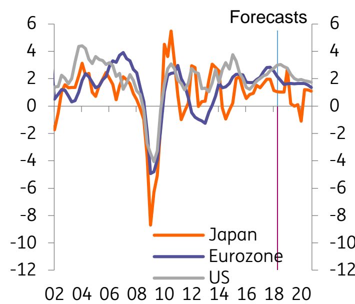
5 July 2018
Global

Monthly Economic Update

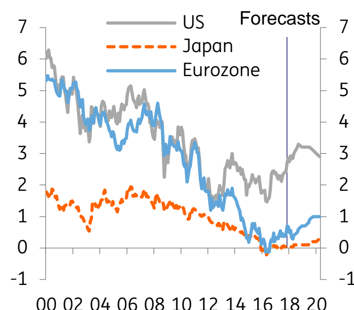
Trump's Trade Gamble

GDP growth (%YoY)



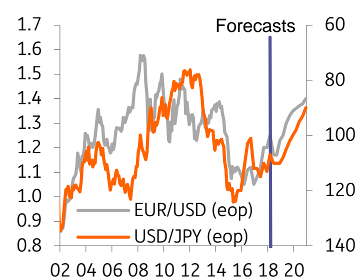
Source: Macrobond, ING

10yr bond yields (%)



Source: Macrobond, ING

FX



Source: Macrobond, ING

President Trump vowed to "Make America Great Again" and a strong economy with low unemployment has been achieved. This success has emboldened Trump to push harder on trade. Although the EU and the US are still exploring possible solutions, business is braced for a step-up in protectionist policies over the summer. The uncertainty such behaviour generates implies downside risk for financial market and boardroom sentiment. This could be even more dangerous for the global economy than the direct impact on trade.

There is limited evidence so far that protectionist measures are derailing the global economy, but growth risks are skewed towards the downside over the summer. The coming months could see $600bn of trade hit with tit-for-tat tariffs between the US and China. Worse for Europe, there is also the possibility that auto imports to the US will also attract tariffs of around 20%.

On their own we are probably talking an impact measured in only one or two tenths of a percentage point on global growth. However, the impact on financial markets and economic confidence may be much larger and lead to a more substantial slowdown in activity. Steep equity market falls and a downturn in investment and job creation could trigger a greater willingness to compromise.

However, we doubt President Trump will change tack before the 6 November mid-term elections. His personal approval ratings have been trending higher and there has been some evidence of Republicans doing a little better in the polling. Nonetheless, right now the Republicans look set to lose control of Congress, which could open the door to an eventual shift in policy.

The US economy itself is performing well. 2Q GDP growth is likely to come in at around 4%, while inflation is set to rise above 3% in the next couple of months. With unemployment at 50 year lows, the Federal Reserve will stick to its "gradual" policy tightening of one hike per quarter, but the trade related drags on activity will slow the pace of hikes next year.

Trade war fears and financial deleveraging reform pose clear downside risks to Chinese growth. However, we are now seeing both fiscal and monetary policy loosening from authorities. The People's Bank of China has ceased rate hikes and has cut reserve requirement ratios, while government spending is picking up. At the same time the currency is weakening under market forces, which should all help to limit the damage.

Under the surface of falling sentiment indicators, political tensions in several countries and trade war fears, the Eurozone economy is continuing its solid recovery. As a result, the European Central Bank (ECB) can bring its quantitative easing (QE) programme to an end this year, but interest rates will likely be left unchanged for at least another year.

Japan is not growing as fast as it was, and will not be immune to a looming global trade slowdown. But the domestic economy is looking a little more robust than for some time, and this could help provide some offset to a poorer export backdrop.

FX markets continue to be governed by trade tensions and firm US interest rates. This is a dangerous cocktail for emerging markets as an asset class and supportive for the dollar in general. Risks to our EUR/USD forecasts are firmly skewed to the downside.

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US: Keep pushing…

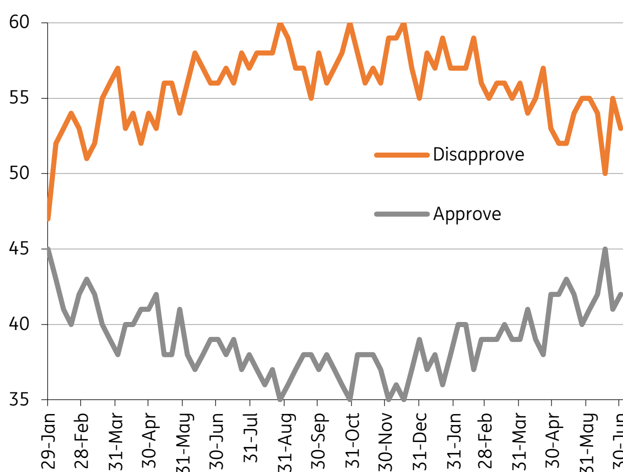
Trade tariffs have had little economic impact so far

President Trump's protectionist push had been blamed by some analysts as the reason why 1Q GDP came in at a relatively disappointing 2% annualised growth. However, we think bad weather and the "typical" seasonal soft patch at the beginning of the year offer a better explanation. There is little evidence that the modest trade tariffs enacted so far have had much impact, especially with high frequency indicators suggesting that the US economy probably grew by 4% in 2Q18.

Economic momentum is strong and tariffs on their own are unlikely to cause significant pain

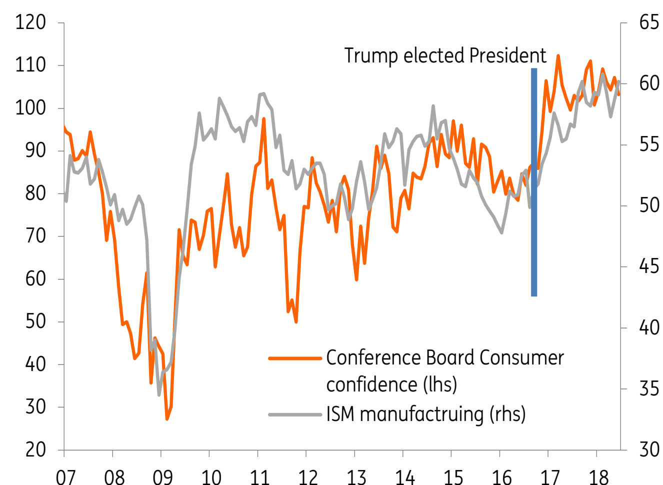
Unemployment is at a 50 year low, business and consumer surveys are close to all-time highs and wages are finally showing some evidence of a long-awaited pick-up as firms struggle to find suitable workers. As such, economic momentum is strong and it will take a lot to derail this story. Trade tariffs are unlikely to do that directly themselves.

Fig 1 President Trump's approval rating



Source: Gallup

Fig 2 The Trump bump?



Source: Macrobond

There is some evidence of higher prices and supply issues, but profitability is not being severely dented

Companies have complained of higher costs and sourcing issues as a result of tariffs, but in an environment of strong demand we have seen few signs of real pain yet. Home builders have been amongst the most vocal with lumber, steel and aluminium tariffs contributing to a $9000 increase in the cost of constructing a single family home over the past 18 months. However, home prices have risen more over that time period.

The Fed will continue hiking interest rates as inflation pushes above 3%

Inflation pressures continue to build with the headline and core (ex food and energy) measures for both consumer price inflation and the personal consumer expenditure deflator at or above the Federal Reserve's 2 % target. With oil prices continuing to rise, wages ticking higher and supply bottlenecks added to price pressures we look for headline inflation to push above 3% in coming months. This should see the Fed stick with its 'gradual' policy normalisation plan, which essentially means a rate hike every quarter.

But businesses are becoming more alarmed by the ratcheting up of tensions

While the story on growth is very positive for now we have to acknowledge escalating trade tensions do risk altering the story. This was reflected in the write-up of the June ISM survey which stated that "demand remains robust, but the nation's employment resources and supply chains continue to struggle. Respondents are overwhelmingly concerned about how tariff related activity is and will continue to affect their business".

Trump's popularity is improving and this may push him on to make more demands

Business is likely to become more concerned over the summer. President Trump's personal approval ratings have been trending higher, boosted by the strong economy and his position on what he terms "unfair" trade practices of other nations. He appears emboldened by this and is pushing on with further rounds of tariffs that will see countermeasures from the Chinese. As such, our trade team believe that we could see

another $600bn of US-China trade hit by tariffs this month with the potential for Trump, after consultation with industry, to impose levies on foreign cars.

Tariffs by themselves may not cause too much damage to the US economy…

This will put up the cost of doing business and see consumers pay higher prices, restrict choice and hurt US exporters. However, given the US is a $20trillion economy and is less trade dependent than Europe and Asia we are probably talking direct impacts on growth of the order of a couple of tenths of a percentage point. Moreover, the ongoing support of tax cuts should provide decent underpinnings for activity.

…but they could hit sentiment and consumer and business spending, particularly if asset prices fall

What worries us more is the uncertainty an escalation of tensions generates. Businesses may become more nervous about expansion plans as they fear what happens next, leading to a slowdown in investment spending and job creation. This perception of risk can also quickly sap consumer sentiment. Financial markets are clearly concerned by the situation and with any negative headlines on trade prompting swift falls. A correction in asset prices could compound the downside risks for economic activity.

Uncertainty is never good for growth and there is little prospect of calm returning ahead of November elections

We doubt we will see any de-escalation before the November 6 mid-term elections. Despite Trump's improving approval rating the Republicans continue to lag in the polls behind the Democrats. Trump is likely to sense he needs to get the core Republican vote out and pushing aggressively on trade can help him do that.

The Democrats may win control of Congress after the Nov 6 mid-terms

That said, opinion polls suggest there is a strong chance the Democrats can win the extra 25 seats they need to take control of the House of Representatives – they are 5-10 percentage points ahead in most national polls. As for the Senate, the Democrats need to hold onto their seats and then topple two of the eight Republican senators that are up for re-election (A senator's term is six years with a third of the Senate up for re-election every two years).

Post-election we see greater opportunity for deals to be struck

If we are right and much of the trade rhetoric is tied to the upcoming US election then there is scope for a deal soon afterwards. It may well be that it is partially tied to European defence spending given his ongoing issue with a lack of expenditure by NATO partners. Trump still talks about getting a deal and we have to remember that talks over the future of NAFTA continue quietly in the background despite his threats to rip it up.

However, should Trump push too far then the risks for growth and his own political future will intensifu.

Nonetheless, he will need to be cautious about pushing too far, hurting business and market sentiment and risking a more serious downturn. Not only could this lead to sharper revisions to growth, policy rates and bond yields forecasts, but it could also jeopardise any chances of re-election in 2020.

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Eurozone: The ECB takes it slowly

The ECB is trying to look through some of the mixed messages on the economy

Political tensions have ebbed away, somewhat, at least for the time being. The Eurozone is back to what it does best: muddling through. At the same time, the mist of weakening soft indicators and solid hard data is thickening. While this has increased downside risks for the growth outlook, it did not prevent the ECB from taking a huge step towards the end of quantitative easing (QE).

Nonetheless, the outlook is looking more challenging with a large degree of uncertainty

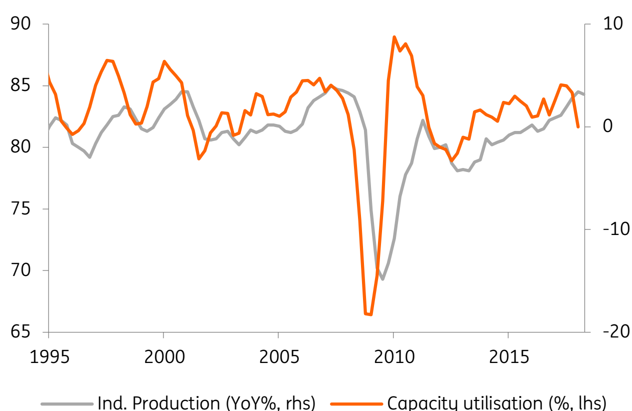
Economic data released over the last weeks still leave policy-makers and forecasters a bit clueless. How strong is the Eurozone recovery really? What ended the year 2017 at record highs, almost endless upward revisions of growth forecasts and a general feeling of Europhoria has reached the middle of the half with diminished expectations, dented enthusiasm and even concerns about the beginning of the end. The gradual decline of confidence indicators since the start of the year as well as erratic and often disappointing hard data contributed to increased nervousness about the state of the Eurozone

economy. Soft patch, severe downswing or simply the transition towards normalisation? What is it?

We believe the Eurozone is in a transition towards more moderate rates of growth

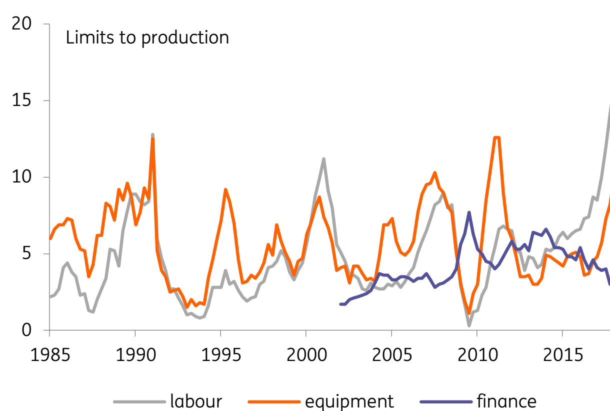
In our base case scenario, the Eurozone economy is neither on top of the world neither in the depths of despair. It is simply in a transition period towards more moderate growth rates. Despite the gradual decline since the start of the year, the absolute levels of confidence indicators remains high and points to continued solid growth. At the same time, sound domestic fundamentals, low interest rates and the renewed weakening of the euro exchange rate should support the Eurozone recovery in the coming months. In fact, there could even be some positive surprises, simply given that expectations have dropped so sharply over the last six months. The bar to a positive surprise has clearly been lowered.

.Fig 3 Production and capacity utilisation



Source: Thomson Reuters Datastream

Fig 4 Limits to production



Source: Thomson Reuters Datastream

Downside risks have increased

Unfortunately, the downside risks to the growth outlook have increased in recent months. Political tensions in several Eurozone countries, fading efforts to further reform the monetary union and trade tensions are the three most prominent potential risk factors.

Politics remains centre stage with Italy set to remain in the spotlight over the summer

Political tensions in Italy and Germany have clearly spooked financial markets. However, latest developments point to typical European solutions to these tensions: a fudge, soothing short-term fears without fully taking away long-term concerns.

We await Italy's budget plan

In Italy, the new government has so far avoided a collision course with Europe on fiscal and economic policies. The coalition partners seem to agree on at least keeping the nominal fiscal deficit below 3% of GDP in the coming years. Italy's finance minister Giovanni Tria suggested that the structural fiscal deficit would not worsen significantly in the near term. At the same time, however, let's not forget that prime-minister Giuseppe Conte had promised earlier to implement both a flat tax of two rates and a guaranteed income of 780 euro per month. It remains to be seen how these two measures can be moulded into a budget plan which stays within the boundaries of Europe's fiscal rules. Here, things could heat up again after the summer.

Migration continues to dominate German politics

In Germany, the tensions on how to deal with migrants almost led to a collapse of the government. Even though chancellor Angela Merkel made first steps towards a European solution at the last European Summit, the Bavarian sister party CSU pushed for more concessions. By announcing possible transit zones for asylum seekers, the German government seems to have avoided a fully-fledged government crisis. However, trust within the government has taken a severe hit and tensions could easily flare up any time again, on almost any topic.

Political instability looks set to persist

The political instability in Germany will make it even harder to see Eurozone leaders to agree on anything substantial with respect to further Eurozone reforms any time soon. While France and Germany seem to have found some common ground, even including a

Further integration seems some way off

budget line for the Eurozone, other governments are extremely reluctant to agree on anything that only remotely smells like transfers. Consequently, beyond making the European Stability Mechanism (ESM) a financial backstop for bank resolutions, it is hard to see how the Eurozone will become more integrated in the coming years.

Trade tensions increases our nervousness on the economic outlook

Finally, a further escalation of the trade tensions hangs like a Damocles sword over the growth outlook for the Eurozone. Even though the direct impact from a further escalation should be manageable (the Ifo institute estimates that 25% import tariffs on European cars could lower Eurozone GDP by less than 0.1%) and even be offset by the weaker euro exchange rate, the pure impact on confidence could hit the Eurozone already in the coming months.

Nonetheless, the ECB seems intent on concluding its QE programme

Unless any of the above risks actually materialises into a tangible and significant downswing of the economy, the ECB looks determined to bring its QE programme to an end at the end of the year. The announcement after the last ECB meeting in June that the ECB anticipates a lowering of the monthly purchases from 30bn euro to 15bn euro after September and an end of the net purchases in December delivered a very clear message.

But with core inflation remaining so low, interest rate hikes are at least a year away.

At the same time, however, the ECB has started to put more emphasis on its forward guidance, stating that it expects interest rates "to remain at their present levels at least through the summer of 2019". It is obvious that the ECB would like to return to interest rates, instead of QE, as the main policy instrument. Against the background of only a very gradual increase in core inflation and growth remaining close to, but probably below, potential, we expect the ECB to first hike the deposit rate and then the refi rate before the end of 2019. A very dovish 'tapering'…

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UK: The big Brexit rethink

Theresa May is pushing a new Brexit direction

With the Brexit clock ticking, and concerns mounting about future frictions at UK borders, Prime Minister Theresa May is convening her Cabinet ministers for an 'away-day' in a bid to forge a unified stance on the future trading relationship.

Of course, this isn't the first time ministers have met like this. Cast your mind back to February, when the Cabinet gathered at Chequers (the PM's rural retreat) and agreed to pursue the so-called "three-baskets approach" – a policy that would see the UK remain aligned to EU rules in some economic areas, whilst diverging in others.

The Government's previous proposal was quickly rejected by the EU

This approach was quickly met with a cold reception in Brussels. EU Officials were primarily concerned about cherry-picking, but the bigger short-term issue was that it would likely result in friction on the Irish border. Two subsequent customs proposals made by the UK – so-called "max-fac" and "customs partnership" models – have been widely rendered as either politically or practically implausible.

May is likely to propose a customs union & single market for goods option

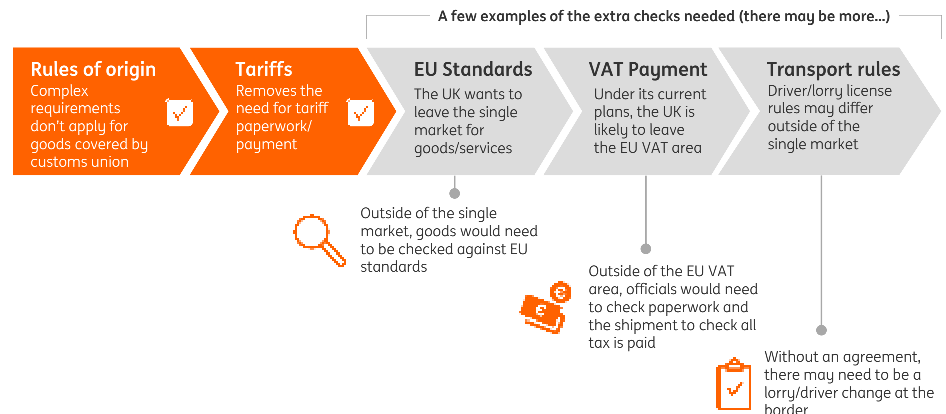
So at Friday's meeting, PM May will reportedly propose a "third way". This is likely to amount to the UK joining a customs union with the EU, as well as remaining in the single market for goods (including agriculture) – albeit probably under a different name.

This would help resolve the Irish border problem

In principle, this resolves a number of issues – not least the fact that it would remove the need for customs infrastructure on the Irish border. Remaining in the customs union would mean firms don't have to embroil themselves in complex rules of origin checks, or pay tariffs on the goods being transported. Staying within the single markets for goods would remove the need for checks to ensure compliance with EU standards. Assuming the UK also decides to remain in the VAT area, this should result in a much smoother customs process. Of course, this is relevant not just for Northern Ireland, but all of the

UK's ports, which would go some way to preventing friction at the biggest one of all – Dover.

Fig 5 Customs union on its own doesn't mean frictionless borders...



Source: ING

The EU is still likely to view this as cherrypicking

So will the EU accept this new vision? Well, the most obvious (and probably most likely) reaction is "absolutely not". In Brussels' eyes, this still fundamentally amounts to cherry-picking as long as services is omitted – the major concern being that a deal that sees the UK flourish outside of the EU could encourage others to seek similar terms.

But some on the UK side have been keen to point out that the EU has accepted this exact arrangement before. Switzerland is in the single market for goods only, while smaller territories such as Jersey also trade with the EU under similar terms. Brussels has also already proposed the customs union + single markets for goods option as a backstop for the Irish border.

On the Swiss model though, with hindsight the EU reportedly views this deal as a mistake. In reference to this, Stefaan De Rynck, a key advisor to Michel Barnier, tweeted recently that "the integrity of the single market is more important today than ever before". And on Jersey/Northern Ireland, the EU would likely contest that it's one thing offering a bespoke agreement in these smaller, politically special cases, and quite another to offer it to a major trading partner.

The EU will likely reject May's new model, although perhaps not unanimously

This means the EU is likely to reject the UK's proposal, although whether this rejection is unanimous is less clear. After all it is arguably the first serious and potentially viable proposal for the future partnership that the UK has put on the table. According to some reports, this is already proving to be a tempting offer outside of Germany and France.

But even if a more flexible EU approach were to prevail, this assumes the UK government can get behind the proposal in the first place. There's no guarantee that will be the case.

The Brexiteers could also find the new model unacceptable

For the likes of Foreign Secretary Boris Johnson and International Trade Secretary Liam Fox, May's proposal could be unacceptable. The idea of becoming a rule-taker would be incompatible with the Leave campaign mantra of "taking back control". Brexiteers also argue this would tie the government's hands when negotiating access for services.

Then there's the obligations that single market membership – even if only partial – would involve. Budget contributions, European Courts of Justice oversight, as well as some form of free movement of people, to name just three. While the EU might ultimately agree to a fudge for some of these issues – payments could be made under the guise of aid payments for instance, while the EFTA court model has been suggested as a possible ECJ middle ground – Brexit-supporting ministers are unlikely to accept this. Some high-profile ministerial resignations therefore shouldn't be ruled out over the next few weeks, although whether this is enough to topple the Prime Minister is not so clear.

May's new proposal does little to help the UK service-sector

But even if hypothetically the EU and UK government can be persuaded by the proposal, is it good enough for the UK economy? Well whilst it would remove costly and time-consuming processes for goods-producers, it would do little to help the much larger service-sector. For instance, banks would still likely lose the right to passport from the UK to the EU27. And as many commentators have pointed out, trade in goods and services are increasingly intertwined. Products often rely on foreign design, finance and transport services as part of the purchase.

With this in mind, the UK government is also reportedly still pushing for mutual recognition when it comes to services. But even if it says yes to the single market for goods, the EU is likely to remain heavily resistant.

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China: The retaliation cycle

The trade war officially begins

By the time this note is published, the US should have imposed tariffs on Chinese goods, and China should have immediately retaliated. It would be an upside shock to the global market if otherwise.

But let's be realistic. The US administration is keen to close the trade deficit gap, and it believes that imposing tariffs on China can do the trick - though we do not agree with this justification. With an uncompromising attitude, China will immediately retaliate on US, likely by imposing tariffs on US goods exported to China, though it could also done using other means.

The way the momentum of this trade evolves is controlled by US

We expect that this is just the beginning of the trade war. The US will likely retaliate, and though this may not be as timely as China's retaliation, it is just a matter of time. And when the US does retaliate, China will too probably without any delay. So, the way the momentum of this trade evolves is controlled by US. It can retaliate quickly to rock the market, or it can retaliate slowly so that the market can react with detailed analyses.

Fig 6 Chinese Manufacturing PMI & New orders

Source: Bloomberg

Export orders have slipped

So how could this affect the economy? Well, tariffs do not only reduce the profit margins of exporters, but could also mean that export orders lose out to other economies that trade similar goods. China exports would be hit, and supply chain industries in China would be affected. This includes logistic services and packaging manufacturers, as well as the affected exporters' suppliers. This has been reflected in lower PMI readings (driven by lower export orders), which would imply lower 2H18 export activities. We suspect the negative impact from the trade war has yet to be fully reflected in the economic data.

Financial deleveraging reform is also biting

But the threat from the trade war, that has delayed investment decisions, is not the only negative factor when we consider economic growth. Financial deleveraging reform is biting economic activities, especially in infrastructure investments, and therefore we have lowered our 2Q18 GDP forecast from 6.8%YoY to 6.7%.

Monetary policy has been loosened

Having said that, we are still optimistic for economic growth in 2H18 given the supportive measures being implemented by the government. Firstly, by not following the Fed to hike the 7-day reverse repo and instead cutting the reserve ratio, the central bank (PBoC) has started to switch the stance of monetary policy from tightening to loosening. These policies should help stabilise borrowing costs faced by corporates, especially SMEs which could be hurt the most by trade war.

There's fiscal support too – particularly in technology

Secondly, there's fiscal spending, for instance the participation in technology-related investment pools has kicked off. Though these investment pools would not benefit export sectors, they would directly contribute to GDP, and would increase the ability of China to have its own high-tech components (for example advanced semiconductor chips) in the future.

Fiscal support for consumption could help offset any fall in export demand

We also expect other fiscal support - e.g. restructuring the individual salary tax - would support domestic consumption, and could increase domestic sales to reduce the impact of tariffs on exports. In the past, this has not proved easy, because goods destined for export were considered to be too expensive for the domestic market. But this has changed. We expect that both the export market and the domestic market are now more compatible with an increasing middle-income class.

We look for USD/CNY at 7.00 by year-end

Put this all together, and our baseline case is that GDP will rise in the second half of 2018 at a rate of 6.7%YoY. We have also revised our end-year USD/CNY forecast to 7.0 from 6.60, and forecast the same USD/CNH as we believe the spread between CNY and CNH will continue to be tiny.

This revision reflects the fact China has room to let the currency weaken by market forces in the middle of a trade war because it is opening up its market to attract more capital inflows. It lessens our previous worry that a weaker yuan would deplete the foreign exchange reserves.

7.00 per dollar seems a steep depreciation but this speed is in line with our forecasts of other Asian currencies. China cannot defy gravity when it comes to appreciating against other Asian currencies, especially against Japan, South Korea and Taiwan because these are competitors in electronic exports. China would also not depreciate against these Asian currencies – China won't initiate a currency war in the middle of trade war.

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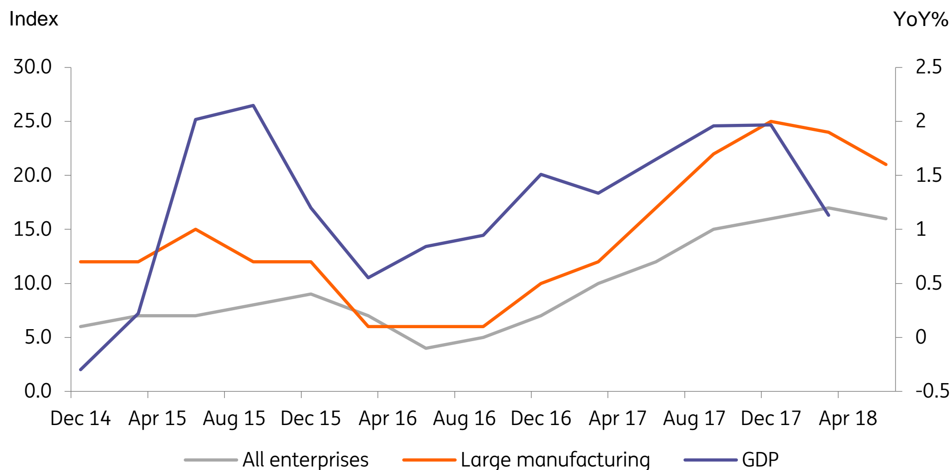
Japan: Momentum slipping

Growth appears to have peaked

Japanese growth appears to have peaked in 1Q18, if the latest Tankan survey can be taken at face value, and unlike the official Japanese GDP data, it probably can. But although the headline index fell, and more than had been expected, there are one or two reasons not to get too downbeat about the Japanese economy just yet.

Fig 7 Japan Tankan survey & GDP



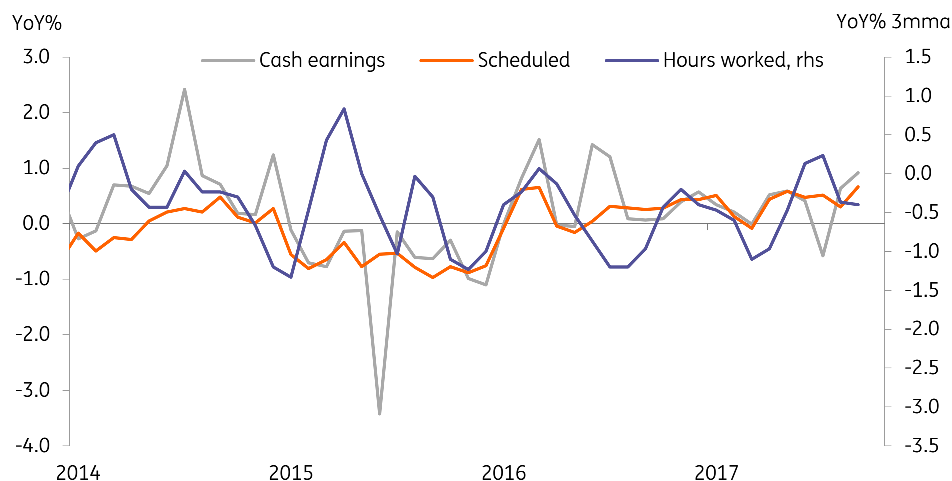
Source: Macrobond

Sentiment of large manufacturers has dipped

For starters, the non-manufacturing surveys, and diffusion indices for smaller firms was a lot less negative (indeed, sometimes actually rose) than the large manufacturing series. Though this might simply be a factor of timing. Large manufacturing firms are typically more export-oriented, and so have probably been more quickly affected by plunging sentiment about trade and export orders than their more domestically oriented and smaller suppliers and service sector support firms. Should the global trading environment worsen further - and we expect it to do so - then it is probably only a matter of time before these other firms go the same way as their larger manufacturing counterparts.

There is just one, rather glaring issue with that downbeat view, and that is investment intentions.

Fig 8 Japan cash earnings



Source: Macrobond

But investment intentions have continued to pick up pace

These have really picked up the pace. And the thing about investment is that when it is growing, it usually does so far faster than the underlying pace of other GDP growth, lifting other sectors in its wake.

Admittedly, the profit outlook detailed in the latest Tankan survey wasn't too impressive, but that, in turn, may reflect some higher employment, even stronger wages growth. Scheduled cash earnings in April slid back to 0.9%YoY, but this looks like noise, and the recent sharp uptrend in wages growth still looks firmly in place.

Overall, the outlook still looks reasonably good

So all things considered, the Japanese outlook still remains a reasonably good one, with stronger domestic demand helping to offset what looks like an unavoidable, but moderate slowdown in the manufacturing export sector.

All this still leaves the Bank of Japan (BoJ) wrestling with a policy target which it will never reach (inflation at 2.0%), and the latest tick higher by the Tokyo headline CPI index still leaves it barely over a quarter (0.6%YoY) of the full target.

The BoJ has continued to backslide on the pace of asset purchases

10Y Japanese government bonds (JGBs) have seen their yields sliding in recent weeks, and they are now just 0.033%. With little pressure for yields to do anything but decline, the BoJ has continued its policy of opportunistic skipping of scheduled bond purchases and flagrant backsliding compared to their targeted pace of asset accumulation. We can only expect this backsliding to continue, even increase as time goes on.

Meanwhile, the cover the BoJ has been waiting for from the European Central Bank (ECB) tapering its policy has not been forthcoming, as clever sleight of hand by the ECB has enabled them to move towards a taper, even the end of negative deposit rates, but in such a slow and disappointing fashion in terms of foreign exchange markets, that it has provided little if any diversion for the BoJ to undertake a similar directional move. This is unlikely to change in the current environment, and we have pushed back the timing of the BoJ's own end to negative rates until 2020.

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FX: Evaluating the scenarios

This is a particularly uncertain time for FX markets. Where the escalation in the global trade war ends nobody knows. This makes a baseline FX scenario exceptionally difficult.

We believe there's more value in outlining potential scenarios.

Rather than delivering back-to-back cuts in our baseline EUR/USD profile (despite mounting pressure in that direction) this month we believe there's more value in outlining potential scenarios. Our full scenario analysis can be found here.

Below we summarise four potential paths for EUR/USD into 2019, all supported by various assumptions for some of the key inputs, such as rate spreads and risk premia.

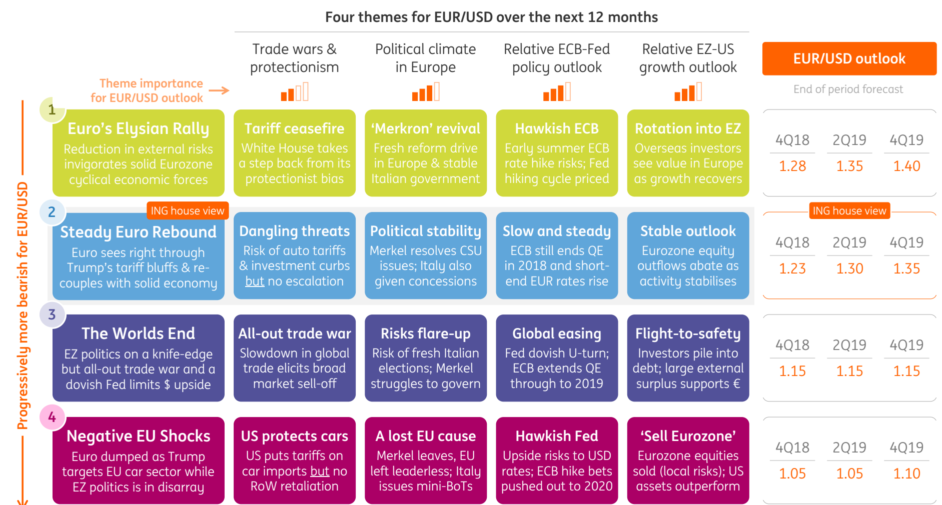
EUR/USD could potentially see 1.10 this summer

Compared to a tentative baseline of EUR/USD recovering to 1.23 by the end of the year, risks look clearly skewed to the downside. Were the Trump team to accelerate their review of auto imports and formally adopt the 20% tariffs on EU auto imports, we could potentially see 1.10 this summer. A scenario of 1.05 would, however, require: a) peak rate divergence where the US economy/Fed pricing is immune to rising trade tensions and b) peak pessimism on German and Italian politics.

It also remains a challenging time for EM FX. Slowing world trade and the Fed potentially taking policy into 'tight' territory could see the headwinds to EM turn into a hurricane.

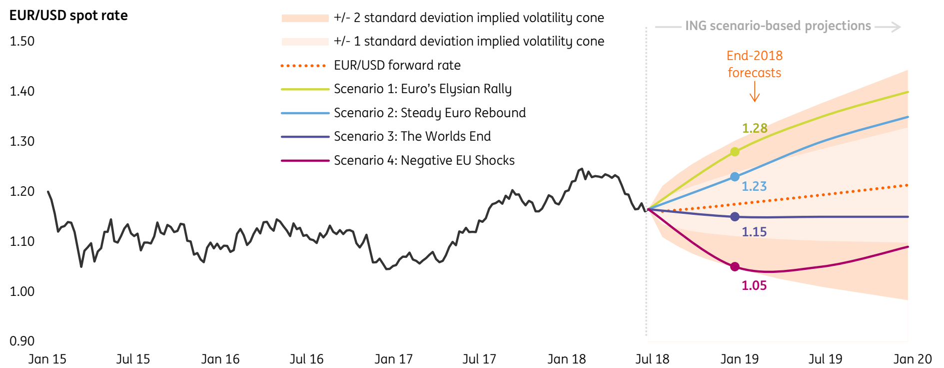
Fig 9 4 scenarios for EUR/USD into end 2019

The landscape for global markets is pretty murky but here are four potential EUR/USD paths



Four themes for EUR/USD over the next 12 months

	Trade wars & protectionism	Political climate in Europe	Relative ECB-Fed policy outlook	Relative EZ-US growth outlook	EUR/USD outlook (End of period forecast) 4Q18	2Q19	4Q19
1 Euro's Elysian Rally: Reduction in external risks invigorates solid Eurozone cyclical economic forces	Tariff ceasefire: White House takes a step back from its protectionist bias	'Merkron' revival: Fresh reform drive in Europe & stable Italian government	Hawkish ECB: Early summer ECB rate hike risks; Fed hiking cycle priced	Rotation into EZ: Overseas investors see value in Europe as growth recovers	1.28	1.35	1.40
2 Steady Euro Rebound (ING house view): Euro sees right through Trump's tariff bluffs & re-couples with solid economy	Dangling threats: Risk of auto tariffs & investment curbs but no escalation	Political stability: Merkel resolves CSU issues; Italy also given concessions	Slow and steady: ECB still ends QE in 2018 and short-end EUR rates rise	Stable outlook: Eurozone equity outflows abate as activity stabilises	1.23	1.30	1.35
3 The Worlds End: EZ politics on a knife-edge but all-out trade war and a dovish Fed limits $ upside	All-out trade war: Slowdown in global trade elicits broad market sell-off	Risks flare-up: Risk of fresh Italian elections; Merkel struggles to govern	Global easing: Fed dovish U-turn; ECB extends QE through to 2019	Flight-to-safety: Investors pile into debt; large external surplus supports €	1.15	1.15	1.15
4 Negative EU Shocks: Euro dumped as Trump targets EU car sector while EZ politics is in disarray	US protects cars: US puts tariffs on car imports but no RoW retaliation	A lost EU cause: Merkel leaves, EU left leaderless; Italy issues mini-BoTs	Hawkish Fed: Upside risks to USD rates; ECB hike bets pushed out to 2020	'Sell Eurozone': Eurozone equities sold (local risks); US assets outperform	1.05	1.05	1.10



Source: ING

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Rates: Just 30bp, seriously?

The 30bp German 10yr yield is too low to be explained purely by fundamentals

The fall to sub 30bp for the 10yr German yield is remarkable when contextualised against an ECB intending to 1. End quantitative easing (QE) this year and ready to, 2. Raise rates next year. While there is lots of talk about a weakening economy, that's neither the driver nor a persuasive argument. We think there two dominant influences, which added to a number of sideshows, are keeping rates under wraps.

We think that residual Eurozone cohesion concerns are a factor, as it dollar strength

The first of the dominant influences is dollar strength, and the risk that more could still be in the works. The transition mechanism here is chiefly through emerging markets, as the firmer dollar has exposed vulnerabilities in the likes of Turkey and Argentina a.o. While there has not been mass contagion, there has been correlation and outflows generally from risk assets in consequence. The counter flow is into core bonds.

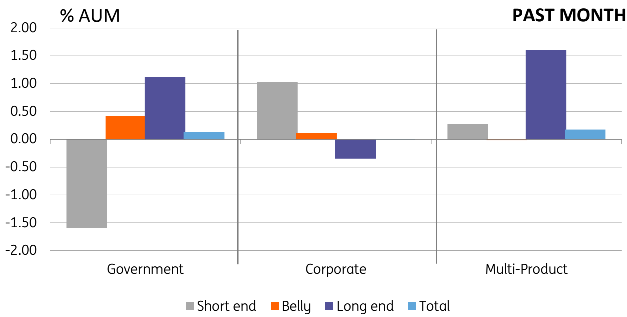
There is also a relative value element in play, through correlation in risk assets

And by the way, the ECB's intension to exit QE has seen the bid falter in investment grade Euro corporates too, adding to strain in lower rating product. The second dominant influence is Italy and the wider Euro project. This is a big driver for flows into Germany in particular. A decent rump of the bid to bunds is driven by its hedge quality should things ever turn sour; effectively it is a long in a deutschmark proxy. Pension funds will always be forgiven for over allocating in the ultra-safe core.

And this plus trade war talk has caused the market to question rate hike ambitions

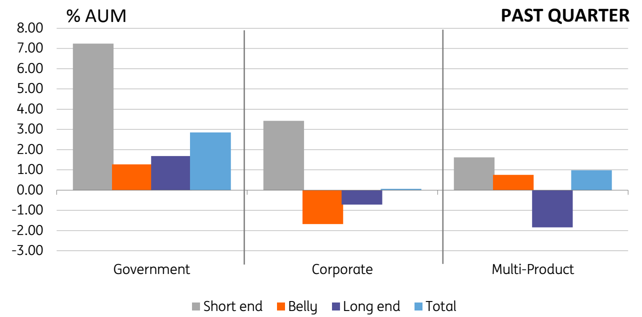
The various sideshows then centre on geopolitics, the trade war narrative (which risks becoming a dominant influence, but we're not there quite yet) and market chatter on resistance to future hikes from central banks. For example, there is no conviction rate hike discount for the Fed above 2.75%, and many doubt the ECB will be in sync enough with the current upturn to get any material traction on a 2019/20 rate-hiking cycle.

Fig 10 Change in assets under management – last month



Source: EPFR Global, ING estimates

Fig 11 Change in assets under management – last quarter



Source: EPFR Global, ING estimates

In consequence investors have been nibbling in the long end again, reducing duration shorts

This all leaves investors with a nervousness on being too short carry, and the average investor has been slowly liquidating some of the over-exposure on the front end of the yield curve and fading longs back into belly and long end funds. This can be clearly gleaned from flows data in the past month (Figure 10), although on a 3mth snapshot (Figure 11) we still find a heavy overweight build in the front end over the back end (implied duration short).

Which means the 3% 10yr US remains in the rear view mirror.

But contemporaneous data are still burning red, so don't bet this is one-way traffic

In consequence, the 10yr Treasury yield finds the path of least resistance is lower, with 3% now seen as a hurdle too far (at least for now). That all said, our US macro model for rates continues to flag fair value at north of 3% but below 3.5%; essentially we find that market rates should be some 100bp above the normal rate which we identify as 2.25% (flat to core inflation). Bund yields would correlate higher, and should rise by more.

As our US economist eloquently notes, this is a near 7% nominal growth rate environment. It won't last, but there is a window ahead for rates to re-test higher again.

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Fig 12 ING global forecasts

	2017					2018F					2019F					2020F				
	FIRST QUARTER	2Q	3Q	4Q	FY	1Q	2Q	3Q	4Q	FY	1Q	2Q	3Q	4Q	FY	1Q	2Q	3Q	4Q	FY
United States																				
GDP (% QoQ, ann)	1.2	3.1	3.2	2.9	2.3	2.0	4.0	3.3	2.3	2.9	1.5	2.2	2.0	1.9	2.2	1.7	1.8	1.8	1.7	1.8
CPI headline (% YoY)	2.6	1.9	2.0	2.1	2.1	2.3	2.7	2.9	2.6	2.6	2.3	2.4	2.4	2.3	2.3	2.3	2.2	2.1	1.9	2.1
Federal funds (%, eop)[1]	0.75	1.00	1.00	1.25		1.50	1.75	2.00	2.25		2.50	2.50	2.75	2.75		3.00	3.25	3.25	3.00	
3-month interest rate (%, eop)	1.15	1.30	1.33	1.56		2.30	2.35	2.62	2.84		3.04	2.99	3.27	3.30		3.55	3.72	3.54	3.46	
10-year interest rate (%, eop)	2.40	2.30	2.30	2.40		3.00	3.00	3.00	3.20		3.30	3.20	3.20	3.20		3.20	3.10	3.00	2.90	
Fiscal balance (% of GDP)					-3.5					-4.0					-4.7					-5.0
Fiscal thrust (% of GDP)					0.0					1.4					0.8					0.4
Debt held by public (% of GDP)					76.1					77.3					79.8					83.0
Eurozone																				
GDP (% QoQ, ann)	2.7	3.0	2.9	2.8	2.4	1.5	1.5	1.7	1.6	2.0	1.7	1.6	1.6	1.7	1.7	1.7	1.6	1.2	0.9	1.6
CPI headline (% YoY)	1.5	1.3	1.5	1.4	1.4	1.3	1.7	2.0	1.6	1.7	1.4	1.6	1.6	1.7	1.6	1.7	1.7	1.7	1.7	1.7
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	0.25	0.25	0.25	0.50	0.50	0.50	0.50
3-month interest rate (%, eop)	-0.33	-0.33	-0.33	-0.33		-0.33	-0.33	-0.33	-0.33		-0.25	-0.20	-0.10	0.10	0.10	0.15	0.30	0.40	0.50	0.50
10-year interest rate (%, eop)	0.45	0.40	0.45	0.42		0.50	0.30	0.40	0.50		0.60	0.70	0.70	0.80	0.80	0.90	1.00	1.00	1.00	1.00
Fiscal balance (% of GDP)					-0.9					-0.9					-1.1					-1.0
Fiscal thrust (% of GDP)					0.2					0.2					0.3					0.1
Gross public debt/GDP (%)					89.2					87.7					86.1					85.1
Japan																				
GDP (% QoQ, ann)	1.9	2.3	1.6	1.3	1.7	-0.6	1.8	1.9	1.0	1.0	6.1	-7.8	1.2	1.4	0.7	1.1	1.1	1.1	1.1	0.6
CPI headline (% YoY)	0.2	0.4	0.6	0.6	0.5	1.3	0.7	1.0	0.6	0.9	0.6	2.2	2.2	2.3	1.8	2.3	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	0.0		0.0	0.0	0.0	0.0	
3-month interest rate (%, eop)	0.00	0.00	0.00	0.00		0.00	0.00	0.00	0.00		0.0	0.0	0.05	0.1		0.1	0.1	0.1	0.1	
10-year interest rate (%, eop)	0.10	0.10	0.10	0.10		0.10	0.10	0.10	0.10		0.1	0.1	0.1	0.1		0.2	0.2	0.2	0.3	
Fiscal balance (% of GDP)					-4.8					-4.1					-3.6					-3.0
Gross public debt/GDP (%)					221.0					223.0					224.0					226.0
China																				
GDP (% YoY)	6.9	6.9	6.8	6.8	6.9	6.8	6.7	6.7	6.8	6.8	6.7	6.7	6.6	6.6	6.7	6.6	6.5	6.5	6.4	6.5
CPI headline (% YoY)	1.4	1.4	1.6	1.8	1.6	2.5	2.0	2.0	2.1	2.2	1.9	1.9	1.9	2.0	1.9	2.0	1.9	1.8	1.7	2.0
PBOC 7-day reverse repo rate (% eop)	2.45	2.45	2.45	2.50		2.55	2.55	2.55	2.55	2.55	2.55	2.60	2.65	2.70	2.70	2.70	2.70	2.70	2.75	2.75
10-year T-bond yield (%, eop)	3.29	3.57	3.61	3.90		3.75	3.54	3.50	3.40	3.40	3.30	3.20	3.10	3.00	3.00	3.00	2.95	2.95	2.90	2.90
Fiscal balance (% of GDP)					-3.7					-3.5					-3.5					-3.5
Public debt, inc local govt (% GDP)					50.0					85.0					100					100
UK																				
GDP (% QoQ, ann)	1.3	1.0	1.9	1.6	1.5	0.9	1.9	1.5	1.8		1.5	1.4	2.3	1.7		2.1	1.7	1.7	1.7	
CPI headline (% YoY)	2.1	2.7	2.8	3.0	2.7	2.7	2.5	2.5	2.3	2.5	2.2	2.1	1.9	2.0	2.0	2.1	2.2	2.2	2.1	2.2
BoE official bank rate (%, eop)	0.25	0.25	0.25	0.50	0.50	0.50	0.75	0.75	0.75	0.75	0.75	1.00	1.00	1.00	1.00	1.25	1.25	1.50	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
3-month interest rate (%, eop)	0.35	0.35	0.35	0.52		0.60	0.80	0.80	0.80	0.80	0.85	1.05	1.05	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		1.45	1.48	1.70	1.80	1.80	1.90	1.90	2.00	2.00	2.0	2.1	2.2	2.2	2.2	2.2
Fiscal balance (% of GDP)					-2.5					-1.8					-1.7					-1.4
Fiscal thrust (% of GDP)					-0.5					-0.4					-0.4					-0.3
Gross public debt/GDP (%)					87.0					86.5					86.0					85.5
EUR/USD (eop)	1.08	1.12	1.20	1.20		1.25	1.17	1.17	1.23		1.25	1.30	1.33	1.35		1.36	1.37	1.38	1.40	
USD/JPY (eop)	112	115	110	113		107	110	110	110		108	105	102	100		98.0	95.0	93.0	90.0	
USD/CNY (eop)	6.89	6.78	6.65	6.51		6.28	6.67	6.80	7.00		7.00	6.80	6.60	6.50		6.5	6.4	6.4	6.3	
EUR/GBP (eop)	0.87	0.88	0.94	0.89		0.88	0.88	0.88	0.86		0.83	0.82	0.81	0.80		0.8	0.8	0.8	0.8	
Brent Crude (US$/bbl, avg)	55	51	52	61	55	67	72	70	68	69	64	66	67	66	66	61.0	66.0	71.0	66.0	66.0

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

Source: ING forecasts

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