Why markets are still underestimating the Fed

Our answers to this month's big questions

THINK Economic and Financial Analysis
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17 November 2017

Our top **six** themes this month

Global Economics
and Strategy Team

November 2017

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Economic and Financial Analysis

#1 Shaking up the Fed: What vacancies and voter rotations mean for rates

#2 NAFTA: What now for the “worst trade deal ever”?

#3 What the 19th congress could mean for China

#4 The latest on the Eurozone economy

#5 Will the Italian election end in a hung parliament?

#6 What’s in store for oil and petro-currencies in 2018

ING

Powell hired, but what about the other Fed vacancies?

There are a series of Fed vacancies that still need filling

Board of Governors

Jerome Powell
Chair nominee

V

Vice Chair
Mid-2018
Vacancy*

V V V

Brainard Quarles

Regional Presidents (2018 voters)

V

NY Fed* Cleveland S. Francisco Atlanta Richmond

Outgoing

Janet Yellen
Current chair

William Dudley
Outgoing NY
Fed President

Stan Fischer
Ex. Vice Chair

V = Vacancy

**William Dudley is currently filling in as Fed Vice Chair, meaning the First Vice President of the NY Fed is currently the alternate member.*

Markets may have shrugged off the upcoming change at the top of the Fed, but they remain complacent about the risks of faster rate rises next year

Assuming Chair Yellen steps down in February, that will leave 4 out of 7 Fed Board positions vacant.

With Trump facing mid-terms next year, it is unlikely he'll want to see clear hawks appointed that could threaten his 3% growth target.

Until Trump has made his decisions and the full 2018 voter mix becomes clear, it is perhaps not surprising that markets continue to treat the Fed's latest "dot diagram" cautiously.

Image sources: Federal Reserve, Shutterstock

Markets are *still* underestimating the Fed's 2018 plans

One hike priced in. We expect two, and the risk is more rather than less

Two doves out

Neel Kashkari
Minneapolis Fed

Charles Evans
Chicago Fed

Annual regional Fed voter rotation

Loretta Mester
Cleveland Fed

John Williams
San Francisco Fed

Two hawks in

The combination of upside risks to growth and mounting inflationary pressures, as well as a hawkish rotation in the make-up of Fed voters, suggests that markets are too cautious in only pricing in one hike next year.

As part of the annual Fed voter rotation, two of the most dovish members will be replaced by two hawks – John Williams and Loretta Mester

Williams is in favour of three hikes next year, and Mester has hinted she'd like the Fed to go 'a little stronger' even than that.

Until Trump gets new governors onto the Fed board, this means the group of voters will be both smaller and more hawkish, faced with an economy that is performing well and that may have more fuel thrown on the fire with tax cuts.

We're expecting a **December rate hike**, and these various factors mean there is **upside risk to our call for two further rate rises next year.**

Image source: Federal Reserve

NAFTA: What now for the "worst trade deal ever"?

President Trump threatened to rip-up NAFTA arguing the US has not benefitted – jobs have been lost and the US' trade deficit has ballooned.

Negotiations need to be completed swiftly (aim of 1Q 2018) – Mexican election in July, US mid-terms next November

Up for debate are rules of origin changes, 5Y sunset clause, "Buy American" government procurement, national minimum content rules

Will Mexico & Canada reluctantly agree to a watered down version of Trump's original demands?

National pride may give way to economic pragmatism as the US demands "some candy"

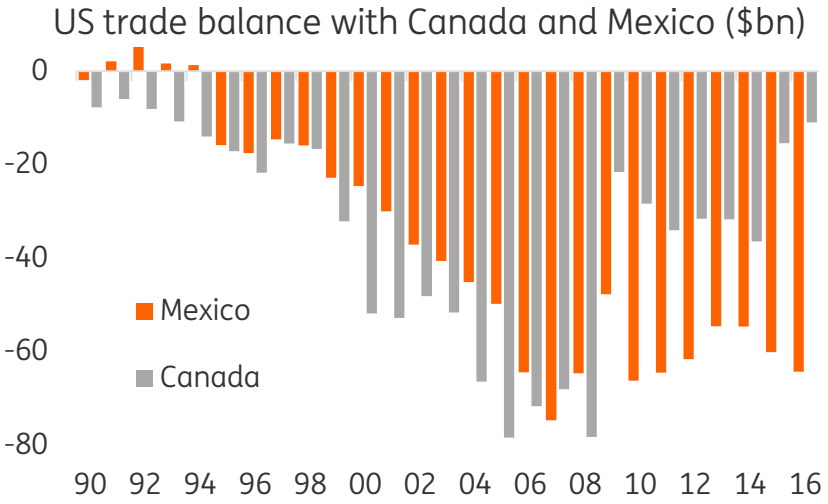
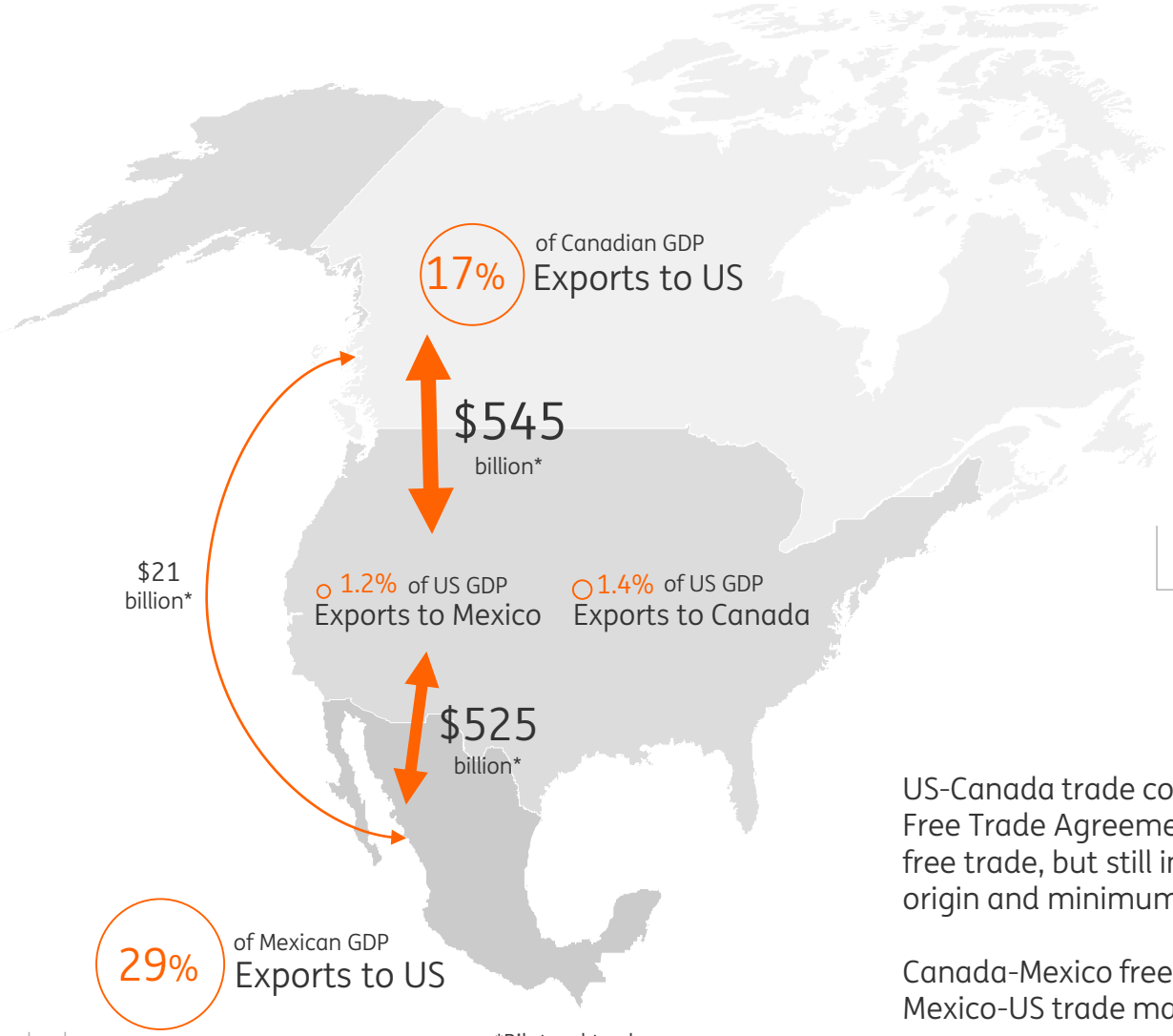
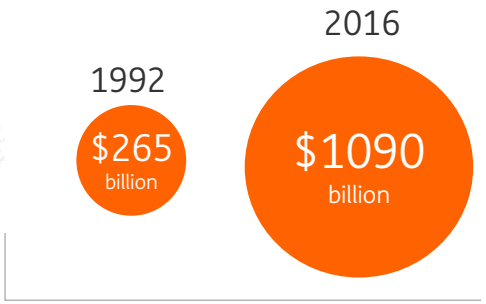


Image source: Shutterstock

Mexico looks most vulnerable from a NAFTA collapse





Total NAFTA trilateral trade

US-Canada trade could revert to 1988 Canada-US Free Trade Agreement. That would preserves tariff free trade, but still implications in terms of rules of origin and minimum content for products

Canada-Mexico free trade could continue, but Mexico-US trade may have to go to WTO rules

Source: Macrobond

*Bilateral trade

What the 19th congress could mean for China

2018-2020

The blueprint

- Build a middle-income class
- Coordinate economic growth with education, talent, innovation, the rural economy, regional growth and environmental sustainability.
- **Avoid systemic risks**

What we expect

- Deleveraging in the corporate & financial sectors to continue, in turn pushing up interest rates
- Anti-corruption will continue
- This would likely lead to changes in the management of State Owned Enterprises (SOEs)

2020-2035

The blueprint

- Increase **technological** ability, aiming to become one of the most innovative countries
- Raise the proportion of middle class citizens
- Narrow the difference between urban and rural development
- Improve environmental sustainability

What we expect

- Household robots would be more common
- But we worry there would be overcapacity in the technology sectors

2035-2050

The blueprint

- Establish a modern society
- Become an influential country in terms of economic power and role on the international stage

What we expect

- To be an influential country, the Yuan would have been internationalised with few capital controls. Before then, interest rates would to become market driven.

But we see three risks to China's blueprint

The blueprint could be achieved earlier than 2050, but there are hurdles

1

Hurdle 1: A build up of central and local government debts

Technology needs more infrastructure investments but the preparation stage requires the government to spend a lot of money. This will put pressure on gross government debt.

2

Hurdle 2: Narrowing the wide urban-rural living standards gap

Given the gap between urban and rural livings standards is already wide, this will be a challenge.

Incomes are rising slightly faster in rural areas (8.7% vs. 8.3% in urban centres), but the level of urban disposable income is still 2.8 times that of rural. Likewise, consumption is 2.3x higher, albeit as with incomes, spending is growing more rapidly in rural areas (8.6% annual growth vs. 6.2%).

3

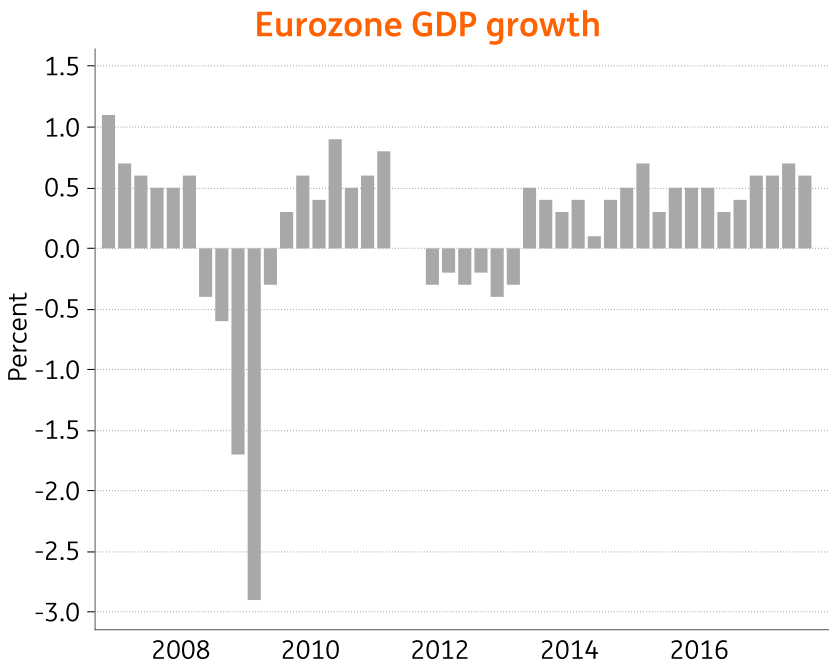
Hurdle 3: Beware of trade and geopolitical conflicts

Other countries would feel the threat in terms of economy size, development of technology, and beefing up military power.

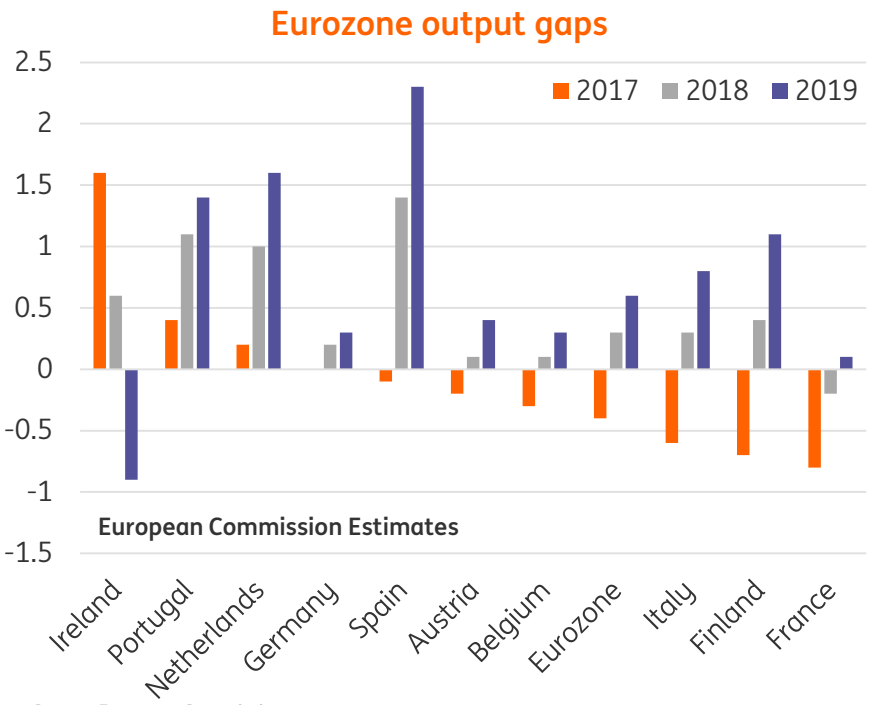
Closing the gap in the Eurozone

The Eurozone economy continues to surprise positively and is showing few signs of coming to an abrupt halt, even with some of the political risks on the horizon.

This means that the output gap could be closed sooner than expected, decreasing the need for stimulus in most Eurozone economies.



Source: ING, Macrobond

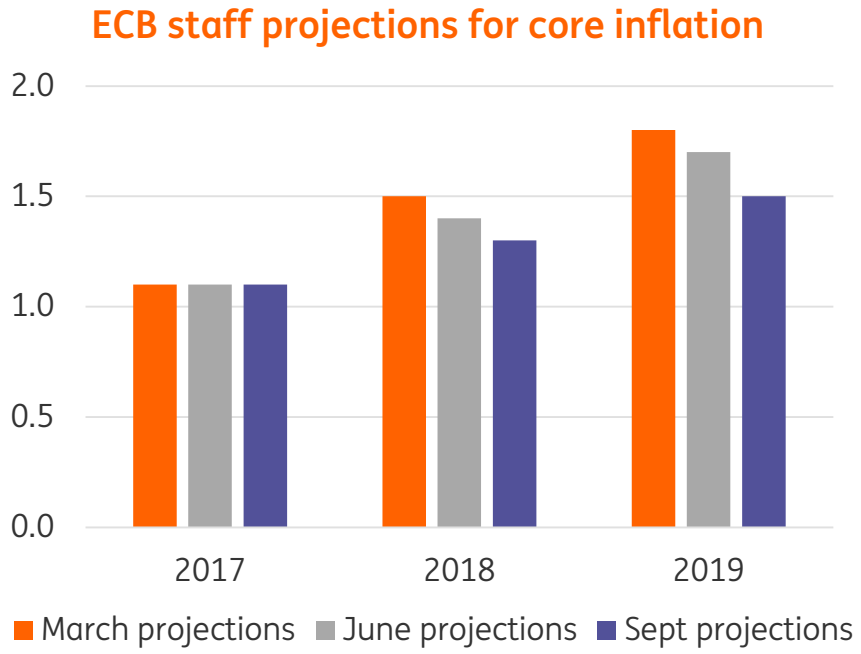


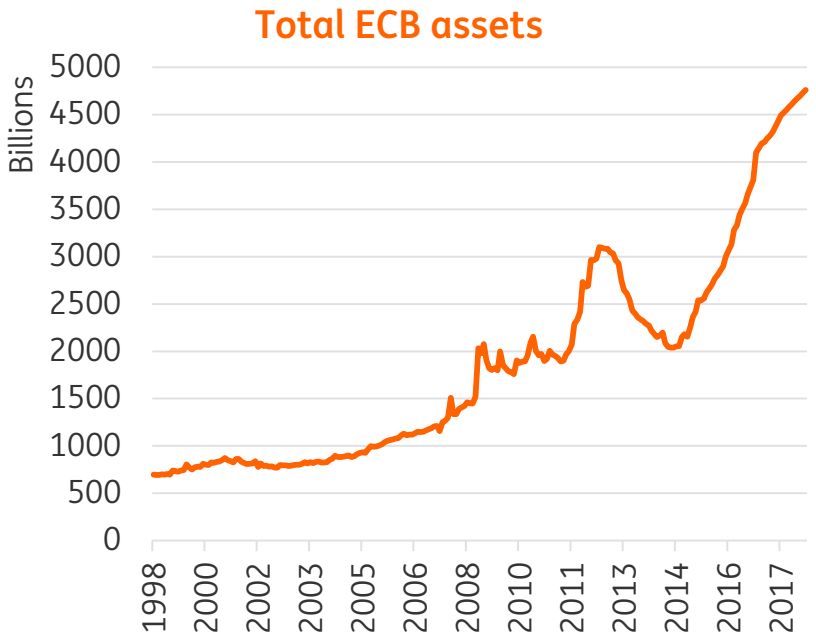
Source: European Commission

As ECB starts to taper, inflation is still a headache

With the Eurozone economy performing well, the ECB has announced it will start to gradually taper asset purchases from January by reducing monthly asset purchases to €30 billion, until September 2018.

But inflation is still low and any pick-up from here is going to be very gradual. That's why European Central Bank (ECB) President Draghi was at pains to stress that the road to 'tapering' of its bond purchases will be a dovish one.





Source: ECB, Macrobond

The countdown to the Italian election is on...

Italian general election

ING expects the election in

March 2018

The new electoral law, which will apply to both branches of the Italian parliament, foresees a **mixed system**. Two-thirds of the seats will be allotted using a proportional system, and a third with a first-past-the-post system, with blocked lists.

Based on the latest opinion polls, **the Italian political spectrum remains divided into three groups of similar size.** As the new law does not include a majority premium, barring substantial opinion shifts, none of the three groups seem to be in a position to win a majority in the parliament.

Key players and possible coalitions

Matteo Renzi
(Democratic Party)

Angelino Alfano
(Popular Alternative)

Nicola Frantoianni (?)
(Italian Left)

Roberto Speranza (?)
(Democrats and Progressives)

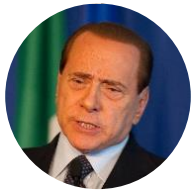
Luigi di Maio
(Five Star Movement)

Hung Parliament?

Based on current opinion polls, **none of the coalitions may be able to form a government in isolation,** therefore the real game will start right after the election.

The recent regional vote in Sicily, won by the centre-right candidate, showed how relevant coalitions can be in the Italian framework. Making them consistent at the national level will likely prove a difficult exercise on all fronts

Matteo Salvini
(Northern League)



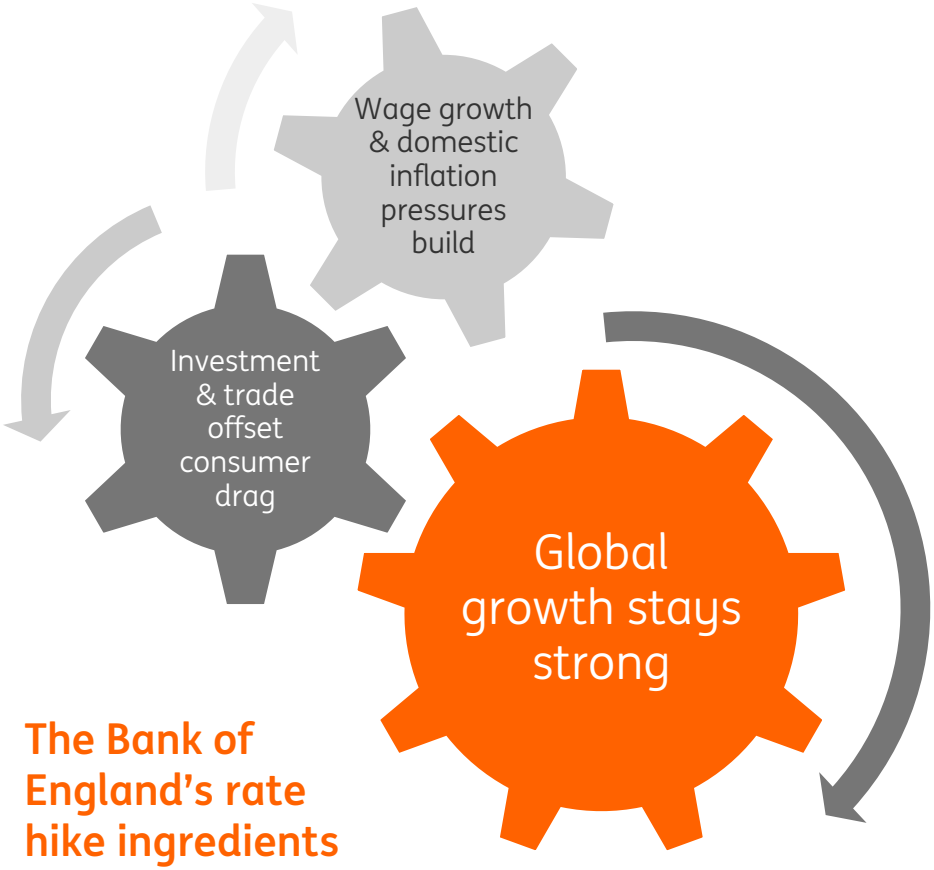
Silvio Berlusconi
(Forza Italia)

Giorgia Meloni
(Brothers of Italy)

Image source: Shutterstock

Bank of England to tread carefully in 2018

We don't rule out a hike next year – but there are a lot of "ifs" in the Bank's outlook…



The Bank of England's rate hike ingredients

The Bank of England has signalled it is prepared to hike twice more – including one increase in 2018

But there are a lot of "ifs", not least all the Brexit hurdles to overcome if it is to be as "smooth" as BoE hopes

We're less confident wage growth & domestically-generated inflation will rise as fast as the Bank hopes. Growth looks set to remain sluggish too.

We don't rule out a 2018 hike – but it isn't guaranteed

Crude oil: What's in store for 2018?

We have revised our ICE Brent forecast for 4Q17 to $57 per barrel and for 2018 to $51 per barrel.

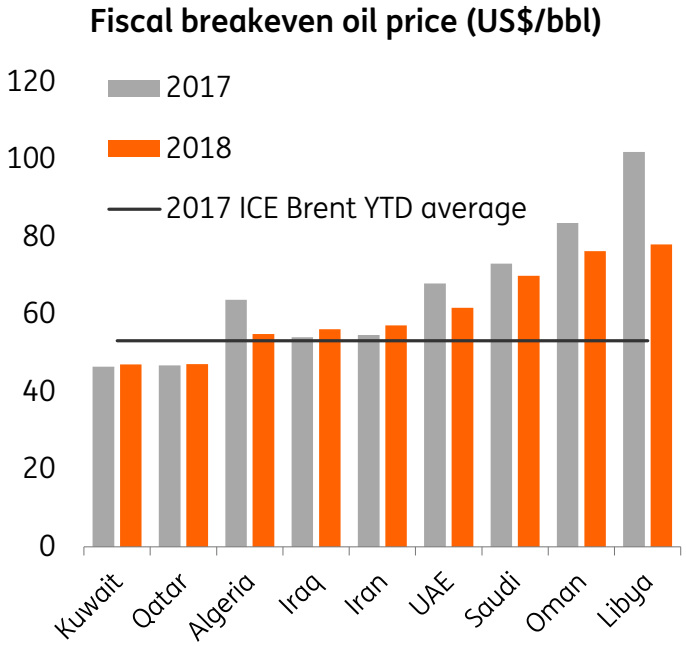
Geopolitical risk, positive economic data, and expectations of an extension to the OPEC production cut have seen ICE Brent trade above US$60/bbl for the first time since 2015.

We are bearish on crude into 2018 on the view that:

1. OPEC will extend their production cut deal to the end of 2018, however the risk is that the longer the deal continues, the more likely compliance starts to slip.

2. Non-OPEC supply will continue to rise despite a slowdown in rig activity. That's particularly true in the US, which is set to see its highest level on record. In 2018, we see the US increasing its market share in Asia.

3. IEA expects that growth in oil demand will slow over 2018 to 1.3MMbbls/d. This number is key for the oil market, as it is less than the 1.4MMbbls/d of non-OPEC supply growth forecasted for the year.



The oil market should return to a small surplus over 2018 at US$51/bbl. The key risk to the view is a worsening of the current geopolitical environment.

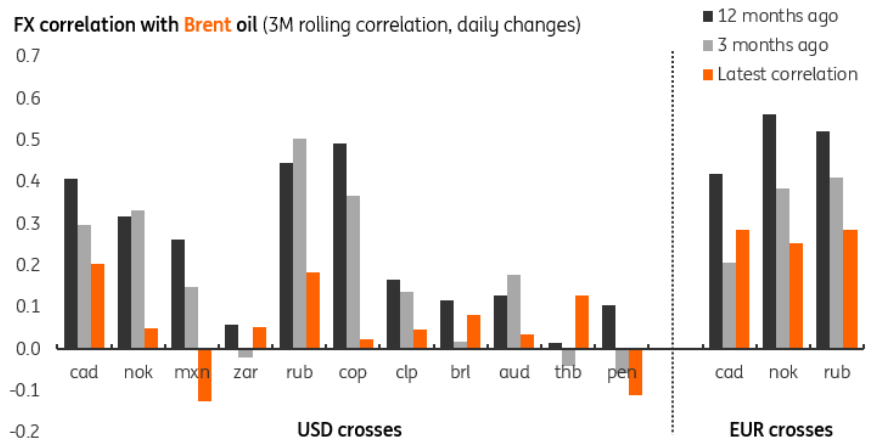
Petro-currencies lose their mojo

Investors seem to doubt the sustainability of crude's rally

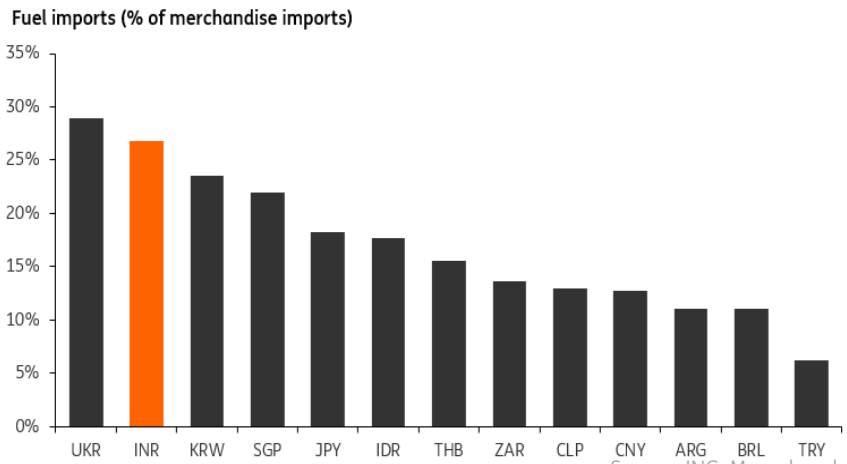
A problem for petro-currencies?

The correlation between petro-currencies and crude has dropped markedly over the last twelve months.

NOK, in particular, has lagged. This may owe to general fatigue with Scandi currencies where both the SEK and NOK are frequently seen as under-valued.



Source: ING, Macrobond



Source: ING, Macrobond

So what next for petro-currencies?

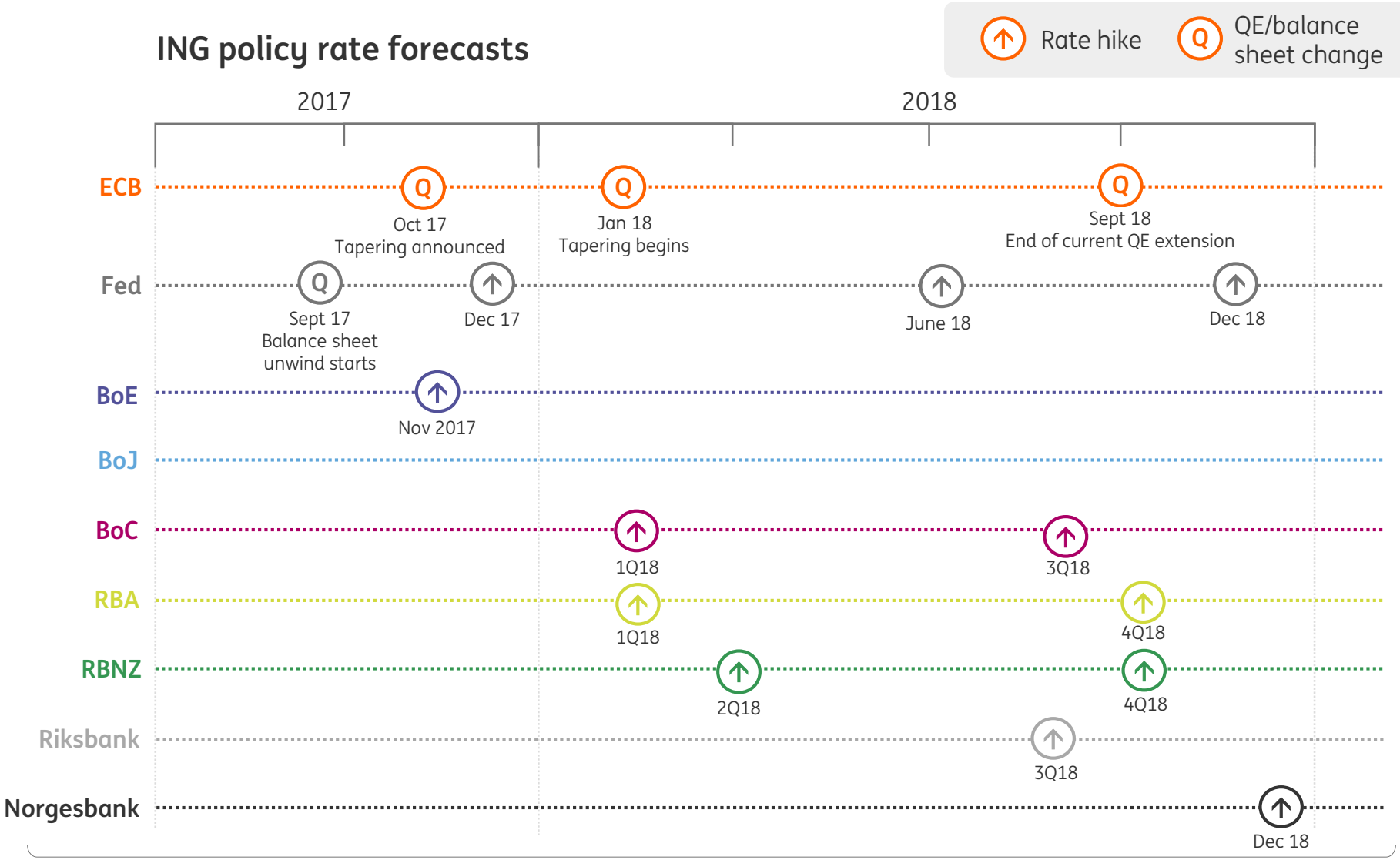
If crude turns lower it would spell trouble for the CAD and RUB where markets are aggressively pricing future rate hikes.

If crude doesn't turn lower the market could start to re-price Norges bank tightening cycle.

What about oil importers?

If crude prices stayed bid or pushed higher, we think vulnerable currencies worth highlighting are India and Turkey (struggled to rein in its current account deficit).

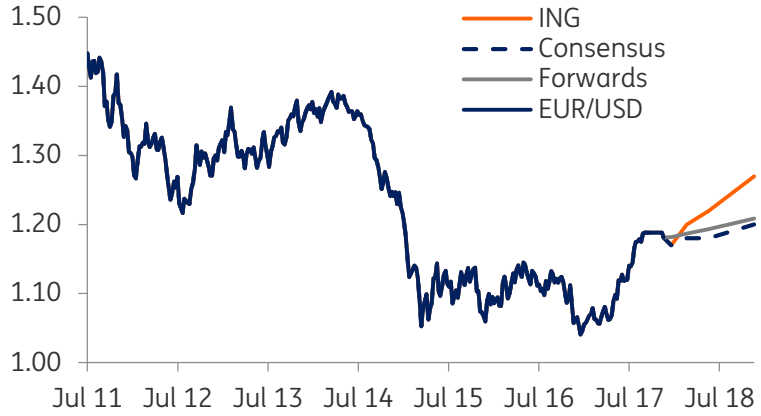
Who's next in line to tighten monetary policy?



Our global forecasts

All data sourced from Bloomberg/ING forecasts

EUR/USD



1M: **1.17** 3M: **1.20** 6M: **1.22** 12M: **1.27**

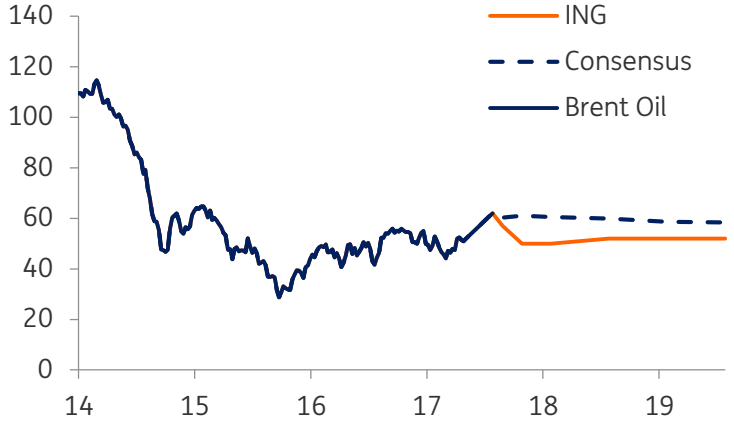
EUR/GBP

1M: **0.88** 3M: **0.88** 6M: **0.88** 12M: **0.86**

USD/JPY

1M: **114** 3M: **114** 6M: **114** 12M: **115**

Oil (Brent Crude)



4Q17: **57** 1Q18: **50** 2Q18: **50** 4Q18: **52**

Our global forecasts

	2017F					2018F				
	Q1	Q2	Q3	Q4	FY	Q1	Q2	Q3	Q4	FY
United States										
GDP (% QoQ, ann)	1.2	3.1	3.0	2.8	2.2	2.6	2.5	2.6	2.7	2.7
CPI headline (% YoY)	2.5	1.9	2.0	2.4	2.2	2.3	2.4	2.6	2.3	2.4
Federal funds (%, eop, lower bound)	0.75	1.00	1.00	1.25		1.25	1.50	1.50	1.75	
3-month interest rate (%, eop)	1.15	1.30	1.33	1.56		1.57	1.87	1.91	2.08	
Eurozone										
GDP (% QoQ, ann)	2.2	2.6	2.4	2.2	2.3	1.8	1.7	1.8	1.8	2.0
CPI headline (% YoY)	1.8	1.5	1.4	1.3	1.5	1.2	1.4	1.4	1.5	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	-0.33	-0.33	-0.33		-0.33	-0.33	-0.33	-0.33	
Japan										
GDP (% QoQ, ann)	1.1	2.5	0.9	2.6	1.5	1.5	0.8	1.3	0.0	1.4
CPI headline (% YoY)	0.2	0.4	0.6	0.2	0.4	0.7	0.5	0.7	0.8	0.7
Excess reserve rate (%)	0.0	0.0	0.0	0.0	0.00	0.0	0.0	0.0	0.0	0.0
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	6.9	6.8	6.7	6.8	6.7	6.6	6.7	6.7	6.7
CPI headline (% YoY)	1.4	1.4	1.6	1.5	1.5	1.5	1.5	1.6	1.7	1.6
PBOC 7-day reverse repo rate (% eop)	2.45	2.45	2.45	2.45	2.45	2.45	2.55	2.55	2.65	2.65
UK										
GDP (% QoQ, ann)	1.0	1.2	1.6	1.1	1.5	1.1	1.6	2.1	1.8	1.4
CPI headline (% YoY)	2.1	2.7	2.8	3.0	2.7	2.7	2.3	2.3	2.4	2.4
BoE official bank rate (%, eop)	0.25	0.25	0.25	0.50	0.50	0.50	0.50	0.50	0.50	0.50
BoE Quantitative Easing (£bn)	445	445	445	445	445	445	445	445	445	445
3-month interest rate (%, eop)	0.35	0.35	0.35	0.60	0.60	0.60	0.60	0.60	0.60	0.60

"USD: Making everyone (else) great again!"

"When caution's not enough for the euro"

"What we really think of the Bank of England's rate decision"

"Brexit battle continues as talks enter round two"

"Confused by Yellen's direction? You're not alone"

"Normalisation will be a long, uncomfortable journey"

"G10 FX: Careless Central Bank Whispers"

Riding the cryptocoaster

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