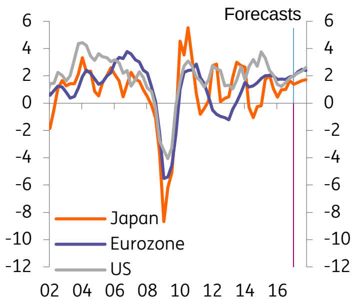
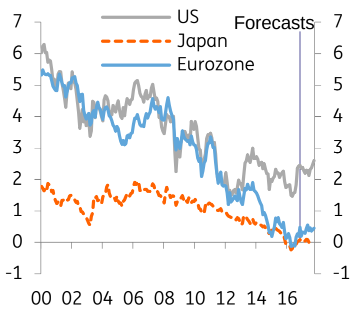
1 December 2017
Global

GDP growth (%YoY)



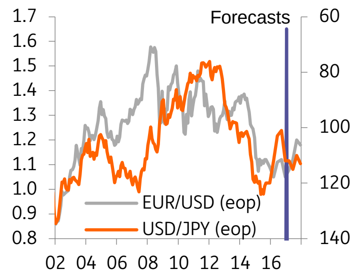
Source: Macrobond, ING

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

Iris Pang

James Smith

Chris Turner

Peter Vanden Houte

Monthly Economic Update

2018: Happy New Year!

For several years now the US has been the main engine for growth in the global economy. Things are changing. Growth expectations across Europe, Japan and emerging markets have been revised up and there is a wave of optimism on activity and jobs. However, inflation barely rates a mention and markets are tentative on the prospect for higher interest rates. Given the improving growth story this could be a risk, particularly for bond markets next year.

Many commentators mocked US President Donald Trump when he said he would get 3%+ growth. But following strong 2Q and 3Q GDP reports and with the 4th quarter shaping up nicely too, the US economy is in a great position. We have now revised up our US 2018 GDP growth prediction to 3%, but little of this is actually down to Trump's actions.

Instead, the ongoing momentum in domestic demand and improvements elsewhere in the global economy explain the acceleration. That said, if Trump can get tax cuts through this will add further upside impetus. As result, we have also revised up our Fed rate hike expectations, anticipating a rate hike on 13 December, followed by three more next year.

Eurozone economic sentiment is now at a 17-year high, which suggests that GDP growth will start the new year with strong underlying momentum. The few remaining political hurdles seem to be manageable, meaning that the stars are aligned for another year of above 2% growth. While inflation is now trending higher, it will still remain below the ECB's target. Another year of negative money market rates seems all but sure.

After months of fractious talks, the UK and EU look close to reaching 'sufficient progress' in Brexit negotiations. This will not only kick-off trade discussions, but also should help foster a swift agreement on a transition period. But there are still a number of tricky questions facing both sides in 2018, not least whether a trade deal can be struck by March 2019.

China has no problems maintaining strong growth. We forecast GDP growth to be 6.7% in 2018, coming primarily from consumption and secondarily from infrastructure investment. Managing the risks brought by reforms will be key for the government to avoid systemic risks, as several reforms will run simultaneously. This means reforms are likely to be implemented only gradually, especially on financial deleveraging.

By trading close to 1.20, EUR/USD is making the dollar look weaker than it actually is. That said, we are not looking for progress on US tax reform to drive independent dollar strength next year. Instead we continue to look for a benign decline in the dollar against those currencies backed by large trade surpluses, recovering growth and the "normalisation" of monetary policies. That is why we expect EUR/USD to trade to 1.30.

The technical underpinning to rates that QE has provided is set to wane as we progress through 2018, especially as the Fed engages in balance sheet unwind. This, coupled with solidifying macro circumstances in the US and the Eurozone, leaves ample room for a 30bp uplift to occur in both 10-year Bunds and 10-year Treasuries in coming months.

US: Trump gets his 3%

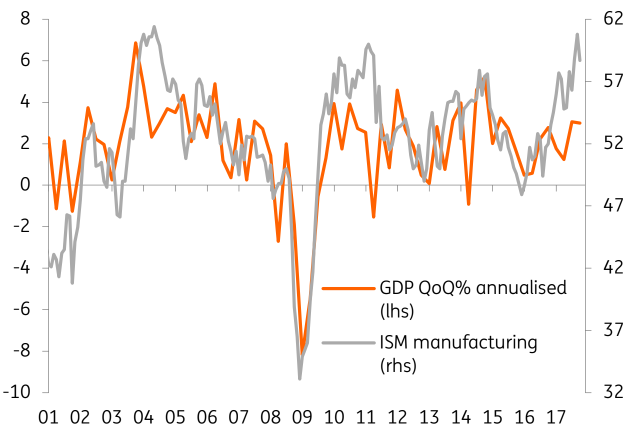
The US looks set to achieve 3% growth…

Many scoffed when President Trump predicted he would get 3% growth in the US. Not anymore. Having already posted 3% annualised growth in 2Q and 3Q 2017, business surveys suggest the 4Q figure should be just as good. The combination of robust domestic economic activity, an improving global backdrop and the prospect of meaningful tax reform means that 3% is now a realistic possibility in 2018 too.

…thanks to strong domestic and strengthening foreign demand

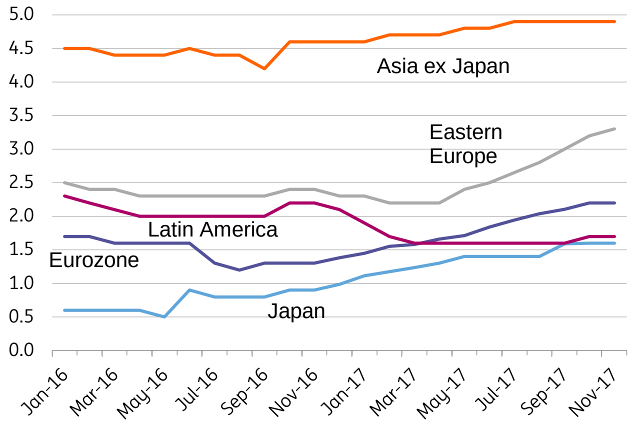
Consumer spending will remain the main driver thanks to ongoing household income growth. Employment gains are showing no sign of slowing and tightness in the jobs market suggests that wage growth is more likely to rise than fall over the coming twelve months. In an environment of strong asset prices and high confidence this should support momentum in spending. If we do get movement on tax cuts in the coming weeks this would likely add more fuel to what is already a very strong story.

Fig 1 ISM survey suggests growth is yet to peak



Source: Macrobond

Fig 2 How 2017 consensus growth forecasts changed



Source: Consensus Economics

Private consumption and investment will be the main growth drivers with tax cuts adding further fuel to growth

We also think that private investment will be a major contributor. Corporate profitability is good and the prospect of tax cuts could incentivise more investment spending, particularly if there is the possibility that US firms can repatriate foreign earnings. With the Treasury estimating that there is around US$2.6tr of earnings sat overseas the return of a sizeable chunk of this could be used to finance investments – or be used for special dividends and share buy-backs.

A better external environment and a softer dollar will also support activity

Furthermore, strengthening global growth will be supportive for net trade. Stronger foreign demand is significant, but there is additional support from the fact that a more positive global story is leading currencies of key trading partners to appreciate against the US dollar. As such, US exports are competitive, further improving growth prospects.

Inflation remains subdued, but we look for it to gradually rise to target

Nonetheless, we have an ongoing conundrum as to why inflation is so low. A shift in the relationship between unemployment and wage growth (the so-called Philips curve), a lack of productivity growth, the internet improving price transparency all help to explain this. But the fact the economy is growing so quickly may still lead inflation to rise, helped by a gradual pick-up in wage growth.

Financial markets remain too cautious on the prospect for interest rate rises, in our view

Consequently, we are looking at an economy that is growing at 3% and has inflation of 2% yet the Fed funds target rate is just 1%. Currently, the Fed funds futures market is fully pricing in a December 13 rate rise yet is only fully pricing in one additional 25bp rate rise in 2018, despite Federal Reserve officials signalling that they think three rate hikes is the most likely path for policy. While we understand market reticence given the Fed has told us they would hike in the past and not carried it through, the US expansion is already amongst the longest on record and the fact inflation remains low, we have much more sympathy for the Fed view right now.

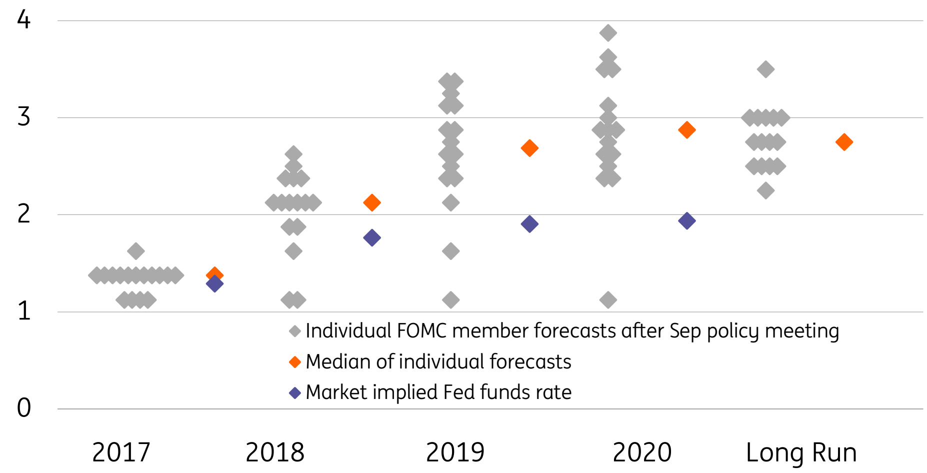
The Fed don't just cite growth and inflation to justify potential rate rises

Not only does the growth and inflation story indicate the likelihood of higher interest rates, but the fact that the Fed have broadened out the reasoning for why they believe rates need to rise offers further justification.

Loose financial conditions are a factor

Officials have cited the fact that the yield curve is the flattest it has been since the financial crisis and the dollar's weakness this year mean that financial conditions are loose. This suggests that they need to do more work at the short-end of the curve to perhaps to make monetary conditions more optimal for the US economy.

Fig 3 Fed funds interest rate expectations



Source: Federal Reserve, Bloomberg

As is the lack of ammunition the Fed has to manage the next crisis

Then there are comments about "somewhat rich" asset prices. 20 years ago when Alan Greenspan was the Fed Chair he suggested that it wasn't the Fed's job to burst bubbles. It was there to clean up any fall-out. This was fine when interest rates were around 6% and the Fed's balance sheet was relatively small. However, now they have much less ammunition to support the economy if crisis hits given interest rates are closer to 1% and the balance sheet is US$4.6tr. This means that they perhaps need to more pre-emptive to prevent bubbles forming in the first place.

The Fed is also worried about leverage and financial stability

This then links into a further factor – financial stability risks. There is clearly some nervousness that the prolonged period of ultra-low interest rates has changed household and corporate behaviour and could lead to increased leverage with "adverse implications for financial stability". This too suggests the Fed is more inclined to take earlier action to reduce the chances of problems forming in the future.

We also have to remember that the Fed is changing

An extra factor that leads us to believe the market is being too cautious is that the voting committee of the Federal Reserve is changing. Janet Yellen is leaving the committee in February meaning there will be four vacancies amongst the seven member Board of Governors.

There is also going to be a more hawkish shift in terms of FOMC voters in 2018

At the same time the alternate voting members are changing with two of the most dovish FOMC officials no longer voting – Neel Kashkari and Charles Evans - to be replaced by two relatively hawkish figures in Loretta Mester and John Williams. So, given the Fed has broadened out the arguments for higher interest rates and the fact that we have a smaller voting committee with a more hawkish tilt to it we are now forecasting three Fed rate hikes in 2018 followed by two further hikes in 2019.

Trump hopes strong growth and tax cuts will help to preserve the Republican majority

In terms of politics, President Trump will hope that strong growth and tax cuts will be enough to convince voters to return strong Republican majorities in Congress at

November's mid-term elections. But recent special elections suggest he shouldn't take anything for granted. If support continues to slip then the prospect of the next wave of his policies, such as infrastructure spending, will look vulnerable.

While the risk of a government shutdown cannot be ignored

There are other risks in the form of a potential government shutdown. A deadline has been set for 8 December for the debt ceiling to be raised (or further suspended). Without agreement the acting assistant secretary for financial markets, Monique Rollins, has suggested the US can meet its obligations "through January 2018". Concerns over the debt ceiling have in the past been the catalyst for hundreds of thousands of workers being furloughed, S&P downgrading the US from AAA status and significant falls in equity markets. Hopefully sense will prevail and such a scenario will be avoided, but it will require achieving a consensus in Washington that has been lacking so far.

James Knightley, London +44 20 7767 6614

Eurozone: The upside prevails

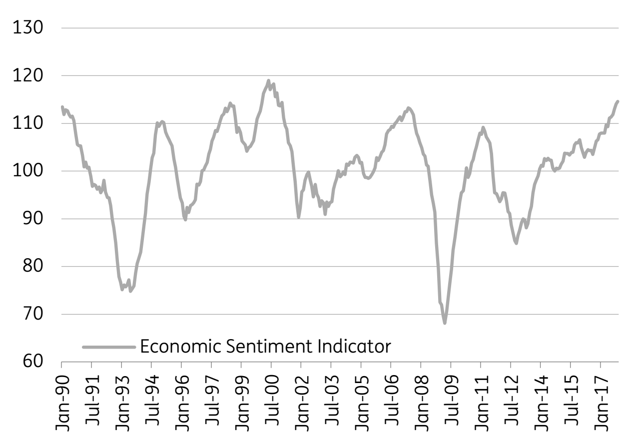
The Eurozone economy has outperformed all expectations...

The Eurozone economy has outperformed all expectations in 2017. Where at the beginning of this year most forecasters kept their growth outlook significantly under the 2% threshold, the final outcome is likely to be somewhat above 2.0%. One of the important reasons for this better-than-expected result turned out to be the absence of political mayhem that many feared in the wake of a string of elections.

...and political risk has somewhat diminished

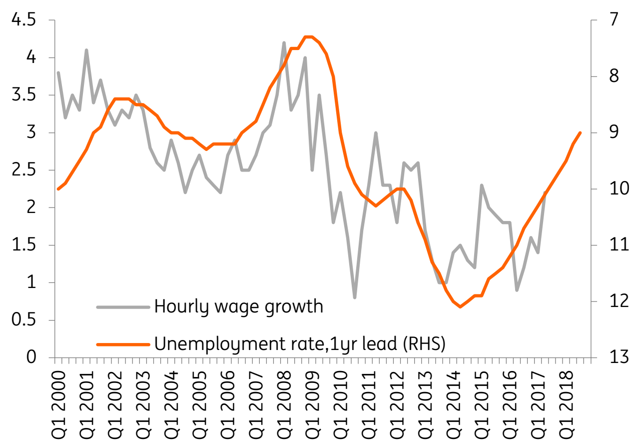
While some political risks are still there (Catalonian and Italian elections) and the forming of a coalition in Germany is proving to be more difficult than expected, it looks as if 2018 will be a second bumper year for the Eurozone economy. True, the Italian elections are likely to yield an inconclusive result, but we don't expect an outcome that could reawaken existential threats within the Eurozone. Likewise, the Catalan problem is unlikely to lead to a collapse of the Spanish state. As it happens, the pro-independence parties in Catalonia have already softened their stance in the run-up to the regional elections on 21 December. Prime Minister Rajoy has already stated that he is willing to negotiate with everyone, as long as they respect the constitution.

Fig 4 Economic sentiment is at a 17-year high



Source: Thomson Reuters Datastream

Fig 5 Wage growth slowly grinding higher



Source: Thomson Reuters Datastream

The positive base effect, strong consumption and investment will yield another above 2% GDP growth rate...

As 2017 is likely to end on a bang, the base effect will already give 2018 growth a boost. The flash Eurozone composite PMI for November was at a 79-month high and the European Commission's economic sentiment indicator even at a 17-year high. On top of that, the forward-looking components at the survey, like hiring intentions and new orders, are also close to record highs, showing that the recovery has momentum. Consumption is on a roll, boosted by rapidly falling unemployment and some wage increases. With capacity utilisation now way above 80%, business investment is likely to grow around 5% next year. As GDP growth may eventually revert to its long-term potential (1.5% at best), some slowdown in the second half of 2018 is possible. The European Commission actually already forecasts a positive output gap (ie, output above its trend) in 2018, which may restrain the potential for a further growth acceleration. But even then average growth for the year should come out at 2.2% after 2.3% in 2017. That said, as we feel that risks are skewed to the upside, 2.5% doesn't seem to be out of reach.

...with 2.5% growth not out of reach

Wage growth is starting to pick up...

While headline inflation is at the mercy of swings in energy prices, underlying inflation (which has become the ECB's point of attention), has in our view clearly bottomed out. While the relationship between unemployment and wage growth – the so-called Phillips curve - has become much flatter, because of structural changes such as globalisation and e-commerce, but it still exists. Falling unemployment remains a leading indicator of rising core inflation, and we're indeed already seeing a timid acceleration in wage growth. The fact that limits to capacity are being reached is impacting prices as well. In the PMI survey average selling prices increased at their fastest pace since 2011 in November. We therefore forecast an increase of core inflation from 1.1% in 2017 to 1.5% in 2018. Headline inflation is likely to hover around that level too next year, heralding an upward trend, but still too low for the ECB.

...but core inflation is unlikely to come out above 1.5% in 2018

Negative short rates are here to stay until 2H19...

In that regard there is little chance that the ECB will alter its easy monetary policy in 2018. We in fact believe that the QE programme will be lengthened until the end of 2018. As for interest rates, a first deposit facility rate hike is not be expected before June 2019. That means that the combination of continuing excess liquidity and negative deposit rates is going to keep short-term money market rates in negative territory until the second half of 2019. That serves as an important brake on any upward potential on bond yields, though we think it is reasonable to expect the longer end of the curve to end the year 2018 around 30bp to 40bp higher than today.

...though some limited pick up in bond yields still looks likely

Peter Vanden Houte, Brussels +32 2 547 8009

UK: The big Brexit questions of 2018

Roughly a third of the two-year article 50 window has now elapsed, but after a particularly fractious few months of talks, there are finally some encouraging signs.

There has been progress on the key issues of the divorce bill and citizen rights

Citizen rights has long been a key concern for EU officials, but the UK's recent acceptance that the European Court of Justice will have role to play here after Brexit (formally a big red line for the UK government) should help reassure negotiators. Likewise, the press are reporting that both sides have reached an agreement on the highly contentious 'divorce bill'. The UK has reportedly agreed to meet all of the financial commitments set out by the EU earlier this year, which nets out to roughly €40-60bn.

The EU looks likely to vote there has been 'sufficient progress' in talks

That makes it increasingly likely that the European Council will take the crucial step of voting in favour of "sufficient progress" at its December summit, allowing talks to move to the next stage. That said, the Irish border issue is still a big sticking point. Both sides don't want a return to a hard border, but the Irish government wants more clarity on the UK's plan to use technology to perform custom checks after Brexit. Given that much of Irish-EU trade transits via the UK, this is a key issue for Ireland and its businesses.

This should allow for a swift agreement on a transition deal

But even here, progress appears to be being made as UK officials seek to give further assurances, chiefly on regulatory issues. And assuming talks can move on to the next stage in December, this should allow for a swift agreement, at least in principle, of a transition period. This is currently expected to last for 2-3 years after the UK formally leaves the EU, and helps avoid the mounting risk that firms start implementing plans for a worst case "cliff-edge" in March 2019. A transition announcement should be good news for sterling, but there are also still a number of important unanswered questions.

When will the UK and EU reach an agreement on the future trading relationship?

The UK is aiming to agree a deal by March 2019, but is that achievable?

The UK government's official position is that it expects to strike a trade agreement before exiting in March 2019. But taking off 3-4 months for ratification, this leaves just shy of a year to agree a deal, which is a very short timeframe (remember the EU-Canada deal took 7 years to finalise). So it's possible that at least some elements of the talks will continue into the transition period.

Uncertainty over trading environments mean businesses are likely to remain cautious

One consequence of this is that, without knowing what trading environment the UK will actually be transitioning into in 2021 or 2022, companies are likely to remain cautious when it comes to longer-term investment even after a transition is announced. In a way, this means that "cliff edge" risks have been delayed, rather than fully averted.

Will a two-three year transition period be long enough?

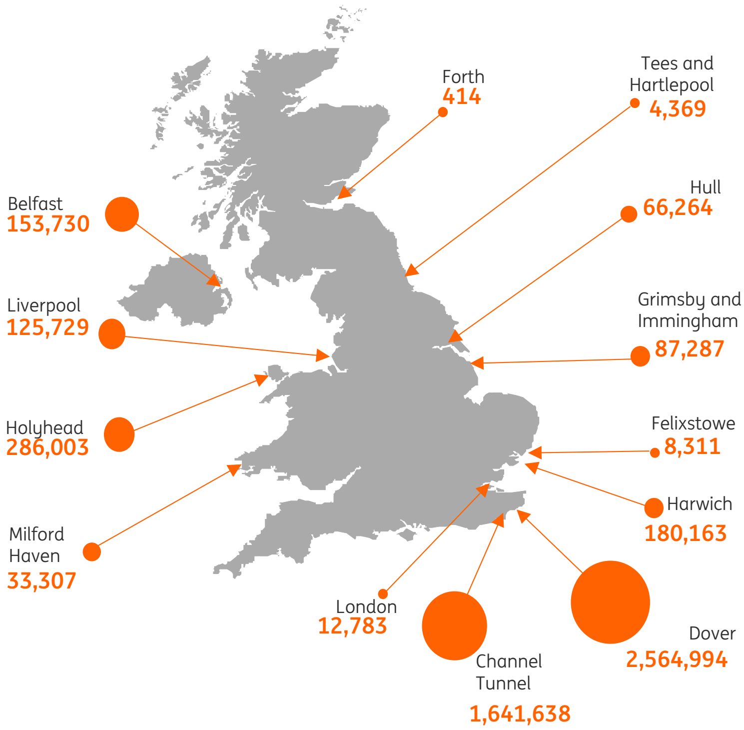
Brexit supporters are keen to limit the length of the transition to 2 years

A big fear of Brexit-supporting ministers is that the transition period could lead to an indefinite period where the UK is neither in nor out of the EU. This is partly because the next election is scheduled for 2022, and an extended transition could leave the government vulnerable to suggestions it hasn't brought the UK fully out of the EU.

Supply chains will take time to reorganise

But does this give firms enough time to adjust? The complexity of modern supply chains mean many goods often travel multiple times between the UK and EU before being sold in the single market. The BMW Mini and pints of Guinness are good examples. These processes will take time (and money) to re-orchestrate.

Fig 6 Lorry traffic at selected UK ports (number of lorries)



Source: Institute for Government, Department for Transport

Having time to set-up any customs checks is also important

Logistics are also a big consideration. At Dover, less than 1% of lorries arriving/departing currently require checks[1]. Given the sheer number of lorries that pass through, maintaining a frictionless border will be key. The British Freight Transport Association has said that adding even two minutes to the process could generate queues of up to 17

[1] *Implementing Brexit: Customs* (Institute for Government report)

miles queues on the M20 motorway. Part of creating a fluid customs process will require new staff, but this too takes time. For instance, it takes 3 years to train a new customs official in Germany, and 2 years in France.

Will there be a new Prime Minister?

Polls are suggesting that voters are dissatisfied with the government's Brexit handling

Since the general election in June, PM Theresa May's position is perceived to have weakened. This has led to questions over how long she can remain in office, particularly as opinion polls are increasingly suggesting the public is dissatisfied with the government's handling of Brexit.

The potential for 'sufficient progress' over the next few weeks could help to repair this image, and the government also appears to have successfully avoided a large fallout over the politically-sensitive 'divorce bill'. But PM May remains vulnerable, and a fresh leadership challenge in 2018 can't be fully ruled out.

Will the Bank of England hike again in 2018?

We still expect the Bank of England to remain on hold, but this is an increasingly close call

Whilst the announcement of a transition deal should unlock some shorter-term business spending, there are still a number of Brexit 'ifs'. The jobs market is also showing early signs of faltering, and wage growth looks set to remain under pressure. This will keep a lid on consumer spending, and in turn, overall growth next year. We still think the Bank will keep rates on hold in 2018, although admittedly this is an increasingly close call. Policymakers have signalled they would be comfortable with a hike next year and a move in February or May certainly can't be ruled out.

James Smith, London +44 20 7767 1038

China: Rising world leader

No worries about strong growth in 2018. The key is to avoid reforms turning into systemic risks

To become a world leader, the first target is to achieve strong economic growth, which China has; the second, which is as important as the first, is to avoid creating a regional or global crisis. This is a challenge for China in 2018 because several reforms will run at the same time, which leaves policy makers walking a fine line.

Economic growth will stay strong

Economic growth driven by consumption and infrastructure investments

Strong growth will come from consumption and infrastructure investment. Rising wages will support consumption which has become an important growth engine for China. The rise in consumption does not only benefit China, it also benefits tourism to the rest of the world. Separately, infrastructure investments (INGF: 10% in 2018) in rural areas, including water management, rail systems and telecommunication infrastructure, will be a second pillar of economic growth.

6.7% GDP growth expected in 2018, slightly below 6.8% in 2017

We expect GDP to increase by 6.7% in 2018, just slightly below 6.8% growth in 2017 because of the expected slowdown in real estate activity. A 10% rise in retail sales, 7.5% in fixed asset investments and 6.5% in industrial production would provide the backdrop for stable GDP growth. Inflation will be mild at around 1.7%.

Key concern for China is managing reform risks

The key concern for the government in 2018 would be the risks brought by reforms. These reforms include (1) continuation of corporate deleveraging and financial deleveraging through market channels; (2) re-commencing the opening of the capital account by promoting outbound investments and prompt processing of outward remittance; and (3) monetary policy reforms, namely interest rate and exchange rate liberalisation and moving forward to formalise a short-term policy interest rate.

Corporate and financial deleveraging to continue in 2018

Corporate deleverage has yielded results, and will move on to other raw material sectors

Corporate deleveraging has yielded some positive results in the coal and steel sectors, and their prices have increased, and have raised corporate profits in these sectors. Cement and glass will copy the overcapacity reduction model in 2018.

Two intentions of SOE reform yield two different forms of debt reduction methods. It all depends whether the SOE has strategic value

The government has planned and executed corporate deleveraging so carefully that it has not triggered a rising risk of a series of defaults in 2017. We note that different deleveraging models apply to different intended results. We see two intentions. One is to reduce corporate debt and leverage ratios straightaway in excess-supply sectors. This applies mostly to local level state-owned enterprises (SOEs) that have little strategic value. The other is to rescue the big SOEs and grow them by merging them with other big SOEs to become more competitive internationally. This is more applicable to central government level SOEs with an outbound investment mission. We expect these model to stay in 2018.

Financial deleveraging would be more challenging than corporate deleveraging

Apart from reducing corporate debt, the central government has started financial deleveraging. This is even more challenging because of the inter-related nature of financial institutions and financial products, and therefore needs the super-financial regulator to coordinate new regulations among different financial regulators. Regulators have started by limiting the issuance of Negotiable Certificates of Deposit. But that is just the beginning of the whole financial deleveraging process.

We expect there will be new regulations on online credit platforms for individuals and corporates, and on the sale of high-risk wealth management products via online platforms or embedded in insurance products or at banks.

Tighter liquidity during financial deleveraging means higher interest rates and perhaps the shutdown of small financial institutions

During financial deleveraging, regulators would tighten liquidity to squeeze out the poorest credit financial institutions. This will drive interest rates higher. This could cause certain small financial institutions to close down, including online P2P lending platforms.

Don't be surprised if these reforms stop suddenly when irregularities occur

If handled incorrectly, the inter-linked nature of the financial sector could easily turn reforms into systemic problems. It is therefore likely that financial deleveraging will be gradual, and may stop suddenly if several irregularities arose simultaneously. If these reforms are successful then China has a more positive setting for future economic growth.

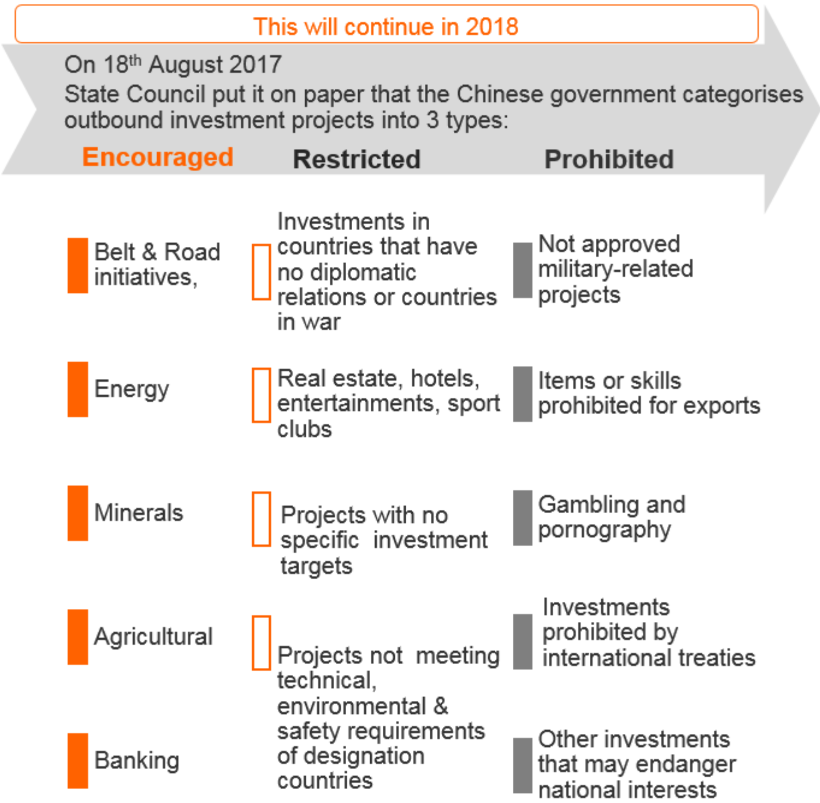
Outbound investments and outward remittance would be easier in 2018

Slow outbound investment in 2017 was due to the government's concern over rapid capital outflows. Recently, the worry of outflows has faded as the yuan has strengthened. As a result, outbound investments in encouraged industries have become easier. However, restrictions on the targeted investment's industries are still in force as stated by the State Council in 2017. These restrictions will continue into 2018 because they are not only about the speed of capital outflows but also about the "branding" of Chinese companies in the world.

Faster outward remittances but only if outbound investments do not result in net outflows

Outward remittances from Mainland subsidiaries to parent companies will pick up pace as concern about outflows eases. But we cannot rule out the risk of a comeback of difficult outward remittances if the yuan does not strengthen as we have forecast, or if there are more outbound investments by Chinese companies that cause net outflows in some months. Those would trigger a slowdown of outward remittance.

Fig 7 Industries that welcome outbound investments



Source: ING

Keep reforming interest rate and exchange rate policies

Expect two rate hikes in 2018, each of 10 basis points

On monetary policy, our forecast is two rate hikes in 2018, one near June, and another near December. We expect each rate hike would be 10 basis points. These hikes are necessary to keep the interest rate spread stable between CNY and USD so as not to trigger capital outflows. We do not expect the PBoC to follow the Fed for every rate hike because deleveraging would push up interest rates generally. But when the PBoC needs a rate hike, it will use the PBoC 7D reverse repo (now at 2.45%). This will enhance the role of the 7D reverse repo as the policy rate though it has not been officially announced.

The PBoC 7D reverse repo rate will become the policy rate

Expect fewer interventions on USDCNY closing price as the exchange rate is liberalised

On exchange rate liberalisation, we expect fewer interventions on the USDCNY closing price, which is an element in the fixing formula, so that the next day's fixing could be closer to true market rate.

Our forecast for USDCNY is 6.50 by 2017 and 6.30 by 2018

We project the yuan to strengthen against the USD (USDCNY) from 6.50 at the end of 2017 to 6.30 by 2018. This is mostly due to the mission to turn capital outflows into inflows. We have argued that a stronger yuan might barely weigh on export growth. Exchange rate appreciation might affect exporters' profit margins but there are tools to hedge foreign exchange risks nowadays onshore.

Iris Pang, Hong Kong +852 2848 8071

Japan: Carry on spending

Japan doesn't really need one, but it will get a supplementary budget anyway

Supplementary budgets used to be a response to economic downturns. But Japan's economy is currently in one of its longest and strongest upturns for years, even cash earnings are now starting to rise. Yet still, the Ministry of Finance is preparing a supplementary budget.

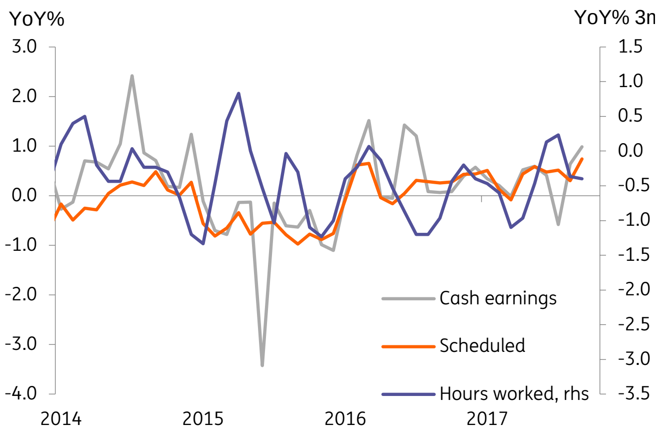
The size of the budget (reported at JPY2.3tr), represents spending of only about 0.5ppt of Japan's roughly JPY500tr economy. That's not a huge amount, and the money will be spent on projects that on the face of it do not sound frivolous either. Day-care centres for pre-school children will free up women to return to the labour force after childbirth – helping boost the labour force and potential economic growth. Disaster prevention measures will provide economic insurance against floods and the like, and infrastructure spending should boost productivity, although Japan is not exactly notorious for its lack of infrastructure.

But with supplementary budgets the norm, the likelihood that this latest package will "boost" growth to any noticeable degree is hard to support. That said, failing to provide a budget like this may have uncovered spending gaps that could have led to weakness.

...but not having one might cause growth to dip

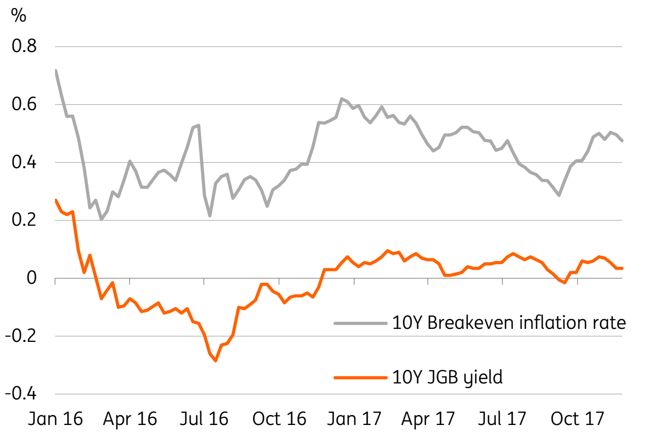
This neatly summarises the problem with fiscal stimulus. Namely, that it does provide early boosts to growth and can offset cyclical downturns. But in the face of long-lasting structural issues, it soon runs out of force. The problem then becomes how to wriggle out of commitments to debt financed spending commitments without causing growth to stall. Japan appears to be still searching for an adequate answer to this question.

Fig 8 Cash wages turning up at last



Source: CEIC

Fig 9 Inflation expectations and JGB yields



Source: CEIC

The BoJ, meanwhile, continues to provide cover for the government's attempts to move the economy onto a fiscally sustainable path with its QQE programme. Recently, there is some evidence that after years and hundreds of trillions of JPY printing, this is working.

Inflation is rising, but inflation expectations are struggling to move higher

Headline inflation will dip this month, but core measures have been rising. This has pulled up break-even inflation rates (a proxy for inflation expectations), though these are struggling to hold onto gains, and have so far lagged, rather than led inflation itself. Meanwhile, with short-dated rates essentially fixed by the BoJ's negative rates on reserves, and zero target for longer dated bonds, real interest rates are negative now, have been for some time, and may become slightly more negative in the months ahead. From an economic standpoint, we don't think this is a big deal, though it may help support financial asset prices further and take some support from the JPY.

Rob Carnell, Singapore +65 6232 6020

FX: New-found confidence in EUR

EUR/USD continuing to trade near 1.20 is probably making the dollar look softer than it actually is. For example Bloomberg's BBDXY dollar index, comprising a basket of 10 global currencies against the dollar, is actually 3% higher than the lows seen in September. It is therefore important to isolate individual themes.

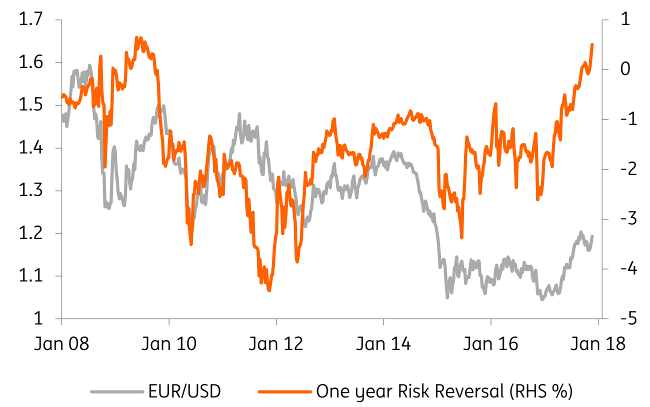
Were it not for reasonably strong US growth outlook and yield spreads wildly in favour of the dollar, EUR/USD would probably be closer to 1.30

One of the strongest themes is the new-found confidence in the EUR. Nowhere is this more obvious than in the FX options market. Here the skew – or the extra cost – investors are prepared to pay for a one year EUR call option over an equivalent EUR put option is the highest since the summer of 2009 – when Fed money-printing was in full-swing and EUR/USD was trading close to 1.50.

Were it not for a reasonably strong US growth outlook and yield spreads wildly in favour of the dollar, EUR/USD would probably be closer to 1.30 right now.

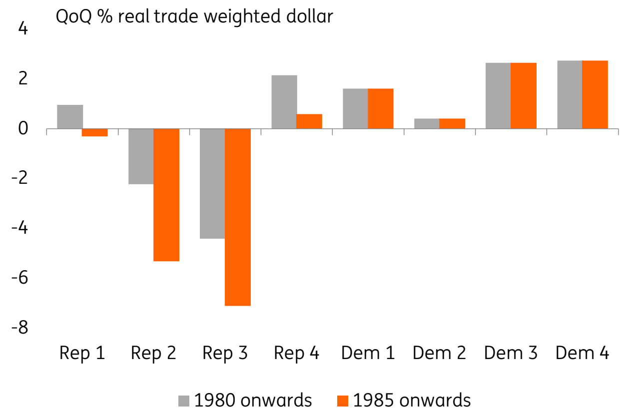
As our readers should hopefully know by now, we're very constructive on EUR/USD over the next few years. We think it can weather some further modest rise in USD interest rates in early 2018 – limiting EUR/USD close to 1.20 – but break-out into the 1.25-1.30 range next summer once Italian political risk is overcome (elections expected March-18) and the normalisation of ECB policy returns to the fore.

Fig 10 The options market is turning very EUR bullish



Source: Bloomberg

Fig 11 How the dollar performs per Presidential year



Source: Bloomberg, ING

What about the dollar? Apart from strength against some challenged high-yielders (TRY and ZAR) it is fair to say it is underperforming: (1) rates, (2) stronger business and consumer sentiment; and (3) the growing prospect of US tax reform.

We're not looking for progress on tax reform to trigger a strong independent rally in USD

On the issue of tax reform, we're not looking for progress to trigger a strong independent rally in the dollar. The surge in the dollar during the Regan tax cuts in the early 1980s was a function not only of: (1) tax cuts and government spending and (2) Fed battling high inflation, but also of very weak growth overseas.

Chris Turner, London +44 20 7767 1610

Rates: Still on inflation watch

Markets discounting half of the Fed's rate hike ambition on the front end

Markets continue to struggle with the notion that this is a rising rates environment, in particular with respect to US rates. The Federal Reserve has effectively communicated an ambition to hike the funds rate by four times in the coming 12-15 months (including a December hike). Yet the 2-year yield sits at 1.75%, still a mere 50bp above the fed funds ceiling. At best the market is discounting half of the Fed's rate hike ambition.

Inflation prints have continued to low ball versus expectations

One of the reasons for the rich valuations from 1-month to 10-years is the inability for the US economy to generate inflation. While we are of the opinion that inflation is on a trend higher, that is just a forecast. The experience so far in 2017 has been one of frustration for inflation bulls. So far this year it has not paid to go against the Fed in terms of hikes, but it has paid to go against the Fed's inflation expectations.

The inflation swap curve is remarkably flat and without a term premium at 2%

This is the central rationale for the maintenance of quite a flat curve. The 10-year has been supported by a lower need for an inflation risk premium. This can be seen in its purest sense from the US inflation swap curve which is virtually flat at 2%. Not only is this quite a benign inflation expectation, but there is no inflation term premium either. Only actual inflation prints to the upside will change this.

But the 5yr is in fact discounting a 2 handle on the fed funds rate

When we confront the USD swap (IRS) curve to the implied Libor profile derived from our Fed funds forecasts, we find that the implied alpha is close to zero out to 5 years, which implies a balanced risk/reward in terms of fixed/float. Bottom line, lock-ins require a 2 handle on the Fed funds rate in order to break-even in terms of pure carry.

In the Eurozone low rates and tight spreads persist, intensifying since the ECB's QE announcement

In the Eurozone, the glass half full prognosis has also been seen from the reaction to the latest ECB QE adjustment where the focus has been on the extension of asset purchases, rather than on the taper. And the follow-through has been a further compression in what are already tight spreads, a theme that has extended right through investment grade space from Eurozone sovereign spreads to corporate spreads.

But pressure for an edged higher in rates comes from both technical and fundamental factor

That all being said, the macro circumstances are also solidifying, both in the US and in the Eurozone. On top of that the technical underpinning coming from QE is by definition to wane as we progress through 2018, especially as the Fed engages in balance sheet unwind. This combination leaves ample room for a 30bp uplift to occur in both 10-year Bunds and 10-year Treasuries in the coming months.

We remain in inflation watch as a likely catalyst

We maintain our view that inflation prints are the most important to monitor in the coming months. Payrolls will come and go but the only real call out there is on inflation. A solid 2-handle for inflation means the funds rate must match this at the very least. That's the crucial underpinning for the eventual evolution of higher rates, and for Eurozone rates too.

Padhraic Garvey, London +44 20 7767 8057

Fig 12 ING global forecasts

	2016					2017F					2018F					2019F				
	1Q	2Q	3Q	4Q	FY	1Q	2Q	3Q	4Q	FY	1Q	2Q	3Q	4Q	FY	1Q	2Q	3Q	4Q	FY
United States																				
GDP (% QoQ, ann)	0.6	2.2	2.8	1.8	1.5	1.2	3.1	3.3	2.9	2.3	3.1	2.9	2.7	2.7	3.0	2.6	2.6	2.7	2.6	2.6
CPI headline (% YoY)	1.1	1.1	1.1	1.8	1.3	2.5	1.9	2.0	2.2	2.2	2.3	2.4	2.6	2.5	2.4	2.3	2.2	2.2	2.3	2.2
Federal funds (%, eop)[1]	0.25	0.25	0.25	0.50		0.75	1.00	1.00	1.25		1.25	1.50	1.75	2.00		2.00	2.25	2.25	2.50	
3-month interest rate (%, eop)	0.62	0.65	0.81	1.01		1.15	1.30	1.33	1.56		1.62	1.89	2.12	2.33		2.43	2.60	2.69	2.95	
10-year interest rate (%, eop)	1.77	1.47	1.59	2.44		2.40	2.30	2.30	2.60		2.70	2.80	2.90	2.90		3.00	3.10	3.20	3.20	
Fiscal balance (% of GDP)					-3.2					-3.5					-2.9					-3.3
Fiscal thrust (% of GDP)					0.0					0.0					0.5					0.6
Debt held by public (% of GDP)					76.8					76.2					76.2					76.4
Eurozone																				
GDP (% QoQ, ann)	2.1	1.2	1.9	2.5	1.8	2.2	2.6	2.4	2.2	2.3	2.1	2.0	2.0	1.8	2.2	1.6	1.6	1.6	1.5	1.7
CPI headline (% YoY)	0.0	0.0	0.3	0.7	0.3	1.8	1.5	1.4	1.4	1.5	1.3	1.4	1.4	1.5	1.4	1.5	1.7	1.7	1.8	1.7
Refi minimum bid rate (%, eop)	0.05	0.00	0.00	0.00		0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.25	0.25
3-month interest rate (%, eop)	-0.22	-0.26	-0.30	-0.31		-0.33	-0.33	-0.33	-0.33		-0.33	-0.33	-0.33	-0.33		-0.25	-0.15	0.00	0.10	0.10
10-year interest rate (%, eop)	0.15	-0.13	-0.05	0.30		0.45	0.40	0.45	0.45		0.50	0.60	0.70	0.75		0.80	0.90	1.00	1.10	1.10
Fiscal balance (% of GDP)					-1.5					-1.3					-1.2					-1.0
Fiscal thrust (% of GDP)					0.1					0.2					0.3					0.0
Gross public debt/GDP (%)					91.5					89.8					88.4					87.0
Japan																				
GDP (% QoQ, ann)	2.8	1.7	1.0	1.4	1.0	0.9	2.5	1.6	1.9	1.5	1.5	-1.1	1.4	0.0	1.1	6.5	-4.1	1.0	0.9	1.1
CPI headline (% YoY)	0.1	-0.4	-0.5	0.3	0.8	0.2	0.4	0.6	0.2	0.4	0.7	0.5	0.7	0.8	0.7	0.9	2.4	2.3	2.3	2.0
Excess reserve rate (%)	-0.1	-0.1	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.00	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
3-month interest rate (%, eop)	0.09	0.06	0.04	0.02		0.05	0.05	0.05	0.05		0.05	0.05	0.05	0.05		0.1	0.1	0.1	0.1	
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	0.10	0.10		0.1	0.1	0.1	0.1	
Fiscal balance (% of GDP)					-5.9					-5.3					-5.0					-7.1
Gross public debt/GDP (%)					212.0					213.0					213.0					212.0
China																				
GDP (% YoY)	6.7	6.7	6.7	6.8	6.7	6.9	6.9	6.8	6.7	6.8	6.7	6.6	6.7	6.7	6.7	6.8	6.8	6.6	6.6	6.7
CPI headline (% YoY)	2.1	2.1	1.7	2.2	2.0	1.4	1.4	1.6	2.0	1.6	2.0	1.6	1.6	1.7	1.7	1.7	1.8	1.9	2.0	1.9
PBOC 7-day reverse repo rate (% eop)	2.25	2.25	2.25	2.25		2.45	2.45	2.45	2.45	2.45	2.45	2.55	2.55	2.65	2.65	2.65	2.65	2.75	2.75	2.75
10-year T-bond yield (%, eop)	2.89	2.88	2.75	3.06		3.29	3.57	3.61	4.00	4.00	4.10	4.10	4.20	4.20	4.20	4.20	4.20	4.30	4.30	4.3
Fiscal balance (% of GDP)					-3.8					-3.5					-4.0					-4.0
Public debt, inc local govt (% GDP)					60.4					50.0					53.0					55.0
UK																				
GDP (% QoQ, ann)	0.6	2.4	2.0	2.7	1.8	1.0	1.2	1.6	1.1	1.5	1.2	1.8	1.6	1.8	1.4	1.7	1.3	2.2	1.6	1.7
CPI headline (% YoY)	0.3	0.4	0.7	1.2	0.7	2.1	2.7	2.8	3.0	2.7	2.7	2.3	2.2	2.1	2.3	2.0	2.1	2.1	2.2	2.1
BoE official bank rate (%, eop)	0.50	0.50	0.25	0.25	0.25	0.25	0.25	0.25	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
BoE Quantitative Easing (£bn)	375	375	445	445	445	445	445	445	445	445	445	445	445	445	445	445	445	445	445	445
3-month interest rate (%, eop)	0.60	0.60	0.30	0.40	0.40	0.35	0.35	0.35	0.60	0.60	0.60	0.60	0.60	0.60	0.60	0.60	0.60	0.60	0.60	0.60
10-year interest rate (%, eop)	1.50	1.60	0.75	1.30	1.30	1.15	1.10	1.35	1.40	1.40	1.40	1.45	1.50	1.50	1.50	1.60	1.80	1.90	2.00	2.0
Fiscal balance (% of GDP)					-2.3					-2.5					-2.5					-2.3
Fiscal thrust (% of GDP)					-0.6					-0.5					-0.4					-0.4
Gross public debt/GDP (%)					86.5					89.2					89.6					89.5
EUR/USD (eop)	1.05	1.11	1.12	1.05		1.08	1.12	1.20	1.18		1.20	1.25	1.27	1.30		1.31	1.32	1.33	1.35	
USD/JPY (eop)	112	103	101	112		112	115	110	113		115	113	111	111		109	108	107	105	
USD/CNY (eop)	6.45	6.65	6.67	6.95		6.89	6.78	6.65	6.50		6.45	6.40	6.35	6.30		6.25	6.20	6.20	6.20	
EUR/GBP (eop)	0.80	0.84	0.88	0.87		0.87	0.88	0.94	0.88		0.86	0.88	0.88	0.85		0.83	0.82	0.81	0.80	
Brent Crude (US$/bbl, avg)	35	47	47	51		55	51	52	57	54	50	50	52	52	51	45	47	50	50	48

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

Source: ING forecasts

Disclaimer