

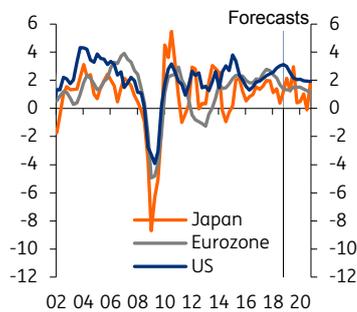
8 March 2019

Global

# Monthly Economic Update

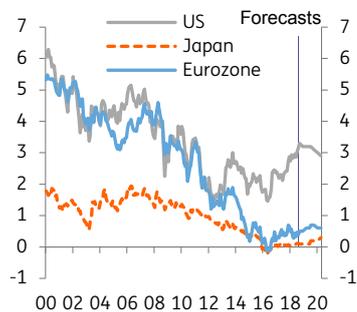
## March: In like a lion, out like a lamb?

### GDP growth (%YoY)



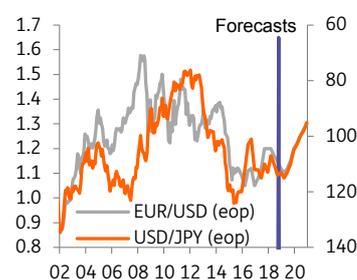
Source: Macrobond, ING

### 10yr bond yields (%)



Source: Macrobond, ING

### FX



Source: Macrobond, ING

### Mark Cliffe

Head of Global Markets Research  
London +44 20 7767 6283  
mark.cliffe@ing.com

### Rob Carnell

### Padhraic Garvey

### James Knightley

### Petr Krpata

### Raoul Leering

### Iris Pang

### James Smith

### Peter Vanden Houte

March is shaping up to be a big month for geopolitics. A deal between the US and China appears close, which could see financial markets rethink their ultra-cautious expectations on US central bank policy. Concerns about global growth could start to fade too. That said, a handful of stumbling blocks could yet scupper a US-China deal. Meanwhile, the threat of a 'no deal' Brexit, and tariffs on EU cars, mean the uncertainty facing policymakers and investors will remain high.

The Federal Reserve has adopted a more cautious approach to monetary policy since the start of the year. Trade tensions, the turmoil in equity markets and tighter financial conditions are cited as 'cross-currents' that are creating uncertainty, and in an environment of low inflation, the Fed can afford to be 'patient'.

However, these tensions appear to be easing. Borrowing costs have fallen back, equities have recovered all their losses, and there are positive signs regarding a potential US-China trade deal. With the jobs market roaring ahead, higher pay and rising inflation pressures mean that there is a strong case for a summer interest rate rise. This remains at odds with financial markets, which are pricing in a prolonged pause with an eventual rate cut in 2021.

Sentiment indicators have begun to stabilise in the eurozone having continuously declined since the start of 2018. However, any rebound looks to remain muted as a trade war with the US and a chaotic Brexit remain significant risks, keeping uncertainty high. What's more, core inflation has fallen back below 1%, nipping any expectation of monetary tightening in the bud. In fact, the ECB has now extended its forward guidance of stable rates up to the end of 2019 and has also announced a new series of TLTROs to avoid a tightening in credit conditions.

The UK Prime Minister faces an uphill struggle to get her deal approved by Parliament, despite hints that her opponents may be shifting their position. That means an extension to the Article 50 negotiating period now looks inevitable, but if this delay is kept relatively short, the threat of 'no deal' will remain. That will keep the pressure on the economy, further reducing the chances of a rate hike this year.

China's government has provided a set of targets for 2019. Almost everything was as expected, especially the new GDP growth target. The government is relying a lot more on fiscal stimulus rather than monetary easing. A repeat of previous guidance on the exchange rate mechanism may mean the yuan will continue to follow the dollar index.

The 10-year German yield at a mere c.20 basis points bears no reflection on the Germany economy. So how can we make sense of this? To keep it plain and simple, it is a measure of fear. That fear is a combination of two elements. First, there is the 'macro' fear that the current slowdown could become more severe. But by far the most significant element is an existential fear about the European project itself, and not enough attention is being paid to this. The EU elections in May could prove pivotal.

In FX, we continue to look for further USD outperformance vs the low yielding G10 currencies in coming months. The Fed will deliver a hike, while the likes of ECB or the Bank of Japan will remain dovish /neutral. The duration of the Article 50 extension will matter for GBP price action, with a longer extension being more positive for GBP than a short one. In the CEE FX space, our top pick remains the Hungarian forint.

## Trade: A turn for the better

A deal is looking closer than ever

**A deal between the US and China is closer than ever. This was reason enough for Trump to postpone the imposition of 25% tariffs on USD 200 billion worth of imports from China, which was previously due to happen on 2 March.**

Reports suggest a Trump-Xi summit could take place soon

Given the ambitious demands from the US, it's certainly not a done deal yet, but given press reports on the progress made thus far and the optimism that Presidents Trump and Xi demonstrate, we are inclined to expect that a deal will be struck. There is no new deadline, but reports suggest that a Trump-Xi summit could take place at the end of March. The public optimism of both presidents about the progress in negotiations has led us to tweak our base case. We no longer expect an additional tariff hike on USD 200 billion of Chinese imports to occur.

But the next few weeks won't be easy for negotiators

Having said that, the next few weeks will not be easy for negotiators. Going by recent press reports, China seems willing to lower its trade surplus with the US by lifting imports. This could include stimulating car imports from the US by lowering import tariffs. China could also potentially open up its markets for automotive and financial services by allowing foreign companies to hold majority stakes in joint ventures with Chinese companies.

China's exchange rate policy is still an unknown in the deal

What's less clear is the sort of deal negotiators are aiming for when it comes to China's exchange rate policy. There is also no sign of whether a deal is possible on China scaling back its 2025 ambition to become a leader in tech markets. That said, China is offering to scale up protections for the intellectual property of foreign companies.

Enforcement won't be easy

But the devil is in the detail here, and enforcement won't be easy. That's why US negotiators reportedly want to keep the possibility open of future tariffs on Chinese imports. If enforcement by China stalls, the 2018 tariff hikes on Chinese goods- which could potentially be abolished as part of a trade deal- may be reintroduced. Alternatively, the abolition of existing tariffs could be made conditional on China making progress with enforcement.

A deal with China doesn't automatically mean an end of the trade war

The upshot is that a trade deal with China doesn't automatically mean that Trump's war on trade is over. And the threat of higher US car tariffs won't disappear. In a recent speech to US Governors, Trump confirmed our long standing interpretation of his [strategy](#), saying that he can only secure new trade deals by imposing/threatening tariffs.

Whilst not our base case, higher car tariffs remains a serious downside risk. These could easily materialise if the EU does not give enough ground on Trump's demands in the forthcoming negotiations.

**Raoul Leering, Amsterdam +31 20 563 4407**

# US: A test of 'patience'

**“Cross-currents” have led the Federal Reserve to adopt a more “patient”, data dependent approach to monetary policy for 2019. While the market is pricing in an eventual cut as the next Fed move, we continue to look for one last 25 basis point hike this summer.**

The US economy maintained momentum throughout 2018 despite some headwinds

With the government shutdown over, we are receiving the backlog of data from the end of 2018. Most notably, 4Q GDP slowed by less than feared to 2.6% annualised, which left full year 2018 growth at 2.9%. The aggressive tax cuts at the beginning of 2018 put the US economy on a strong footing, with momentum being well maintained despite escalating trade tensions and the financial market turmoil seen in the latter part of the year.

But risks have increased and the Fed is adopting a more neutral stance on the outlook for interest rates

It was for these reasons that the Federal Reserve adopted a more cautious position in January. Earlier this week, Fed Chair Jerome Powell repeated comments that economic and financial market “crosscurrents and conflicting signals” have created uncertainty. While officials continue to believe that the US economy is broadly in good shape, the fact that inflation pressures are perceived to be “muted” means the Fed can afford to be “patient” with regards to decisions on future policy changes.

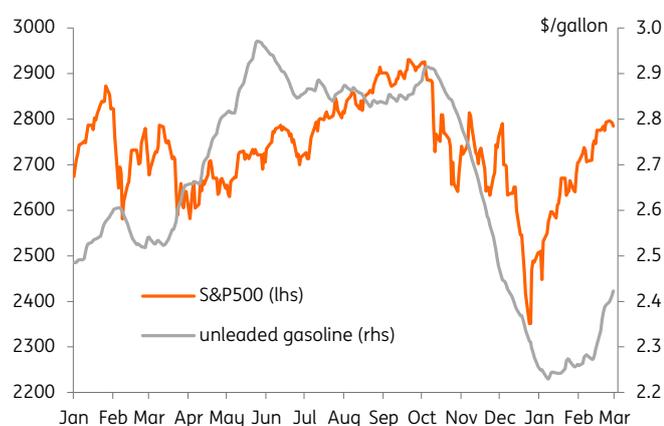
Markets are pricing the next move as being a rate cut

At present, markets believe that the Fed’s neutral stance will eventually give way to policy easing with Fed funds futures contracts pricing in a 25 basis point rate cut by the summer of 2021. However, we continue to believe that the next move is more likely to be an interest rate increase.

Some tensions have eased since the start of the year, meaning there are positives for growth

Indeed, the economic tensions appear to have eased since the start of the year. The US-China trade truce that was called in early December delayed the imposition of additional tariffs on imports from China. President Trump continues to seek a concrete deal that will result in a lower bi-lateral deficit together with Chinese concessions on intellectual property and technology transfer. The hope is that a late-March summit can seal the deal with a 150 page document reportedly being finalised. Meanwhile, risk appetite has returned with equity markets recovering all of the losses seen since the beginning of October. Interestingly, gasoline prices have not rebounded to anywhere near the same extent so household spending power continues to benefit.

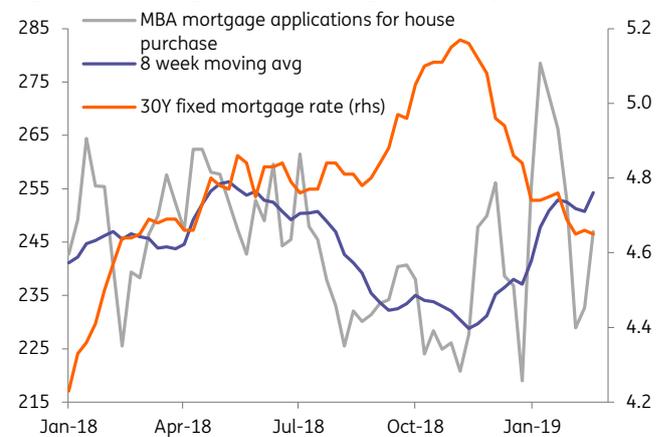
**Fig 2 Equities rebound, but gasoline faces resistance**



Source: Macrobond

The economy won't match the pace of 2018 though

**Fig 3 US housing market making a recovery?**



Source: Bloomberg

We certainly accept that the US economy is not going to grow as strongly in 2019 as it did last year with the government shutdown having already helped take some of the wind out of its sails. The fiscal support from 2018’s aggressive tax cuts will undoubtedly fade while the lagged effects of higher interest rates and the stronger dollar clearly act as a brake.

Weaker external demand is also a concern with Asia and European growth having slowed markedly through 2018 amid escalating trade protectionism fears.

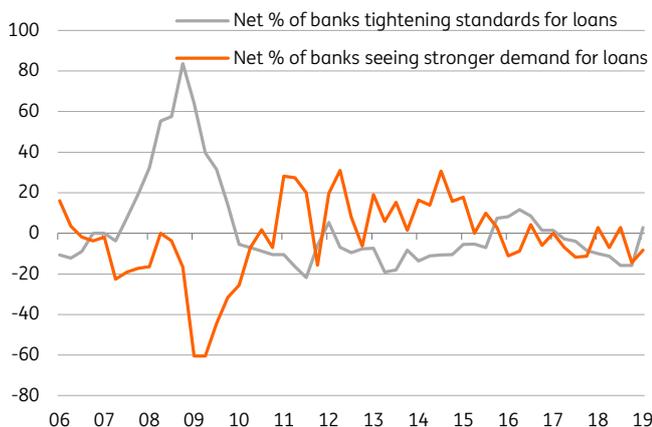
The jobs market remains a key source of strength

That said, we still think there are clear positives that can keep the economy growing soundly, which in turn will lead to rising inflation pressures. Indeed, the jobs market remains an ongoing source for optimism. Firms have continued to hire workers aggressively at the start of the year and wage pressures are rising. With real household disposable incomes growing strongly we expect consumer sentiment to remain high, supporting broader spending growth in the economy.

The housing market may also be turning around

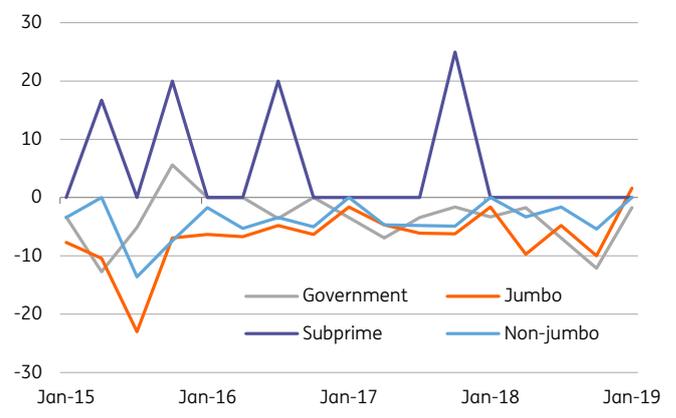
There have also been some positive signals in the property market. Mortgage rates have dropped back sharply following the correction lower in Treasury yields and this is prompting a pick-up in mortgage applications and approvals. Consequently, we could see a possible turnaround in home sales through 1H19, which may in turn stimulate a recovery in residential investment – a key component of GDP that has fallen for four consecutive quarters.

**Fig 1 Senior Loan officers' survey - large & medium sized firms (revenue >\$50mn)**



Source: Macrobond

**Fig 2 Senior Loan Officers survey - Net % of banks tightening mortgage standards**



Source: Macrobond

Lending conditions don't appear to be a constraint on growth

Moreover, lending conditions do not appear onerous. Indeed, the Federal Reserve's lending conditions survey suggests that there has been no major tightening of financial conditions despite the turmoil seen in markets at the back end of last year. As such, a lack of financing availability doesn't appear to be a major constraint on economic activity. There are also encouraging signals regarding broader investment spending with business surveys holding at healthy levels. The latest ISM indices are consistent with decent growth.

With inflation gradually rising we still look for a Fed rate hike in 3Q

Given the lack of spare capacity in the economy and the fact wage pressures are building, we look for inflation to continue pushing higher through 2019. So, the combination of firm economic activity, a tight jobs market and rising inflation means we continue to look for a rate rise over the summer, but it is looking more likely to be in 3Q rather than in 2Q.

Trade remains the main risk

Trade policy remains a critical issue though. President Trump has been indicating that he thinks the US and China may be close to a deal, but there are issues to be hammered out regarding how any deal will be implemented and policed. Markets will remain cautious until they see something concrete – hopefully later this month. If such a deal does materialise this would lift a dark cloud that has been hanging over the global economy.

If we see a re-escalation of tensions then the outlook for policy will change

However, should China trade talks break down, just as the US-Korea nuclear talks have done, then our forecast of an additional Fed rate hike looks vulnerable. If new trade sanctions are implemented then this would be economically damaging, with American businesses and consumers facing higher prices and disruption to supply chains. We are also likely to see a repeat of the bear market sentiment seen in late 2018. The economic

risks would be heightened further should President Trump choose to hike tariffs on European car imports. After all, the Department for Commerce has decreed that having a strong US domestic auto industry is a national security issue so President Trump has until mid-May to decide.

A short, sharp shock may deliver the concessions Trump wants, but it will come at a near-term economic cost

Donald Trump will be seeking concessions from Europe during the period that would remove the need for tariffs. However, if concessions aren't forthcoming he may hope that a short, sharp shock will be enough to incentivise Europe to back down. This would allow him to take a clear 'victory' on trade to the US electorate at next year's Presidential election, but it would likely come at the expense of weaker near-term growth. The hit to sentiment and squeeze on spending power it generates may mean the Fed takes an even more cautious approach to monetary policy. Indeed, this trade war scenario is much more consistent with current market pricing of the next Fed move being an interest rate cut.

James Knightley, London +44 20 7767 6614

## Eurozone: A sense of stabilisation

Sentiment indicators are bottoming out

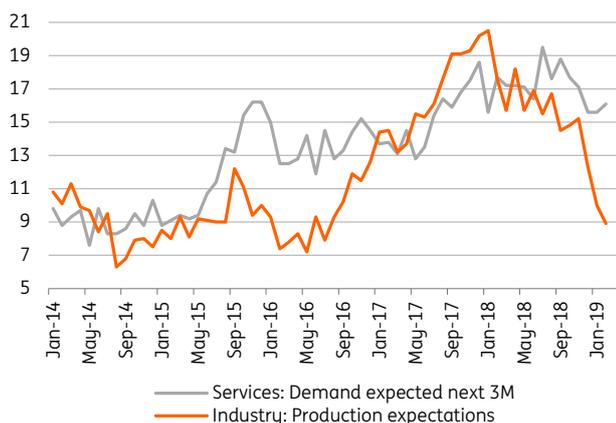
The stock market rally over the first months of the year has brought some welcome relief. Sentiment indicators, which had been falling since the start of 2018, are finally stabilising, though we shouldn't overdo the potential for a strong recovery over coming months.

Weakness remains concentrated in the manufacturing sector...

The European Commission's sentiment indicator fell again in February, but the drop was very small, with several sectors actually improving. The weakness seems to be mainly concentrated in the manufacturing sector on the back of a weaker global economy and increased volatility.

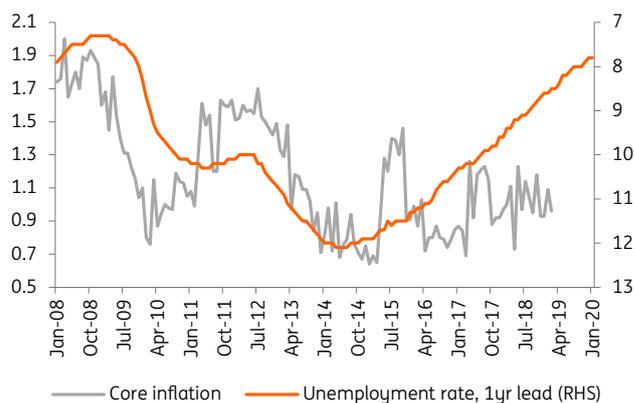
The uncertainty surrounding Brexit and the danger of higher tariffs on European cars in the US (for an assessment of the likely impact see [here](#)) are still important, and might lead to some hesitation as far as business investment is concerned. [Research](#) from the ECB shows that the heightened uncertainty is indeed likely to weigh on investment decisions. Loan growth to non-financial corporates dropped from 3.9% to just 3.3% year-on-year on an adjusted basis in January. Still positive, but clearly decelerating.

Fig 3 Eurozone manufacturing remains the weak link



Source: Thomson Reuters Datastream

Fig 4 Slow transmission from low unemployment to inflation



Source: Thomson Reuters Datastream

...while consumption related activity looks healthy

Consumption-related indicators on the other hand look rather upbeat. Sentiment indicators improved both in the services and retail sectors, while consumer confidence also climbed in February. With the petering out of the yellow vest movement in France, the winter of discontent seems to be all but over. In Germany, a strong wage agreement in the public sector is yet another indication that consumption is likely to be supported this year by increasing purchasing power. No wonder eurozone retail sales started the year on a strong footing.

Remaining uncertainty will keep the upturn rather muted...

With the economic situation now stabilising, the question is where things will head next. The Eurocoin indicator, an estimate of the underlying growth pace, fell further to 0.24% in February. But the eurozone should be able to benefit from improving confidence, assuming the threat of a no-deal Brexit is dispelled and the European Union isn't dragged into a trade war with the US. We still expect a minor acceleration in the second quarter but given the stage of the business cycle, we believe that such an upturn is just a temporary improvement in an overall slowing trend. We maintain a GDP growth forecast of 1.2% for both 2019 and 2020, with the quarterly growth pace somewhat slower next year compared to 2019 (the fact that the average growth rate is the same has to do with base effects).

...with GDP growth stabilising around 1.2%

Core inflation fell back below 1%...

Inflation is still going nowhere. We know that headline inflation can show some volatility on the back of gyrating oil prices, but underlying inflation has remained remarkably stable and low. As a matter of fact, core inflation even fell back below 1.0% in February (though rounded to 1.0%). So we're still far away from a one-for-one transmission from higher wages to higher inflation, as we argued last month. Selling price expectations actually moderated in all sectors in February, according to the European Commission's monthly survey. So expect only very mild upward pressure on core inflation over coming quarters.

...triggering a more dovish stance from the ECB

With growth expectations scaled back and the last inflation figures not really pointing to increasing price pressures, the ECB has to tread carefully. At its March meeting the Governing Council decided to extend its forward guidance, signalling that it will not hike interest rates before the end of 2019. On top of that, a new series of TLTROs will be introduced from September 2019 onwards, to prevent an unwarranted tightening of credit conditions.

Short-term interest rates are likely to remain negative throughout 2020...

With the US (and probably also the eurozone) slowing further into 2020, we don't expect the ECB to hike the main refinancing rate over the forecasting horizon, meaning that money market rates are likely to remain negative throughout 2020.

...keeping bond yields low for some time to come

In this case, the upward potential for sovereign bond yields remains limited. With US bond yields likely to decline in 2020 in anticipation of a more pronounced slowdown, we believe that European bond yields will not end 2020 any higher than in 2019. So overall a low interest rate environment will remain in place for some time to come.

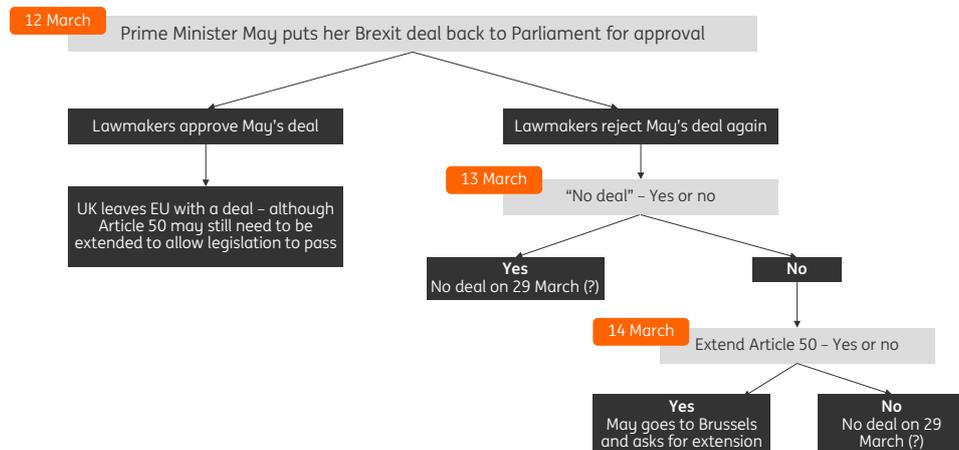
**Peter Vanden Houte, Brussels +32 2 547 8009**

# UK: Will May's deal pass after all?

Lawmakers will soon get a say on extending Article 50

The next week in Westminster may well prove to be the most important in the Brexit process so far, which is saying something. In a series of votes, we'll discover whether Parliament has changed its mind on Prime Minister Theresa May's deal, and if not, whether lawmakers would prefer 'no deal' instead. If the answer to both of those questions is "no" – which seems likely – then MPs will finally get a vote on whether the UK should return to Brussels and ask for extra time. So how will things pan out?

Fig 5 How the big week in Westminster is shaping up



Source: ING, various

## There have been signs that the Brexiteers are looking for a 'ladder to climb down'

May's deal was heavily defeated back in January

Cast your mind back to mid-January when May's deal was heavily defeated by Parliament. 118 Conservatives, alongside 10 Democratic Unionist (DUP) lawmakers rejected the deal, and until recently it has looked highly unlikely that the Prime Minister would be able to win over such a high number of dissenters.

But with the looming threat of a delay, the calculation facing Brexiteers is changing

But over the past week or so, the calculation facing the Brexiteers has subtly changed. Where before the choice was essentially between May's deal and 'no deal', it is now highly likely that a rejection of the deal will be followed by a delay to Brexit via an extension to the Article 50 period. In principle, a long delay could see a shift towards other Brexit alternatives like a second referendum, or a softer future relationship, both of which are much less appealing in the eyes of many pro-Brexit MPs than the current deal.

MPs may also soon get the opportunity to call for a softer Brexit – another worry for Brexiteers

There is also talk that rebel lawmakers may try to force the government to stage a series of 'indicative votes' on or around 19 March, to try to establish if a majority does indeed exist for any of these alternative Brexit paths. Reports over the past few days suggest the Government is using this to warn pro-Brexit MPs that this may be their last chance to stop a softer Brexit outcome.

So will any of this be enough to convince MPs to change their minds on May's deal? Certainly there have been hints that some Conservatives may be looking for a ladder to climb down. Jacob Rees-Mogg, head of the Brexit-supporting European Research Group, appears to have watered down his demands surrounding the Irish backstop.

The Prime Minister hopes all of this will convince lawmakers to back her deal after all

On that basis, the Prime Minister will be hoping that some changes to the deal may bring enough of her own lawmakers onside. Some hardline pro-Brexit MPs will probably never support the deal, but the hope is that some Labour MPs may be prepared to make the switch – particularly those that represent staunch Leave-supporting seats and are

wary about there being a second referendum (which 'in theory' is now official Labour policy).

### **May still faces an uphill battle to get her deal approved**

Having said all that, we still think May will struggle to get her deal through over the next week, although the scale of the defeat may be smaller. [The Telegraph](#) reports that ministers think they could still lose by 60-100 votes.

Brexiteers' demands are still miles away from what the EU might accept

After all, the Brexiteers' demands, while perhaps slightly watered down, remain miles away from what the EU might realistically accept. Secondly, when it comes to the threat of a Brexit delay, a lot will depend on how long this is perceived to last. A shorter Article 50 extension, which appears to be the favoured option at the moment and is unlikely to see too much change in the negotiations, may come as less of a concern to pro-Brexit lawmakers than a longer delay.

Finally, even if there are some 'indicative votes' in Parliament on different Brexit options, there is no guarantee any particular one will gain enough support.

Indicative votes may well be inconclusive, so pro-Brexit MPs might be relatively unfazed if they do happen

True, when push comes to shove, many believe a narrow majority of MPs might be prepared to back some form of softer Brexit. But timing matters, and come 19 March (if these votes do indeed take place), the UK Parliament is likely to have already requested a Brexit delay.

This could take some of the immediate heat out of the situation, reducing the incentive for MPs to reveal their true Brexit preferences just yet. For May, this means that the Brexiteers may be relatively unfazed by her 'indicative votes' threat.

### **An Article 50 extension looks inevitable – but how long will it last?**

May's deal likely to be voted down again

The upshot then is May's deal is likely to be voted down on 12 March, and MPs are likely to request an Article 50 extension on 14 March. The big question is how long a Brexit delay might last. Let's briefly consider the impact of each in turn:

A shorter extension to Article 50 would be more economically damaging than a longer delay

A **shorter** two to three month delay looks more likely at this stage, given that this would help to avoid some of the logistical challenges presented by the European elections. But within such a short period of time, there is a clear risk that not much would change and for businesses, this would keep the 'no deal' risk alive.

While it's possible the Article 50 period could be extended again, the near-term uncertainty will continue to take its toll on investment. Consumers are also likely to remain wary. That would see the chances of a 2019 Bank of England rate hike recede, although if a deal is finally agreed, we suspect policymakers might not hang around for too long when it comes to further tightening.

A **longer** extension would provide more reprieve for businesses, which may unlock some hiring and capital spending - although having come to the cliff edge once, it's possible firms will use the extra time to insulate themselves from another 'no deal' scenario.

That said, given the more favourable wage growth story, consumers may become a little more confident, and this could tempt the Bank of England into hiking rates over the summer. But this relies on the economy regaining momentum through the second quarter. If it doesn't, then it's equally possible that a long extension to Article 50 could result in a prolonged pause at the Bank of England.

**James Smith, London +44 20 7767 1038**

## China: State sees headwinds

Two session targets are mostly as expected.

**China's 'Two sessions' – the annual meetings of the national legislature and top political advisors- haven't been as exciting as last year when the government was celebrating the 40<sup>th</sup> anniversary of its reform and opening up policy. While we've had a new set of targets, they're almost as expected and details are missing when it comes to reforms.**

GDP growth target set at 6.0% to 6.5%.

The GDP growth target is now set at 6.0% to 6.5% for 2019, lowered from 'around 6.5%' in 2018. This lower growth target was expected by the market, and therefore didn't create many ripples.

But the big tax cut is surprising. It saves jobs and consumption.

The more surprising policy was an aggressive fiscal stimulus. Tax and fee cuts amount to CNY 2 trillion, which includes a 3% cut in value-added tax for manufacturing industries. This policy will give some breathing room to private companies by lowering expenses, which should help keep businesses and jobs alive. Without it, we would have seen more private firms closing down, which would result in job losses and a fall in consumption.

Private firms will not add CAPEX because they are still worried.

However, even with a smaller cost burden, private firms will still be keeping a watchful eye on the uncertainties surrounding the trade war/ truce, and may be reluctant to boost capital spending. So while the tax cut may save jobs and means the private sector won't slow further, it doesn't necessarily mean the private sector will boost economic activity in general.

Local governments will build more roads.

To generate growth, the state is looking at infrastructure investment. This is the responsibility of local governments and will be financed through local government special bonds, which is corporate debt totalling CNY 2 trillion, and therefore means local governments won't be loading up on debt themselves.

Big fiscal stimulus means headwinds in 2019.

Altogether, the fiscal stimulus is worth CNY 4 trillion, which is line with our previous estimates. This means the state believes the economy is weakening, and the stimulus amount is aimed at preventing growth from dropping below 6%. There has been no specific focus on tightening measures in the housing market, which suggests the government recognises the importance of this sector to the construction industry.

"Prudent" monetary policy means we are unlikely to see a repeat of January's high loan growth.

Meanwhile, the government is maintaining a prudent stance when it comes to monetary policy. After 5 March, the date when this stance was announced, the central bank kept the daily injection of liquidity very moderate. We expected the medium lending facility (MLF) to be replaced completely by the targeted MLF (TMLF), which lends money via banks to small private firms at a lower interest rate. But this didn't happen. It seems to us that the central bank is refraining from pumping too much liquidity into the market. So a repeat of the high loan growth we saw in January looks unlikely.

Yuan mechanism will follow 2016?

On the yuan, the state repeated its rhetoric from 2016 when USD/CNY started to follow the dollar index closely. Re-using identical phrases for the yuan suggests a similar USD/CNY move this year. Our forecast for USD/CNY and USD/CNH is 6.75. The yuan will likely gain some support from capital inflows into Chinese asset markets due to the inclusion of these assets in global indices.

How long could the truce last, if any?

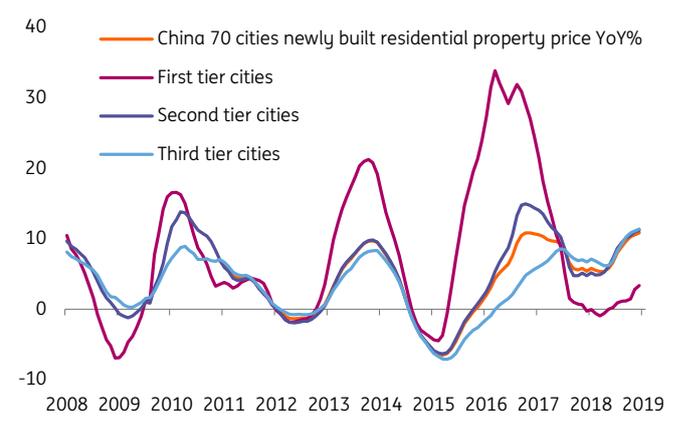
The largest political event of the year provided some clues about China's growth trajectory and the risks it faces in 2019. But there were no hints about any progress on the trade war, which is still a big risk to China and rest of the world. Even if there is a truce, the market will ask how long this is likely to last, and how quickly all of the affected businesses can recover. Sizeable fiscal stimulus from the Chinese government offers part of the answer.

**Fig 6 With the fiscal stimulus, manufacturing PMI will rise**



Source: ING, Bloomberg

**Fig 7 The housing market can be a rescue to construction**



Source: ING, Bloomberg

Iris Pang, Economist, Greater China, Hong Kong +852 2848 8071

## Japan: Old style

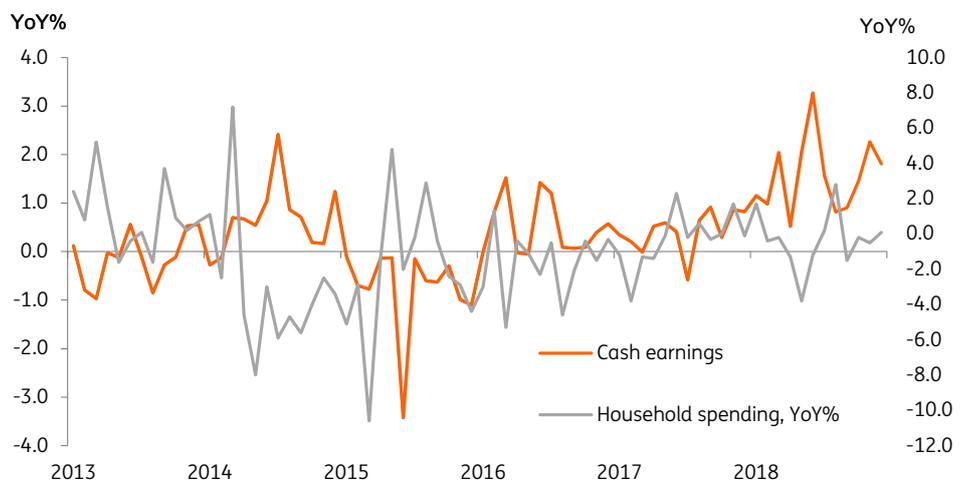
Fourth quarter growth was a bit of a 'dead-cat' bounce

Despite some better wage growth, consumption hasn't grown

As we feared, 4Q18 GDP failed to bounce back as strongly as we had initially hoped. After a 2.6% annualised decline in 3Q18, the 1.4% bounce in 4Q18 was of the distinctly 'dead-cat' variety. Certainly not the 'sharp bounce' one business TV channel reported on the day. And since then, the data hasn't got much better.

One of the biggest disappointments for Prime Minister Shinzo Abe, we imagine, must be that after convincing businesses to be more generous with wages, which they now are, with wage growth honing in on 2.0% year-on-year, household spending still remains virtually flat. The idea that paying people more through scheduled cash earnings and not through one-off bonuses would lead to a smaller percentage being saved, has simply not been borne out by reality.

**Fig 8 Cash wages and household spending**



Source: Bloomberg, CEIC

Exports are, like everywhere else in Asia, falling - a combination of trade war effects and the global slump in semiconductor / electronics demand. And corporate profits are weakening - which doesn't bode well for either continued wages or employment growth, and puts a question mark against recent capital spending figures which came in a little stronger than expected.

**Inflation isn't going anywhere**

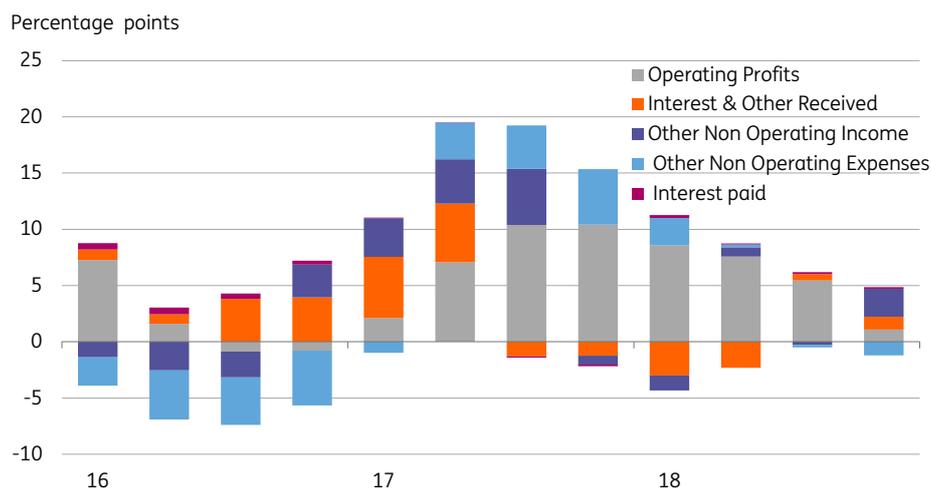
Inflation data, too, has utterly failed to make it any further, and has now drifted back in the direction of zero. This isn't a big deal as far as the real economy goes. Japan isn't exhibiting any genuine 'deflationary trends', but it's encouraging the Bank of Japan to talk up remedial policies aimed at pushing inflation in the direction of their 2.0% target.

By now, one would have thought that by having undershot the target for so long with no obvious adverse effects, someone would have understood that the target itself may not be attainable, and might be the wrong level to target.

**There's growing talk of action at the Bank of Japan**

That sort of thinking doesn't seem to have permeated into the inner circles of the central bank, though recent commentary from governor Haruhiko Kuroda amongst others, has been to talk up the prospects of policy actions to provide a further boost to the economy. We certainly have come a long way, and in an unfortunate direction since this time last year, when all talk was of taper.

**Fig 9 Contribution to profits growth (percent)**



Source: CEIC, ING

Now, forget any change to the negative rate on excess reserves. 10-year bond yields may be targeted below zero, and the asset purchase programme (which we note is virtually stagnant at current levels) could be ramped up. None of which, we believe, will make any meaningful difference.

**Rob Carnell, Singapore +65 6232 6020**

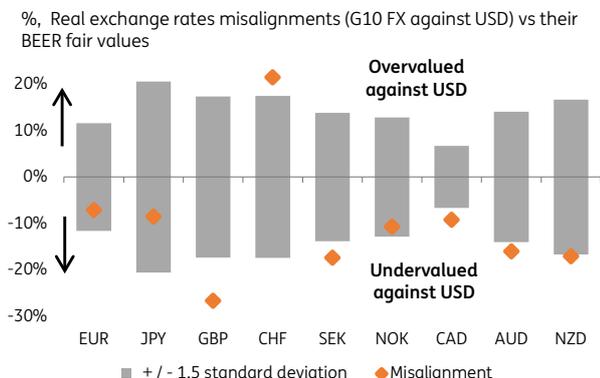
## FX: Dollar against the low yielders

**Solid US economic data and a likely market-friendly resolution of the US-China trade talks should eventually translate into an additional Federal Reserve rate hike in the third quarter, in our view. With the market pricing in close to zero probability of a hike this year, any tightening should help to support the dollar against the low yielding G10 FX, where soft activity data has made tightening a low probability event. In essence, we continue to look for further USD outperformance vs the low yielding G10 FX in the months ahead.**

Here the Japanese yen, euro and Swedish krona tick the box and the latest dovish ECB meeting provides a case in point. With the case for one additional Fed hike this summer and the already non-negligible interest rate differential between the US dollar and these three currencies, going long on these low yielders against USD is not attractive because of the negative carry cost and also the lack of catalysts for the currencies to strengthen.

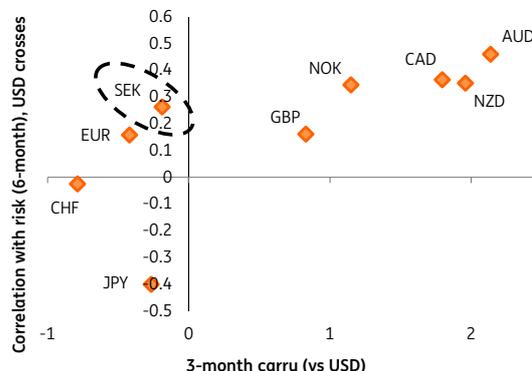
This is despite the fact that USD screens expensive both on a trade-weighted and bilateral basis. But the valuation alone is not a sufficiently strong reason for currencies to appreciate if there are no catalysts to close the valuation gap. As per [EUR: Another punch from the ECB to the euro](#), the ECB won't clearly deliver such catalysts for the euro and neither will the Riksbank or the Bank of Japan, for their respective currencies.

**Fig 10 Dollar is expensive against most of G10 currencies**



Source: ING, Bloomberg

**Fig 11 SEK offers a poor risk rewards vs G10 activity FX**



Source: ING, Bloomberg

As we've written, ([SEK: Struggling to find the silver lining](#)), we are one of the most bearish forecasters on the Swedish krona, with the currency offering a rather poor risk-reward compared to its G10 peers. As figure 11 shows, SEK exerts the lowest beta to risk among the G10 activity currencies (meaning the currency benefits less during risk-on days) and has a vastly lower yield (with the Riksbank still running negative interest rates). And now, the bar for the Riksbank to hike in 2H19 is high.

The rise of sterling stalled during March, lacking any tangible progress in the EU-UK negotiations on changes to the Irish backstop. The market had already priced out the probability of a hard Brexit in February and at one point had arguably overestimated the odds of a second referendum. Next week's parliamentary vote will be crucial for GBP.

Our base case is that PM May won't get support in parliament and that lawmakers will vote for an extension of Article 50. As we've noted in [Delaying Brexit](#), we believe the duration of the Article 50 extension will matter for GBP price action. A short extension (i.e. three months or less) should only translate into limited GBP upside (i.e. EUR/GBP at 0.85) as economic uncertainty would prevail, the Bank of England won't be in a position to hike and the risk of a cliff edge would be only briefly postponed. In contrast, an Article 50 extension of nine months or more would likely lead to greater GBP upside (EUR/GBP at 0.83) as a more prolonged window of stability may allow the BoE to hike.

We're still not waving the white flag on our constructive view on emerging markets FX as an expected resolution on US-China trade talks should be positive for this segment, while an eventual Fed rate hike is likely to be in part dependent on a stable global risk environment. This means that the Fed, which is watching external developments closely, is unlikely to deliver a rate hike in an environment where risk assets / EM FX sell off, suggesting that an eventual hike is not inconsistent with a constructive view on EM FX.

In central and eastern Europe FX, our top pick remains the Hungarian forint. The forint has been the best performing CEE currency this year, and we look for more gains this month ahead of the crucial National Bank of Hungary meeting on 26 March, when the central bank is expected to announce the start of its Bubor normalisation. This points to HUF outperformance vs the Polish zloty (where the central bank retains a neutral bias) as well as the Czech koruna (where the still heavy positioning is limiting the transmission from central bank tightening to the currency.)

Petr Krpata, London +44 20 7767 6561

## Rates: Sub-20bp Bund yield only rationalised by angst

The ultra-low 10yr German yield does not reflect the performance of the German economy.

Rather, it is reflection of fear, and a chunk of this is Euro project existential fear

As a long in Germany is a part insurance in the case where things all go wrong

And especially as there has been a steady flows of things going wrong in recent years

This also explains some high spreads, with Italian spreads being the prime example

For that reason, we think the EU elections coming in May will be an important measure of sentiment in Europe

It will likely be okay, but we need to see the case proven first. Once proven, core rates can then trek higher again.

**The 10-year German yield at a mere c.20 basis points bears no reflection whatsoever on the Germany economy. With nominal growth running in excess of 2.5%, such a low yield implies a negative real rate of more than 2%, which under normal circumstances would imply significant macro angst. And while there has been a slowdown, it is nowhere near as sinister as that discount suggests. So how can we make sense of this?**

Plain and simple, the 20bp 10-year German yield is a measure of fear. And the closer we get to zero the more aggravated that fear becomes. That fear is a combination of two elements. First, there is an element of macro fear - that the current slowdown could become more severe, but the more significant element is the fear underlying the European project, and not enough attention is being paid to this.

The logic here is that long-positions in Germany, even at just 20bp, come with a sizeable element of protection should the European project come across hard times, in the sense that if it all fell apart long positions in Germany offers the best possible outcome - a proxy Deutschemark. We're not anticipating a collapse, but such a scenario can be reverse-engineered from core market valuations, especially German ones.

Recent years have seen a whole series of existential threats come to the fore in the eurozone, starting with Greece, followed by numerous bailouts. Right now, we have a Brexit referendum awaiting execution, a populist government elected in Italy, and a rise in populism generally across Europe. This may not amount to anything sinister, but then again we can't be sure about that, especially given the number of improbabilities that have occurred.

As things stand, there is a spectrum of spreads above Germany that provide varying degrees of risk/return options. Italy is 265bp over Germany, which in itself is a remarkable spread. In part, it's driven by how low the German yield is and it's also circular, as the low German yield reflects a flight to safety, which is a necessary implication from political risks being taken elsewhere, with Italy being a good example.

Against this backdrop, one of the key elements to watch over coming months will be the build-up to the European elections in May. Not that the European elections are typically a significant event for bond markets, but this time they will act as a key barometer of where the European psyche is right now. A sizeable increase in the populist vote is expected, although ironically dented by Brexit, which will exclude UK separatists from having their say - as UK seats will be re-distributed or culled for now.

While there is a strong likelihood that the traditional pro-European parties will continue to dominate proceedings post the outcome of the elections, any significant gains made by parties of a disruptive ilk would add to the unease that is in play. We think the bond market discount is overly sinister here, and that bund yields should be higher to reflect this (c.50+bp). At the same time, perhaps policy-makers are not paying enough attention to the battle cries coming from the eurozone bond market.

**Padhraic Garvey, London +44 20 7767 8057**

Fig 13 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    |
| <b>United States</b>                 |       |       |       |       |       |       |       |       |       |       |       |       |       |       |       |       |       |       |       |       |
| GDP (% QoQ, ann)                     | 1.8   | 3.0   | 2.8   | 2.3   | 2.2   | 2.2   | 4.2   | 3.4   | 2.6   | 2.9   | 2.0   | 2.3   | 1.8   | 2.0   | 2.4   | 1.7   | 1.7   | 1.7   | 1.9   | 1.8   |
| CPI headline (% YoY)                 | 2.6   | 1.9   | 2.0   | 2.1   | 2.1   | 2.7   | 2.7   | 2.6   | 2.2   | 2.4   | 1.6   | 1.7   | 1.8   | 2.0   | 1.8   | 2.4   | 2.2   | 2.1   | 2.1   | 2.2   |
| Federal funds (% eop) <sup>1</sup>   | 0.75  | 1.00  | 1.00  | 1.25  | 1.25  | 1.50  | 1.75  | 2.00  | 2.25  | 2.25  | 2.25  | 2.25  | 2.50  | 2.50  | 2.50  | 2.50  | 2.50  | 2.50  | 2.50  | 2.50  |
| 3-month interest rate (% eop)        | 1.15  | 1.30  | 1.35  | 1.55  | 1.55  | 2.30  | 2.35  | 2.45  | 2.65  | 2.65  | 2.60  | 2.60  | 2.85  | 2.85  | 2.85  | 2.90  | 2.90  | 2.90  | 2.90  | 2.90  |
| 10-year interest rate (% eop)        | 2.40  | 2.30  | 2.30  | 2.40  | 2.40  | 3.00  | 3.00  | 3.00  | 2.80  | 2.80  | 2.80  | 3.00  | 2.90  | 2.80  | 2.80  | 2.70  | 2.70  | 2.60  | 2.40  | 2.40  |
| Fiscal balance (% of GDP)            |       |       |       |       | -3.5  |       |       |       |       | -4.0  |       |       |       |       | -4.7  |       |       |       |       | -5.0  |
| Fiscal thrust (% of GDP)             |       |       |       |       | 0.0   |       |       |       |       | 1.2   |       |       |       |       | 0.5   |       |       |       |       | 0.8   |
| Debt held by public (% of GDP)       |       |       |       |       | 76.1  |       |       |       |       | 77.4  |       |       |       |       | 80.2  |       |       |       |       | 83.3  |
| <b>Eurozone</b>                      |       |       |       |       |       |       |       |       |       |       |       |       |       |       |       |       |       |       |       |       |
| GDP (% QoQ, ann)                     | 2.7   | 2.7   | 2.7   | 2.7   | 2.5   | 2.7   | 1.7   | 0.6   | 0.8   | 1.8   | 1.1   | 1.6   | 1.4   | 1.4   | 1.2   | 1.1   | 1.2   | 1.0   | 0.9   | 1.2   |
| CPI headline (% YoY)                 | 1.5   | 1.3   | 1.5   | 1.4   | 1.4   | 1.3   | 1.7   | 2.0   | 2.0   | 1.8   | 1.4   | 1.2   | 1.2   | 1.5   | 1.3   | 1.6   | 1.6   | 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  | 0.00  | 0.00  | 0.00  | 0.00  | 0.00  | 0.00  | 0.00  | 0.00  | 0.00  |
| 3-month interest rate (% eop)        | -0.33 | -0.33 | -0.33 | -0.33 | -0.33 | -0.33 | -0.33 | -0.33 | -0.33 | -0.33 | -0.32 | -0.30 | -0.30 | -0.15 | -0.15 | -0.15 | -0.15 | -0.15 | -0.15 | -0.15 |
| 10-year interest rate (% eop)        | 0.45  | 0.40  | 0.45  | 0.42  | 0.42  | 0.50  | 0.30  | 0.40  | 0.24  | 0.24  | 0.20  | 0.30  | 0.40  | 0.40  | 0.40  | 0.30  | 0.30  | 0.30  | 0.30  | 0.30  |
| Fiscal balance (% of GDP)            |       |       |       |       | -0.9  |       |       |       |       | -0.6  |       |       |       |       | -1.0  |       |       |       |       | -0.9  |
| Fiscal thrust (% of GDP)             |       |       |       |       | 0.2   |       |       |       |       | 0.0   |       |       |       |       | 0.2   |       |       |       |       | -0.2  |
| Gross public debt/GDP (%)            |       |       |       |       | 89.2  |       |       |       |       | 87.7  |       |       |       |       | 86.3  |       |       |       |       | 85.1  |
| <b>Japan</b>                         |       |       |       |       |       |       |       |       |       |       |       |       |       |       |       |       |       |       |       |       |
| GDP (% QoQ, ann)                     | 1.9   | 2.3   | 1.6   | 1.3   | 1.9   | -0.9  | 2.2   | -2.6  | 1.4   | 0.7   | 1.7   | -0.8  | 5.0   | -5.9  | 0.5   | 2.8   | 1.5   | 1.0   | 1.5   | 0.6   |
| CPI headline (% YoY)                 | 0.2   | 0.4   | 0.6   | 0.6   | 0.5   | 1.3   | 0.6   | 1.1   | 0.9   | 1.0   | 0.3   | 0.9   | 0.8   | 1.8   | 1.0   | 2.3   | 2.2   | 2.1   | 1.0   | 1.9   |
| Excess reserve rate (%)              | -0.1  | -0.1  | -0.1  | -0.1  | 0.0   | -0.1  | -0.1  | -0.1  | -0.1  | 0.0   | -0.1  | -0.1  | -0.1  | -0.1  | 0.0   | -0.1  | -0.1  | -0.1  | -0.1  | 0.0   |
| 3-month interest rate (% eop)        | 0.00  | 0.00  | 0.00  | 0.00  | 0.00  | 0.00  | 0.00  | -0.05 | -0.05 | -0.05 | 0.05  | 0.05  | 0.00  | 0.00  | 0.00  | 0.00  | 0.10  | 0.10  | 0.10  | 0.10  |
| 10-year interest rate (% eop)        | 0.10  | 0.10  | 0.10  | 0.10  | 0.10  | 0.10  | 0.10  | 0.10  | 0.10  | 0.10  | 0.00  | 0.00  | 0.00  | 0.00  | 0.00  | 0.00  | 0.00  | 0.00  | 0.00  | 0.00  |
| Fiscal balance (% of GDP)            |       |       |       |       | -4.8  |       |       |       |       | -4.1  |       |       |       |       | -3.6  |       |       |       |       | -3.0  |
| Gross public debt/GDP (%)            |       |       |       |       | 221   |       |       |       |       | 223   |       |       |       |       | 224   |       |       |       |       | 226   |
| <b>China</b>                         |       |       |       |       |       |       |       |       |       |       |       |       |       |       |       |       |       |       |       |       |
| GDP (% YoY)                          | 6.9   | 6.9   | 6.8   | 6.8   | 6.9   | 6.8   | 6.7   | 6.5   | 6.3   | 6.6   | 6.2   | 6.2   | 6.3   | 6.3   | 6.3   | 6.3   | 6.2   | 6.2   | 6.2   | 6.2   |
| CPI headline (% YoY)                 | 1.4   | 1.4   | 1.6   | 1.8   | 1.6   | 2.2   | 1.8   | 2.3   | 2.5   | 2.2   | 2.5   | 2.5   | 2.6   | 2.6   | 2.6   | 2.6   | 2.6   | 2.5   | 2.4   | 2.5   |
| PBOC 7-day reverse repo rate (% eop) | 2.45  | 2.45  | 2.45  | 2.50  | 2.50  | 2.55  | 2.55  | 2.55  | 2.55  | 2.55  | 2.55  | 2.55  | 2.55  | 2.55  | 2.55  | 2.55  | 2.55  | 2.55  | 2.55  | 2.55  |
| 10-year T-bond yield (% eop)         | 3.29  | 3.57  | 3.61  | 3.90  | 3.90  | 3.75  | 3.48  | 3.63  | 3.30  | 3.30  | 3.25  | 3.20  | 3.15  | 3.10  | 3.10  | 3.10  | 3.05  | 3.05  | 3.00  | 3.00  |
| Fiscal balance (% of GDP)            |       |       |       |       | -3.7  |       |       |       |       | -4.5  |       |       |       |       | -4.5  |       |       |       |       | -4.0  |
| Public debt, inc local govt (% GDP)  |       |       |       |       | 50.0  |       |       |       |       | 88.0  |       |       |       |       | 102   |       |       |       |       | 103   |
| <b>UK</b>                            |       |       |       |       |       |       |       |       |       |       |       |       |       |       |       |       |       |       |       |       |
| GDP (% QoQ, ann)                     | 1.3   | 1.0   | 1.9   | 1.6   | 1.5   | 0.4   | 1.7   | 2.5   | 0.7   | 1.4   | 0.7   | 1.2   | 2.0   | 2.2   | 1.3   | 1.5   | 1.7   | 1.2   | 1.1   | 1.6   |
| CPI headline (% YoY)                 | 2.1   | 2.7   | 2.8   | 3.0   | 2.7   | 2.7   | 2.4   | 2.5   | 2.3   | 2.5   | 2.0   | 2.0   | 1.8   | 1.9   | 1.9   | 2.2   | 2.1   | 2.1   | 2.0   | 2.1   |
| BoE official bank rate (% eop)       | 0.25  | 0.25  | 0.25  | 0.50  | 0.50  | 0.50  | 0.50  | 0.75  | 0.75  | 0.75  | 0.75  | 0.75  | 0.75  | 1.00  | 1.00  | 1.00  | 1.25  | 1.25  | 1.50  | 1.50  |
| BoE Quantitative Easing (£bn)        | 445   | 445   | 445   | 445   | 445   | 445   | 445   | 445   | 445   | 445   | 445   | 445   | 445   | 445   | 445   | 445   | 445   | 445   | 445   | 445   |
| 3-month interest rate (% eop)        | 0.35  | 0.35  | 0.35  | 0.50  | 0.50  | 0.60  | 0.80  | 0.80  | 0.80  | 0.80  | 0.85  | 0.85  | 0.85  | 1.05  | 1.05  | 1.30  | 1.35  | 1.60  | 1.65  | 1.65  |
| 10-year interest rate (% eop)        | 1.15  | 1.10  | 1.35  | 1.20  | 1.20  | 1.45  | 1.48  | 1.57  | 1.30  | 1.30  | 1.35  | 1.45  | 1.65  | 1.70  | 1.70  | 1.90  | 2.00  | 2.10  | 2.10  | 2.10  |
| Fiscal balance (% of GDP)            |       |       |       |       | -2.5  |       |       |       |       | -1.4  |       |       |       |       | -1.5  |       |       |       |       | -1.5  |
| Fiscal thrust (% of GDP)             |       |       |       |       | -0.5  |       |       |       |       | -0.4  |       |       |       |       | -0.4  |       |       |       |       | -0.3  |
| Gross public debt/GDP (%)            |       |       |       |       | 87.0  |       |       |       |       | 84.0  |       |       |       |       | 83.0  |       |       |       |       | 81.5  |
| EUR/USD (eop)                        | 1.08  | 1.12  | 1.20  | 1.20  | 1.20  | 1.20  | 1.17  | 1.15  | 1.12  | 1.12  | 1.12  | 1.10  | 1.15  | 1.20  | 1.20  | 1.22  | 1.25  | 1.28  | 1.30  | 1.30  |
| USD/JPY (eop)                        | 112   | 115   | 110   | 113   | 113   | 107   | 110   | 114   | 113   | 113   | 112   | 113   | 107   | 100   | 100   | 99.0  | 98.0  | 97.0  | 95.0  | 95.0  |
| USD/CNY (eop)                        | 6.89  | 6.78  | 6.65  | 6.51  | 6.51  | 6.28  | 6.67  | 6.87  | 6.88  | 6.88  | 6.74  | 6.85  | 6.85  | 6.75  | 6.75  | 6.70  | 6.60  | 6.70  | 6.70  | 6.70  |
| EUR/GBP (eop)                        | 0.87  | 0.88  | 0.94  | 0.89  | 0.89  | 0.88  | 0.88  | 0.89  | 0.90  | 0.90  | 0.85  | 0.85  | 0.85  | 0.85  | 0.85  | 0.85  | 0.85  | 0.85  | 0.85  | 0.85  |
| Brent Crude (US\$/bbl, avg)          | 55    | 51    | 52    | 61    | 55    | 67    | 75    | 76    | 69    | 72    | 65    | 68    | 69    | 73    | 69    | 70    | 74    | 76    | 74    | 74    |

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

Source: ING forecasts

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