In Case You Missed it: One year to go

One year to go until Britain leaves the EU, Italy's populist parties edge closer to forming a government and we highlight the investment proposition offered by Central and Eastern Europe. Here's our thinking

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Explore our new slide pack for our latest thoughts on Brexit negotiations, the UK economic outlook and the pound with one year to go

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Source: iStockphoto

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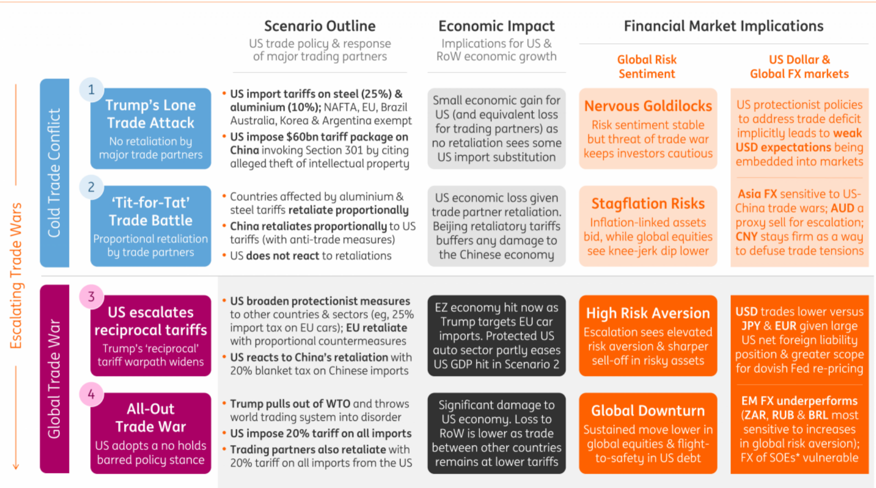
Trade Wars: Episode 1 - The Presidential Menace

Four scenarios for how trade wars could unfold and how costly a global trade war would be for major economies - as well as the implications for the US dollar and global risk sentiment

Key Messages

- For global market dynamics to transition from what we see as currently being a Cold Trade Conflict to a real Global Trade War, we need to see one of two things: (1) a broadening of current US protectionist measures to other countries/sectors or (2) the US administration reacting to any initial retaliatory tariffs from Beijing.
- Were an All-Out Trade War to break out, we estimate that the US will lose out most (-2.0% of GDP cumulatively over two years) – as US exporters would face higher tariffs at all borders, while the rest of the world continues trading with each other at prevailing trading arrangements.
- It is the signalling channel of US trade policy that has typically been the key driver for the USD in prior 'trade war' episodes. Protectionist measures implicitly signal the US administration's desire for a weaker USD – and such expectations are likely to be entrenched in FX markets until credibly broken

ING's Trade War Scenarios – Transitioning from a Cold Trade Conflict to a Global Trade War



Source: ING FX Strategy. *SOEs = Small Open Economies

ING's Global Trade War Scenarios: Four Degrees of Escalation

The Trump administration's decision to impose tariffs on US steel and aluminium imports and a $50-$60bn tariff package on imported goods from China – means that global trade policy has formally shifted into the realms of a protectionist world.

If countries that are hit do not retaliate to these initial US protectionist measures, the world is 'only' facing a **one-sided contained trade attack** (Scenario 1) - and not a trade war in our view. In this case, the economic effects are limited - with the Chinese economy hit the most (we estimate a cumulative 0.6% GDP loss over two years). If US imports from China, as well as steel and aluminium imports from a range of countries, are partly substituted by domestic production - we estimate that this could lead to a 0.3% increase in US GDP after two years.

Going forward, the immediate risk is whether trade partners seek to retaliate in equal and proportional measures – giving rise to some sort of **'Tit-for-Tat' Trade Battle** (Scenario 2). While reports suggest US and Chinese officials may initially be looking to take a more diplomatic approach, the reality of unsuccessful and challenging trade negotiations means the prospect of significant countervailing measures being imposed by Beijing – beyond the trivial $3bn retaliatory tariffs on imported goods from the US already announced – is fairly high.

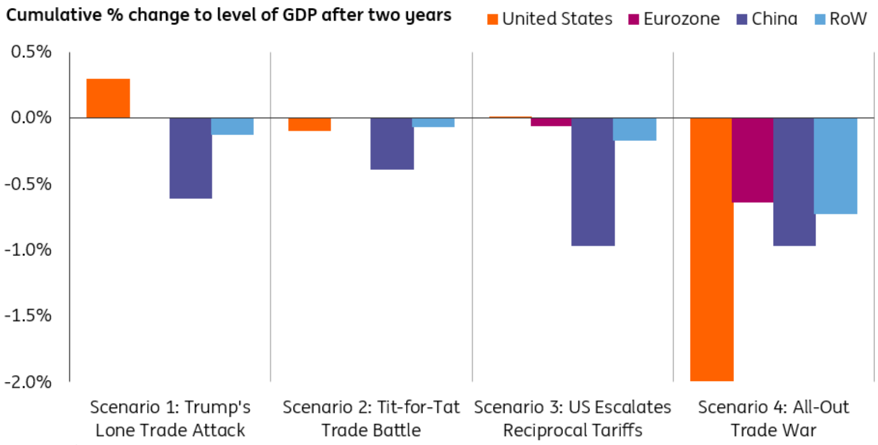
For global market dynamics to transition from what we see as currently being a **Cold Trade Conflict** (Scenario 1 or 2) to a real **Global Trade War** (Scenario 3 or 4), we stipulate that one of two forms of escalation must prevail:

1. President Trump steps up his 'reciprocal' tariff rhetoric by broadening protectionist measures to other countries and sectors (we see US imports of EU cars as the next potential high-level target)
2. The US administration reacts to any significant retaliatory tariffs from Beijing by imposing much harsher protectionist measures (we use the example of a 20% blanket tariff on Chinese imports).

Bold steps like these - which in conjunction we define as a **US Escalation of Reciprocal Tariffs** (Scenario 3) - could ultimately lead to the start of an **All-Out Trade War** (Scenario 4) in which all countries eventually impose a 20% import tax on all imported goods. A trigger for this could be major trading partners giving complete disregard to the international rules that currently govern global trade (and in this tail risk scenario, we assign a non-trivial risk to say the US pulling out of the WTO).

Were an all-out trade war to break out, we estimate that the US will lose out most (-2.0% of GDP cumulatively over two years) – because US exporters would face high tariffs at all borders, while the rest of the world keeps trading with each other at prevailing trading arrangements.

Estimated impact of trade wars on the GDP of major economies (4 scenarios)



Source: ING estimates

Political Economy of the Dollar: Protectionist US policies reinforce weak USD expectations

Mercantilist Trump: Back with a vengeance

US politics - and a narrower focus on what is set to be a close set of midterm congressional elections in November - has been a big element of the policy shift that we've seen in White House in recent months. Add to this the turnover of staff and the departures of globalists (Cohn and Tillerson) - and it's clear to see that the administration's mercantilist and nationalist 'America First' policy agenda is more than just a political show.

For President Trump to truly engage with the core voter base that effectively won him the election, actions may now have to speak louder than campaign rhetoric. As such, one should expect to see trade and foreign policies dominating the White House agenda in the run-up to the November midterm elections.

Political Economy of the Dollar: US protectionism reinforces weak USD expectations

In November 1978, one Paul A. Volcker - then President of the New York Federal Reserve - wrote an op-ed piece titled 'The Political Economy of the Dollar'. In it, he writes "the United States no longer stands astride the world as a kind of economic colossus as it did in the 1940's - nor, quite obviously, is its currency any longer unchallenged".

This seems somewhat fitting in the current environment. It's clear from the President's tweets alone - which have seen mentions of 'trade deficits' increase almost four-fold over the last quarter - that the US administration has narrowed its economic focus on reconciling the balance-of-payments deficit. However, recent trade policy announcements - and the imposition of tactical import tariffs on selected sectors and countries - shows that the White House is now willing to take a more proactive approach to address the US external trade position.

> *Protectionist measures implicitly signal the US administration's desire for a weaker USD - and such expectations are likely to be entrenched in currency markets until credibly broken*

The negative consequences for the US dollar are two-fold:

1. The willingness to impose actual protectionist policies - and the ongoing threat from the White House that more may be yet to come - means that US policy uncertainty remains high (and hence USD assets may trade with a discount in the near-term to compensate for this uncertainty)
2. The adoption of protectionist measures implicitly signal the US administration's desire for a weaker USD - and such expectations are likely to be entrenched in currency markets until credibly broken

Indeed, investors are probably finding it difficult to reconcile the case for a stronger US dollar with the Trump's administrations adamant focus to tackle the US trade deficit - especially in a 'gung-ho' manner that demands instant success. Equally, if it is the expectations channel that drives currency markets, current USD weakness is a sign that global investors are not convinced that US protectionist measures will be successful in tackling the US trade deficit (and therefore boosting US economic activity). Our empirical analysis shows that there is evidence justifying such expectations (the US economy loses out under a All-Out Trade War scenario). Equally, structural trade deficits do not get resolved overnight (or even over a Presidential term).

So, despite what standard textbooks may tell us about tariffs and exchange rates, we expect unilateral protectionist measures by the US to weigh on the dollar - with global investors loss of confidence in the US economic regime expressed through a diversification away from US assets. Were global trade war dynamics to escalate, we note the US dollar would face two additional channels of downside: (1) a repricing of US monetary policy expectations - where the 80bp of Fed tightening by end-2019 looks inconsistent with an environment where a global trade war is being played out and (2) a large US net foreign liability position (around $8 trillion) making the USD vulnerable any deterioration in the investment environment.

In such an environment, one would expect the dollar to underperform its relatively low-yielding, safe-haven currency peers like the JPY and EUR - both of which command a better net external foreign asset position and have relatively limited scope for any monetary policy re-pricing.

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One year on from Article 50, GBP remains the comeback kid of FX markets

The trade-weighted pound is up more than 5.5% and while the path to recovery has been gentle and bumpy, sterling's move higher is evidence of its undervaluation and an inverse relationship with Brexit uncertainty. Going forward, we expect GBP to continue on a path of recovery - with a 3-5% appreciation in the trade-weighted index

Source: Shutterstock

Shifting to a higher gear as Brexit transition verifies 'Comeback Kid' status

All the cards are falling into place for GBP/USD to post a bullish move to 1.45 in 2Q18 – which is where our conviction continues to lie**.** Looking at GBP's report card in March including Brexit politics, UK economic data and the Bank of England's (BoE) policy outlook have all turned into short-term positives for GBP – helping it to retain its status as the 'comeback kid' in FX markets.

We're now back to good old-fashioned data watching in the near-term – given that this will dictate the pace of GBP's cyclical recovery. Under the status quo on the global economic backdrop and trade wars are a big question mark here, it looks like a rate hike in May is a done deal.

Were the UK economy to regain some of its 'cyclical swagger' – and data outperforms the broadly low expectations of investors, we would expect sentiment for two BoE rate hikes in 2018 to gain further traction. This will be the cue for GBP to post another bullish move higher.

May rate hikes seems to be in the bag and GBP bulls are asking what next?

The question for GBP investors now turns to the pace of BoE tightening – which we suspect both economic data and Brexit progress will continue to dictate.

However, the two are not mutually exclusive. But for those thinking market expectations over BoE policy are too 'rosy', comments by policymaker Gertjan Vlieghe that we may see one or two rate hikes a year are the first real indication by a BoE official on the annual pace of policy normalisation and gives implicit support to a steeper UK rate curve and GBP remaining at current elevated levels.

Theoretically, there is now scope for the UK economy to surprise to the upside following the agreement of a Brexit transition. Lower economic uncertainty coupled with political stability may facilitate an environment where UK investment comes back online – and if sizable enough could see the UK shake off its status as one of the worst-performing G10 economies. Markets are underestimating this channel.

Short GBP on Brexit and UK politics has clearly been one of the biggest 'pain trades'

Whether it's Brexit fatigue, the Divorce and Transition Deal precedence of a last-minute agreement or 'FOMO' - the fear of missing out on a positive re-pricing of Brexit risks, the pound's relative resilience – noting the stability in EUR/GBP within the narrow 0.87-0.89 range – is quite telling of how investors may be less inclined to chase a negative Brexit headline. A continuation of solid UK economic data would offset any Brexit-specific risks. Such a trading environment was non-existent in 2017, where markets were largely taking their cue solely from Brexit progress.

The shift in positive GBP sentiment is still in its infancy – as real money investors have not broadly become 'bullish believers' just yet. GBP/USD speculative positioning is at a multi-year high (+12%) – though we note that there remains a large discrepancy between leveraged funds and asset managers. The latter group of investors remain structurally short GBP/USD (20% of open interest).

Every small-step of Brexit progress will see these structural shorts slowly unwind - and gives us greater confidence that GBP's cyclical recovery has room to extend.

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Central and Eastern Europe's FDI proposition: Ready, aim, invest

Despite the recent rise in protectionist sentiment, Eurozone growth is showing some real momentum. Capacity constraints are close to being reached and if the strong demand for new orders is to be filled, investment will be a necessity. We expect Eurozone investment to pick-up both at home - and also abroad in the form of foreign direct investment

Source: Shutterstock

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Article | 26 March 2018 Italy

Italian election puzzle: tentative progress in the making

A Five Star Movement and Centre-right ticket now seem the obvious starting point for the government formation guessing game. Putting it in place will require a strong willingness to compromise on both camps. Easier said than done

Source: Shutterstock

PM Gentiloni remains the caretaker for now

The election of the presidents of the two houses of the Italian parliament turned out smoother than feared. After some inconclusive votes on Friday, when all parties were still testing ground, the solution to the puzzle was found overnight, with an agreement between the Five Star Movement (5SM) and the Centre-right coalition.

> *In our view, the road to a future government is far from smooth. Passing the European 'test' won't be easy*

When the voting process resumed on Saturday, it was soon apparent that the parties involved in the agreement will stick to their word. In a couple of rounds, Roberto Fico, a top representative of the left-hand of the 5SM, was elected as the new president of the House of Deputies, supported by its party and by the whole centre-right. PD's MPs continued supporting their candidate, instead. The same agreement made Elisabetta Casellati, a long-term Forza Italia lawmaker the speaker of the Senate.

After the election of the two presidents, the outgoing PM Paolo Gentiloni submitted his resignation to President Mattarella, who asked him to remain as a caretaker for the time being.

A meaningful test, but no guarantees it'll be enough

After the inconclusive electoral result, the election of the presidents of the parliament was the first test of the parties' willingness to compromise.

The relatively quick agreement on the names provided some evidence of a constructive approach for most players. Many commentators have seen in the agreement between Luigi Di Maio and Matteo Salvini, the preamble for a 5SM-League government ticket. To be sure, this remains a possibility, but it's far from a done deal.

Indeed, after the election of the two presidents, most parties involved took a prudent stance, denying that the agreement reached on the presidencies would be immediately replicable to form a "political" government.Silvio Berlusconi seemed particularly keen on dismissing this hypothesis but Salvini remained silent and did not dissent from his coalition partner.

Stumbling blocks remain on the way to a "political" government

In our view, the road to a future government is far from smooth.

The possibility of a 5SM - Centre right alliance has become the obvious starting option for the government formation guessing game. Reaching the same agreement for a new "political" government will require more willingness to compromise on both sides. Redline crossing would become almost inevitable, with a substantial risk of disappointing an electorate which had been attracted by strong calls. Notwithstanding some similarities in public order and migration themes, differences in programmes remain substantial on key economic issues: the so-called citizenship wage, one of the 5SM's strongest campaign themes and the Centre-right's flat tax idea look scarcely compatible.

Also, the cohabitation with arch-enemy, Silvio Berlusconi might cause many headaches within the 5SM ranks, particularly if it is set to last. The alternative of a 5SM–League ticket, with a relatively small majority margin in the Senate, might be scarcely attractive to Salvini, who would be joining a government as a junior partner.

In the meantime, the PD seems for the time being determined to play the opposition game. In the background, the possibility of some form of national unity government (which could eventually include the PD) might re-emerge as the solution of last resort.

President Mattarella's consultations to start after Easter

Over the next few days, the formation of parliamentary groups will complete the list of institutional to-does before President Mattarella is able to start the first round of consultations to form a new government.

The consultations should start after Easter, possibly on 3 April, and might take more than one round to complete. In our view, President Mattarella will give all those involved the time they need to submit proposals, possibly aiming at forming a government without the maturity attached. In doing so, he is likely to check for proposed government programmes to be compatible with Italian obligations and commitments to our European partners. Given the rather overt intolerance to current fiscal rules shown by both the League and the 5SM during the campaign, passing the "European" test might not be easy, but something might be changing.

In a televised interview yesterday, the deputy leader of the League, while re-affirming that a different approach in the relationship between Italy and Europe was a non-negotiable item, he was less adamant in his call for the introduction of a flat tax, referring to a more general need for a tax shock and for incentives to reduce the labour cost.

If the view is shared by 5SM, the chances of a possible compromise on a government alliance will clearly increase. More to come after Easter.

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French public deficit below 3% for the first time in ten years

French public deficit was 2.6% of GDP in 2017 - the lowest it has been since 2007. The budget has mainly been helped by the economic recovery in 2017 but fiscal measures should bring the deficit closer to 3% of GDP again in 2018

Source: Shutterstock

-2.6% Budget deficit in 2017

Percentage of GDP

Higher growth and low interest rates are good for debt stabilisation

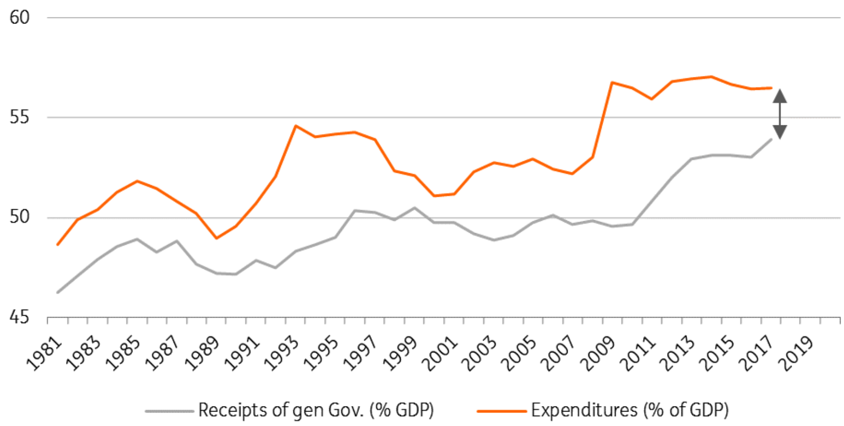
The French economy grew twice as fast in 2017 when compared to 2016 in real terms (and even more in nominal terms) which is used to calculate debt in percentage of GDP.

This helped tax receipts to increase by four percent in 2017 while expenditures (outside debt service) increased by 2.7%. This divergence slashed the primary deficit (spread between receipts and expenditures) from 30 to 15 billion euros or 0.7% of GDP. With debt service declining thanks to the low-interest rate environment by 3.7% on the year (to 44.4 billion euros or 1.9% of GDP), the total budget deficit was limited to 2.6% of GDP. Therefore, the increase in total debt was also limited, to 0.4pp of GDP at 97%.

It was expected that the total budget deficit would end up below the 3% GDP threshold in 2017, but such a reduction in the primary surplus was not expected and its possible, it may not last either.

Indeed, as the Government decides to transform the CICE tax credit in structural charge reduction, it should affect expenditures as a percentage of GDP as of this year. The European Commission currently believes it will push the deficit beyond 3% of GDP again.

Higher receipts are closing the gap rather than lower expenditures



Source: Thomson Reuters

Given that the growth prospects are currently better (we expect 2.2% GDP growth for France this year) and that debt service should continue to decline this year, we think that the deficit could still be limited to 2.8% of GDP in 2018.

For 2019, we believe that it will stabilise below that level, allowing the gross public debt to stabilise as a percentage of GDP. Therefore we don't believe that the French debt will reach 100% of GDP before 2020.

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Article | 28 March 2018 United States

Thoughts from the Americas

Having recently spent two weeks visiting clients in the Americas we outline the main discussion points and client feedback

Source: Shutterstock

Trade wars & protectionism

President Trump is trying to cut the US trade deficit, particularly with China, but his success may be limited given huge tax cuts and rising wages are giving US consumers more money to spend. Much of the increase in cashflow is being used to buy imported consumer goods, so getting a smaller deficit is going to be challenging. The fact so many countries have since been excluded from the US tariffs shows a willingness to do deals to avoid trade wars while there was growing optimism in Mexico that NAFTA will survive with Mexico willing to offer concessions to Trump. China reportedly offering to talk also gives some hope that the situation will calm. The fact that the Republicans lost the Pennsylvania House seat, despite it being a steel area, suggests a level of ineffectiveness of the protectionist policy with the electorate as we look towards the mid-terms in November. Clients broadly felt the protectionist rhetoric was more bark than bite and that things will calm down.

Rising US government borrowing

Fiscal sustainability is a worry. The fiscal deficit potentially hitting 5% of GDP despite the economy growing 3% YoY is causing nervousness. Should growth disappoint (trade war, geopolitical risks, etc) that 5% of GDP fiscal deficit could quickly become 7% or 8%. At a time when the Fed is reducing its balance sheet and concern that China could threaten to reduce Treasury purchases if we do enter an all out trade war there is a recognition that this situation could add to upward pressure on Treasury yields.

Rising inflation risks and strong growth

This too could add to upside risk for bond yields and market rate hike expectations. Corporates broadly said that pay is rising in their company. Several said that you can't just offer a couple of percent. They have to be big increases, especially for companies based outside the major cities where attracting staff is more challenging. There are widespread worries about staff quitting as they are not sure where they will be able to get replacement hires. Our suggestion that inflation could hit 3% this summer (cell phone data plan charges, medical care costs, dollar weakness, rising commodity prices) raised a few eyebrows but no real shock.

Federal Reserve policy

The path for Federal Reserve interest rate hikes may be more aggressive than the market is pricing. Our 4 hikes for 2018 with the risk of 3 next year got no real pushback given our arguments relating to growth and inflation and the changing make-up of the FOMC voters.

Upside risk for US Treasury yields

With the Fed hiking rates, concerns over the US' fiscal position and our assumption that trade fears will gradually recede, our prediction of a higher, flatter yield curve (10Y yield in 3.25-3.50% range in 2H18) didn't face much opposition. Corporates customers are all expanding strongly, and there is no sense of a slowdown on its way amongst the ones we visited (a broad range of industries ranging from tech to distribution to cyclicals and services).

Euro's upside risks

We were talking a very positive EUR/USD story. The combination of "good" dollar weakness (global growth warranting stronger currencies) turning to bad dollar weakness (Trump's protectionism, Steve Mnuchin's suggesting a weaker dollar can be a good thing, rising deficits) coupled with a positive euro story - rebounding portfolios into the euro area, FDI flows relating to Brexit (people switching from investing in the UK to the Eurozone) and the 3%+ Eurozone current account balance. Our suggestion that we could see 1.40 at some point in 2019 caused a few awkward squirms, but there was an acceptance that it wasn't a completely mad call – we were there only 4 years ago. Latam financial institutions were increasingly switching from US to European assets. They were negative on the USD and were fully backing the stronger EUR call and stronger JPY view.

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