

# ING's outlook for 2018

A round-up of what our economists and strategists are looking out for in the year ahead

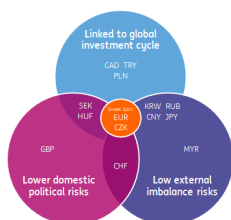
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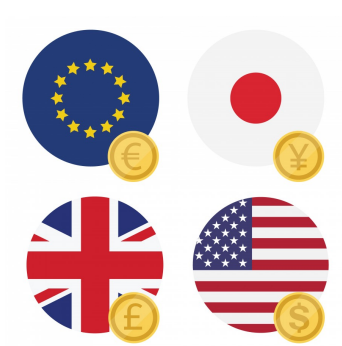


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### At a glance guide to FX in 2018

As part of our 2018 FX outlook, 'Happy Hour', here's a guide to where we think major currency pairs could be heading

By Chris Turner

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Article | 6 December 2017

## 5 reasons Eurozone growth could be even stronger than you think in 2018

The Eurozone was the global economy's Cinderella story of 2017. The question now: Was this a one-off performance or can it can maintain the pace? We think the latter



### 2017 surprised on the upside

Will the Eurozone be 2015 Leicester City or will it be Chelsea with continued strong performance thanks in part to a generous supply of money? We think the latter and we could even see a further acceleration of growth from here.

About a year ago, sentiment about the Eurozone was downbeat. People were still reeling from the UK decision to leave the EU and the US Presidential elections caused a lack of trust in political polling. This led to EU disintegration risk to top the list of investor worries with many Eurozone elections ahead.

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*We expect growth at 2.2% in 2018, well above trend*

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About a year later, things look very different. Europe's most boring election, in Germany, actually

seems to have resulted in the largest uncertainty of all. Most governments formed have either maintained previous positions on Europe or become more euro-minded.

With so much focus on politics, acceleration of economic indicators went almost unnoticed at first. But a strengthening job market, weak inflation, exports profiting from improving global growth and decade highs for consumer confidence are causing the Eurozone economy to accelerate. This year, we expect GDP growth to come in at 2.3%, which would be a tie for strongest growth in a decade. There are few signs pointing to a slow start of 2018 either. We, therefore, expect growth at 2.2% in 2018, well above trend.

**2.2%** 2018 Eurozone growth  
ING estimate

## 2018 will be off to a good start

Leading indicators for the Eurozone point to continued robust growth in the New Year. Recent strength in the labour market will fuel household consumption at the beginning of 2018 too. Credit standards have eased over recent years, although the past quarters have seen some stabilisation. Nevertheless, bank lending growth is slowly increasing, fueling further investment and providing a tail-wind to the housing market recovery. Despite a somewhat stronger euro than at the start of 2017, exports are likely to continue to be supported by the global recovery as the Eurozone's main export partners are, on average, expected to experience somewhat faster growth over 2018.

**But that's not all. There are indicators that are even pointing to accelerating growth in the months ahead. Could it be that the Eurozone economy shifts into even higher gear?**

New orders are pointing towards an acceleration in the economy. Order books have improved to levels previously seen at the top of the business cycle, suggesting an accelerating recovery of Eurozone industry. Industrial output had lagged the overall economy but is closing the gap with an annual growth rate of 3.3% in September. The recent surge in new orders could be a prelude an acceleration in Eurozone GDP growth.

With demand continuing to improve in the Eurozone, many businesses are now indicating they are reaching the limits of their production capacity. That requires expansion and causes corporate investment to increase. Given the current levels of capacity utilisation, it could well be that annual non-financial corporate investment growth increases to above 5%.

Businesses are not just reaching capacity in terms of capital; employment is increasing as new orders continue to grow and backlogs of work increase. Survey questions indicate that the labour market is roaring. The Eurozone PMI for November indicated that hiring is now at a 17 year high, while the European Commission shows that business expectations of employment are at the highest since the start of the indicator in 1985. As businesses are also reporting higher vacancy rates, there may even be an upside to wage growth in the year ahead. Improved employment boosts average personal disposable income and is closely connected to consumption.

Related to the previous point, consumer confidence has reached the highest level since January 2001. In fact, outside of a few months in 2000 and January 2001, consumers have never been more confident. Even in the roaring nineties or around the fall of the Berlin Wall Eurozone consumers weren't this positive. This is mainly because their outlook for employment and personal finances is very good, which boosts their plans for consumption. The surge in expectations to buy durable goods could push annual consumption growth to around 2.5% YoY early next year.

We could even expect some government support next year. The effects of austerity measures are fading at the moment, causing government expenditure to improve. This year we expect the fiscal stance, the impact of government spending on economic growth, to be 0.2%, up from 0.1% in 2016. For next year, there is even more room for improvement as the French fiscal stance is likely to improve significantly.

## So why not expect growth rates of 3% next year?

These exuberant indicators only paint part of the picture for the Eurozone. While there are indeed upsides to the outlook, some reasons for more modest expectations are compelling. Even though the labour market has been steadily improving, meaningful wage growth is still not expected for 2018. This has a dampening effect on consumption as it limits household income growth. Risks to export growth include our expectation of a somewhat stronger euro and possible increased trade barriers. And what about the diminishing support of the European Central Bank?

While the political climate in the Eurozone has remained stable since the 2017 elections, the aftermath might still have a sting to it. Uncertainty around a new German government will make ambitious Eurozone reform plans in the coming months even less likely. Moreover, significant German fiscal stimulus for 2018 seems to be too ambitious with a caretaker government in place. This will curb German growth potential for next year. Worried eyes will also land on Italy in 2018 with elections happening before the end of May. With the ECB reducing its asset purchases by 30 billion per month, the question is whether this will not cause delayed investments in the Eurozone's third-largest economy.

All in all, there remain enough side notes for us not to have 2018 as the best year since the inception of the Eurozone as our base case. Still, there are a lot of signs pointing towards a stellar start to the year. And with the Eurozone being the surprise of 2017, it is not unthinkable that another year of amazement at European data points is in the making.

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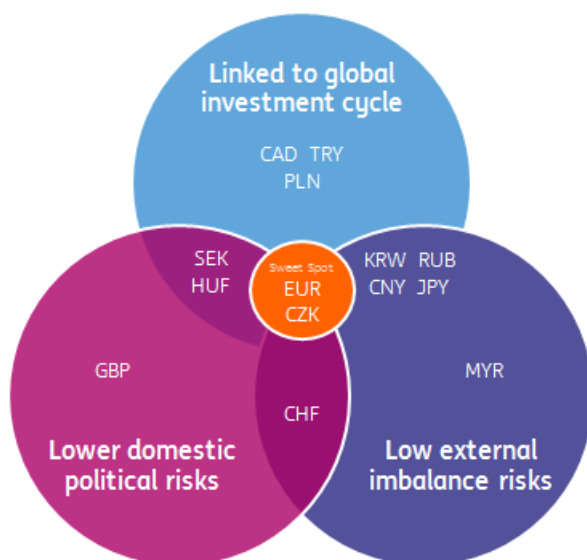
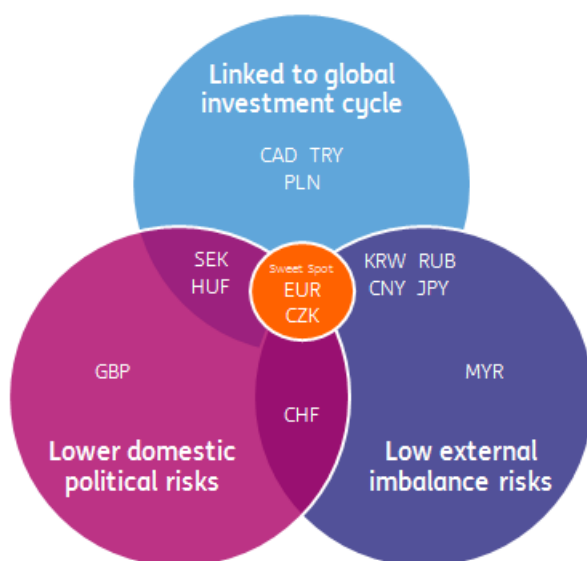
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# 2018 FX Outlook: Happy hour!

ING's definitive analysis of the current FX environment going into the new year



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# Brexit: Seven big questions looming in 2018

The announcement of 'sufficient progress' removes a big layer of uncertainty for markets and the UK economy, but there are still a number of big questions looming in 2018



Source: iStockphoto

## Progress at last

After months of deadlock, the EU and UK have finally reached a deal which allows the European Council to declare 'sufficient progress' to move onto trade talks. The UK has reportedly agreed to meet all of the financial commitments set out by the EU earlier this year. They have also accepted that the European Court of Justice will have a role to play in policing citizens rights, formally a big red line for the UK government.

But the big sticking point was the Irish border. The wording agreed earlier in the week, which committed to "no regulatory divergence" on the island of Ireland, raised fears within the Democratic Unionist Party (DUP) that this could weaken Northern Ireland's access to the UK internal market. But a series of additional commitments - including one that guarantees "unfettered access" for Northern Ireland to the overall UK market - appears to have reassured the DUP.

Now these 'divorce issues' are resolved, here are the seven things we'll be focusing on in 2018.



## 1 Is a transition deal now a given?

Almost. Now that the European Council has agreed 'sufficient progress' has been made, this should allow for a fairly swift agreement of a two or three year transition period after March 2019. There is increasing consensus that businesses need confirmation of this by March 2018 if they are to avoid enacting contingency plans for a 'cliff edge'. That should be possible, mainly because the more controversial elements of the transition - abiding by EU law and allowing free movement - have already been accepted by the UK. Equally, several legal matters also need to be resolved, so it may not be until later in the first quarter when the transition is agreed on paper.

Either way, the agreement of a transition would be a positive for the UK economy as it should help unlock at least some short/medium-term investment.

## 2 Will a two or three year transition period be long enough?

A big fear of Brexit-supporting ministers is that the transition period could lead to an indefinite period where the UK is neither in nor out of the EU. This is partly because the next election is scheduled for 2022, and an extended transition could leave the government vulnerable to suggestions it hasn't brought the UK entirely out of the EU.

But does this give firms enough time to adjust? The complexity of modern supply chains means many goods often travel multiple times between the UK and EU before being sold in the single market. The BMW Mini and pints of Guinness are good examples. These processes will take time (and money) to re-orchestrate.

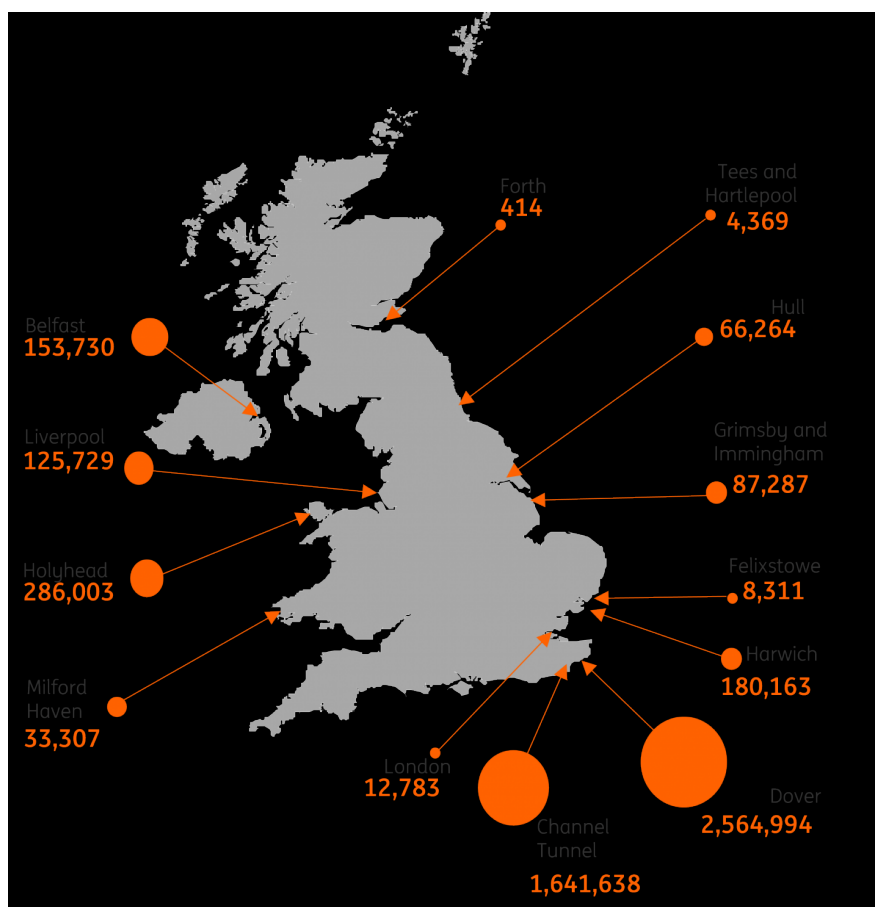
Logistics are also a big consideration. At Dover, less than 1% of lorries arriving and departing require checks<sup>[1]</sup>. Given the sheer number of lorries that pass through, maintaining a frictionless border will be key. The British Freight Transport Association has said that adding even two minutes to the process could generate queues of up to 17-mile queues on the M20 motorway. Part of creating a fluid customs process will require new staff, but this too takes time. For instance, it takes three years to train a new customs official in Germany, and two years in France.

<sup>[1]</sup> *Implementing Brexit: Customs* (Institute for Government report)

Of course, there is the potential for the transition period to be extended. If negotiations take longer than expected, it is unlikely that the UK government would walk away and trigger "cliff edge" Brexit having worked so hard to avoid it this time around.

While this may upset the most hardline of Brexiteers, the government compromises made so far suggest they are increasingly acknowledging the need to minimise the threats to the economy and jobs.

## Lorry traffic at selected UK ports (no. of lorries)



Source: Institute for Government, Department for Transport

### 3 Will there eventually be a deal?

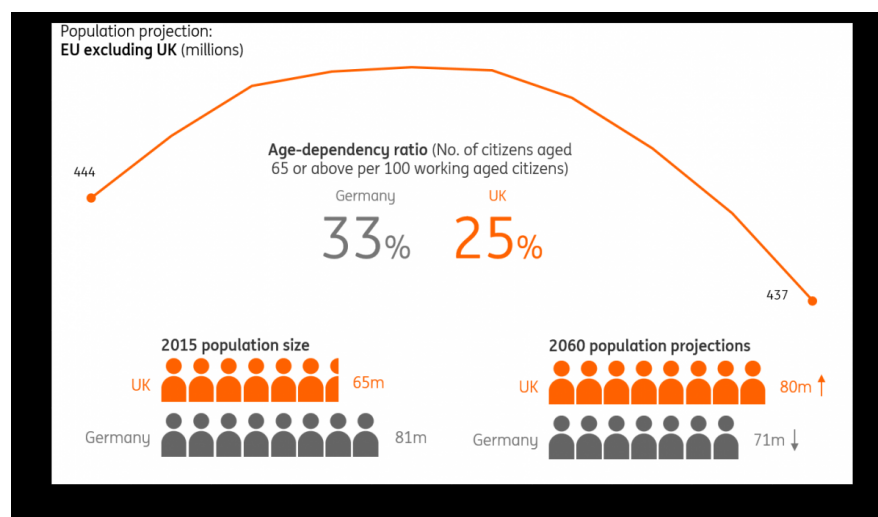
Given the volume of trade done between the UK and the EU, the impacted supply chains, the millions of jobs and tax revenues, a deal makes sense for both sides.

The UK position has already softened on the divorce bill and the role of the European Courts of Justice and it seems as though they are also edging back from the "no deal is better than a bad deal" scenario. The EU is also recognising the importance of getting a positive agreement for both sides by acknowledging the need for a transitional period. Nonetheless, the actual trade discussions will be tough and protracted, but two factors argue in favour of a mutually beneficial deal.

Firstly, the worst case scenario of no deal and the adoption of World Trade Organisation Rules would introduce tariffs on trade. On average they amount to 2-3%, but a wide range of food products will be hit particularly hard. This could see upward pressure on prices and a further squeeze on spending power. But the key issue is the wide criteria. For example, the full US trade schedule contains 192,275 different lines of tariffs, which means companies can face tough choices on optimising their production processes if they have to import multiple different types of components. Dispute settlement also takes a long time - typically a year and up to 15 months if there is an appeal - a period during which trade can be heavily impacted.

The second reason that argues for a positive deal is demographics. The fact that birth rates have declined across the EU, means that Europe's population is set to fall over coming decades. However, in the UK the birth rate has increased in recent years, fuelled by immigration. Consequently, the EU predicts that the UK is set to overtake Germany as Western Europe's most population nation within the next 20 years. From the EU's perspective, having access to a growing market that is on its doorstep and is cheap to export to clearly makes sense, particularly when the domestic market is being squeezed.

## Demographics give an extra incentive for a deal



### 4 When will the UK and EU agree a trade deal?

Now that some of the more thorny issues of the Brexit process are resolved, PM May will reportedly sit down with her cabinet over the coming weeks to try to agree on a "model" for the trading relationship by the spring to give businesses a better understanding of the direction of travel. After that, the UK government's official position is that it expects to strike a trade agreement before exiting in March 2019.

But taking off three to four months for ratification leaves less than a year to agree on a deal, which is a very short timeframe. So it's possible that at least some elements of the talks will continue into the transition period. One consequence of this is that, without a concrete idea of what trading environment the UK will actually be transitioning into in 2021 or 2022, companies are likely to remain cautious when it comes to longer-term investment even after a transition is announced. Until details emerge, this effectively means the 'cliff edge' risk is still present, albeit two or three years later. It's worth remembering too that, in the EU's words, "nothing is agreed until everything is agreed".

### 5 What will the trading arrangement look like?

'Imaginative', 'creative' and not 'off the shelf' were all phrases used by Prime Minister May in September to describe the bespoke trading arrangement she'd like to agree with the EU. The European Economic Area (EEA) option would require free movement (a big red line). The free-trade option, like the Canada-EU deal, would get around this by allowing the UK to control migration, and enable it to strike separate trade deals with other countries. But crucially, access to services

(including finance) is notoriously difficult to negotiate as part of free-trade deals. This is why David Davis is now talking about the need for a "Canada plus-plus-plus" arrangement that includes services, which accounts for more than 70% of the UK economy.

So can the UK agree on a half-way house? Well, clauses embedded in existing free-trade deals mean that whatever the EU offers the UK on services, it would also have to offer to other countries that it already has agreements with (Canada and South Korea for example). This means there is a reduced incentive for the EU to offer the UK a bespoke deal, which makes it more likely the UK will ultimately have to choose between the Canada-style free-trade agreement or the EEA.

## 6 Will Prime Minister Theresa May stay?

Since the general election in June, PM Theresa May's position is perceived to have weakened. This has led to questions over how long she can remain in office, particularly as opinion polls were suggesting the public is dissatisfied with the government's handling of Brexit.

The fact that the Prime Minister has been able to reach an agreement with the EU on 'sufficient progress', having navigated a delicate path within her own party and with the DUP, could help to repair this image. By and large, the government has also successfully avoided a large fallout over the politically-sensitive 'divorce bill', and the first opinion poll after the announcement of the deal has seen the Conservative's popularity bounce. They now have a narrow lead of one percentage point over Labour.

Nonetheless, PM May remains vulnerable, and a fresh leadership challenge in 2018 can't be fully ruled out should negotiations falter. We also have to recognise that there is always the potential for a by-election to be called as there are typically four to five a year. So given PM May's wafer-thin majority the government could still fall, paving the way for new elections.

## 7 Will the Bank of England hike again in 2018?

While the announcement of a transition deal should unlock some short-term business spending, there are still some Brexit 'ifs'. The jobs market is also showing early signs of faltering, which could limit the potential for a takeoff in wage growth next year. This will keep a lid on consumer spending, and in turn, overall 2018 growth.

Another rate increase is therefore not guaranteed, although policymakers have signalled they would be comfortable with a hike next year. A move in February or May certainly can't be ruled out, particularly if a transition is swiftly agreed.

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## 2018 Commodities Outlook

For most commodities, 2017 was a good year with energy and metal markets rallying. Turning to 2018, we think base metals should remain well supported but expect the energy complex to weaken



### Crude oil – Growing non-OPEC supply

OPEC has done a much better than expected job in complying with their production cut deal. This stronger compliance, along with growing geopolitical concerns has proved bullish for prices. Now with OPEC set to extend the deal through to the end of 2018, some would think that the recent supportive environment is set to remain. However, we don't think so.

Non-OPEC supply is set to exceed demand growth over 2018, which will see the global markets in surplus. This also assumes OPEC stick to their cuts. The risk is that the longer the deal continues, the more likely we see some producers falling short of their commitments, which would only push the oil market further into surplus.

### Copper – Deficit environment to remain supportive for prices

The tighter copper market over 2017 was predominantly driven by mine disruptions at the two largest copper mines in the world over 1H17. But on the demand side, improving global manufacturing numbers has proved bullish for prices.

Expect the copper market to remain well supported, with the previous low price environment doing little to attract investment in the sector. We forecast a deficit market in the region of 150kt over

2018.

## Iron ore – Under pressure

The iron ore market traded above US\$90/t in early 2017 but has weakened considerably since – trading below US\$55/t at one stage. We expect prices to remain under pressure in 2018.

2018 will be the year where Chinese steel capacity cuts should equate to weaker iron ore demand – and this comes at a time when inventories held in Chinese ports sit near record levels. Meanwhile, supply is set to pick up in 2018 as we continue to see the ramp-up of mines in both Australia and Brazil.

There is also growing speculation that the Indian government may lift the export tax on iron ore, which would boost supply.

## Coal – Short term support, but downward pressure longer term

Thermal coal prices are likely to remain well supported in 1Q18 with Northern Asia reaching peak heating demand for the winter. But for coking coal, Chinese steel winter cuts should weigh on import demand. Looking at supply, there is the potential for disruptions, with it increasingly looking as though a *La Nina* event will occur over the Northern Hemisphere winter months. This event usually means wetter than usual weather, in parts of Australia.

However, Chinese domestic coal prices continue to trade above government target levels, and so as a result of this we expect them to take action to increase domestic supply. The stronger price environment may also increase global supply in the longer term, which should mean weaker prices further out.

## Soybeans – Large inventories likely to cap prices

The global soybean market remains well supplied, with inventories set to end the 17/18 season at record levels. There is one upside risk that the market is watching closely, and that is the growing *La Nina* weather risk. For Brazil, it usually means drier weather over the Northern Hemisphere winter, and so there are some in the market who are worried that this could impact Brazilian soybean output.

But we are moving closer towards the period when US farmers will start to make planting decisions for the 18/19 season, and it looks as though farmers will increase soybean acreage at the expense of corn. Assuming average weather, the US could see another strong soybean harvest next season.

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## Swiss Economy 2018 outlook

The Swiss National Bank will have to wait until late 2019 before the current activity rebound brings inflation back



Source: Shutterstock

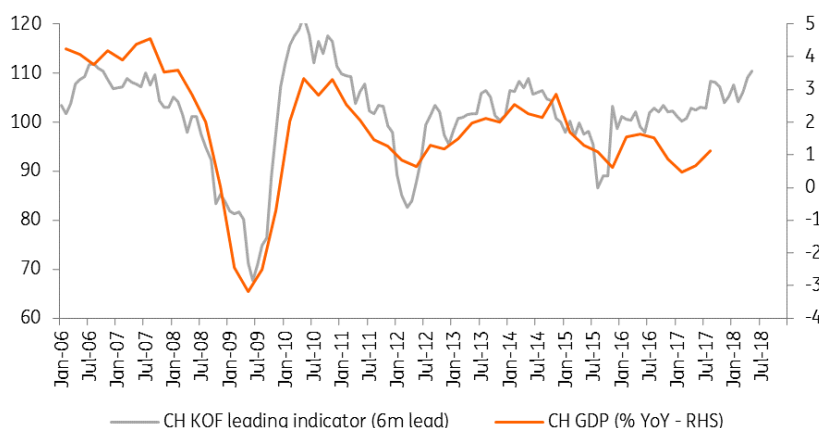
The Swiss economy has not exactly stood on its own two feet since 2015: the strong appreciation of the CHF following the end of the monetary floor under the EUR/CHF depressed trade while domestic demand was still strong.

2017 was the weakest year since 2012, but we expect GDP growth to reach 1.8% in 2018. Both dynamic exports based on a weaker CHF and higher domestic demand should contribute to the rebound.

In 2016, the latter was depressed by the lower activity induced by the former. At mid-2017 both legs ended up weak, which explains why 2017 growth is not expected much above 1%, the weakest pace of expansion in the economy since 2012. This should change in 2018 as most indicators point to a rebound at the turn of the year. With the economy back on its two feet again, growth should reach 1.8% in 2018 and 2% in 2019.



## GDP growth is set to rebound in 2018

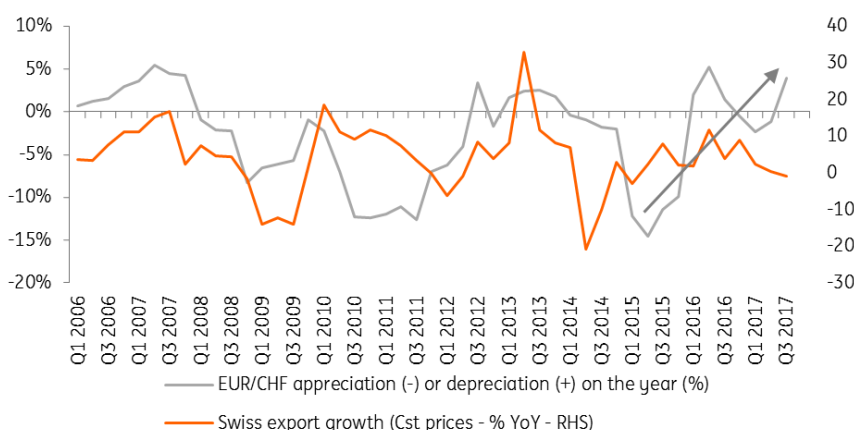


Source: Reuters

## Exports should benefit from higher global demand and weaker CHF

We expect Swiss exports to have contracted by more than 1% in 2017, which should weigh on GDP growth, despite the recovery in manufactured goods exports. In parallel, the depreciation of the CHF against the euro should bring a positive trend back by the last quarter of 2017. This recovery should continue in 2018. Core industrial sectors have already benefited from the currency move in 17Q3, especially in the chemical and pharmaceutical industry. With the USD weaker, the Swiss trade surplus with the United States should stabilise below 15 Bn USD. Therefore, Bern should not fear to be labelled a currency manipulator by The trump administration in 2018 (which would be the case if the trade surplus were to reach 20 Bn USD).

## A weaker currency should rekindle export growth



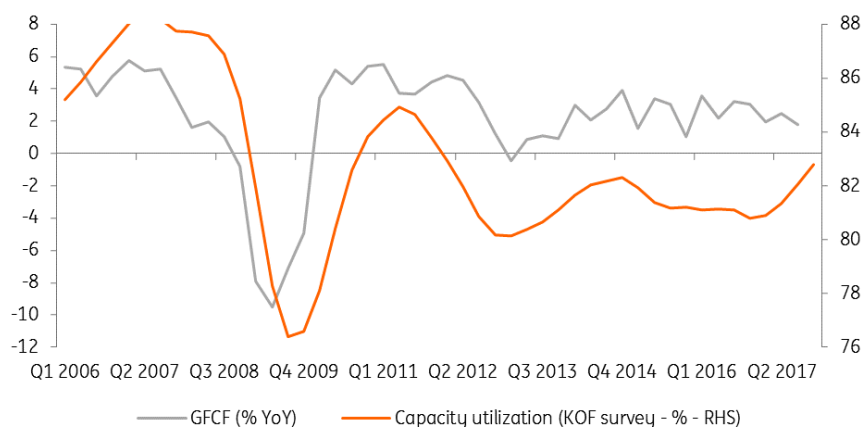
Source: Reuters

## Improved exports should allow Swiss companies to invest and hire

Industrial production was growing by 8.6% a year in 3Q17. The recovery in industrial activity,

mainly lead by external demand, has brought capacity utilisation back to their 2012 levels. With industries running at almost 83% of capacity, stronger business investments should be observed in coming quarters after 0.9% QoQ observed in 17Q2 and 17Q3. However, this rebound could be dampened by the expected weakening of household investments. Activity in the residential building sector has indeed been abating in recent quarters and the small contraction in household investment witnessed in 17Q3 (-0.1% QoQ) could be repeated in coming quarters. Nevertheless, the rebound in total investments should reach 4% in 2018, supporting GDP growth.

## Capacity utilisation is back at its 2012 level

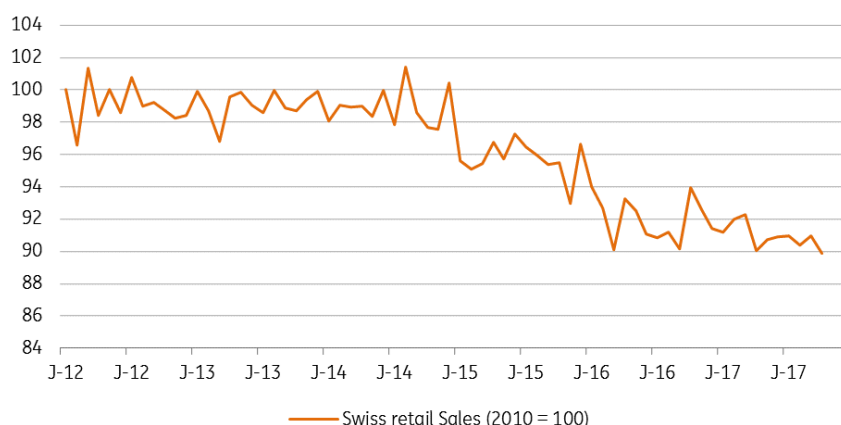


Source: Reuters

## Private consumption is also set to rebound

Private consumption growth is expected to have been weak in 2017; economic uncertainties were still weighing on companies' hiring intentions in the beginning of the year and the unemployment rate remained slightly above 3.2% in the first half of the year. This led to a further decline in retail sales which are back at their 2007 level. Consumer confidence was very low in 2017, at its 2009/2011 average (1.3), which explains the limited private consumption growth of the first three quarters (0.2% QoQ on average). With the recovery in the industrial sector and the brightening economic outlook, unemployment should decline in 2018 (it was back at 3% already in November) and confidence should look up. We expect private consumption growth to rebound from 1.3% in 2017 to 1.6% in 2018. The trend should continue further after 2018, especially if deflationary pressures end up abating: we do not expect retail sales to deteriorate further. They have a long way to recover.

## Retail sales have a long way to recover



Source: Reuters

## More inflation... but how much ?

All in all, the Swiss economy is set for a bounce back in 2018, with higher activity being fuelled by external demand. GDP growth should rebound from 1.0% to 1.8% in 2018 and 2.0% in 2019. Lower unemployment and higher inflation should support consumer confidence eventually benefiting the retail sector. If this bright outlook after several years of slow growth should bring inflation, the question remains: by how much? Indeed, the whole scenario is very much dependent on the continuing depreciation of the CHF, and hence on the SNB's monetary policy. We expect it to remain very supportive in 2018. At its December monetary policy meeting, the SNB left the target range for the 3m Libor at -1.25%/-0.25% with a negative deposit rate of -0.75%. The exemption was also left unchanged (at 20 times the minimum reserve requirements).

120%

Size of the SNB balance sheet

3Q17, as a share of GDP, above Japan's 99%

## SNB December assessment

In a slight change of wording, President Jordan reiterated during the press conference that the SNB "will remain active in the foreign exchange market as necessary, while taking the overall currency situation into consideration". If the SNB still thinks that "the franc remains highly valued", it acknowledges that "overvaluation has decreased", as the CHF has depreciated further against both the EUR (7% in the last 6 months) and USD.

Yet, for the SNB, the situation mainly reflects a decreased demand for safe havens and "remains fragile", justifying a status quo in its interventionist stance. However, the SNB suggests that this "fragility" (or the likelihood of the return of risk aversion) is declining with the strength of the economic outlook, both abroad and in Switzerland. The SNB growth forecast for 2018 is now 2% and President Jordan was quite upbeat on the world economic recovery in December. We believe that the current positive growth outlook could bring back some moderate inflationary pressures in 2018.

# 2.1%

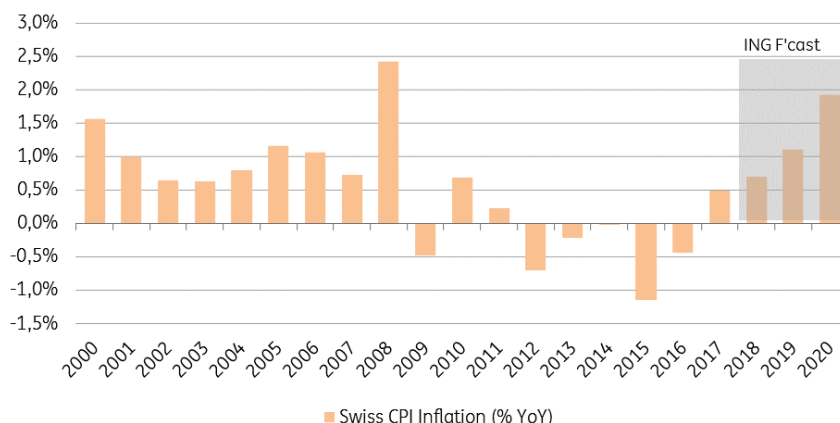
## The first official SNB inflation forecast

Above 2% in 20Q3

### Inflation forecasts

The most important figure of the conference was the SNB inflation forecasts for 2019 and mid-2020, which came out at respectively 1.1% (unchanged since March) and 2.1% (for 20Q3). The SNB also revised upwards its inflation forecast for 2017 (+0.1pp at 0.4%) and 2018 (+0.3pp at 0.7%). This shows that the SNB remains very cautious about declaring victory on deflation, but is still eager to show that getting back to the 2% target in the medium term is possible. We see a possibility that a weaker exchange rate will lead to better growth and higher inflation above 1% in 2019, but will it be enough for the SNB to follow the ECB in raising rates by then?

### Inflation should remain low, albeit more positive



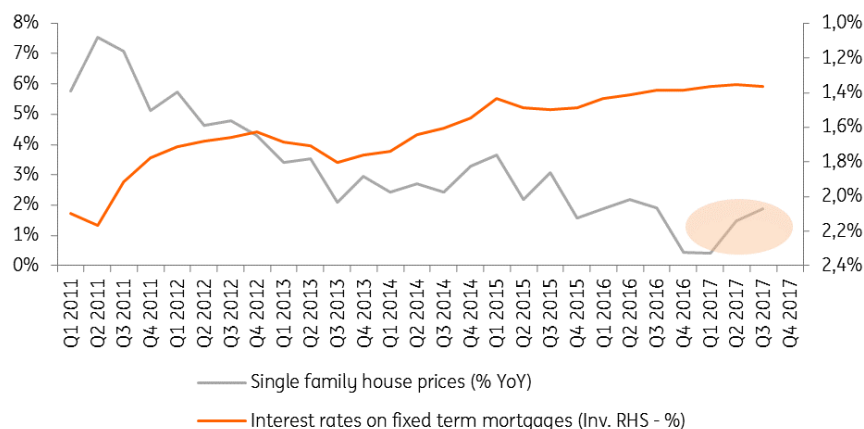
Source: Reuters

### Expect more of the same from the SNB in 2018

In 2018, with the return of inflation being slow despite a dynamic economic recovery, we do not expect any change in the monetary policy stance. Short-term interest rates will, therefore, remain negative. Moreover, it is likely that long-term interest rates will continue to reflect low inflation expectations and hence increase more slowly than in the Eurozone in 2018. Negative rates and stable short-term interest rate spread against the euro will remain the SNB's favourite tools to add downward pressures on the EUR/CHF which should reach 1.25 at the end of the year with very limited FX interventions.

In 2019, with stronger growth prospects and a CHF installed beyond 1.25 against the EUR by mid-2019, we think the SNB will be able to imitate the ECB in raising short-term interest rates by 25bp in the second half of the year. They should, however, remain negative until the end of 2019. With inflation coming back towards the 2% target in 2020, the door towards normalisation will be then open.

## Swiss house prices had resisted the trend in lower interest rates... until now



Source: Reuters

## Some segments of the Swiss real estate market could be overheating

Finally, having negative interest rates lengthened until 2020 could bring some financial stability risks, notably through excessive asset valuation. In December, the SNB also expressed itself on financial stability. From that perspective, Vice-President Zurbrügg insisted on the imbalances on the Swiss mortgage and real estate markets. The SNB noted, in particular, a marked rise in residential investment property prices where it currently sees that “risks have accumulated”. In particular, increasing vacancy rates could be the sign of oversupply in some segments.

In parallel, the SNB noted that mortgages with high loan-to-income ratio have reached a historical high, showing that “incentives for domestically focused banks to increase risk-taking remains substantial”. Since last year, the SNB has been repeating a clear message: if the race to the bottom (in mortgage interest rates) continues, the risk of an overheating housing market could reappear, and with it higher financial stability risks. So far, this has not triggered an increase in the compulsory capital buffer for domestic banks but the SNB suggested in December that this could still happen.

As the outlook for growth and inflation is only improving slightly, the Swiss National Bank (SNB) is likely to continue acting as an economic safety guard in 2018. On the one hand, the current SNB inflation forecast is unlikely to allow for any monetary tightening before late 2019. On the other hand, a stronger economic outlook and some inflationary pressures should eliminate any risk of further accommodating measures.

We, therefore, think that the SNB will keep its negative interest rates unchanged until late 2019 and will refrain from any further FX interventions while staying open to the possibility to intervene in case of a sudden risk aversion come-back. All in all, the current policy mix equilibrium still looks very stable for the SNB.

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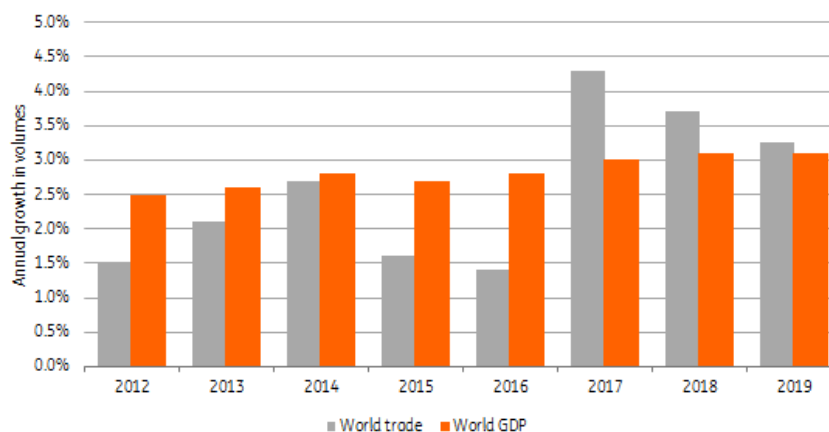
# Trade in 2018: Nowhere close to its heyday

Trade in 2018 will pick up speed but rebalancing of the Chinese economy and global value chain trends mean we won't see world trade growth doubling GDP growth, as it did before the crisis



With fourth-quarter trade data still to come, we expect 2017 to be the strongest year for world trade since 2011. With an annual growth of roughly 4.5%, world trade will outpace world GDP growth for the first time in six years.

## World trade exceeds world GDP growth in 2018 and 2019



Source: ING Forecasts



However, the high growth rate this year is largely the consequence of a favourable carryover effect from last year. Trade dipped in 1H16, but it recovered strongly towards the end of the year. Simply hanging on to the trade level of December 2016 – with no growth whatsoever in 2017 – would already have been enough to deliver a 3% annual trade growth in 2017. So 2017, has done a little better than this, but not much.

## Don't let the data fool you

In 2018, trade growth will pick up some speed thanks to increases in GDP and investment growth in the largest trading nations. Japanese growth will come down, but US growth will pick up. Russia and Brazil will continue recovering from their recessions in recent years. Economic growth in the Eurozone will cool off a bit, but investment growth will increase.

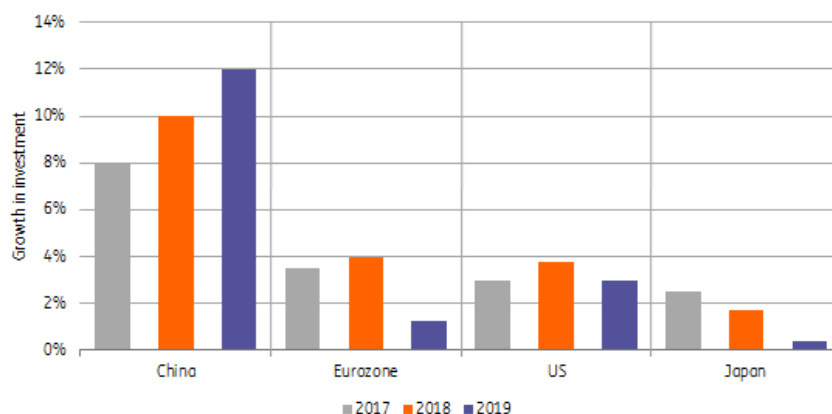
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*We're not expecting a surge in trade growth in 4Q17 like 4Q16, so the carryover effect should be smaller in 2018.*

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These developments should deliver higher monthly trade growth, but annual growth in world trade for 2018 as a whole is expected to be lower than 2017, at 3.7%. This is because the base for comparison is less favourable. We're not expecting a surge in trade growth in 4Q17 like 4Q16, so the carryover effect should be smaller in 2018. In 2019, we expect investment growth in the major trading countries to slow somewhat and, hence, trade growth to fall back to 3.25%.

## Higher investment growth in 2018, but lower in 2019



Source: ING Forecasts

Although world trade growth is set to outpace the growth of world GDP in both 2018 and 2019, this will only be by a small margin, and nowhere close to the decade before the financial crisis when world trade grew twice as much as world GDP. This was, among other things, the result of the fast spread of global value chains, boosting business in intermediates.

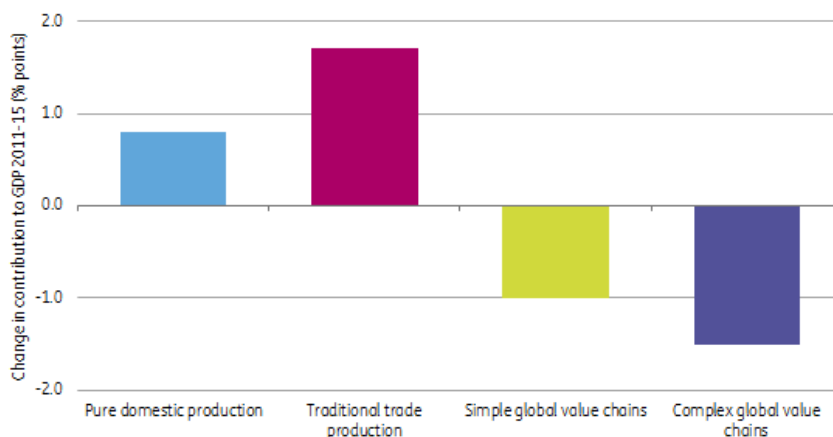
## Offshoring has lost its appeal

The latest data on global value chains indicate offshoring has slowed. The data shows production

chains are contracting, which is reflected in less cross-border trade in intermediates, which are no longer rising as a share of global trade.

The contribution to world GDP from products made within a global value chain has declined since 2011.

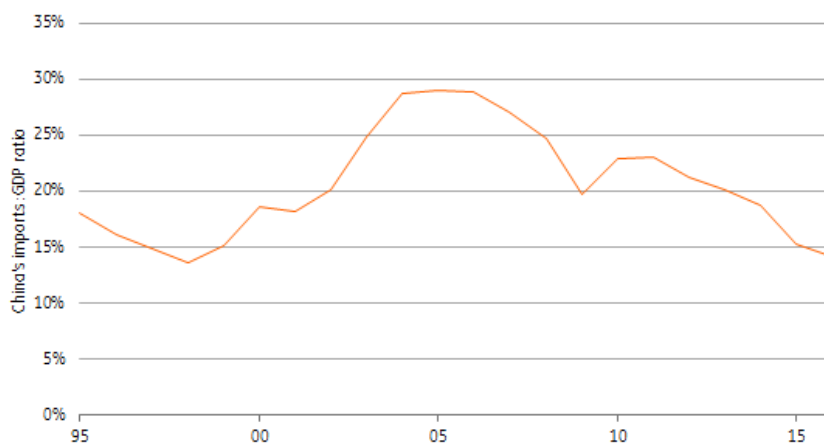
## Global value chains are adding less to GDP



Source: World Input Output Tables, University of Groningen, ING calculations

One of the reasons for the lower trade in intermediates is China increasingly using domestically produced intermediate goods in place of imports, which is reflected in its declining import ratio.

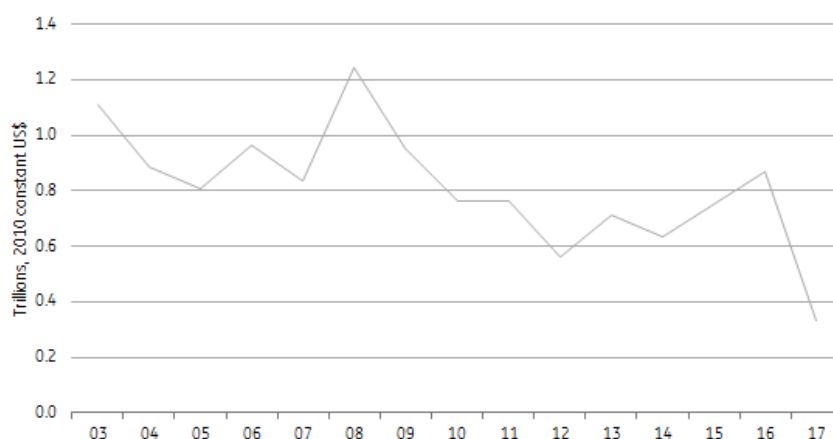
## The Chinese economy is less import intensive



Source: UNCTAD, ING calculations

Greenfield foreign direct investment flows have - with the exception of 2016 - have remained weak in recent years compared to the period before the crisis and taken a nosedive in 2017. As with the stagnating growth in the share of intermediate goods in total trade, this suggests that offshoring is not about to generate another acceleration in world trade growth.

## Nosedive for Greenfield FDI flows in 2017



Source: fDi Markets, IHS (Markit), ING calculations

Note: 2017 based on data from January-August

China's broader rebalancing strategy towards consumption and away from exports also limits the potential for trade growth, because the import intensity of consumption is lower than that of investment and exports.

## Protectionism: the dog is barking but will it bite?

Protectionism in the Trump era is the barking dog that hasn't really bitten in 2017. World Trade Organisation (WTO) figures published in November show that G20 countries introduced an average of three trade restrictive measures per month in the past six months, the lowest rate in the post-crisis period.

## Fewer restrictive measures in the Trump era



Source: WTO Report on G20 Trade Measures, November 2017

Trade facilitating measures, in the meantime, continued to be introduced at a rate similar to previous years. These measures are not limited to national or bilateral agreements, but also include important international agreements that will stimulate international trade in the coming years. This includes ratification of the 2013 Bali Agreement to lower custom barriers, the extension

of the free trade agreement for IT products (ITA) and the decision of TPP countries to go ahead with liberalising trade without the US. It all shows that free trade is far from over.

Nevertheless, the downside risks from protectionist policies remain. We have not heard the final word on NAFTA re-negotiations yet, and the situation certainly looks dangerous. Were NAFTA to fail, it would be a severe blow. The same risks are involved in the prospective EU and the UK trade agreement, where the best outcome can only be neutral for world trade, but risks are firmly on the downside.

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## At a glance guide to FX in 2018

As part of our 2018 FX outlook, 'Happy Hour', here's a guide to where we think major currency pairs could be heading



### Our overall thinking

Optimism reigns! In contrast to fears at the start of the year, policy uncertainty has actually fallen. This and signs of co-ordinated growth have sent consumer and business confidence to post-Global Financial Crisis highs. Pro-growth FX is starting to perform well. We are less worried than some by the removal of central bank liquidity. Instead, we believe the conversion of business confidence into stronger investment will be the key story for FX markets in 2018. European and Asian FX score highly here.

But this 'Happy Hour' by definition cannot be extended indefinitely. Stiffer headwinds may emerge towards the end of 2018 and greater weight may be given to FX backed by external surpluses. We believe the dollar softens under most scenarios.

Below see our summary of major currency pairs. And take a look at our overall FX thoughts [here](#):

## The dollar, the euro, the pound and the Scandies

**We look for EUR/USD to trade to 1.30 in 2018.** The EUR is in the 'sweet spot' of this global recovery and looks well-positioned for the investment cycle. Strong Eurozone growth (potentially 2.5%) focuses attention on ECB normalisation. Eurozone's 3% current account surplus also protects the still-undervalued EUR during risk-off episodes.

**The dollar's best chance of a rally may be in 1Q18** when 10-year US Treasury yields advance to 2.60/2.70%. **That could push USD/JPY to 115.** However, recovering growth stories elsewhere in the world should extend the dollar's benign decline later in 2018. Coincidentally, the dollar also usually suffers in the second year of Republican presidencies.

We look for **GBP to be one of the primary beneficiaries of reduced policy uncertainty** – at least in the early part of 2018. Approval to proceed to Phase II of Brexit should prompt a brief re-rating of the UK economic cycle and **send GBP/USD to 1.40.**

The Scandies have confounded the market in the final quarter of 2017. We look for a technical SEK rally in 1Q18 as local money market rates increase – **taking EUR/SEK to 9.60** – but look for stability thereafter. **Only undervaluation supports NOK in 2018.**

## \$-bloc, CE3 and EMEA high-yielders

**Dollar bloc FX** will be the relative underperformers of 2018. Within the space, **CAD** is set to gently rally amid a BoC hiking cycle. Depleting yield advantage will keep **AUD** and **NZD** sidelined – with the latter to bounce back first in 2Q18 on an RBNZ tightening story.

**CE3 currencies should continue to perform strongly.** Of the pack, we continue to favour the **CZK**. Gains should be driven by a central bank genuinely concerned by capacity pressures and in the midst of a tightening cycle. **CE3 currencies also benefit from the investment cycle** and the exposure to the strengthening Eurozone recovery.

EMEA high yielders will continue to face challenges in 2018. Both the **TRY** and **ZAR** are very cheap, but to recover will require resolution of political challenges as well as appropriate policy responses – be they fiscal for South Africa or monetary for Turkey. **The RUB should prove a relative outperformer** buoyed by yield and lower volatility.

## Latam and China

**Latam FX** in 2018 will once again be determined by the political calendar and the relative performance of commodities pertinent to local producers. **MXN** will struggle ahead of elections in July and perhaps a NAFTA stand-off too. **USD/MXN could trade to 20.50 next summer.**

October elections should also keep **BRL** in check. The Chilean peso looks to be the region's outperformer, given the expected deficit in the copper market.

The **Renminbi should enjoy modest gains** against a slightly softer dollar, with the PBOC now having the market under greater control. **KRW** looks well positioned to benefit from the global industrial cycle and the start of a tightening cycle. **USD/KRW to 1000.** We also like the recovery story in Malaysia. Philippine Peso to underperform.

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