

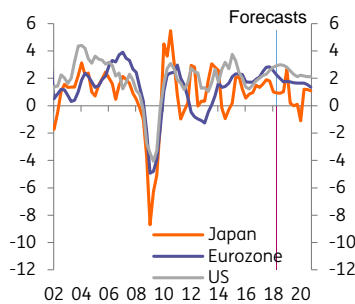
8 June 2018

Global

Monthly Economic Update

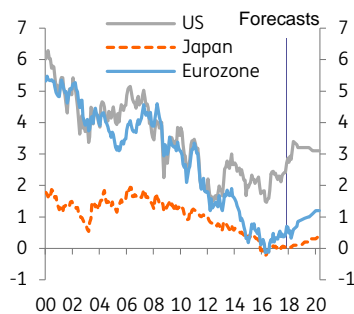
A long, hot summer...

GDP growth (%YoY)



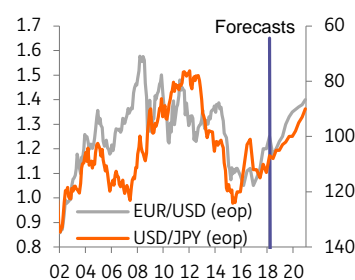
Source: Macrobond, ING

10yr bond yields (%)



Source: Macrobond, ING

FX



Source: Macrobond, ING

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The next few weeks present a number of political challenges that could upset global economic growth and financial market confidence. President Trump continues to ratchet up the rhetoric on trade as he aims to squeeze maximum concessions from Europe and China, but he risks pushing too far as retaliation measures escalate. At the same time European politics will remain in the headlines as Brexit talks go in circles and Italy potentially tests the EU's patience.

US growth appears to be bouncing back sharply in 2Q18, with households and businesses seemingly brushing aside trade war fears and higher fuel and borrowing costs. The jobs market is in great shape and is supporting confidence and spending, leaving the Federal Reserve on course to hike interest rates three more times this year.

Nonetheless, how President Trump proceeds on trade will be critical for both the outlook for US growth and the US political situation. The Republicans continue to lag behind in opinion polls, which means there is a strong probability the Democrats could win control of Congress. This will make passing Trump's legislative agenda much more challenging while raising talk of his potential impeachment.

As for the Eurozone, both Italian and Spanish politics offered some drama over the last few weeks and the current calm is not to be taken for granted. On the international scene trade tensions are not abating yet, an important threat to Eurozone export industries. Eurozone growth is still OK, but not more than that. That means that the ECB's exit from its easy monetary policy will be extremely slow, even though inflation has picked up.

In the UK, the Bank of England is probably leaning more towards an interest rate rise in August than the markets expect. But here again, the economic data risk being overshadowed by politics, as the UK debate over exiting the EU gets increasingly messy. The government is split over two proposed ways forward on trade, and in any case the EU has already cast doubt on both.

We think that the US trade disagreement with China not only reflects a desire to reduce the trade deficit, but also concerns about the rise of China and the perceived threat its "Made in China 2025" policy could spell for the US high-tech industry. As China opens up a range of markets to the world, the US risks being shut out as other countries build stronger trade ties in areas such as agriculture and energy.

In Japan, the first quarter slowdown was likely only a pause, nothing more. We anticipate activity strengthening through the second quarter – barring disasters, such as an all-out trade war.

Having been hit hard by Italian politics, the EUR is trying to make a come-back – helped by speculation over the end-point of ECB QE. Politics, global trade policy, higher core rates and idiosyncratic EM stories all prove risks for FX markets this summer. Given the lack of visibility, we're cutting our year-end EUR/USD forecast to 1.23 from 1.30.

As Italian fears slowly ease, and talk of ECB QE and Fed hikes restores, core rates have been able to regain some of their poise. We continue to look for the US 10-year yield to breach 3% and move towards 3.25-3.5% over coming months.

US: Trading on Trump

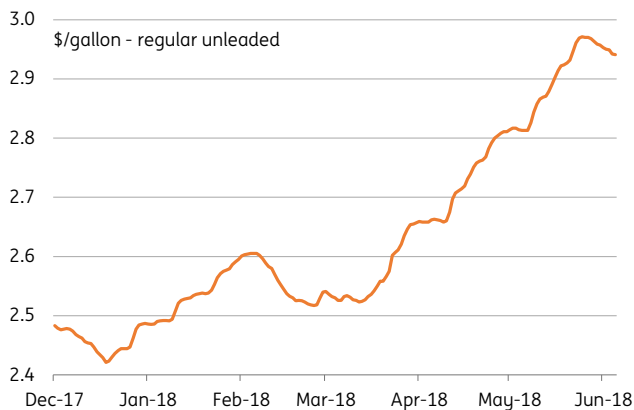
Growth looks set to rebound strongly in 2Q18 with a figure above 3% looking likely

Markets may be worried about trade wars and fuel costs, but households and businesses also see plenty of positives

The US experienced its “typical” soft patch in 1Q18, with statisticians continuing to puzzle over the reasons for this multi-year phenomenon. GDP growth slowed to a still very respectable 2.2% from the 3% rates averaged in the last three quarters of 2017, but high frequency data suggests that 2Q18 GDP growth will rebound above 3%. The Atlanta Fed’s “Nowcast” model suggests it could be as high as 4.8%. We are more cautious given that there is still a lot of data to come, but something north of 3.5% is possible.

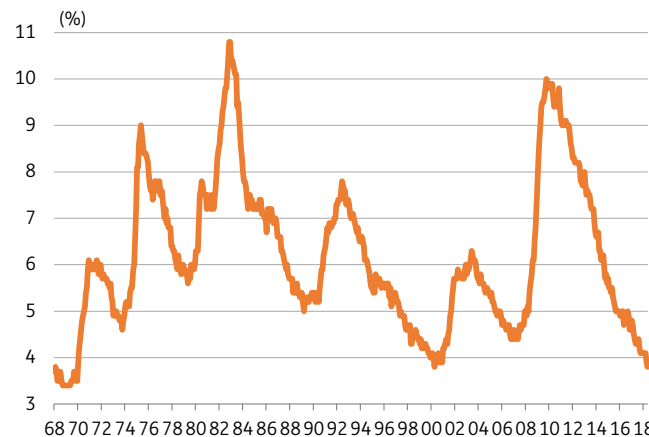
Either way, households and businesses appear to be brushing aside market fears of a trade war and the negative impact of higher gasoline prices and mortgage rates. The strength in the labour market and rising asset prices are driving consumer sentiment, which is at levels last seen 18 years ago. Employment growth is averaging 207,000 per month YTD in 2018 versus the 182,000 monthly average in 2017 and you have to go all the way back to December 1969 to find a lower unemployment rate. Wage growth remains disappointingly soft at 2.7%, but the broader employment cost index is rising more quickly at 2.9% for private wages. Coupled with tax cuts equating to around \$900 per household, real disposable household income is rising 2%YoY meaning that there is plenty of cash in consumers’ pockets.

Fig 1 US gasoline price



Source: Bloomberg

Fig 2 US unemployment rate over past 50 years



Source: Bloomberg

Corporates recognise trade protectionism as a threat...

... but supply bottlenecks are a bigger issue right now with worker compensation a particular focus

The Fed looks set to hike 3 more times this year

Likewise, businesses remain upbeat on their economic prospects despite concerns relating to the White House’s trade policies. The latest Federal Reserve Beige Book suggested survey respondents noted “some concern about the uncertainty of international trade policy” along with the “future effects on prices”. Nonetheless, the report concluded that “outlooks continued to be positive”.

Since President Trump stepped up the protectionist rhetoric, business surveys have strengthened and hiring remains robust with small business owners reporting having to raise wages more aggressively to fill positions - a net 35% of firms are having to raise worker compensation, the highest since records began 32 years ago. In fact supply bottlenecks are one of the biggest issues for companies with the National Federation of Independent Businesses reporting job openings are at an all-time high while nearly a quarter of firms are finding it difficult to get workers with the right skillsets.

Consequently, it looks as though the US economy is in a good position with the Federal Reserve set to continue implementing “gradual” monetary policy tightening. Given that we expect the economy to expand 3% this year and inflation measures to push above 2% - of the major inflation measures the Fed watches only the core personal consumer

Should trade fears increase we may see activity slow slightly and the Fed may choose to hike more moderately

We forecast two rate hikes in 2019 although would be tempted to put in three should trade tensions ease

The fact that the trade deficits with China and the EU continue to rise suggests a near-term de-escalation is unlikely

But there is increasingly vocal criticism at home

expenditure deflator is below 2% – we look for the Fed to hike rates again on June 13. We also expect them to follow up with additional rate hikes in 3Q and 4Q 2018.

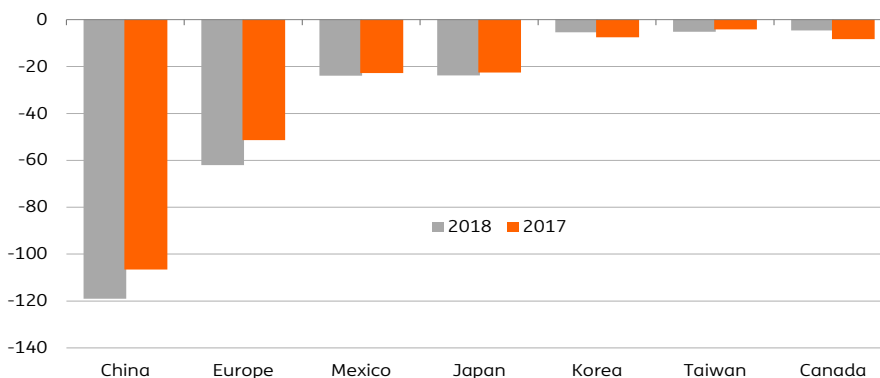
Nonetheless, trade fears could yet influence Fed policy. Should the situation escalate this could weaken sentiment, investment and hiring amongst businesses, while also putting up costs. Fed officials have made it clear they are more concerned about potential negatives for growth rather than upside risks for inflation resulting from tariffs, implying that it could result in slower policy tightening from the central bank.

Given this uncertainty we have retained our forecast that the Fed will hike rates only twice in 2019. Higher borrowing and fuel costs will gradually act as a brake on activity, while the recent strength of the dollar suggests inflation may not accelerate as much as we had feared. However, should trade tensions ease and wage growth accelerate in response to the very tight jobs market then we could see the need to insert a third hike.

Right now a de-escalation looks like wishful thinking. Trade deficits with China and the EU continue to widen and will likely continue doing so given the \$1.5 trillion tax cut the President handed households. Trump has threatened further rounds of tariff increases in response to China and EU retaliation measures, so room for a climbdown seems limited.

On the other hand, amid growing domestic corporate criticism regarding the economic damage tariffs can do, Trump may yet be prepared to let some of his more extreme demands slide. If other countries are prepared to offer concessions then there is scope for deals to be made and he can still claim a “victory”.

Fig 3 YTD US trade balance with selected partners (\$bn)



Source: Bloomberg, ING

The mid-term elections in November could be a factor as Trump seeks a “win”

If trade tensions escalate too much this could backfire on Trump and lead to defeat in the mid-terms

This is important given the upcoming November mid-term elections. Trump’s approval rating remains low at 40% and the Republican party continues to lag in opinion polls. However, there have been some tentative signs of a narrowing and if he can take a “win” on global trade and the economy continues to motor on then the risk that the Democrats win control of Congress may recede. As such he may be more willing to make concessions than is widely perceived.

Instead, if protectionist measures escalate and people start seeing prices rise and companies warn of tougher trading environments then the electorate may give him more than a bloody nose. Defeat would make it much easier to block his legislative agenda and would also give the Democrats greater power to launch investigations into his administration. It would also heighten talk of potential Presidential impeachment, with Trump’s recent comments about potentially being able to pardon himself regarding Robert Mueller’s Russia investigation adding a twist to the story.

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Eurozone: Politics to the fore again

Both Italian and Spanish politics offered some drama over the last few weeks, while on the international scene trade tensions are growing. Eurozone growth is still OK, but not more than that. That means that the European Central Bank's exit from its easy monetary policy will be extremely slow.

A coalition of ant-establishment parties at the helm in Italy

After months of paralysis, May saw a lot of drama unfolding in the Italian political arena. A coalition of the two anti-establishment parties, Lega and 5SM, was all but blocked by President Mattarella because of a euro-sceptic Finance Minister. After the proposal of a technical government, a plan that was doomed to fail from the outset, and a subsequent violent financial markets reaction, both populist parties eventually managed to clinch a deal, which got the presidential green light. This led to some relief on financial markets.

Some clashes with the EU likely...

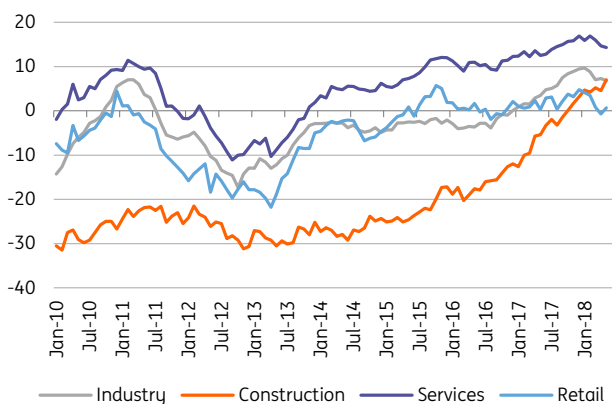
However, we will have to see to what extent the new Italian government will want to play along with European (fiscal) rules. Some of their plans would drive the budget deficit significantly higher, if implemented all at once. We expect that some compromise will be reached eventually, which could leave Italy with a mildly expansionary fiscal policy, though probably only after severe tensions with the EU. The good news is that in recent polls a comfortable majority of the Italian population still back the euro, which should make the coalition more reluctant to gamble with Italy's future as a member of the Monetary Union. Meanwhile, the Italian government will probably want to score some points on immigration and a recognition of Italy's burden at the June EU summit could help in this regard.

...though a majority of the Italian population wants to keep the euro

Spanish prime minister unseated

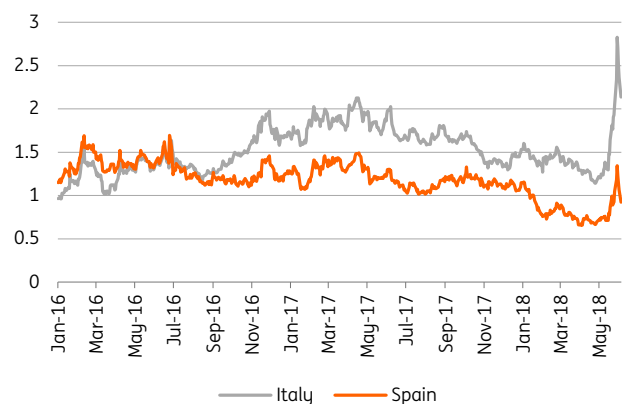
In Spain Prime Minister Mariano Rajoy was unseated in a vote of confidence and replaced by the socialist leader Pedro Sanchez. Sanchez will lead a minority government supported by the far left party Podemos and a number of small regional parties, which threatens to make it quite unstable. We think that new elections are likely to happen over the next 12 months but in the meantime Sanchez surprised with a pro-European stance and willingness to actively steer the Eurozone reform debate.

Fig 4 Sentiment indicators remain at elevated levels



Source: Thomson Reuters Datastream

Fig 5 10 yr bond yield spread with Germany



Source: Thomson Reuters Datastream

Moderate growth continues...

While it's too soon to assess the impact of the political turmoil on the economy, we can certainly say that second quarter growth will hardly be better than the moderate growth in the first quarter. Sentiment indicators stabilised in April and May, but didn't recover from their drop in the first quarter. However, the backbone of the recovery is still strong. When looking at consumer confidence, it is true that households have become a bit less upbeat on the economy in general. But at the same time they're very positive about their own financial situation and on employment perspectives, which remains a good base for

...with consumption to remain supportive

Strong activity in the construction sector...

further consumption growth. On top of that oil prices have started to come down, which will support purchasing power in the coming months. On the back of the low interest rate the order books assessment in the construction sector was at its highest level ever in May. And while sentiment indicators have come down both in the services and manufacturing sectors, they remain at relatively elevated levels.

... but manufacturing might be hurt by trade restrictions

However, one big worry, especially in the manufacturing sector, is growing trade tensions. The US import tariffs on steel and aluminum are relatively small fry for European exports, but Donald Trump has talked about higher tariffs on car imports, a much bigger sector in Europe, especially in Germany. While it is hard to tell where this will end, it is clearly a downside risk for growth in Europe. We therefore have adjusted our growth outlook further downwards and are looking now at 2.1% GDP growth in 2018 and 1.8% in 2019.

Temporary spike in inflation will not last...

The heady increase of HICP inflation to 1.9% in May was stronger than expected, strengthening the case of the hawks within the ECB. However, most of the rise was due to the higher oil prices in combination with a somewhat weaker euro. Since oil prices are falling again and the euro exchange rate is not expected to weaken much further from current levels, the upward impact on inflation should dissipate gradually in the course of the year. Moreover, core inflation remains at 1.1%, which is still on the low side.

...keeping the ECB wary not to exit QE prematurely

Despite new uncertainties, the ECB seems to be willing to gradually bring QE to an end. Latest remarks by ECB chief economist Peter Praet suggest that even the doves are open to discuss tapering. Even though we still believe that the ECB will be wary not to ditch QE prematurely to keep a maximum level of flexibility, an announcement at the June meeting of a short extension of the Asset Purchase Programme until the end of the year at 10bn euro per month, while keeping the statement open-ended, has become more likely. As for rates hikes, our base scenario remains a first rate hike in September 2019.

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UK: A summer of tough decisions

Markets have reassessed their Bank of England expectations

It's fair to say markets have had a quite a big rethink on the Bank of England over the past few weeks. Governor Carney's surprisingly cautious comments back in April were compounded by what investors interpreted to be a fairly dovish May BoE statement. Markets are no longer looking for a rate hike this year.

But as wage growth rises, we suspect rates hikes are coming

We suspect this might have been a bit of an overreaction. Our own read of the May statement was not ever so different to that of February or March. Wage growth, a central plank of the Bank's tightening bias, has continued to show signs of life and policymakers remain confident that the tight jobs market will see the upward trend persist.

The BoE isn't overly concerned about growth

The BoE was also surprisingly blasé about the sharp slowdown in first quarter growth. The Bank thinks most of the dip is explained away by the bad weather, and in fact suspects the worryingly-low 0.1% quarterly growth figure could be subject to quite hefty upward revisions.

But the big risk to a summer rate hike comes from retail

All of this leads us to think that policymakers want to hike rates further if they can, and that at roughly 50%, markets may still be slightly underestimating the chances of an August rate rise. That said, this is far from a done deal and relies on the data proving the Bank right on growth. The biggest risks lie in the retail sector.

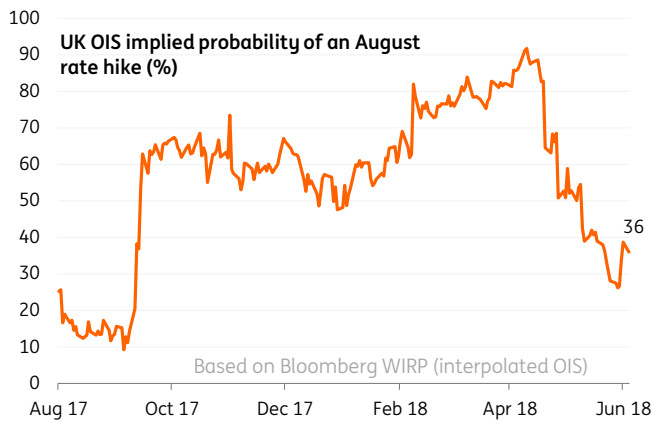
It's clear that the period since the start of 2018 has been one of the roughest for retailers since the financial crisis. Admittedly the better weather of the past few weeks will have provided some much needed respite, but equally we don't see the 'perfect

storm' of slower demand, higher wage costs and elevated business tax rates blowing over anytime soon.

Consumers remain cautious, even the income squeeze eases

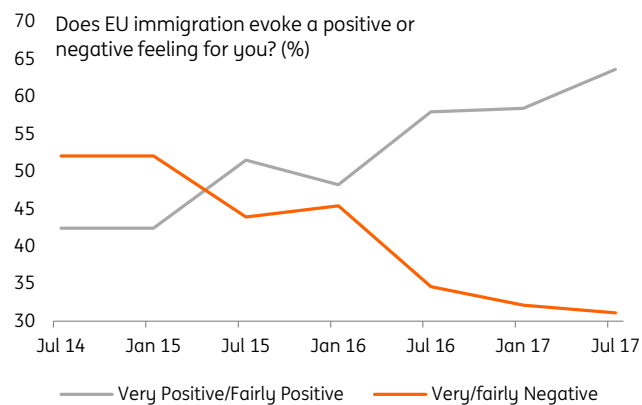
Household incomes aren't being squeezed quite as heavily as they were late last year, but equally they aren't rising in real terms either – particularly in light of the recent upsurge in petrol prices. And while consumer confidence appears to have recovered a little since the start of the year, shoppers remain pessimistic about the general economic environment. Assuming that stems from generally slower growth and Brexit uncertainty – both of which look to persist – we think an imminent recovery in spending is unlikely.

Fig 6 Odds of an August rate hike have tumbled



Source: Bloomberg

Fig 7 Immigration has become less of a public concern



Source: European Commission/DG COMM

The government is divided on the best customs arrangement after Brexit

Speaking of Brexit, the fierce debate over the UK's future customs relationship with Europe may finally be about to reach a head. As both sides continue to search for a solution to the Irish border conundrum, the UK government has continued to discuss two options – so-called “maximum facilitation”, which would use technology and trusted-trader schemes to minimise border checks as much as possible, and a “customs partnership”, a scheme that would see tariffs/VAT collected on the EU's behalf when a Europe-bound good first arrives in the UK.

Both have been widely criticised in recent weeks. The former is untested and risks flaring tensions at the Irish border, whilst the latter would be extremely complicated to implement and perhaps ultimately unworkable. Importantly, the EU has rejected both of these UK visions – but even with that aside, it's clear both methods would take years to implement.

The UK has agreed the need for a backstop...

And this is time that the UK doesn't have. With just two and a half years until the post-Brexit transition period is slated to end, focus is switching to a possible 'backstop' solution, that would kick-in should the overall EU-UK trading relationship fail to avoid a hard Irish border.

...but disagrees on what that backstop should look like

The EU's proposal would see Northern Ireland remain in the customs union and single market for goods, which would avoid the need for physical checks at the border. But this raises the possibility of creating barriers within the UK itself, between Northern Ireland and the rest – and as we know from previous rounds of talks, the DUP (the party that supports Prime Minister May's majority in parliament) is vocally against this. Recall that May said just a few months ago that “no UK prime minister could ever agree to this”. As such, the government's alternative would see the UK overall remain in a customs union until 2021, by which time it hopes a better solution would have arrived.

The House of Commons will vote on whether to remain in a customs union

We could carry on discussing this for much longer, but the upshot is that things are beginning to get pretty messy. Interestingly though, this whole debate could be

rendered redundant as early as Tuesday 12th June. That's because the House of Commons is set to vote on a series of amendments to a Brexit-related bill, one of which – if voted through – would require the government to take efforts to remain in a customs union after leaving the EU.

This House of Lords has already voted in favour of this, and whilst the government is staunchly against remaining in a customs union, a number of Conservative MPs, alongside the opposition Labour Party, feel differently. The vote looks set to be very tight, but if the government loses the vote, it would come as a major blow to PM May's Brexit vision.

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China: Strong “no trade war” tone

China is unimpressed by the US approach to tariffs

China has become increasingly annoyed by a US administration that keeps changing its mind on tariffs. It now seems that all of the results of negotiations so far would be taken back off the table, unless the US cancels its planned tariffs on China. Media reports suggest that the US could announce its tariff plan by mid-June.

Sanctions on high-tech goods are also possible

Apart from trade, if the US follows through with its plan to announce sanctions on Chinese high-tech goods and related businesses before the end of June, it is also likely that China will take a similar approach for US businesses operating in China. Clearly then, June looks set to be a tense, roller-coaster month for China-US trade and investment.

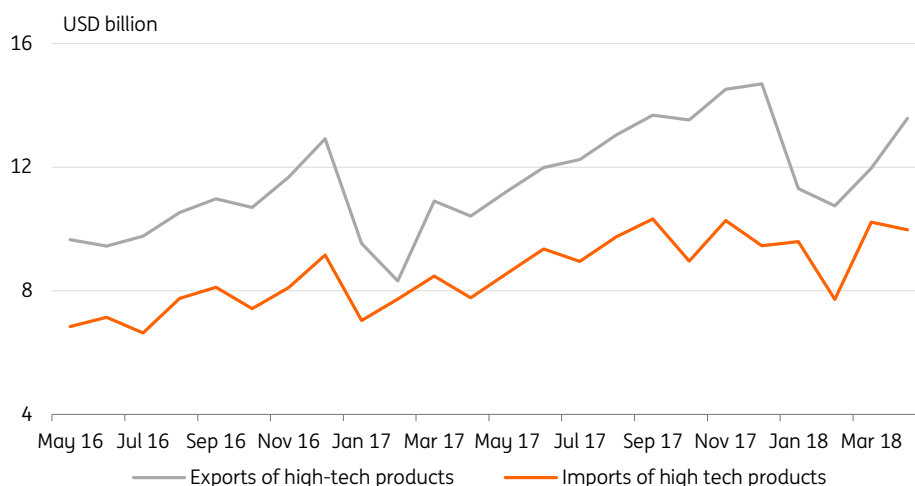
China has said it plans to open markets to the rest of the world

Meanwhile, China has made repeated statements that it plans to further open up its markets to the rest of the world – especially for consumer goods, clean energy and high-tech products. But if the US imposes tariffs on Chinese goods, China will do the same for US goods. That implies that the opening up of the Chinese market would benefit every other economy, except the US.

The US may not be able to benefit from this liberalisation while tariffs are pursued

Take China's tariff cut on automobiles as an example. The policy benefits all automobile manufacturers, from European brands, Japanese and Korea producers. US manufacturers however would not gain, assuming the US does not lift tariffs on Chinese imports of steel and aluminium.

Fig 8 Chinese trade in high tech products



Source: ING, CEIC

Of course, tariffs on automobiles may not hurt the US ever so much, given that it does not export cars in large numbers. But, if the opening up of markets is about agricultural

The liberalisation would help a range of countries boost trade ties with China

products and energy, and if US insists on announcing tariffs on Chinese goods, then US companies would be worse off from the tariff cuts by China on these goods.

The opportunities brought-about by China's liberalisation would most likely be felt by so-called 'Belt and Road' countries when it comes to energy, and by Europe/Asia for agricultural products. They can enter into the China market without facing competition from US companies. Empty trade talks would effectively mean the US is shutting itself out of the business, whilst at the same time, the rest of the world would have stronger trade ties with China.

The US may be worried about its status as the biggest economy

[As we pointed out in previous notes](#), the US may not be only targeting a narrowing in the bilateral trade deficit. It also feels that its status as the biggest economy, and the most high-tech economy, in the world is under threat from China's "Made in China 2025" plan.

We believe that US is working hard to delay China's economic advancement, especially in sectors related to high-tech industry. Therefore, the chances of the US allowing more exports of technological-related goods and services to China is fairly low, even if this would help lower the trade deficit.

With more investment in high-tech sectors, our growth target still holds

In this case, we think China would put more effort into achieving its self-sustained high-tech target by investing more in targeted industries. The biggest tech companies in China are echoing Xi Jinping's view to strive for being self-sustained in high-tech sectors. We expect that investment in these sectors will be one of the key drivers of future Chinese growth. Our forecast of 6.8% GDP growth still holds, on the basis that this investment will offset the loss of activity from deleveraging reform and any loss of trade.

For 2Q18, we also keep our forecast for 6.8% YoY GDP growth, helped by decent consumption and investment, as indicated by good PMI numbers and industrial profits.

[We have also revised our yuan forecast](#) due to the stronger dollar created by recent trade tensions and uncertainty in Europe.

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Japan: The pause that refreshes

Japan appears to be going through a classic inventory cycle

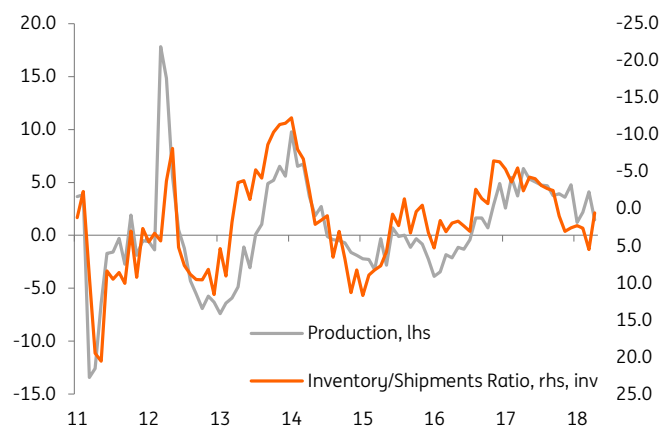
In times gone by, when economics still largely worked, central banks maintained a positive interest rate and money printing was considered heretical, there used to be a periodic business cycle. This was no bad thing. With every period of growth, along with the beneficial effects such as rising wages, and profits, there would also be some negative spillovers, such as an accumulation of unproductive activity, capacity or inventories. Every five to seven years or thereabouts, there would be a mild downturn or recession. Some jobs would be lost and some firms would go bust. But the liberated capital and labour from this downturn would mostly be re-shuffled into more productive uses to fuel the next up-leg of the business cycle. In much the same way that we sleep at night to rejuvenate, or tides wash away and refresh the waters along our coasts, the negative short-run aspects of recessions were made up for by the post-recession benefits.

Japan seems to be undergoing just such an old-fashioned inventory cycle right now.

Falling inventories relative to shipments should see production rise

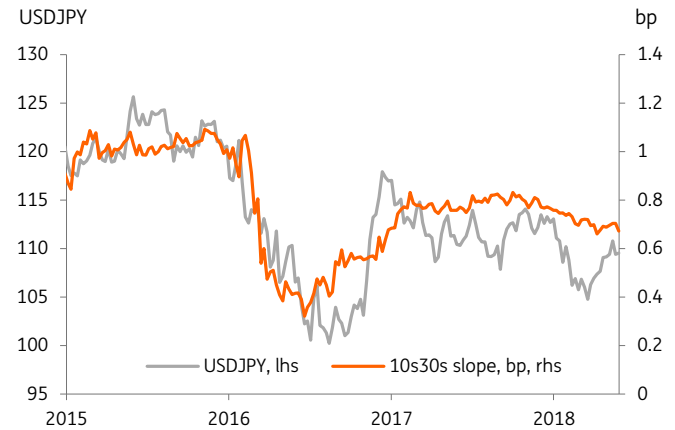
After rising for several months, the year on year growth rate of Japan's inventory to shipments ratio fell last month (inverted in the accompanying charts, so they rise). This fall in the inventory ratio should, if continued, start a process that will enable production to start rising again in the coming months.

Fig 9 Inventory to shipments ratios & production growth



Source: Macrobond

Fig 10 Yield slope and JPY



Source: Bloomberg

Any up-turn is unlikely to be exciting...

...but should be enough to lift growth back into the 1-2% range

But there are risks – and the biggest is trade

What is also clear, however, is that the amplitude of Japan's business cycle is very shallow, so any resultant upturn is unlikely to be very exciting. Production growth should accelerate from about zero now to about 5%YoY during the rest of the year, but thereafter, is likely to fluctuate in a zero to 5% range.

While so many other economic relationships fail to work these days or do so only very weakly, the Japanese relationship between industrial production and GDP growth remains very tight. So a recovery of industrial production into the 0-5% range should lift Japanese growth from its 1Q stagnation back into the 1-2% range, for an average of about 1.0%.

While a GDP growth rate of 1% may not sound very exciting, it is a realistic long-run growth rate for an economy where the population and labour force are now shrinking rapidly. Indeed, at a per capita GDP rate, this is slightly more than 2.0% currently, which sounds about right for an economy as technologically advanced as Japan.

Even this forecast is not without risks, however. Top of this list is a collapse in global trade that will work its way backwards into weaker production growth and thereby weaker GDP growth. As we note elsewhere, whilst not our central scenario, our outlook on global trade is becoming increasingly pessimistic, thanks largely to the belligerent actions of the Trump administration.

The recent weak newsflow has taken BoJ tapering off the radar, but it may not stay off for very long:

1. Former BoJ Governor Shirakawa has said that measuring inflation accurately has become difficult, downplaying the undershooting of the inflation target
2. Board member Sakurai has said excessive monetary easing could destabilize the economy. "The BOJ must examine how best to guide monetary policy as needed without any preset idea" Sakurai is quoted as saying in the Japan Times. Though in other comments, he sounded pretty dovish.
3. In another surprise in markets, the BoJ trimmed its usual market purchases of JGBs in the 5-10Y maturity range. Either this marks realization that the inflation target is unreachable, or unnecessary, or reflects the running out of available assets to buy.

We've seen such surprise moves before, and this last bullet is maybe more tactical than strategic. One thought is that the BoJ will resort to yield curve control, rather than focus explicitly on the 10Y yield, such that a steeper 10s30s slope will result in a weaker currency. If nothing else, this would help muddy the BoJ's targets, making it less obvious

that it was missing them (transparency and clarity in central banking is not always a good thing). A more substantive change in BoJ policy could also be helped as the ECB shifts its stance on QE. As we note in the Eurozone section, it looks as if Eurozone QE is coming to an end after all this year, and that will make the BoJ's job of changing policy that much easier.

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FX: Poor visibility

We are cutting our year-end EUR/USD forecast to 1.23 from 1.30

We are cutting our year-end EUR/USD forecast to 1.23 from 1.30. We also see EUR/USD lingering around the 1.15/17 levels for longer this summer given the uncertainty of global trade policy and also the extent to which European leaders draw the sting out of Italian populism with a more conciliatory approach to immigration, for example.

In addition to the aggressive squeeze in short dollar positions seen from April onwards, EUR/USD has also had to endure independent EUR weakness on the back of Italian politics. At its peak, we estimated that EUR/USD contained a 4% European political risk premium when it was trading close to 1.15 at the height of the Italian political crisis.

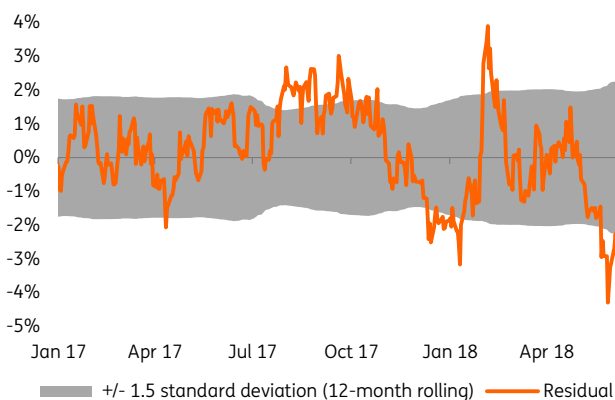
Since the establishment of the European Stability Mechanism in 2012, the European political risk premium in EUR/USD has been limited to 4% according to our calculations. But that relies on the assumption that a country in need of support is prepared to accept policy prescriptions from abroad – akin to an IMF deal. Does that assumption hold true?

The political risk premium in the EUR may narrow somewhat if the EU has something to offer Italy in late June

For now our team tend to see Italian risk calming as we learn how the new government plans to conduct its relationship with Brussels. An important test of this relationship will come at the June 28-29 European Council meeting in Brussels. Should the EU have something to offer Italy on migration challenges or fiscal leniency, the political risk premium in the EUR may narrow somewhat.

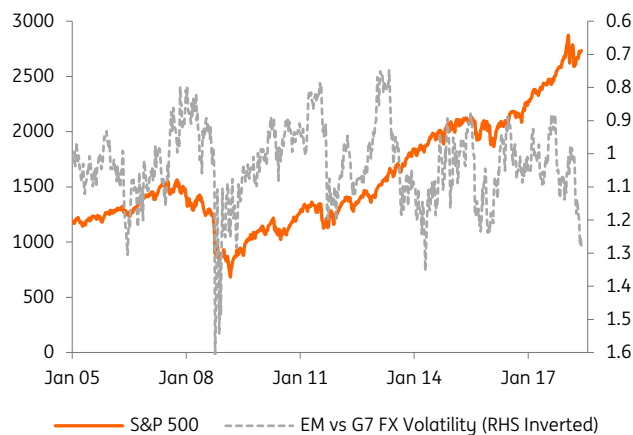
Whether a formal ECB discussion over the end-point to QE can re-ignite independent EUR strength also remains to be seen. We tend to think this is more a story for 4Q18.

Fig 9 EUR/USD divergence from short term fair value*



Source: ING. : *Large and persistent divergence is sign of a risk premium

Fig 11 EM FX volatility picking up



Source: Bloomberg, ING

Instead our bigger fears concern the path for trade policy. One of the surprises in 1Q18 was how quickly Eurozone business activity and confidence slowed – in part a function of growing trade tension hitting the generally more open economies of Europe.

Trade events could pose large risks to the EUR this summer

Unless the rest of the G7 leaders can talk President Trump down from his protectionist perch, the sequence of trade events could pose risks to the EUR this summer. At present

an EU retaliation to US steel tariffs looks likely in July. In which case Washington would likely follow-through with its threat to impose tariffs on the EU auto industry – citing national security concerns. That would mark a severe, Euro-centric escalation in the 2018 trade war. It is thus hard to rule out EUR/USD retesting 1.15 this summer.

The threat of a populist President in Mexico looks the next challenge for EM

All this comes at a time when the Fed looks intent on tightening and idiosyncratic stories discourage investors returning to EM. After Argentina, Russia and Turkey, the threat of a populist President in Mexico looks the next challenge for EM. In all, we are wary of the risk environment into July and would favour JPY out-performance on the crosses.

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Rates: Italian hiccup for core

“Quitally” worries drove Bund and Treasury yields lower. But back now to a re-test higher in rates

The big dip in the US 10yr yield back below 3% was undoubtedly driven by the build of an Italy exit discount. ‘Quitally’ remains a low probability event, but did require a price discovery exercise. One week later and Italy is still stranded in the 250bp area over 10yr Germany, but the US 10yr yield has managed to recover and now looks to have an appetite to get decisively back above 3% again. Our view is it will, and we remain of the opinion that it will remain above 3% for a number of months if not quarters.

Still, these are still dangerous times for Italy; elevated spreads maintain a worry discount

That of course assumes that ‘Quitally’ remains in the black swan box. One problem here is Italy does not actually need to leave the Eurozone for the market to discount it, and indeed discounting it is a clean means to giving Italian leaders a proper smell of what it could be like. There was an element of that last week; decision makers in Italy would have experienced at first hand the sense of helplessness that would obtain if the market were to begin to believe that an Italian exit could be on the radar screen.

Italy CDS briefly got to Nigerian levels. Lower since, and still well below the bigger Greek worry

The question is whether this has had the desired effect. And the answer is not that clear. Italian CDS (just like the spread to Bunds) has come off its highs, but remains very elevated (Figure 12). It in fact got to above the likes of Nigerian and Egyptian CDS at one point (and now having fallen back is still just 40bp through Nigeria). But by the way Greek CDS is some 100bp wider than these African states, which illustrates the market view that Greek vulnerabilities are still significantly more elevated than Italian ones.

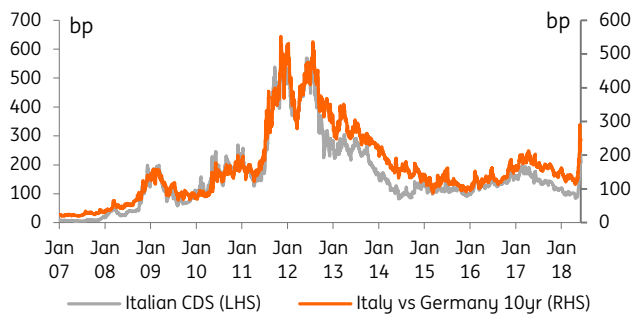
That aside, the central discount is Italy would commit economic suicide by leaving. Hence Bunds have recovered

That in part explains why core rates have managed to regain their poise, with not only the US heading back towards 3% but the 10yr Bund looks to have a re-take of 50bp in its sight (after having briefly touched the depths at 18bp). As angst recently crescendoed the realisation dawned that Italy could not risk the economic suicide that euro exit would bring with it. And especially for Italy, as it would have further to fall, and would likely land with a far bigger thump (vs Greece). Hence, Bund yields are back up despite the maintenance of wide Italian CDS spreads (Figure 13).

We continue to target 3.25% to 3.5% for 10yr US and the 50bp to 100bp range for 10yr Bund (QE decision dependent)

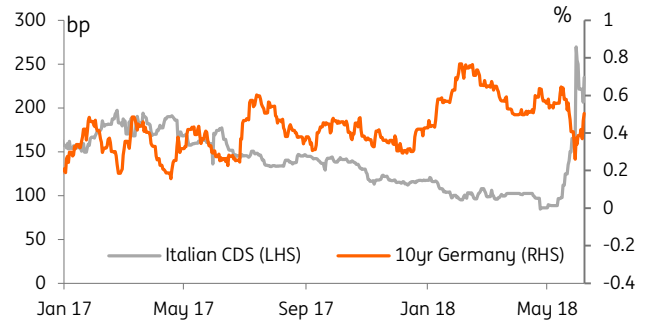
Will all of this dent Fed rate hike ambitions? Unlikely, at least there would be no reason to abort the next planned move(s). The same thought process is in play for market rates, as long maturities will continue to reflect an estimate of where a rolling exposure to short rates would average out at, plus a premium. And, importantly, that premium is still not priced adequately. So even in the case where euro troubles managed to shave one or two hikes off the terminal rate, there is still room for the 10yr to edge higher. We maintain a target of 3.25% to 3.5% for the 10yr US and 50bp to 1% for 10yr Germany in the coming months. The wider range for Germany reflects an ECB QE unwind surprise factor, as despite talk of extensions the ECB could still abruptly end QE by Q4.

Fig 12 Italian CDS vs Italy 10yr spread to Germany



Source: Bloomberg, ING estimates

Fig 13 Italian CDS vs Germany 10yr yield



Source: Bloomberg, ING estimates

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Fig 14 ING global forecasts

	2017					2018F					2019F					2020F				
	1Q	2Q	3Q	4Q	FY	1Q	2Q	3Q	4Q	FY	1Q	2Q	3Q	4Q	FY	1Q	2Q	3Q	4Q	FY
United States																				
GDP (% QoQ, ann)	1.2	3.1	3.2	2.6	2.3	2.3	3.5	3.4	2.7	3.0	1.7	2.4	2.3	2.1	2.4	1.8	2.2	1.9	2.0	2.0
CPI headline (% YoY)	2.5	1.9	2.0	2.2	2.1	2.3	2.7	2.9	2.6	2.6	2.3	2.3	2.3	2.3	2.3	2.3	2.2	2.1	2.1	2.2
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	3.25	
3-month interest rate (% eop)	1.15	1.30	1.33	1.56		2.30	2.35	2.65	2.85		3.05	3.10	3.20	3.30		3.60	3.75	3.75	3.75	
10-year interest rate (% eop)	2.40	2.30	2.30	2.40		2.30	3.20	3.40	3.30		3.20	3.20	3.20	3.20		3.20	3.10	3.10	3.10	
Fiscal balance (% of GDP)					-3.5					-4.4					-4.9					-4.3
Fiscal thrust (% of GDP)					0.0					1.4					0.8					0.4
Debt held by public (% of GDP)					106.4					105.1					105.2					105.0
Eurozone																				
GDP (% QoQ, ann)	2.6	2.9	2.8	2.7	2.4	1.6	1.7	1.9	1.8	2.1	1.7	1.6	1.6	1.7	1.8	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	1.9	1.7	1.7	1.5	1.6	1.6	1.8	1.6	1.8	1.8	1.8	1.8	1.8
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	0.50	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		0.15	0.30	0.40	0.50	
10-year interest rate (% eop)	0.45	0.40	0.45	0.42		0.50	0.50	0.60	0.70		0.85	0.90	0.95	1.00		1.00	1.10	1.20	1.20	
Fiscal balance (% of GDP)					-0.9					-1.0					-1.0					-1.1
Fiscal thrust (% of GDP)					0.2					0.2					0.2					0.1
Gross public debt/GDP (%)					89.2					87.7					86.2					85.0
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	0.9	1.1	0.7	1.0	0.7	2.1	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	0.2	0.2		0.3	0.3	0.3	0.4	
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	6.8	6.7	6.7	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	2.3	2.2	2.1	2.3	1.8	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	2.60	2.60	2.65		2.65	2.65	2.65	2.70		2.70	2.70	2.70	2.75	
10-year T-bond yield (% eop)	3.29	3.57	3.61	3.90		3.75	3.65	3.50	3.40		3.30	3.20	3.10	3.00		3.00	2.95	2.95	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	1.8	0.4	2.5	1.8	2.0	1.5	1.7	1.3	2.3	1.6	1.8	2.0	1.6	1.6	1.6	1.8
CPI headline (% YoY)	2.1	2.7	2.8	3.0	2.7	2.7	2.4	2.4	2.2	2.4	2.1	2.0	1.9	2.0	2.0	2.2	2.3	2.2	2.2	2.2
BoE official bank rate (% eop)	0.25	0.25	0.25	0.50	0.50	0.50	0.50	0.75	0.75	0.75	0.75	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	
3-month interest rate (% eop)	0.35	0.35	0.35	0.52		0.60	0.70	0.80	0.80		0.85	1.05	1.05	1.05		1.30	1.35	1.60	1.65	
10-year interest rate (% eop)	1.15	1.10	1.35	1.20		1.45	1.40	1.60	1.70		1.90	1.90	2.00	2.00		2.1	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	1.20	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	108	105	105		103	102	100	100		98.0	95.0	93.0	90.0	
USD/CNY (eop)	6.89	6.78	6.65	6.51		6.28	6.50	6.55	6.60		6.70	6.55	6.55	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		67	72	70	68		64	66	67	66		61.0	66.0	71.0	66.0	

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

Source: ING forecasts

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