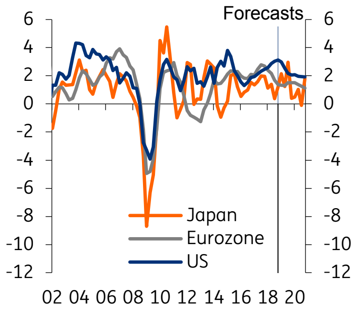
5 April 2019
Global

Monthly Economic Update

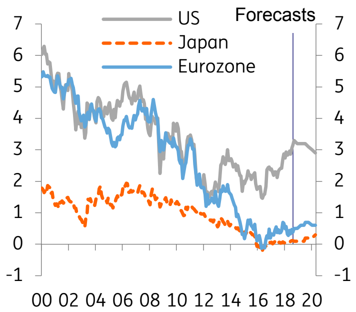
Cheer up! The gloom is mostly set to fade

GDP growth (%YoY)



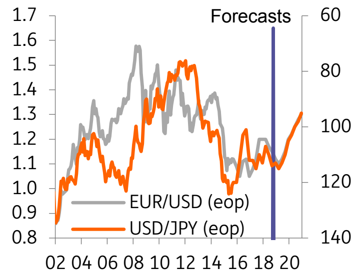
Source: Macrobond, ING

10yr bond yields (%)



Source: Macrobond, ING

FX



Source: Macrobond, ING

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A sense of gloom has been hanging over markets for the past few months, reflecting trade tensions, softer activity data and political strife. However, the situation may already be starting to improve with progress on US-China trade talks and tentative signs of stronger activity from major economies. Nonetheless, politics are never far away, with European parliamentary elections and Brexit creating uncertainty. We are also waiting for President Trump's decision on possible auto tariffs. So while we are becoming a little more optimistic, market caution is likely to linger for a little while longer.

The US yield curve inverted and interest rate cuts are being priced in from the Federal Reserve as fears of an economic slowdown gripped financial markets. This largely reflects some mixed domestic data and worries about demand from China and Asia. However, we are more upbeat, with clear signs that 1Q GDP growth may be significantly stronger than initially feared, while a robust labour market should underpin consumer sentiment and spending.

We would also argue that the yield curve is not as powerful recession predictor as it has been in the past. Moreover, if we see a positive resolution to US-China trade tensions this may lift more of the gloom and lead to a re-pricing of the path for interest rates.

While first-quarter Eurozone growth was weak, March data seems to suggest a rebound is in the offing. With improving consumer sentiment and international trade off lows, the second quarter could come a bit stronger, provided that a 'hard Brexit' is avoided. Inflation continues to surprise to the downside, justifying continuing monetary stimulus. Reports of the European Central Bank contemplating a two-tier system for excess liquidity, thereby helping the banks, are perhaps a bit premature. We believe this scheme will only be put in place if an additional rate cut would be considered.

Nobody knows for sure where Brexit will take us over coming days, but talk of a long extension to the Article 50 period is growing. That would continue to put pressure on investment, not just because of the uncertainty, but also because firms may have to restart their contingency planning. The chances of a 2019 UK rate increase are fading, but don't rule one out completely if a Brexit deal can be approved by MPs relatively soon.

China's fiscal stimulus has begun to work. Manufacturing PMI showed activity expanded in March. We believe this is in large part thanks to the fiscal measures taken over recent months. Continued support from fiscal policy will likely be required to maintain activity even if a trade agreement with the US is reached.

Japan's economy continues to disappoint on both growth and inflation, though the latter presents few genuine problems except presentational for the Bank of Japan, and a debate about the logic of continued negative rates and money printing is beginning to gather volume. We have dropped out the consumption tax hike from our forecast.

The markets see a US rate cut as probable. If the next move in the Fed funds rate is down, then history also shows that the 10yr can trade 25-50bp through in anticipation. At the same time, we believe the pessimism about growth is a tad overdone.

Unless Eurozone growth can prompt a re-rating of European equities or longer tenor debt spreads move substantially against the dollar, it is hard to see EUR/USD breaking out of a 1.10-15 range in the next 3-6 months. We are thus downgrading our end 2019 and 2020 forecasts to 1.18 and 1.25 respectively.

US: Recession or rebound?

An inverted US yield curve signals a clear fear of recession with financial markets fully pricing Federal Reserve interest rate cuts. Are things really that bad?

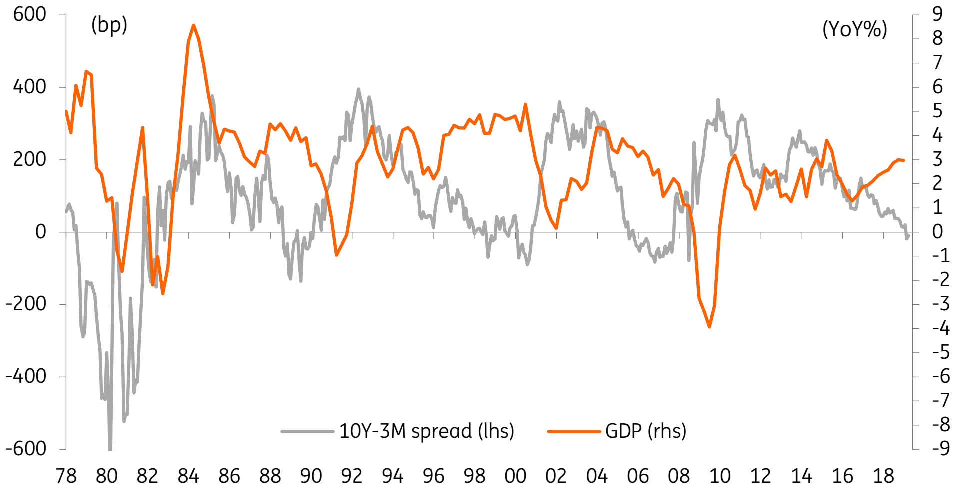
Markets are worried about an economic slowdown

Last month the Federal Reserve confirmed its increasingly dovish tone by dropping the two interest rate hikes officials had been pencilling in for this year. While the members of the Federal Open Market Committee (FOMC) continue to have one rate hike in their forecast for 2020 and talk positively about the economic outlook, financial markets appear increasingly concerned about prospects.

Interest rate cuts are being priced in and the US yield curve has inverted

Weak European and Asian figures coupled with mixed domestic data and the Fed's change of stance has led to a growing sense that an economic slowdown is on its way. Inflation is not perceived to be a threat, so financial markets now believe the Fed's next move will be to cut rates, potentially later this year. Longer-dated yields have fallen too with the yield curve having inverted – 3M interest rates are now higher than 10-year bond yields. The worry is that an inverted yield curve has preceded each of the last nine recessions, so such an event is typically cited as a clear indicator of impending doom.

Fig 1 US yield curve hints at recession risk



Source: Macrobond, ING

There are certainly more headwinds

We have regularly written about the headwinds facing the US economy this year, namely the lagged effects of higher interest rates and the stronger dollar, the fading support from the fiscal stimulus, signs of weakness in Europe and Asia and the uncertainty generated by ongoing trade tensions with the rest of the world.

And this justifies the Fed's "patient" stance

As such we certainly recognise there are threats to growth and accept there is valid concern about disruption relating to the government shutdown from late December to late January. Data has been volatile in recent months and the uncertainty that this creates fully justifies the Federal Reserve's "patient" stance regarding monetary policy.

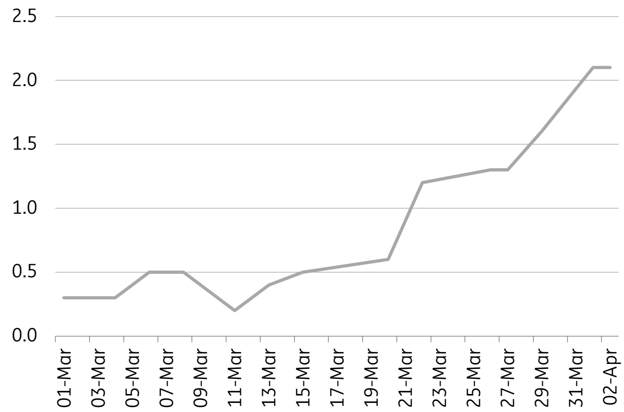
However, there are technical factors that mean its prediction of recession may be false this time

However, it's important to remember that an inverted yield has given false signals before and that the 2-10Y and 10-30Y part of the curve remains positively sloping. We also have to acknowledge the distorting influence of the Federal Reserve's large quantitative easing purchases and remember that negative yields in Europe have been driving a "search for yield" which is contributing to strong demand for US treasuries. These technical issues help support the argument that things are "different this time" and the yield curves usefulness as a guide for recession may be weaker.

After a soft patch the US macro data is looking stronger

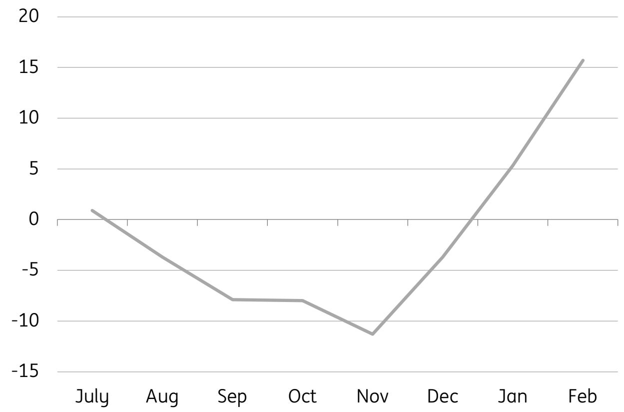
Moreover, we feel there are positives that can keep the economy expanding at a decent pace both this year and next, which will help core inflation continue to move higher. After a poor start things are looking up for 1Q GDP. The Atlanta Fed GDPNow model provides an estimate of what GDP growth will be based on the economic data released so far. It has been shooting higher in recent weeks and is currently pointing to 2.1% growth for Q1, which is very respectable given the recent tendency for GDP readings in the first quarter to disappoint.

Fig 2 Evolution of Atlanta Fed NowGDP prediction for 1Q GDP annualised growth



Source: Federal Reserve Bank of Atlanta, ING

Fig 3 3M annualised growth in US construction spending



Source: Macrobond, ING

The outlook for 1Q GDP growth has brightened considerably

The ISM manufacturing index has been a positive signal while there have been some improvements in consumer spending. Construction spending has also been a major boost with 3M annualised growth currently running in excess of 15%. Moreover, the housing market looks set to contribute more broadly with plunging mortgage rates prompting a notable increase in mortgage applications for home purchases. Looking longer term, the strong jobs market is leading to rising worker pay and should help to underpin confidence and spending. None of this appears consistent with an imminent threat of recession.

But a deal on trade is critical for the economic outlook

However, a positive outcome on trade talks is critical for maintaining the longer term economic outlook. Protectionism threatens supply chains, risking higher costs for businesses and consumers whilst sapping confidence. If an agreement can be reached with China this would be a major boost for the global economic environment. Officials suggest the talks are going well, but an actual signed deal may be weeks away and markets will remain cautious until they see something concrete.

We remain hopeful, but President Trump could switch his attention towards Europe

Our assumption remains that there will be a deal given President Trump will want to take a trade “victory” into the 2020 election campaign. This implies some scope for compromise and if progress can be made we should see markets gradually re-appraise the growth outlook and the prospects for inflation. However, a trade conflict with Europe is another threat that could materialise with President Trump yet to decide on whether to implement auto tariffs.

We look for decent growth overall and a gradual increase in core inflation, which will keep Fed policy on hold

Overall, our position remains that while the economy does face more threats this year there are reasons for optimism, most notably the strong household fundamentals. If we can also get a positive resolution to the ongoing trade talks this can remove a huge amount of uncertainty and give business the confidence to put more money to work. Consequently, we look for US GDP growth of 2.3% this year with 2020 growth currently pegged at 1.8. In such an environment we expect the Federal Reserve to keep monetary policy unchanged this year and next, likely prompting a modest re-steepening of the yield curve lasting through the summer.

However the risk is an inverted yield curve can be self-prophesising...

That said, we have to be wary that a prolonged inverted yield curve driven by recession fears can potentially be self-fulfilling. Banks typically borrow short term and lend longer term so when the yield curve is inverted it can be very damaging for profitability and could result in decreased risk tolerance. This implies the threat of tighter lending standards if yield curve inversion is sustained.

... and lead to tighter financial conditions

Indeed, when asking banks about this, the Federal Reserve's Senior Loan Officers report concluded an inverted yield curve would be interpreted as 'signalling a less favourable or more uncertain economic outlook and likely to be followed by a deterioration in the quality of existing loan portfolio.'

Such an environment would add to the US economic headwinds

So far there is little evidence that the flattening and subsequent inversion of the yield curve is feeding through into reduced credit availability, but that could change if the inversion persists. A scenario of much tighter credit conditions would clearly add to the headwinds facing the US economy and heighten the chances of the Fed responding with lower interest rates.

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Eurozone: Tentative green shoots

First quarter figures remained weak...

The first quarter saw hardly any acceleration in Eurozone growth momentum. Although economic indicators have been equivocal lately, we see sufficient reason to expect a stronger second quarter, unless a sudden shock would hit the economy.

....with confusing March data

It has been a rather difficult month for economic pundits. A number of indicators have been rather disappointing. Both the composite PMI and the European Commission's economic sentiment indicator fell unexpectedly in March, with the services sector now also weakening. In that regard, the weaker global environment and slowing international trade, that had already hit the manufacturing sector in the course of 2018, is now seemingly starting to have second round effects on the services sector.

However, this rather sober assessment does not chime with a number of national economic sentiment indicators. Both the French INSEE indicator and the German IFO indicator improved in March, with the services sector actually doing very well in Germany.

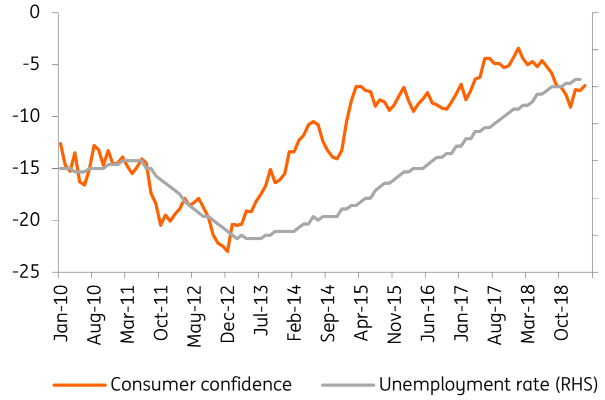
Trade is bottoming out ...

What to make of this? The contradictory data at least suggests that it is certainly too soon to pencil in a strong upturn. But at the same time, there are some green shoots, suggesting that even manufacturing is likely to bottom out. The DHL global trade indicator signalled a mild improvement in international trade for Germany in March.

At the same time, domestic demand is still supported by growing employment and the gentle upward trend in wages. In March the European consumer showed himself rather upbeat about his household finances over the next 12 months, which bodes well for consumption.

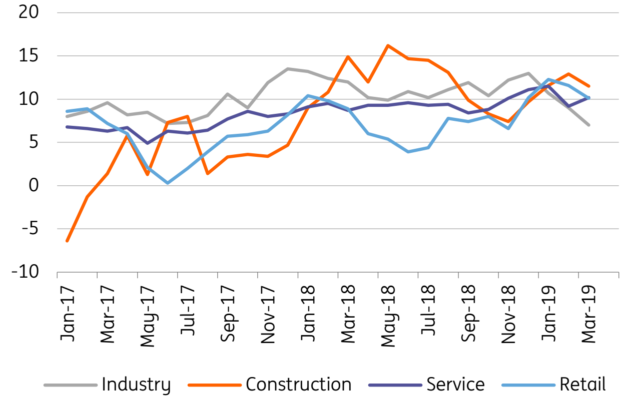
Also, bear in mind that fiscal policy is slightly more expansionary this year compared to previous years. In that regard we continue to expect some growth acceleration in the second quarter, resulting in 1.2% for the whole of the year. For next year we currently forecast the same growth rate, which is clearly below the ECB's expectation for 2020 (1.6% GDP growth).

Fig 4 Eurozone consumer more upbeat again



Source: Thomson Reuters Datastream

Fig 5 Price expectations moving sideways



Source: Thomson Reuters Datastream

A hard Brexit could cost 0.3 percentage points of growth

Of course, Brexit remains the elephant in the room. If a hard Brexit were to materialise over the next few weeks, then we can forget about a growth pick-up. It looks quite likely that a hard Brexit would strongly distort trade flows and international value chains. Also, depending on the financial markets and confidence impact, annual GDP growth could be cut by 0.3 percentage points, with the biggest impact in the second and third quarters.

Another potential worry is the political situation in Italy. On the back of the recession there is clearly a deterioration in the budget deficit which will have to be addressed in the course of the year. As we think that Lega will win big at the European parliamentary elections, with 5star losing, we don't exclude elections just after the summer. This would imply that the current government would not have to decide on the more difficult budget for 2020, which would probably result in a further deterioration of public finances.

Inflation remains stubbornly low…

In a recent speech Mario Draghi, the president of the ECB, remained confident that the inflation would pick up. However, survey results are still ambiguous. Selling price expectations increased in services in March, but remained stable in retail trade, while they strongly declined in construction and industry. Consumer price expectations also fell in March. And although the late Easter has distorted inflation figures, one cannot deny that core inflation currently remains below 1%. We therefore downgraded our inflation forecasts to 1.2% in 2019 and 1.6% in 2020. We wouldn't be surprised if headline inflation fell temporarily below 1% in the course of this year.

…. pleading for a continuing accommodative monetary policy

All of this explains why the ECB will want to keep in place sufficient accommodation. The discussion surrounding monetary policy is now even starting to focus on the question of whether the ECB will still have some ammunition, should the expansion come to a standstill. Off course there are the new TLTROs. The ECB conveniently hasn't announced the conditions yet and according to Chief Economist Peter Praet this will only happen in June, which gives the ECB still some time to assess the economic developments. The interest rate will likely be generous if in the meantime the economy slows further.

A two tier system for excess liquidity is studied…

…but unlikely to be put in place soon

Another issue that created some excitement in the markets was Mario Draghi's remark that the ECB will monitor the banks' health in the wake of compressed interest margins. This opens the possibility of a two-tier system for excess liquidity, which would neutralize a part of the side-effects of the negative interest rate policy. However, we would caution against any premature expectation for this to happen. As a matter of fact, it is only likely to be put in place if the ECB would be forced to cut negative rates even further in the wake of adverse economic developments.

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UK: What next for the economy?

With a week to go, nobody really knows what will happen next (!)

With just a week to go until the current 12 April Brexit deadline, it's fair to say that nobody knows for sure what will happen between now and then. After three failed attempts to persuade lawmakers to back her Brexit deal, UK prime minister Theresa May has conceded that she will need to reach across party boundaries to try and break the deadlock.

Some form of 'softer Brexit' still looks most likely to prevail

Things are changing quickly but, in principle, this makes a softer Brexit path more likely. Either the government will agree a solution with the opposition Labour Party directly or failing that, the PM will ask Parliament directly through another round of 'indicative votes'. Either way, we suspect either a permanent customs union, or the so-called 'Common Market 2.0' proposal (customs union plus single market) are most likely to prevail. For more on what these options mean in practice, see our infographic guide.

Another extension looks likely, although some within the EU appear reluctant to let things drag on for much longer

One way or another, a further extension to the Article 50 negotiating period looks likely – and in fact the Prime Minister has already suggested she will ask for one. The EU will have to approve this – and there have been some splits among leaders about whether one should be granted, particularly if a request isn't coupled with a decent justification.

A delay of 9-12 months is possible

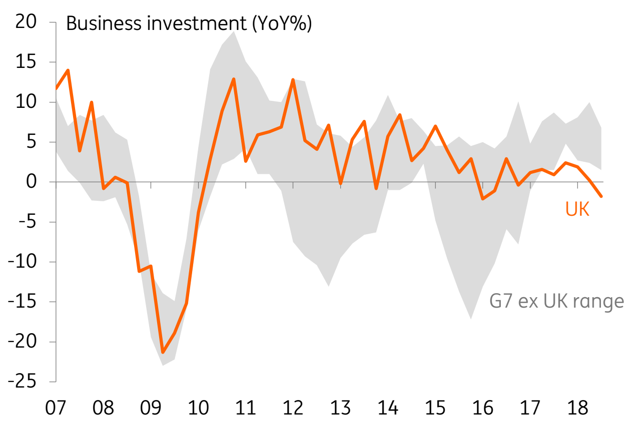
At this stage though, our base case remains that the EU will allow a long extension to the Article 50 period, perhaps lasting as long as 9-12 months. This would be on the basis that the UK participates in European Parliamentary elections, but may well contain a mechanism to allow it to be cut shorter if British MPs can rally behind a deal sooner.

We'll have to wait and see exactly what the EU decide, but what would a long delay mean for the economy?

Investment fell in every quarter of 2018

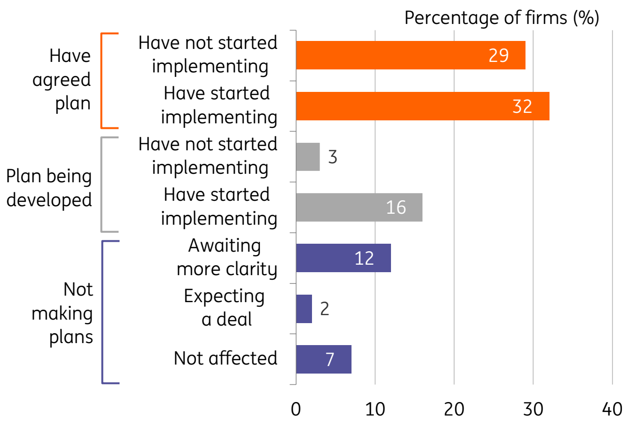
Well, firstly it's worth remembering that growth has already been very poor over recent months. In particular, investment has been very disappointing and on a year-on-year basis, was the worst among G7 economies in 2018. More recently, that can be easily attributed to businesses making preparations for a 'no deal' Brexit.

Fig 6 Investment has been really poor in the UK



Source: Bank of England

Fig 7 Not all firms had 'no deal' plans back in January



Data from the Februrary inflation report
Source: Bank of England Agents Survey

Until recently, firms weren't fully prepared for 'no deal'

Judging by various surveys, it seems that for many firms, this contingency process may have only begun in earnest over the past few weeks. A Bank of England survey from January indicated that, back then, around half of companies felt they weren't ready for 'no deal'. Likewise, the government estimated in February that out of the 240,000 British firms believed to have only ever traded within the EU, only 40,000 had applied for a

European Union registration and identification number (EORI)– the most basic requirement to fill in customs documentation.

Contingency planning has picked up over recent weeks, hitting growth

This contingency activity has undoubtedly picked up over recent weeks, and the latest economic numbers show that this is taking its toll on growth. The service sector – which accounts for around 80% of UK output – slipped into contraction in March, according to the latest PMI.

A long delay might give businesses a temporary reprieve

If there is a long extension to the Brexit negotiating period then, in theory, the temporary removal of the 'no deal' threat would give businesses a bit of a reprieve. That could unlock a bit of pent-up capital spending and hiring, although overall we suspect investment will remain under pressure.

Firms may use the extra time to continue contingency planning

Having come this close to the cliff-edge once, we suspect firms will use the extra time carefully to prepare for a possible repeat scenario. For many companies, this will be very costly. Goods producers/suppliers will be forced to renegotiate and extend contracts on additional warehousing space to allow for future stockpiling requirements.

This is very costly – firms may have to unwind and rebuild stock levels all over again

Those firms that deal with perishable goods may need to start the whole stock building process from scratch. Similarly, many firms may decide that it is simply too costly to hold or to finance elevated inventory levels for such a long time and instead may look to unwind the current stockpile and rebuild it nearer the new cliff-edge date.

A long extension would reduce the changes of a 2019 rate rise

Those are a few specific examples, but the upshot is that growth as a whole is likely to remain under pressure if Brexit is delayed for a significant period of time. In our opinion, this could easily write off any Bank of England tightening later this year.

If a deal can be approved, growth may modestly recover

However, if a deal can be approved relatively soon, and the transition period begins, things could look slightly different. Investment will remain clouded by an ongoing lack of clarity surrounding the details of the future relationship, but the reduced uncertainty could see some consumer spending come back online. Wage growth is accelerating pretty rapidly on the back of various skill shortages, while inflation remains benign.

That would keep the door to a 2019 hike open – although global growth concerns could equally lead to a prolonged pause

A moderate recovery in growth if there is a deal could revive thoughts of Bank of England tightening later in the year, and certainly policymakers have kept the door ajar to a rate hike if Brexit goes smoothly. We still very loosely have a rate rise pencilled in for November on the basis that policymakers appear to want to move policy to a more neutral stance. That said, with global central banks turning more dovish, it's equally possible that the Bank of England could decide to remain on pause for much longer yet.

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China: Incipient recovery?

China's fiscal stimulus is supporting the economy.

China's fiscal stimulus has begun to work. The official manufacturing PMI showed activity expanded in March, with the survey measure rising to 50.5 in January from 49.2 in February.

It is unlikely that the government will withdraw fiscal stimulus soon.

Without the fiscal loosening, we think even this slight recovery in the manufacturing sector would have been unlikely. The authorities are likely to maintain fiscal stimulus even if a trade deal the US is signed in order to support the economy.

We believe that manufacturers' profit should improve with the current fiscal support. Upstream manufacturers, such as miners, will benefit first, and then it will gradually move downstream to manufacturers of final goods.

But the fiscal support only benefits the domestic side of the economy and will not help exporters.

However, we expect that fiscal stimulus will mainly boost infrastructure investments and related production, e.g. investments in mining and transportation. It cannot change the external environment, especially the uncertainties surrounding the US-China trade war. Export-related manufacturers will continue to suffer from US tariffs, and they will consequently be more reluctant to expand their factories.

Trade negotiations continue, but a range of difficult issues remain unresolved

Trade negotiations between China and the US continue, but still appear some way from a final resolution. Both sides face difficult choices, with China's currency policy and approach to cybersecurity two key outstanding issues where it appears the two sides have yet to reach agreement.

We continue to forecast 4 RRR cuts this year, but now expect each cut to be smaller (0.5pp vs 1pp)

On monetary policy, the central bank (PBoC) governor has said that room for further required reserve ratio (RRR) cuts is limited. As such, we still expect four cuts this year but have revised each RRR cut to 0.5 from 1 percentage point. Small private firms in China still need targeted monetary easing as they do not benefit from the fiscal stimulus.

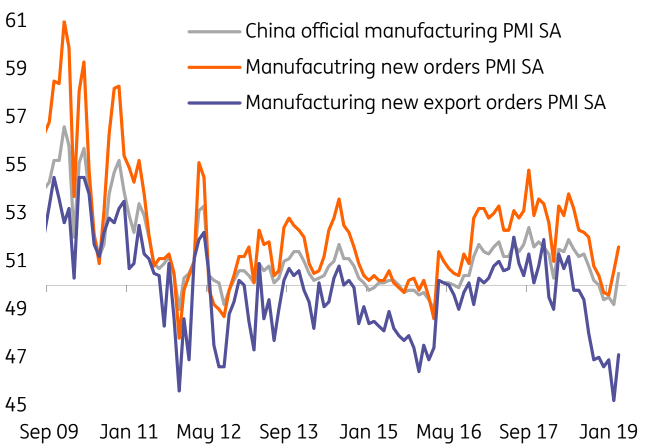
Yuan will appreciate moderately

On the yuan, we keep our forecast for USD/CNY and USD/CNH at 6.75. A major appreciation seems unlikely, as the US has pressed China to commit to refrain from using currency depreciation as a policy tool in the future. That means the Chinese authorities will not want to see an appreciation now, given they may not be able to reverse it later if needed.

Uncertainty around US-China trade remains high

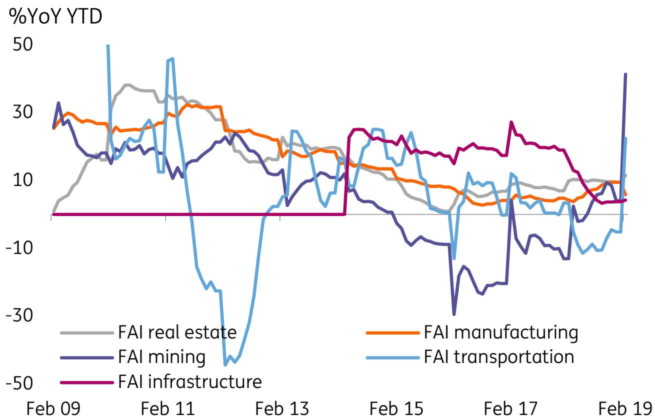
In short, the Chinese economy is currently supported by fiscal stimulus. The risk from the trade tension remains material, and a deal is by no means guaranteed. And even there is an agreement, questions will remain about how long it will last.

Fig 8 With the fiscal stimulus, manufacturing PMI is rising



Source: ING, Bloomberg

Fig 9 The recover was only in the sectors of transportation and mining from infrastructure projects



Source: ING, Bloomberg

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Japan: Losing patience

BoJ policies are coming under scrutiny...

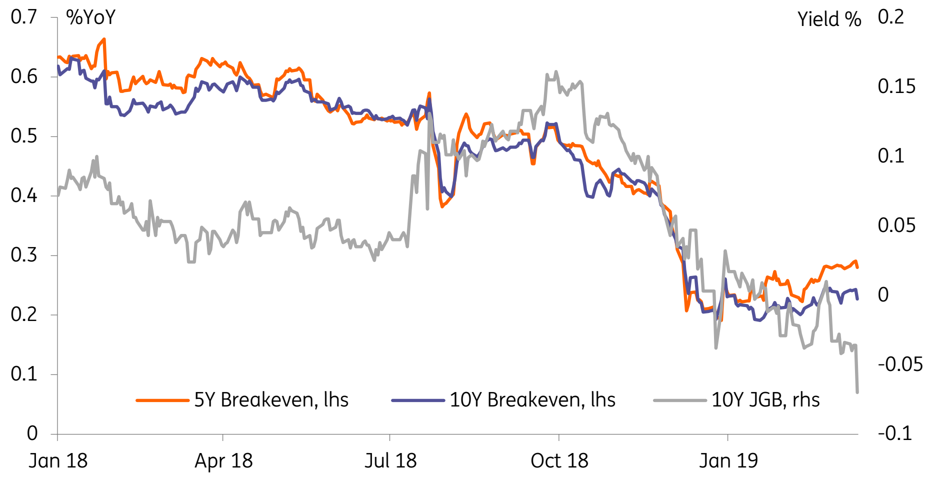
...with the Ministry of Finance and PM suggesting more flexibility

Last month, we ended our note with an aside on the various alternative policies the Bank of Japan (BoJ) might adopt to offset what was beginning to look like a meaningful deterioration in the economic backdrop. Since then, there has been an interesting debate led by the Ministry of Finance, but also seemingly with support from PM Abe, which is beginning to question the BoJ's 2% inflation target, and suggests greater policy flexibility.

Inflation has fallen again, and there seems no likelihood that the 2% target will ever be reached

This inflation target was missed by a country mile once again in February, with national inflation coming in at 0.2%YoY, even missing the consensus 0.3% forecast. Minister Aso made a point that is worth repeating, mainly because it makes real what is otherwise an esoteric discussion between economists about inflation expectations, policy credibility and investment and savings substitution. He said" "For the general public, there isn't a single person out there saying it's outrageous that we haven't reached 2 percent inflation". Markets certainly don't take the BoJ's target credibly, with 5 and 10Y breakeven measures of inflation expectations of only around 0.2-0.3%.

Fig 10 Inflation expectations and bond yields



Source: Bloomberg

For most Japanese, low inflation is not a problem

Taro Aso makes a valuable point. For many ordinary households, the price of everyday goods such as food is already high, and some decline would be regarded as no bad thing. We doubt it would spur a death-spiral of deflation concerns.

There is more to this debate than meets the eye – but it is a very important development

This debate about BoJ policy is still in its infancy. Aso and Abe have since held a press conference in which they have expressed their full support for BoJ Governor Kuroda. But this is probably not the last we have heard on this topic, which raises many sensible questions about ultra-low interest rate policy, the appropriate level of inflation targets, central bank credibility and forward guidance. This is certainly too much to cover here. But for a little aside on one aspect of this debate, you could read a short note we recently wrote on the counterintuitive impacts of ultra-low rate policy on growth and inflation in Japan[1].

With growth and inflation slowing, we no longer expect a consumption tax hike in October

The other thing to mention this month is that in the wake of the softness in both growth and inflation, we have decided to remove from our forecast numbers the consumption tax hike that was due to be implemented in October this year.

This wouldn't be the first postponement…

The consumption tax plan was confirmed by PM Abe in October last year, but this wouldn't be the first time its implementation was postponed. Removing the tax hike removes the artificial boost to inflation that was due to kick-in during 4Q19 and provide 4 quarters of artificially higher inflation- the only way Governor Kuroda would ever be able to meet the BoJ's 2% target except via the import channel.

…and affects both our GDP and inflation forecasts

The removal of this tax hike from our forecasts also affects our GDP numbers, as these tax increases cause households to front-load expenditure, though with the unfortunate side effect that this also usually generates a subsequent slump in spending – even recession immediately after. We don't believe the economic backdrop of Japan's economy will be looking sufficiently robust to withstand such buffeting, and this plan will be shelved once more pending a return to stronger growth, possibly in 2020, though we are not taking a view on that just yet.

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[1] https://think.ing.com/opinions/bank-of-japan-best-intentions-poor-outcomes/

FX: EUR/USD languishes

EUR/USD is languishing near the lows of the year, dogged by poor Eurozone growth prospects and exceptionally low EUR interest rates. We are still bullish EUR/USD in the medium term, but it looks like the rally will happen later and be less powerful.

One big surprise is that EUR/USD has enjoyed very little support from the sharp narrowing of EUR:USD interest rate differentials over the last few months. Given that EUR rates are rock bottom, this is really an issue of the dollar surviving the sharp decline in US rates. So what's going on?

EUR/USD is increasingly being driven by interest differentials at the longer end of the curve

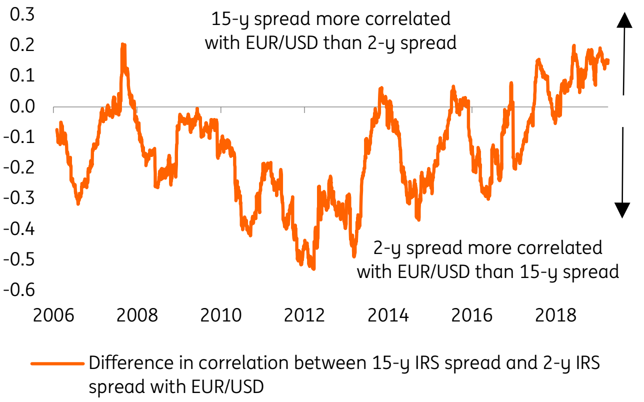
As we highlight below, it seems as though EUR/USD is increasingly being driven by interest differentials at the longer end of the curve. With short term rates now looking pretty anchored on both sides of the Atlantic (the ECB's forward guidance into 2020 and the Fed with a symmetrical bias for the time being), it may well be that all the action occurs at the long end of the curve.

The fall in EUR/USD spot & the narrowing in 2 year spreads create attractive levels to sell dollars forward

The problem is that even at the long end of the curve, rates are increasingly moving in sync. Thus the big drop in European rates after the dovish ECB and poor Eurozone data had a big impact on US rates as well. Lower volatility in these spreads is reducing FX volatility, where EUR/USD traded option volatility is at the lowest level since 2014.

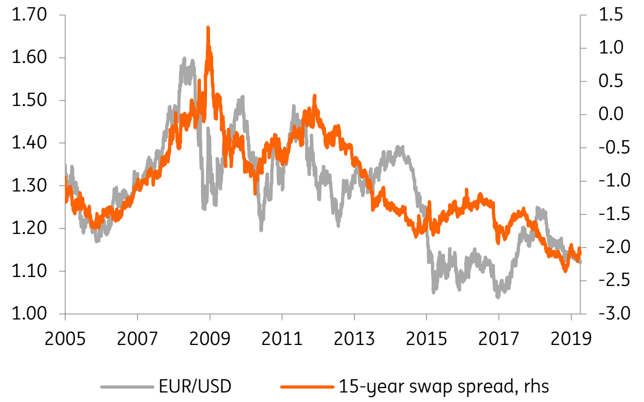
The lower cost of option volatility is good news for businesses looking to hedge EUR/USD exposure. Also, the fall in EUR/USD spot and the narrowing in two year spreads provide historically attractive levels to sell dollars forward – and expensive levels to buy dollars.

Fig 11 Longer tenor differentials having a greater say



Source: Bloomberg, ING

Fig 12 EUR/USD versus 15 year swap differentials



Source: Bloomberg, ING

While we are bearish on the dollar in the medium term based on twin deficits, the weak Eurozone position places the burden on the US to define the EUR/USD trend. Do we really know when the US will slow enough such that two year US rates start to trade 50bp under Fed Funds ahead of an imminent Fed easing cycle? The answer is probably not.

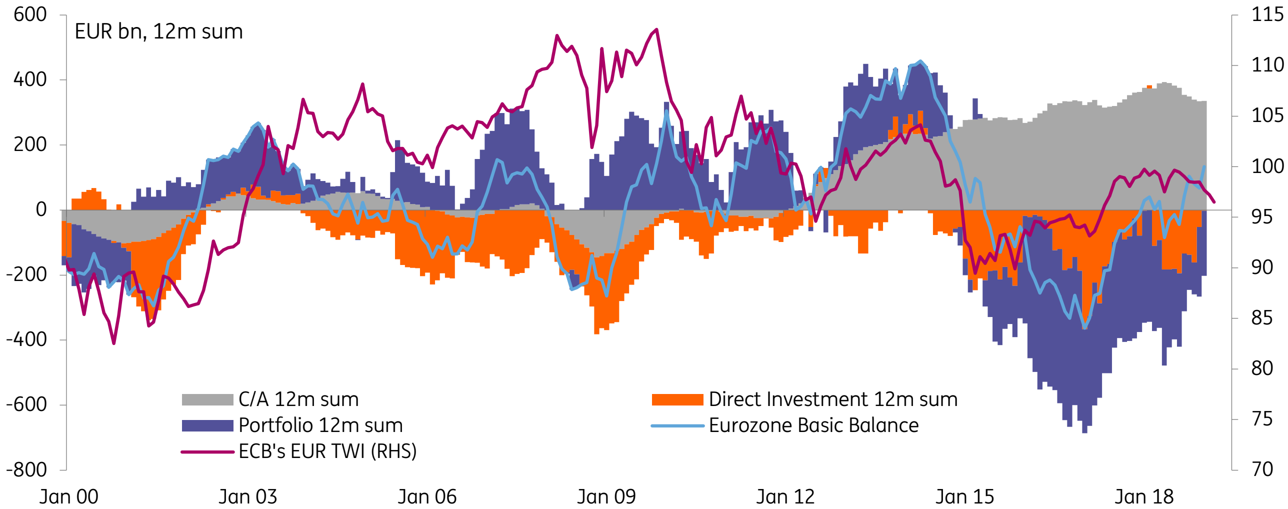
With the impact of rate differentials generally on the wane, it is probably also worth checking in on the Eurozone Balance of Payment position – to get an update on flows.

As highlighted below the Basic Balance (the current account plus net FDI plus net portfolio flows) is actually looking more positive for the EUR. However, to get the kind of powerful Basic Balance position that can drive EUR substantially higher, we need to see portfolio flows to cross back into positive territory (which hasn't been the case since the ECB started QE in 2015).

Unless Eurozone growth prompts a re-rating of European equities or longer tenor debt spreads, EUR/USD looks set to stay soft

Unless Eurozone growth can prompt a re-rating of European equity markets or longer tenor debt spreads move substantially against the dollar (probably via lower US rates), it is hard to see EUR/USD breaking out of a 1.10-15 range in the next 3-6 months. We are thus downgrading our end 2019 and 2020 forecasts to 1.18 and 1.25 respectively.

Fig 13 BoP looks more balanced for the EUR – but negative rates won't help bond flows



Source: Bloomberg, ING

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Rates: Inversion implications

In fact the 3mth to 10yr has not inverted (if you use 3mth bills)

While the inversion seen between 3mth Libor and the US Treasury 10yr yield has attracted headlines, we would add a couple of important caveats. Libor is not what it was. It is no longer the "interbank rate", rather it is essentially where banks print commercial paper (CP). With (virtually) no volumes going through the interbank market, banks need to hang their estimates on something tangible (hence the CP reference). And importantly, this overstates the "3mth rate". Note that 3mth Libor trades some 20bp above 3mth T-bills, and 3mth bills vs 10yr US Treasury is not inverted.

A full inversion is close though, in part bullied by a negative term premium

In addition, the 10yr Treasury yield is understated. We see this on a number of fronts. First, the New York Fed estimates the 10yr term premium at -80bp. It has never been lower, but has been hammered down ever since the Fed first engaged in quantitative easing (QE). This should be no big surprise, as the Fed's buying of bonds pushed market yields below levels that would otherwise have obtained, a simple supply/demand dynamic, where the Fed augmented the bid for bonds.

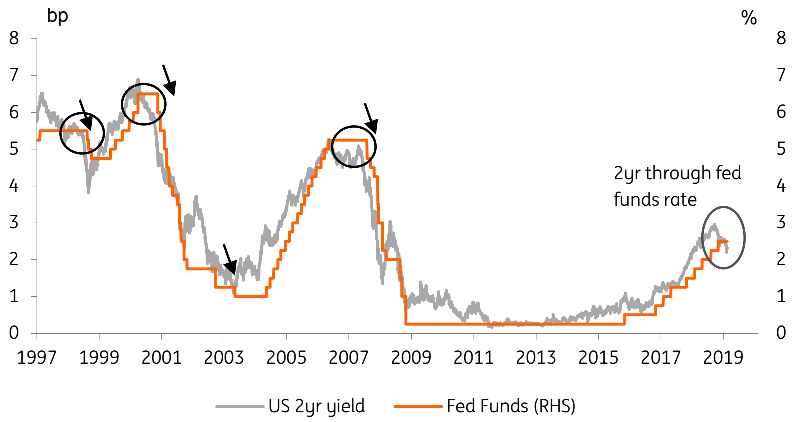
And the aftershocks of QE keep 10yr yields down too, even if we have since moved to QT

Even though the Fed has since engaged in quantitative tightening (QT) through not reinvesting bonds that roll off its balance sheet, echoes of the negative term premium remain. This aggressive negative term premium is also seen in a benign inflation breakeven discount as implied from the inflation-protected Treasury market. The implied breakeven inflation rate is 1.8% for the coming 5 years. This compares with a current (urban) inflation rate of 1.5%, and within the past year this was at an oil price impacted 3%. The current breakeven leaves little wiggle room to the downside.

Still, the 2/5yr is inverted and the 2yr is now trading through the fed funds rate

Bottom line, reflective of a large negative term premium and a very benign implied inflation expectation, the US 10yr yield is quite low for what is still a bubbly economy. And, despite the froth, an angst narrative dominates the market discount. The 2/5yr curve has technically inverted and the 2yr has traded through the fed funds rate, as is typical when the Fed has peaked historically (Figure 13).

Fig 14 The US 2yr yield and fed funds rate (ceiling)



Source: ING estimates

The market discount is for the next move from the Fed to be a cut. That would push the 10yr to 2% to 2.25%.

Feels like too much angst is being priced.

Consequently, we find that the market discount is decidedly negative on the macro prognosis. It is a discount that sees a rate cut as probable in the coming quarters, and sees minimal inflation risk in the coming years. If the next move in the fed funds rate is down, then history also shows that the 10yr can trade 25-50bp through in anticipation. That is consistent with the 2% to 2.25% area, which incidentally is where we identify neutrality to be (to generate a zero real rate at flat to core inflation).

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Fig 153 ING global forecasts

	2017					2018F					2019F					2020F				
	1Q	2Q	3Q	4Q	FY	1Q	2Q	3Q	4Q	FY	1Q	2Q	3Q	4Q	FY	1Q	2Q	3Q	4Q	FY
United States																				
GDP (% QoQ, ann)	1.8	3.0	2.8	2.3	2.2	2.2	4.2	3.4	2.6	2.9	1.7	2.2	1.8	1.9	2.4	1.7	1.7	1.7	1.7	1.8
CPI headline (% YoY)	2.6	1.9	2.0	2.1	2.1	2.7	2.7	2.6	2.2	2.4	1.6	1.7	1.8	2.0	1.8	2.4	2.2	2.1	2.1	2.2
Federal funds (%, eop)[1]	0.75	1.00	1.00	1.25	1.25	1.50	1.75	2.00	2.25	2.25	2.25	2.25	2.25	2.25	2.25	2.25	2.25	2.25	2.25	2.25
3-month interest rate (%, eop)	1.15	1.30	1.35	1.55	1.55	2.30	2.35	2.45	2.65	2.65	2.60	2.62	2.62	2.62	2.62	2.57	2.57	2.57	2.39	2.39
10-year interest rate (%, eop)	2.40	2.30	2.30	2.40	2.40	3.00	3.00	3.00	2.80	2.80	2.30	2.60	2.50	2.45	2.45	2.35	2.30	2.25	2.20	2.20
Fiscal balance (% of GDP)					-3.5					-4.0					-4.7					-5.0
Fiscal thrust (% of GDP)					0.0					1.2					0.5					0.8
Debt held by public (% of GDP)					76.1					77.4					80.2					83.3
Eurozone																				
GDP (% QoQ, ann)	2.7	2.7	2.7	2.7	2.5	2.7	1.7	0.6	0.8	1.8	1.1	1.6	1.4	1.4	1.2	1.1	1.2	1.0	0.9	1.2
CPI headline (% YoY)	1.5	1.3	1.5	1.4	1.4	1.3	1.7	2.0	2.0	1.8	1.4	1.1	0.9	1.3	1.2	1.5	1.5	1.6	1.6	1.6
Refi minimum bid rate (%, eop)	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	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	-0.33	-0.33	-0.32	-0.30	-0.30	-0.30	-0.30	-0.30	-0.30	-0.30	-0.30	-0.30
10-year interest rate (%, eop)	0.45	0.40	0.45	0.42	0.42	0.50	0.30	0.40	0.24	0.24	-0.07	0.20	0.30	0.25	0.25	0.25	0.25	0.25	0.25	0.25
Fiscal balance (% of GDP)					-0.9					-0.6					-0.9					-0.8
Fiscal thrust (% of GDP)					0.2					-0.1					0.2					-0.2
Gross public debt/GDP (%)					89.2					87.7					86.5					85.3
Japan																				
GDP (% QoQ, ann)	1.9	2.3	1.6	1.3	1.9	-0.4	1.9	-2.4	1.9	0.8	-0.1	-0.2	-0.2	1.0	0.1	0.8	0.6	0.7	0.8	0.6
CPI headline (% YoY)	0.2	0.4	0.6	0.6	0.5	1.3	0.6	1.1	0.9	1.0	0.3	0.8	0.4	0.1	0.4	0.6	0.6	0.8	1.0	0.8
Excess reserve rate (%)	-0.1	-0.1	-0.1	-0.1	0.0	-0.1	-0.1	-0.1	-0.1	0.0	-0.1	-0.1	-0.1	-0.1	0.0	-0.1	-0.1	-0.1	-0.1	0.0
3-month interest rate (%, eop)	0.00	0.00	0.00	0.00	0.00	0.00	0.00	-0.05	-0.05	-0.05	0.05	0.05	0.00	0.00	0.00	0.00	0.10	0.10	0.10	0.10
10-year interest rate (%, eop)	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Fiscal balance (% of GDP)					-4.8					-4.1					-3.6					-3.0
Gross public debt/GDP (%)					221					223					224					226
China																				
GDP (% YoY)	6.9	6.9	6.8	6.8	6.9	6.8	6.7	6.5	6.3	6.6	6.2	6.2	6.3	6.3	6.3	6.3	6.2	6.2	6.2	6.2
CPI headline (% YoY)	1.4	1.4	1.6	1.8	1.6	2.2	1.8	2.3	2.5	2.2	2.0	2.5	2.6	2.6	2.4	2.6	2.6	2.5	2.4	2.5
PBOC 7-day reverse repo rate (% eop)	2.45	2.45	2.45	2.50	2.50	2.55	2.55	2.55	2.55	2.55	2.55	2.55	2.55	2.55	2.55	2.55	2.55	2.55	2.55	2.55
10-year T-bond yield (%, eop)	3.29	3.57	3.61	3.90	3.90	3.75	3.48	3.63	3.30	3.30	3.10	3.05	3.00	2.95	2.95	2.95	2.90	2.90	2.85	2.85
Fiscal balance (% of GDP)					-3.7					-4.5					-4.5					-4.0
Public debt, inc local govt (% GDP)					50.0					88.0					102					103
UK																				
GDP (% QoQ, ann)	1.3	1.0	1.9	1.6	1.5	0.2	1.6	2.8	0.9	1.4	0.7	1.1	1.7	2.2	1.3	1.5	1.7	1.2	1.1	1.6
CPI headline (% YoY)	2.1	2.7	2.8	3.0	2.7	2.7	2.4	2.5	2.3	2.5	2.0	2.0	1.8	1.9	1.9	2.2	2.1	2.1	2.0	2.1
BoE official bank rate (%, eop)	0.25	0.25	0.25	0.50	0.50	0.50	0.50	0.75	0.75	0.75	0.75	0.75	0.75	1.00	1.00	1.00	1.25	1.25	1.50	1.50
BoE Quantitative Easing (£bn)	445	445	445	445	445	445	445	445	445	445	445	445	445	445	445	445	445	445	445	445
3-month interest rate (%, eop)	0.35	0.35	0.35	0.50	0.50	0.60	0.80	0.80	0.80	0.80	0.85	0.85	0.85	1.05	1.05	1.30	1.35	1.60	1.65	1.65
10-year interest rate (%, eop)	1.15	1.10	1.35	1.20	1.20	1.45	1.48	1.57	1.30	1.30	1.00	1.20	1.30	1.40	1.40	1.50	1.50	1.50	1.50	1.50
Fiscal balance (% of GDP)					-2.5					-1.4					-1.5					-1.5
Fiscal thrust (% of GDP)					-0.5					-0.4					-0.4					-0.3
Gross public debt/GDP (%)					87.0					84.0					83.0					81.5
EUR/USD (eop)	1.08	1.12	1.20	1.20	1.20	1.20	1.17	1.15	1.12	1.12	1.12	1.10	1.12	1.18	1.18	1.20	1.22	1.23	1.25	1.25
USD/JPY (eop)	112	115	110	113	113	107	110	114	113	113	112	113	110	108	108	105	103	102	100	100
USD/CNY (eop)	6.89	6.78	6.65	6.51	6.51	6.28	6.67	6.87	6.88	6.88	6.74	6.85	6.85	6.75	6.75	6.70	6.60	6.70	6.70	6.70
EUR/GBP (eop)	0.87	0.88	0.94	0.89	0.89	0.88	0.88	0.89	0.90	0.90	0.85	0.85	0.85	0.85	0.85	0.85	0.85	0.85	0.85	0.85
Brent Crude (US$/bbl, avg)	55	51	52	61	55	67	75	76	69	72	65	68	69	73	69	70	74	76	74	74

[1]Lower level of 25bp range; 3-month interest rate forecast based on interbank rates
Source: ING forecasts

Disclaimer