

# January Economic Update: Overdoing the gloom

2019 is starting on a downbeat note, as further signs of a global slowdown continue to fuel a flight-to-safety in the markets. However, while growth is unlikely to match the favourable surprises of early 2018, the gloom may be overdone. Read more in our latest economic update

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By Padhraic Garvey, CFA

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# ING Global Forecasts

	2017					2018F					2019F					2020F				
	1Q	2Q	3Q	4Q	FY	1Q	2Q	3Q	4Q	FY	1Q	2Q	3Q	4Q	FY	1Q	2Q	3Q	4Q	FY
<b>United States</b>																				
GDP (% QoQ, ann)	1.8	3.0	2.8	2.3	2.2	2.2	4.2	3.4	2.6	2.9	1.6	2.0	2.0	2.0	2.3	1.7	1.7	1.7	1.9	1.8
CPI headline (% YoY)	2.6	1.9	2.0	2.1	2.1	2.3	2.6	2.6	2.2	2.4	1.6	1.9	1.9	2.1	1.9	2.3	2.2	2.1	2.1	2.2
Federal funds (% eop) <sup>1</sup>	0.75	1.00	1.00	1.25		1.50	1.75	2.00	2.25		2.25	2.50	2.75	2.75		2.75	2.75	2.75	2.75	
3-month interest rate (% eop)	1.15	1.30	1.33	1.56		2.30	2.35	2.45	2.64		2.80	3.00	3.15	3.15		3.15	3.15	3.15	3.15	
10-year interest rate (% eop)	2.40	2.30	2.30	2.40		2.75	2.85	3.05	2.70		2.85	3.00	3.00	2.90		2.80	2.80	2.80	2.80	
Fiscal balance (% of GDP)					-3.5					-4.0					-4.7					-5.0
Fiscal thrust (% of GDP)					0.0					1.2					0.5					0.8
Debt held by public (% of GDP)					76.1					77.4					80.2					83.3
<b>Eurozone</b>																				
GDP (% QoQ, ann)	2.7	2.8	2.7	2.7	2.5	1.6	1.8	0.7	1.0	1.9	1.4	1.7	1.5	1.4	1.4	1.4	1.2	1.0	0.9	1.3
CPI headline (% YoY)	1.5	1.3	1.5	1.4	1.4	1.3	1.7	2.0	2.0	1.8	1.6	1.5	1.3	1.5	1.5	1.6	1.6	1.7	1.7	1.7
Refi minimum bid rate (% eop)	0.00	0.00	0.00	0.00		0.00	0.00	0.00	0.00		0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
3-month interest rate (% eop)	-0.33	-0.33	-0.33	-0.33		-0.33	-0.33	-0.33	-0.33		-0.32	-0.26	-0.25	-0.10		-0.10	-0.10	-0.10	-0.10	
10-year interest rate (% eop)	0.45	0.40	0.45	0.42		0.50	0.30	0.40	0.24		0.30	0.50	0.60	0.60		0.60	0.60	0.60	0.50	
Fiscal balance (% of GDP)					-0.9					-0.6					-0.9					-0.8
Fiscal thrust (% of GDP)					0.2					0.0					0.2					-0.1
Gross public debt/GDP (%)					89.2					87.6					85.8					84.8
<b>Japan</b>																				
GDP (% QoQ, ann)	1.9	2.3	1.6	1.3	1.7	-1.1	3.0	-1.1	4.2	1.7	2.6	-0.6	5.8	-5.8	1.7	2.9	1.6	1.1	1.6	1.2
CPI headline (% YoY)	0.2	0.4	0.6	0.6	0.5	1.3	0.6	1.1	1.0	1.0	0.7	1.3	1.2	2.1	1.3	2.4	2.2	2.1	1.0	1.9
Excess reserve rate (%)	-0.1	-0.1	-0.1	-0.1		-0.1	-0.1	-0.1	-0.1		-0.1	-0.1	-0.1	-0.1		0.0	0.0	0.0	0.0	
3-month interest rate (% eop)	0.00	0.00	0.00	0.00		0.00	0.00	-0.05	-0.05		0.05	0.05	0.00	0.00		0.00	0.10	0.10	0.10	
10-year interest rate (% eop)	0.10	0.10	0.10	0.10		0.10	0.10	0.10	0.10		0.1	0.1	0.1	0.1		0.2	0.2	0.2	0.3	
Fiscal balance (% of GDP)					-4.8					-4.1					-3.6					-3.0
Gross public debt/GDP (%)					221					223					224					226
<b>China</b>																				
GDP (% YoY)	6.9	6.9	6.8	6.8	6.9	6.8	6.7	6.5	6.3	6.6	6.2	6.2	6.3	6.3	6.3	6.3	6.2	6.2	6.2	6.2
CPI headline (% YoY)	1.4	1.4	1.6	1.8	1.6	2.2	1.8	2.3	2.5	2.2	2.5	2.5	2.6	2.6	2.6	2.6	2.6	2.5	2.4	2.5
PBOC 7-day reverse repo rate (% eop)	2.45	2.45	2.45	2.50	2.50	2.55	2.55	2.55	2.55	2.55	2.50	2.50	2.45	2.45	2.45	2.40	2.40	2.35	2.35	2.35
10-year T-bond yield (% eop)	3.29	3.57	3.61	3.90	3.90	3.75	3.48	3.63	3.30	3.30	3.25	3.20	3.15	3.10	3.10	3.10	3.05	3.05	3.00	3.00
Fiscal balance (% of GDP)					-3.7					-4.5					-4.5					-4.0
Public debt, inc local govt (% GDP)					50.0					88.0					102					103
<b>UK</b>																				
GDP (% QoQ, ann)	1.3	1.0	1.9	1.6	1.5	0.3	1.7	2.5	1.0	1.4	1.3	1.5	2.0	1.6	1.5	1.5	1.7	1.2	1.1	1.6
CPI headline (% YoY)	2.1	2.7	2.8	3.0	2.7	2.7	2.4	2.5	2.2	2.5	2.2	2.2	1.9	2.1	2.1	2.1	2.1	2.0	1.9	2.0
BoE official bank rate (% eop)	0.25	0.25	0.25	0.50		0.50	0.50	0.75	0.75		0.75	1.00	1.00	1.00		1.25	1.25	1.50	1.50	
BoE Quantitative Easing (Ebn)	445	445	445	445		445	445	445	445		445	445	445	445		445	445	445	445	
3-month interest rate (% eop)	0.35	0.35	0.35	0.52		0.60	0.80	0.80	0.80		0.85	1.05	1.05	1.05		1.30	1.35	1.60	1.65	
10-year interest rate (% eop)	1.15	1.10	1.35	1.20		1.45	1.48	1.57	1.30		1.50	1.70	1.85	1.85		1.90	2.00	2.10	2.20	
Fiscal balance (% of GDP)					-2.5					-1.4					-1.5					-1.5
Fiscal thrust (% of GDP)					-0.5					-0.4					-0.4					-0.3
Gross public debt/GDP (%)					87.0					84.0					83.0					81.5
EUR/USD (eop)	1.08	1.12	1.20	1.20		1.20	1.17	1.15	1.12		1.10	1.12	1.15	1.20		1.22	1.25	1.28	1.30	
USD/JPY (eop)	112	115	110	113		107	110	114	113		113	113	110	105		103	100	98.0	95.0	
USD/CNY (eop)	6.89	6.78	6.65	6.51		6.28	6.67	6.87	7.00		7.10	7.20	7.30	7.30		7.30	7.20	7.10	7.00	
EUR/GBP (eop)	0.87	0.88	0.94	0.89		0.88	0.88	0.89	0.90		0.89	0.85	0.85	0.85		0.85	0.85	0.85	0.85	
Brent Crude (US\$/bbl, avg)	55	51	52	61	55	67	75	76	69		65	68	69	73		70	74	76	74	

<sup>1</sup>Lower level of 25bp range; 3-month interest rate forecast based on interbank rates

Source: ING forecasts

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## US: Look on the bright side

Despite the current market doom and gloom there are plenty of positives for the US economy



Source: Shutterstock  
Fed Chair, Jerome Powell

### Greater headwinds for growth in 2019

2018 was a good year for the US economy, but the situation will undoubtedly get tougher in 2019. We have written at length about the intensifying headwinds – namely the lagged effects of higher borrowing costs, the stronger dollar, the fading support from the 2018 fiscal stimulus and weaker external demand at a time of rising trade protectionism.

Some of these factors can already be seen in the data. With 30-year fixed rate mortgage costs rising above 5%, mortgage applications are falling and slowing the housing market. Business surveys have also softened of late, as concerns about rising trade protectionism and what it might mean for costs and supply chains mount. We have consequently seen a moderation in investment spending on equipment, despite the fact that President Trump's corporation tax cuts were supposedly introduced to stimulate domestic capital expenditure.

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*We believe the current market doom and gloom has been overplayed*

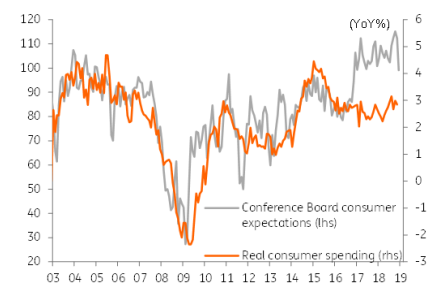
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Financial markets have been deeply troubled by these developments, with the S&P500 falling nearly 20% peak-to-trough since October. President Trump’s open criticism of Federal Reserve policy decisions and the current partial government shutdown, caused by an impasse over the proposed \$5 billion security wall along the border with Mexico, is adding to the unease and could take a couple of tenths of a percentage point off 1Q GDP growth. It has resulted in billions of dollars being wiped off the value of investment and pension funds and has seen consumer confidence come under pressure.

As such, it should be no surprise that we doubt the economy will grow as fast as it did in 2018. However, we believe the current market doom and gloom over the US’s prospects has been overplayed and market expectations that the Federal Reserve will possibly cut interest rates this year are wide of the mark.

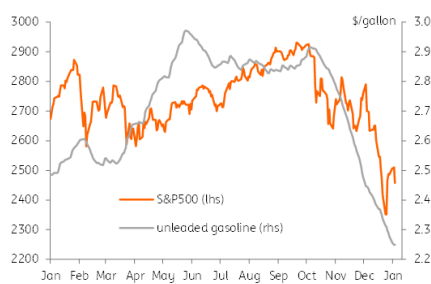
For starters, the fact that consumer confidence has only dropped back to the levels seen in the summer when equities were still riding high, underlines the fact that there are still clear positives for the household sector elsewhere in the economy.

Fig 1 Confidence fall doesn't imply spending collapse



Source: Macrobond  
Source: Macrobond, Bloomberg

Fig 2 Gasoline prices have fallen further than equities



Source: Bloomberg

## Tight jobs market, faster wage growth and lower gasoline prices could help growth

Indeed, the jobs market remains hot with demand for workers outstripping supply. The National Federation of Independent Businesses reported this week that the proportion of firms that can't fill their current vacancies is at all-time highs (39%). This analysis was backed by the most recent Federal Reserve Beige Book, which suggested that “over half of the Districts cited firms for which employment, production, and sometimes capacity expansion had been constrained by an inability to attract and retain qualified workers”.

This means wages are being bid up and employees are feeling the benefits. Wage growth is now above 3% year-on-year, and we think it will rise further, given the competition for suitable workers at a time when the unemployment rate is at a 49-year low. The Beige Book stated that “in addition to raising wages, most Districts noted examples of firms enhancing nonwage benefits, including health benefits, profit-sharing, bonuses, and paid vacation days.”

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*We think the growth slowdown will be fairly modest, especially when considering that 2018 saw the fastest US growth for 13 years*

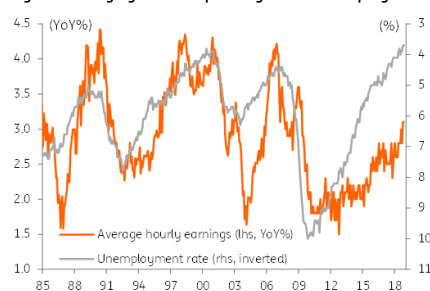
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We also have to remember that gasoline prices have been plunging at an even faster rate than equities – down 65 cents/gallon since October – leaving more cash in drivers’ wallets (close to \$90 billion based on annual consumption). At the same time, house prices continue to rise despite the slowdown in demand for mortgages, so the household balance sheet remains in decent shape overall.

As for the corporate side, while business surveys have come off their highs, they remain at levels consistent with healthy growth rates. The current US-China trade ceasefire until March also provides some breathing room and if progress can be made (such as at the Jan7-8 US-China summit in Beijing) eventually resulting in some form of resolution, or at least an extension of the peace, this would clearly be positive for the economic outlook in the first half of the year. However, we certainly aren’t complacent on this issue and believe tensions will likely intensify before meaningful concessions are made and a longer-term truce is called.

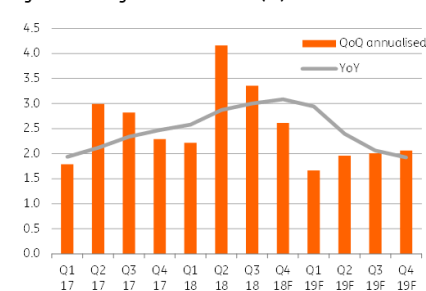
Taking all these factors together we think the growth slowdown will be fairly modest, especially when considering that 2018 saw the fastest US growth for 13 years. We see the economy expanding around 2.3% in 2019 versus 2.9% in 2018 although the quarterly profile sees annualised growth rates running roughly two-thirds those seen in 2018.

Fig 3 US wage growth responding to low unemployment



Source: Macrobond  
Source: Macrobond, ING

Fig 4 US GDP growth & forecasts (%)



Source: Macrobond, ING

## Two hikes in 2019 now our base case

As for price pressures, the plunge in the oil price means headline inflation rates are looking less threatening for 2019. Further gasoline price falls are likely in the coming weeks, while airfare and transportation costs, in general, should move lower. The delay to the introduction of additional tariffs on Chinese imports also supports a lower forecast profile for inflation in the near term. However, given the lack of spare capacity in the US economy, we see core inflation continuing to rise through the first half of 2019.

Rising wages will be a major driver of this and therefore a key factor that will keep the Federal Reserve on course to raise interest rates further in 2019. However, we are likely to see a slower and more modest set of hikes versus 2018, as indicated by the more dovish narrative at the December FOMC meeting and the Fed’s acknowledgement that “financial developments” could weigh on the outlook. Having signalled back in September that three rate hikes in 2019 was the most likely scenario, five FOMC members lowered their projection in December, leaving the median forecast at just two 25 basis point moves in 2019.

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*We still look for tighter monetary policy over the summer*

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We also have to remember that the Federal Reserve is shrinking its balance sheet while there is growing talk – most notably from Lael Brainard – concerning raising the countercyclical buffers as a way of shoring up the financial system while also tightening monetary conditions. Consequently, we, like the Federal Reserve, see two hikes as being the most likely scenario for 2019 versus the four hikes experienced in 2018.

In terms of our profile for Federal Reserve interest rate hikes we now expect to see a pause in 1Q19, but in an environment of rising wage and core inflation pressure we still look for tighter monetary policy over the summer. Given financial markets are not anticipating any rate hikes this year, there is some scope for re-pricing in the Treasury market, particularly if equity markets can recover some of their losses over the early part of 2019. Add in the fact that US government borrowing continues to rise at the same time as the Federal Reserve is running down its balance sheet, we see the 10-year yield pushing back up to 3% in coming months.

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Article | 4 January 2019

## Eurozone: A weak end to the year

While the dispute over Italy's budget has been resolved, trade wars and Brexit remain substantial risks to eurozone growth, which is already suffering from a slowdown. As the ECB's growth and inflation forecasts are likely to be disappointed, we see little incentive for the ECB to tighten monetary policy



Source: Shutterstock

### Weak Eurozone growth in 4Q18 could persist into the start of 2019

The year 2018 ended on a weak note for the eurozone economy, with sentiment indicators still heading south and stock markets tanking. While there are still positive drivers that make it too soon to call the end of the expansion, growth in 2019 is likely to be lower than in 2018 with risks skewed to the downside.

After a strong start, the eurozone economy lost momentum throughout 2018. To be fair, with capacity constraints showing up, the eurozone could simply not maintain a growth pace above 2%. But there were other headwinds that explain the growth deceleration.

The uncertainty provoked by the trade wars, the strong euro exchange rate in effective terms, the slowdown in the emerging world, the uncertain Brexit outlook and the clash between Italy and the European Commission all contributed to a loss of confidence. Not to mention some very specific

problems in the German car industry that resulted in a GDP contraction in the third quarter there.

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*While there are still positive drivers that make it too soon to call the end of the eurozone expansion, growth in 2019 is likely to be lower than in 2018 with risks skewed to the downside*

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Sentiment indicators have weakened further in December, with the eurozone manufacturing PMI falling to 51.4 from 51.8 in November. The social unrest in France, initiated by the so-called Yellow Vests, has probably shaved off 0.2 percentage points of French 4Q GDP growth.

Because of that, we expect eurozone 4Q GDP growth to be below 0.3% on a non-annualised basis. With export growth unlikely to accelerate much in the coming months, the first quarter is unlikely to see a significant pick-up. However, the labour market is still strong, with wage growth gaining traction. Combined with much lower energy prices, this should boost purchasing power and consumption in the first half of the year. On top of that, there is some fiscal loosening in the offing in the three biggest member states.

## Politics still poses risks

The Italian problem seems to be resolved for now as the Italian government and the European Commission reached a compromise, allowing for a budget deficit of 2.04% in 2019. The Excessive Deficit Procedure will be shelved for the time being.

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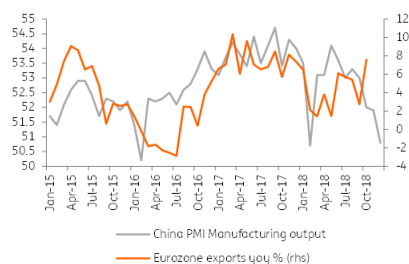
*We're convinced that not only the ECB's growth forecasts (1.7% for both 2019 and 2020) are too optimistic, but that inflation might also surprise to the downside*

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On the back of this agreement, there was a strong decline in Italian bond yields. However, on the trade front, there is still the risk that US President would want to impose import tariffs on European cars (the US Commerce Department is expected to issue a report on the strategic character of the automobile sector for the US economy by 17 February).

Finally, the risk of a hard Brexit is still there, something that could temporarily disrupt exports to the UK. All in all, we continue to forecast 1.4% in 2019 and 1.3% in 2020, but there are clearly some downward risks.

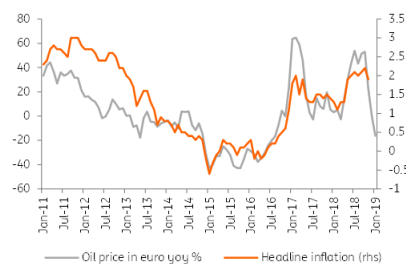
Fig 1 EM weakness will weigh on EZ exports



Source: Thomson Reuters Datastream

Source: Thomson Reuters Datastream

Fig 2 Falling oil price will push inflation down



Source: Thomson Reuters Datastream

## ECB growth and inflation forecasts seem way too optimistic

We're convinced that not only the ECB's growth forecasts (1.7% for both 2019 and 2020) are too optimistic, but that inflation might also surprise to the downside. The strong fall in energy prices will have a downward impact on headline inflation in the coming months. And while higher wages could boost core inflation, we think tighter profit margins will partially neutralise this impact. In these circumstances, we see little incentive for the ECB to tighten monetary policy.

We still believe there could be a small hike in the deposit rate, say 15 to 20 basis points, in the fourth quarter of 2019, but we don't see any refi rate hike over the forecast horizon. This basically means that the money market rate will probably remain negative throughout 2020. A reason why bond yields, which are now depressed by the bout of risk aversion on financial markets, are unlikely to see strong upward pressure for some time to come.

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## UK: Breaking the Brexit deadlock

The UK economy is beginning to stall as Prime Minister Theresa May prepares to hold a crunch vote on her deal in mid-January. This looks set to be rejected by MPs, potentially opening the door to either a second referendum or a push towards the 'Norway option'. Nobody truly knows what option will prevail, but some form of Brexit delay is becoming more likely



Theresa May leaves Downing Street, December 17th

### 'No deal' remains the default Brexit scenario - unless MPs can unite around an alternative

As the new year begins, it's worth reminding ourselves that as things stand, the default legal position is that the UK will leave the EU on 29 March without a deal, unless Parliament can unite around a particular alternative course of action. Nobody truly knows which (if any) particular option may ultimately command a majority amongst MPs, but there are a few main scenarios.

First off, there's the deal that the Prime Minister agreed with Brussels back in November and the fact remains that Theresa May faces a steep, uphill battle to get it approved by Parliament. A crucial vote on the agreement - which was dramatically postponed in mid-December - will take place on 14 January, and right now, it looks set to be rejected, potentially by a heavy margin.

Turning the tide will be tough – if not impossible – particularly given that the EU has made it clear it is not prepared to renegotiate. Back in December, Theresa May had hoped to win legal assurances that the contentious Irish backstop would never be needed, but the EU has made it clear this would render the agreement an invalid insurance policy against a hard border in Northern Ireland.

## **If the deal is voted down, MPs are likely to get a say on next steps**

So what next if Parliament votes down the deal? Well, talk of a no-confidence vote in the government is likely to rise once again, although so far the Labour Party has been reluctant to go down this path. However if a confidence vote were to happen and get enough support among MPs (which still seems like a tall order, given that some Conservative/DUP MPs would need to back it), then an election would be triggered within 14 days- if an alternative government cannot be confirmed by lawmakers.

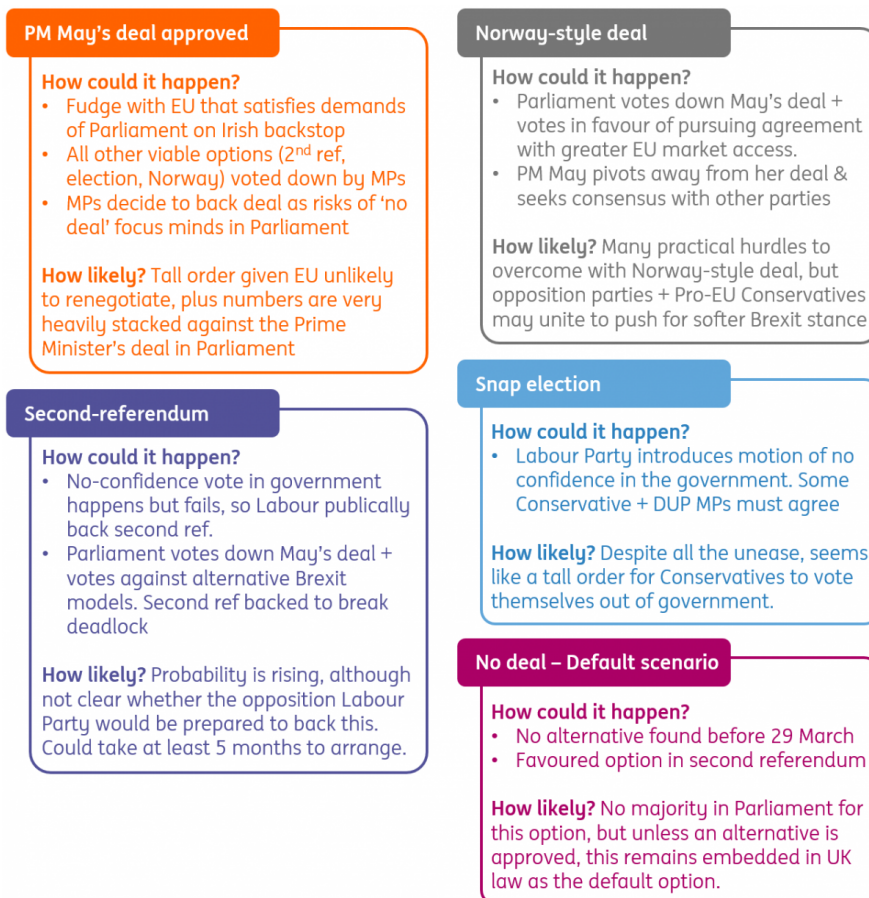
Assuming there isn't a snap election, MPs will still likely get a say on what happens next. The government will have to inform Parliament of its next steps within 21 days of losing the vote, and this plan could be amended by lawmakers. It's probably at this point that we'll find out whether there is a majority for a new Brexit direction.

Of all the possible options, a second referendum, or a push towards something resembling the so-called Norway-option, seem most likely to command a majority.

Of course, both still face challenges. In the case of a second referendum, there is no consensus on what question would be on the ballot paper, neither have the polls shifted enough to suggest the verdict would be decisively different today versus the 2016 vote.

In the case of the EEA-style deal, the EU is reportedly wary that the UK could struggle to permanently accept being a rule-taker in key areas (e.g. finance). It's also likely that the Irish backstop would still be kept in place, given that the EEA has a one-year exit clause, raising concern in Brussels that it could be used as a way to ultimately reach a harder Brexit and risk border frictions within Ireland. It would also require the government to drop perhaps it's reddest of red lines – no freedom of movement.

## How the different Brexit options could materialise



Source: ING

## A Brexit delay looks more likely - although this isn't challenge-free either

No one knows which way MPs will go, but what ties all of these options together is a lack of time. Our understanding is that a second referendum could take upwards of five months to arrange, allowing time for legislation to pass, the question to be consulted upon and a regulated campaign period. A softer Brexit option would take time to renegotiate, while a general election would take a minimum of five weeks – and if a new government came in, presumably extra time to reshape the existing deal.

This is important because Parliamentary rules mean that new legislation (such as the EU Withdrawal Act) need to be laid 21 sitting days before coming into effect – which in other words, means the deal needs to be approved by Parliament by 26 February.

Put simply, the chances of some form of Brexit delay are rising. An extension to the Article 50 period seems the most likely way of doing this, and assuming the rationale for doing so was for the UK to change course in some way, or hold a fresh vote, then it is unlikely EU member states would object.

## *The chances of some form of Brexit delay are rising*

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That said, this approach isn't without its challenges either. The main hurdle is the EU Parliamentary elections, which would need to take place before new MEPs gather for the first time on 2 July and potentially putting a time limit on a possible Article 50 extension. Some have suggested this could be navigated by temporarily giving the MEP roles to MPs from the House of Commons, although it's not clear whether this would be legally permissible. The more drastic alternative to an extension would be to revoke Article 50 altogether, although it's very hard to see the government or Parliament opting to do this without the public's consent.

### **The economy is beginning to suffer**

Whatever happens, it's clear the economy is entering a tumultuous phase. [Growth slowed through the final quarter of 2018](#) and we expect the economy to continue to struggle. While the Bank of England appears keen to continue tightening policy when it can, the odds of a rate hike before the summer are fading and the prospect of a Brexit delay (thus prolonging the uncertainty for firms and consumers) would likely rule out another rate hike until much later in 2019.

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## China: In need of stability

The Chinese economy is weakening, as shown by manufacturing surveys, but fiscal stimulus should soon be in place to counter unemployment risks. The central bank will use its new tool, the Targeted Medium-Term Lending Facility (TMLF), to provide lifelines to both small and private companies



Workers at an electronic factory in Eastern China

### Trade war risks to re-emerge

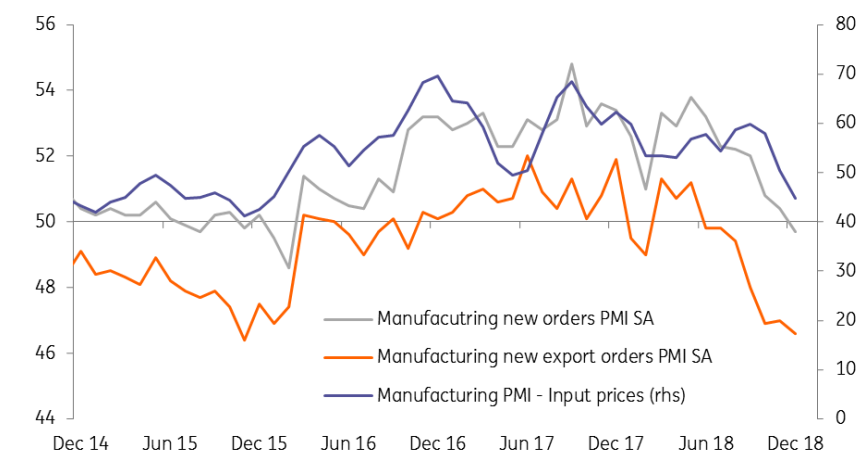
The Chinese economic outlook depends critically on the development of the trade dispute. If a truce with the US is extended, there will be more upside than downside risk for the Chinese economy and global growth. But for the time being, we are still projecting a trade war scenario re-emerging sometime after 1 March 2019.

The trade war impact has fed through the export sector to domestic sectors via the supply chain. Ports, logistics, and packaging all face lower demand.

Business surveys show that the Chinese economy is weakening. Headline PMIs have been contracting, and the 'new orders' sub-index started to contract in December. Manufacturers, in general, have suffered from fewer orders from the domestic market, as well as fewer orders from foreign markets.



## Shrinking manufacturing activity



Source: ING, Bloomberg

## Pro-growth measures needed

If there are no pro-growth measures we will see jobs at risk, which is a key threat that the central government wants to avoid. Within the [“six stability” agenda](#) set by the central government, job security is the top priority, which shows its importance to the government and to society. In terms of growth, job security is also important to avoid the trade war impact spiralling into a downward cycle, which affects spending and therefore corporate earnings.

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*Regarding fiscal stimulus, we expect a package of CNY 4 trillion in 2019*

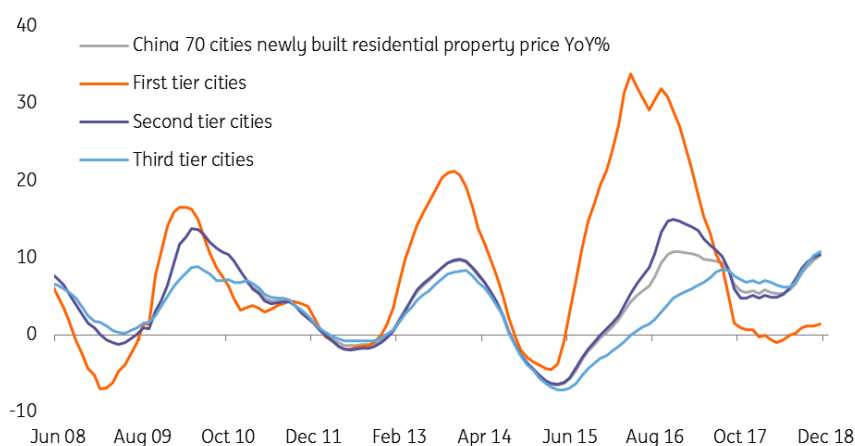
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As a result, fiscal stimulus and monetary easing measures will be needed. Regarding fiscal stimulus, we expect a package of CNY 4 trillion in 2019, and if the trade war continues into 2020, the same amount will be in place next year.

Most of the funding will come from local government special bond issuance, which by definition is “corporate” debt rather than fiscal debt. So we don’t really expect a big jump in the fiscal deficit to GDP ratio of around 4%.

These funds will be used for infrastructure investment. This is a quick solution for local governments to support GDP growth. Some local governments will start to relax housing measures to prop up housing construction activity.

## Propping up the housing market



Source: ING, Bloomberg

The central government will develop high-quality manufacturing and 5G applications. As 5G faces hurdles on equipment exports, the government will broaden its 5G coverage and speed up 5G applications domestically.

On monetary policy, the central bank has announced a new tool, the Targeted Medium-Term Lending Facility (TMLF), which has an interest rate 0.15 percentage points below the general Medium Term Lending Facility (MLF), with funds channelled to smaller companies and private companies.

We have yet to see how the central bank will implement the new tool, but we expect it to start using it this month. We believe that the TMLF will not fully replace the MLF, but the size of TMLF could be larger than MLF because the government wants to keep private companies alive to avoid job losses.

We also expect the first cut of the required reserve ratio (RRR) to take place this month. Similar to TMLF, this RRR cut will be a targeted cut for smaller companies.

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### *The People's Bank of China changed its exchange rate policy stance to maintaining a stable currency*

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Near the end of 2018, in its meeting minutes, the People's Bank of China changed its exchange rate policy stance to "maintain a stable exchange rate at a reasonable level". We believe the central bank is aiming to minimise the chances of market chaos and massive capital outflows, even if the probability of such an event is very low. Our current USD/CNY forecast is 7.30 by the end of 2019. We may revise the forecast to a milder yuan depreciation, but before that, we need to monitor the trend to confirm the PBoC's definition of "stability".

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## FX: Dollar close to its peak

Peak dollar rhetoric dominates the FX environment as we look to the final stage of the dollar rally. The effect of fiscal stimulus on US growth is fading and the Fed isn't far away from the end of its tightening cycle, supporting our expectations that the dollar is to undergo a long-term bearish trend when the peak has past



Source: Shutterstock

As per our [2019 FX Outlook: Peak Dollar](#), we still expect the dollar to peak and look for the very last leg of the dollar upside. Although global trade war concerns and a sharp fall in equity markets are likely to lower the overall scale of the Fed tightening this year (our economists have downgraded the Fed outlook for 2019 from three hikes to two), given the current ultra-dovish market pricing (the market is pencilling in a partial rate *cut* this year) even more modest tightening vs what we previously expected should be enough to provide some support to the US dollar during the first half of the year.

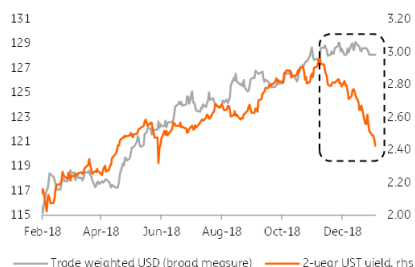
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*The Fed will continue tightening and the widening interest rate differential between the US and G10 low yielders will push USD higher*

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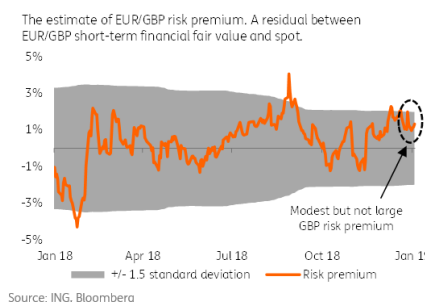
The trade-weighted dollar should still do well as either (a) the global environment deteriorates further (not our base case) and USD will retain support in trade-weighted terms via its safe- haven characteristic (a trend observed over the past two months when the trade-weighted USD remained flat despite the aggressive dovish re-pricing of the Fed outlook); or (b) the global environment and risk assets stabilise, the Fed will continue tightening and the widening interest rate differential between the US and G10 low yielders will push USD higher.

Fig 12 USD did fairly well despite the dovish re-pricing



Source: ING, Bloomberg  
Source: Bloomberg, ING

Fig 13 Only modest risk premium priced into sterling



Source: ING, Bloomberg

But this should be the last leg of the dollar upside and the currency should embark on a gradual long-term bearish trend from 2H 2019 onwards as the Fed will be close to its terminal rate and the likely growing market concerns about the US twin deficit should push the dollar lower. While we acknowledge that the dollar decoupled from the widening twin deficit last year, this was in our view due to the unique mix of tight US monetary policy and loose fiscal policy. This is unlikely to be repeated this year as the Fed is not far away from the end of its tightening cycle while the effect of the fiscal stimulus on US growth is fading.

This means EUR/USD will move higher in the latter part of the year (we forecast 1.20 by the year-end) though this should be largely about a weak USD rather than a strong EUR. Unlike in 2017, we don't believe the ECB will be a catalyst for a stronger euro this year. With the central bank expected to barely deliver one 20 basis point depo rate hike very late this year and no increase in the refi rate over the forecast horizon, the case for a domestically-induced EUR rally is rather low.

*Despite the rising odds of the Article 50 extension, this does not necessary argue for a bullish GBP stance*

Despite rising odds for an Article 50 extension, this does not necessarily argue for a bullish GBP stance as (1) by delaying Article 50 the uncertainty will still remain in place; (b) the reasons behind the delay may prompt further GBP weakness (such as early elections). And although some risk premium is already priced into GBP (around 1.5% into EUR/GBP based on our financial fair value model) the fairly large veil of uncertainty about the Brexit outcomes should keep such risk premium in place and could even cause it to rise further. We thus expect EUR/GBP to continue to trade around the 0.90 level and sterling to lag.

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## Japan: Talking down the economy

Japan's economy was severely hit by the weather, with a partial recovery now being seen. However, inflation continues to undershoot expectations, while Bank of Japan rhetoric is keeping a lid on bond yields, although the real target may be to moderate yen appreciation

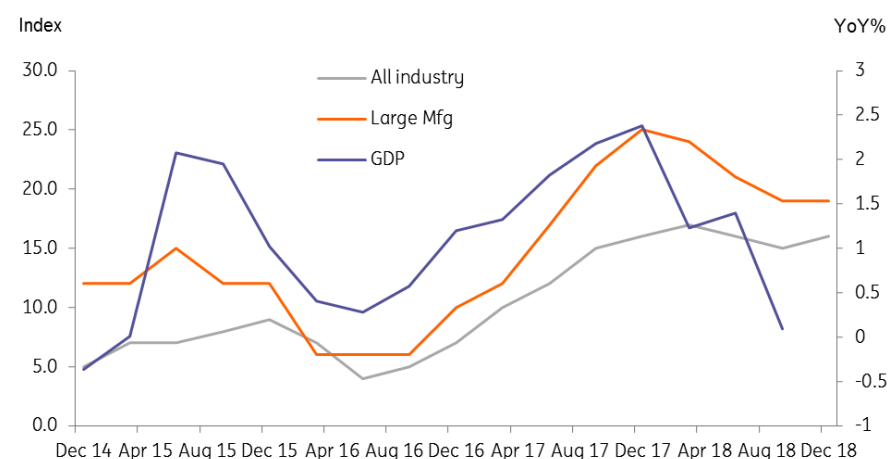


Source: Shutterstock

Last month, we entertained the view that Japan's economic weakness in 3Q18 GDP was largely weather-related, owing to the impact of September's Typhoon Jebi, and that the fourth quarter of 2018 would see a strong bounce back that could carry over into 2019.

Directionally at least, the run of news seems to be validating this idea, and the 4Q18 Tankan survey released by the Bank of Japan at the end of 2018 shows manufacturing and non-manufacturing activity diverging positively from the earlier GDP figures. This data suggest that the phase of restoration, recovery, and replacement is already well underway and that should provide a couple of quarters of strongly supported growth – absent further natural disasters.

## Japan: GDP and Tankan survey



Source: CEIC

## An Orwellian version of forward-guidance

However, this has not provided much comfort to the Bank of Japan. At their last policy meeting of 2018, they put more emphasis on the downside risks to growth and the economy and seemed to be backing further away from the hints at a policy taper they had made earlier in the year.

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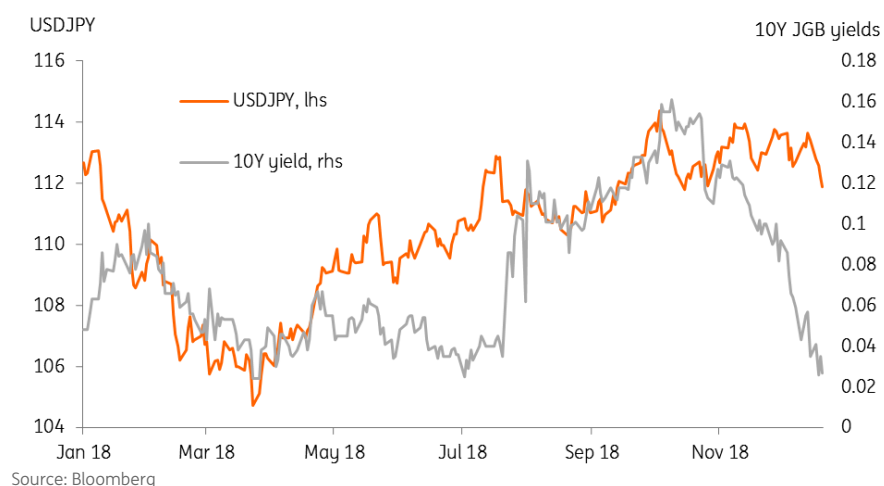
*The central bank is still clinging on to the claim that their 2% inflation target is achievable*

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In what seems to be a sort of Orwellian version of forward-guidance, where thoughts of any taper are being dispelled, the central bank is still clinging on to the claim that their 2% inflation target is achievable, and not too far off – claims that are unsupported by reality. They perhaps believe that admitting a 2% inflation rate is no longer a viable objective could set in train a much weaker set of inflation expectations that could deliver a self-fulfilling downward spiral towards deflation.

Breakeven inflation rates in Japan are already at barely 0.2% on a 5–10-year basis and have been falling since January last year, though their descent has picked up pace recently. That probably has more to do with the sharp decline in conventional bond yields than any genuine worry about the outlook for inflation, though there are no reliable survey-based inflation expectation measures to compare this with.

## USD/JPY and 10-year Japanese bond yields



We think, the decline in bond yields is a response to BoJ rhetoric and actively managed by them, although the principal target, we suspect, is not bond yields themselves, which at their recent peak, were only about 0.2% for the 10-year government bond (10Y JGB).

Instead, we suspect that yen strength is the bigger motivator. With scepticism rising about the continued resilience of the USD, the EUR story looking less supported by fundamentals, CNY under downward pressure and GBP at the mercy of Brexit fears, the JPY stands out in this “flower show” as the only display not covered in aphids.

Ultimately, this is not a game the BoJ can win, but we suspect they will be content if their actions manage to limit and control the scale and speed of any further appreciation of the currency.

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Article | 4 January 2019

## Rates: Pivot and turn

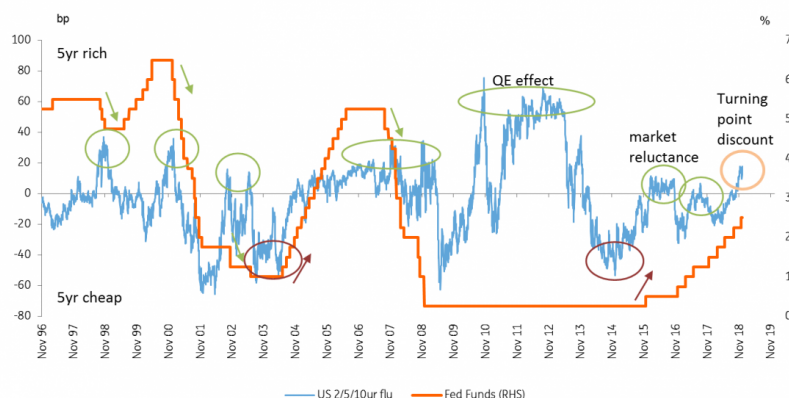
The recent downturn in bond yields, prompted by political worries, may continue in the near term. However, we expect US yields to shift back towards the upper end of their current range as concerns about core US inflation and rising issuance reassert themselves



Source: Shutterstock

Bond market turning points are best picked up by the positioning of the 5-year bond on the yield curve. The chart below illustrates this by looking at the 5-year yield relative to a combination of the 2-year yield and the 10-year yield. On the very right-hand-side, it is clear that the 5-year has broken out, and is now trading “rich”. History shows that this is not a perfect signal, but more often than not it is bullish for bonds and can signal a turning point for the Fed.

## Fed fund rates alongside the 2/5/10-year fly (modelled as long the wings and short the belly)



Source: Bloomberg, ING estimates

The chart below then shows the effect of this; market yields have been pulled back down towards the Fed funds ceiling at 2.5%. History shows when the Fed peaks, market yields trade through the funds rate. We are at that critical juncture right now.

## Fed funds rates alongside the 2-year yield and 10-year yield



Source: Bloomberg, ING estimates

That said, just because market yields have fallen back to the level of the funds rate doesn't necessarily mean that they can't back up again. In the last two rate hiking cycles, market rates broke below the fed funds rate prematurely, in the sense that the Fed continued to hike and market rates subsequently saw new highs.

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*A pause may be a logical outcome given the confluence of negatives in play right now*

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Certainly, a glance at the above two charts would give the Fed pause for thought, which is why we

argue that a pause may be a logical outcome given the confluence of negatives in play right now. We had anticipated that some of these would have faded by now. But as Italy has melted as an issue, a renewed focus on China has taken centre stage, underpinning the slowdown narrative.

This keeps market rates in check, and if circumstances deteriorate further, the fall in market rates is not complete. Stock market performance will be as good a barometer as any in the coming weeks, but bond markets rarely remain slavish to equity markets for long, and will typically pan an often wider panoramic view of domestic and global circumstances.

Plus, there are two key undiscounted issues. First, US bond yields will react to US fundamentals, and in particular to core inflation, which we see in the 2.25% area. This should act as a floor for market yields, as negative real yields are a step too far. Second, there is a growing net supply issue ahead. A Treasury deficit in the 5% to 6% area plus a Fed continuing to unwind QE implies a heavier feel for bond markets.

For now, the focus seems to be less on the known (e.g. still firm US macro underpinning and higher net supply prognosis) and more on the unknown (e.g. trade war risks being stoked by a China slowdown narrative). The thing is that the known is in play with relative certainty, while the unknowns could fade into something less sinister than currently discounted - the glass half full prognosis.

The bottom line is that market yields are now testing the lower end of a 100 basis point range that we identify between the core inflation floor of 2.25% and the cycle high seen for the 10-year yield at 3.25%. If the glass half empty attitude is realised, we stay down here. But more than likely, we will re-visit the upper half of that range at the very least, which by definition brings the 2.75% to 3.0% area into play; and that's a whole different dimension.

We reiterate that market yields went on to take out higher highs in previous rate hike cycles, as the Fed continued to hike despite its convergence with market yields. It could be different this time if a risk case scenario materialises, and e.g. Brexit will help to sustain angst through 1Q. But if we get through 1Q, the case for US market yields to test the other end of the current trading range strengthens.

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