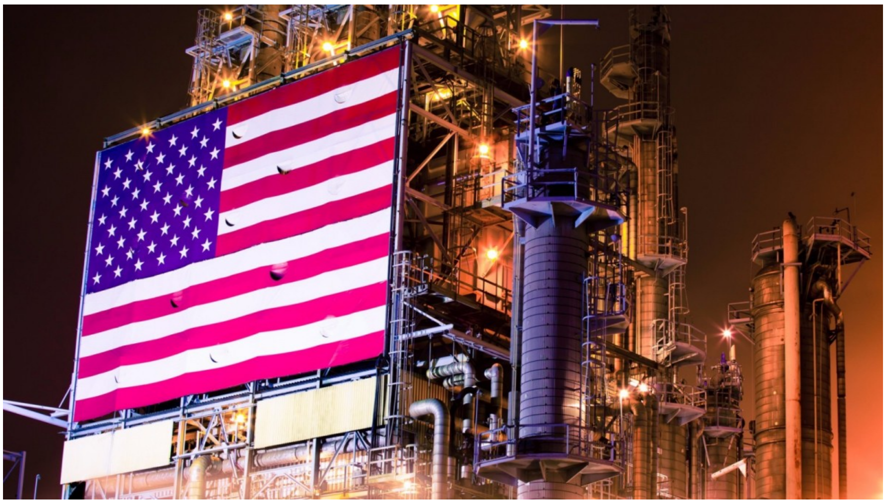
Article | 7 September 2018

US: Onwards and upwards

Given fiscal tailwinds, the strong jobs market and surging corporate profits, we look for the economy to continue growing robustly through the rest of the year, which will keep the Fed on its “gradual” policy tightening path



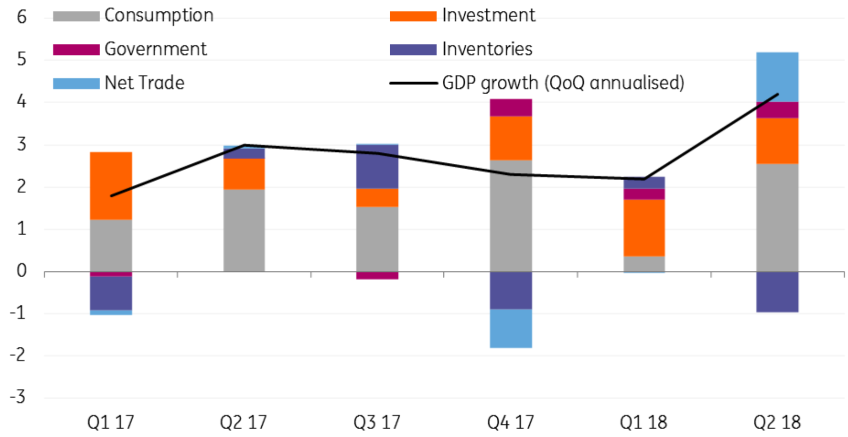
Source: iStockphoto

A positive story

For all the negative headlines regarding trade wars, interest rate hikes, political uncertainty and fears for what an inverted yield curve could portend, the US economy continues to perform very well. The US expanded 4.2% annualised in 2Q18 and we look for growth of 3-3.5% in 3Q with full year 2018 growth of around 3%. With all of the key inflation measures at or above the Federal Reserve’s 2% target policy makers are likely to continue with “gradual” interest rate hikes.

In terms of the 2Q GDP report, consumer spending made a major contribution as the combination of a strong jobs market and huge tax cuts boosted household incomes. Investment also performed strongly while net exports contributed around a quarter of the 4.2% annualised growth.

Contributions to US GDP growth



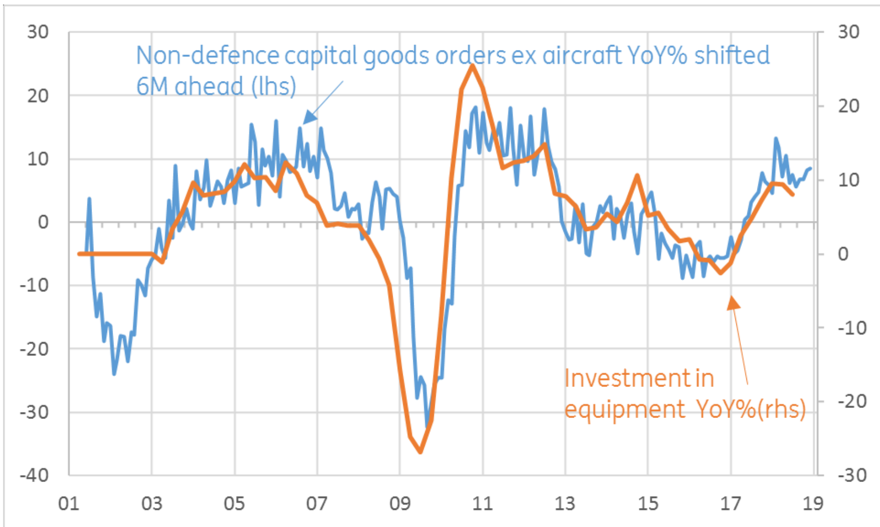
Source: Bloomberg, ING

3Q looking strong

The third quarter is likely to see net exports swing back to a negative contribution given the recent trade numbers while inventories are likely to be at least partially rebuilt. Consumer spending is set to post decent growth again given tax cut-induced positive real household disposable incomes and the fact confidence has risen in both July and August to currently stand at an 18-year high.

The investment outlook is looking very strong, too. Corporate profit growth is accelerating, rising 7.7% year on year in 2Q18 while after tax profits are up over 16% YoY. This shows companies have money to spend, which is evident in durable goods orders data. Non-defence capital goods orders are picking up again and are consistent with investment in equipment and software growing in excess of 10% YoY.

The outlook for investment remains strong



Source: Macrobond

But there are risks for 2019

While headline CPI and PCE deflator inflation readings of 2.9% YoY and 2.3%, respectively are likely close to a peak, we suspect the core rates at 2.4% and 2% have further to rise. There is growing evidence that pay pressures are building given the tightness in the jobs market and this could help nudge broader inflation readings higher. As such, we continue to expect Federal Reserve interest rate hikes in September and December.

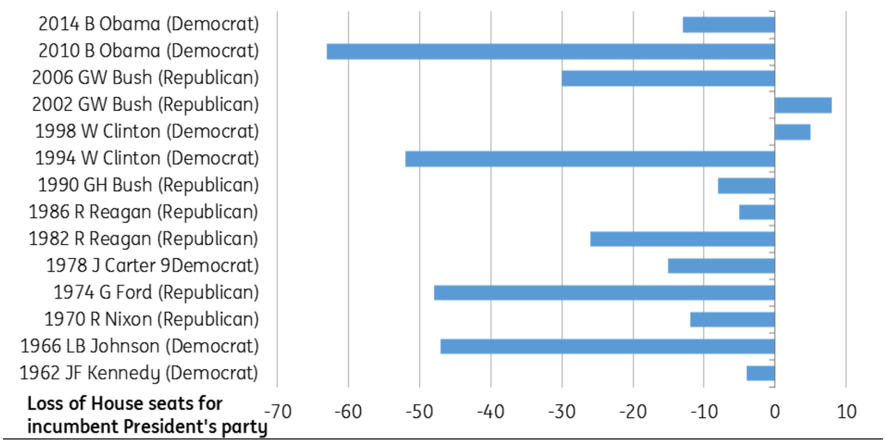
Nonetheless, headwinds are building for the economy and this should result in slower growth in 2019. This, in turn, will help to keep the yield curve relatively flat. We see QoQ annualised growth averaging closer to 2% next year based on tighter monetary conditions (lagged effects of rate hikes and the strong dollar plus some talk about raising bank capital buffers given Fed comments about financial stability) and the fading support from fiscal stimulus. It is probable that there may be some slowdown relating to trade protectionism and emerging market worries, which could soften the investment and job creation outlook.

Trade to remain in the headlines

On trade, there have been some encouraging signs regarding a deal with Mexico, but a standoff with Canada and threats to pull out of the WTO aren't positive. It is difficult to see any meaningful improvement in US-China relations this year particularly with President Trump about to pull the trigger on an additional round of tariffs on $200 billion of imports into the US. The EU-US friction also looks set to continue with Trump suggesting that the EU's offer of removing tariffs on imports of US-made vehicles is "not enough", implying that European authorities need to do something to stop consumers preferring European made cars over US cars.

Trade threats have little prospect of easing until after the 6 November US mid-term elections when all 435 House of Representative seats are up for grabs along with a third of the Senate. Currently, the Republicans hold the Presidency and majorities in both the House and the Senate, but there is a strong chance the Democrats will break this stranglehold – incumbent Presidents typically see their party lose seats at the mid-terms. This could have ramifications for economic and trade policy while also dramatically heightening the chances of impeachment proceedings being started against President Trump.

A president's party usually loses seats at a mid-term election



Source: The American presidency Project

The threat to Trump

Three key factors tend to determine the outcome of mid-term elections: The President's personal approval rating, the generic polling of the parties and the health of the economy. Unfortunately for Trump and the Republicans, they only really have the economy going for them.

Trump's personal approval rating is just 41%, which is the lowest of any President in the September of their second year since Harry Truman over 70 years ago. The polling for the Republican party is not great either with surveys suggesting the Democrats are around 5-8 percentage points ahead of the Republicans across the nation. At the same time, there has been a surge in the number of Republican politicians who are not going to contest their seats, most notable being House speaker Paul Ryan. These are termed "open seats", which have historically been more difficult to defend.

Given the Democrats need to gain just 23 seats to win control of the House, a swing which is less than that of 1994, 2006 and 2010, we suspect it is achievable. A Democratic takeover of the Senate is less likely, but not impossible. Of the 35 seats being voted on, the Democrats control 24 together with two independents who caucus with them while the Republicans have nine. Given the Vice-President has the casting vote in any legislative vote tie, the Democrats need to win two or more of those nine Republican seats. The surprise result in Alabama's special election late last year will give them hope.

Loss of Republican control of Congress would severely limit Trump's ability to pass legislation, hurting the prospect of further fiscal stimulus (such as his $1.5 trillion infrastructure spending plan) or healthcare changes. However, it could open the door to concessions on trade.

With the election out of the way, pro-trade Republican politicians and corporates, who have been quiet in the lead up to polling, may be prepared to make a more forceful stand against Trump's protectionist measures. The President may well listen if there is growing evidence of a negative impact on the economy – so long as he can still portray the end result as a "big win". Concessions from the EU and China could get him there.

The risk is he could choose to double down and implement further protectionist measures, but this would risk hurting equity markets, which he often views as the key barometer of his performance. A weaker economy and falling US household wealth would not stand him in good stead for a defence of his presidency in 2020.

The bigger personal threat to Trump is that of impeachment. The most plausible scenario is if the investigation of Russian interference in the 2016 election by special Counsel Robert Mueller shows direct and incontrovertible evidence to support impeachment. A simple majority in the House in favour of starting proceedings would result in a Senate trial. Given this would require a super majority of 67 out of 100 Senators who are likely to largely vote on party lines, Trump could survive, but it would be tight.

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Eurozone: Half full or half empty?

While the eurozone economy hasn't suffered too much from the trade skirmishes, uncertainty around both the Italian budget and the Brexit deal is likely to prevent any growth acceleration in the second half of the year. With inflation only likely to pick up at a snail's pace, the odds of seeing much monetary tightening remain low over the next two years

Source: Shutterstock

Second quarter growth was OK-ish and cease fire in trade war is good news

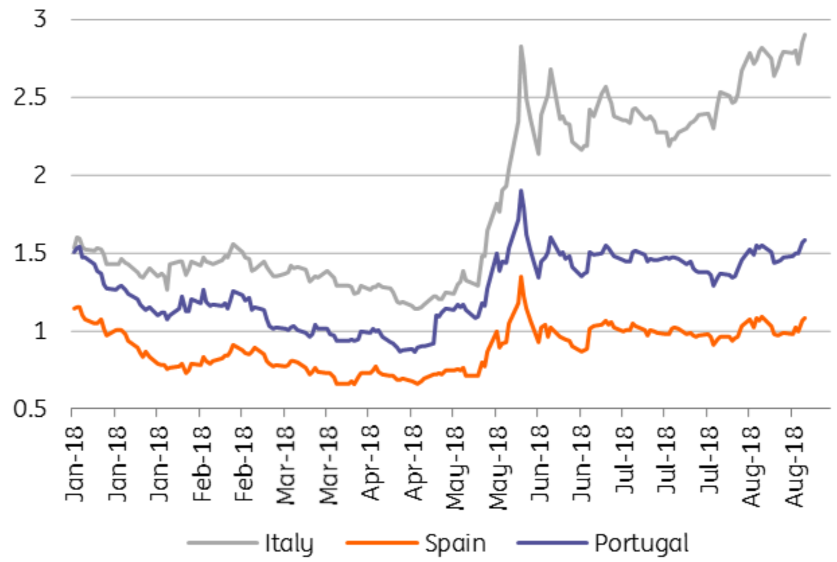
Is the glass half full or half empty? That seems to be the question for the eurozone economy. The second quarter saw 0.4% quarter-on-quarter GDP growth, the same as in the first quarter which was held down by exceptional factors. So no acceleration, but at the same time the eurozone economy hasn't suffered too much from the trade skirmishes, initiated by President Trump. Where do we go from here? On a positive note we should mention Jean-Claude Junker's visit to Washington D.C., which resulted in a cease fire in the trade hostilities, taking away some uncertainty for European companies. The first increase in nine months of the German Ifo-index in August is testimony to that.

Let's also not forget that still loose monetary policy and a weak euro exchange rate will remain growth-supportive in the months ahead. At the same time, the international economic environment has become less upbeat, with several emerging economies experiencing financial tensions, though this might be compensated to some extent by the still buoyant US economy.

Italian budget poses uncertainty

Some of the major risks to growth are still political. The new Italian government has been on a confrontational path with the European Union since the beginning of its mandate. At first, it was immigration but the next battlefield is likely to be the budget. While Finance Minister Giovanni Tria tries to reassure European partners that all deficit rules will be respected, leaders from his coalition partners seem to be willing to up the stakes with a more expansionary budget. No wonder the Italian 10-year bond yield has shot up from 1.6% in May to around 3.30% at the start of September, partially reflecting redenomination risk.

Italian risk: 10yr spread with Germany



Source: Thomson Reuters Datastream

The potential of a no-deal Brexit deal remains a risk to the recovery in 2H 2018

Fitch's recent change of the rating outlook to negative is not helping either. We expect tensions to remain in the coming month, though the final budget deficit foreseen for 2019, is likely to stay below 3.0% of GDP, with the European Commission grudgingly approving. Meanwhile, the critical deadlines for a Brexit deal are also rapidly approaching. While the impact of no-deal is likely to be more harmful to the UK economy than to the European Union, it would still inject an element of uncertainty and is likely to be felt in the countries with the strongest trade ties with the UK. A no-deal still looks very likely to be avoided, though October has already been abandoned as a deadline.

Growth momentum to remain 'decent'

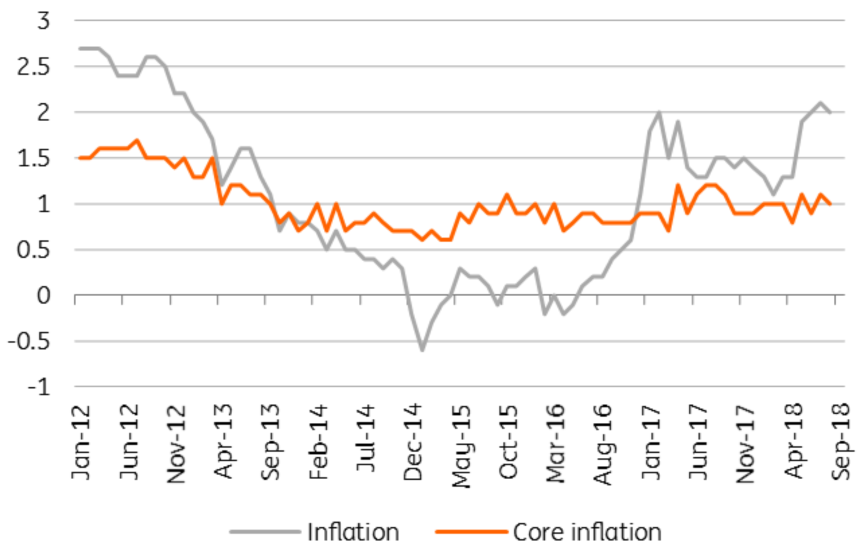
While in these circumstances it looks rather unlikely to see a growth acceleration in the second half of the year, the underlying growth momentum remains strong enough to sustain the 0.4%

quarter-on quarter growth pace for a bit longer. Real disposable income is now growing at a pace close to 2%, while unemployment fell to 8.2% in July. On top of that, German fiscal policy is becoming more expansionary, which should sustain consumption in the quarters to come. Although sentiment indicators have fallen back from the extremely high levels seen earlier in the year, they remain at a level signaling sustained growth. All in all, we expect 2.0% GDP growth this year. That said, 2019 and 2020 are likely to see some deceleration, which is not that unusual given the fact that the output gap has now all but closed. The more forward-looking indicators like the credit impulse or the OECD leading indicator confirm that the growth pace has left its peak behind. We anticipate a 1.7% expansion in 2019 and 1.5% in 2020.

Increasing wages should gradually exert some upward price pressures

Headline inflation at 2.0% in August is basically an oil story, as underlying inflation remains stuck at 1.0%. That said, growth in compensation per employee increased from 1.8% in the fourth quarter of 2017 to 2.0% in the first quarter of 2018, while growth in negotiated wages increased from 1.5% to 1.8% in the first quarter of 2018. So the trough in wage growth now looks behind us and the Phillips curve relationship, which still holds according to recent research by the IMF, is pointing to further upward wage pressure, which should ultimately also push core inflation higher. However, this is likely to be a very gradual process as inflation persistence in the eurozone can be important, meaning that a period of low inflation has a tendency to keep a lid on future inflation.

Core inflation is stuck at 1%



Source: Thomson Reuters Datastream

The scope for more rate hikes is very limited

The ECB remains at ease with its exit strategy, stopping the net asset purchases by the end of this year and starting the interest rate hike process in the second half of 2019. While we see the deposit rate at 0% and the refi rate at 0.25% by the end of next year, this is largely a normalisation process. After that the ECB will tread more cautiously in tightening monetary policy. Our end of year forecast for the refi rate in 2020 is only 0.50%. One has to bear in mind that with markets starting to anticipate a slowdown in the US, pushing down the dollar, the scope for monetary tightening in the eurozone will indeed be very limited.

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Rates: Why they are so low

Core rates are low for many reasons, ultimately a reflection of excess demand over supply - which has been affected by quantitative easing. But there is also a fear factor in play, not just flight from struggling emerging markets, but also from the Italian story which could, although not our base view, disrupt the eurozone significantly

Source: Shutterstock

Flight to safety from emerging markets

Core rates are being constrained by fear. And it has little to do with future recession worries, at least not directly. The biggest fears are centred on various brewing idiosyncratic risks lurking outside core markets. There is an emerging markets aspect to this centred on the likes of Argentina and Turkey. The catalysts vary, but 40-50% collapses in respective currencies is as good as a barometer as any. This has generated a flight to safety, infecting the likes of Brazil, South Africa and Russia. The drivers vary, ranging from election uncertainty to macro mismanagement to sanctions fears. But one outcome is clear; this all generates flows into safer shores, like Treasuries and proxies.

Ultra low bund yields act as an anchor for Treasuries

At the same time, while the US economy is jogging along nicely (prompting a steady rhythm of hikes from the Fed) there is also a brake in play in the guise of bund yields that remain far closer to crisis level than they arguably should be. In our last edition, we marvelled at the 30 basis point bund yield. Since then it has managed to crawl up to 35 basis points; still remarkably low. This, however, has far less to do with Turkey or other emerging markets stories. We are not even convinced it has to do with the fragility of the recovery. We, in fact, think there is a euro existential question being slowly brought back to the fore. It may amount to nothing more than a test, but it is still one that needs passing.

We have been here before: Near a point where Greece could have left the project

The sovereign debt crisis very nearly saw Greece exit the eurozone. If it had, it would have been a big deal. But at the same time, as the crisis unfolded, market participants and indeed politicians began to harden to the notion that what had been unthinkable had become a live possibility. In the end Greece had a large debt problem, but when contextualised against a relatively small economy it was manageable. As we roll forward to today a lot of positive things have happened, like a QE programme that probably prevented a dip into depression, a significant reduction in excesses, macroeconomic growth and rescue mechanisms put in place.

We don't subscribe to extremes, but the current Italian story does affect pricing

That said, Italy is a whole other matter in terms of size and potential to unravel the single currency. Now we don’t think that will happen we hasten to add. But worries about the extremes and what they could entail are part and parcel of the decision-making tree that financial market participants will use to price spreads against a backdrop where one of those branches does end up with the extinction of the euro. A less extreme scenario would be where Italy leaves and the rest stumbles on with a massive mess in its wake. At the other extreme is a baseline view that this all blows over, and in the end is a negotiation tactic on the part of an eclectic government that pushes populist ideals to the limit, but not over it.

Italy has positives in its favour. Nominal growth (including inflation) is running at 2.7% and the primary surplus (fiscal balance excluding interest rate payments) is 1.5% of GDP. Given that Italy has a debt/GDP ratio of 130%, a factor of 1.3 times the sum of the above two inputs solves for a breakeven coupon print of 3.2%. The Italian 7-year yield at 3% is a decent proxy for the average coupon, which is dangerously near the breakeven rate. Why is this important? Well if Italy is forced to print coupons above 3.2% it would mean that its debt/GDOP ratio will rise (unless offset by higher growth or a higher primary surplus, both of which are unlikely). No conclusion here, yet; but watch this space.

What keeps investors awake at night is why some sleep better: Being long 10-yr bund at 35 basis points

And why tell this Italian story? To paint a picture. Bottom line, no pension fund board would criticise a policy decision to buy 10-yr Germany at 35 basis points, as this looks as good an insurance policy as you could get in the case of an extreme event that saw Italy exit the euro; a deutschemark proxy. And this anchors US Treasuries too.

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Japan: Mostly good

Japan's economy is in decent shape, judging by GDP and the labour market performance, and its persistently low inflation is doing no harm at all. Which leads us to question the Bank of Japan's continued extremely dovish policy stance

Except for an unrealistic inflation target, policy measures are working

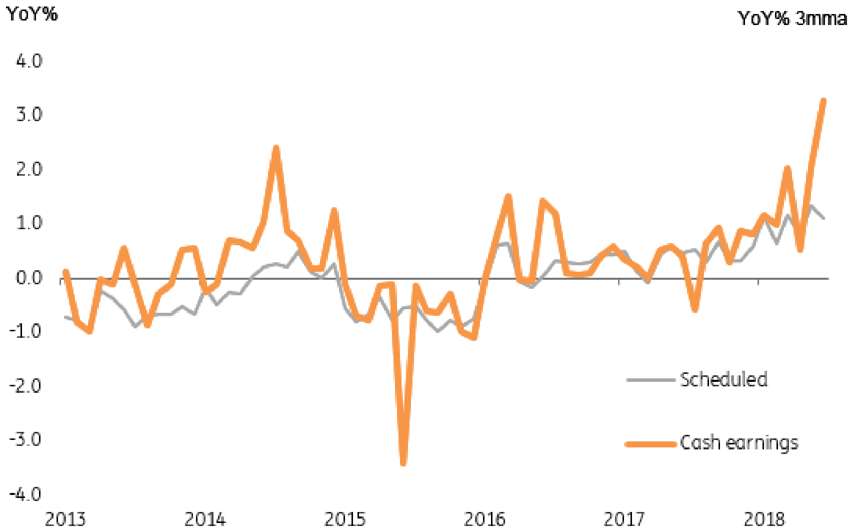
If the Bank of Japan (BoJ) did not have such an unrealistic inflation target (2.0%), and therefore didn't have to spend so much time, and let's face it, so much money, trying to achieve the unachievable, we would look at Japan's economy right now and conclude that the BoJ and the government were doing a decent job.

The labour market is tight, and spending and wages are growing well

An unemployment rate of only 2.5% is a very good figure, with rising labour force participation the main reason behind last month's slight uptick. Match this with further gains in cash earnings, now running at 3.0% year on year, a rate that is good by any G-7 standard, and the outlook for consumer spending looks robust, and, importantly, sustainable. This is no debt- fuelled spending binge.

And it isn't just consumer spending that is motoring. Business investment has also picked up strongly. The 2Q18 figure for business investment of 12.8% YoY, or 14.0% YoY excluding software, is a noticeable pick up from the low single digit growth recorded in 1Q18, and almost double what analysts had expected.

Japanese cash wages - up, up and away



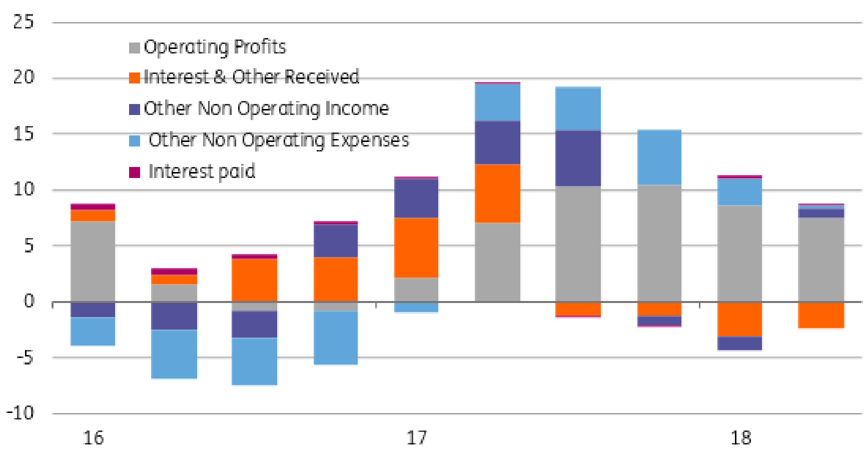
Source: Bloomberg

2Q19 GDP could well be revised higher from an initial 1.9% annualised rate

Put this all together and you have all the makings of a decent upgrade to the initial 2Q18 GDP figure of 1.9%. We are pencilling in 2.4%, but a figure closer to 3.0% can't be ruled out.

Helping all this along is the backdrop for corporate profits. These have slowed since their end-2017 peak rate, but that was always to be expected. And the rate of growth now, though more moderate, looks steady, and remains supportive.

Profit growth slowing, but remains positive



Source: Bloomberg

Abe likely to win LDP top job again

The decent macro backdrop plays into the hands of Prime Minister Shinzo Abe, who is standing for re-election as LDP leader. He is viewed as likely to get it, as his likely opponent, Ishiba reportedly lacks a sufficiently strong party backing to oust him.

Inflation is still low, but then it should be

Headline inflation is a touch higher at 0.9% YoY, but this is almost entirely food, and energy. Strip these out and inflation remains insignificantly above zero at 0.3%. This is only a "problem" because the inflation target has been set at 2.0%. Were it, more reasonably, set closer to zero, then monetary policy would not have to waste resources purchasing assets and distorting market prices in pursuit of the unachievable.

BoJ policy remains contorted

BoJ policy continues to say one thing, whilst delivering another. The recent "dovish' forward guidance on BoJ policy lacks any credibility given the slowdown in asset purchases of the last year. And the one-off increase of purchases during normal market operations was no more than a check on rising yields which are now consistently trading above 0.1%. This should not be viewed in any way as a change in policy direction. The net purchase of assets in the coming quarters will likely be smaller, not larger than in recent quarters.

Indeed, as the BoJ slowly extricates itself from its official asset purchase commitments, benchmark yields could rise still further.

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China: Ready to strike back

China is gearing up to respond to an expected escalation in US trade agression. Counter-measures against US exports and US business interests look likely, while fiscal and monetary stimulus aims to support the Chinese economy

The first train linking China and Kazakhstan is a boost to the Belt and Road initiative

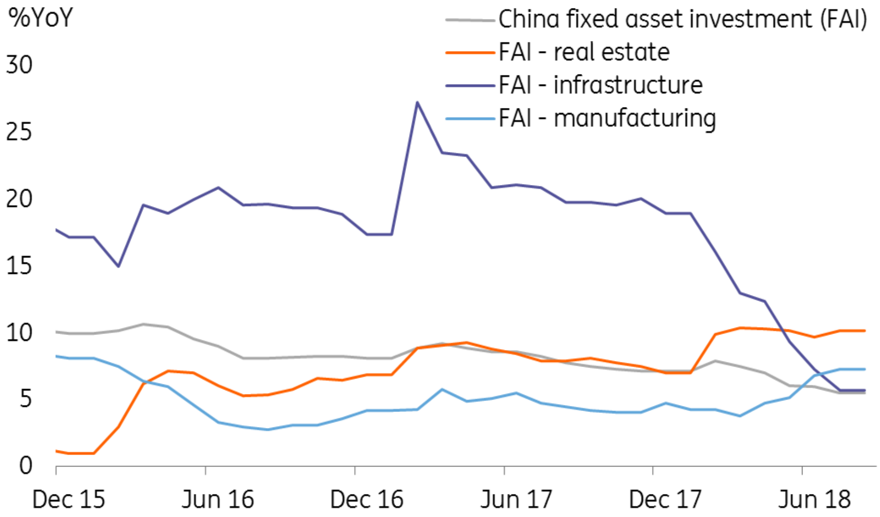
Trade war with the US likely to escalate

On 3 August China's Ministry of Commerce announced a $60 billion list of goods on which to impose tariffs ranging from 5% to 25%. This came after US President Trump said he would increase the tariff rate on the next $200 billion of goods to be hit from 10% to 25%. Together with the US's previous tariffs on $50 billion of Chinese exports, this would mean nearly half of China's exports to the US are covered by tariffs. This will have a major impact on China's export, manufacturing and logistics sectors, and therefore the economy as a whole.

China's retaliatory tariffs will not be enough to match the US like-for-like because China imports much less from the US than it exports. For this reason, China is very likely to impose qualitative retaliation (behind the border obstacles than make it more difficult for US companies to compete in Chinese markets) when the US imposes the next tariffs in order to fully match. The form that qualitative retaliation will take is uncertain, and how harsh these measures will be is also not known. Qualitative retaliation is open-ended in nature, and could create much more uncertainty in the market than simple tariffs.

The Chinese response will depend on how far the US goes with its next round of tariffs. Negative feedback from US companies could pressure the US government to trim the list of goods hit by tariffs, and lower the rate imposed. In that case, China would not retaliate as harshly and the dynamic between the two sides might change for the better. This may lead to risks subsiding gradually.

Chinese fixed asset investment



Source: Bloomberg

Support measures to help the domestic economy

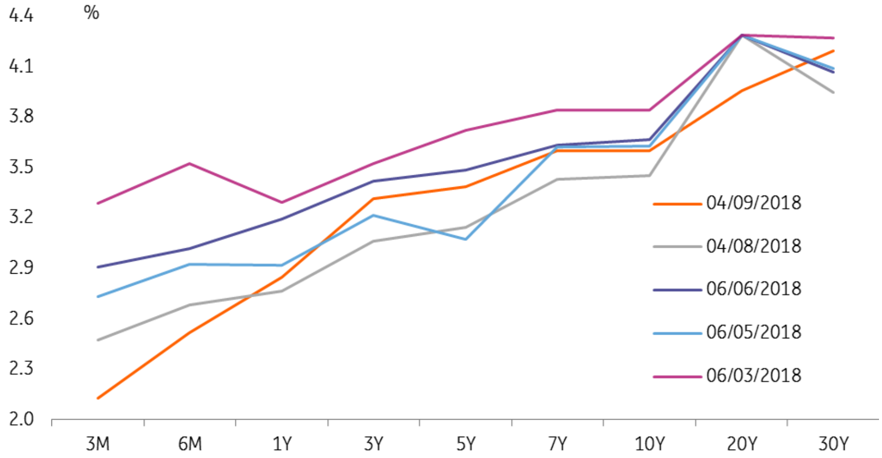
China has put fiscal stimulus and monetary easing in place in order to offset the damage from trade war as much as possible. The front end of the sovereign curve has fallen, suggesting that risks in the Chinese economy are rising.

The State Council announced a CNY2.6 trillion fiscal stimulus package in August, and has also requested that local governments prepare a pool of backup infrastructure investment projects. Fiscal stimulus could increase to CNY5 trillion in 2H18 with another CNY5 trillion in 1H19, particularly if this has to offset the negative impact from the full $200 billion in added tariffs should the US carry out its threats in full. For China's leaders, keeping manufacturing activities stable so that jobs are secured is a key priority.

In addition, the Chinese central bank (PBOC) has eased liquidity and guided interest rates lower. Liquidity is ample, with a net injection of CNY195.5 billion from the Medium Lending Faciities in August. 3M SHIBOR has fallen from 4.155% at the end of June to 2.878% on 4 September. We expect a targeted required reserve ratio (RRR) cut of 50 bps in October in order to direct liquidity to smaller enterprises and so avoid a liquidity crunch as the export environment deteriorates.

The central bank has also restarted the counter-cyclical factor in the USDCNY daily fixing mechanism which, together with the 20% reserves on short yuan forwards, has slowed the yuan's depreciation.

Chinese sovereign yield curve



Source: Bloomberg

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