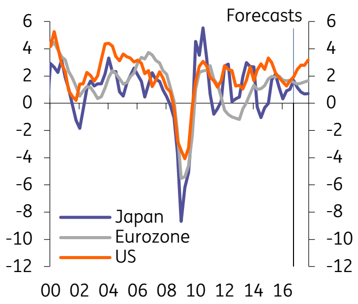
ECONOMICS | Global

1 June 2017

Monthly Economic Update

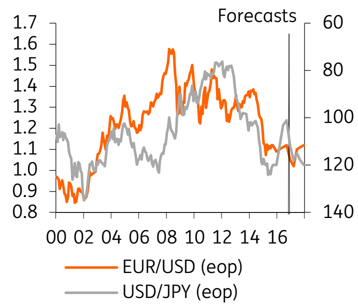
Waiting for a Raise

GDP growth (% YoY)



Source: Macrobond, ING

FX



Source: Macrobond, ING

Despite maturing recoveries and falling unemployment on both sides of the Atlantic, there is little sign of a significant acceleration in inflation. In part this is because wage inflation is failing to pick up as expected. This is complicating the central banks' plans to raise interest rates. While the US Federal Reserve looks set to take two small steps in the coming months, there may be a longer wait for further moves. Meanwhile, the European Central Bank is no hurry to raise, despite brighter economic and political news.

In the US, the macro case for a June FOMC hike looks questionable to us, following weaker GDP, inflation and wages growth – but markets are almost fully pricing in a June hike, and the lack of any cautionary noise from the Fed suggests that "...if you can't beat them, join them". So we have reluctantly shifted to a June hike, but left the September hike in too – matching the Fed's "dots", and exceeding market expectations.

But hopes for a big fiscal stimulus are waning, with the latest sally from the White House – the President's Budget – seeming to go down in flames almost from the outset. With 90 days-notice given to Congress of NAFTA re-negotiation, trade may deliver more "wins" for the Trump administration than fiscal policy ever will.

The Eurozone story is looking encouraging with strong activity data and fading political risk. However, inflation remains very low and wage growth is yet to pick up. Nonetheless, the market is focusing on the ECB's exit strategy. It is clear that the ECB will take a very gradual approach with a tapering and extension of the QE programme likely to be announced by September with a rate hike probably not happening until late 2018.

The UK's 8 June election looks like it could be closer than initially thought. A stuttering campaign by Prime Minister May has seen her opinion poll lead narrow in dramatic fashion, but the quirks of the UK's political system mean that the Conservatives remain the favourites. The most market positive thing to come from this is that with the next election now pushed back to 2022, it gives the new government greater flexibility to agree to a longer transitional arrangement to smooth the UK's path out of the EU.

The Chinese newsflow has been rather mixed of late with the Moody's downgrade and tweaks to the currency policy causing some concern. However, there has been no real change in economic fundamentals and we await MSCI's decision on whether to include Chinese A shares in their emerging market indexes, which could lift sentiment.

Japan is no exception when it comes to a lack of wage pressures emanating from a tight labour market. We've had some better news from the economy, but structural issues mean that inflation still has a long way to go before the BoJ considers tightening.

Expect the EUR to hold onto its recently-acquired swagger. While the ECB will be very careful with its communications policy at this stage in the cycle, markets still sense a significant policy change – and EUR/USD levels near 1.15 should be fully justified this summer. In the UK expect lots more GBP volatility in the run-up to the 8 June election. Yet major GBP losses may be avoided since a Hard Brexit is already priced.

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US: Now we wait

Trump has proved that policy changes in the US are never easy…

Trump's first 100 days were a lesson in how difficult it for any US politician to get anything done, even when they appear to control the US legislature and the executive. The next 100 days will show just where the power really lies.

… and the President's budget will likely go the same way as the skinny budget and big tax announcement

After a couple of abortive attempts to push an agenda of tax cuts and infrastructure spending, the "President's budget" announced on 23 May, looks likely to follow the same path, and the grandiose title "A New Foundation for American Greatness" belies a document that is short on detail, and low on convincing arithmetic. Most of headline measures included in the budget, such as the US$52bn increase in defence spending, increased spending on border defence, or corporate tax cuts had already been announced either in the "skinny budget" or the in the big "Tax announcement".

The budget contains some questionable assumptions

The budget claims it will bring the US deficit to balance within 10 years, with a US$3.6tr reduction in public spending over that period. But the revenue gains from this and other policy measures are estimated to be substantially higher at US$5.6tr, and assume an increased rate of growth that may not make it past the scrutiny of Congressional lawmakers, who will likely take a much more conservative view of the economic impact of these budget measures.

Fig 1 Budgetary impact of President's Budget 2017-2027

% GDP	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027
Receipts	18.3	18.2	18.1	18	18.1	18.1	18.2	18.2	18.3	18.4
Outlays	20.5	20.7	20.3	20	19.9	19.4	18.9	18.9	18.7	18.4
Deficit	2.2	2.5	2.2	2	1.8	1.3	0.8	0.6	0.4	-0.1
Dynamic deficit assumption	-0.01	-0.11	-0.29	-0.44	-0.63	-0.84	-1.00	-1.18	-1.38	-1.60
Debt held by the pubic	76.7	76.2	75.1	73.7	72.2	70.2	67.8	65.3	62.7	59.8

Source: White House

Click here to see full document

Fiscal neutrality is required for easy passage of this budget – and its claims to be fiscally neutral lack credibility

With a neutral fiscal impact likely to be a requirement of any budget if it is to pass a vote in the Senate, and with widely differing views on both sides of the aisle on what entitlements can be shaved, and what loopholes closed to pay for any tax reductions, our base case is that the eventual 2017/18 budget will contain nothing that can be described as "radical". Though there could be some marginal tax cuts, and simplifications of the tax code.

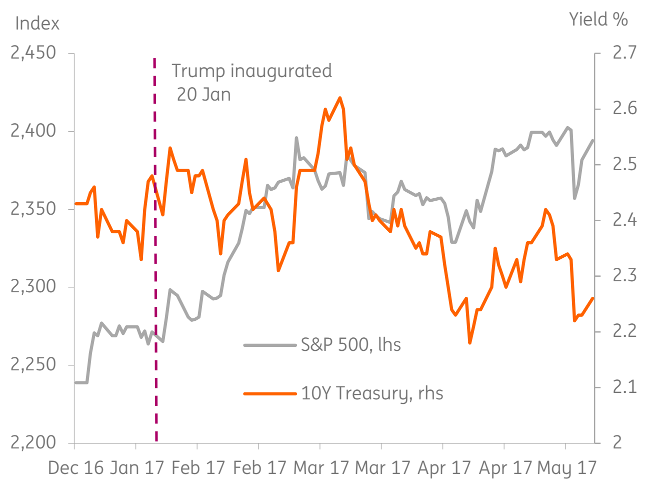
Expectations for a Trump-boost are ebbing

Markets have scaled back the Trump-premium. Equities have wobbled, and US Treasury yields have come back down to the 2.20-2.30% range, in line with our 2Q17 forecast and even in line with our underlying 1Q-2Q17 story of "elation, followed by disappointment".

But downside risk is also somewhat limited in terms of fiscal policy

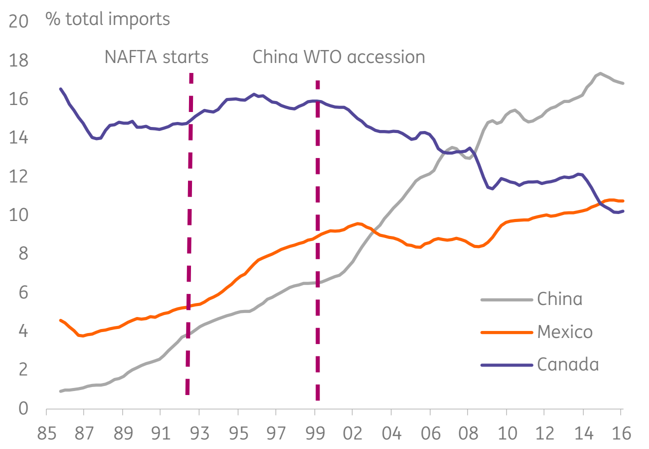
But for those looking for a really gloomy story, the downside risk is basically that Trump fails to deliver – which leaves us where we are currently. We don't believe the current macro backdrop is intolerable. In fact, we believe that the economy is not far off potential growth and the labour market is quite tight. As a result, there are few reasons to be all that disappointed by the absence of a big fiscal stimulus. Even a marginal simplification of the tax code could reduce some perverse incentives, and possibly stimulate investment. Failure to achieve that would be an opportunity lost, or at least postponed. But it would also leave us no worse than we are today.

Fig 1 Markets struggling to move forward after initial gains



Source: Thomson Reuters DataStream

Fig 2 NAFTA – not really the US import problem



Source: Betdata

Trade policy remains a potential game-changer – with NAFTA negotiations now looming

It is on trade policy, however, that we are likely to see some more meaningful policy direction. Congress has now had the 90 days notification it requires, for the Trump administration to begin to renegotiate NAFTA. This sounds ominous. Indeed, the lumber tariff imposed on Canada last month, is a powerful message to Mexico. And that message is, "The US means business".

The US may have won a weak deal from China, but we think they will play hardball with NAFTA

Following what many have argued was a weak trade agreement with China on market access for US beef, and credit cards (the Chinese increasingly pay with smart-phones and eat more pork than beef), this Canadian tariff may have come as some surprise. There is, however, no geopolitical trade-off equivalent to North Korea to superimpose onto the NAFTA talks. So with Congress likely to be relatively quiet on the budget over the summer recess, much of the political noise during the next 100 days may come from position taking by all three NAFTA members ahead of the substantive discussions to begin late August / early September.

The US macroeconomic backdrop is relatively uninteresting

The US macro backdrop remains remarkably uninteresting. 1Q17 GDP growth was the usual downward aberration, and markets and the Fed were probably right to ignore it. Growth will bounce back in 2Q17, showing the underlying rate of growth to still be about 2.0-2.5%.

With little to dissuade them, markets are almost certain of a June FOMC hike

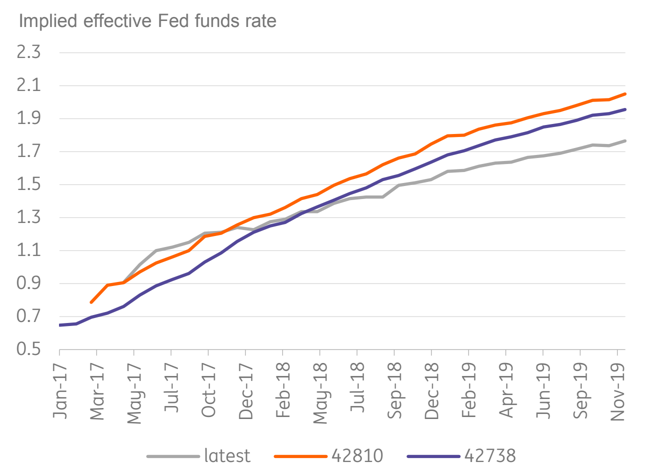
Financial markets have priced in almost a 100% chance of a June rate hike, and with little noise from Fed members to temper this view (indeed recent support from the Philly-Fed's Harker), we have to reluctantly concede that they are right to do so, and are changing our forecast to add in a June hike, whilst still keeping in the hike in September. This leaves Fed chair, Janet Yellen, plenty of room to start the process of balance sheet restructuring later this year, which means it will be up and running for her successor. This assumes, as we believe likely, that she chooses not to serve another term, or that President Trump finds an alternative Fed Chair.

But while a June hike is virtually fully priced in, September is not, and nor is there much priced in at all for a third hike this year by December, and very little for the whole of 2018.

If the case for a June hike is so strong, we wonder why not more is being priced in for 2H17?

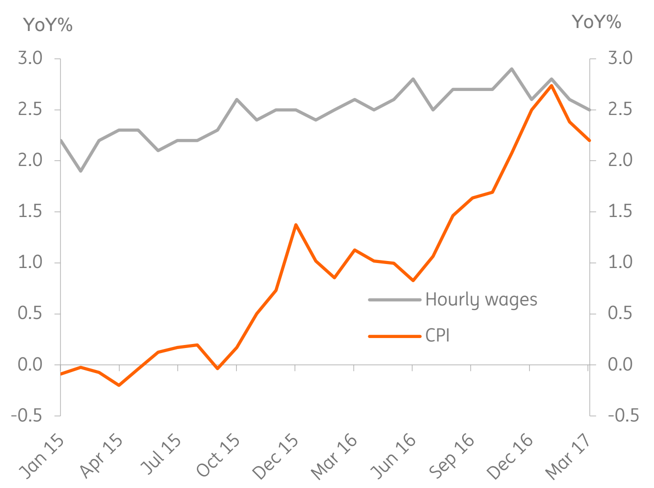
Inflation has taken a pause from its gradual ascent over the past year, which likely reflects the lack of inflationary pressures in the jobs market in addition to softer energy prices. Wage growth has been disappointing given the steep falls in the unemployment rate and declines in measures of underemployment that the US has been experiencing. This is likely to be partly explained by weak productivity, but there are areas, particularly in construction and manufacturing that are starting to buck the trend.

Fig 2 Implied effective Fed funds rate – evolution since Jan 17



Source: Fed funds futures

Fig 3 Real wages feel the squeeze



Source: Macrobond, Bloomberg

Weak productivity is depressing pay, but staff retention may become more of an issue

Job-to-job flows are starting to pick up and the conventional view is that firms will gradually start to worry about staff retention. This is usually associated with a broader increase in pay rates across companies, which starts to push up wages through the economy.

Wages should gradually strengthen, boosting the case for more rate hikes

We should see wages gradually move higher, but we are still some way off the 3%+ wage growth that we think would be consistent with a more aggressive pace of Fed rate hikes. Even so, the arguments for rates virtually on hold after June look perplexing. Either the June hike is a much more marginal call than current pricing, or the rest of the curve is priced "incorrectly".

Do markets simply have to be "told" meeting by meeting?

We have felt for some time that markets have become too reliant on Central bank guidance for pricing, rather than taking an informed view based on fundamentals. This seems to have reached an extreme right now. Every hike has to be spoon-fed to markets to get priced in one at a time. Our best guess is that the implied policy rates, and forward rate projections for longer dated Treasury benchmarks are too low. About the only way to explain this pricing is that markets anticipate the next hike weighing heavily on an overstretched equity market, which we admit is a possibility. But as an explanation for current pricing, it seems too convoluted.

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Eurozone: Treading cautiously

Markets focus again on the ECB's exit strategy...

With the political risk somewhat ebbing and the economy doing well, markets are focusing once again on the ECB's exit strategy. Mario Draghi formulated the current situation as follows in the European Parliament: "Downside risks to the growth outlook are further diminishing, and some of the tail risks we were facing at the end of last year have receded measurably. The fact that domestic consumption and investment are the main engines driving the recovery makes it more robust and resilient to downside risks, which relate predominantly to global factors."

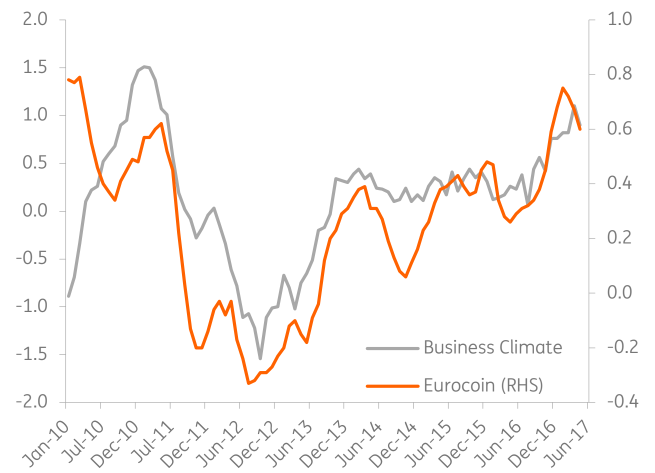
... with the ECB wary of creating unwanted tightening

However, the ECB remains at the same time extremely wary not to provoke a repeat of the "taper tantrum" the US experienced, ie, a rapid tightening of financial conditions after a Fed statement that the quantitative easing programme would be phased out. This taper tantrum fear transpired very clearly from the Minutes of the April meeting of the Governing Council. The change in communication is likely to happen in homeopathic doses to avoid a market upset.

Political risk has not entirely disappeared

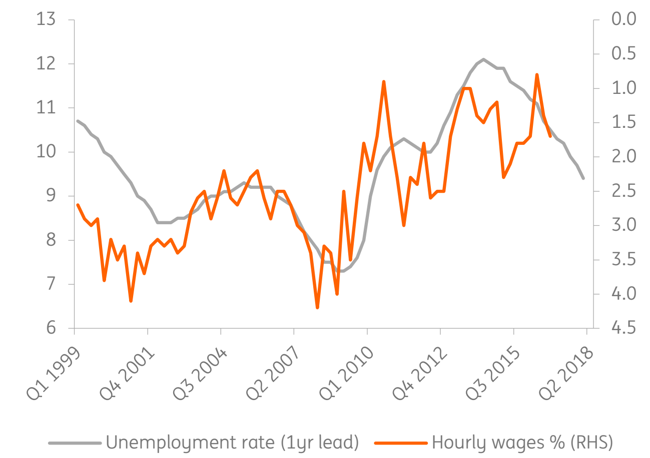
While we agree with the ECB's more optimistic assessment, not all homegrown risks have disappeared. The elections in Germany and even the advanced election in Austria in October shouldn't bring big market headaches. However, Italy remains a more difficult issue. With a new electoral law likely to be approved over the coming weeks, snap elections could become more likely again, something that is already making bond market nervous. While Spain is doing fine economically, tensions are building between the minority government and Catalonia that wants to organize an independence referendum in September. Finally, Greece still hasn't received the second instalment of the third bail-out plan. While we expect this to happen in June, debt relief (and hence IMF involvement in the third bail-out) looks unfeasible before the German elections (24 September).

Fig 4 Growth is no longer accelerating



Source: Thomson Reuters DataStream

Fig 5 Wage growth pick-up could be a 2018 story



Source: Thomson Reuters Datastream

Growth is rather robust…

… though not accelerating

On the economy there are certainly reasons to be cheerful. The PMI composite index stabilized in May at a six-year high, with the hiring component especially strong. This bodes well for consumption growth in the coming quarters. However, eyeballing the €-coin-indicator, tracking the underlying growth pace of the economy, GDP growth surely looks strong, but no longer accelerating. It actually fell to 0.60% in May, the third consecutive fall. The same message was given by the slight decline of the European Commission's sentiment indicator in May. All in all we stand by our forecast of GDP growth of 1.8% in 2017 and 1.7% in 2018. If all political hurdles are taken without upheaval, there is even a chance to see a 2% growth rate.

Inflation remains very low…

…as wage growth is not picking up yet

With underlying inflation falling back below 1% in May, the ECB has little reason to hurry with its exit strategy. It has now been stated several times by members of the ECB's Governing Council that a sustainable increase in inflation is unlikely as long as wage growth doesn't pick up. On that count there is little progress to be seen. Even in Germany, where unemployment has fallen back below 4%, wage growth remains rather subdued. This, however, chimes with new research from the ECB, showing that there is more unused capacity in the labour market (underemployment), than the official unemployment figures suggest. Also, the fact that employment creation was until now essentially a service sector story, where wages tend to be lower on average than in manufacturing, might have kept wage growth down.

On top of this, labour market reform has probably reduced wage bargaining power. No wonder that the ECB's Chief Economist, Peter Praet, expects the traditional Phillipscurve-relationship, namely the link between lower unemployment and higher inflation, to manifest itself only relatively late in the economic cycle – certainly not before 2018. A potential further strengthening of the euro exchange rate could also keep inflation lower for longer.

Very gradual exit approach…

… with the first deposit rate hike only in 4Q18

In that regard we expect the ECB to shift the communication only very gradually, with first a more balanced outlook for the economy and the dropping of the possibility that rates could go even lower in the forward guidance. By September the lengthening (and tapering) of the QE programme until June 2018 should be announced. A first (deposit) rate hike would follow in 4Q18. But even then the excess liquidity will remain in the markets, keeping money market rates in negative territory until the end of 2018. That will also limit the upward pressure on bond yields, once the ECB refrains from further adding to the size of its balance sheet.

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UK: May's mandate for Brexit?

Huge opinion poll leads convinced Theresa May to call an early election

Having previously promised not to call an early election, huge opinion poll leads proved too tempting for Prime Minister Theresa May to ignore. Britain votes again on 8 June, the third national ballot in three years, but the Conservatives' hopes for winning the largest parliamentary majority since Tony Blair's landslide victory in 1997 are fading fast.

However, stumbles on the campaign trail have hurt her ratings and the election outcome could be far closer than initially thought

The Conservative party mantra is that "strong and stable leadership" is required for what could be a tumultuous period for the UK and this had resonated with the electorate. But May's momentum has faded in dramatic fashion in recent days. Opinion polls have narrowed in the wake of a Conservative U-turn on social care for the elderly and growing criticism of Theresa May's leadership style. At the same time, the opposition Labour Party has started making headway with a much more redistributive manifesto that would see a reversal of austerity and nationalisation of utility, rail and mail companies.

The Conservatives are picking up support from former UKIP voters while the pro-EU stance of the Liberal Democrats is failing to win them support

Despite these moves, a Conservative party victory remains the most likely outcome. The fact that the UK has triggered Article 50 and Brexit has become a reality has seen UKIP's relevance questioned and its support collapse – the bulk of which is transferring to the Conservatives. Meanwhile, the Liberal Democrats' tactic of putting a second referendum on Brexit as its core policy has failed to generate the support imagined. Surveys suggest that those who voted for the UK to remain an EU member are increasingly reconciled to the view that the will of the people must be respected and Britain will leave the EU (so-called Re-Leavers).

The SNP remain strong, but a Conservative majority remains the most likely outcome

The Scottish nationalists (SNP) will remain a very strong regional force, but they too could lose seats to the Conservatives. Taking this altogether and combining it with the quirks of Britain's first past the post electoral system, sampling experts currently suggest the Conservatives will increase their majority from 17 seats to around 90 seats despite their recent polling setbacks. However, other methods suggest it could be much smaller than this, but they would still have a majority.

We don't think an enlarged Tory majority would bring major Brexit benefits

Theresa May has suggested a larger parliamentary majority will boost Britain's chances of winning a good deal in Brexit negotiations. This looks like wishful thinking. The size of the Conservative's majority in parliament will make little if any difference to the EU's demands of a substantial divorce payment, nor its stance of making sure that they win the best deal possible for their own constituents.

But it would ease the pressure on the government in key votes

Nonetheless, it will make passing what could be very contentious Westminster legislation easier. The current majority of just 17 MPs ran the risk of government defeats on key votes in coming years. A more sizeable majority would give Theresa May more breathing room with new Conservative MPs keen to show their loyalty and back the Prime Minister in parliament. It also allows Prime Minister May to pursue her own policies rather than be beholden to the 2015 election manifesto that carried David Cameron to victory.

It does make it easier to opt for a longer transition period to help smooth the UK's path out of the European Union

Where calling the election provides Brexit benefits is that Theresa May has more scope to agree a transitional period that could help smooth Britain's exit from the EU. Facing the electorate in 2022 rather than 2020 gives more time and flexibility to make sure it is the best possible "new arrangement" before she faces the voters once again. This reduces the chances of a "cliff edge" in 2019 which could be potentially very damaging. We remain optimistic on the potential for a mutually beneficial deal, but getting a transitional arrangement is of critical importance.

The Conservatives could still lose

Of course we can't completely discount the possibility that the Conservatives' support falls away in the last week of campaigning and they end up being defeated – only one poll has suggested this is a likely outcome so far. The most probable scenario would be a coalition including Labour and the Liberal Democrats with support from the Scottish and Welsh nationalists.

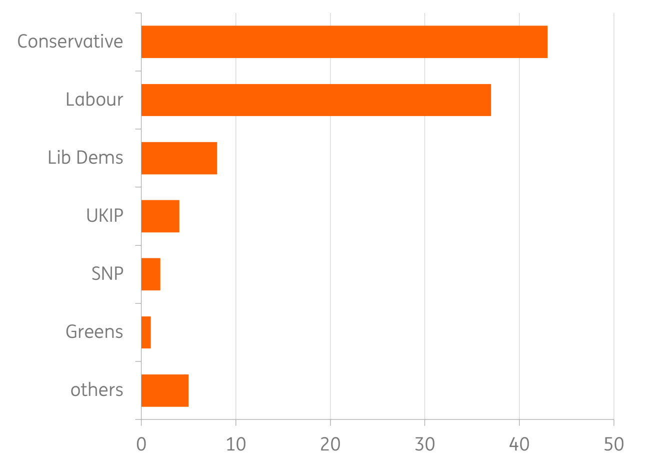
It would likely require a coalition of parties with lots of different views, particularly on Brexit…

… and increase the probability of a Scottish independence referendum

Labour's position on Brexit is that they "accept the referendum result and a Labour government will put the national interest first". However, their likely coalition partners are all much more pro-EU. Labour would likely acquiesce to demands for a second Brexit referendum on the final deal from the smaller parties. But starting from scratch on a new strategy for Brexit would be challenging given that two of the 24 months set aside for negotiations have already passed. It would also make a Scottish Independence vote all the more likely as the SNP will make this a requirement before agreeing to back Labour.

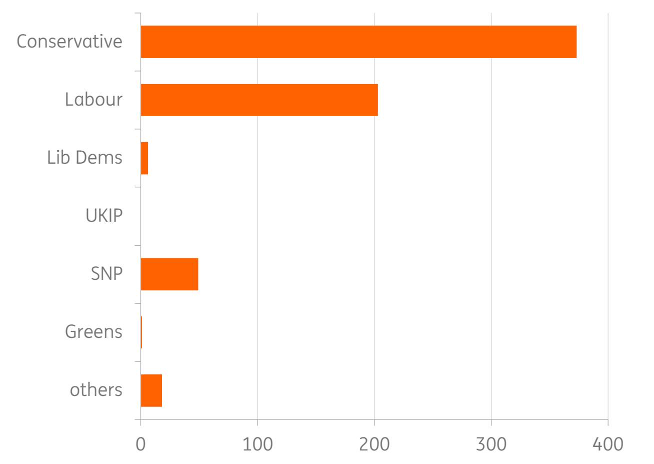
Labour has said that it wants to place a "strong emphasis on retaining the benefits of the Single Market and the Customs Union". But any thoughts that this outcome would yield a "softer" Brexit could be quickly dispelled if the parties start disagreeing on what they want to achieve. This could make failure in Brexit negotiations more likely.

Fig 6 Latest opinion polls



Source: Survation

Fig 7 What this might mean for parliamentary seats…



Source: Electoral Calculus

"Soft" Brexit is by no means assured under this scenario

Alternatively, what would happen if Labour reverts to being a supporter of ongoing EU membership? They are unlikely to stop Brexit given their election manifesto (plus it would require EU approval). However, there may be little incentive to negotiate Brexit properly. This pro-EU government could simply say that they failed to get a deal that satisfies the UK interests. The electorate would be left with a second referendum choice of severe economic dislocation (but "freedom" from European rules) versus staying in the EU. Given 52% of the population had voted for Brexit first time round, this would be a high risk game that could see major financial market volatility.

Economic weakness will persist during negotiations…

We see little prospect of this election delivering clarity on the likely outcome of Brexit negotiations. In fact uncertainty is likely to increase as Brexit talks get underway – a mooted start date is 19 June. With the economy already showing signs of weakening - a very disappointing 1Q GDP report produced growth of just 0.2% QoQ - we see little prospect of Bank of England interest rate hikes.

… meaning little chance of a Bank of England rate rise anytime soon

The squeeze on spending power with wages failing to keep pace with the cost of living at a time when businesses pull back on hiring and investment due to economic uncertainty are our chief concerns. Weakness here will more than offset any export gains caused by the competitiveness boost from sterling's plunge.

Economic weakness will also more than offset near-term BoE worries about sterling induced above target inflation. With businesses reluctant to offer pay rises given weak productivity and uncertainty over Brexit, the medium-term inflation threat will gradually diminish.

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China: Moody's downgrades, the PBOC tweaks, MSCI considers

Moody's downgrades

Moody's pulled the trigger on its negative rating outlook, downgrading China's sovereign rating by one notch to A1. It placed a negative outlook on the rating in March 2016 amid elevated global financial market turmoil associated with uncertainty about China's exchange rate policy. At the time Moody's cited weakening fiscal metrics, falling foreign reserves and uncertainty about the authorities' capacity to implement structural reforms.

Rising debt ratios…

We thought Moody's would view the manifestly greater macro and financial market stability and financial system de-leveraging reforms as grounds for restoring a stable rating outlook. In the event the agency attached greater weight to rising leverage: "Moody's expects that economy-wide leverage will increase further over the coming years…Rising debt will erode China's credit metrics…" On Moody's numbers the government's direct debt burden will rise from 37% in 2016 to 45% by the end of the decade, a level in line with a single-A sovereign rating, not a double-A.

… but no change in China's economic fundamentals

Moody's released a statement in which it summarized a 21 May 2017 rating committee meeting discussion as follows: "The issuer's economic fundamentals, including its economic strength, have not materially changed. The issuer's fiscal or financial strength, including its debt profile, have not materially changed".

S&P looks a bit of an outlier

S&P also changed the outlook on its sovereign rating to negative from stable in March 2016. Its AA- sovereign rating now stands out as the highest among the three rating agencies (Fitch's rating is aligned with Moody's at A+), which we assume imparts more than even odds of S&P following Moody's and downgrading by one notch.

One country, two ratings after a fashion

While Moody's and S&P have observed a "One Country, Two Ratings" rule, in practice their Hong Kong ratings have moved in lockstep with their China ratings. Thus, simultaneously with its China downgrade, Moody's downgraded Hong Kong by one notch to Aa2. In doing so it preserved the two-notch differential in favour of Hong Kong it has maintained since 2007 (S&P has maintained a four-notch differential since 2005).

Moody's sold at the bottom

We think Moody's sold the low. A downgrade would have made sense in 2011, in our view. Since 2013 the authorities have been occupied with cleaning up the excesses from the 2009-10 credit boom, which are most evident in property, local government finances and shadow banking, and putting the activities on a sound footing for the future.

The PBOC tweaks

Toward the end of May the China Foreign Exchange Trading System or CFETS unit of the People's Bank announced a modification of its "closing price plus basket" formula for setting the daily USDCNY reference rate. Helpfully, it published a post on its website explaining what was going on.

A dynamic, counter-cyclical adjustment factor

The motivation for the latest tweak – in February they shortened the reference trading period for currencies in the basket to 15 hours (4:30pm to 7:30am) from 24 – was to halt unwarranted renminbi depreciation pressure. The post explained how, given China's solid economic fundamentals, the CNY should appreciate when the US dollar index depreciates. Instead, it had been depreciating (Figure 8), which the statement blamed on "irrational expectations" of one-way market moves. The tweak adds a counter-cyclical adjustment factor to the closing price plus basket formula, which will be "adjusted dynamically according to the macroeconomic fundamentals."

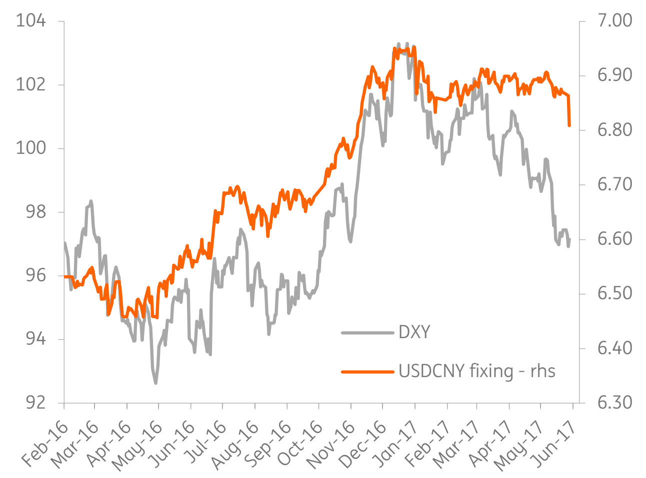
The PBOC tired of exchange market intervention

We think the authorities tired of having to intervene in the foreign exchange market to counter what they considered irrational CNY depreciation pressure in order to obtain a more fundamentals-based closing price. They identified the problem as a bug in the "closing price plus basket" formula that assigned too much weight to the closing price. The modification fixes the bug.

The impact effect was as hoped for

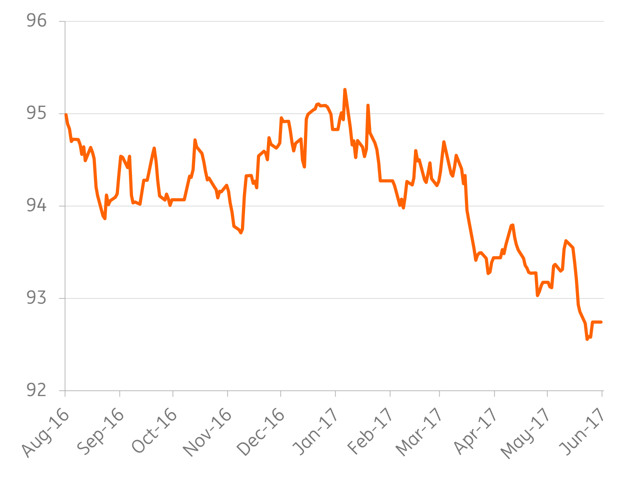
We infer from the rally in CNY and CNH on the first day of trading following the unveiling of the USDCNY fixing formula tweak that the consensus viewed it as signalling the PBOC wanted a stronger CNY. We expected the tweak would "work"; people would eventually be persuaded that the CNY, like the rest of USD/AXJ, should appreciate when major currencies appreciate (the US dollar index goes down). But we thought it would take more than one session.

Fig 8 The PBOC considered the downward stickiness of USDCNY when DXY depreciates unwarranted



Source: ING Bank, Bloomberg

Fig 9 The tweak will make it easier to stabilize the CNY-TWI



Source: ING Bank, Bloomberg

A sentiment swing

Changes in sentiment can be sudden, however, and we may be experiencing one. The official China Securities Journal attributed the improvement in liquidity in May partly to a "general feeling in the market" that the central bank had become more willing to extend liquidity.

Strong CNY, stable TWI

We'll be guided by the Shanghai Composite index as to whether the general feeling persists. If it does, all our financial market forecasts would be up for review. In particular, we would revise our forecast of one more 10bp hike in the PBOC's reverse repo rates and liquidity facility rates to on hold and our 3.70% yearend 10-year government bond yield forecast lower. For now, consistent with the CNY-TWI remaining stable (Figure 9), we revise our yearend USDCNY forecast to 6.68 from 6.79.

MSCI considers

Lastly, on 20 June MSCI will reveal whether it is fourth time lucky for Chinese stocks – so-called A-shares – to be included in their emerging market indexes. The Shanghai-Hong Kong stock connect redressed the shortcoming related to repatriation of capital that blocked last year's attempt. There has been less progress on the two other, the suspension of trading in some stocks and regulatory barriers to launching financial products linked to indexes that include Chinese stocks.

MSCI vs Moody's

A positive result from the MSCI would go some way toward reversing the negative impression from the Moody's downgrade. However, we don't think either the Moody's downgrade or MSCI inclusion would have much more than a symbolic short-term effect. The fund flows from MSCI inclusion would in the first instance be negligible, about US$5bn based on China's 0.5% weight in the MSCI emerging markets index and a universe of about US$100bn of assets passively invested in emerging market exchange traded funds. However, MSCI inclusion could be a large medium-term positive if investors view it as a commitment to further opening to international capital.

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Japan: Looking beyond the jobs

Despite an ultra-low unemployment rate, wages & inflation have failed to pick up

It's a global question, but the link (or lack of one) between very low unemployment and higher inflation is, at least at face value, very relevant in Japan. At 2.8%, Japanese unemployment is the lowest since the mid-1990s, and has fallen sharply from a high of 5.4% in 2009. But despite that, and a humongous amount of BoJ stimulus, core inflation has fallen back to zero and wages have flat lined. So why has this been the case?

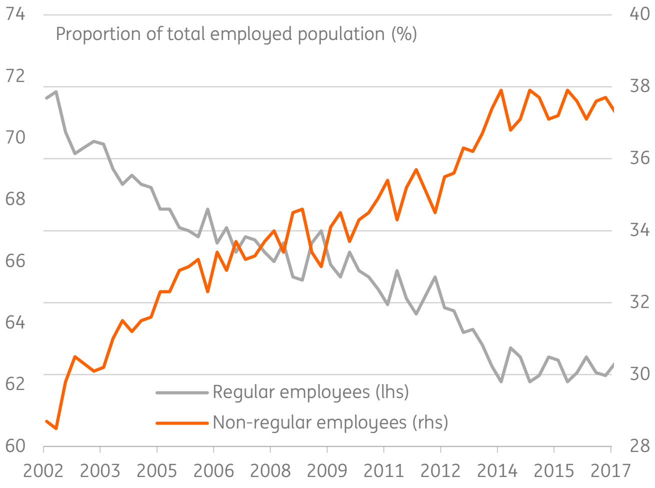
Only 2% of jobs created since 2010 have been "regular"

To find the answer, you need to look beneath the headline unemployment rate and look at the composition of the labour force. As Figure 10 shows, "non-regular" employment (part-time or temporary jobs) now makes up a much larger share of the total than in the early-2000s. In fact, fewer than 2% of jobs created since 2010 have been "regular" (ie, full-time).

This means there has been limited pressure on wages

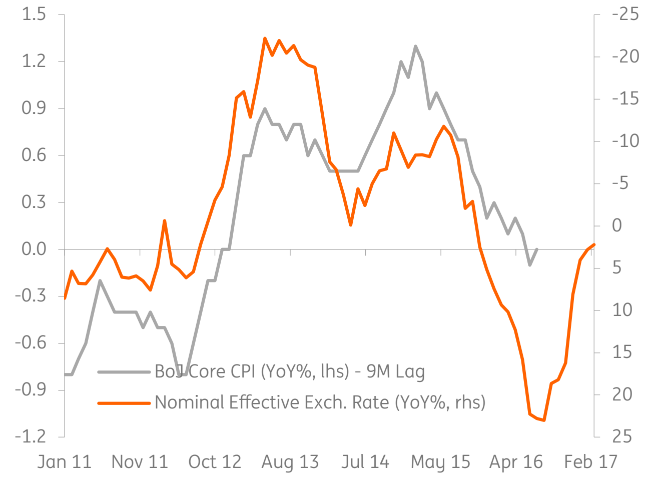
We think this structural shift is at least partly to blame for the lack of wage/inflationary pressures stemming from the tight labour market. Part-time, and in particular temporary/agency employment, is less likely to be associated with regular pay increases. This is similar to the experience in the UK, where the rise of "zero-hour contracts" is arguably one reason why wage growth has been slower to recover, along with weak productivity.

Fig 10 Regular vs non-regular employees



Source: Statistics Japan

Fig 11 Core inflation vs the exchange rate



Source: Macrobond

Recent activity data has been more promising...

But where wage pressures have been lacking, the latest activity data has been more promising. Recent trade data was encouraging and first quarter GDP beat expectations, crucially revealing the fifth consecutive quarter of growth above 1%. Whilst this is clearly above-trend for Japan, we suspect we'll have to see growth remain at this elevated level to have much impact on underlying (core) inflation.

... but don't expect the Bank of Japan to tighten policy any time soon

At 0%, the dip in the Bank of Japan's preferred measure looks like it is close to bottoming out (Figure 11), but the road to 2% is still a long one. That means the BoJ will be in no hurry to tighten policy, and the focus for now is still firmly on making its bond-buying programme more sustainable.

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FX: ECB tiptoes through tapering

We expect the EUR to retain its recently-acquired swagger

Financial markets are not known for their patience. They now sense a change in ECB policy. The ECB is well aware of these sensitivities and is no doubt carefully calibrating how to change communication without triggering a drastic tightening of monetary conditions. That said, we expect the EUR to retain its recently-acquired swagger and it to make further headway to 1.15 this summer.

The Draghi ECB has a good communications track-record

Perhaps unsurprisingly EUR/USD has been trading well above levels suggested by typical short term (largely rate-spread) models. This follows a set of encouraging 1Q17 GDP data across the Eurozone, questioning how long the ECB needs to maintain ultra-loose policy. Minutes of the April policy meeting revealed just how sensitive the ECB was to communication at this stage in the monetary policy cycle. And the Draghi ECB has a good communications track-record, suggesting EUR strength will not get out of control.

Financial markets typically front-run significant policy adjustments

Yet financial markets typically front-run significant policy adjustments. Once the ECB reveals a serious review of its PSPP programme (sometime this summer), we expect EUR/USD levels near 1.15 to be fully justified – and EUR/USD to roughly hold around that area until Italian political risk is resolved potentially this autumn.

We look for any dollar strength to be expressed largely against the JPY

The recent rise in EUR/USD has also been helped by the stagnation in US fiscal policy. The last vestiges of the reflation trade look to be leaving the US Treasury market, where the ten year Term Premium has dipped back to levels seen early November. We also doubt that Fed policy will be a major driver of the dollar this year. Yet there is a chance of Trump making some limited progress on a pro-growth budget later this year (Congress may vote in July/August). If that is the case, we look for dollar strength to be expressed largely against the JPY – and look for EUR/JPY to advance to 140.

While a smaller Tory working majority – or the very outside risk of a Progressive Alliance - would likely hit GBP hard over the short term...

... over the medium term GBP downside looks relatively limited.

Also very much in focus is GBP. Recent GBP strength has reversed after opinion polls have shown a dramatic decline in the Conservative lead over Labour. Investors had previously welcomed the prospects of a larger Conservative working majority and the greater negotiating room for Brexit. While a smaller working majority for the Conservatives –or the very outside risk of a Progressive Alliance (labour, Lib Dem, SNP) - would likely hit GBP hard over the short term, we argue that GBP is already priced for a Hard Brexit and believe that GBP downside will be relatively limited.

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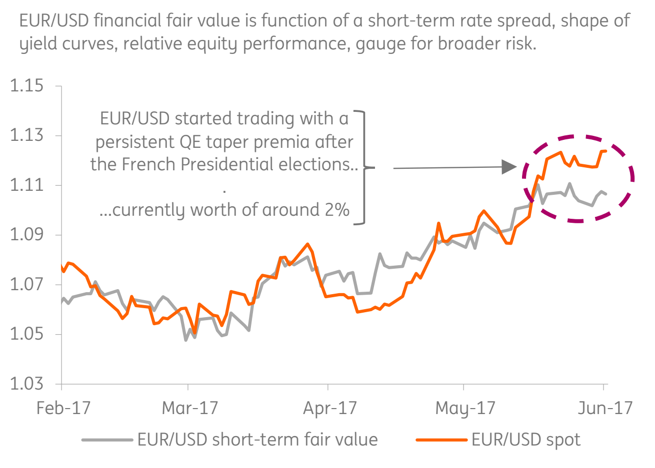
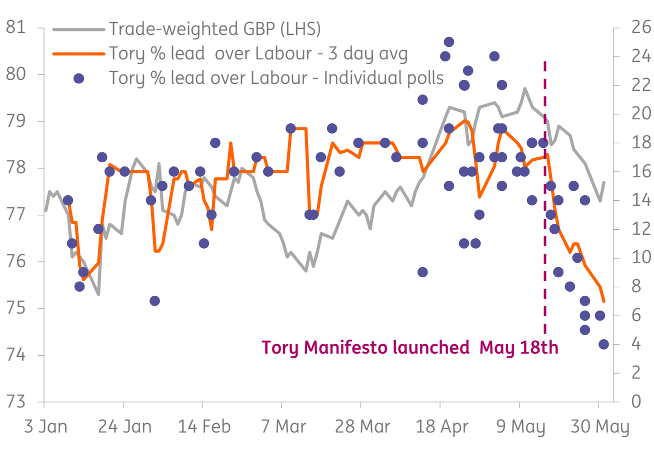
Fig 12 EUR/USD starts to trade above short-term fair value



Source: ING

Fig 13 Dwindling Tory lead drags GBP lower



Source: Wikipedia, ING

Rates: Markets turn cautious ahead of June meetings

Beyond the short-term, investors are cautious

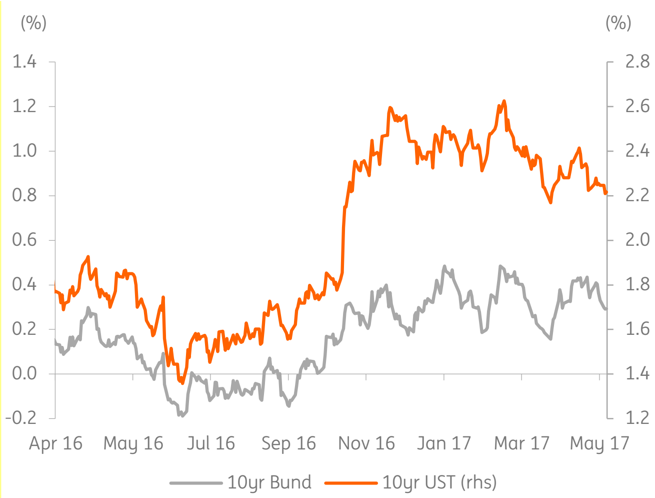
June holds two important central bank meetings for interest rates: The ECB meeting on 8 June and the FOMC meeting on 14 June. The Fed is widely expected to deliver another rate hike with markets virtually pricing it in. However, beyond the short term investors have become more cautious. With the new administration running into political headwinds the "Trumpflation"-bump has been largely priced out and expectations of fiscal stimulus were pared back.

Focus is switching to the Fed's balance sheet plans

But markets are also contemplating the Fed shifting the focus towards adjusting its balance sheet starting 2H this year. This may explain why markets are more cautious on pricing in further hikes beyond June. By the end of 2018, markets are discounting only 60bp of tightening from current levels. We see room for these expectations to correct.

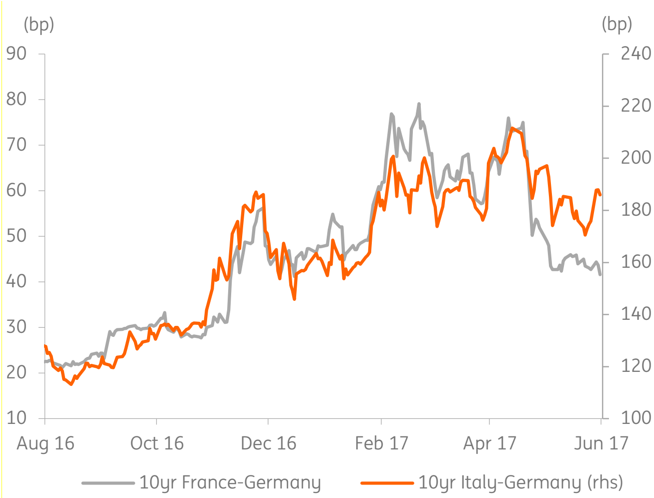
In the Eurozone, growth prospects seem robust, but the ECB has kept the focus on the lack of accompanying inflationary pressures ahead of the June meeting. 10yr Bund yields thus remain stuck in their year to date trading range. The short-end of the yield curve recently received fresh support from dovish rhetoric from ECB President Draghi, who stated that "*an extraordinary amount of monetary policy support, including through our forward guidance, is still necessary*".

Fig 14 "Trumpflation"deflated



Source: Bloomberg, ING

Fig 15 Attention shifts from French to Italian politics



Source: Bloomberg, ING

Eurozone markets have largely priced out a depo rate hike in 1H18

As a consequence, 1y1y EONIA has slipped to the lowest level in five weeks, with ECB dated EONIA forwards now having largely priced out the (illogical) notion of a depo rate hike in 1H18. A Reuters report this week had suggested that the Governing Council is set to upgrade the growth risk assessment to "balanced" and will likely remove the easing bias on rates in the forward guidance, but as this is pretty much the consensus view 1y1y EONIA failed to respond.

Italian spreads have re-widened on talk of snap elections

Within Eurozone government bond markets the attention has shifted from France towards Italy. The success of Macron in the French presidential elections has led to a retightening of government bond yield spreads verus Bunds, but in the case of Italy the relief has proven short lived. The 10yr Italy/Germany spread has re-widened by more than 15bp towards the 190bp area from its May lows, as lawmakers in Italy encouraged talk of snap elections to be held in autumn – earlier than anticipated.

Despite the ECB having signalled only gradual and cautios adjustments to their communication, the earlier election date could coincide with the ECB's announcment of tapering its government bond purchases. This combination could weigh on Italian government bonds and also see an increase of spill-over effects into other markets which have so far been less affected by the renewed political rumblings in Italy.

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Fig 16 ING global forecasts

	2016F					2017F					2018F					2019F				
	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)	0.8	1.4	3.5	1.9	1.6	1.2	3.6	3.2	2.7	2.4	3.1	2.6	2.4	2.9	2.9	3.2	3.0	3.3	3.0	3.0
CPI headline (% YoY)	1.1	1.1	1.1	1.8	1.3	2.6	2.2	2.5	2.6	2.5	2.5	2.8	2.7	2.7	2.9	2.7	2.7	2.7	2.7	2.5
Federal funds (%, eop)[1]	0.25	0.25	0.25	0.50		0.75	1.00	1.25	1.25		1.25	1.50	1.50	1.75		1.75	2.00	2.00	2.25	
3-month interest rate (%, eop)	0.62	0.65	0.81	1.01		1.15	1.30	1.55	1.60		1.65	1.85	1.95	2.10		2.20	2.35	2.45	2.60	
Fiscal balance (% of GDP)					-3.2					-4.0					-5.0					-5.8
Fiscal thrust (% of GDP)					0.0					0.6					1.0					0.7
Debt held by public (% of GDP)					76.6					75.8					74.8					74.5
Gross public debt/GDP (%)					106.0					106.0					107.0					108.0
Eurozone																				
GDP (% QoQ, ann)	2.2	1.3	1.7	1.9	1.7	1.9	1.9	1.6	1.8	1.8	1.8	1.7	1.7	1.7	1.7	1.5	1.5	1.5	1.4	1.5
CPI headline (% YoY)	0.0	0.0	0.3	0.7	0.3	1.8	1.7	1.5	1.4	1.6	1.2	1.4	1.5	1.6	1.4	1.5	1.7	1.9	1.9	1.8
Refi minimum bid rate (%, eop)	0.05	0.00	0.00	0.00		0.00	0.00	0.00	0.00		0.00	0.00	0.00	0.00		0.00	0.25	0.25	0.50	
3-month interest rate (%, eop)	-0.22	-0.26	-0.30	-0.31		-0.33	-0.33	-0.33	-0.33		-0.33	-0.33	-0.25	-0.10		0.10	0.20	0.25	0.40	
Fiscal balance (% of GDP)					-1.5					-1.4					-1.4					-
Fiscal thrust (% of GDP)					0.1					0.3					0.2					-
Gross public debt/GDP (%)					91.5					90.8					89.7					-
Japan																				
GDP (% QoQ, ann)	2.8	1.7	1.0	1.4	1.0	2.2	0.5	1.0	0.9	1.2	1.2	1.0	1.0	0.9	1.0	0.9	0.9	0.9	0.9	0.9
CPI headline (% YoY)	0.1	-0.4	-0.5	0.3	-0.1	0.3	0.5	0.8	0.6	0.6	0.8	0.9	0.9	0.9	0.9	1.0	1.0	1.0	1.0	1.0
Excess reserve rate (%)	-0.1	-0.1	-0.1	-0.1		-0.1	-0.1	-0.1	-0.1		-0.1	-0.1	-0.1	-0.1		-0.1	-0.1	-0.1	-0.1	
3-month interest rate (%, eop)	0.09	0.06	0.04	0.02		0.05	0.05	0.05	0.05		0.05	0.05	0.05	0.05		0.1	0.1	0.1	0.1	
Fiscal balance (% of GDP)					-5.9					-5.3					-5.0					-7.1
Gross public debt/GDP (%)					212.0					213.0					213.0					212.0
China																				
GDP (% YoY)	6.7	6.7	6.7	6.8	6.7	6.9	6.7	6.6	6.5	6.7	6.4	6.5	6.5	6.6	6.5	6.5	6.3	6.3	6.2	6.3
CPI headline (% YoY)	2.1	2.1	1.7	2.2	2.0	1.4	1.8	2.5	2.2	2.0	2.5	2.0	1.6	1.8	2.0	2.0	2.0	2.0	2.0	2.0
PBOC 7-day reverse repo rate (% eop)	2.25	2.25	2.25	2.25		2.45	2.55	2.55	2.55		2.65	2.65	2.75	2.75		2.75	2.85	2.85	3.00	
Fiscal balance (% of GDP)					-3.8					-3.4					-3.0					-3.0
Public debt (% GDP), incl. local govt.					60.4					64.5					67.8					70.4
UK																				
GDP (% QoQ, ann)	0.6	2.4	2.0	2.7	1.8	0.7	1.5	1.0	0.7	1.5	1.1	1.4	1.8	1.6	1.2	1.9	2.1	1.6	2.2	1.8
CPI headline (% YoY)	0.3	0.4	0.7	1.2	0.7	2.1	2.8	2.9	3.0	2.7	2.8	2.7	2.7	2.7	2.7	2.7	2.5	2.3	2.2	2.4
BoE official bank rate (%, eop)	0.50	0.50	0.25	0.25		0.25	0.25	0.25	0.25		0.25	0.25	0.25	0.25		0.25	0.50	0.50	0.75	
BoE Quantitative Easing (£bn)	375	375	435	435		435	435	435	435		435	435	435	435		435	435	435	435	
3-month interest rate (%, eop)	0.60	0.60	0.30	0.40		0.35	0.30	0.35	0.40		0.40	0.40	0.40	0.40		0.50	0.70	0.70	0.90	
Fiscal balance (% of GDP)					-2.4					-2.4					-2.3					-1.6
Fiscal thrust (% of GDP)					-0.6					-0.9					-0.7					-0.8
Gross public debt/GDP (%)					86.5					85.5					84.5					82.7
EUR/USD (eop)	1.10	1.11	1.12	1.05		1.08	1.12	1.15	1.15		1.15	1.20	1.20	1.20		1.22	1.23	1.24	1.25	
USD/JPY (eop)	112	103	101	112		112	115	118	120		118	120	120	120		115.0	115.0	112.0	110.0	
USD/CNY (eop)	6.45	6.65	6.67	6.95		6.89	6.86	6.83	6.79		6.75	6.70	6.65	6.60		6.60	6.60	6.60	6.60	
EUR/GBP (eop)	0.80	0.84	0.88	0.87		0.87	0.87	0.88	0.85		0.83	0.85	0.83	0.80		0.80	0.80	0.79	0.78	
Brent Crude (US$/bbl, avg)	35	47	47	51		55	50	45	45		40	45	50	50		45	50	50	55	

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

Source: ING estimates

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