

In Case You Missed It: US dollar's ripple effect

We modestly raise our USD forecast as the dollar's rally continues, the Fed remains on course for a June hike, US unemployment hits a rare low, the US-China trade deadlock continues and Argentina struggles to save the peso

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USD: Curb Your Enthusiasm

The US Dollar’s tale of Two Larry’s: When it comes to the greenback’s outlook, Larry David’s “Curb Your Enthusiasm” is probably a more fitting sound bite than Larry Kudlow’s “King Dollar”



ING’s revised forecasts for major currency pairs – May 2018

	1Q18	2Q18	3Q18	4Q18	1Q19	2Q19	3Q19	4Q19
EUR/USD	1.25	1.20	1.23	1.30	1.31	1.32	1.33	1.35
Prior	1.25	1.28	1.28	1.30	1.31	1.32	1.33	1.35
USD/JPY	107.0	108.0	106.0	105.0	103.0	102.0	100.0	100.0
Prior	107.0	105.0	103.0	100.0	100.0	100.0	100.0	100.0
GBP/USD	1.42	1.36	1.40	1.53	1.58*	1.61*	1.64*	1.69*
Prior	1.42	1.45	1.45	1.53	1.58	1.61	1.64	1.69

Source: ING. Notes: (1) Prior as of 06 April 2018; (2) *Our 2019 GBP forecasts remain under review

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Federal Reserve: On course for June

The Fed left monetary policy unchanged with the likely path for rate hikes remaining “gradual”. Nonetheless, with activity rising moderately and inflation having “moved close” to 2%, the US looks set for a June rate hike



Source: Shutterstock

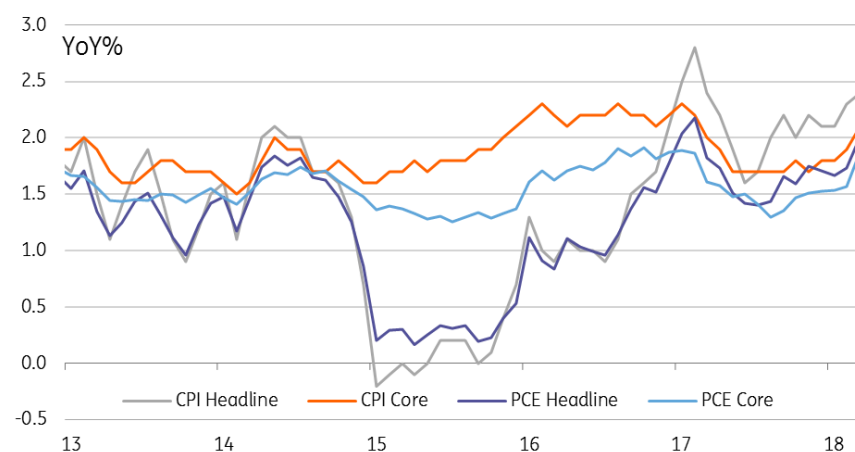
1.5-1.75% The federal funds target rate range

As widely expected the Federal Reserve voted unanimously to leave the fed funds target rate in the range 1.5-1.75%. The accompanying statement reports that the economy continues to expand at “a moderate rate”. It acknowledged a slight slowdown in consumer spending, but noted investment continued “to grow strongly” and the jobs market is “strong”.

Meanwhile inflation measures have “moved close to 2 percent” with an emphasis placed once again on the fact the inflation target is “symmetric”. Consequently the Fed is of the view that economic risks remain “roughly balanced” and that conditions will evolve in a manner that warrants ongoing “gradual increases in the federal funds rate”.

The dollar has weakened a touch and Treasury yields are fractionally lower, which may reflect a hint of disappointment that the Fed were not more upbeat on the economy and the threat of inflation. It could possibly be down to the re-inclusion of “symmetric” as a way of underlining the gradual approach to policy tightening - the Fed looked through temporary dips in inflation and therefore will look through temporary spikes. Either way the Fed were unlikely to be very bold given there is a long way to go until the June 13 FOMC meeting.

Rising inflation supports the case for rate hikes



Nonetheless, with Friday's jobs report set to show US unemployment falling to 4% - a new 18 year low - and business surveys increasingly highlighting the problem of supply bottlenecks, we see growing upside risks to inflation. Indeed, next week's CPI is set to tick higher and we see the real possibility of headline inflation reaching close to 3% in the summer and core inflation breaching 2.5%.

Meanwhile the economy appears to have regained momentum following a soft run in January and February, which was probably a hangover from the hurricane rebuild/replace spending mini-boom in 4Q17. The combination of rising wages and employment together with huge tax cuts means the domestic demand story looks robust while the lagged effects of the softer dollar gives US exporters a competitive edge to benefit from stronger global demand.

As such, we continue to see the balance of risks skewed towards a more aggressive Fed response to combat fears of economic overheating. We look for a June rate hike followed by two further 25bp moves in the second half of the year with the main threat to our view being an escalation of economically damaging trade tensions.

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US jobs report: Mixed messages but rate hikes remain on track

The new low in unemployment will attract the headlines, but wage growth disappoints. Nonetheless, the fundamentals look sound and will keep the Fed hiking rates consistently each quarter



Source: Shutterstock

3.9% Lowest US unemployment reading since December 2000

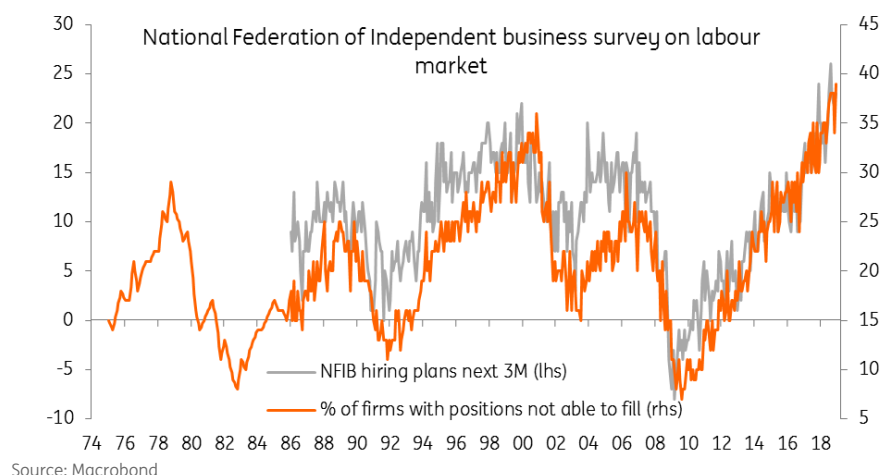
The April US jobs report is a bit mixed. Employment rose 164,000, but when you add in 30,000 upward revisions to the past two months then it is pretty much in line with the market expectation for a 193,000 rise. Unemployment fell to 3.9%, the lowest level since December 2000, but the fall from 4.1% was amplified by a sizeable chunk of unemployed people leaving the labour force – note the participation rate fell from 62.9% to 62.8%. Rounding out the report was a softer wage number. There were some downward revisions and a weaker month-on-month reading for April of 0.1%, which mean the annual wage growth rate remained at 2.6%, rather than coming in at 2.7% as predicted.

It isn't a particularly exciting report and certainly shouldn't alter market expectations for monetary policy in any meaningful way, but it just feels a bit soft given the state of the economy. Other surveys paint a stronger picture and we still believe that the wage story will turn higher and be the catalyst for the Fed to take a more aggressive stance on the inflation threat.

For example, the National Federation of Independent Businesses reported yesterday that 57% of surveyed businesses were hiring in April, up four points on March while a net 33% of small businesses are raising worker compensation – this survey has only been higher once (May 2000) in its 34-year history. We think it is possible we will see annual pay growth hit 3.5% YoY in the latter part of this year.

Given the \$1.5 trillion of tax cuts coming through, this will also mean consumers have plenty of cash in their pockets to spend and that GDP growth in the US economy overall will come in close to 3% this year. Meanwhile, next week's CPI report will likely show headline and core CPI ticking up to 2.5% and 2.2% YoY respectively. As such, a strong growth and firm inflation environment will keep the Fed in tightening mode and we continue to look for three further interest rates rises this year, starting with 13 June.

Wages disappoint, but the NFIB survey suggests companies are paying up...



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China-US trade talks: A likely stalemate

We expect no material change in the current deadlock between China and the US over trade



Source: Shutterstock

China's view: If the US withdraws tariffs then China will too

The world is focusing on Liu He, economic adviser to Xi Jinping, as one of the negotiators in bilateral trade talks with the US. But this time the spotlight should be on Wang Qishan, the firefighter of China, now the vice president who has "unlimited" tenure with Xi Jinping. Wang's return to the government with this very important role is not only to continue the anti-corruption campaign, but also to deal with the new Sino-US relationship.

We expect that Wang will only offer what China has already announced - opening up the financial markets and cutting tariffs on imported automobiles.

If the US withdraws tariffs then China will also withdraw tariffs. We believe the chances are low as this would not change the overall trade deficit of the US economy. And, in fact, China alone could not change the US's trade deficit position.

US intention: Is it trade or Made in China 2025?

We need to be clear on the objective of these trade talks to assess the possible results of this negotiation. Is it a talk on trade or is it a talk on China's strategic plan, Made in China 2025?

The tariffs that the US is to impose on imports of Chinese electronics and machinery, as well as

automotive and aerospace products, are a result of the US Section 301 investigation into policies that force foreign companies in China to transfer intellectual property to their joint venture partners in China. Joint venture companies may not think they are forced to do so as they share profits from the businesses.

If the talks start with the US's intention to stop or slow down China's national strategic plan, then the talks could end quickly. China is aware that it lacks the ability to be self-sustained in core high-tech products. This would only speed up achieving Made in China 2025.

Expect a deadlock

These trade talks are more than who blinks first in the negotiations.

From the analysis we laid out, we expect the talks to yield little in terms of results.

This would be negative for trade-related sectors, including logistics services and related manufacturing activities.

However, this would have little impact on China's GDP growth in the next two years because we expect China to boost investments in high-tech sectors to offset the loss in net exports and related economic activities. We keep our China GDP forecasts at 6.8% in 2Q18, and 6.7% in 2H18 and 2019.

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Argentina: Robust policy shifts suggest steadier FX trends

With the announcement of decisive fiscal and monetary measures today, we expect the ARS to find stronger footing, and even appreciate slightly in the coming weeks



Source: www.buenosairesfotogenica.com

The Argentinean peso, which had been suffering from the government's decision to weaken the central bank's inflation mandate, is likely to stabilise, following the very hawkish course-correction announced in the past few days.

On the monetary policy front, BCRA raised the reference rate by 6ppt today, to 40%, accumulating a 12.75ppt increase over the past week. The bank's repo corridor was also widened materially, with the 7-day active (lending) rate set at 47% and the passive (borrowing) rate set at a much lower 33%. The one-day repo rate was set at 57%.

Today's announcement also indicated that appetite for FX intervention remains intact, but concerns regarding the rapid depletion of FX reserves that took place over the past weeks pushed the bank to broaden its approach. Following the experience of Brazil's BACEN and Mexico's Banxico, the BCRA will also intervene through FX derivatives, providing FX hedge that settles in ARS and does not affect the level FX reserves. Also, BCRA is also demanding that local banks sell, as of 7 May, all of their FX holdings that exceed 10% of their total liquid assets.

Room for direct spot FX intervention is relatively limited now. Gross FX reserves have now dropped to US\$56bn, down from a US\$64bn peak in January. Assuming that private sector FX deposits and an FX swap with China account for about US\$23bn of that, net FX reserves are approaching the US\$30bn threshold, beyond which market concerns could rise.

BCRA's decision was complemented with the announcement, also this morning, of a much-needed fiscal policy tightening, with the Finance Ministry announcing a 0.5ppt-of-GDP reduction in the 2018 primary fiscal deficit target, from 3.2% of GDP to 2.7%, which aims to cap the overall fiscal deficit at 5% of GDP.

The Argentinean peso's medium-term outlook remains weighed down by the worrying rise in its current account deficit, which appears to be rising towards an unsustainably high 6% of GDP, and the country's strong reliance on external debt issuance to finance that deficit. Today's fiscal tightening aims, in part, to address this rise in the twin-deficits, which should top 10%-of-GDP this year, and has made Argentina especially vulnerable at a time that FX financing costs and risk aversion are rising.

But, having depreciated by more than accumulated inflation over the past two years, since after the Macri administration allowed the currency to float in December 2015, we suspect the ARS entered overshooting territory yesterday, and consider a level closer to 21.5 to be more aligned with the "fair-value" for the peso right now. Given the strong resolve suggested by today's action, we would be surprised if the ARS doesn't stabilise and even appreciates over the next few weeks.

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First thoughts on the EU's budget plans

The European Commission's proposals for the post-Brexit budget includes interesting and probably somewhat controversial new tools placing pressure on both CEE and Western countries. Getting these proposals through the negotiation process will be anything but easy



Source: Shutterstock

Today, the European Commission presented its proposal for the so-called multi-annual financial framework 2021-2027. In short, the EU budget for the post-Brexit era.

From a general perspective, the main takeaways are that despite Brexit, the EU budget will increase, which will lead to higher individual contributions by all member states; a very small Eurozone budget through the backdoor and the introduction of the so-called "rule of law."

As regards to the increase of individual contributions, the proposal will struggle to find positive feedback from most member states. In the run-up to today's proposals, many governments have already voiced their concerns or opposition against higher net contributions.

These proposals are another attempt to create a more integrated Europe. But higher contributions and more conditions for money for Eastern European countries, will make it hard to get the

required unanimity

With regards to the Eurozone budget, the European Commission makes another step in putting pressure on the member states. Further reforms of the monetary union will be on the agenda of the next European Summit in June. But with the proposed multi-annual financial framework, the EC now presents two admittedly small programmes only for Eurozone member states.

Firstly a reform support programme with an overall budget of 25bn euro basically following the idea of “money for reforms” and secondly a European Investment Stabilisation Function to absorb asymmetric macroeconomic shocks by giving loans. The entire facility should amount to up to 30bn euro.

Even though the two proposals regarding the Eurozone are very small in terms of size and are not much more than a drop in the bucket, they clearly shed light on the broader Eurozone reform debate. In our view, the two proposals could already be as-good-as-it-gets combined with morphing the ESM into an EMF. They could be a good face-saving compromise between France and Germany as they cannot be called a Eurozone budget, while at the same time fulfilling the conditions of what the proponents of a Eurozone budget have always had in mind.

As regards to the “rule of law,” the European Commission proposed to link EU funding to the rule of law. The new proposed tools would allow the EU to suspend, reduce or restrict access to EU funding for countries which have rule of law deficiencies. A measure clearly aimed at some Eastern European countries and Poland and Hungary come to mind. This could be a new way to impose 'more Europe' on member states. But the question is whether this conditionality will really succeed in creating a more pro-European spirit.

Due to the rule of law clause, the EU budget proposal has been particularly in focus for the CEE investors. Many investors have seen it as a downside risk to selected CEE countries' outlooks. However, we see a very high bar for the EU countries to lose access to the cohesion funds given that the new budget plans require unanimity. We also have a hard time seeing how the EU could stop the payment of funds to one country while keeping the payments to other counties flowing under the current rules. The experience of the Article 7 and the need for a unanimous agreement is a point in case - as long as there is no agreement on a new medium-term budget. As far as CEE investors are concerned, we don't see the budget plans as CEE negative. At least not for now.

The European Commission's proposals are another attempt to create more integrated Europe. Higher contributions and more conditions for money for Eastern European countries, however, will make it hard to get the required unanimity.

Don't forget these proposals will now be negotiated between the European Parliament and the European Council. Eventually, the European Council will have to adopt them with unanimity. If the Council does not manage to take a decision, the budget lines of 2020 will be extended for as long as needed. Be prepared for tough and long negotiations.

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