



Can anything get in the way of a stronger Euro?

Our answers to this month's big questions



Our top six themes this month

Global Economics
and Strategy Team

May 2017



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Economic and Financial Analysis

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The major risk elections seem to have passed... almost

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Why good is not good enough when it comes to Eurozone growth

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Why we expect two jumps in EUR/USD over the next two years

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Our four scenarios for Trump's next 100 days

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Reflation dashboard: How fiscal stimulus hopes are fading

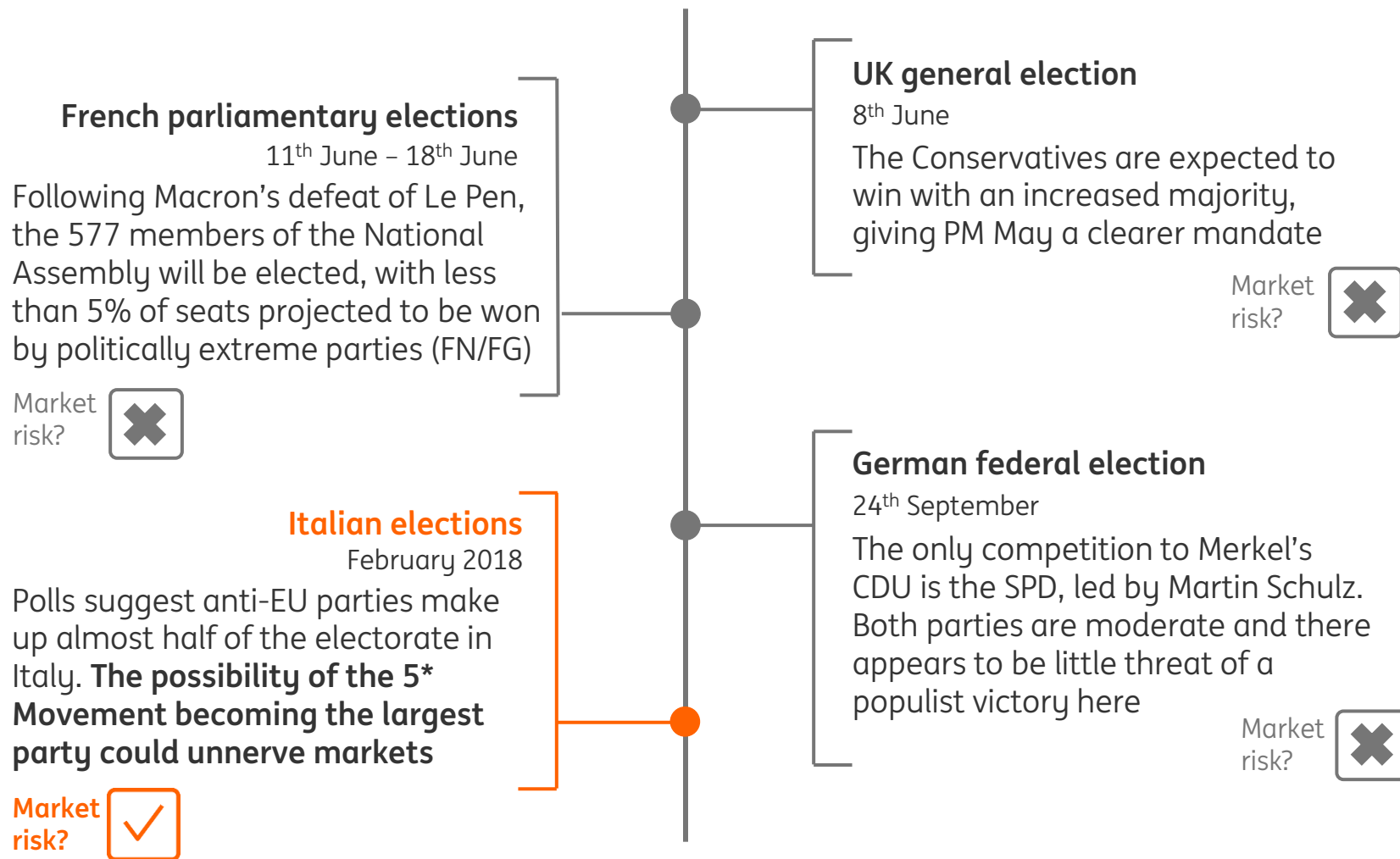
#6

The latest on the UK General Election, and what it means for Brexit

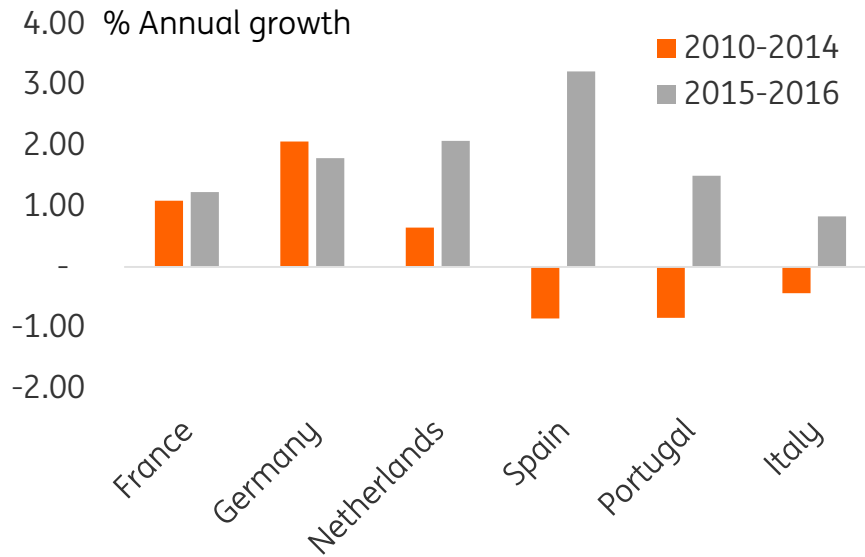


The big risk elections seem to have passed... Almost

Upcoming elections in UK, France and Germany pose little risk to markets, but don't forget about Italy



Despite the politics, the Eurozone recovery is looking good...



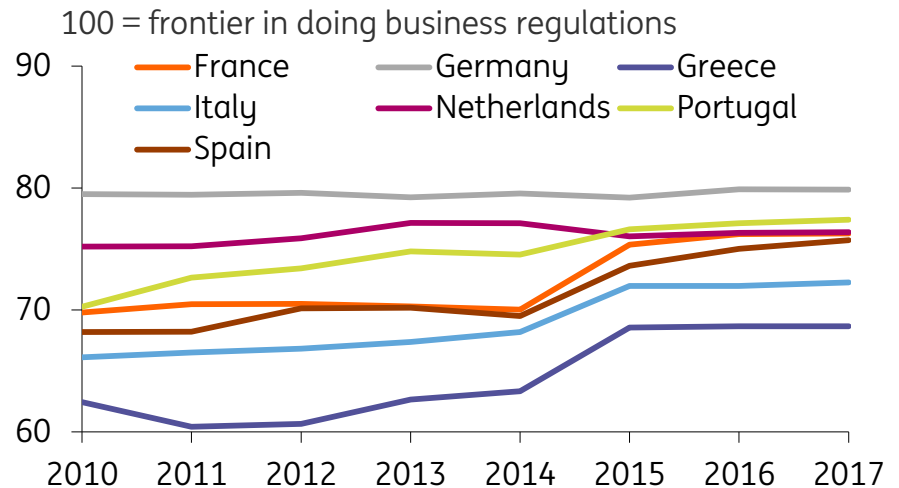
Despite political risk, the Eurozone economy looks to have grown faster than the US and UK in 1Q17

Our forecast of 2% growth for 2017 would be the second strongest year in a decade – and this isn't just driven by France and Germany, but broader growth across countries:

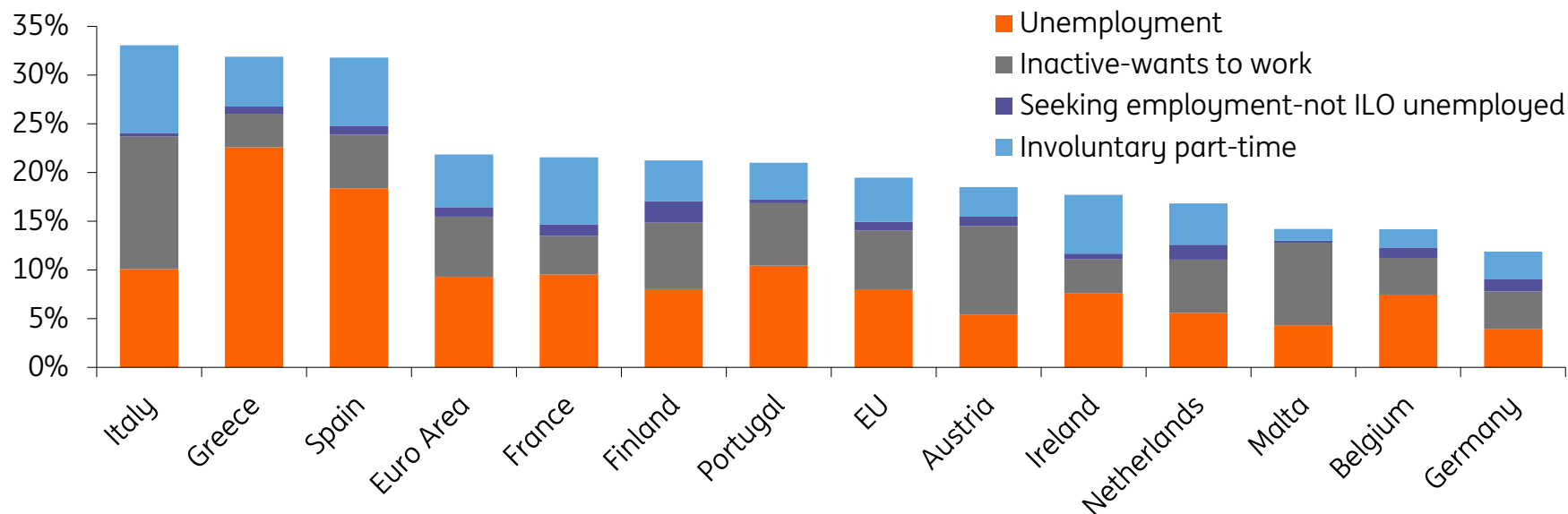
Spain, Portugal, Ireland and the Netherlands are looking strong, and more competitive

Private consumption, investments and fiscal policy have all continued to improve during 2017 so far. The Eurozone economy looks to be firing on all cylinders

This recovery is not only the result of favourable external conditions and very accommodative monetary policy, but structural improvements in several countries too



...but good isn't good enough: Structural issues need tackling



Three factors are responsible for limiting structural growth in the Eurozone:

- 1 Declining working age population
- 2 Weak capital stock growth
- 3 Low productivity growth

But there are solutions...

Immigration and **reactivation of the hidden workforce** could counter the drop in working age population – underemployment is still common

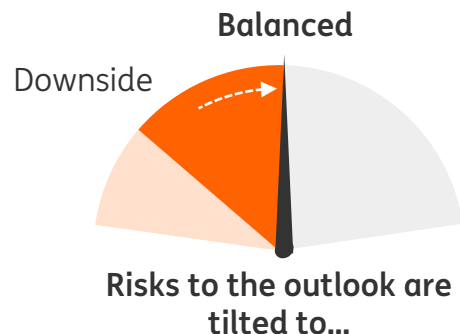
Looser fiscal policies could help capital stocks to growth by enabling governments to start public investments or incentivise the private sector to invest

Boosting productivity is the most challenging: until technologies become cheaper and more widespread, weak productivity growth may continue

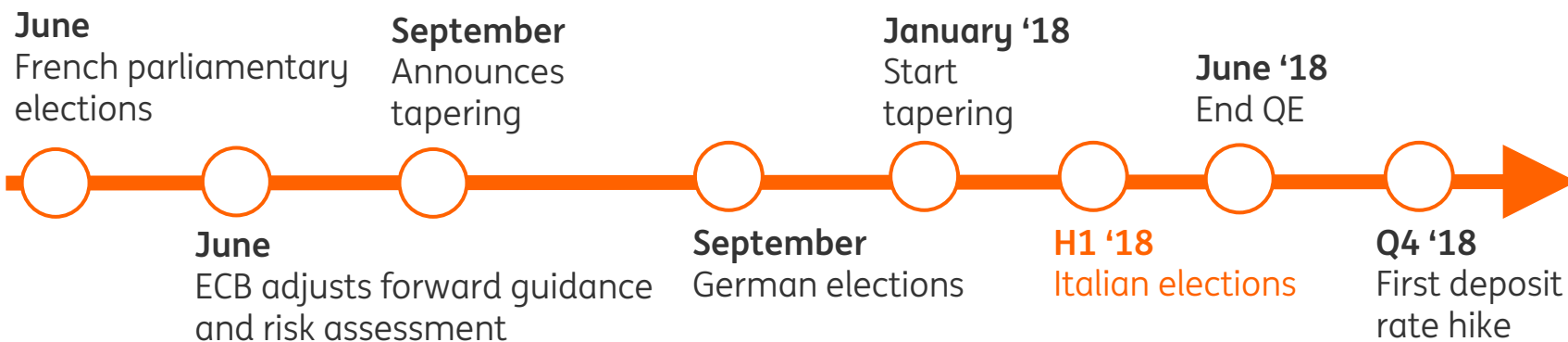
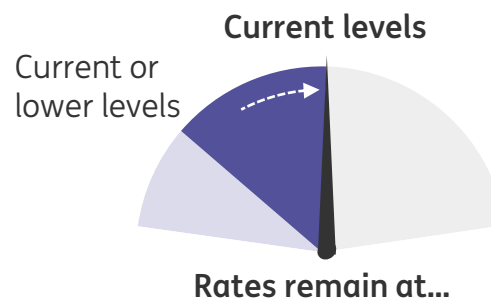
The next steps for the ECB now election risks are fading...

We expect the risk assessment and forward guidance to be adjusted at the June meeting

Adjustment of the risk assessment

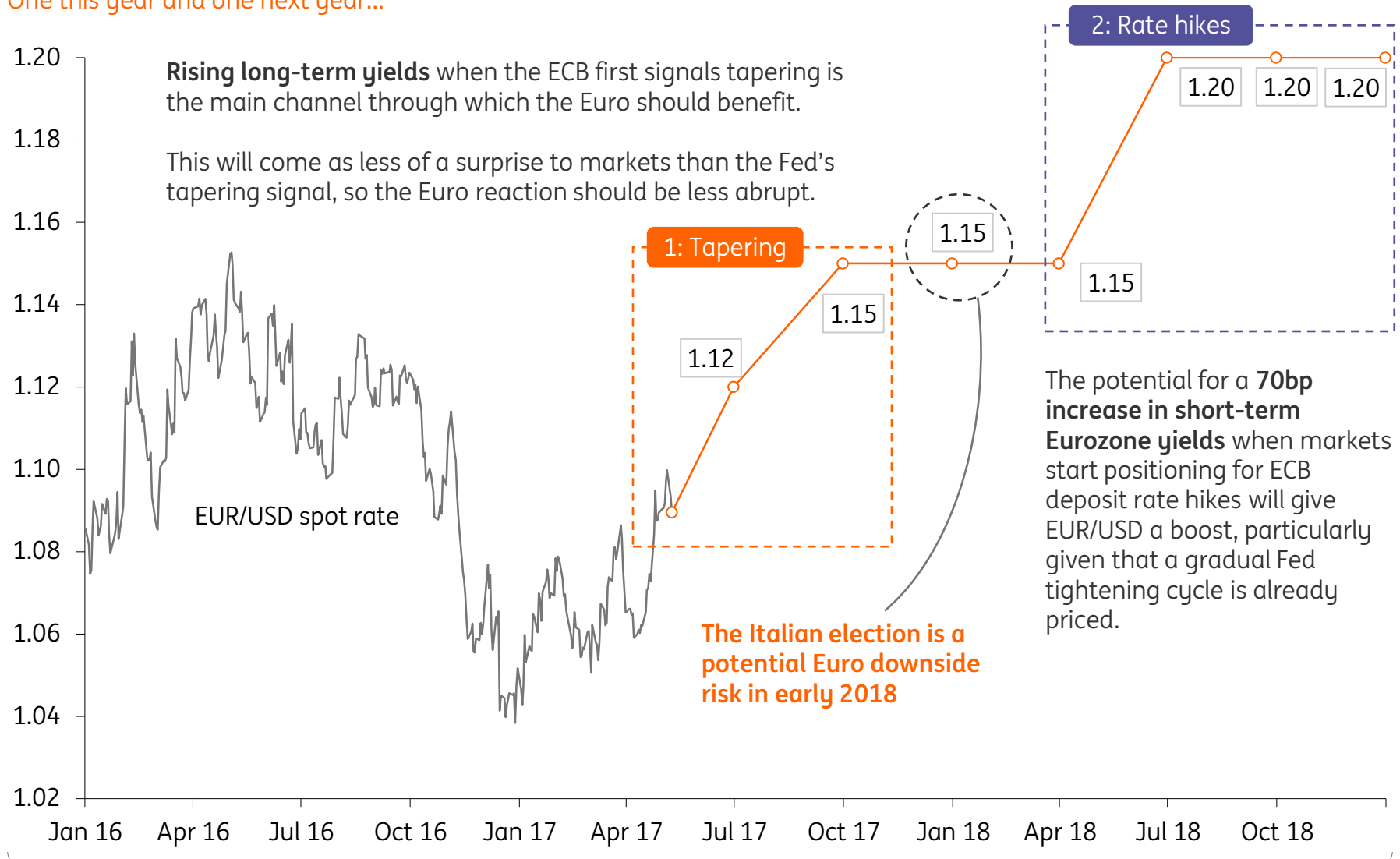


Forward guidance

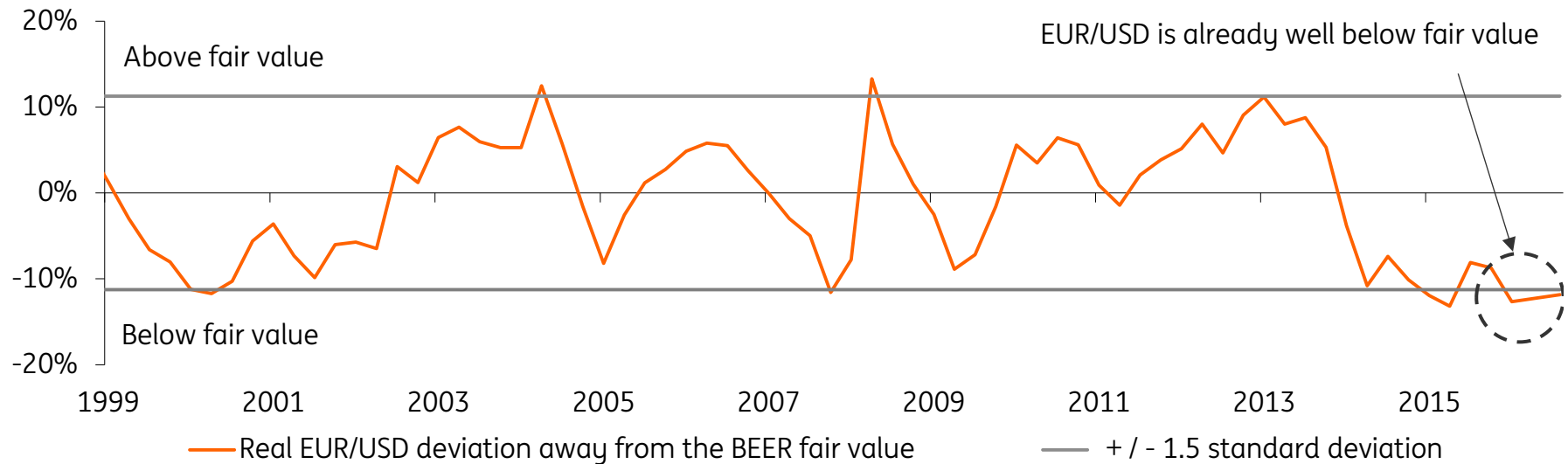


Expect two jumps in EUR/USD as the ECB normalises

One this year and one next year...



It's not just the ECB, there are other stars aligning for the Euro



Valuation will become a Euro amplifier

We think that EUR/USD is currently trading around 12% below its fair value (based on a range of metrics).

That's held EUR/USD back from falling considerably below 1.05 this year, despite elevated political risks and excitement about Trump.

We think will only reinforce the upside Euro risk.

Election risk news has a diminishing effect...

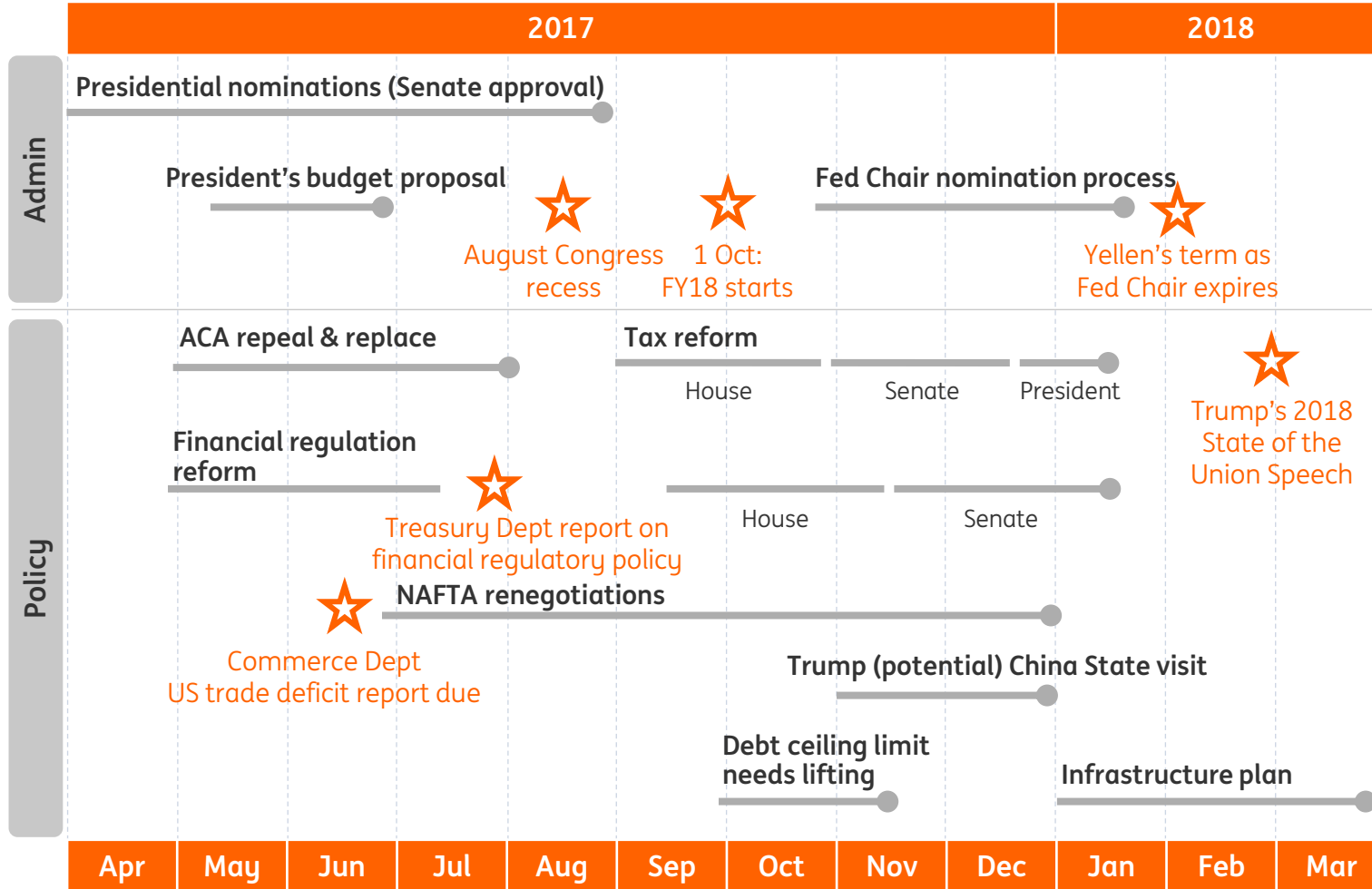
There is still a clear risk to the Euro from next year's Italian election.

But negative political news is having a reduced effect on the Euro, compared to in the Greek crises.

That might be linked to the ECB regaining credibility to "do whatever it takes" to save the Euro.

Trump: The next 100 days...

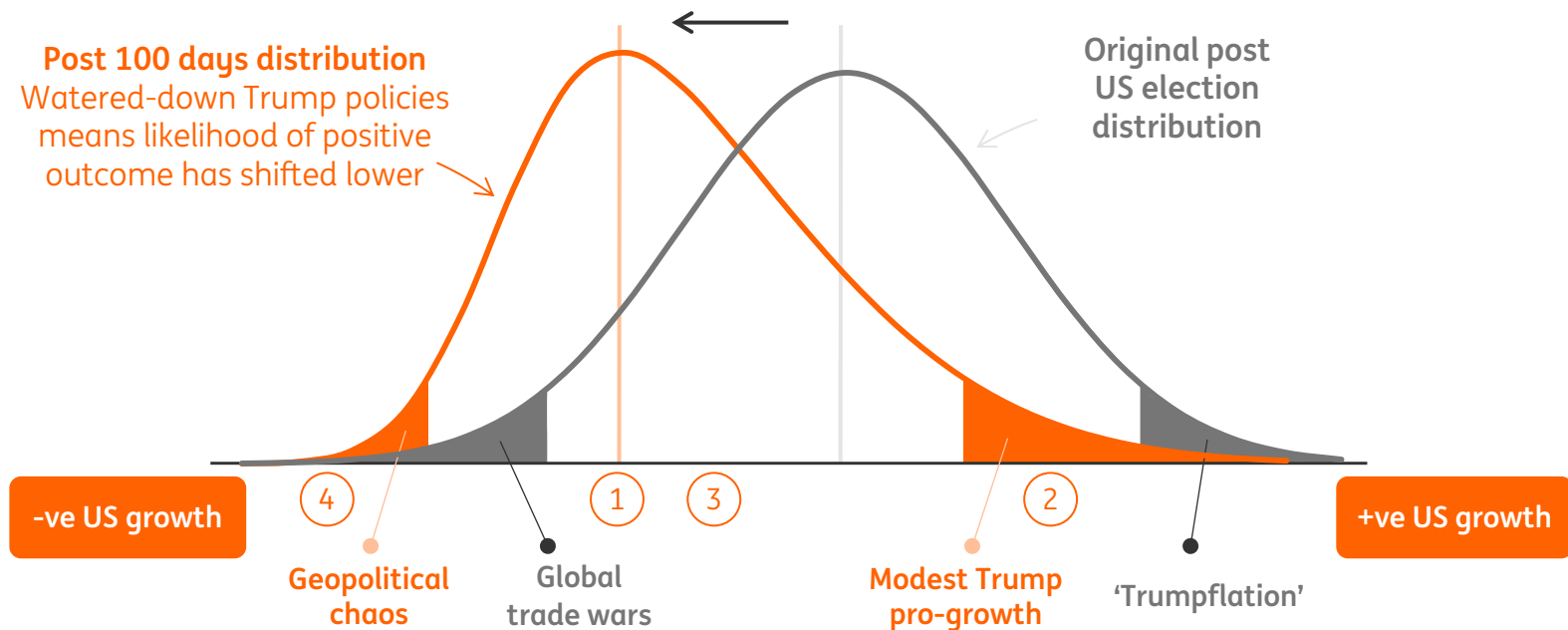
What to expect on key policy areas over the next year



Assessing Trump policy risks

Geopolitical politics replaces protectionism as the negative tail risk

Downshift in expectations given a more watered-down Trump policy regime



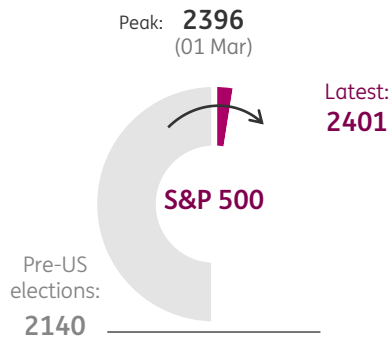
4 Trump scenarios over the next 100 days:

- 1 Muddling Through**
Trump policy uncertainty prevails leaving global markets directionless
- 2 Reflation Recovery**
Trump tax reform plans pass Congress hurdle and provide modest stimulus
- 3 Global Tightening**
ECB QE exit & Fed balance sheet shrinking = a perfect storm for long-term yields
- 4 Geopolitical Chaos**
Trump foreign policy causes geopolitical fears to escalate in markets

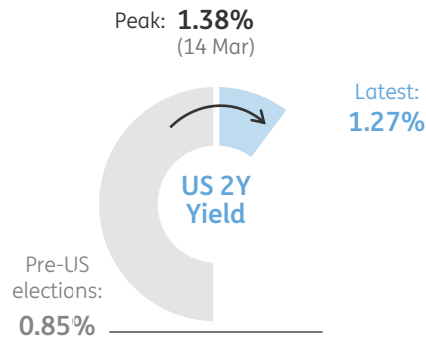
Trump reflation dashboard

Rise and fall in markets shows fading fiscal stimulus hopes

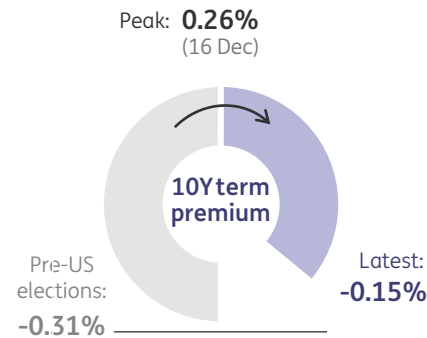
US equities



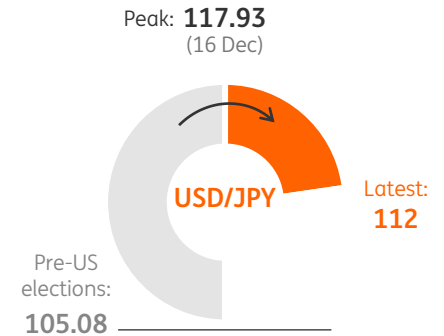
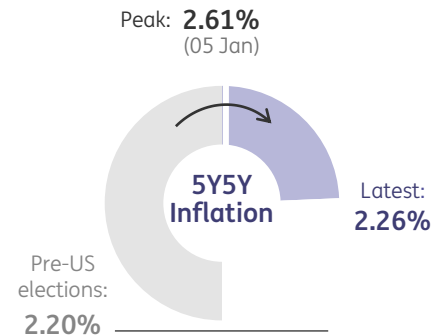
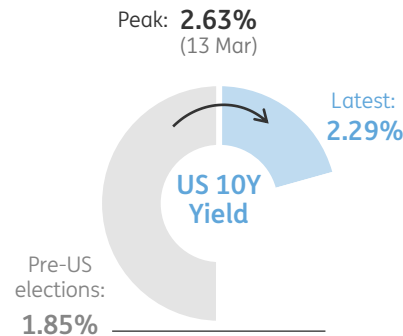
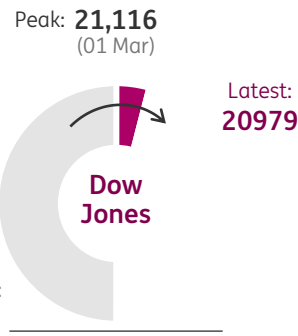
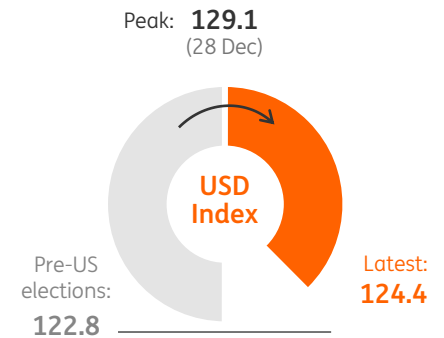
US yield curve



Reflation expectations



FX



Updated on 17th May 2017

Weighing up the dollar positives and negatives...

Our USD outlook can be seen as a **balanced seesaw, with supporting factors likely to be offset by medium-term headwinds**. Investors will want to see the finer details of Trump's proposed tax reforms – as well as Congressional backing – before buying into a significantly positive US growth story.

Dollar **supportive** factors

Pro-growth Trump policy regime

- Tax repatriation holiday will create \$ demand
- Tax reforms (corporate & household tax cuts)
- Deregulation policies
- Infrastructure spending plans (\$1trn package)

US economy close to full capacity

- US inflation risks underestimated
- Fed balance sheet reduction

USD

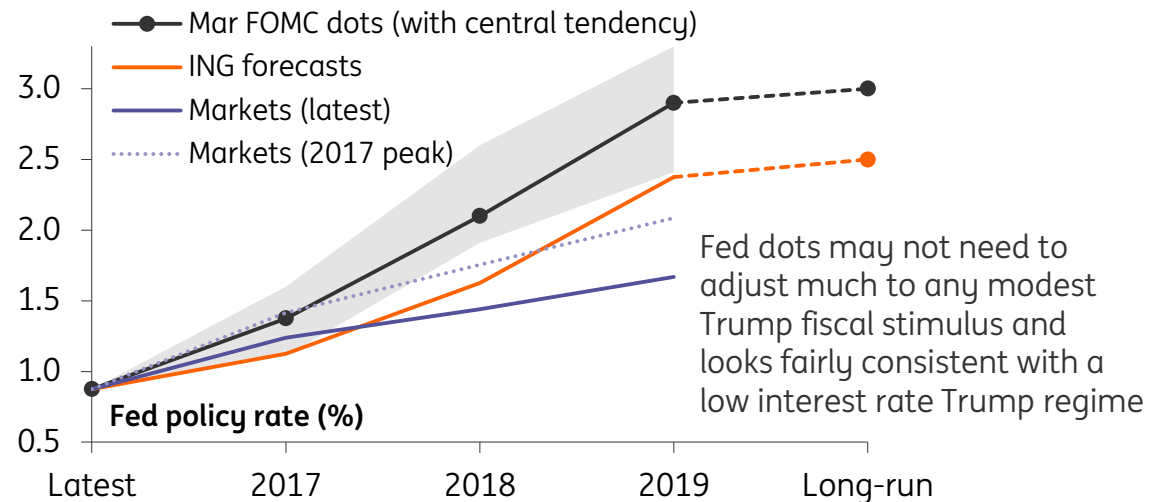
Dollar **downside** factors

Short-term

- Trump “jawboning”
- Geopolitical tensions

Medium-term

- Neutral Fed philosophy
- Structural twin deficit (trade & fiscal)



Source: ING, Federal Reserve, Bloomberg

Trump's next 100 days: Four scenarios for global markets

Reflationary assumptions

	US 10Y yield (range)	Fed policy bias (relative)	Inflation & Term Premia	US equity markets	Risk aversion & volatility	FX Playbook
1 Muddling Through Trump policy uncertainty prevails leaving global markets directionless	2.3%-2.5% Modest uplift as US inflation risks re-priced	Neutral Risk that Fed only hikes once more in 2017	Small pickup in inflation premium as US macro data rebounds	Resilient Tax hopes will underpin S&P 500 around 2350	Low Lower Trump tail risks should keep risk aversion low	Credit EM FX with a +ve local story given goldilocks market backdrop
2 Reflation Recovery Trump tax reform plans pass Congress hurdle and provide modest stimulus	2.8%-3.0% Strong bearish steepening in US yield curve	Hawkish tilt Fed still tightens fairly gradually in reflation mode	Both inflation & term premia rise as global growth optimism rises	More upside Reality of stimulus lifts US earnings estimates	Low Orderly moves in a watered-down Trump world	USD/JPY optimal reflation vehicle; USD bid against EM high-yielders
3 Global Tightening ECB QE exit & Fed balance sheet shrinking = a perfect storm for long-term yields	2.6%-2.8% US yields dragged higher by rising Bund yields	Neutral Tighter financial conditions keeps Fed cautious	Global term premia rise as access to 'easy money' falls	Correction risks Sharper sell-off in bonds may -vely affect equities	High Higher bond market volatility disrupts carry	EUR crosses see greater upside against typical carry currencies
4 Geopolitical Chaos Trump foreign policy causes geopolitical fears to escalate in markets	Below 2.0% Investors seek safe assets & pile into Treasuries	Dovish rethink Fed on hold given uncertain global backdrop	Term premia turns more -ve as markets enter risk-off mode	Sell-off Global equities fall as investors rotate into bonds	High Spike in volatility as global risk aversion rises	USD falls versus safe-haven JPY but up against EM FX universe

Source: ING

UK election dashboard: Conservatives look set for big win

Will it make a difference to Brexit? A bit...

The snap election gives PM May greater flexibility to get a transition period agreed, given the next vote won't be until 2022.

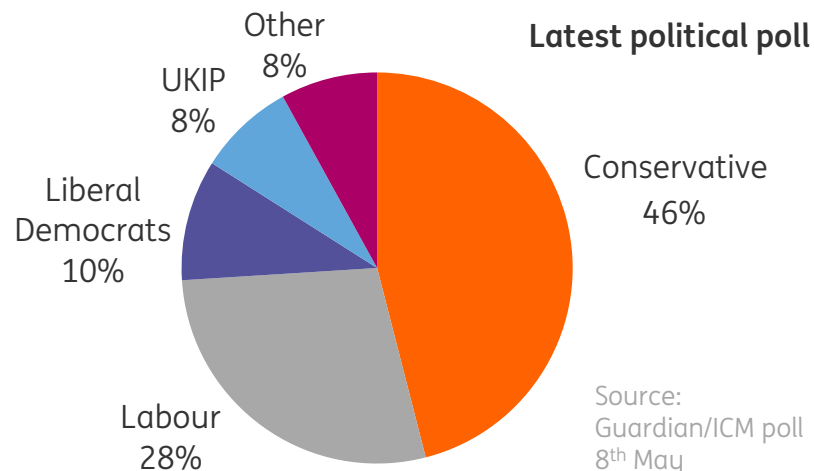
A larger majority may also give her greater confidence to be more realistic/open with the public on the possible economic effects of Brexit.

But the road to Brexit will still be rocky...

The EU's draft negotiation guidelines, and the fallout from a dinner between the Theresa May and Jean-Claude Juncker, suggest that both sides could hardly be further apart on their Brexit views.

We still think that a positive outcome for both sides is possible given the amount of trade and jobs that are dependent on it.

But there are many obstacles in the road: first of all, the size of the so-called "exit bill".



Predicted Conservative majority

170

Based on latest polls
(Current majority is 17)

Source: Electoral Calculus

Latest odds

1/33

Odds of Conservatives winning the most seats

Source: Oddschecker

We don't expect a UK rate hike before Brexit talks end...

Economic uncertainty will outweigh concerns about rising prices

Since the beginning of the year, business surveys have softened and consumer spending has slowed, culminating in a disappointing 0.3%QoQ 1Q17 GDP growth (vs 0.7% in 4Q16).

Slowing growth

This was significantly weaker than the Bank of England's 0.6% March forecast and has helped dampen market rate hike expectations.

Why we don't expect a UK rate hike before 2019

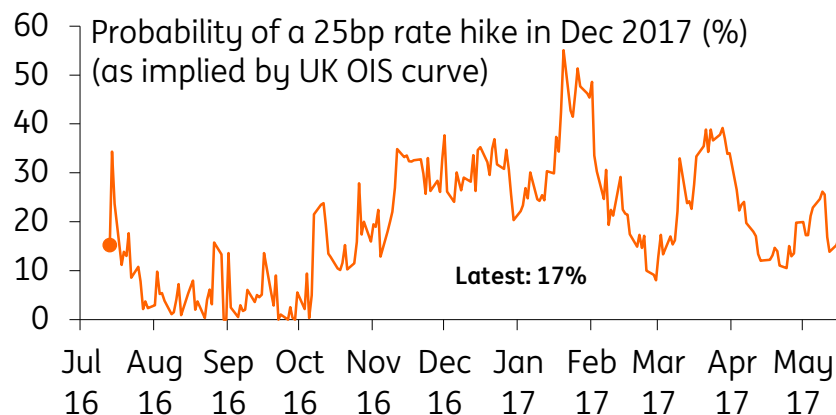
Cost of living

Inflation is surging due to the lagged effects of sterling's plunge pushing up the cost of imports. However, domestically generated price pressures are weak, with wage growth having softened and petrol prices dropping. Household inflation expectations are also contained.

MPC changes

Kristin Forbes, the MPC member who actually voted for a rate rise in March will be leaving the committee next month.

This will make getting a majority to vote in favour of action more challenging.



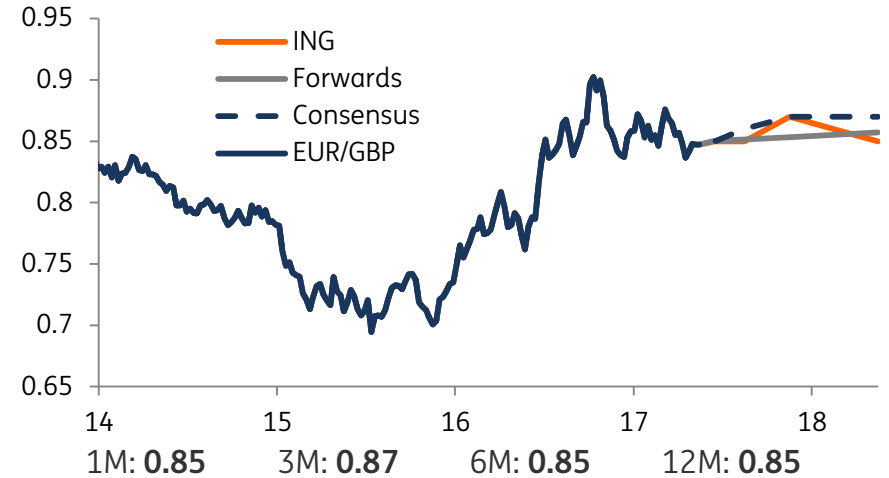
Our global forecasts

All data sourced from Bloomberg/ING forecasts

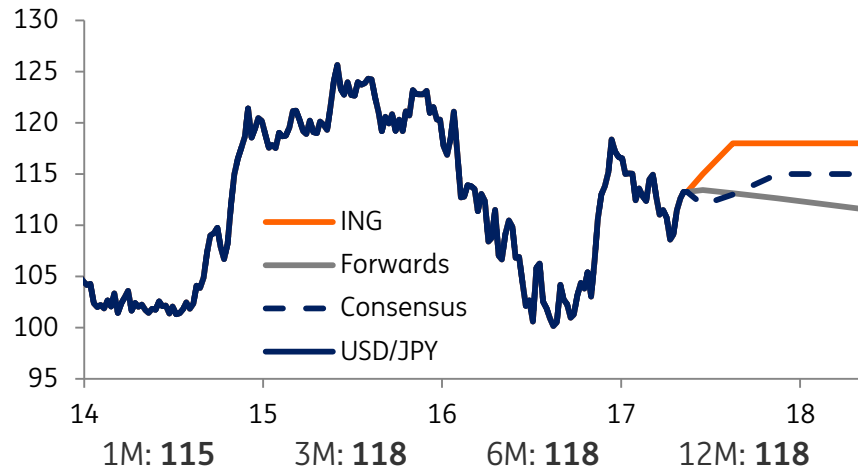
EUR/USD



EUR/GBP



USD/JPY



Oil (Brent Crude)



Our global forecasts

	2017F					2018F				
	Q1	Q2	Q3	Q4	FY	Q1	Q2	Q3	Q4	FY
United States										
GDP (% QoQ, ann)	0.7	2.2	3.9	3.3	2.2	2.7	2.7	3.0	2.9	2.9
CPI headline (% YoY)	2.7	2.8	3.1	3.1	2.9	2.9	2.9	2.9	2.9	2.9
Federal funds (% eop, lower bound)	0.75	0.75	1.00	1.00		1.00	1.25	1.25	1.50	
3-month interest rate (% eop)	1.15	1.15	1.31	1.33		1.33	1.60	1.69	1.85	
Eurozone										
GDP (% QoQ, ann)	1.9	1.6	1.6	1.8	1.8	1.8	1.7	1.7	1.7	1.7
CPI headline (% YoY)	1.8	1.5	1.4	1.3	1.5	1.2	1.4	1.5	1.6	1.4
Refi minimum bid rate (% eop)	0.00	0.00	0.00	0.00		0.00	0.00	0.00	0.00	
3-month interest rate (% eop)	-0.33	-0.32	-0.32	-0.32		-0.32	-0.32	-0.25	-0.10	
Japan										
GDP (% QoQ, ann)	0.7	0.5	0.7	0.9	0.8	1.3	1.3	1.4	1.4	1.1
CPI headline (% YoY)	0.3	0.5	0.8	0.9		1.0	1.1	1.2	1.2	
Excess reserve rate (%)	-0.1	-0.1	-0.1	-0.1		-0.1	-0.1	-0.1	-0.1	
3-month interest rate (% eop)	0.05	0.05	0.05	0.05		0.05	0.05	0.05	0.05	
China										
GDP (% YoY)	6.9	6.8	6.8	6.5	6.8	6.4	6.5	6.5	6.6	6.5
CPI headline (% YoY)	1.4	1.8	2.5	2.2	2.0	2.5	2.0	1.6	1.8	2.0
PBOC 7-day reverse repo rate (% eop)	2.45	2.55	2.55	2.55		2.65	2.65	2.75	2.75	
UK										
GDP (% QoQ, ann)	1.2	1.6	1.1	0.6	1.7	1.1	1.4	1.7	2.3	1.2
CPI headline (% YoY)	2.1	2.6	2.7	2.8	2.6	2.7	2.7	2.7	2.7	2.7
BoE official bank rate (% eop)	0.25	0.25	0.25	0.25		0.25	0.25	0.25	0.25	
BoE Quantitative Easing (£bn)	435	435	435	435		435	435	435	435	
3-month interest rate (% eop)	0.35	0.35	0.35	0.40		0.40	0.40	0.40	0.40	

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