Week in Review: Economics trumps politics

US jobs growth surged, Trump approved new import tariffs, the ECB dropped its easing bias and political events in Europe produced mixed results. Here's a look back at the week that was

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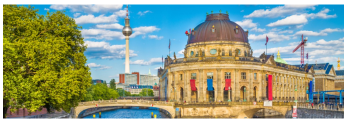

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US jobs: A likely story...

A surge in payrolls, workers coming back to the jobs market and companies not having to pay staff more is the message from the February jobs report. We have our doubts about this...

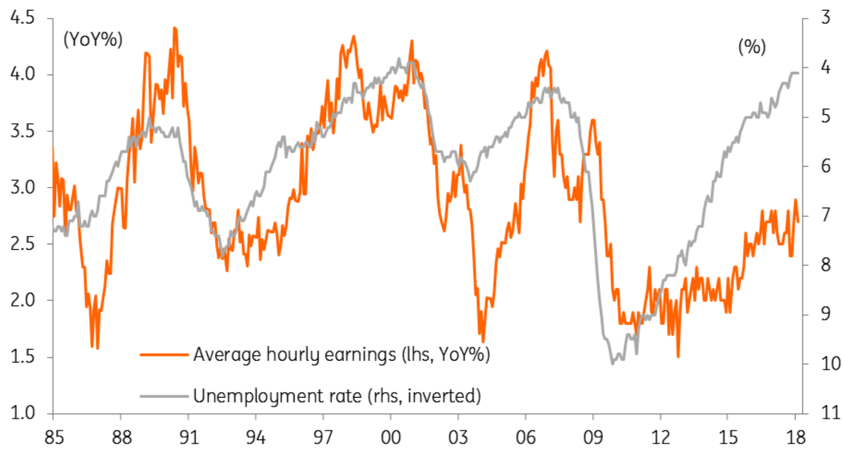
Source: Shutterstock

Too good to be true?

The US jobs report for February shows payrolls rose 313,000 last month (with 54,000 upward revisions), versus the consensus forecast of 205,000 reinforcing the message that a 25bp Federal Reserve interest rate hike on 21 March is a done deal. Despite this, the unemployment rate remained at 4.1%, rather than dropping to 4% as expected while wage growth rose only 0.1% month-on-month, meaning the annual rate of wage growth slipped to 2.6% from a downwardly revised 2.8%.

The working week also increased to 34.5 hours from an upwardly revised 34.4 and the labour participation rate jumped from 62.7% to 63%. Essentially the data says around 800k people suddenly entered the jobs market last month and virtually all found work (unemployment only increased 22k).

On the face of it, this is a fantastic story. Rising wage growth and the prospect of "better" jobs has led people to return to the workforce and companies are able to fill their vacancies without increasing pay i.e. non-inflationary growth. Except that this isn't the story we are getting from other reports.



Source: Macrobond

Other reports tell a different story...

Yesterday's National Federation of Independent Business labour survey showed small businesses are increasingly struggling to find workers with a net 22% saying this is the greatest impediment to doing business (the largest single factor cited). As such, the competition to find new - and retain current - staff meant that the proportion of businesses raising pay was its largest since 2000 and the net proportion planning to raise pay is close to 19-year highs.

With JOLTS data showing that there is only one unemployed worker for every new job opening, it is also clearly a problem for larger corporations. As such, it is taking longer to fill vacancies. Consequently, we are a little sceptical of today's jobs report and instead we think payrolls growth will slow and wage growth will quicken in coming months.

This is just one reason why we think headline consumer price inflation could hit 3% in the summer (others include dollar weakness, rising commodity prices, cell phone data plan quirks and medical care costs). As such, we look for four rate hikes this year, starting in March, with the Fed signalling a clear willingness to do so in updated forecasts

Author

James Knightley
Chief International Economist, US
james.knightley@ing.com

Snap | 9 March 2018

Tariff exemptions: Damage undone?

President Trump's decision to exempt Canada and Mexico from import tariffs (pending NAFTA negotiations) significantly limits the impact on domestic steel and aluminium markets. Metal consumers will be tempted to breathe a sigh of relief but duty paid imports of aluminium are still required

Source: Shutterstock

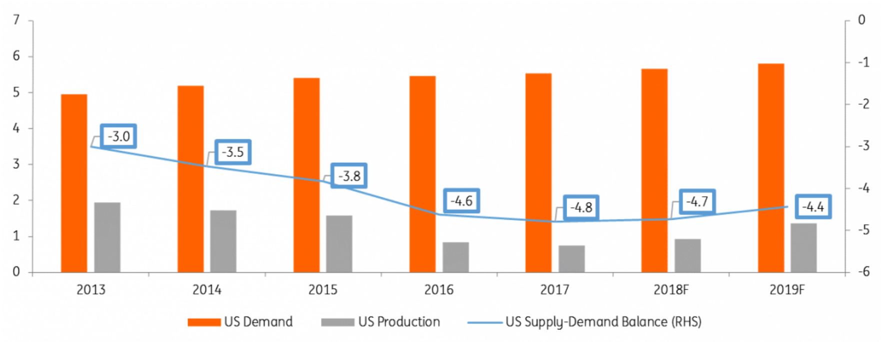
Canada is crucial, allies even more so

The US relies on imports for 80% of its primary aluminium consumption, a 4.8Mt void that at best falls to 4.4MT by 2019 if domestic smelters restart. Canada is by far the largest supplier providing 50% of imports. A section 232 ruling that did not exempt Canada would have therefore meant an almost 1:1 passing through of duty to the premiums paid by the consumer (around 10¢/lb). With US aluminium premiums up 60% year-to-date much was already priced in but we suspected premiums could get to 20¢/lb if Canada was included. The impact will now be considerably more limited and could become almost negligible were exemptions to spread to other ''allies": Middle East, Western Europe, Australia, New Zealand etc.

The CME forward curve for Midwest premiums now anticipates premiums have peaked at 17¢/lb with the curve in backwardation down to 13.5¢/lb by 2020. The ability for Canada to grow its exports, and further country exemptions, will influence how much more downside materialises.

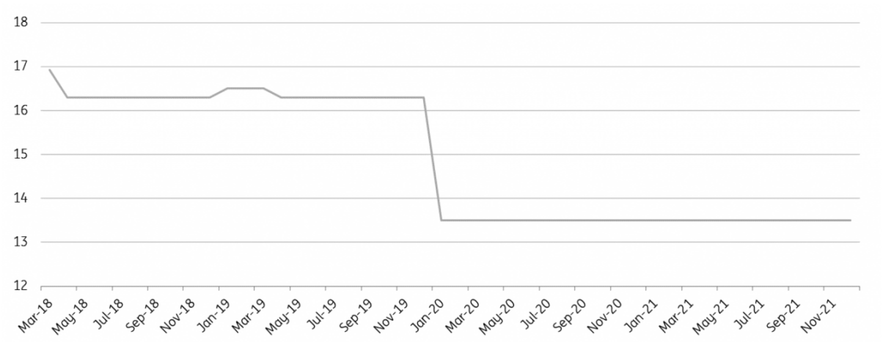
Mike Bless, CEO of Century, is reported to believe that Canada will still have quotas preventing it from boosting shipments into the US tariff-free. At full capacity, Canadian production could satisfy up to 70% of US import needs but the continued outage at the ABI Quebec smelter limits contribution closer to 60% and if domestic sales cannot be neglected for foreign material then it remains 50%. Excepting a big draw down in any customs cleared off-warrant stocks (our bear case) Russian/ Middle Eastern primary metal imports still need to be incentivised regardless. Given a 10% import duty, that incentive still requires 15¢/lb although cheaper transit will allow them to be undercut by EU stocks closer to 13¢/lb. The stock pull on this major net consuming region will likely see EU premiums on the up as well. A bottleneck in US inland freight costs could also see premiums easing as the year rolls on.

Facing Facts: US imports outweigh Canadian capacity (Mt)



Source: ING Research

CME Curve sees premiums at peak (¢/lb)

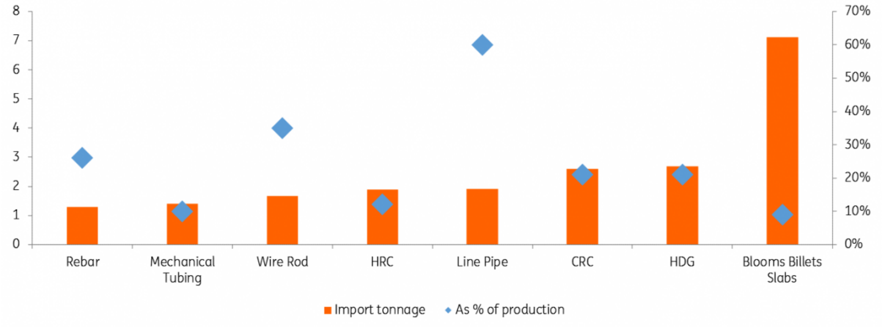


Source: CME, ING Research

Steel: More limited impact, products exemptions could be key

Compared to the high import reliance of aluminium, the duty impact on steel was always set to be lower. Steel imports make up only 30% of US steel demand and 20% excluding Canada/Mexico. With steel utilisation running at 74% last year, a move up to 80% and slashing exports (9MT) could quickly reduce the ex-Canada/Mexico import need below 10%. Duties paid by consumers overall will be a fraction of the 25% but the impact could vary by product. Smaller markets like line pipe have much higher import reliance but news that certain products can appeal for exemptions will likely provide relief here.

US Steel imports by tonnage and depency (Mt, %)



Source: ISSB, Bloomberg, US Customs, AISI, ING Research

Author

Amrita Naik Nimbalkar
Junior Economist, Global Macro
amrita.naik.nimbalkar@ing.com

Mateusz Sutowicz
Senior Economist, Poland
mateusz.sutowicz@ing.pl

Alissa Lefebre
Economist
alissa.lefebre@ing.com

Deepali Bhargava
Regional Head of Research, Asia-Pacific
Deepali.Bhargava@ing.com

Ruben Dewitte
Economist
+32495364780
ruben.dewitte@ing.com

Kinga Havasi
Economic research trainee
kinga.havasi@ing.com

Marten van Garderen
Consumer Economist, Netherlands
marten.van.garderen@ing.com

David Havrlant
Chief Economist, Czech Republic
420 770 321 486
david.havrlant@ing.com

Sander Burgers
Senior Economist, Dutch Housing
sander.burgers@ing.com

Lynn Song
Chief Economist, Greater China
lynn.song@asia.ing.com

Michiel Tukker
Senior European Rates Strategist
michiel.tukker@ing.com

Michal Rubaszek
Senior Economist, Poland
michal.rubaszek@ing.pl

This is a test author

Stefan Posea
Economist, Romania
tiberiu-stefan.posea@ing.com

Marine Leleux
Sector Strategist, Financials
marine.leleux2@ing.com

Jesse Norcross
Senior Sector Strategist, Real Estate
jesse.norcross@ing.com

Teise Stellema
Research Assistant, Energy Transition
teise.stellema@ing.com

Diederik Stadig
Sector Economist, TMT & Healthcare
diederik.stadig@ing.com

Diogo Gouveia
Sector Economist
diogo.duarte.vieira.de.gouveia@ing.com

Marine Leleux
Sector Strategist, Financials
marine.leleux2@ing.com

Ewa Manthey

Commodities Strategist
ewa.manthey@ing.com

ING Analysts

James Wilson
EM Sovereign Strategist
James.wilson@ing.com

Sophie Smith
Digital Editor
sophie.smith@ing.com

Frantisek Taborsky
EMEA FX & FI Strategist
frantisek.taborsky@ing.com

Adam Antoniak
Senior Economist, Poland
adam.antoniak@ing.pl

Min Joo Kang
Senior Economist, South Korea and Japan
min.joo.kang@asia.ing.com

Coco Zhang
ESG Research
coco.zhang@ing.com

Jan Frederik Slijkerman
Senior Sector Strategist, TMT
jan.frederik.slijkerman@ing.com

Katinka Jongkind
Senior Economist, Services and Leisure
Katinka.Jongkind@ing.com

Marina Le Blanc
Sector Strategist, Financials
Marina.Le.Blanc@ing.com

Samuel Abettan
Junior Economist
samuel.abettan@ing.com

Franziska Biehl
Senior Economist, Germany

Franziska.Marie.Biehl@ing.de

Rebecca Byrne
Senior Editor and Supervisory Analyst
rebecca.byrne@ing.com

Mirjam Bani
Sector Economist, Commercial Real Estate & Public Sector (Netherlands)
mirjam.bani@ing.com

Timothy Rahill
Credit Strategist
timothy.rahill@ing.com

Leszek Kasek
Senior Economist, Poland
leszek.kasek@ing.pl

Oleksiy Soroka, CFA
Senior High Yield Credit Strategist
oleksiy.soroka@ing.com

Antoine Bouvet
Head of European Rates Strategy
antoine.bouvet@ing.com

Jeroen van den Broek
Global Head of Sector Research
jeroen.van.den.broek@ing.com

Edse Dantuma
Senior Sector Economist, Industry and Healthcare
edse.dantuma@ing.com

Francesco Pesole
FX Strategist
francesco.pesole@ing.com

Rico Luman
Senior Sector Economist, Transport and Logistics
Rico.Luman@ing.com

Jurjen Witteveen
Sector Economist
jurjen.witteveen@ing.com

Dmitry Dolgin
Chief Economist, CIS

dmitry.dolgin@ing.de

Nicholas Mapa
Senior Economist, Philippines
nicholas.antonio.mapa@asia.ing.com

Egor Fedorov
Senior Credit Analyst
egor.fedorov@ing.com

Sebastian Franke
Consumer Economist
sebastian.franke@ing.de

Gerben Hieminga
Senior Sector Economist, Energy
gerben.hieminga@ing.com

Nadège Tillier
Head of Corporates Sector Strategy
nadege.tillier@ing.com

Charlotte de Montpellier
Senior Economist, France and Switzerland
charlotte.de.montpellier@ing.com

Laura Straeter
Behavioural Scientist
+31(0)611172684
laura.Straeter@ing.com

Valentin Tataru
Chief Economist, Romania
valentin.tataru@ing.com

James Smith
Developed Markets Economist, UK
james.smith@ing.com

Suvi Platerink Kosonen
Senior Sector Strategist, Financials
suvi.platerink-kosonen@ing.com

Thijs Geijer
Senior Sector Economist, Food & Agri
thijs.geijer@ing.com

Maurice van Sante

Senior Economist Construction & Team Lead Sectors
maurice.van.sante@ing.com

Marcel Klok
Senior Economist, Netherlands
marcel.klok@ing.com

Piotr Poplawski
Senior Economist, Poland
piotr.poplawski@ing.pl

Paolo Pizzoli
Senior Economist, Italy, Greece
paolo.pizzoli@ing.com

Marieke Blom
Chief Economist and Global Head of Research
marieke.blom@ing.com

Raoul Leering
Senior Macro Economist
raoul.leering@ing.com

Maarten Leen
Head of Global IFRS9 ME Scenarios
maarten.leen@ing.com

Maureen Schuller
Head of Financials Sector Strategy
Maureen.Schuller@ing.com

Warren Patterson
Head of Commodities Strategy
Warren.Patterson@asia.ing.com

Rafal Benecki
Chief Economist, Poland
rafal.benecki@ing.pl

Philippe Ledent
Senior Economist, Belgium, Luxembourg
philippe.ledent@ing.com

Peter Virovacz
Senior Economist, Hungary
peter.virovacz@ing.com

Inga Fechner

Senior Economist, Germany, Global Trade
inga.fechner@ing.de

Dimitry Fleming
Senior Data Analyst, Netherlands
Dimitry.Fleming@ing.com

Ciprian Dascalu
Chief Economist, Romania
+40 31 406 8990
ciprian.dascalu@ing.com

Muhammet Mercan
Chief Economist, Turkey
muhammet.mercan@ingbank.com.tr

Iris Pang
Chief Economist, Greater China
iris.pang@asia.ing.com

Sophie Freeman
Writer, Group Research
+44 20 7767 6209
Sophie.Freeman@uk.ing.com

Padhraic Garvey, CFA
Regional Head of Research, Americas
padhraic.garvey@ing.com

James Knightley
Chief International Economist, US
james.knightley@ing.com

Tim Condon
Asia Chief Economist
+65 6232-6020

Martin van Vliet
Senior Interest Rate Strategist
+31 20 563 8801
martin.van.vliet@ing.com

Karol Pogorzelski
Senior Economist, Poland
Karol.Pogorzelski@ing.pl

Carsten Brzeski
Global Head of Macro

carsten.brzeski@ing.de

Viraj Patel
Foreign Exchange Strategist
+44 20 7767 6405
viraj.patel@ing.com

Owen Thomas
Global Head of Editorial Content
+44 (0) 207 767 5331
owen.thomas@ing.com

Bert Colijn
Chief Economist, Netherlands
bert.colijn@ing.com

Peter Vanden Houte
Chief Economist, Belgium, Luxembourg, Eurozone
peter.vandenhoute@ing.com

Benjamin Schroeder
Senior Rates Strategist
benjamin.schroder@ing.com

Chris Turner
Global Head of Markets and Regional Head of Research for UK & CEE
chris.turner@ing.com

Gustavo Rangel
Chief Economist, LATAM
+1 646 424 6464
gustavo.rangel@ing.com

Carlo Cocuzzo
Economist, Digital Finance
+44 20 7767 5306
carlo.cocuzzo@ing.com

Article | 8 March 2018

ECB: Breadcrumbs for the hawks

The ECB dropped its easing bias on QE but subdued inflationary pressure leaves the extension of QE beyond September as our base case scenario

Bye bye easing bias

The biggest news of today's ECB press conference is the dropping of the easing bias. While the ECB reiterated that it would extend QE if necessary, it let go of the pledge to increase QE "in terms of size and/or duration" if the inflation outlook or financial conditions were to worsen. While dropping a sentence that has been in the ECB's introductory statement since 2016 is a significant change, ECB president Draghi gave his best trying to downplay exactly this significance during the press conference. Draghi stressed the fact that QE was still intended to "run until the end of September 2018, or beyond, if necessary, and in any case until the Governing Council sees a sustained adjustment in the path of inflation consistent with its inflation aim". Also, the forward guidance on interest rates was left unchanged and Draghi remarked that the ECB's reaction function had not changed.

2.4%

ECB estimate for GDP growth in the Eurozone this year

Up from 2.3% estimate in December

The ECB's macroeconomic assessment has not changed since the January meeting. The recovery remains strong and the expected acceleration of inflation is still much more wish than reality. On the back of the strong growth momentum in recent months, the ECB's staff projections for GDP growth were slightly revised upwards for 2018 to 2.4% (from 2.3% in the December projections) and remained unchanged for 2019 and 2020 (1.9% and 1.7% respectively). As expected, protectionism was added to the list of downside risks to the growth outlook. Or to paraphrase it: with downside risks stemming from protectionism and exchange rate volatility, the current US economic policies are regarded as the biggest risk for the Eurozone economy.

1.4% ECB forecast for headline inflation in 2018

As regards inflation, the ECB's words still look much more promising than the actual numbers. According to Draghi, headline inflation will hover around 1.5% for the remainder of the year and underlying inflation remains low. This rather benign take on inflation is also reflected in the ECB's staff projections. According to the projections, headline inflation is expected to come in at 1.4% in 2018 and 2019 and 1.7% in 2019. Against this background, the ECB's confidence "that inflation will converge towards our inflation aim" is still much more based on wish than reality and facts. It is therefore not surprising that the ECB believes that overall, an ample degree of monetary stimulus remains necessary for underlying inflation pressures to continue to build up and support headline inflation developments over the medium term.

All options still available

It was obvious that the ECB would not and could not really react to the ongoing trade tensions as there is simply speaking very little the ECB could actually do. Only once trade tensions or exchange rate volatility pose a risk to the growth and inflation outlook, would the ECB consider reacting. Therefore, it does not come as a surprise that the ECB today changed it communication somewhat. At the same time, we would not overestimate this change. Even after dropping the easing bias, the ECB still has all options to extend QE. Beyond September 2018 but also beyond December 2018. And let's be honest, if the Eurozone economy were to suddenly enter a severe downturn, dropping the easing bias today would definitely not prevent the ECB from doing "whatever it takes". Taking all these factors together, we remain comfortable with our expectation of at least one more extension of QE, beyond September 2018.

Breadcrumbs for the hawks

Against the background of a growing divide within the ECB, today's communication change should, in our view, be seen as a conciliatory move to please both the ECB's hawks and doves. Dropping the easing bias was probably like doves feeding the hawks some breadcrumbs.

Author

Carsten Brzeski
Global Head of Macro
carsten.brzeski@ing.de

Article | 5 March 2018 Italy

Italy: Hung parliament, left without obvious short-run solution to gridlock

Without an outright winner but with a populist twist in parliament, forming a new government will be complicated. Expect tactical positioning by party leaders and clarity about the presidents of the two Houses, before an attempt at a coalition is made

Source: Shutterstock

The Italian elections have delivered a hung parliament and based on preliminary data, no party/coalition of parties managed to reach an absolute majority of seats. However, the new political geometry of the Italian parliament that has emerged differs from what opinion polls had suggested on the proportional part of the vote.

According to preliminary data, the Five Star Movement did better than expected, reaching around 32.5% of votes (some 4pps higher than opinion polls). The centre-right coalition's aggregate score was at c.37%, broadly in line with the opinion polls, but the composition diverged substantially, marking a shift of power in favour of the populist Northern League (at c.17.6%) from Forza Italia (c. 14%).

The centre-left front (c. 23%) was the clear loser, scoring some 4pp less than the polls had suggested.

No obvious solution to gridlock

The new geometry of the Italian parliament makes the formation of a new government a very complicated exercise for all players. Poor turnout for the centre-right and centre-left parties suggests the Forza Italia-Democratic Party (PD) core will not be able to forge a grand coalition.

The centre-right coalition, the biggest political aggregate in the new parliament might in principle attempt to build a coalition, but under a Northern League leadership, it might find it hard to attract moderates from the centre-left to reach a majority and strike an agreement. The PD's claim that it would rather be in opposition seems to confirm our doubts.

After such a strong showing, the 5SM is a natural candidate to play a key role in the formation of a new government. However, reaching an alliance agreement with mainstream parties could be very complicated, as the 5SM would likely try to enforce strict preconditions. The possibility of the PD becoming the preferred partner, which cannot be ruled out, might depend heavily on whether PD leader Matteo Renzi decides to resign or not.

In searching for an ally, the 5SM might consider teaming up with the Northern League. While a distinct possibility, this remains unlikely, in our view, as its political viability might be limited, with neither electoral base at ease with the idea.

Expect President Mattarella to keep new elections as a last resort

President Sergio Mattarella will obviously have a big role in the process. We believe he will tread very carefully, exploring all possible solutions to the gridlock and keeping the new elections hypothesis as a last resort with the current electoral system.

We believe he will have to confront the fact that the undisputable victory of populist parties in principle adds a potential bias to future economic policies, and to fiscal policy in particular. Both the Northern League and the 5SM have typically been very critical towards European fiscal rules, deemed too rigid and perceived as an unneeded straightjacket. Pushing for a deviation from the current fiscal trajectory when France and Germany are working towards a new European governance might turn out to be a dangerous exercise.

Should all exploratory mandates fail to succeed, a technocratic solution (or national unity government) with a narrow mandate (such as approving a new electoral law) might ultimately emerge as the backstop outcome.

In our view, in the current setting, a solution to the gridlock will take time to unfold. Party leaders are tactically taking time, well aware that the road to a negotiation is intrinsically long. The new parliament will first gather on 23 March, and the election of the presidents of the two Houses will follow suit. This will be the first relevant test, given possible subsequent alliances.

Only after the presidents are elected, towards the end of March, will president Mattarella start his round of consultations which could result in a mandate.

Author

Paolo Pizzoli
Senior Economist, Italy, Greece
paolo.pizzoli@ing.com

Germany: It's a 'GroKo'

More than five months after the elections, Germany will finally get a new government. It will be the old one. A grand coalition, in Germany also known as the 'GroKo'

The SPD party members voted for another grand coalition with Angela Merkel's Christian Democrats, allowing her to stay on as chancellor for a fourth term. In the end, 66% of SPD member votes were in favour of the grand coalition; this was much bigger in numbers than expected.

On 14 March, the German parliament will vote on the next chancellor. With the SPD vote, 14 March will only be a formality. After more than five months, Germany will get a new government - one that basically will deliver more of the same as in the last four years. The government is expected to bring fiscal stimulus, investment in education and digitalisation, some tax relief and steps to tackle social inequality. This new government will, in our view, also cautiously and slowly push forward with European and Eurozone integration; no bold steps. For us, the most exciting project is in the intended economic and tax harmonisation between France and Germany.

Everyone wins, but not necessarily the SPD

At least in the short run, the SPD vote should bring some stability to Germany and Europe. Even though we are very hesitant to call this an upcoming breakthrough for Europe and the Eurozone, the new government will clearly be supportive of further integration. The question will obviously be how far this integration will go. Chances are high that it will remain an integration process of very small steps.

For German politics, Angela Merkel and the CDU will now have time to restructure the party and to build up a new generation for the post-Merkel era. At the same time, one exciting question will be whether the AfD - as populist parties in so many other European countries - can benefit from its role as the biggest opposition party. Earlier experiences in other countries have shown that grand coalitions over a longer time period can strengthen populist parties, both on the left and right wing of the political spectrum. The biggest challenge, however, will come for the SPD. The party vote and the preceding discussion have shown that it is a party under severe stress and conflicting views.

Party renewal while being part of government is a very challenging task, to say the least. Germany and Europe now look somewhat reassured in the near-term future. The SPD, not necessarily so.

Author

Carsten Brzeski
Global Head of Macro
carsten.brzeski@ing.de

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