

In case you missed it: Dovishness all over again

US jobs miss forecasts cementing market expectations of a slowdown, and if the Fed cuts rates, the ECB will probably follow suits as it is a smidge away itself. Elsewhere, we've revised our yuan forecast lower amidst President Trump's trade crusade as the damage from the trade war is set to make 2019 the worst year for trade since the financial crisis

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Disappointing US jobs report: A huge miss

While we were expecting jobs growth to slow down this time, few could have predicted such weak payroll numbers. The poor reading only cements market expectations for Fed rate cuts ahead



75,000

May increase in payrolls

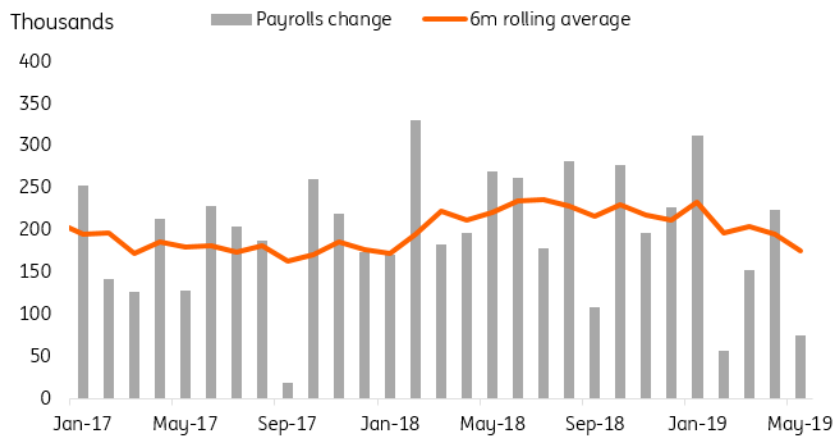
(Revised 224k in April)

Worse than expected

The latest US jobs report has done little to stem the wave of economic pessimism sweeping over markets. Jobs growth slipped to 75k, although importantly we think is more likely to be down to constrained supply rather than weaker demand for labour. Admittedly there have been one or two pockets of weakness – manufacturing employment growth has slowed in recent months, but in May, manufacturing growth barely moved from the previous month (slowed to 3000). However, we expect it to come under further pressure as production slows in the near-term

The manufacturing sector isn't immune from the wider skill shortage issue that has swept through the jobs market. The NFIB small business survey suggests that almost 40% of firms have positions they cannot fill, while these firms cite labour quality as by far their single biggest problem.

US monthly change in non-farm payrolls



Source: ING, Macrobond

In other words, a slower trend in jobs growth over coming months shouldn't necessarily be interpreted as a sign of emerging weakness. Importantly, there are broad signs that these supply constraints are gradually translating into higher wage growth.

Average hourly earnings missed estimates but still rose by 0.2% on the month and there are also signs are having to offer a broader range of incentives to retain/attract staff. The latest Federal Reserve Beige Book talked of firms using expanded benefits packages to improve retention.

In short, the latest jobs report still suggests the US economy is in relatively solid shape for the time being. With wage growth outpacing inflation and consumer confidence close to multi-year highs, consumer spending should continue to underpin overall growth during the second quarter.

But with rising concerns over where President Trump will take his trade war to the next stage, risks facing the economy are undoubtedly growing – albeit the 100bp of easing now priced in by the end of 2020 may be a little overdone.

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Fed easing and the dollar: Necessary, but not sufficient

There is a conviction that the Fed is going to have to cut rates to insulate the economy from trade wars. US rates are collapsing, but the dollar is holding up reasonably well. We suspect that is due to wide US yield differentials and uncertainty over overseas growth prospects. That said, expect defensive positions to build against the dollar



Source: Shutterstock

Markets are convinced the Fed will ease

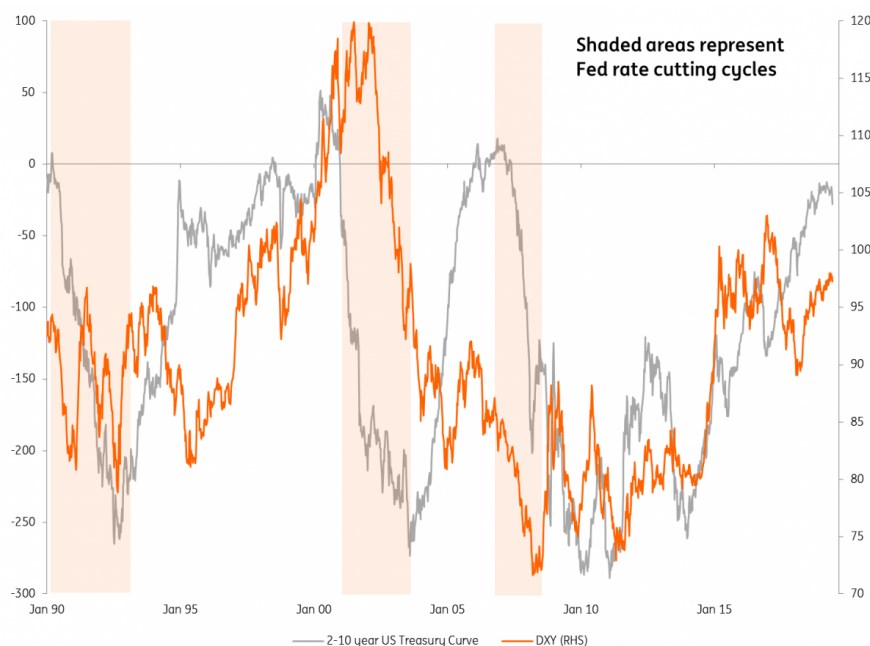
After all the discussion about whether the flat/inverted US yield curve portends the next US recession, it now seems the market is convinced that the Federal Reserve has to act. Beyond the aggressive pricing of Fed cuts (67bps by the end of 2019 and another 33bp by end 2020), we are starting to see a clear, bullish re-steepening of the US 2-10 year Treasury curve.

After all the discussion about whether the flat/inverted US yield curve portends the next US recession, it now seems the market is convinced that the Federal Reserve has to act

During the last three major Fed rate cutting cycles this curve steepened around 250bp as reflationary Fed policy filtered through the market. Typically a weaker dollar plays a role in reflationary US policy, but its decline is not always immediate. In particular, 2001-02 saw the dollar stay temporarily supported even as US interest rates crumbled.

What will it take to sink the dollar now? We think a dollar decline will have to come through two clear, but related channels: i) interest differentials and ii) growth differentials. The former drives fundamental FX hedging (corporates) and investment (FX reserve manager) decisions. The latter drives broader portfolio (debt and equity) allocations and at some point will pressure-test widening US deficits, commonly seen as the Achilles heel of the dollar.

Bullish re-steepening of the US curve is normally a dollar negative



Source: ING, Bloomberg

When will yield differentials hit the dollar?

Despite the material decline in US Treasury yields and the US – G10 FX rates spread, dollar losses have been fairly muted. The dollar is down by 1.1% against G10 FX basket (equally weighted) and 0.9% against the euro since 27th May (with UST yields down by 38bp). The limited reaction of the dollar here is partly explained by the historically low correlation of the dollar crosses to the interest rate differential. This phenomenon has been in place for the past few quarters.

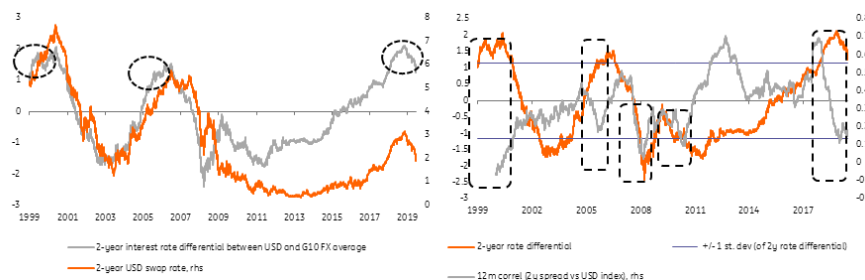
In our view, the low correlation of USD crosses towards interest rate differentials is currently due to the simple fact that US rates are still significantly above those of its peers

In our view, the low correlation of USD crosses towards interest rate differentials is currently due to the simple fact that US rates are still significantly above those of its peers. Even though US rates have fallen, the differential remains very high which in turn reduces the need for investors to rotate from the still high yielding dollar. For the private sector, it means that it is still too expensive to hedge US investments and USD receivables. For FX reserve managers, US 2-5 year yields are still well above those available in other high-grade sovereigns.

In the right-hand figure below we show that when the USD-G10 FX interest rate differential reaches extremes versus its historical standard deviation bands, the sensitivity of the dollar crosses to it declines. As per above, if the rate differential is too high, even a decent decline (from a very high starting point) doesn't make it attractive for investors to rotate meaningfully out of the USD. Equally, when the rate differential is substantially negative, even some marginal increase in the dollar's favour is not meaningful enough for investors to go long USD.

We estimate that the market would have to price in one more (independent) 25bp cut by the Fed (while keeping interest rate expectations for cuts for the G10 peers unchanged) for the current rate differential to fall into the one standard deviation band and two independent cuts for the rate differential to be comfortably within this band. Only then is the dollar likely to react more meaningfully (on the negative side). This suggests then that the bar for a more meaningful USD decline remains high, at least from the rate point of view.

USD yield differentials narrowing, but still near extremes



Source: ING, Bloomberg

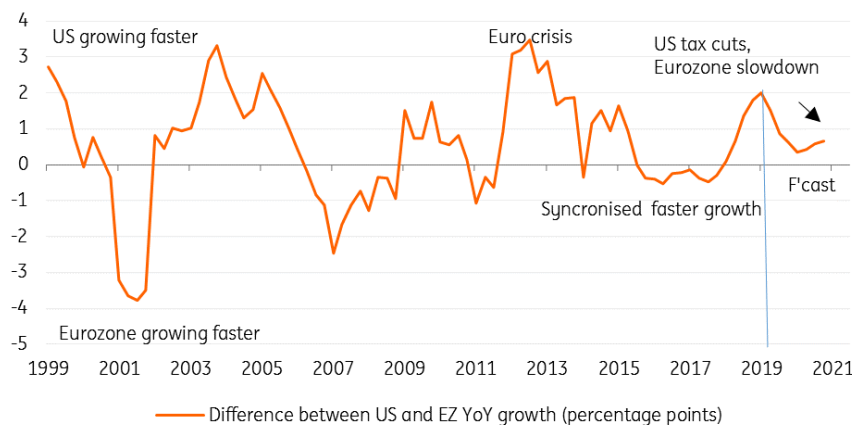
The jury's out on growth differentials

As we highlighted in early May, [5 Reasons why we're medium term EUR/USD bulls](#), we feel growth differentials will turn against the dollar over the next couple of years. Yet the conviction levels on this story right now, especially US versus European growth, are low given the nature of the current shock - trade wars - and the eurozone being a very open economy (one of the most open in the G10 FX space). This and the delicate position in European politics - think Italy and Brexit suggest the EUR will struggle to fully participate in a dollar decline - even if the Fed were to deliver an early easing cycle.

Our eurozone macro team also highlight the risk of the [Eurozone's 'Japanification'](#), which may limit the ECB's scope to hike rates. This recalls the events of 2000-2001 when fears over 'eurosclerosis' prevented EUR/USD from immediately participating from the collapse in dollar rates as the US Dot Com bubble burst.

For this reason, we're in no hurry to revise our end 2019 EUR/USD forecast of 1.15.

US versus Eurozone growth differential: peaking?



Source: ING, Bloomberg

Defensive positions against the dollar

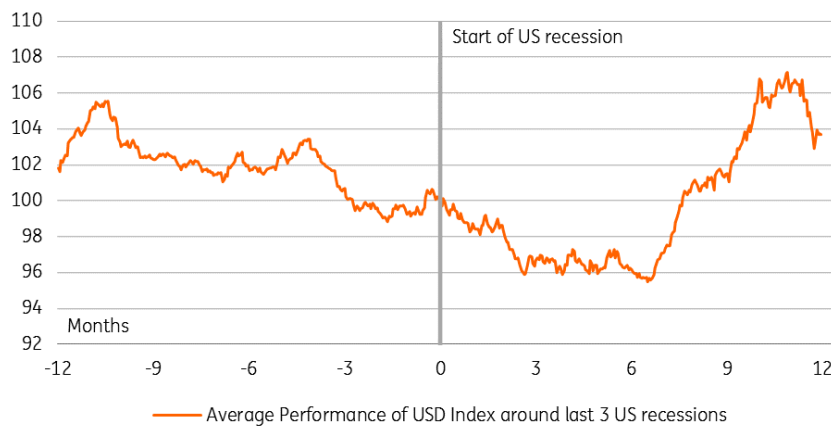
Even though short term US interest rates already deeply discount a Fed easing cycle and may not go that much lower in the short term, we still expect the market to adopt defensive positioning against the dollar. We say this because our [trade team's baseline view](#) is that the US trade war with China and the EU will escalate over the next three to six months. We suspect that means that US recession fears will build.

Given the risks, we expect investors to increasingly look to express a bearish dollar view via USD/JPY. Also expect the CHF to remain in demand

If the above is indeed the case, investors will want to position defensively against the dollar. In particular, historical analysis of the USD trade-weighted index performance around the last three recessions (1990, 2001 and 2008) suggests that - on average - the greenback peaked around 11 months before the start of the economic downturn. Then, the dollar index gradually decreased in value and bottomed around seven months into the recession. As noted above the dot-com bubble crisis in 2001 represents an exception.

Given the risks, we expect investors to increasingly look to express a bearish dollar view via USD/JPY. That means USD/JPY could be trading at 100 far earlier than the late 2020 window in our current forecasts. We also expect the CHF to remain in demand - especially if the risk of Italian elections and auto tariffs emerge this autumn. This will keep the Swiss central bank busy intervening to hold EUR/CHF above 1.10/11, but could see dollar pessimism evolve into a preference for short USD/CHF positions should EUR/CHF surprise the market and break under 1.10.

USD index performance around last three US recessions



Source: Bloomberg, Fed, ING

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ECB: Dovish vehemence from Vilnius

Dovishness all over. With today's meeting, the European Central Bank is, in our view, only a small economic slip away from a rate cut



Source: Shutterstock

At its meeting in Vilnius, the ECB today clearly tried to convey a dovish message to financial markets, demonstrating its willingness and readiness to act. Today's meeting was as dovish as it can get without actually engaging in new action.

The ECB's concerns mainly seem to be driven by increased and prolonged uncertainty, rather than the fear of an imminent collapse of the eurozone economy. In fact, the ECB's macro-economic assessment remained relatively unchanged. The latest round of ECB staff projections (to be accurate, from the eurosystem staff) showed only minor changes compared with the March projections.

- The growth outlook for 2019 was even revised upwards to 1.2% (from 1.1%), while the 2020 and 2021 forecasts were slightly lower than in March, now at 1.4% (from 1.6%) and 1.4% (from 1.5%).
- As regards inflation, there were also hardly any changes, with headline inflation now expected to come in at 1.3% in 2019 (from 1.2%), 1.4% in 2020 (from 1.5%) and 1.6% in 2021 (unchanged).

In sum, the staff projections did not actually provide sufficient room to act. Instead, ECB President Mario Draghi explicitly cited prolonged uncertainty, noting in the press conference that the trade

conflict and Brexit have not disappeared as quickly as the ECB had hoped in March. In fact, these uncertainties are here to stay for much longer, according to the ECB.

Against this backdrop of increased and prolonged uncertainty, the ECB today decided to:

1. Push its forward guidance on interest rates to “at least through the first half of 2020”, from “at least until the end of 2019”.
2. Offer a new series of cheap loans for banks (TLTRO III) at 10 basis points above the main refinancing rate (currently 0.1%) and 10 basis points above the deposit rate for banks reaching an ECB benchmark for net lending similar to the one in the previous TLTROs (this rate would currently be -0.3%).
3. Finally, the ECB definitely shelved the issue of a tiering system for the deposit facility for the time being, stating that the “positive contribution of negative interest rates...is not undermined by possible side effects on bank-based intermediation”. Still, this discussion is not entirely dead. The ECB will continue to monitor it carefully and Draghi kept the door open, pointing to the possible necessity of a tiering system in case of changed (rate) circumstances.

Enshrining the legacy

An interesting aspect of today's change in forward guidance is that it will actually bind Draghi's successor to continue with his legacy for almost a year, at least. This was definitely not the main goal of today's decision but the Governing Council committed any next president to its current monetary policy. There will be no reversal of monetary policy like in 2011 when Draghi started his term.

Fierce determination to act

The most important part of today's meeting came during the Q&A session when Draghi repeated several times the ECB's readiness to act “if adverse contingencies were to materialise”. The surprise moment was when he reported that the ECB today actually discussed options like rate cuts and restarting quantitative easing in such a scenario. According to Draghi, no one should have doubts about the ECB's policy stance.

Only one economic slip away from a rate cut

All of this means that the ECB has joined the choir of global central banks which have either already delivered new easing measures or are contemplating them. In fact, the ECB is now only a fraction away from new stimulus. It's not their preferred option but it will probably only take a small economic slip for the ECB to cut rates.

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Article | 6 June 2019

EUR & ECB: Ready to offset the possible dovish Fed

Despite the lack of explicit action, the European Central Bank (ECB) got as close as it gets to an interest rate cut. This means that if the Fed starts cutting, the ECB will likely do too. Hence, calling for an imminent and pronounced EUR/USD upside may be premature



Source: Shutterstock

As close as it gets

While President Draghi could not deliver a clear and explicit dovish bias due to the lack of a meaningful change to the eurozone (EZ) growth and inflation ECB staff forecasts (note that the ECB staff projections did not fully capture the recent deterioration in the global trade war outlook due to the cut-off date), the signal was very clear. In our view, the ECB is as close as it gets to an interest rate cut (see [ECB: Dovish vehemence from Vilnius](#)). If the Fed is in a situation whereby it needs to cut interest rates (largely due to the trade war effect) it is likely that the ECB will deliver interest rate cuts as well.

ECB ready to cut rates...

Should the global trade wars intensify by the end of June (ie, the US imposing tariffs on all Chinese exports) our economists don't rule out an ECB cut already in the July ECB meeting (a modest cut of 10bp) before a tiering system is introduced in September (as the ECB will need more time to come

up with details of the system) and an even larger cut being delivered then should it be necessary. This all can happen before President Draghi leaves office (his last meeting is in October).

... at least partly offsetting the Fed

This suggests that any immediate upside to EUR/USD can be fairly limited even if the Fed starts the easing cycle (which still remains a big if) as (a) already plenty of easing is priced in for the Fed for this year (close to three 25bp rate cuts); (b) the ECB may follow and deliver further easing via a modest outright cut first and then more meaningful cuts with the tiering system. This means that one central bank's dovish bias can be (at least partly offset) by the other's. Hence, the lack of a sustained break in EUR/USD above the 1.1300 level today and the turnaround when President Draghi mentioned that some board members discussed cuts and quantitative easing (QE).

Calling for an imminent EUR/USD upside is premature

This suggests that calling for an imminent and pronounced EUR/USD upside break from here may be premature as the ECB is unlikely to stand idle if and when the Fed eases. Moreover, as will be the case for the US growth, the eurozone economy will be also affected by the trade wars given the very open nature of its economy (one of the most open in G10 FX space). And there is still President Trump's decision on the EZ auto-tariffs to be made. As per [World trade heading for the worst year since 2009](#), our trade team believes the auto-tariffs will be imposed in 4Q19, which also limits the EUR/USD upside potential as this would be a clear negative for the eurozone economy.

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China: Revising yuan lower but 7.0 should hold

We are revising our USD/CNY and USD/CNH forecasts to reflect expectations for a weaker yuan. This is a result of the rising tensions between China and the US over trade and technology. However, we don't expect the currency pairs to pass through 7.0. Here's why



Source: Shutterstock

Our yuan forecast has been hit by the technology war

Back in April, we thought trade negotiations were progressing well. We were wrong. China has since demanded a revision to the terms of the draft trade deal which it says are "disrespectful" to China. This move has rocked the market globally.

USD/CNY jumped from 6.7349 at the end of April to 6.7915 at the open of the first trading day in May. This change of sentiment means the yuan is going to depreciate rather than appreciate for the rest of the year.

China also wants to leverage the yuan's depreciation, showing that it does not intend to appease the Trump administration, which has urged Beijing to stabilise the value of the yuan.

Letting the USD/CNY or USD/CNH pass 7.0 is playing with fire

While we do expect the yuan to depreciate, we need to answer the big question of whether the USD/CNY or USD/CNH will pass the key 7.0 mark.

We believe that the yuan exchange rate will not be allowed to touch this level as this would create considerable turmoil in onshore asset markets. We believe that the central bank will prevent this from happening.

If the People's Bank of China were to let the USD/CNY pass 7.0 tomorrow, this would result in a depreciation of 1.33% in a single day. Exporters wouldn't receive more orders simply because their product unit price is 1.33% cheaper, so this move wouldn't make a significant impact on exports.

However, letting the USD/CNY pass through 7.0 has the potential to lead to considerable volatility in the onshore equity market, similar to what followed the sudden exchange rate liberalisation event in 2015. Since the collapse in 2015, the A-share index has not returned to its high of 5,353 points and closed at 3,632 points on 3 June 2019.

As the trade and technology war escalates, Chinese policy makers are likely to aim to dampen uncertainty to the market. As such, we rule out any scenario of USD/CNY and USD/CNH passing through 7.0 unless tensions ease to a level where there is no longer any threat of a trade or technology war, something we do not expect in 2019.

Revising yuan forecasts

We are revising our USD/CNY and USD/CNH forecasts to 6.90, 6.95 and 6.90 by end of 2Q, 3Q and 4Q 2019, respectively, from our previous forecast of 6.75 by the end of 2019.

We expect the central bank, PBoC, to stabilise the onshore yuan mainly through stabilising the daily fixing of the exchange rate, so as to send a signal to both onshore and offshore markets that the yuan is stable.

The spread between the onshore and offshore yuan, which is the difference between USD/CNY and USD/CNH, should not increase, as there are very few arbitrage channels for carry.

The spread between onshore and offshore yuan not large enough for cross border arbitrage



Source: ING, Bloomberg

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Germany: Horrible start to the second quarter

Disappointing April data from industrial production and trade suggest that the latest ECB's dovishness is justified



German industry had a disappointing start to the second quarter. Both industrial production and trade fell in April, adding to the latest concerns that the eurozone's largest economy will not be able to maintain its growth pace of the first quarter of the year.

Industrial production fell by a sharp 1.9% month-on-month in April, from 0.5% MoM in March, the first drop since January this year. On the year, industrial production was down by 1.8%. Production in all sectors dropped, except for activity in the construction sector.

At the same time, German exports (seasonally and calendar adjusted) fell like a stone, dropping by 3.7% MoM in April, from 1.6% MoM in March. Imports decreased by 1.3% MoM, from 0.4% MoM in March. As a result, the trade balance shrank to €17.94 billion in April from €22.6 billion in March.

Two data points - one story

Let's be clear, this is a horrible start to the second quarter for German industry, as global trade tensions as well as temporary problems in the automotive sector and chemical industry have left their marks. One-off factors should have disappeared by now and even turned into temporary positives. Yet the experience of the last few years shows that there is almost always another

disruptive one-off factor waiting around the corner. This means that industry will continue to fluctuate between, on the one hand, low interest rates, high capacity utilisation and a strong need for new investments which eventually should be supportive and, on the other hand, disruption from trade tensions as well as structural changes in the manufacturing sector.

Despite the order book deflation since last summer, businesses still report filled pipelines of assured production. At the same time, however, another sharp increase in inventories brings back memories of last year and should curb the optimism.

The German export sector also continues to suffer from the trade conflict. But it's not all gloom and doom. Maybe it was hoarding in the run up to the first Brexit deadline but exports to the UK increased in the first few months of the year. In fact, German exporters almost sold as much to the UK as to China over this period. Also, the share of exports going to the US slightly increased though this could clearly be a two-sided sword as it shows how vulnerable the German economy is to possible US tariffs. At the same time, the weakening of the effective exchange rate since September 2018 should have partly cushioned the negative impact from global trade tensions. Currently, the effective exchange rate is below its 2018-level, providing some tailwind for exports in the months ahead.

Down but not out, yet

Looking ahead, the past has often shown that a single month is clearly not a good illustration of German industry or the entire economy. The April data could even be partly distorted by seasonal effects. However, there is no doubt that the German economy had a disappointing start to the second quarter, justifying the European Central Bank's new dovishness. It now needs even stronger domestic demand and a bounceback in May and June to avoid a return to recessionary territory.

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Italy: Debt-driven excessive deficit procedure recommendation: take two

The move from the EU Commission, which did not come as a big surprise, will now force a clarification between the Italian government stakeholders on the future attitude towards Europe. Should a compromise not be reached, chances of a September political election would likely shoot up



Source: Shutterstock

EU Commission recommends debt-driven excessive deficit procedure against Italy

After the exchange of letters between the Italian government and the EU Commission, the latter decided earlier today to recommend the opening of a debt-driven excessive deficit procedure against Italy for the 2018 divergence.

Commission report provided details, casting doubts on 2019/2010 developments

This was circumstantiated in the preannounced EU Commission Report prepared ex Art 126(3) of the Treaty. While acknowledging that Italy complied with the deficit criterion, the Report highlights

that this was not the case for the debt criterion. According to the Commission, the ample 7.8% gap recorded in 2018 will not be filled in 2019 and 2020, based on both the Italian Stability Programme, and, by a wider margin, on the Commission's own projections.

The Commission imputes the projected increase in the debt/GDP ratio to the combined effect of lower-than-projected primary surpluses and on the projected shortfall in privatization proceeds. The Commission does not see big risks to short-term debt sustainability, but its assessment of medium- and long-term sustainability has them deteriorating. According to the report, primary surpluses in the area of 3.2% of GDP will be needed to stabilize the debt/GDP ratio in the long run. The recent "quota 100" initiative, meant to temporary allow for earlier age retirement access is also seen as a problem, accentuating already high age-related expenditure.

Relevant factors assessment overall failed

When delving with so-called relevant factors, ie, factors deemed relevant from countries under scrutiny for a comprehensive assessment of compliance with the deficit and debt criteria, the Commission report is relatively negative.

Using notified data, the Commission deems the 0.1% of GDP deterioration in the Italian structural adjustment in 2018 as falling short of the 0.3% adequate structural effort. Furthermore, the Commission sees a high risk of deviation from the adjustment path towards the medium-term budgetary objective also in 2019 and in 2020.

While acknowledging that the economic slowdown recorded by Italy over 2H18 can be argued as a mitigating factor together with the negative impact of low productivity on potential output, the limited progress (or even some backtracking) on the reform front are seen as only partially addressing the 2018 Country-specific recommendations.

What next?

Article 126 of the Treaty indicates that the Commission proposal will now be examined by the Economic and Financial Committee (EFC), which will have two weeks to decide whether to back or not back the Commission's assessment. Should the EFC agree on the assessment, the Commission could then address an opinion to Italy and inform the EU Council. The next EU Council meeting of 20-21 July might then offer PM Conte the opportunity to discuss the issue. The final decision on a formal opening might be taken by the Ecofin on 9 July.

Different openness to a constructive approach to the EU Commission, for the time being...

As it has often been the case since the start of the recent European elections campaign, today the leaders of the government parties, also vice-PMs, failed to speak with one voice. Di Maio, the leader of 5SM, complained that Italy had been treated unfairly by the Commission, but added that Italy wanted constructive talks with the EU Commission over its budget. Salvini, the leader of the League, seemed less open to a compromise. In a Facebook post he wrote that the only solution to reduce the debt was by cutting taxes via a flat tax and allowing Italians to work more, adding that cuts, sanctions and austerity had pushed up debt, poverty and unemployment.

...but a tight calendar might soon impose full disclosure

Apparently, PM Conte's Monday televised appeal for the two government stakeholders to reconcile and focus on the implementation of the government contract has not played out, as yet. In his speech, he had clearly said that he was not willing to break European rules so long as these existed and had sounded cold on the flat tax proposal, preferring instead the idea of a comprehensive reform of the tax system. Today, after the EU Commission's decision, PM Conte re-stated he is aiming to have constructive talks with the Commission on the realization of 2019 budget objectives, and might yet manage to avoid the formal opening of an excessive deficit procedure against Italy. The big question mark is whether Salvini will accept a negotiating strategy or not. If not, he might be forced to take the initiative and pull the plug from the current government. A decision in this sense after the 9 July Ecofin might be compatible with fresh political elections in the second half of September.

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World trade heading for the worst year since 2009

The strong setback to world trade growth at the end of 2018 and the damage from the trade war will make 2019 the worst year for trade since the financial crisis, with only 0.4% growth. 2020 is likely to show growth around 2%, but that improvement could vanish if the trade war drags on in 2020



Source: Shutterstock

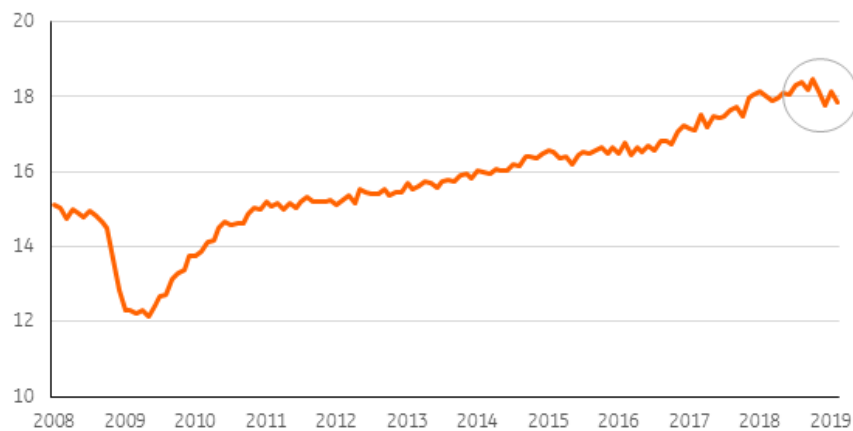
Uphill battle

The outlook and this article were updated on Monday the 10th of June to include the effects of the US - Mexico migration deal.

World trade is fighting an uphill battle in 2019. During the last two months of 2018, global trade levels dropped more than 3%. An economic setback in the world's largest (trading) economies and plunging confidence among investors led to the largest fall in trade volumes since the global financial crisis.

A rough start for world trade in 2019

World trade volumes in 2010 USD (trillion)



Source: CPB, Netherlands Bureau for Economic Policy Analysis

World trade volumes in 2010 USD (Trn)

Trade will adjust

The latest data shows that the volume of world trade in March was still lower than average trade levels in 2018. This means that global trade volumes still have quite some catching up to do in 2019 before the year to date volumes match those of last year. This feeding through of the setback in late 2018 strongly limits the upward potential of trade growth this year.

1Q19 has shown better than expected economic growth in the US, the eurozone and China, but so far this has hardly translated into higher growth for world trade. However, we expect trade levels to adjust to higher levels of GDP and industrial production. The growth of industrial production has been negative in some parts of the world during the first few months of this year but not everywhere. Global industrial production has been well above 2018 levels, indicating that there is ample room for trade to do some catching up.

March showed the first step in that direction and time charter shipping rates suggest that this continued in April and May. After the catch-up process is completed, we expect the economic cycle to support trade volumes in a way that would result in 'normal' (five year average) month on month growth rates. This would result in trade growth of 1.2% in 2019.

However, if we consider the ongoing negative effects of the US-China tariff hikes in 2018, the effect of the latest tariff hike by the US and the retaliation from China, trade growth will come down to 0.6%, assuming a status quo for the rest of the year regarding the trade war.

We expect the upward influence of the economic cycle on trade in 2020 to be roughly the same as in 2019, which would result in world trade growing by 1.7% next year. Taking into account the feeding through of the tariff hikes of 2019, trade growth would be 1.6% in 2020.

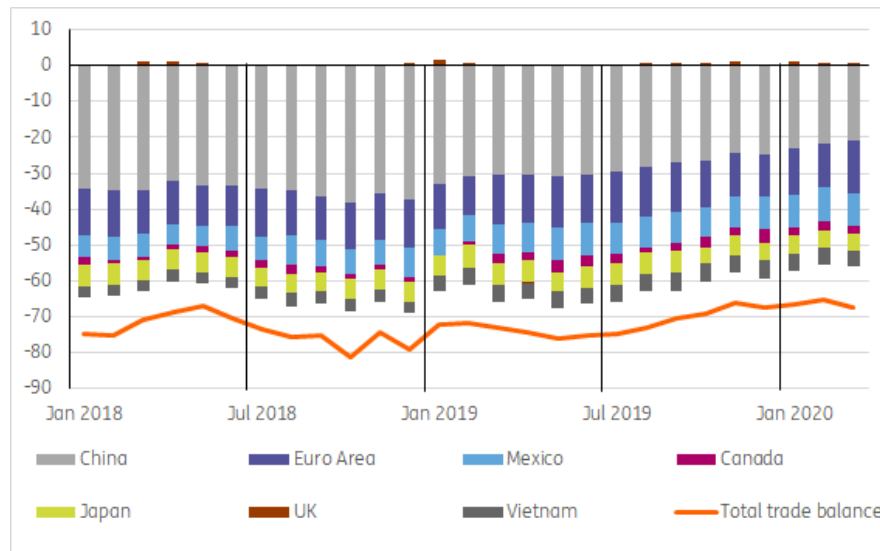
Trump will hike tariffs again if trade partners don't give in to his demands

But, what is likely to happen next in the ongoing tit-for-tat trade war? Additional tariff hikes on US imports from China and imports from other trade partners, like Japan and the EU, are a serious possibility, given recent events.

It is hard to forecast how the trade war will play out exactly. We present three scenarios and attribute a somewhat higher probability to scenario 2 than 1 and 3.

Container ship rental prices bottoming out

Index, October 2018 = 100



Trade war in 2019 and 2020

After a couple of months in which the trade conflict appeared to de-escalate, tensions fired up again in early May this year. President Trump's decision to hike tariffs on the \$200 billion package of goods, his threat to extend higher tariffs to all US imports from China, and the retaliation and tougher public stance of China, have all unnerved the financial markets. The boycott of Huawei, postponed or not, could turn the trade war into a broad business war with China.

Last week, Trump added a whole new chapter in his attack on free trade by announcing import tariffs on all imports from Mexico if the country does not curb the flow of immigrants to the US. The President threatened to impose a 5% tariff this month and to increase the pressure by raising it with monthly increments of 5% to 25% in October. These tariffs seem off the table for now, since a deal between the US and Mexico has now been reached.

By scrapping the tariffs on steel and aluminium for Canada and Mexico to get his deal through Congress, President Trump has shown that he is willing to compromise. And the fact that the President decided to postpone the decision about higher import tariffs on cars by six months shows that he is open to negotiation.

At the same time, the US administration has made clear that, during these six months, it expects car exporting countries to agree on measures that will diminish their car exports to the US. As such, the US is still using the (threat of) tariffs to steer the EU, and other car exporters like Japan, into making concessions. So, while things are calm for now on this front, the risk of the US-EU and

US-Japan trade conflict escalating has not subsided.

This all fits into Trump's overarching strategy of trying to strong-arm trading partners to give the US better terms of trade.

Recent events show that there is a good chance President Trump will deploy his favourite policy tool again this year or next if China, the EU or Japan, don't give in (fast) enough to his demands. Although the President has said that the stock market is the barometer of his policy success, the negative response of the equity market to his decision to hike tariffs on Chinese imports did not stop him from deploying this weapon again last week. This indicates that President Trump is prioritising his top campaign promises, like getting better terms of trade for the US and reducing the inflow of illegal immigrants.

For calculating the effect on world trade in 2019 and 2020 of future developments in the trade war we take the second scenario. This suggests trade will grow no more than 0.4% in 2019 - the worst year since the great collapse of trade in 2009- and 2.2% trade growth in 2020.

Currently risks seem to be tilted to the downside. However, it wouldn't surprise us if President Trump would once again change his tone of voice, because he likes to play the game of 'blowing hot and cold'. That could lead to a more positive negotiation climate which would enhance cutting deals. After all, Trump plays tough but in the end he cannot afford to fail in negotiating better trade deals for the US.

1 Scenario 1: Deals with China, the EU and Japan without further tariff hikes

One possibility is that the recent tariff hikes and threats of (further) hikes by President Trump are enough to force China, the EU and Japan to enter into a deal with the US before the presidential elections in November 2020. Although the US administration's decision to raise tariffs to 25% on the \$200 billion package of Chinese imports has tainted the friendly negotiating climate to strike a deal, the economic damage caused by the hikes and the prospect of increasing damage if Trump carries out his threat to impose tariffs on all Chinese goods, is an incentive for China to make a few more concessions.

In this scenario, Trump considers the disadvantages of tariff hikes more so than he has done so far. Until now, he has emphasised that tariffs create jobs in industries like steel and aluminium and that tariff income is pouring in. But after the latest retaliatory tariffs from China, US industries and consumers will increasingly be hit by higher prices. Add to this that patience is running thin in the agriculture sector and other industries hit by retaliation, and the President may find himself under pressure to water down his demands and end the trade conflict.

In this scenario we expect the US to strike a deal with China by the end of 3Q19, scrapping half of the current tariffs immediately and a gradual phasing out of the remaining tariffs in 2020, provided that both sides live up to the agreement.

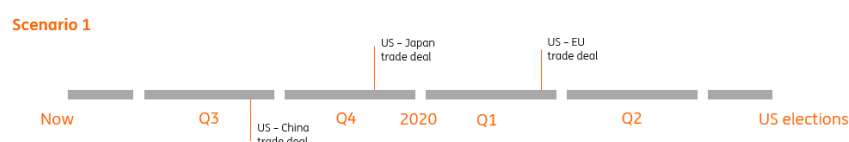
It's hard to gauge the exact content of the agreement but it's probable that China will at least agree to import \$70 billion more of American goods and commodities on an annual basis since they offered to do this at an earlier stage of negotiation. In this scenario, the deal also contains agreements about majority shareholdings of foreigners in Chinese companies and/ or joint ventures, better protection of intellectual property and concrete steps by the Chinese

government to prevent forced technology transfers from Western companies in joint ventures.

The concession of the US administration in this scenario could consist of no longer insisting that China let go of its ambition to be a world leader in certain tech markets.

This scenario of a relative quick ending of the trade war would limit the trade damage to 0.5% this year, resulting in world trade growing by 0.7% in 2019. The effect of the undoing of the imposed tariff hikes accelerates in 2020, which has a positive influence on trade of 1.0%. In this scenario trade growth would be 2.7% in 2020.

Timeline scenario 1



Source: ING

In this scenario, we think no car tariffs will be applied. The US strikes a trade agreement with Japan in the course of 4Q19. The US and the EU will strike a deal as well but it will take until the end of 1Q20 because the negotiations between the US and EU are lagging.

A deal on cars will be part of these agreements, probably by bringing EU import tariffs (10%) in line with the American ones (2.5%) over the course of probably three to five years. The US, in return, will reduce its import tariffs on pickup trucks (currently 25%) to EU levels.

A deal on cars with Japan will have to take the form of quantity restrictions to Japanese exports because import tariffs in Japan are currently not higher than the American (actually lower).

The US will, in this scenario, water down its agricultural demands and settle for a mutually executed study that looks into possible reforms of the Japanese and EU agricultural sector.

The positive of the agreements for both Japan and the EU will be that, as part of the deal, non-tariff barriers for industrial goods will be brought down by all parties. This increases the possibility to export to the US in the medium term. In this scenario, we assume that half of the non-tariff barriers for the \$220 billion trade between the US and Japan, will be lifted, which increases both US and Japanese exports by \$2.8 billion. This compensates Japan almost fully for the \$3.1 billion reduction of its auto exports to the US, which is the consequence of a deal on cars similar to that struck between the US and Japan in the 1980s when Japan agreed to 'voluntarily' restrain car exports to the US by 7.5%. The US, and world trade will have a net gain of \$2.8 billion because of its benefits from taking down half of the non-tariff barriers without having to lower its auto exports to Japan.

For world trade, the net gain is negligible but taking down half of the non-tariff barriers for US-EU trade delivers a gain of 0.1% for world trade, of which three quarters will materialise in 2020, bringing the gain for world trade of all the trade agreements in this scenario to 1% in 2020 (see table).

Trade war threatens to squash trade recovery in 2020

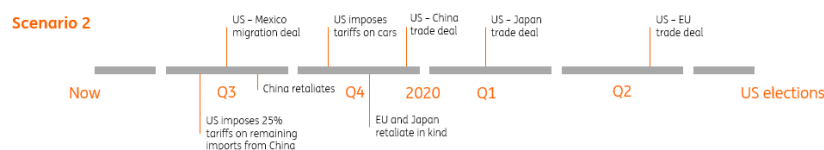
2 Scenario 2: Deals with China, EU and Japan after new tariff hikes

In this scenario, things get worse before they get better. China will initially stick to its current tougher (public) stance to show that it won't be bullied by President Trump. Only after the US imposes tariffs on all Chinese goods in 3Q and China retaliates- among other things by making it difficult for US firms to do business in China (border procedures, slower granting of permits, black listing, etc)- will both parties fully realise the consequences of this trade war.

It will take some words of reconciliation from President Trump and a willingness to attenuate some of his most far-reaching demands for the Chinese to be prepared to give in a bit more so that a deal can be struck. By saying recently that there is a "good possibility" of a deal, the President has made a start.

The content of the deal could be similar to what we've described in our first scenario, but we would probably have to wait, until the end of the year (4Q 2019) before a scenario like this ends up in a deal.

Timeline scenario 2



Source: ING

This scenario is also characterised by tariff hikes on US automotive imports from the EU and Japan before the US strikes deals with the EU and Japan. The trade conflict with the US will escalate first because, in this scenario, both the EU and Japan are likely to object to President Trump's condition that negotiations have to result in a net gain for the US. Moreover, the President's demand to bring the agriculture sector to the negotiation table will block a deal because opening up the agricultural markets is a very sensitive issue in Europe and Japan and at odds with the negotiating agenda that President Trump agreed with Jean-Claude Juncker last summer.

In this scenario, it will take until the end of 1Q before Trump secures a deal with Japan and one quarter longer to strike a deal with the EU.

The further escalation of the trade war leads to a larger impact on world trade growth in 2019 (-0.8%), meaning that world trade would only grow by a meagre 0.4%. There is some feeding through of this into the first part of 2020 but this is eventually overtaken by the positive effects of the unwinding of all the tariff hikes after the deals are struck, leading to a net positive effect on trade of 0.5% in 2020. This would bring world trade growth to 2.2% in 2020.

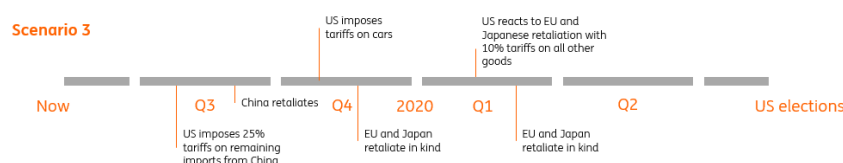
Scenario 3: Escalation without results: no deals with China, EU and Japan

In this scenario, it takes one quarter more for Mexico to come to an understanding about curbing the flow of illegal immigrants into the US.

The US steps up the trade war against China by applying the 25% tariff hike to all goods and escalates the trade conflict with the EU and Japan, too. These trade partners refuse to enter into a deal that is characterised by too few concessions from the US to compensate them for opening their agricultural markets. In this scenario, US import tariffs on cars will be hiked by 20 percentage points at the end of the six month delay period (mid-November), despite significant resistance within the US against the escalation of the conflict with traditional allies like the EU.

By holding trade partners at gunpoint repeatedly, Trump risks they get fed up and leave the negotiation table

Timeline scenario 3



Source: ING

In this scenario, the EU and Japan will retaliate in kind and China will respond as described in the second scenario. President Trump will react to this by levying a tariff hike of 10% on half of the other imports from Japan and the EU, followed again by retaliation in kind. No deal will be struck before the US elections in November 2020.

In 2019 the impact on world trade will be a bit worse because the conflict with China will be prolonged for another quarter. In 2020, scenario 3 continues to hit trade because tariff hikes, will bite more than in 2019. So we're likely to see a negative effect in 2020 of 1.1 percentage point on world trade in this most negative scenario.

In this scenario trade growth will be only 0.6% - almost five times less than in our first scenario where the trade war ends quickly.

World trade growth 2019 and 2020

Scenario	Trade war effect		Trade growth	
	2019	2020	2019	2020
Scenario 1	-0.5%	+1.0%	0.7%	2.7%
Scenario 2	-0.8%	+0.5%	0.4%	2.2%
Scenario 3	-0.9%	-1.1%	0.3%	0.6%
Average			0.5%	1.8%

Source: ING

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We were wrong on RBI policy, but for the right reasons

The shift in Indian central bank policy stance from 'neutral' to 'accommodative' doesn't mean there will be more rate cuts. Hopefully, the central bank recognises pipeline inflation pressures and stays put in the meetings ahead



Source: Shutterstock

Reserve Bank of India's new Governor Shaktikanta Das

5.75% RBI repurchase rate
25bp cut today

Another RBI rate cut - not quite what we expected

As expected by an overwhelming majority in the Bloomberg survey, the Reserve Bank of India slashed the key policy rate by 25 basis point for the third time this year, taking the repurchase rate to 5.75% and reverse repo rate to 5.50%. The central bank also changed its monetary policy stance from 'neutral' to 'accommodative' but there was no change to the 4.00% cash reserve requirement ratio for commercial banks.

We thought the RBI would see through the latest GDP slowdown recognising pipeline inflation pressures from food and fuel prices, a weaker currency and an excessively loose fiscal policy

We were a consensus outlier in our forecast of an 'on-hold' policy, partly based on our conviction that this is what we think the central bank should be doing rather than what it would necessarily do, given that the economy has had enough stimulus - two rate cuts earlier this year, plus significant fiscal boost from government's re-election bid.

We believed the RBI would see through the latest GDP slowdown recognising pipeline inflation pressures from food and fuel prices, a weaker currency and an excessively loose fiscal policy.

Does change of policy stance matter?

We think the RBI's easing cycle is now finally over, especially after today's rate cut and despite shifting the policy stance from neutral to accommodative. Also, the previous two rate cuts in February and April were despite the 'neutral' stance, which was changed from 'calibrated tightening' stance in the February meeting (the same meeting they in fact cut rates). Another rate cut with neutral stance might not have gone down too well, which is why we view today's shift in stance as nothing more than justifying today's rate cut decision.

If risks are 'broadly/evenly balanced' in India, why has the central bank changed the policy stance from neutral to accommodative?

However, we are reading today's RBI statement as recognising some inflation risk from 'a broad-based pick-up in prices in several food items', even as the statement points to weak domestic and external demand weighing down non-food items while muted passthrough of global crude price volatility keeps domestic fuel price in check.

The RBI has nudged its inflation forecast for the first half of FY19-20 higher to 3.0 - 3.1% from 2.9 - 3.0% but cut that for the second-half to 3.4 - 3.7% from 3.5 - 3.8% with risks broadly balanced. They've also lowered the growth forecast for the current fiscal year to 7.0% from 7.2%, again with risks evenly balanced, which begs the question - why change the policy when risks are 'broadly/evenly balanced'?

In our view, the RBI easing cycle is finally over

By the time, all these rate cuts and the fiscal stimulus come through the real economy over the next two quarters, the inflation genie is most likely to be out of the bottle.

We maintain our forecast for a rate hike in the second quarter of 2020

A weak currency and increasing tariff barriers are likely to encourage imported inflation, amid risks of supply shocks from food and fuel prices. Negative growth in agriculture GDP in the last quarter of FY18-19 doesn't bode too well for food prices, for which prospects also hinge on the monsoon season.

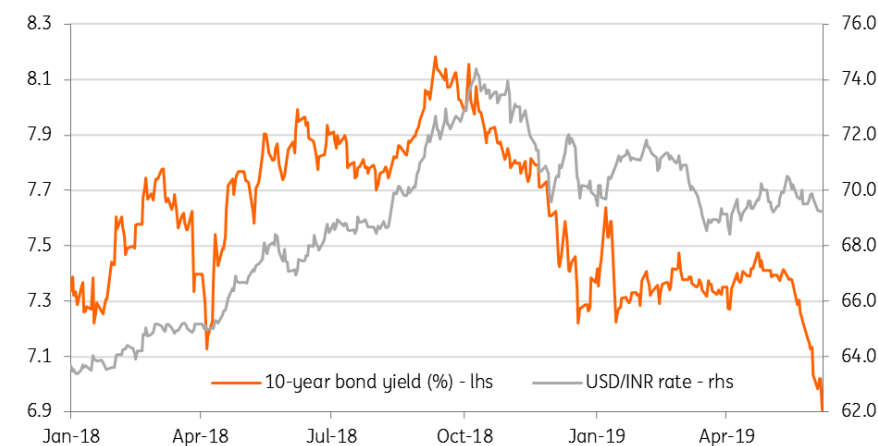
We continue to see inflation reaching the 4% mid-point of the RBI's target zone over next two quarters. Hopefully, the RBI will eventually see this as coming and leave policy on hold in the forthcoming meetings. Barring a prolonged slowdown in the economy and muted inflation in 2020, we believe the next move in the RBI policy rates would be higher.

We maintain our forecast for a rate hike in the second quarter of 2020.

What's in it for the markets?

Ideally, a widely expected policy decision should have no impact on markets, but we still think the recent strength of the government bond and the rupee is transitory. Besides potential inflation risk, the wide fiscal deficit and supply overhang from that on the bond market should make the yields sticky downward going forward.

A short-living rally in government bonds and INR



Source: Bloomberg, ING

As for the rupee, we think the market overbought the currency amid the euphoria of prime minister Narendra Modi returning to power for the second term. As for most emerging market currencies with a backdrop of twin deficits (fiscal and current account deficit), the external environment currently hasn't been friendly and it's unlikely to be so in the near-term as long as the trade war continues.

Moreover, with President Trump now shifting focus towards India, there will be more tailwind for INR depreciation going forward. We wouldn't be surprised if the currency re-asserts its recent status as an Asian underperformer in the days ahead.

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