

## Week In Review: Calm before the storm?

US core inflation held steady, EU leaders scrambled to make headway on Brexit and UK Chancellor Philip Hammond proposed scrapping the £50 note. Here's a look back at the week that was

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Snap | 13 March 2018

United States

## US core inflation remains stable despite surging apparel costs

We think today's CPI data could mark the end of the prolonged period of sub-2% core CPI



Source: Shutterstock

With markets increasingly on the lookout for signs of positive US inflation surprises, today's consumer price data is unlikely to make too many waves. The key takeaway is that core inflation remained unchanged at 1.8% year-on-year, although there is still quite a lot of noise beneath the surface. For instance, apparel costs – a key factor behind last month's positive inflation surprise – put in another massive monthly growth performance (1.5%), reversing the fairly noticeable decline we saw at the end of last year.

Pinning down the exact cause of this is fairly tricky, particularly at a time of intensifying competition within the clothing sector. For the most part, we suspect this is largely noise.

Underlying volatility aside, we think today's data could mark the end of the prolonged period of sub-2% core CPI. In the March set of data (released next month), a distortion related to cell phone data pricing will drop out of the annual comparison. Having been chopping 0.2-0.3 percentage points off most inflation measures, that should see core CPI move back up to 2%, and the headline rate move closer to 2.5/2.6% YoY.

Rising housing/medical costs also look set to add upward momentum to overall inflation over

coming months, whilst the weaker dollar looks set to provide a boost too – particularly as, in an environment of strong consumer demand, firms have the pricing power to pass higher costs onto shoppers.

This is a key reason why we expect four rate hikes from the Fed this year.

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# Brexit: Counting down to next week's crucial EU summit

With Brexit talks fast approaching the halfway stage, negotiators are rapidly trying to reach an agreement on the transition period, ahead of a key EU leader's summit



Source: Shutterstock

## Déjà vu?

We're one week away from a crucial EU leaders' summit in Brussels. Both sides have reportedly made good progress over the past few days, following several weeks of gridlock in negotiations. Politicians appear increasingly confident that a deal can be reached ahead of the summit, but as talks continue over the weekend, the biggest threat to an agreement next week is the dispute over the Irish border.

Sound familiar?

The situation as we approach the March gathering of European leaders looks distinctly similar to that just ahead of the December meeting - only this time, negotiators are rapidly trying to agree a deal that creates a post-Brexit transition period. Business groups have made it clear that a commitment is urgently needed to prevent firms from having to enact contingency plans for March 2019. Here are three things we know at this stage:

## Positive steps have been made - particularly on the transition timeline

From citizens rights, to the UK's voice on any future new EU laws, both sides appear to have made progress on resolving key disagreements during talks this week - with [one report](#) citing an EU official as saying the UK has made concessions at "supersonic speed" in a bid to get a deal agreed in time for next week's summit.

One such area where UK negotiators appear to have taken a step back is on the length of the transition. Both sides have been clear that the transition period should be time-limited - although there have been subtle disagreements in recent weeks over exactly how limited this time should be in practice.

The EU has said that the transition should end in December 2020, which coincides with the end of the current EU budget period (or 'multi-annual financial framework' to give its official title). The UK government appears to favour a slightly longer timeframe, which would give businesses and government departments more time to adjust to the changes Brexit will bring.

But with time of the essence, it looks increasingly likely that the UK will agree to the EU's initial timeframe at this stage. Brexit Secretary David Davis has said that he "could live with" a shorter transition. An extension would require the UK to commit to extra budget contributions beyond 2020, which would be time-consuming to agree upon, but more importantly, would be very politically challenging for the UK government to accept now.

## 2 The Irish border dispute could yet see talks break down

Despite the positive steps that have been made over the past week, both sides remain poles apart on the Irish border situation.

As part of the phase I agreement back in December, the UK government committed to "no regulatory divergence" between Ireland and the North. But the UK's decision to leave the customs union, as well as its proposal for post-Brexit trade (that would see key economic areas diverge from EU regulations), have raised questions over whether this is achievable.

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### *Both sides remain poles apart on the Irish border situation*

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In her closely-watched speech a couple of weeks ago, Prime Minister Theresa May floated two possible solutions. The first is technology - using new methods to ensure that goods can flow between the UK and EU without the need for physical customs checks. The second is to create a new 'customs partnership', that would see the UK apply European tariffs and standards on goods destined for the EU - the theory being that this removes the need for checks when the good is subsequently transported across the UK-EU border. Both options have received a fair amount of criticism - the former because it comes without precedent, the latter because of its likely complexity (the UK itself has said it could be challenging to implement).

Amidst concern in Brussels that the UK's proposals don't go far enough, the EU raised the stakes a couple of weeks ago by floating the possibility of a 'backstop' option, that would keep Northern

Ireland in a customs union if the overall Brexit trade deal fails to address the border issues. PM May has since said that "no UK Prime Minister could ever agree" to this.

In a bid to get the transition period urgently signed off, the UK has reportedly proposed a month-long period of intense negotiations on the Irish border issue between now and mid-April. But as talks enter the final stage ahead of Thursday's summit, it's unclear whether this will be enough. It also remains very uncertain whether the EU will ultimately require the UK to accept the proposed backstop option in exchange for a green light on the transition next week.

### 3 A transition agreement would bring a May rate hike firmly into play

But if an agreement on the transition can be reached, this will open the door even further to another near-term rate hike from the Bank of England. Policymakers will also have a [firm eye](#) on Wednesday's wage growth data as they look for further evidence that tightness in the jobs market is putting pressure on firms to lift pay packets.

We expect a rate hike in May, and we could see the Bank talk up the possibility of this in their statement on Thursday - although the timing of the meeting (on the same day as the summit) could complicate effects to send a signal to markets.

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## Brexit transition: Bullish for sterling

EU leaders have agreed to a Brexit transition deal, which we think will help alleviate uncertainty surrounding the UK economy. News on wages and a Bank of England meeting this week will now determine where the pound goes from here

### EU and UK officials agree Brexit transition... one of GBP's bullish trifecta achieved this week

- **EU and UK officials have agreed to the terms of a Brexit transition deal – and while (at the time of writing) details of the agreement are still being announced– we suspect today's outcome will go some way to alleviating the short- to medium-term uncertainties surrounding the UK economy.** The pound has moved higher against both the US dollar and euro (around +0.5%) – given that today's reported agreement is a positive surprise for investors who had broadly scaled back their expectations for any Brexit progress being achieved this week.
- **We believe that GBP's re-pricing of Brexit transition optimism is now complete – and revert our attention back to UK economic fundamentals to determine the scope and extent of any GBP appreciation over the coming weeks.** A Brexit transition agreement is one element of GBP's bullish trifecta this week; if all the cards were to fall perfectly into place – and we also see a status quo hawkish Bank of England policy message and constructive UK wage inflation data – then we would not rule out a sharp move in GBP/USD up towards the year-to-date highs around 1.4250-1.4300 (+2.0% approx).
- **Our base case remains for GBP/USD to move up to 1.45 as the UK economy regains some of its cyclical swagger – but we do think that patience may be required before investors look to take that bet.** We had previously cited two non-mutually exclusive catalysts for this to happen: (1) positive UK data surprises and (2) reduced UK economic uncertainty in the form of an agreed Brexit transition deal. Today's news means that the latter condition has been ticked – and gives us greater conviction over our 1.45 target.
- Indeed with the UK economy at an inflection point – in theory, reduced Brexit uncertainty means the scope for positive UK data surprises over the coming year has increased. Forward-looking indicators (business surveys and PMIs) over the coming weeks and months will be a big test of this – and we'll be monitoring these closely to see the responsiveness of UK economic activity to reduced uncertainty brought about by an agreed Brexit transition deal.
- **Bottom line:** Risk-reward suggests that an extremely cheap GBP has greater room for a cyclical recovery over 2018 (we still look for a 3-5% sterling appreciation in trade-weighted terms this year).



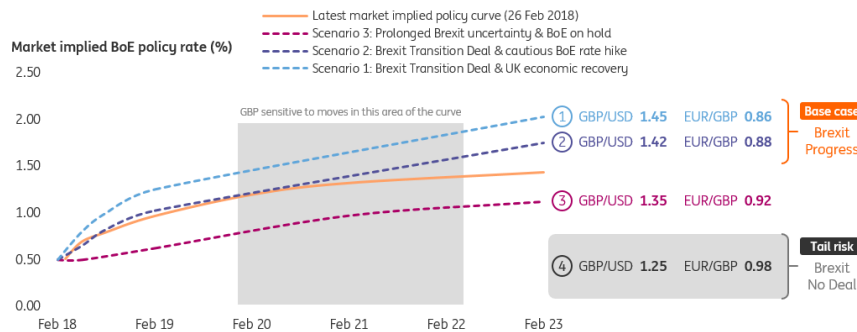
## Brexit transition deal in focus at the March EU leaders summit: Risk-reward suggests greater GBP upside in the event of a positive outcome

- The immediate focus for investors at the upcoming 22-23 March EU leaders summit is whether both sides can formally agree on a Brexit transition deal - which, if successfully achieved, would go some way to reducing the [long-run risks surrounding the UK economy](#). While it appears the UK government has conceded to the transition period ending in December 2020 - and potentially EU citizens' rights - the major sticking point remains over the Irish border.
- In principle, if a deal can be finalised, we would expect GBP to see a sharp knee-jerk move higher - noting that this would be a positive surprise given that investors have downgraded their expectations for a transition being agreed at this summit, while more neutral GBP positioning and a small Brexit risk premium in the currency (our model estimates suggest GBP/USD should be trading in region of 1.39-1.41) also lends support to a move higher.

## A hawkish Bank of England signal and nascent signs of wage inflation would be an added boost to GBP

- One of the channels through which we expect GBP strength to materialise in the event of a positive transition deal outcome is reaffirmed sentiment over BoE policy tightening. Not only would we see greater market conviction over a May rate hike (currently 70% priced in), but the potential for a re-invigorated UK economy in the near-term could also spur talk of a second BoE rate hike in 2018.
- The case for a steeper UK rate curve this week would find additional support from:
  1. A Brexit-contingent hawkish signal at the March BoE policy meeting (Thu)
  2. A series of constructive UK economic data releases - namely core CPI inflation remaining sticky at 2.6% YoY (Tue) and headline wage inflation also showing signs of moving higher (Wed). Feb UK retail sales (Thu) is expected to come in a tad softer - though markets may look through this given the largely weather-related disruptions.
- If all the cards were to fall perfectly into place for GBP this week - that is the combination of Brexit progress, a status quo BoE message and constructive UK economic data - we could see a bullish breakout in GBP (especially against a weak USD), and would not rule out a sharp move up towards the year-to-date highs around 1.4250-1.4300 (approx +2.0%).

## Road to a Brexit transition deal: Four scenarios in play for GBP over 2Q18



Source: ING FX Strategy

## Only signs of complete gridlock between UK-EU officials would break the pound

- On the flipside, while it may be tempting to paint the EU leaders summit as a make-or-break moment for GBP, we would not see the failure of a transition agreement being reached this week as a reason to sell the currency.
- Investors should focus on the tone of Brexit talks - where we think only signs of complete deadlock and a lack of appetite from either the UK or EU to concede on key sticking points would see GBP's recent resilience come majorly unstuck. We think downside risks for GBP/USD this week may be contained to 1.3750-1.3800 (approx -1.5%).

### ING's outlook for GBP: Medium-term bulls

- With BoE policy tightening and a resilient UK economy acting as a 'put' on the pound amid short-term Brexit risks, we continue to think there is more GBP upside over the coming months. We target GBP/USD at 1.45 in 2Q18.
- Equally, the currency should hold its ground against a strong euro and we look for EUR/GBP to trade within the broad 0.85-0.90 range, with a positive Brexit transition outcome suggesting greater risks of a move to the 0.86-0.87 range in the near-term.

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## Cashing out?

If the UK scraps the £50 note, will anyone really care? Our ING International survey provides some answers

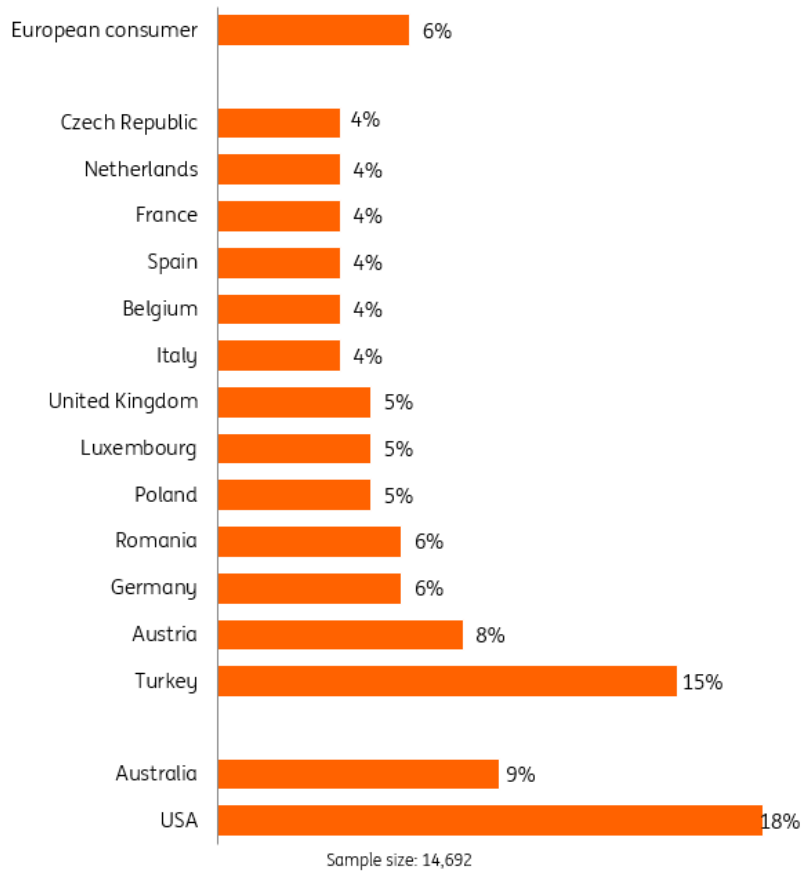


Source: Shutterstock

Removing the highest denomination bank note from circulation would not have a great effect on the vast majority of people's individual finances. This is one conclusion from the 2017 [ING International Survey](#) on the cashless society. Only six percent across Europe said it would affect them.

## Imagine the highest denomination note will be withdrawn from circulation. Would it affect your finances?

Shares who choose "yes". Other possible replies include "no" and "I don't know".



Discussion about the role of cash was ignited again when it was mentioned by the UK Chancellor in his 2018 [Spring Statement](#).

The movement away from cash has been happening for a more than a decade. In 2016, cash accounted for only 40% of all payments in Britain, down from 62% in 2006, according to [Payments UK](#).

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*Digital technology has changed the way people shop, sell and save. While cash will continue to be an important method of payment, more people are moving towards digital payments every year - Philip Hammond*

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The situation in Europe is similar. Long before card payments – either contactless or not – became common, transfers from bank accounts were frequent and growing quickly. This is clear in [payments data](#) regularly collected by the European Central Bank. Amongst non-cash payments, card payments dominate. Cheques are now almost a relic.

The UK government is [seeking views](#) about cash and digital payments. Following a backlash in some sections of the press, the government has already stepped aside from a suggestion to scrap one and two penny coins. However, the idea of removing the largest denomination note (£50) from circulation remains under discussion.

## Finances unaffected but attitudes vary

One reason many people say their finances would not be affected by removing the largest denomination note could be that the majority don't pay by cash once the amount moves above €50. According to ING International Survey data covering 13 European countries, 88% of consumers consider making payments by cash when the amount is €10 or less. This falls to 50% for amounts between €11 and €50. Above this, cash payments fall to 21%. Non-cash payments rise to 79%. Non-cash payments include credit and debit cards, mobile payments and banking transfers.

Attitudes to and use of cash vary noticeably across Europe. People in Germany and Austria tend to prefer cash. Surveys show they not only prefer the anonymity and (supposed) security of cash but also carry more cash in their wallet or purse.

## Good news for government finances

Changes to the way people make payments are happening often. Although seen by many as a personal issue with few economy-wide effects, this may not be the case. Increased use of non-cash payment methods makes [open banking](#) approaches more likely to succeed. This could transform banking and payment systems. Further, increased use of cash payments may affect government finances. The UK government [estimates the tax gap](#) – the difference between what is owed and what the tax authority actually collects – at £34 billion in 2015-16, which is 6% of tax liabilities. The gap has fallen from an estimated 7.9% of liabilities in 2005-06. The government's consultation paper seeking views notes: "The increasing use of digital payments and the reduction in the use of cash could have a positive impact on increasing tax compliance and decreasing money laundering."

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## SNB : Caution remains the codeword

As expected, the Swiss National Bank left its interest rate unchanged. But the economy is expected to rebound in 2018, which could lead to somewhat higher inflation and allow for some very gradual monetary tightening in late 2019. In this context, we expect the CHF to stay on a depreciation track



Source: Shutterstock

### CHF overvaluation remains a reason to intervene

As expected, the Swiss National Bank (SNB) kept its interest rate unchanged on sight deposit at -0.75% and the target range for the three-month Libor at between -1.25% to -0.25% in March.

Moreover, the SNB President Thomas 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”.

The SNB still thinks that “the franc remains highly valued” and it acknowledges that since December “the Swiss franc has appreciated slightly overall on the back of the weaker US dollar”. The SNB also believes that “the situation in the foreign exchange market is still fragile and monetary conditions may change rapidly”, justifying the status quo in its interventionist stance.



# 2.0% Inflation forecast for 3Q 2020

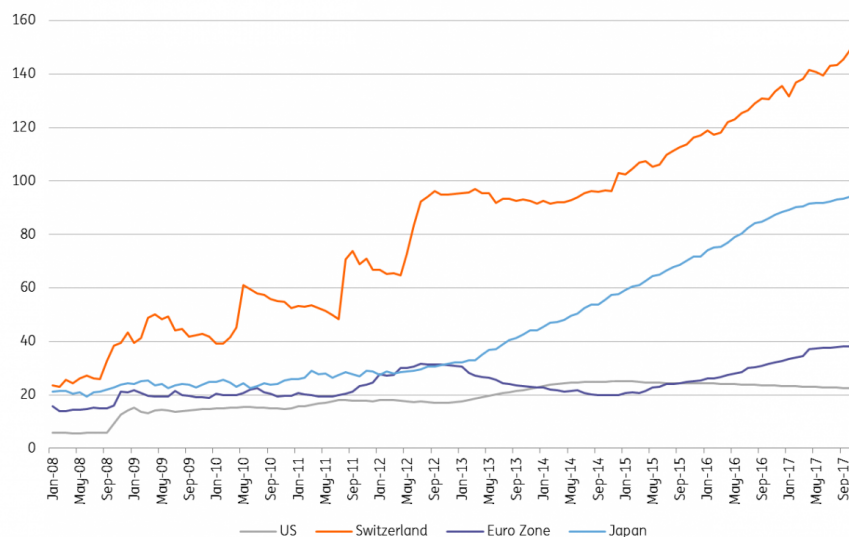
## The SNB was a bit less upbeat on inflation

After a strong end to 2017 with Q4 GDP growth increasing at 0.6% QoQ (and 1.9% YoY), the SNB's growth forecast for 2018 is constant at 2%, which would be the highest rate since 2014, and President Jordan is quite upbeat on the world economic recovery.

Concerning inflation, after five years of negative or zero inflation, it reached 0.5% in 2017 and increased to 0.6% YoY in February. Given the "somewhat stronger franc", the SNB revises downward its inflation forecast for 2018 (0.6% from 0.7% in December) and 2019 (0.9% vs 1.1% before), while it expects inflation to reach 2% by the third quarter in 2020.

This shows that the SNB remains very cautious about declaring victory on deflation, but it is still eager to show that getting back to the 2% target in the medium-term is still possible. We see a possibility that a weaker exchange rate next month will lead to better growth and higher inflation, above 1% in 2019.

## Size of the SNB balance sheet in 4Q17 as a share of GDP, above Japan's 99%



## Expect more of the same in 2018

On the one hand, the current SNB inflation forecast is unlikely to allow for any monetary tightening before late 2019. Moreover, to avoid further appreciation of the CHF against the EUR that could decrease inflation, we think the SNB won't start to tighten before the ECB starts increasing the interest rate, which is not expected before June 2019.

On the other hand, a stronger economic outlook and some inflationary pressures should

eliminate any risk of further accommodating measures. A sharp rise in real estate prices will probably be counteracted with macro-prudential measures.

Therefore, we 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. This should allow the CHF to depreciate a bit in 2018.

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Snap | 12 March 2018

## Precious metals: Gold lacking the safe haven allure

Gold prices ended last week fairly flat with US trade tariffs spurring only the briefest of rallies while funds continued to liquidate. All eyes are now on US inflation and Treasury auctions to see if the outflows can be reversed



Source: shutterstock

### Gold lacking safe haven allure

Gold's performance was disappointing following news (February 28th) that the US would indeed impose steep trade tariffs on aluminium and steel. Despite the obvious threats to global growth and a sell-off in equities, gold prices did not show evidence of safe haven flows until March 6th when bullion briefly managed to surge 1% and come close to the \$1340 mark. These gains were short-lived, however, and erased by the next day.

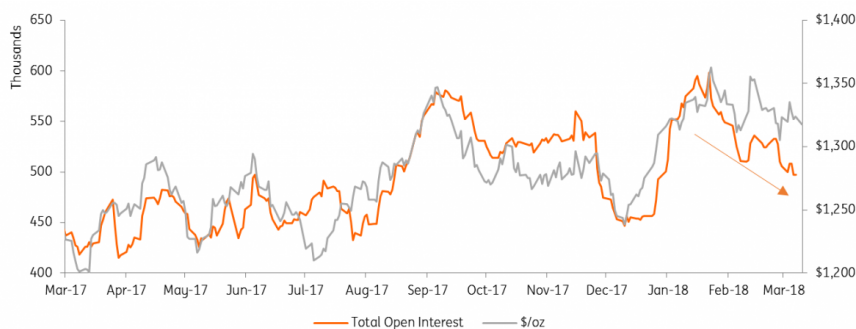
Gold's lack of allure as a safe haven is most evident when priced in Japanese yen. Following the tariff news, yen-based gold prices hit their lowest level since August. In JPY terms, prices are down 5% since the stock market correction at the start of February.

Competition from other assets and frustration over stale dollar-based returns has resulted in an exodus of fund positioning with no real conviction for shorting either. Comex open interest has fallen 17% from its January high and 7% in March alone. Net money manager positioning was flat

in the week ending Tuesday 6th but this masked a general withdrawal by both longs and shorts. Similarly, short interest on the SPDR ETF actually ended February at the highest level since November though this was largely the result of a decline in long holdings overall.

In our last [precious note](#), we cautioned that a return in real yields could further divert flows. However, whilst real rates have indeed settled in higher, the upturn in inflation-linked swaps seems to have actually peaked for now. The fact that steel and aluminium tariffs did not trigger a deeper bond sell-off beyond inflationary bets showed that the contagion to US holdings and indeed the dollar was fairly benign. Now that the proposals are watered down (i.e exemptions) it might seem like a smart move, but our FX team remains cautious, noting that [Trump's trade war is a reason for foreign investors to shy away from US Treasuries](#). All eyes will be on US Treasury auctions this week for signs of major trading partners diversifying away from US debt holdings. Weakness in US holdings ought to weigh upon the dollar and boost safe-haven inflows, whether gold can begin attracting these allocations will determine the near-term outlook.

## Gold positioning exodus (Comex open interest, '000 lots)



Source: CME, ING

## All eyes on inflation data tomorrow

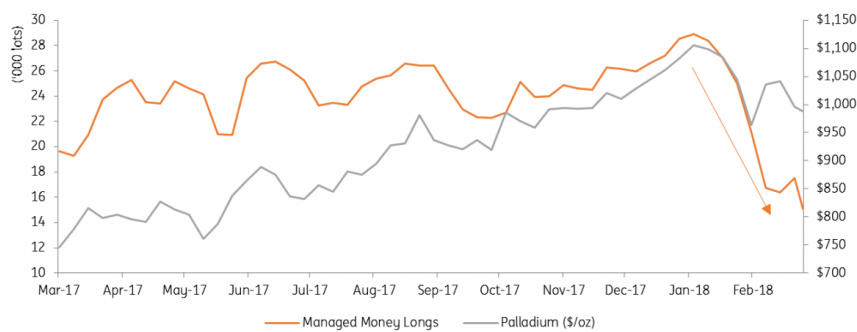
The highlight of the economic calendar will be the US inflation data tomorrow, with wounds still sore from the inflation-induced equity sell-off in February. Friday's US jobs report showed that payrolls increased by 313,000 last month and well above the market consensus, but wage growth slowed to 0.2% from 0.1% the month before. Filling vacancies without raising pay points to non-inflationary growth, which is not a positive development for gold though [our economists have raised doubts](#). Other reports show businesses struggling to find workers, which suggests future payrolls will slow and pay growth will quicken. Consumer price inflation could hit 3% by the summer, which drives our constructive forecasts for gold this year.

## Trump tariffs hit palladium hardest

Palladium was the most immediate victim of President Trump's tariffs, with prices falling 5% the next day. Commenters speculated that higher input costs for aluminium and steel could hit US auto markets and spill over into the global trade of parts and vehicles. The US traded nearly \$430 billion in vehicles, parts and accessories in 2017 and auto dealings with Europe became a hot topic in the Twittersphere. However, we think the scale of the move was more a reflection of the prevailing ongoing liquidation in palladium than a precise link to fundamentals. CFTC data shows that managed money has liquidated by more than 50% since peaking in mid-January.

The platinum-palladium ratio recovered slightly on the post-tariff sell-off but remains comfortably below parity. The forward curves have pushed back platinum overtaking palladium until December 2018 compared to a June date last month. Based on our own forecasts, we don't think such a move will happen for the next few years due to platinum's weaker fundamentals with the palladium backwardation actually making it more expensive for investors to short the ratio. For platinum, another jolt comes from Germany where the top court validated cities' rights to limit/ban diesel cars in the city centre to fight pollution. The ruling could have wide repercussions across Europe, where nearly half of the vehicles are diesel-powered – diesel cars emit nearly 8-10 times more nitrogen oxides than gasoline.

## Palladium managed money longs down by over 50%

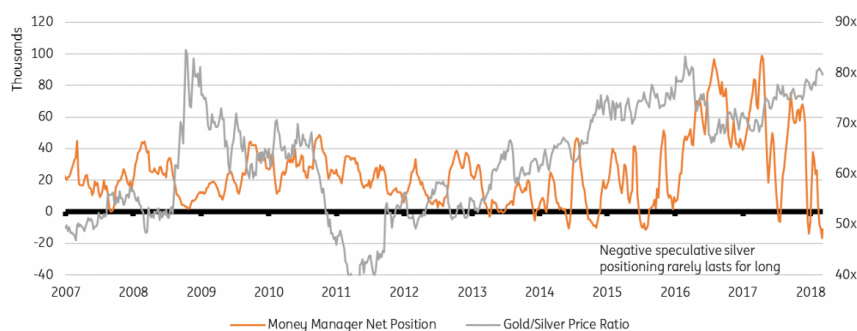


Source: CME, ING Research

## Silver: Still undervalued to gold

The gold-silver ratio remains around the 80x level seen during the great financial crisis, deeply inconsistent with our positive outlook for the global economy. Silver money manager positioning data remains net short for four weeks running which has only happened three times since 2006 and, at the most, lasted six weeks. It seems highly likely therefore that silver fund positioning will soon turn.

## Net short silver positioning rarely lasts long



Source: CME, ING Research

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