

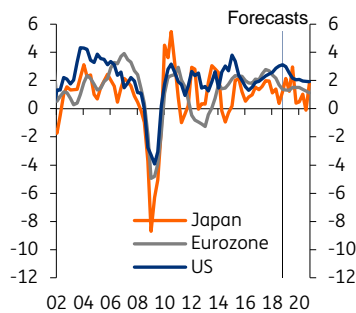
9 May 2019

Global

# Monthly Economic Update

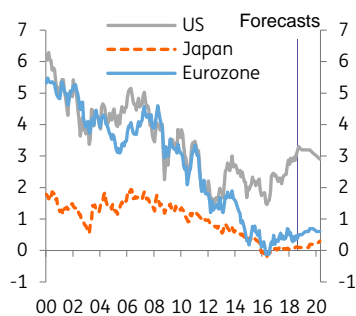
## Just when things were looking up...

### GDP growth (%YoY)



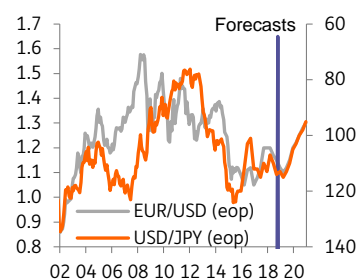
Source: Macrobond, ING

### 10yr bond yields (%)



Source: Macrobond, ING

### FX



Source: Macrobond, ING

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Just as pockets of optimism had begun to emerge in the global economy, trade tensions are back. President Trump has taken the trade war a step further with the imposition of fresh tariffs on China, which also raises questions about the possibility of auto tariffs. We still think a US-China deal remains likely, not least because President Trump will not want a damaged economy and stock market as he heads into a key election year. But in the meantime, trade uncertainty, as well as risks relating to forthcoming European elections and Brexit, suggest that financial market caution is likely to stay with us for a little while longer.

The re-emergence of US-China trade tensions has spooked financial markets, but ultimately we still think a deal is likely. Failure to get a deal, perhaps coupled with further tit-for-tat tariff hikes, would be harmful to both economies and would hit equities. Such an environment would be deeply damaging for President Trump's chances of re-election in 2020, so we suspect the latest move is designed to extract last-minute concessions from China, rather than a serious effort to trigger a larger global trade war.

However, stronger-than-expected growth in China following earlier fiscal and monetary stimulus provides its government with some extra chips when it comes to renegotiating. The negotiations concern much more besides trade – China's ability to export its 5G network, coupled with geopolitical tensions in the South China Sea, also matter.

Despite the ongoing uncertainty, the US economy continues to prove the doubters wrong, following another robust GDP growth figure for 1Q19. The economy is adding jobs in significant numbers, while financial conditions continue to improve thanks to rising equity markets, a strong and stable dollar and falling mortgage rates. Inflation could rise more quickly than the market anticipates given rising fuel costs and wage pressures emanating from the labour market. While financial markets continue to price in interest rate cuts, the Federal Reserve is maintaining a cautiously upbeat tone that signals stable monetary policy through 2019.

The Eurozone also saw stronger-than-expected first quarter growth, which was probably helped along by a normalisation of the exceptional factors that had held back growth in the second half of last year. But while a recession certainly doesn't look imminent, a growth acceleration also seems unlikely. The rise in April inflation was caused largely by calendar effects so there's not much sign of an upward trend. All this suggests the ECB will stay put for the time being.

In the UK, there are good reasons to think that the Brexit deadlock won't be broken before the new October Article 50 deadline. Cross-party talks don't appear to be making much headway, while there remains a risk of a summer Conservative Party leadership battle. A further extension to the Article 50 period is perhaps more likely than not. But while we think a 'no deal' exit will be avoided, firms will have to continue making preparations and this will keep a lid on economic growth over the summer months.

May is typically a bad month for EUR/USD. 1.10 looks the target this summer as US data holds up well and the ECB contemplates the signals it wants to send with the TLTRO III in June. A surprise decline in the Renminbi would also shake up the low volatility mood.

While risk assets have rallied off earlier lows, the US 10-year yield has not managed to budge much from the 2.5% area. However, the positive macro-story in the US, coupled with the fact that a Fed rate cut remains some way off, suggests the balance of risks are slowly swinging back in the direction of a test higher for market rates.

## Trade: 'Tariff man' strikes again

President Trump's decision to raise tariffs on Chinese imports has once again clouded the already weak trade outlook. But we think this will prove temporary because we think a deal between the US and China is still the most likely outcome.

World trade has been fighting an uphill battle in 2019. During the last two months of 2018 trade levels dropped no less than 3.8%, the largest two-month decline since 2009. As this has fed through, it has made it hard to obtain decent YoY growth rates in trade during 2019.

We expect trade to catch up with economic activity, undoing part of the late-2018 setback. We also expect the underlying pace of trade growth to return to the long-term average growth of 0.2% per month. These factors will only deliver 1.2% growth overall in 2019, thanks to the very negative carry over from 2018.

Importantly, this doesn't full account for the 2018 tariff hikes, which haven't fully run their course yet. It also doesn't take on board the latest hike in import tariffs from 10 to 25% on the USD200bn package, and the subsequent retaliation from China. We expect this response to be proportional to its response to the initial imposition of the 10% tariff hike from the US on this package of goods. The combined effect of these tariffs would lower our 2019 trade growth forecast by 0.7ppts, meaning that we expect only 0.5% trade growth this year.

We still think that there will be a deal in the end. The fact that negotiations are continuing amid the tougher rhetoric is positive. For China, the dependency on US demand for its products is significant, accounting for 3% of Chinese GDP. Conversely, President Trump knows that patience is beginning to run a little thin towards his aggressive trade policies in those sectors that have been most hit by Chinese retaliation (for example agriculture).

As we go on to discuss in the US article, we think President Trump wants a deal ahead of the 2020 election – not least to prevent his opponents being able to leverage the possible economic damage and stock market losses in their campaigns. Therefore, we think the US may end up watering down some of its demands, as it did in the renegotiation of NAFTA.

For now, we think a deal will be struck at the end of Q3. In the meantime, the latest tariff hike is likely to do some temporary damage to world trade, although this could unwind once a deal is done – particularly if tariffs begin to be phased out. We think that half of the mutual tariff hikes will be removed shortly after a deal is done, with the other half phased out gradually in 2020, assuming both parties live up to their end of the bargain.

However, the risks are clearly tilted to the downside. Recent actions from President Trump show that tariff hikes remain his favourite policy tool. This is something to keep in mind when considering whether he will implement tariff hikes on cars.

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Annual trade figures have struggled to be decent this year and even with a catch up we would only expect 1.2% overall growth

Elevated US tariffs arrived on Friday 10 May, but we still think a deal will be struck in the end

With intent to attain a deal before the 2020 election, the US is likely to water down some of its demands

But, meanwhile, the latest tariff hike will do some damage to world trade – though this should only be temporary as tariffs phase out once a deal is secured

# US: In defiance of markets

**1Q GDP outperformed, jobs growth remains strong, consumer optimism is high and wages are rising. The case for rate cuts remains weak in our view.**

The US economy posted another robust GDP growth figure in Q1

We have long talked about the intensifying headwinds to growth that the US faces this year. These include the fading support from fiscal stimulus, the lagged effects of higher interest rates and the stronger dollar together with uncertainty caused by trade protectionism amidst a weakening global growth story. However, you should never underestimate the US economy and yet again it proved the doubters wrong by posting 3.2% annualised growth in Q1.

Trade and inventory did make significant contributions, but this isn't the entire story

This is a remarkably strong performance since as recently as early March there were analysts suggesting a negative quarter was possible given the gloom surrounding the global economy and the fallout from the Dec-Jan government shutdown. The naysayers continue to look for the negatives though and highlighted the fact that inventory building contributed 0.65 percentage points of the 3.2% total growth with trade adding an extra 1 percentage point to growth.

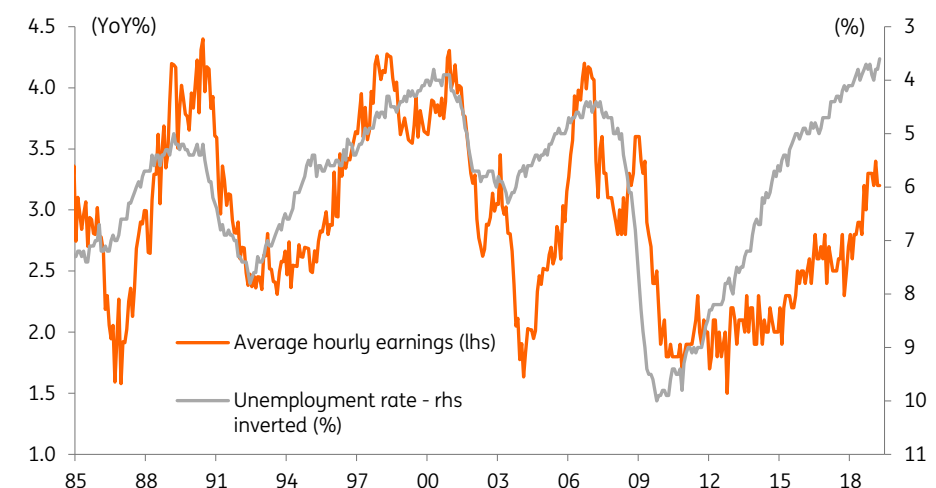
Both components will become more of a drag on growth in coming quarters

This relates to the aborted tariff hike on Chinese imports that was scheduled to come in on January 1<sup>st</sup>. US businesses ramped up imports in the latter part of 2018 to beat the proposed tariff hike and correspondingly cut orders for the start of 2019. As such imports fell in 1Q while exports held up. Of course, the tariff hike wasn't implemented so imports are likely to rise back in the second and third quarters. Inventories have swung around for the same reason and we agree that both of these components will become drags on overall growth.

The household sector has strong fundamentals

Nonetheless, the domestic demand story is very positive. The jobs market remains strong with another 263,000 jobs created in April and unemployment dropping to 3.6% - a 50 year low. The lack of available workers with the right skill sets is an increasing challenge for companies with the National Federation for Independent Businesses reporting that 38% of its members have vacancies they cannot fill.

**Fig 1 Wage are responding to the tight jobs market**



Source: Bloomberg

Wages are picking up while benefit packages are being improved too

This demand-supply imbalance in the jobs market is boosting pay to some extent, but not by quite as much as we had expected. Pay rose 0.2%MoM, that's 3.2%YoY in April, but given the competition for workers, we expect pay to continue grinding higher. It is important to remember that businesses are increasingly using non-wage benefits to

attract and retain staff with increased vacation days, improved pension and healthcare packages and signing bonuses being used according to the latest Federal Reserve Beige Book.

Consumer spending should make a significant contribution to 2Q GDP growth

With workers feeling secure in their jobs and receiving pay rises and improved packages it isn't surprising to see consumer confidence rising once again. Equity markets are close to all-time highs and the plunge in mortgage rates also helps. The one negative is the recent rebound in gasoline prices, which is a highly noticeable hit to household cash-flow. Nonetheless, real incomes overall are rising and this should keep consumer spending supported. Indeed we wouldn't be surprised to see consumer spending rebound by 3.5% after the modest 1.2% growth rate recorded in Q1.

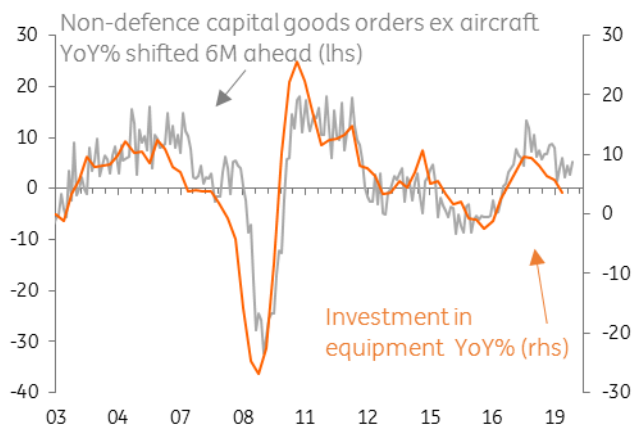
Residential investment may also start to make a positive contribution

We are also a little more optimistic about residential investment in the second half of the year. This component has been a drag on overall growth for five consecutive quarters, but the plunge in mortgage rates has prompted a surge in mortgage applications and is starting to be seen in housing transactions.

We expect the US economy to expand 2.5% in 2019

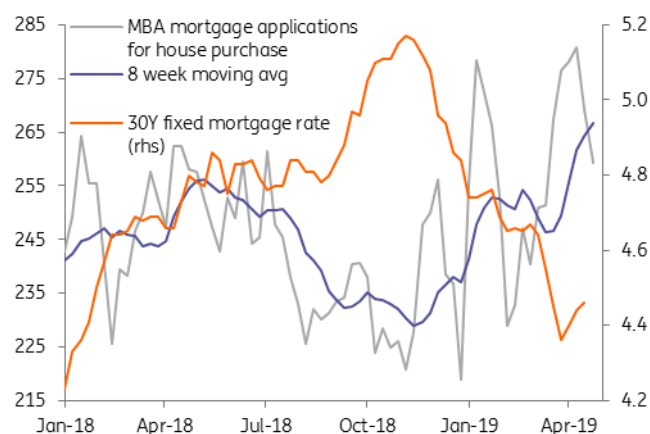
The news on the corporate sector has been a little more mixed with the ISM surveys moving lower, but they remaining firmly in growth territory. That said the core durable goods orders numbers have been moving higher recently, pointing to an improving outlook for investment.

Fig 2 The outlook for investment is improving



Source: Macrobond

Fig 3 Mortgage applications surge as rates plunge



Source: Macrobond

Trade remains a key issue for corporate America and equity markets, particularly now that President Trump has upped the ante with an increased level of tariffs on Chinese goods. However talks continue and while there may not be any imminent breakthrough, we think a deal will most likely be agreed that will see them removed together with a more general easing of tensions in Q3.

Both sides would be hurt economically by tariff hikes. China admittedly more so, but US equity markets would likely suffer too, just as we saw through late 2018. A weaker economy, deteriorating sentiment and plunging stock prices would play into the hands of President Trump's opponents as he seeks reelection. We see this more as a way to try to force China into last minute concessions, rather than something more long-lasting and economically-damaging. Nonetheless, tensions could get worse before they get better, given the President is set to decide on whether to proceed with tariffs on foreign car imports

The combination of the much stronger 1Q GDP growth and the robust domestic story, offset by the impact of renewed trade tensions on balance leaves us with a slightly

stronger 2019 full-year growth forecast of 2.5% (vs 2.4% previously). We have kept our 2020 and 2021 forecasts unchanged

Inflation could also rise more quickly than anticipated thanks to wage and energy price effects

As for inflation, we think the market is being a little too relaxed regarding the prospect of a pick-up. Rising labour costs in the form of both wages and other benefits could be passed onto consumers while higher energy price will feed through into other components. Gasoline prices have jumped 30% from \$2.23/gallon in mid-January to \$2.88 today and this will soon start to be felt in transport fares and distribution costs.

We think the bond market is too negative and we expect the Fed to keep rates unchanged in 2019

For now, the market is of the mindset that inflation will remain low, growth will slow and the Fed will need to respond by cutting interest rates later this year. We disagree. Given the decent activity story, the improvement in financial conditions and the prospect of rising inflation we see little reason for the Federal Reserve to cut interest rates – assuming of course that the trade tensions are resolved before too long.

The Democrat candidate list keeps growing

As for politics, it is early days in the 2020 presidential election race, but competition for the Democrat candidature is certainly hotting up with Joe Biden officially entering, but we are still a long way from the November 3<sup>rd</sup> 2020 polling day.

The economies of the key swing states are performing well, giving President Trump a strong platform from which to seek re-election

In our recent note 'US Politics Watch: Presidential election 2020 and beyond' report we highlighted what we felt were the five key swing states that will determine who wins the Presidency - all of which went to President Trump in 2016. Of course, economic performance is not the only factor that determines how people vote, but looking at the numbers for these key swing states, Michigan, Wisconsin, Pennsylvania, Florida and Arizona, it gives Donald Trump a strong platform for his re-election campaign.

This poses challenges for the Democrat challengers

All have recorded faster growth than the median state and all have experienced strong jobs markets. As such a challenger may need to focus more of their initial campaigning on healthcare, environment policy, regulation of big tech and identity politics to convince the electorate that political change is required.

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# Eurozone: Positive surprises

Stronger growth in the first quarter...

...was helped by a normalisation of exceptional factors in the second half of 2018

While we don't see a growth acceleration...

... a recession looks also rather unlikely over the next few quarters

The European elections might give strong domestic messages both in France and in Italy

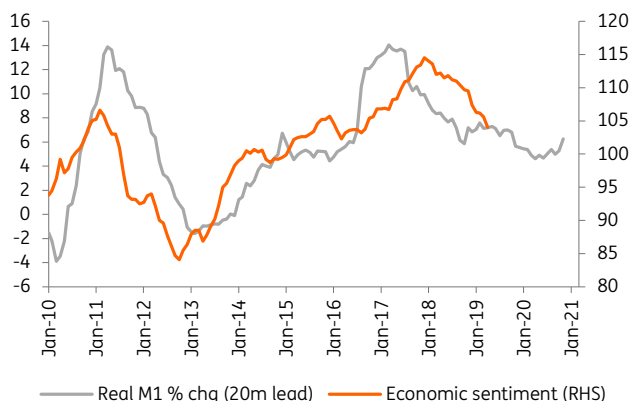
Looking at the latest data in the Eurozone, we can finally spot some reasons to be cheerful. According to Eurostat's flash estimate, the Eurozone's GDP grew by a better than expected 0.4% in the first quarter or 1.2% year-on-year. Italy put in 0.2% GDP growth, thereby ending the technical recession that started in the third quarter of 2018. But there's no need to get overexcited: while it is still very premature to pencil in a recession in Europe over the next 12 months, a significant growth acceleration shouldn't be expected either.

The stronger than expected growth in the first quarter was probably helped by a normalisation of exceptional factors that held back growth in the second half of last year. But the first indicators for the second quarter cast some doubt that this growth rhythm can be maintained. Both the European Commission's economic sentiment indicator and the PMI fell in April. The Eurocoin Indicator, a monthly proxy of the underlying growth pace, declined to a mere 0.18 last month, definitely not a sign that the expansion is accelerating.

To be sure, it is not that we see growth petering out in the coming months; there is still sufficient underlying momentum. Unemployment fell more than expected to 7.7% in March, underpinning consumption. We also believe the weakness in manufacturing is unlikely to last. The pick-up in China and some of the emerging markets should support European exports, though it might last until the third quarter before this effect really shows in the figures. The fact that German industrial production increased by a stronger than expected 0.5% month-on-month in March, might already be a sign that industry is bottoming out. Growth of real narrow money, according to the [ECB](#) one of the best leading indicators of economic activity, clearly points to slow growth, but at the same time only limited recession risk up to the beginning of 2020. We are still comfortable with our GDP growth forecast of 1.2% both in 2019 and 2020, though 2021 might see a slowdown to only 0.9%.

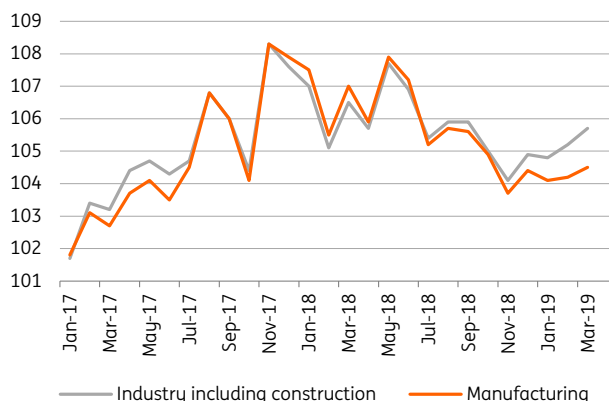
On the political front, the European elections might also be important for domestic reasons. The outcome in France will be seen as a poll on how the French react to President Macron's reform proposals. In Italy, it will most likely show a strengthening of the League within the governing coalition, which could ultimately entice Matteo Salvini to trigger elections later this year to consolidate his strength. Italy is likely to see some renewed uncertainty anyway, as the European Commission already indicated a deterioration of Italian public finances, necessitating corrective measures in the 2020 budget.

**Fig 4 Real money growth doesn't anticipate recession**



Source: Thomson Reuters Datastream

**Fig 5 German industry is showing signs of life**



Source: Thomson Reuters Datastream

The inflation spike in April was caused by calendar effects

The inflation spike in April, with headline inflation jumping to 1.7% and core inflation to 1.2%, can be forgotten immediately. This is just a year-on-year glitch, caused by the late Easter holidays this year, pushing up hotel and package holiday prices. In May this should normalise again. We agree that the somewhat higher oil prices could push up inflation, but this impact is likely to remain muted. As for core inflation, a more reliable measure for underlying price dynamics, we don't expect it to top 1.5% over the next two years, clearly undershooting the ECB's inflation objective.

ECB is likely to keep interest rates stable for a long time...

The ECB's change of tone has provoked speculation on new monetary initiatives. As such, the idea of a two-tiered deposit facility system was cheered by financial markets. However, ECB Board member [Benoît Cœuré](#) poured cold water on the proposal by stating that there is no economic reason to do it, as so far the negative interest rate doesn't seem to impact lending in member states with a high degree of excess liquidity. We, therefore, expect interest rates to remain stable over the forecast horizon.

...while tweaks to the conditions on the TLTROs might be used to calibrate monetary policy

That said, the ECB might want to use the new TLTROs to make small adjustments to the monetary policy stance over the next two years. Banks will be entitled to borrow up to 30% of the stock of eligible loans as at 28 February 2019 at a rate indexed to the interest rate on the main refinancing operations over the life of each operation. But there is no need to announce the same conditions for all upcoming TLTROs: conditions could be slightly tweaked according to the economic circumstances.

As for bond yields, we only see minor upward potential. While the halting of net purchases could trigger upward pressure, the expectations of short rates remaining low for a very long time and lower US bond yields in 2020 are likely to dampen this movement.

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## UK: The slow countdown to October

There are good reasons to think not much will change before the new October Brexit deadline

The dust is beginning to settle after the EU's decision to grant a six-month extension to the Article 50 Brexit negotiating period. But four weeks on, and there are good reasons to think the deadlock won't be broken before the new October 31 deadline.

Cross-party talks are focussed on some kind of customs arrangement

Poor local elections results for the two major political parties appear to have injected some fresh impetus into cross-party talks between prime minister Theresa May and Labour leader Jeremy Corbyn.

Recent press reports indicate that talks are centred on the idea of a 'temporary customs arrangement' lasting until 2022, with a possible agreement to extend the stand-still transition period until then too. Put simply, it implies accepting the terms of the withdrawal agreement now, and leaving the future agreement with all to play for – presumably for the winners of the next 2022 election to have the final say.

But a deal still seems some way off

However, there are two reasons why the Labour leadership remains reluctant to sign-up to this kind of deal.

Firstly, it is unlikely to stand the test of time. Assuming Theresa May steps down as leader once a deal is ratified then a more Eurosceptic Conservative leader could look to renege on the cross-party agreement and pursue a different, 'harder' version of Brexit. The ratification of a deal would also reduce the chances of a general election, something which the Labour party are still keen to initiate.

Any deal will struggle to get through the House of Commons

Secondly, any cross-party deal is unlikely to contain a commitment to hold a second referendum. The prime minister has ruled this out as an option, while Jeremy Corbyn himself has long-favoured a customs union (possibly with the single market too) over another public vote.

This latter point is important because there are believed to be around 150 Labour MPs who would vote against a deal unless it comes with a second referendum attached. A deal that closely resembles a customs union also risks losing Conservative MPs in a Commons vote. 236 Tories voted against a customs union in the second round of indicative votes back in early April, and while many of these may well shift position with the prime minister, it's possible 100-or-so will continue to oppose this option over concerns about the ability to negotiate trade deals.

It's also worth remembering that any deal – be it May's deal, a cross-party agreement or another option pursued by Parliament – would still contain the contentious Irish-backstop.

Put simply, there are no guarantees that a meaningful deal can be struck between the two main parties – and more importantly, even if there is a deal, there are no guarantees it would get through Parliament. Another round of 'indicative votes' on different Brexit options also seems unlikely to be more successful than before, given that the immediate pressure has alleviated.

There's mounting pressure on the Prime Minister to step down

In the meantime, pressure is growing on PM May to stand down as leader of her party. While she has indicated she is prepared to stand aside if a Brexit deal is ratified, the most recent headlines suggest she is keen to stay in place until the Autumn. As things stand, there is no easy way for the party to force her to step down until December, when there will be another opportunity to hold a no-confidence vote. There are moves afoot within the 1922 committee – a group of Conservative lawmakers that decide on internal party matters – to change the rules to allow an earlier vote, but so far no such decision has been made.



A summer leadership election is still possible

Time will tell whether this push is successful, although there is a reasonable chance that there is a leadership contest over the summer to decide upon a new leader. Based on recent polling, former Foreign Secretary Boris Johnson remains odds-on to emerge as the next leader.

Will the EU grant a further Brexit extension in October?

Whatever happens, we think it's increasingly unlikely that a resolution to the Brexit stalemate can be found before October, begging the question of what happens next. The consensus among political commentators is that the EU would probably be open to a further Article 50 extension. After all, a number of nations were reportedly in favour of a much longer delay at the ad-hoc April European Council meeting.

There are mixed opinions in Brussels, and France in particular is taking a hard line

That said, some nations have been much less keen to grant more time and France, in particular, wanted a much shorter extension to be granted in April. A possible rise in the populist share of the vote in the European elections means this hardline stance could stay in place come the October European Council.

Many in Brussels are also wary of the UK disrupting the EU's policy agenda the longer it stays a member, and a large showing for the Brexit party in the European elections, combined with a more Eurosceptic prime minister, could see these fears broaden as October approaches.

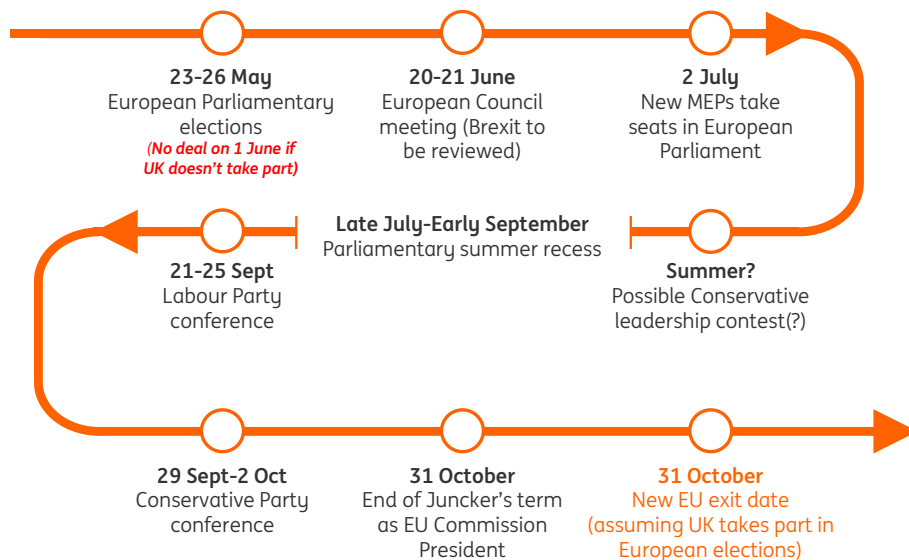
An extension is more likely than not – although a more Eurosceptic leader, or a wave of anti-EU MEPs being elected could change that

For the time being, our base case is that there will be minimal progress on Brexit before October and that a further extension seems more likely than not. We continue to think 'no deal' is relatively unlikely, given that if the EU does reject a further extension, it seems more likely that Parliament would step in to avoid an abrupt exit on WTO terms – perhaps even by revoking Article 50. If this were to happen, then it would most likely be spun as a 'revoke to regroup' decision, rather than a permanent 'revoke to remain'.

A Bank of England rate hike this year seems unlikely – but don't rule it out completely

But while a cliff-edge exit remains unlikely, businesses will have to continue making preparations for the worst-case scenario. This will keep a lid on growth over the summer, although activity could receive a little more impetus from consumer spending. We currently don't expect the Bank of England to hike rates this year. That said, if Article 50 is indeed extended again, the most recent press conference gave us the impression that policymakers could be minded to tighten policy again in November if the economic outlook pans out roughly as they predict.

Fig 6 The road to the new October Brexit deadline



Source: ING

# China: Growth aids trade battle

China enjoyed a better than expected GDP growth in 1Q19

This gives China extra room for renegotiating terms in any trade deal.

The cost of confronting the US is not only on the trade but also on 5G equipment exports

China may need more fiscal stimulus and monetary easing if the trade war continues to escalate.

Yuan will move in a narrow range so not to send any wrong signal to the market that there is a risk of capital flight

Last month, we noted that China has enjoyed a recovery created by fiscal stimulus and monetary easing. This was demonstrated by the recent GDP figures, where first-quarter growth matched the 6.4% YoY pace seen in 4Q18.

Stronger-than-expected economic growth should provide the Chinese government with extra chips when it comes to renegotiating the terms of a draft trade deal with the US.

The latest turning point in the trade negotiations appears to have been triggered by disagreements over a reciprocal penalty system. But for China, the cost of confronting the US is more broad-based than trade. The US, along with some of its allies, have aired concern over the use of Chinese-made 5G equipment. Equally, tensions have risen in the South China Sea. If China successfully renegotiates, then it has the potential to reduce some of these risks.

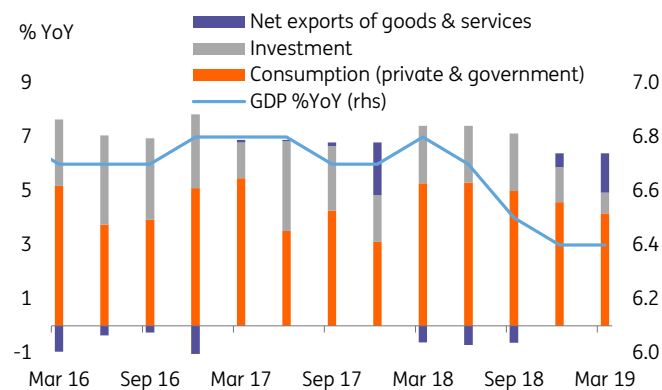
If China renegotiates successfully then the potential risks on 5G exports and geopolitical tension around the South China Sea will be reduced.

But let's not forget, China's negotiation chips come from fiscal stimulus and monetary easing. Domestic consumption, as reflected in retail sales, is not as bright as it seems. China may need even more fiscal stimulus and monetary easing to support a possible long-running renegotiation.

On the same day that the US revealed China has started renegotiating, the Chinese central bank, PBoC, restructured the system of required reserve ratios for small agricultural commercial banks. Though the extra liquidity released is a small drop of CNY280 billion out of an M2 money supply of CNY188,941 billion, it is a symbolic move that shows the willingness of the Chinese government to ease even further.

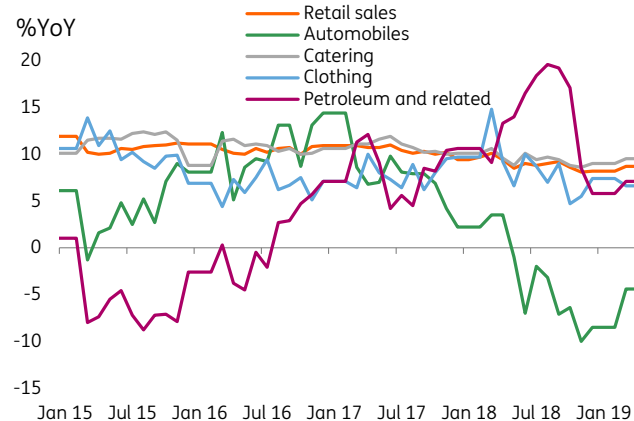
We keep our forecast for USD/CNY and USD/CNH at 6.75. But we have revised the 2Q and 3Q forecasts to 6.75 and 6.80 from 6.85. A big yuan depreciation when the trade war escalates could easily send an incorrect signal to the market that there are risks of capital flight. We have therefore kept our forecasts of USDCNY and USDCNH in a narrow range. We also keep GDP forecasts at 6.2%YoY in 2Q19 and 6.3% for 2019.

**Fig 7 China GDP is supported by "consumption" from government**



Source: ING, Bloomberg

**Fig 8 Consumers have been careful when it comes to spending**



Source: ING, Bloomberg

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# Japan: Mixed messages

The macro data paint a very muddy picture

1Q19 GDP could come in at about 1%...

...a bit slower than 4Q18, but not bad

The make-up looks as if it will be very mixed and contradictory

Bits of investment look very strong, other bits are in recession

From a purely macro perspective, the last month has answered no questions about the trajectory of Japan's economy. Indeed, to the contrary, the picture is less clear than it has been for some time.

We are approaching the release of 1Q19 GDP data, which means that we have near-complete, and semi-complete high-frequency data for most of the subcomponents of GDP, as well as for inflation. The story is as follows:

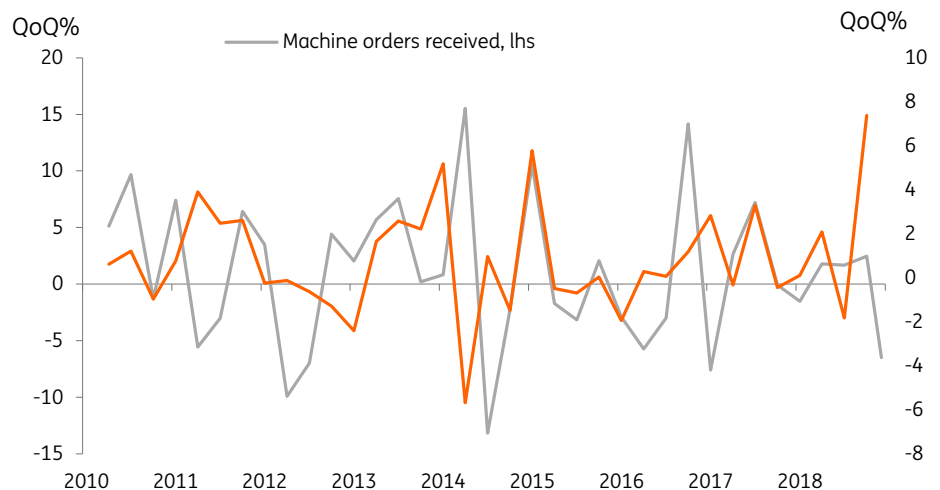
1Q19 GDP may not look too bad at first glance; we are looking for something around 1.1% at a seasonally adjusted annualised rate. That would follow a 1.9% rate in 4Q18, so looks decent, albeit perhaps indicative of a slight moderation in pace.

But Japanese GDP can't really be taken so literally, and is also prone to huge revisions, so aside from saying it is likely to be slower in 1Q19 than 4Q18, we can't confidently say much more at this stage.

Within this total are some real "head-scratchers". For example, private consumer spending looks as if it could register a healthy 2% pace. But cash earnings, which had been providing some lift to the household sector, have recently crashed to low sub-1% levels, and this does not look sustainable.

On the investment side, residential investment seems to be undergoing something of a boom, prompting questions about the Bank of Japan's purchasing of real estate investment trusts (JREITS). Business investment in plant, machinery and non-residential construction looks terrible in contrast, so the net investment picture will be determined by a largely unforecastable horse race between these two components.

**Fig 9 Business investment (in GDP) and machine orders**



Source: CEIC, ING

Exports are very weak, but net trade is harder to call, or how this impacts inventories

Net trade is another source of considerable uncertainty. We know that exports have been badly hit by the slowdown in global trade, the US-China trade war and the global tech slump, not to mention the slump in the auto sector. What we can't say with any precision is how this plays off against what also looks to have been a very weak quarter for imports, and whether this has led to a surge in inventories, or has been accompanied by destocking from previous inventory accumulation. We have opted for the latter, but inventories are often calculated residually by statistical agencies, so we have no confidence that this will actually turn out as forecast.

None of this helps us much with our outlook for the rest of the year

Putting this all together, it is very hard to characterise whether 1.1% is a good or a bad result for Japan, even if this is close to the figure that eventually gets published. It certainly doesn't set the economy up for a big rebound in 2Q19, but it isn't particularly worrying either.

Inflation looks a little better, but still way off target

Inflation did nudge a little higher in March, though this coincided with a further tweak to Bank of Japan (BoJ) forward guidance that to paraphrase, guarantees no tightening of policy until at least Spring 2020, and probably not then either. This, according to BoJ was to offset misperceptions about their intentions. We don't believe there were any. But in any case, it won't help the BoJ achieve their inflation target, and even they seem to have given up on it if recent economic projections are to be taken at face value.

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## FX: Sell in May....

The low FX volatility story has also been driven by the tightly managed USD/CNY - but that anchor looks to be slipping

The investor adage of 'Sell In May' has not always been that helpful - the S&P 500 has actually rallied for the last six consecutive months of May - but rising geopolitical risk certainly gives rise to caution. A less benign environment suggests activity currencies (including the Euro) will stay on the back foot, while the dollar should hold onto gains.

FX markets have largely been characterised by declining volatility this year (helping some high yield currencies) and high short term US rates that seemingly support the dollar in good times and in bad. In addition to monetary policy (especially the ECB's), the low volatility story has also been driven by the tightly managed USD/CNY near 6.70. However, that anchor looks to be slipping.

It remains to be seen how US-China trade relations play out over coming weeks and months, but a breakdown in negotiations and the CNY sliding back to towards 7/USD (not our preferred view) would certainly un-nerve emerging market currencies and re-direct investments towards the safe haven USD and the JPY.

That story would also pressure the EUR at a time that the Eurozone is struggling to shake-off the effects of last year's trade war. Despite the slightly better than expected 1Q19 GDP figure, Euro area growth concerns remain and the market will be wary of the ECB's meeting in June where details of TLTRO III will be announced, cementing low rates.

Seasonal trends suggest May is a bad month for EUR/USD

Additionally, the wild card of European elections and Washington's threat to impose tariffs on auto imports hang over the Euro this summer. If that weren't enough, seasonal trends also suggest May is a bad month for EUR/USD. It has fallen in eight of the last ten months of May for an average decline of about 1.5% on the month.

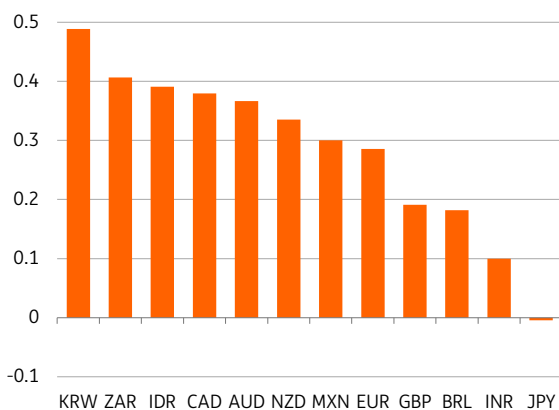
We therefore see no reason to change our 1.10 EUR/USD forecast for end June 19

We see no reason to change our 1.10 EUR/USD forecast for end June 19. We have, though, recently scaled back the expected EUR/USD recovery into 2020/21, but importantly keep the view that widening US deficits and the mature business cycle means that the dollar peaks this year. The timing of that peak will have to be driven from the US side - since re-rating stories overseas are conspicuous by their absence.

The scope for a UK leadership election in 3Q19, ushering in a more Eurosceptic PM, still poses a health warning to GBP.

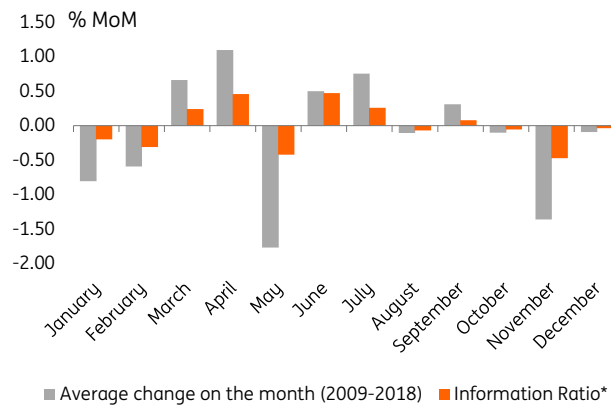
Elsewhere, we are not now big subscribers to the idea of a GBP re-rating this summer. The path ahead for a Brexit deal remains clouded and the market has stopped listening to BoE threats of a path to more frequent rate increases. The scope for a UK leadership election in 3Q19, ushering in a more Eurosceptic PM, still poses a health warning to GBP.

**Fig 2 Year-to-date correlations with CNY (versus USD)**



Source: Bloomberg, ING

**Fig 3 EUR/USD average returns... sell in May**



Source: Bloomberg, \*Avg change adjusted by standard deviation of changes

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## Rates: Why core market rates may rise

The US 10yr in the 2.5% area is remarkably steady given the strong inflow to risk assets

Inflows into risk assets have been impressive since the beginning of the year, in stark contrast to the dramatic selling of risk assets seen into end-2018. That risk asset selling coincided with an equally dramatic fall in the US 10yr yield from 3.25% to 2.5%. And while risk assets have since rallied off those lows, the US 10yr yield has not managed to budge much from the 2.5% area.

There have also been some gyrations in macro data, but with little effect on yields

Some dodgy US economic data justified a medium-term Fed rate cut preference through Q1, in turn keeping market rates under wraps. But since then, US data has perked up. The fall in the 30yr mortgage rate that coincided with the fall in Treasury yields has also managed to stabilise angst that has been growing in the housing market. But still, the 10yr Treasury has held in the 2.5% area.

Higher market rates are becoming more probable should these themes persist

The balance of risks ahead are slowly swinging in the direction of a test higher for market rates. The basic assumptions here are an ongoing inflows process to risk assets and a positive gloss on macro data. The off-setting pull lower in rates comes from the ongoing global slowdown narrative, weakness in Europe, and an ongoing stubbornness with respect to the regeneration of inflation generally.

Low US rates are also impacting European rates

The latter remains a massive issue in the determination of exceptionally low markets rates in Europe. But as we have noted before, low German rates are also reflective of a safe haven status against a backdrop where Italian government bonds have struggled with Italian political and macro concerns. Such concerns will linger right through to the end-May EU elections at the very least.

But it is also circular, as Euro angst keeps core rates down, as does the fall in US rates

It is circular though, as the German 10yr yield at zero is also being pushed there by the US 10yr Treasury yield falling to the 2.5% area, to yield a 250bp Treasury/Bund spread. While the mean of this spread is around 50bp in the past 3 decades, rationalising a fair value spread in the 250bp area is not difficult based off a fed funds rate at 2.5% versus an ECB deposit rate of -40bp. Bund yields at zero partly reflect Treasuries at 2.5%.

European rates need US rates to do the heavy lifting first

The cleanest way for European rates to rise from here would be for US rates to show them the way, most likely being pushed higher by some firm labour market data. Right now the slowdown narrative is dominating the market discount. But this cannot

This is probable. High yield is suggesting that default risk is contained

This compared with a dis-inversion of the curve should nod the market discount in the direction of higher rates

continue if risk assets maintain the buying interest seen so far this year. The buying of risk assets by definition shows confidence in future growth and tolerable default risk.

One of the best performances so far this year has been from high yield corporates. This is a high beta sector and is expected to outperform in a market that is seeing spreads narrow. But is it also re-assuring for growth continuation, as it implies a benign implied market discount for recession. The rationale here is if a recession was imminent, corporate high yield would run scared on account of higher default risk.

The yield curve inversion narrative has also been curbed. Not only has the 10/30yr held on a respectable steepness, but the 2/10yr has re-steepened, and the inversion on the 2/5yr has almost disappeared. All this implies that a rate cut from the Fed is still quite a way off. If the Fed does anything in the coming year it is more likely to be a hike than a cut, and this risk is not being discounted. Market rates should begin to build that risk into current valuations, which implies some underlying upward pressure.

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Fig 12 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	3.2	1.8	1.7	1.8	2.5	1.8	1.8	1.7	1.6	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	2.2	2.2	2.4	2.1	2.8	2.2	2.2	2.2	2.4
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	2.25	2.25	2.25	2.25	2.25	2.25	2.25	2.25
3-month interest rate (% eop)	1.15	1.30	1.35	1.55	1.55	2.30	2.35	2.45	2.65	2.65	2.60	2.60	2.60	2.60	2.60	2.60	2.60	2.60	2.40	2.40
10-year interest rate (% eop)	2.40	2.30	2.30	2.40	2.40	3.00	3.00	3.00	2.80	2.80	2.30	2.50	2.60	2.45	2.45	2.35	2.30	2.25	2.20	2.20
Fiscal balance (% of GDP)					-3.5					-4.0					-4.5					-4.6
Fiscal thrust (% of GDP)					0.0					1.1					0.4					0.0
Debt held by public (% of GDP)					76.1					76.7					78.5					80.8
<b>Eurozone</b>																				
GDP (% QoQ, ann)	2.7	2.7	2.7	2.7	2.5	2.8	1.7	0.6	0.9	1.8	1.5	1.2	1.6	1.4	1.2	0.9	1.2	1.0	1.0	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	1.3	1.2	1.3	1.3	1.5	1.5	1.6	1.6	1.6
Refi minimum bid rate (% eop)	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
3-month interest rate (% eop)	-0.33	-0.33	-0.33	-0.33	-0.33	-0.33	-0.33	-0.33	-0.33	-0.33	-0.32	-0.30	-0.30	-0.30	-0.30	-0.30	-0.30	-0.30	-0.30	-0.30
10-year interest rate (% eop)	0.45	0.40	0.45	0.42	0.42	0.50	0.30	0.40	0.24	0.24	-0.07	0.10	0.20	0.20	0.20	0.20	0.20	0.15	0.15	0.15
Fiscal balance (% of GDP)					-0.9					-0.5					-0.9					-0.8
Fiscal thrust (% of GDP)					0.2					-0.2					0.2					-0.2
Gross public debt/GDP (%)					89.2					87.8					86.6					85.4
<b>Japan</b>																				
GDP (% QoQ, ann)	1.9	2.3	1.6	1.3	1.9	-0.4	1.9	-2.4	1.9	0.8	1.1	0.8	-0.1	1.0	0.6	0.8	0.6	0.7	0.8	0.7
CPI headline (% YoY)	0.2	0.4	0.6	0.6	0.5	1.3	0.6	1.1	0.9	1.0	0.3	0.8	0.4	0.1	0.4	0.6	0.6	0.8	1.0	0.8
Excess reserve rate (%)	-0.1	-0.1	-0.1	-0.1	0.0	-0.1	-0.1	-0.1	-0.1	0.0	-0.1	-0.1	-0.1	-0.1	0.0	-0.1	-0.1	-0.1	-0.1	0.0
3-month interest rate (% eop)	0.00	0.00	0.00	0.00	0.00	0.00	0.00	-0.05	-0.05	-0.05	0.05	0.05	0.00	0.00	0.00	0.00	0.10	0.10	0.10	0.10
10-year interest rate (% eop)	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Fiscal balance (% of GDP)					-4.8					-4.1					-3.6					-3.0
Gross public debt/GDP (%)					221					223					224					226
<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	6.4	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	1.8	2.5	2.6	2.6	2.4	2.6	2.6	2.5	2.4	2.5
PBOC 7-day reverse repo rate (% eop)	2.45	2.45	2.45	2.50	2.50	2.55	2.55	2.55	2.55	2.55	2.55	2.55	2.55	2.55	2.55	2.55	2.55	2.55	2.55	2.55
10-year T-bond yield (% eop)	3.30	3.55	3.60	3.90	3.90	3.75	3.50	3.65	3.30	3.30	3.05	3.20	3.00	2.95	2.95	2.95	2.90	2.90	2.85	2.85
Fiscal balance (% of GDP)					-3.7					-2.6					-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	0.2	1.6	2.8	0.9	1.4	2.0	0.9	1.2	1.8	1.5	1.5	1.7	1.2	1.1	1.5
CPI headline (% YoY)	2.1	2.7	2.8	3.0	2.7	2.7	2.4	2.5	2.3	2.5	1.9	2.1	1.9	2.0	2.0	2.4	2.1	2.1	2.0	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	0.75	0.75	0.75	0.75	1.00	1.00	1.25	1.25	1.25
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	0.85	0.85	1.05	1.10	1.30	1.35	1.35
10-year interest rate (% eop)	1.15	1.10	1.35	1.20	1.20	1.45	1.48	1.57	1.30	1.30	1.00	1.20	1.35	1.40	1.40	1.50	1.50	1.50	1.50	1.50
Fiscal balance (% of GDP)					-2.5					-1.4					-1.5					-1.5
Fiscal thrust (% of GDP)					-0.5					-0.4					-0.4					-0.3
Gross public debt/GDP (%)					87.0					84.0					83.0					81.5
EUR/USD (eop)	1.08	1.12	1.20	1.20	1.20	1.20	1.17	1.15	1.12	1.12	1.12	1.10	1.12	1.15	1.15	1.16	1.17	1.18	1.20	1.20
USD/JPY (eop)	112	115	110	113	113	107	110	114	113	113	112	113	110	108	108	105	103	102	100	100
USD/CNY (eop)	6.89	6.78	6.65	6.51	6.51	6.28	6.67	6.87	6.88	6.88	6.74	6.75	6.80	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	0.86	0.88	0.86	0.86	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	64	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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