

January Economic Update: Turbulent twenties

With political populism showing little sign of abating the risk is that the 2020s will be even more turbulent than the last decade

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By Padhraic Garvey, CFA

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US: The twists and turns ahead

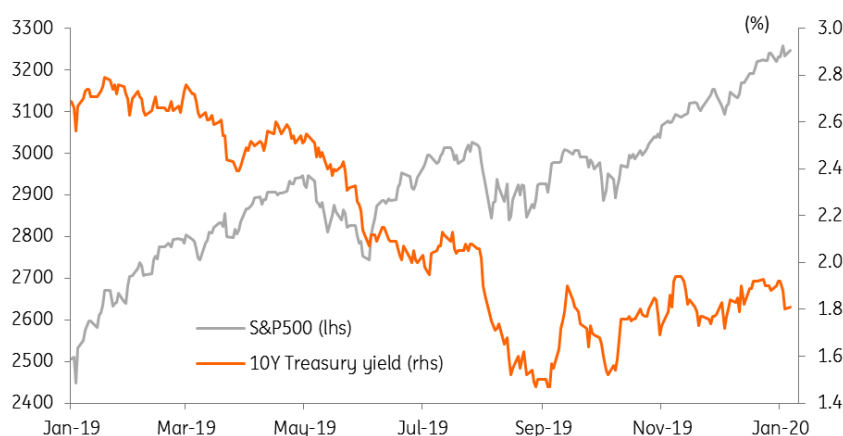
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2019: Out on a high

Looking back to the beginning of 2019, we predicted the economy would grow 2.3% and that looks almost spot on. However, a more aggressive Federal Reserve response than we predicted was needed to achieve it. Trade tensions were a key theme of 2019 as protectionist measures raised costs, hurt supply chains and damaged corporate profitability while weak global demand and a strong dollar compounded the problems. During the summer, there were real fears of recession with the Treasury yield curve inverting and equities selling off. However, the combination of three 25 basis point interest rate cuts and President Trump announcing a 'phase one' deal on trade with China was enough to reinvigorate confidence such that the S&P 500 ended the year up 30% while 10-year Treasury yields ended 2019 90 basis points lower.

US 10Y Treasury yields versus S&P500 equity index



Source: Macrobond, ING

2020: Political warfare

2020 has not started quite so rosily. Tensions with the Middle East took a dramatic turn for the worse following the assassination of Iranian military leader Qasem Soleimani. And while hostilities appear to have subsided somewhat, market sentiment remains vulnerable.

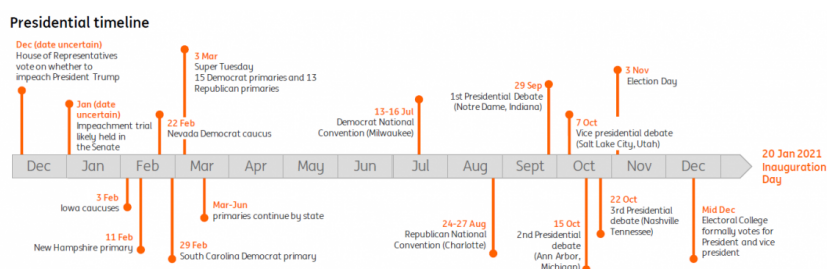
Domestic politics also remains a source of uncertainty. Arguments over the trial rules are holding up President Trump's impeachment, with a growing risk that the verdict is not reached until March. This could have implications for the selection of the Democrat Presidential candidate, given that Senators Bernie Sanders and Elizabeth Warren from the more populist wing of the party will be tied up in the Senate trial proceedings rather than on the campaign trail while current front runner Joe Biden risks being tarnished due to his son's ties to Ukraine, which is central to the trial. Moreover, Joe Biden may be required to testify.

With the Iowa and New Hampshire caucuses scheduled for 3 and 11 February, respectively, this has the potential to open the door for alternative centrist Democrats to make advances such as Pete Buttigieg and the big spending Michael Bloomberg.

Ultimately, polarised partisanship in the present Congress means that President Trump, having been impeached by the Democrat-controlled House, will be acquitted by the Senate, as the entire Democratic caucus, every Independent, and 20 Republican Senators would need to vote against the president for him to be convicted.

Nonetheless, it could still prove to be damaging for President Trump, especially if more revelations emerge, so the best we can say is that the outcome of the November election remains highly uncertain. The range of possible economic and regulatory implications from the varying candidates is broad, as we outlined in our latest [US Politics Watch](#). Consequently this could be a factor that keeps businesses cautious and reluctant to put money to work in a meaningful way this year.

US Presidential timeline



Source: ING

Good and bad

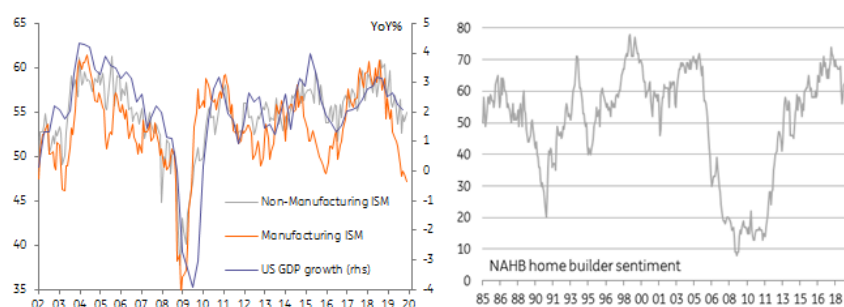
More positively, the phase one trade deal between the US and China is scheduled to be signed on 15 January and this will hopefully draw a line under the tit-for-tat escalation in tariffs experienced over the past two years. However, there is little sign of this positive news feeding through into improvements in the US manufacturing sector just yet.

Regional manufacturing surveys remained weak in December and the national ISM measure hit new lows, led by weakness in new orders. Durable goods orders and shipments continue to look soft, pointing to ongoing weak investment spending. The squeeze in corporate profits, political uncertainty due to the upcoming Presidential election and the latest ratcheting up in geopolitical tensions, further diminish the chances of a major rebound in this key component of GDP.

Additionally, the Boeing 737 Max production halt could have significant implications for first quarter GDP, largely through inventories not increasing as rapidly – there have been no deliveries of the jet so this is where they have been showing up in recent months. It could also result in job losses at suppliers (there are more than 600 companies involved in production). Later in 2020, assuming 737 Max sales are eventually allowed, it should result in a boost to exports and investment with inventories being run down.

Nonetheless, the jobs market remains firm, which should underpin consumer spending while the housing market looks to be a decent source of growth in 2020. Mortgage rates are much lower than 12 months ago and this has led to a pick-up in demand with home builder confidence at record highs. This bodes well for residential investment and is a key reason why we have revised up our 2020 GDP forecast to 1.7%.

ISM business surveys and the National Association of Home Builders sentiment index



Source: Macrobond, ING

The Fed's steadying hand

The stabilising effect of the Fed's rate cuts and the US-China trade deal means that while not particularly strong, growth looks durable, with little near-term prospect of recession. With the Fed suggesting it needs to see a "material" change in the outlook for it to consider another policy change, the prospect of near-term rate cuts looks minimal. Should trade and geopolitical risks subside further then the likelihood is we will see the Federal Reserve on hold through 2020.

Unfortunately, our confidence that politics will provide a benign backdrop is low given the upcoming impeachment trial and the prospect of a brutal presidential election battle. There is a sense too that President Trump could attempt to make political capital by striking out at perceived injustices with other nations as he seeks re-election. In this regard, US-EU trade tensions remain a threat for 2020 given the lingering topic of un-level auto tariffs and US unhappiness over some EU countries imposing taxes on US tech company revenues.

Erring on the side of caution

With global growth remaining subdued, the Fed seemingly reluctant to provide more fuel with rate cuts, and little prospect of any additional fiscal support – note the 2020 FY budget will result in spending increasing by just \$50 billion – we continue to err on the side of caution when it comes to growth. Inflation is also likely to remain benign, with the core PCE deflator still running at just 1.6% year-on-year, wage growth at barely 3% and the University of Michigan reporting that consumer inflation expectations five years ahead hit a new historical low in December.

So while the US backdrop is looking better than we were thinking just a couple of months ago, we remain wary and suggest the US will modestly underperform market expectations. Given this prognosis, the risks appear skewed towards a modest additional policy ease from the Fed and Treasury yields dropping towards a 1.75-1.5% range by mid-2020.

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Eurozone: Signs of stability

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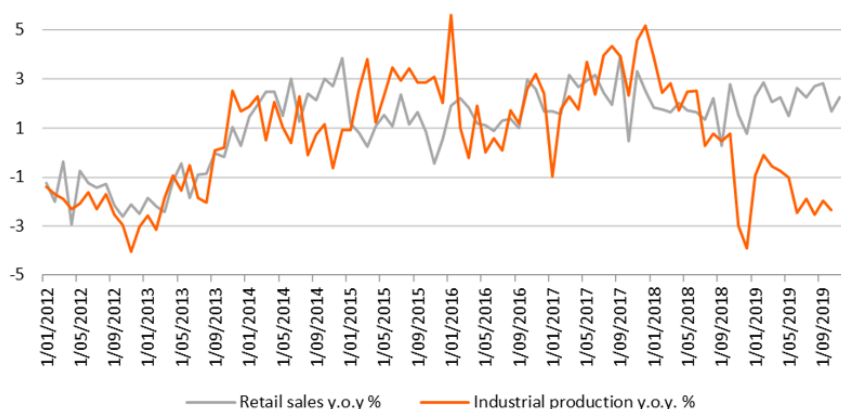


Could a trade deal stop the bleeding in manufacturing?

Judging from the final reading of the Manufacturing PMI in December, the bleeding hasn't stopped yet. The PMI came in at 46.3 from 46.9 in November. The worrying thing is that new orders continued to deteriorate markedly, a sign that output is bound to stay weak for some months to come. Moreover, the rate of job losses last month in manufacturing was the sharpest since the start of 2013. But bear in mind that this is in industry, not in the economy as whole, although manufacturing captures changes in the economic cycle earlier than services.

The impending US-China trade deal could offer relief as it takes away some of the uncertainty that has weighed on business investment. Indeed, apart from the intermediate goods sector, the weakest PMI numbers were recorded in the investment goods sector, an illustration that economic uncertainty has played an important role in the current slowdown. So, if the mood turns and firms start to invest more, aided by still very favourable financing conditions, the deceleration might reverse in the course of this year. At the same time, the European services sector is holding up well, with the PMI index in December rising to the highest level in four months. And with retail sales rising by 1% month-on-month in November, the consumer is still very much alive.

Divergent trends: consumer versus industry



Source: Refinitiv Datastream

Still plenty of risks

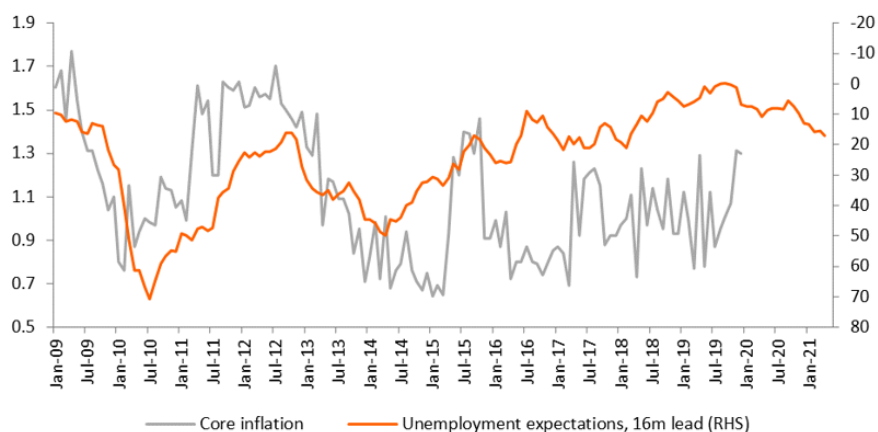
In any case, a strong upturn seems unlikely, as risks continue to lurk in the background:

- The Trump administration could decide to start a trade fight with Europe now that a truce has seemingly been reached with China. There are already tensions between France and the US on the French digital tax. We don't expect any escalation on this front, but the risk is certainly there.
- Even though we are now quite sure that Brexit is going to happen imminently, a lot can still go wrong in the negotiations to reach a trade deal.
- Italian politics will likely be less calm when important regional elections are held at the end of this month.
- Social unrest on the back of (planned) pension reforms continues in France at a time when the country is experiencing better economic growth than the European average.
- Finally, the unrest in the Middle East, which has pushed up oil prices, could weigh on European consumers' purchasing power, if it continues.

Structurally slow growth

We have slightly upgraded our GDP forecast for 2020 to 0.8% (from 0.7%), but we remain at the lower end of expectations (the European Central Bank is still pencilling in 1.1% GDP growth this year, a scenario that relies on a swift recovery). Be aware that GDP growth forecasts for 2020 might differ, depending on whether or not forecasters take into account working day adjustments. Most eurozone countries will have more working days in 2020 than in 2019. The eurozone economy has seen an average growth rate of 1.4% over the last decade and it doesn't look as if the next decade will top that. On the contrary, an ageing population and lacklustre productivity growth imply potential growth very close to 1%. That is why we see growth picking up to 1.0% in 2021, but anything more than that will be difficult to achieve.

Inflation in a subdued upward trend



Source: Refinitiv Datastream

Slightly higher inflation

Inflation has been picking up recently on the back of rising oil prices. However, core inflation is also creeping higher, as we expected. In December, both headline and underlying inflation were reported at 1.3%. That said, we are still far from a self-reinforcing wage-inflation dynamic. In fact, some of the wage metrics, which were in an uptrend, have been moderating recently. So while we do believe that inflation has troughed, we are likely to see only a slow upward move from here.

ECB on hold

A lot has been written about the Swedish Riksbank's decision to increase interest rates in the face of a slowing economy. The Riksbank has cited the negative side effects of interest rates below 0%. Commentators have considered this move to be a potential template for the European Central Bank. However, the ECB has put in place a tiering system for excess liquidity, which softens the negative impact on the banking system. Moreover, clear forward guidance has been given, which stipulates that the inflation outlook must converge robustly with the objective of below but close to 2%, before interest rates will be raised. Even though inflation is now rising a bit, we are still some time away from this condition being fulfilled. In the course of 2021, however, markets will start to anticipate a change in monetary policy, which could push money market rates slightly higher in the second half of that year.

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UK: Big changes coming as EU trade talks loom

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Source: Shutterstock

Prime Minister Boris Johnson

Negotiators face an uphill battle to get a free-trade agreement this year

December's landslide election victory for PM Johnson means the UK will now almost certainly leave the EU at the end of this month.

But when it comes to the future relationship, [things are still foggy](#) – both in terms of what form the agreement will take, and how long it will take to negotiate.

On the latter, it looks increasingly likely that the UK won't ask for an extension to the transition period – the standstill phase currently set to last until the end of 2020.

A basic free-trade agreement (FTA) in goods might just about be

feasible by the end of 2020

That sets up a challenging, but perhaps not impossible, task of reaching some form of trade agreement by the end of the year.

Most trade experts think a basic free-trade agreement (FTA) in goods might just about be feasible by the end of 2020 – if (and it is quite a big if) the UK signs up to most of what the EU asks for. Those demands are likely to include ‘level playing field commitments’ – rules that ensure the UK cannot try to undercut the EU on things like workers’ rights and state aid. Fishing rights are also likely to be fairly high up the wish-list.

But even if the Prime Minister accepts these demands – which is likely, but not a given – then the UK economy could still face steep changes to its trading relationship with Europe at the start of next year.

[Click here to read our complete Brexit guide to 2020](#)

Expect changes to the UK-EU trade relationship in 2021

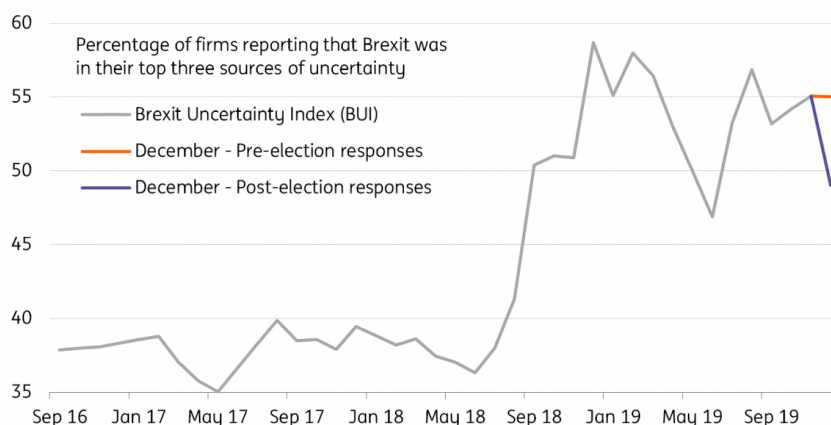
Free trade in goods does not mean frictionless trade, and businesses face the potential for higher costs and more paperwork. To qualify for zero tariffs, firms will need to prove their goods are sufficiently UK made. It’s often cheaper and easier to simply pay the default higher tariff than it is to spell out where various components originate.

A basic FTA is also unlikely to do much for services, which represent 80% of the UK economy. The jury is out on just how far either side might be willing, or legally able, to cushion the blow when the UK leaves the single market next year.

If nothing else, both sides are aiming to agree equivalence for financial services by June, as well as a data adequacy agreement later this year. It is possible that other ‘patches’ might be found too, but the fact is there will almost certainly be new market access restrictions for UK services.

In short, there are plenty of Brexit-related questions to be resolved during 2020 – and with most issues unlikely to be resolved until fairly late in the day, there won’t be quick answers.

Tentative evidence that Brexit uncertainty has fallen among firms since the election



Source: Bank of England

Results from the December BoE Decision Maker Panel. Pre/post election readings are unweighted

Another tricky year for the UK economy

For the UK economy, this means another year of uncertainty.

Admittedly, the first few survey readings since the election suggest firms are turning a little more positive on the outlook. Business optimism was the highest since September 2018 according to December's services PMI, which was coupled with a rise in new orders.

On that basis we certainly wouldn't rule out a modest increase in capital spending in the near-term, particularly where the time horizon is fairly short. If this optimism does translate into slightly better short-term growth momentum, then that may help prevent the jobs market from slipping into a more pronounced decline. For now, we aren't in the camp expecting Bank of England rate cuts over the next few months.

But the dominant story will continue to be one of subdued investment, as firms begin to grapple with the growing likelihood of changes to the EU trading relationship in a little under 12 months. The latest Bank of England decision-maker panel suggested that while firms are seeing a decline in Brexit-related uncertainty, 42% don't expect it to be fully resolved until at least 2021, up from 34% in November.

All of this suggests growth will remain lacklustre during 2020, albeit potentially less volatile than in 2019. We're pencilling in 1.2% full-year growth for 2020.

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China: Interest rate reform won't stop yuan volatility

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Leading members of the People's Bank of China, including Governor, Yi Gang (waving)

PBoC continues its interest rate liberalisation mission

The People's Bank of China recently announced that banks have to use the Loan Prime Rate (LPR) as the reference rate for lending. Banks can add or subtract points from the LPR to derive the lending rate to customers, with the spread reflecting the risks of a specific loan. The one-year LPR is currently at 4.15%.

This is different from the previous practice of using the one-year benchmark lending rate as a reference point. This rate has not moved since 23 October 2015 and stands at 4.35%.

The usual question we get asked is whether this equates to a rate cut (4.35% vs 4.15%). We'd argue it isn't, because the points that are added/subtracted from the LPR to form the ultimate lending rate should reflect the difference between the 1Y benchmark lending rate and the 1Y LPR, and therefore the final lending rate should stay the same.

What will be the next liberalisation stage?

The PBoC has a formula for the LPR. It is a function of the Medium Lending Facility (MLF). When there's a lower 1Y MLF interest rate, the 1Y LPR should also be lowered.

But the MLF rate is still not market-based. It is an open market operation interest rate involving policy banks and commercial banks, which is in fact controlled by the PBoC.

The next stage of liberalisation will be a more market-based MLF interest rate. But we have to wait until the transmission mechanism between the MLF and LPR is fully established. This could take a couple of years.

What will this mean for interest rate movements in 2020?

This year, borrowers will see their interest rates linked to the LPR rather than the 1Y benchmark rate. We can, therefore, ignore the 1Y benchmark rate (we have ignored it since 2017).

Instead, we should focus on how the PBoC changes the LPR. Even though the LPR is a function of the MLF, this does not necessarily mean that if there's no change in the MLF, there will be no change in the LPR. We have to study how the PBoC structures the LPR. It could also be that the PBoC has to manage market expectations when it comes to the LPR's formation. Clear communication from the central bank is very important.

We believe that at the beginning, the PBoC will keep it simple - when the MLF moves, the LPR will move to the same extent. This should at least be the case during the first half of the year. Later on, the PBoC could try some variation.

Monetary policy in 2020 - further easing to come

We expect that the PBoC will continue to use both interest rates and liquidity policy tools in 2020 to support the economy.

Given that there is unlikely to be a complete rollback of US tariffs, and the technology war has escalated (potentially hitting technology exports), we expect one to two interest rate cuts, each by five basis points on the 7D reverse repo and the 1Y MLF.

With the cuts in the MLF, we expect the same cut in the 1Y LPR and 5Y LPR, at least for the first half of the year, keeping the LPR mechanism straightforward. This should result in an almost parallel downward shift in China's sovereign yield curve, though the liquidity policy tool will change the shape of the curve.

Liquidity injections will put extra downward pressure on the short end of the yield curve, which should make the yield curve appear slightly steeper.

We believe that the PBoC will inject liquidity via open market operations, including the MLF, to smooth out ad hoc liquidity tightness. The central bank has announced it will cut broad-based reserve requirement ratios by 0.5 percentage points, to 12.5% for big banks and to 10.5% for smaller banks in January, to ease liquidity pressures ahead of massive loan demand at the beginning of the year, which is a seasonal pattern within the Chinese banking system.

The yuan should be volatile

The yuan, USD/CNY, has been volatile in 2019, ranging between 6.67 in March and 7.18 in September. This has reflected developments in trade negotiations, rather than the relative monetary policies of China and the US.

We believe the yuan will continue to see volatile trading in 2020 because there is still a lot of uncertainty about the phase one trade deal, which has yet to be signed. And even if it is signed, there are still a number of tariffs imposed on China that will not be rolled back. ([The media has reported](#) that the rollback of tariffs may only be 7.5% on some Chinese goods). The market's focus could also soon shift to a phase two deal, and whether such an agreement is even likely as the US presidential election approaches in November.

In addition to the trade war, there is an emerging technology war against Chinese technology brands operating in the US and Europe, which will add extra pressure to the Chinese economy.

The high degree of uncertainty here suggests the yuan will remain volatile this year. This makes our year-end forecast for 2020 of 6.85 per dollar less valuable than would otherwise be the case.

A volatile yuan in 2019



Source: ING, Bloomberg

Japan: Just spend it

In what looks like an admission that monetary policy is out of ammunition, Japan's government is now turning back to fiscal stimulus to give the...



Japan has smoothed the impact of the consumption tax hike

The last time the Japanese government attempted to expand the tax revenue base by increasing the consumption tax, it delivered a fiscal drag^[1] to the economy of 1.9% of GDP. Japan's annual GDP in fiscal year 2014 fell to -2.6% from 2.8% the previous year.

This time, the government has put in place considerable offsetting measures to the latest consumption tax hike - cuts to pre-school education fees, free higher education, and benefits for low income pensioners for example, to soften the blow.

^[1] Fiscal drag is defined as the change in the cyclically-adjusted primary balance.

Not much of a "boom" before the "bust"

Notwithstanding this, the economy is slowing. 3Q19 GDP managed 0.4% quarter-on-quarter growth - hugely disappointing given the expectation for some front-loading of expenditure. And despite the limitations of the front-loading, the decline in retail activity that has followed it suggests that a post-tax slump may be developing.

The government may in the past have turned to the Bank of Japan (BoJ) for some assistance. But

with negative policy rates, zero-yield targeted 10Y Japanese government bonds, and a faltering quantitative easing programme, a generous viewpoint is that the BoJ has maxed out its policy options.

The size of the package has been exaggerated

Now, despite the persistent deficit, and the huge stock of government debt, Japan is about to unleash another fiscal stimulus programme. For those who believe that this is the global answer to weak growth (some European Central Bank members, for example), Japan is an instructive lesson in how not to do it, and the limitations of fiscal policy.

Any inclination to utter phrases like "kick-starting the economy", should be rapidly expunged from your thoughts.

The headline of the package has also swelled with repeated speeches, to stand at a chunky sounding JPY26 trillion (USD239 billion). Though as far as we can see from the Ministry of Finance, this refers to total spending on the boosted areas, not the actual additional (incremental) spending.

Selected fiscal stimulus measures and their cost

Stimulus measures	Supplementary budget	Initial budget for FY20 (increase from FY19)
Natural disaster recovery and protection	JPY2.4tr	JPY1.1tr
Boosts to SME productivity, overseas operations agriculture and forestry	JPY0.8tr	n/a
Support for child rearing, private consumption (points system for cashless payments) and society (child care, higher education)	JPY1.0tr	JPY0.6tr
Total	JPY4.3tr	JPY1.8tr

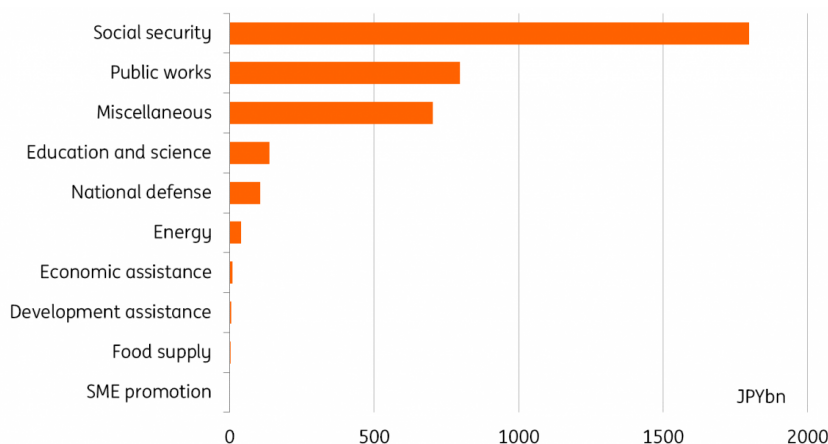
Source: Ministry of Finance, ING

This is "slump avoidance" not "stimulus"

The measures so far outlined provide an offset to the construction spending slowdown anticipated at the end of the 2020 Tokyo Olympics preparation, and include plans to provide a tablet for every school desk to the end of junior school. It is also suggested that cashless payment will be encouraged by providing cash equivalent points to accounts that load up in excess of 20,000 yen onto smart phone payments systems.

There is without doubt a considerable amount of double-counting relating to these headlines. But as far as we can tell from the [published documents](#), the combined size of supplementary budget measures and "stimulus" within the initial FY2020 budget sum to a much smaller JPY6.1 trillion (JPY4.8 trillion from the supplementary budget and JPY1.8 trillion from the initial budget). Perhaps the most telling figure is the FY2020 primary budget deficit which stands at an estimated JPY9.2 trillion, exactly the same as FY2019 – in short, the "fiscal thrust" is zero.

Incremental fiscal support measures (Supplementary 2019 and FY2020 initial budgets)



Source: Ministry of Finance, ING

Kick that can

In contrast, the government is claiming the package will have a net stimulatory impact on the economy of around 1.4 percentage points of GDP.

You can go round and round in circles with Japanese public finances and get nowhere fast. Whatever form of reality you accept with these numbers, the short story of this fiscal package is that far from providing a reason for upgrading our GDP forecasts for 2020, this latest stimulus merely provides an excuse not to slash them, and raises questions about how to avoid a slump in 2021.

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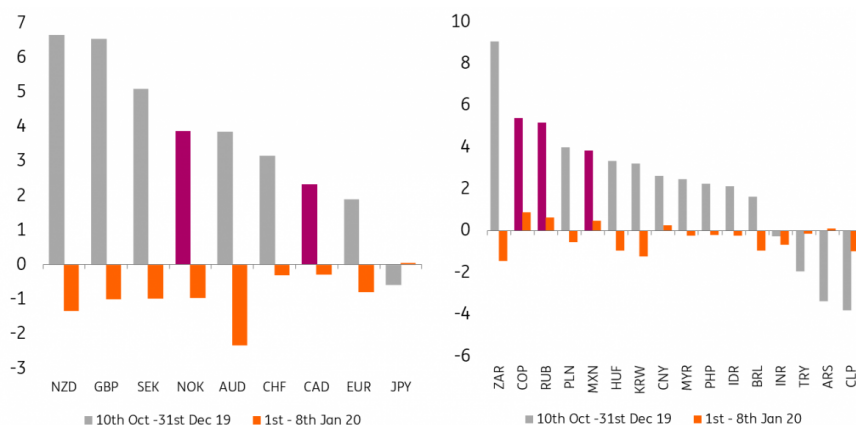


Energy dependencies exposed

Global equity markets rallied over 10% in the fourth quarter as investors welcomed the US-China trade truce and the pre-emptive easing put in place by both the Federal Reserve and the European Central Bank. Away from the gyrations of the British pound, the currencies that benefited the most were generally those of economies most open to trade (EUR under-performed here) and the commodity producers.

Events in the Middle East have served to undermine some of the confidence in the recovery and saw those pro-risk currencies hand back gains. Currencies hanging onto their gains have been the net oil exporters, especially the likes of the Colombian peso, Russian rouble and Mexican peso in the emerging market space.

FX performance against the dollar since equities started rallying in Oct 2019, oil exporters hold gains



Source: Bloomberg, ING

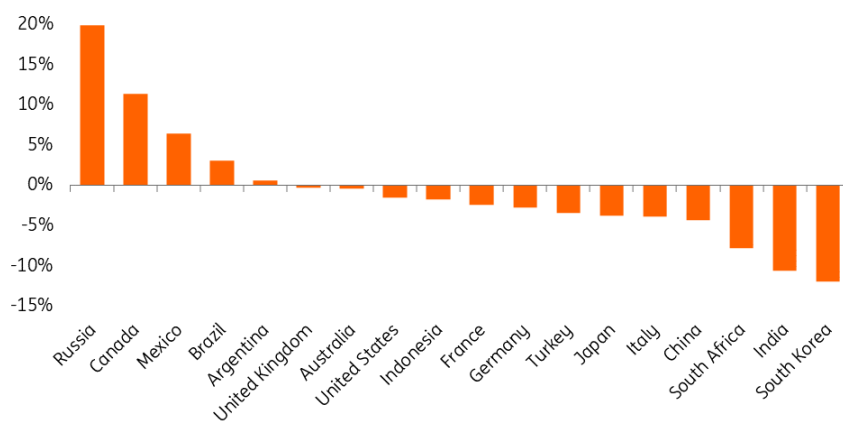
FX markets and oil prices

Tension in the Middle East has naturally focused attention on oil shocks and the FX markets. In theory, terms of trade and positive income shocks should benefit the oil exporters at the expense of the importers. Below we highlight the net oil balance as a percentage of GDP for G20 countries.

Academic literature on the impact of oil shocks on the FX markets is quite mixed but of the published papers we do like [a 2012 ECB paper](#), which concludes that oil demand, rather than supply shocks are bigger drivers of the FX market. A bullish re-assessment of global demand helped commodity producers late last year and unless we see a significant setback to the global growth view this year, we expect commodity currencies to stay well supported.

For EUR/USD, there is no correlation with energy prices. However, we do suspect that an oil supply shock would be slightly EUR/USD negative on the basis of i) the US having superior energy dependence to the eurozone and ii) the pass-through of higher oil prices into CPI is twice as powerful in the US as it is in Germany, perhaps keeping short-end USD money market rates supported.

Oil balances as % of GDP (2018 data)



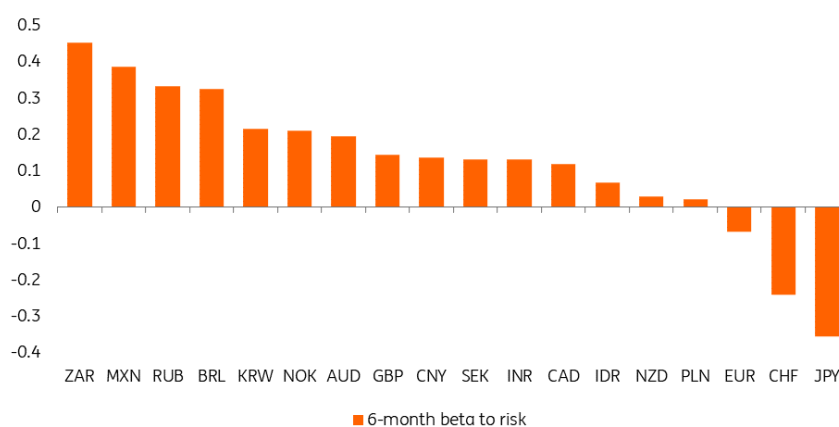
Source: World Bank, ING

Equities will play an increasing role in FX

After healthy gains in 2019, we expect equity markets to play an increasingly important role in determining FX rates this year. Corrections in the MSCI World Index were very mild in 2019 (not exceeding 6%) and one has to look back to late 2018 for a 10%+ correction.

Surveys showing that fund managers are finally underweight cash suggest equity markets may be exposed to larger corrections this year. FX markets show a clear spectrum of positive and negative betas on changes in global equity prices and investors should probably add a little more yen and Swiss franc to portfolios this year. As we discussed last year, the euro's emerging role as a funding currency means that the EUR/USD is now starting to show a negative beta to changes in the equity market.

FX betas to daily changes in the MSCI World Equity Index



Source: Bloomberg, ING

Election year

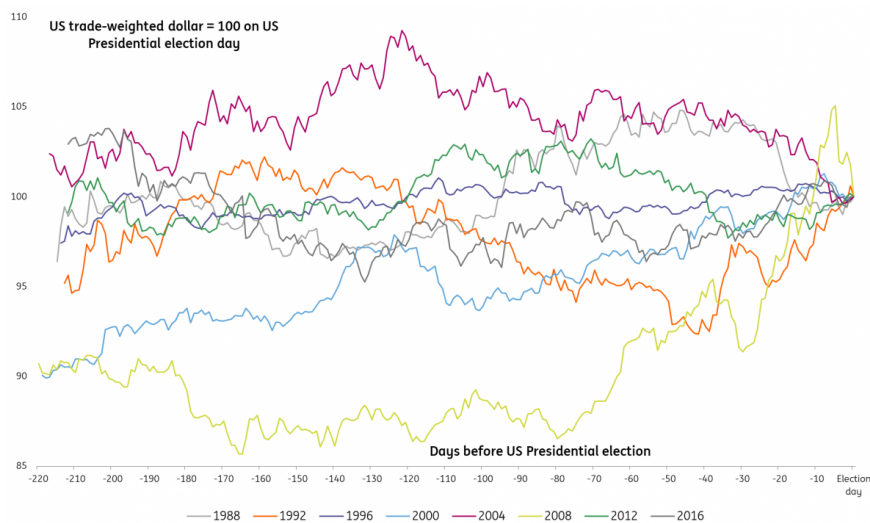
It is probably a little early to be saying this, but it seems that a simple narrative is emerging where good US data is seen as good news for President Trump's election campaign and also seen as good news for the dollar. The recent narrowing in the November 2019 monthly US trade deficit is a case in point. On that subject, the market may start to take note of the race for the Democratic nomination – perhaps into Super Tuesday in March – with a special interest in whether Elizabeth Warren or Bernie Sanders are selected, as these candidates are seen as negative for the dollar should they make it to the White House.

In terms of dollar performance in a US Presidential election year, the chart below looks at the last eight cycles. It is a bit messy, but there are certainly no big dollar bear trends there and it seems that the dollar, compared to the start of the election year, only ended marginally lower on election day in two of the eight cycles. That ties in with our view of the DXY this year, looking for a modest 2-3% decline rather than anything more severe. Please see a more detailed discussion on this subject in our [2020 FX Outlook](#).

In practice, this means that both EUR/USD and USD/JPY will be confined to relatively narrow ranges of 1.10-1.15 and 105-110, respectively. The jury remains out on sterling this year, but we suspect volatility levels will be a little lower, and GBP can end the year a little higher, if Prime Minister Boris Johnson can secure some kind of trade agreement before the transition period ends

in December 2020.

How does the dollar perform in a US election year?



Source: Bloomberg, ING

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Rates: All the 2s in 2020

The rates profile for 2020 has a particular focus on the 2s when it comes to the global benchmark (the US). Or more correctly, the sub 2s. That describes...



Source: Shutterstock

The logic for higher rates in 2020 is there. The US 10-year yield trades with a negative term premium of -90 basis points. That suggests the 10-year yield is far too low. Inflation expectations from the TIPS market pitch inflation in the next 10 years at 1.75%. That's a 25bp discount to current inflation in the 2% area; it should be a 25bp premium. That's a 50 basis point deviation from a "fairer value". Meanwhile, the US consumer is very confident and the labour market is firm. Our basic macro model pitches fair value for the 10-year at 2.25% to 2.5%.

But to get there will prove quite difficult in 2020 on account of a number of other competing drivers. There is still very strong demand for fixed income. This comes from pension funds looking to match liabilities which are discounted with something close to the risk free rate. Also from banks, which must fill liquidity buckets, and remain big buyers of core bonds globally. Central banks also hold a significant rump of core government bonds through quantitative easing programmes, and these holdings will increase by \$1 trillion in 2020.

On top of that, uncertainty with respect to the rules of engagement remains. We are one tweet away from a pivot in policy, and a key election event awaits in November. The best barometer of how this is affecting sentiment is in manufacturing surveys, which are below 50 in the US and still well below that threshold in Europe. Then from a technical perspective we find that yield curves remain quite flat, implying a muted forward uplift. And curve structures remain bullish (5-year

trading rich to the wings, both on the US and European curves).

Things have improved through. The Chinese PMI is back above 50 and European PMIs look to have troughed (albeit at uncomfortably low levels). Imminent recession risk in the US has also receded. Tensions in Iran have been tamed for now. Brexit is more certain. And trade tensions have diminished. That all being said, the risks here remain elevated, which is why the US 10-year has struggled to break back above 2%. It could do so now though, and has a window in the coming weeks, but it's unlikely to stay there. There are just too many balls being juggled, and it only takes one of them to fall. That would take the 10-year back below 2%, to that famed sub-2% zone.

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