

## October Economic Update: Buffeted by political storms

The global economy continues to drift, but October looks set to be a month of political action that could cause a stir in markets. From trade talks to Brexit, find out what our economists and strategists are expecting as we enter an uncertain period in the global economic cycle.



THINK Economic and Financial Analysis

3 October 2019



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# October Economic Update: Buffeted by political storms

The global economy continues to drift, but October looks set to be a month of political action that could cause a stir in markets. The US Presidential impeachment process is getting underway. While we doubt it'll succeed, it could make President Trump more willing to move in China-US trade negotiations to deliver a "win" that his re-election campaign desperately needs. In Europe, there are tentative signs that governments are willing to spend more to help activity. Brexit is once again centre stage as hopes of a last-minute deal ahead of the 31 October deadline fade. An Article 50 extension is likely, and an election looks almost inevitable, but given the volatility in UK politics, this may not bring the clarity businesses, and markets are hoping for.

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## US: A polarised nation

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## Eurozone: Fiscal policy to the rescue?

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The massive gulf between the UK and the EU on the Irish backstop mean chances of a revised deal this month are slim. Failure to get an agreement approved by MPs would oblige the UK prime minister to ask Brussels for more time. The way Boris Johnson tackles this deadline, and the way an extension is viewed by voters, will be key in a late-2019 election

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## FX: Dollar remains in demand

Having proven to be the strongest G10 currency over the third quarter, the dollar should also perform well in 4Q. Keeping the dollar bid are familiar themes such as expensive dollar hedging costs and unattractive investment stories outside of the US. We can't see these themes changing anytime soon and expect EUR/USD to trade between 1.05 and 1.10 in 4Q

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## Rates: The twilight zone

We get accustomed to extreme levels as we hit them, but a 1.5% US 10-year inflation break-even and a practically zero 10yr real rate is worth paying attention to. German real yields at -1.5% is another one. These are not just levels, they are also market discounts painting a gloomy picture for the future. And these implied expectations are only getting worse

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## US: A polarised nation

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The latest economic and political newsflow highlight the divides in the US. Presidential impeachment hearings are set to go ahead so there is little prospect of any bipartisan policy agreements ahead of the November 2020 election. With trade and global growth worries lingering, markets will continue to look to the Federal Reserve to provide support



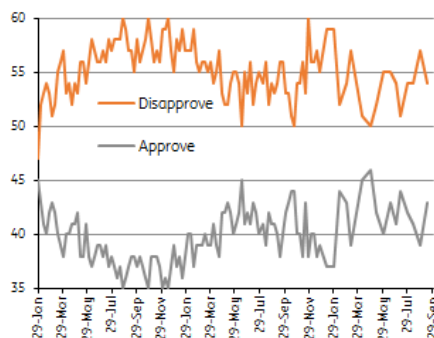
### Presidential impeachment to go ahead

The biggest development since our August update has been that House Democrats have initiated impeachment proceedings against President Donald Trump. This follows reports that he withheld state aid to Ukraine before calling on Ukrainian President Volodymyr Zelensky to investigate Hunter Biden, the son of former Vice President Joe Biden.

No Republican senator has yet expressed support for impeachment and 20 Republican votes (nearly 40% of their caucus) would be needed. Among Republicans, support for impeachment is only around 10-15%, which is insufficient to force Republican senators, and Democratic senators in heavily Republican states, to convict President Trump. Only clear evidence of wrongdoing which significantly sways public opinion is likely to change the vote in the Senate.

Our view remains that President Trump will contest the November 2020 elections.

### An unpopular President, but it could be worse...



Source: Gallup, ING

### Donald Trump versus previous president approval ratings at same point in presidency

Dwight Eisenhower 71% (Sep 1955)  
George H W Bush 68% (Sep 1991)  
John F Kennedy 56% (Sep 1963)  
George W Bush 51% (Sep 2003)  
Ronald Reagan 47% (Sep 1983)  
Bill Clinton 46% (Sep 1995)  
**Donald Trump 43% (Sep 2019)**  
Barack Obama 41% (Sep 2011)  
Jimmy Carter 32% (Sep 1979)  
Richard Nixon n/a (Sep 1971)

### Gridlock in Washington set to continue

As to whom he faces, the Democrat candidature race is seemingly between the centrist Joe Biden and the more progressive Elizabeth Warren and Bernie Sanders.

Joe Biden is leading in opinion polls, but a prolonged impeachment process risks constant association of his name to the story about corruption and that could be damaging. Nonetheless, the partisan nature of the impeachment also means that his Democrat rivals will likely have to show strong support for him through this process. We have recently updated our scenarios for the economic and political implications of next year's election.

In the near term, tensions in Washington mean less prospect of approval of meaningful infrastructure spending or further healthcare reform. It may also hold up the US-Mexico-Canada Agreement on trade and a potential future UK-US trade deal given these deals will need to be approved by the House and Democrats may be reluctant to give Trump a "win".

What are the chances of President Trump's re-election in 2020? Here are our scenarios

### Manufacturing versus services

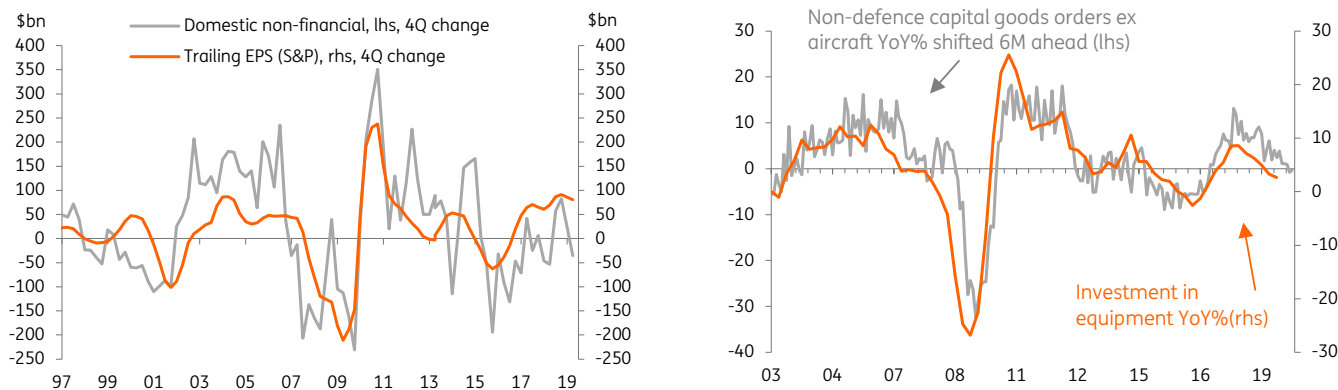
Economically, the US is just as split. Worries over weaker global growth, the impact of trade tensions and the strength of the dollar, which is eroding US companies' international competitiveness, are all acting as a major drag on the manufacturing sector. Higher tariffs are putting up costs and hurting supply chains, leading to weaker corporate profitability. This is now clearly damaging sentiment and making firms more reluctant to invest and hire new workers.

*“Economically, the US is just as split”*

The GDP measure of corporate profits, which is a broad measure of business profitability, swung into negative territory in 2Q19, which is

clearly not a positive signal. Then we had the durable goods orders report, which is now indicating that domestic equipment investment is set to head into negative territory. Added to this we have seen payrolls growth slow from 223,000 per month in 2018 to 158,000 per month so far in 2019. This is the weakest rate of employment growth since 2010.

### Profits and orders point to a slowdown in investment and hiring



Source: Macrobond, ING

### Although cracks may be forming

Despite this, the service sector economy remains resilient thanks primarily to the strength of consumer spending. Employment growth is slowing, but it is important to remember that it is at record levels and wages are rising. Households, therefore, have a sense of job security and the confidence and the cash flows to spend.



This has been reflected in strong retail sales growth, but also increasingly in a pick-up in home sales. Housing transaction typically has a strong correlation with other economic indicators, such as construction figures and home furnishing sales figures so the consumer sector looks set to continue being a key support for US growth.

That said there are some signs of cracks forming. Recent consumer confidence readings have softened and rising inflation is potentially becoming more of an issue. Meanwhile, an increasingly acrimonious domestic political situation could be another reason for households and businesses to become less positive.

### **Trade headlines to drive sentiment**

Trade policy remains critical to the medium-term outlook for US economic activity. Talks between the US and China resume on 10 October and while there have been words of encouragement from both sides, we doubt anything meaningful will result at this stage. China is using domestic stimulus to support growth and does not appear inclined to give in to President Trump's demands on intellectual property and market access.

There has been some speculation surrounding a potential "mini-deal" that involves China importing more US farm products in exchange for a postponement of additional tariffs in October and December, but this too has been dismissed by members of the US Administration. As such we expect to see trade tensions linger, which will continue to weigh on both US and global economic sentiment and risk appetite.

### **Federal Reserve to offer more "insurance"**

Given this environment we expect the Federal Reserve to remain wary about the economic outlook and stand ready to cut interest rates further.

We expect to see another 25bp interest rate cut in December with a further 25bp move in 1Q20 as the weakness in US manufacturing and the global economy are increasingly felt in other sectors.

A slowdown in US activity, weaker employment growth, flagging equity markets and the threat of a long and attritional impeachment process may make the President more inclined to agree to a deal with China in early 2020. After all, President Trump wants to get re-elected and with opinion polls not looking particularly encouraging for him he may be willing to compromise to deliver a "win". If this happens, we suspect there will be a bounce in sentiment as a dark cloud that has been hanging over the global economy gets blown away.

Time will tell if that provides enough of a boost for him to get re-elected, but opinion polls suggest he may have to move sooner rather than later.

# Eurozone: Fiscal policy to the rescue?

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Forward-looking indicators like new orders and hiring intentions point to a further growth slowdown in the coming months, although strong real money growth and a modest fiscal stimulus would be compatible with some improvement in the course of 2020. The ECB is unlikely to remove any monetary stimulus before 2022



## Vindication for the ECB

The continuing deceleration and tenaciously low inflation pushed the European Central Bank to act again in September with both a 10 basis point rate cut and a €20 billion monthly restart of the asset purchase programme (APP). Note that in the forward guidance no specific end date was given for both measures. Apart from that, the ECB lengthened the duration of the latest targeted longer-term refinancing operation (TLTRO) to three years at more generous conditions. Finally, a tiering system for the excess liquidity was announced to mitigate the negative impact of the current interest rate policy on the banks.

The ECB surely must feel vindicated by the most recent survey results. The flash composite PMI fell in September to 50.4, only just above the boom-or-bust level of 50, while the European Commission's economic sentiment indicator shrank more strongly than expected. The slowdown in sentiment indicators in the PMI survey is to a large extent driven by new orders for goods and services dropping at the sharpest rate since June 2013. No surprise that companies are starting to become more cautious in hiring new staff, though for the time being eurozone unemployment is still declining.

## Second half of 2019 will be weak

In Germany, the weakness in the important manufacturing sector has started to spread to other sectors, though growth in services remains positive and the latest consumption and labour market data surprised to the upside. This remains the story for the whole of the eurozone: a manufacturing sector flirting with a recession on the back of the contraction in world trade, while the services sector and to some extent also construction still manages to hold up.

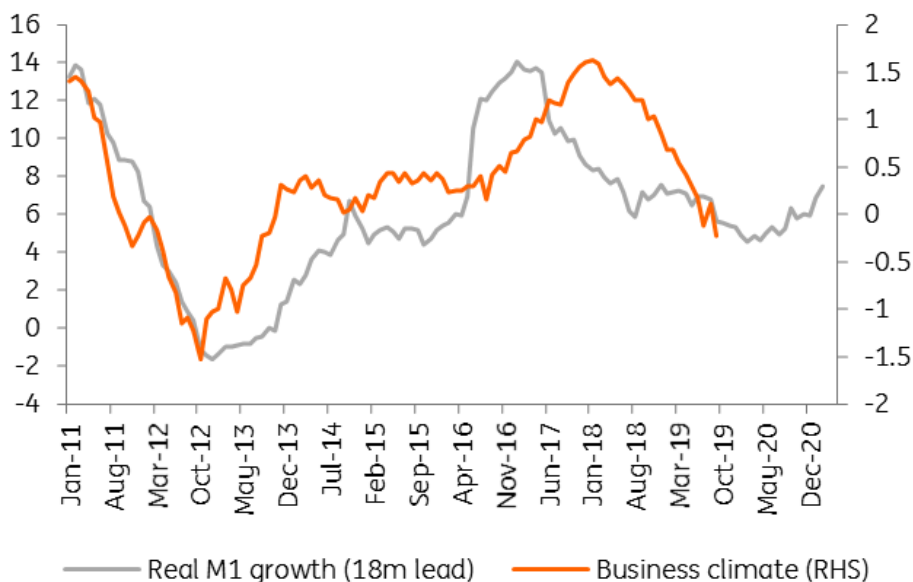
Therefore, we expect the second half of 2019 to be weak, though GDP growth of 1.1% for the whole of the year still seems feasible.

### The question is where we go from here

If some of the uncertainties (think trade war and Brexit) are lifted in the first half of 2020 and the inventory cycle in the manufacturing reaches its lowest point, we might well see some growth acceleration in the course of 2020. Don't forget that a number of member states are also thinking of fiscal stimulus, something the ECB has been advocating. In France and the Netherlands, tax cuts have already been announced, which should give consumption a boost next year. While Germany has come up with a "green package", providing a small stimulus for the coming years, and the planned end of the so-called solidarity tax, the government has also suggested that it could do more if the economy tanks.

Thankfully, German consumption isn't looking as lacklustre as industrial activity: German consumer confidence actually went up in October. From the monetary side, there is of course also plenty of support. Financing conditions remain quite favourable, with interest rates at historically low levels. Looking at real M1 growth, which has been a good leading indicator in the past, an acceleration in the second half of next year seems likely. However, because of the weak base effect from the second half of 2019, this will only translate into 0.7% GDP growth, whereas 2021 should come out slightly higher. We're now pencilling in 1.0% growth.

### Real money growth signals turnaround in 2020



Source: Refinitiv Datastream

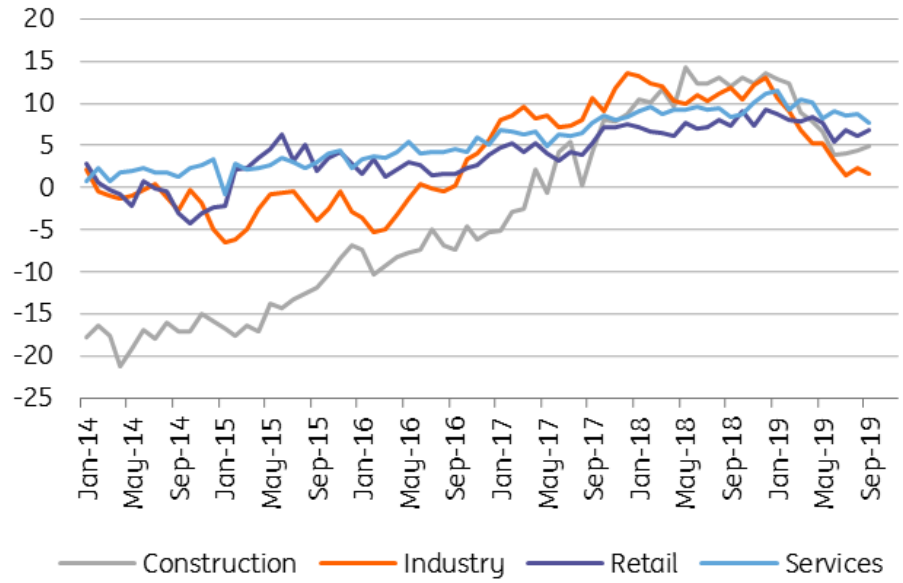
### Inflation remains low, so do interest rates

Wage growth has been picking up slightly, but this is unlikely to translate rapidly into higher inflation. Selling price expectations in industry and services actually declined in September, while they increased somewhat in retail trade and construction. We see core inflation hovering between one and 1.5% for some time, on the low side of where the ECB wants it to be.

More action from the ECB has become unlikely, given the big package they announced in September. On top of that, the number of dissenters in the Governing Council has grown, with some of them not hesitating to contest the ECB's monetary policy in public. But even then, the ECB is likely to continue its very easy policy for the foreseeable future. That means that money market rates will remain firmly in negative territory until

at least the end of 2021, while it will likely also take some time for the German 10 year Bund yield to rise above 0%.

**Inflation expectations soften**



Source: Refinitiv Datastream



# UK: Brexit - election looms as chances of last-minute deal fade

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The massive gulf between the UK and the EU on the Irish backstop mean chances of a revised deal this month are slim. Failure to get an agreement approved by MPs would oblige the UK prime minister to ask Brussels for more time. The way Boris Johnson tackles this deadline, and the way an extension is viewed by voters, will be key in a late-2019 election



## A revised Brexit deal remains elusive

With less than a month to go until the current 31 October Brexit deadline, the probability of a deal being struck is falling rapidly.

UK prime minister Boris Johnson has a little over two weeks to both secure a revised Brexit deal from the EU and gain parliamentary approval for it. Failure to do so by the 19th of October would, under the terms of the so-called Benn bill passed by lawmakers in mid-September, oblige the prime minister to ask the EU for another Article 50 extension.

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*“The EU remains deeply sceptical of the UK’s ideas”*

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The government will reportedly table fresh proposals for the contentious Irish backstop this week – that’s the mechanism to avoid a return to a hard border between Northern

Ireland and the Republic of Ireland. But while the UK appears more open to allowing NI to abide by EU rules on certain goods, it is much more reluctant to allow alignment on customs and VAT.

The exact details of the proposal haven’t been released, but papers [leaked](#) this week suggest the government is looking at a system of customs checks set back from the border, combined with GPS tracking of shipments.

[We explored some of the challenges](#) associated with customs in more detail last week, but the upshot is that the EU remains deeply sceptical of the UK’s technological ideas to reduce friction at the border.

There will also be unease in Brussels at reports the UK wants Northern Irish single market alignment to only last for four years. While this appears to be designed to win over the Democratic Unionist party, who will be key in getting a deal approved in parliament, Dublin will be wary that this could lead to further border checks a few years down the line.

All of this means a compromise looks unlikely to be reached by the mid-October European Council meeting. If nothing else, EU leaders will be acutely aware that there is still probably no majority in parliament for a mutually-acceptable deal.

### How the UK's reported proposals compare with the current Irish backstop

Regulations (Single market)	Customs (Tariffs, rules of origin)	VAT
<p><b>Existing backstop</b> Northern Ireland essentially remains in the single market for goods to avoid regulatory checks</p> <p><b>UK proposals*</b> Similar – NI follows EU rules for food/ animal and industrial goods. However this is time-limited – ends after 4 years, but NI Assembly gets a vote on whether to continue alignment with EU rules</p> <p><b>Issues</b> Ireland reluctant to accept time-limited backstop given border could get "harder" over time</p>	<p><b>Existing backstop</b> UK as a whole remains in a customs union with the EU – means no tariff/rules of origin paperwork required</p> <p><b>UK proposals*</b> UK (incl. NI) leaves customs union. Possible solution is customs clearing centres a few miles either side of the border, with GPS tracking to record when shipment crosses the border</p> <p><b>Issues</b> Customs infrastructure raises concerns about security around border. Also concerns that there would be an incentive for firms to smuggle – therefore trusted-trader schemes may not work</p>	<p><b>Existing backstop</b> Northern Ireland subject to EU rules on VAT – EU views this as a core part of its single market framework</p> <p><b>UK proposals*</b> Northern Ireland remains outside of the EU's VAT system, but no VAT-related checks at the border</p> <p><b>Issues</b> EU concerned this potentially opens door to fraud – without checks goods may go untaxed (imports fail to have VA</p>

\*UK proposals based on details published by the Daily Telegraph on 1 October  
Source: Daily Telegraph, ING

### Can PM Johnson really evade the 19 October deadline to ask for a Brexit delay?

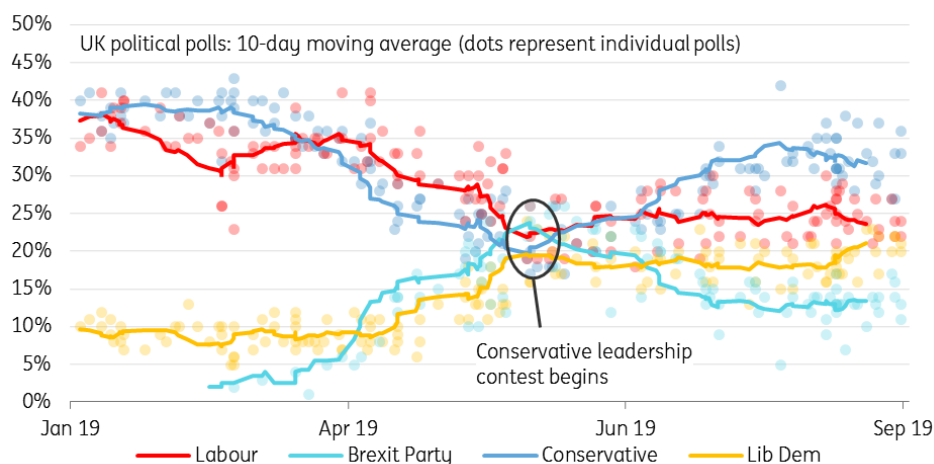
That poses the question of how the prime minister will deal with the 19 October deadline – the day when he would be obliged to ask for another Article 50 extension if a deal is not approved. While the government has said it will abide by the law, it has hinted that it has found a way of circumventing the requirement to send this letter to Brussels.

This presents a conundrum for opposition lawmakers. Some lawmakers are concerned that the government may simply refuse to send the letter. The PM could also decide to resign rather than ask for another delay, thereby requiring the swift formation of an alternative caretaker government to ask for an Article 50 extension, before taking the UK to the polls.

By that point, there will only be a matter of days left until 31 October. Some MPs – notably from the [Scottish National party](#) – would therefore prefer an earlier vote of no confidence to prevent a last-minute race to ensure 'no deal' is avoided.

That said, prominent [legal experts](#) appear sceptical that any meaningful loopholes exist in the Benn bill. The major opposition Labour and Lib Dem parties therefore appear comfortable with riding out the next few weeks until 19 October. After all, even if PM Johnson refused to send the letter to the EU after that date, the courts would likely step in fairly rapidly – the recent Supreme Court case made that fairly clear.

### Conservatives currently lead in the political polls



Source: YouGov, Suvation, Opinium, ComRes, Ipsos, BMG

### An extension may not be a complete disaster for the Conservatives

From Labour's perspective, the advantage of holding fire on a vote of no confidence is that an Article 50 extension on prime minister Johnson's watch would be potentially embarrassing for the government. Don't forget that the prime minister has repeatedly labelled the 31 October Brexit date as "do or die" – a failure to meet this could play into the Brexit party's hands at a general election.

But things are rarely ever that simple. If recent UK elections are anything to go by, it is equally conceivable that all of this could actually play into the Conservative party's campaign strategy. PM Johnson has frequently termed the Benn bill legislation as a "surrender", and Number 10 [reportedly](#) believes this message is cutting through to voters.

If an Article 50 extension is perceived by many voters to have been forced through by opposition lawmakers or by judges, then Number 10 may calculate that this could help carry the Conservative campaign slogan of "getting Brexit done".

#### A late-2019 general election still looks highly likely

Either way, a late 2019 general election is still the most likely scenario. While opposition lawmakers recently [denied the government](#) the opportunity to go the polls before 31 October, there is little doubt that Labour and other opposition parties want the opportunity to fight an election.

Once an Article 50 extension is secured, the countdown to a general election – perhaps as little as five weeks later – will almost certainly begin.

# China's not so happy 70th birthday

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The 70th anniversary of the People's Republic of China came against the difficult backdrop of the trade war, protests in Hong Kong, swine flu and a struggling economy



The 70th anniversary of the People's Republic of China came against the difficult backdrop of the trade war protests in Hong Kong, swine flu and a struggling economy.

Policy tools are being tweaked continuously and the net result is that, so far, the economy as a whole continues to hang together. This is taking a lot of effort though and has brought the currency into play as a prominent, if not a very effective new policy lever.

### **African swine flu no laughing matter**

Given the energy-sapping influence of the trade war and the political irritation of the Hong Kong protests, the very last thing that China needs right now is a food safety shock. But the African swine flu is rampaging, not just through China, but across the region leading to the decimation of swine herds and soaring pork prices.

### **Human risk from the disease**

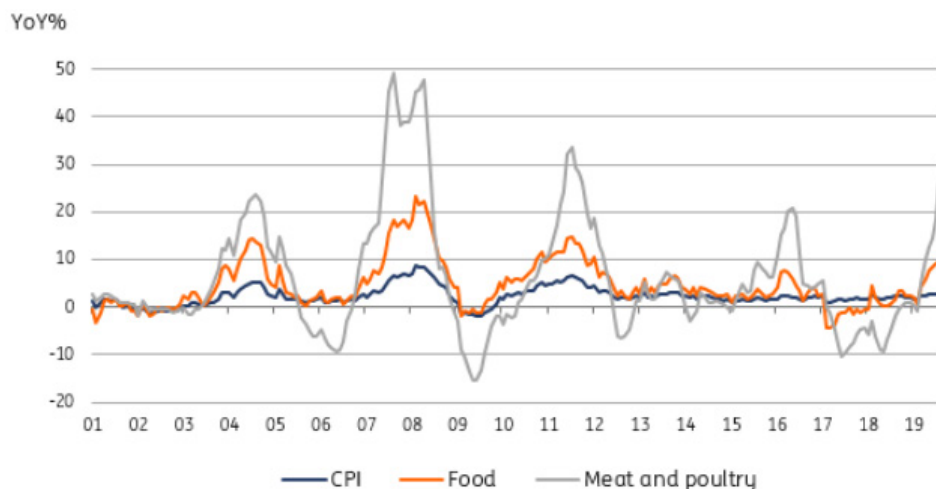
This is a serious disease, which can also affect humans – hence the additional concern. To date, the World Health Authority has tallied more than 600,000 human cases worldwide, and 18,440 deaths - a mortality rate of more than 3%. The figures for China are much smaller, at 2,040 and no reported deaths. But reports suggest more than half of the swine herd in China has succumbed to the flu or been slaughtered as the disease spreads.

### **Inflation rising - a tax on households**

Overall food price inflation has already soared to more than 12% as a result. And this is effectively a tax on households, weighing on their ability and inclination to spend.

This would be bad enough in normal times. But right now, with authorities in China on a “war-footing” to prevent the trade war from derailing the economy – it is even more concerning.

**Chinese inflation**



Source: CEIC

**More fiscal and monetary tools being used**

Fiscal tools have already been activated, including tax cuts and subsidies, as well as infrastructure spending financed by local government bond issuance. Monetary policy levers have also been added and incremental nudges to policy accommodation are ongoing, as we saw this month with the further [downward push to the loan prime rate by 5 basis points, and cuts to required reserve ratios.](#)

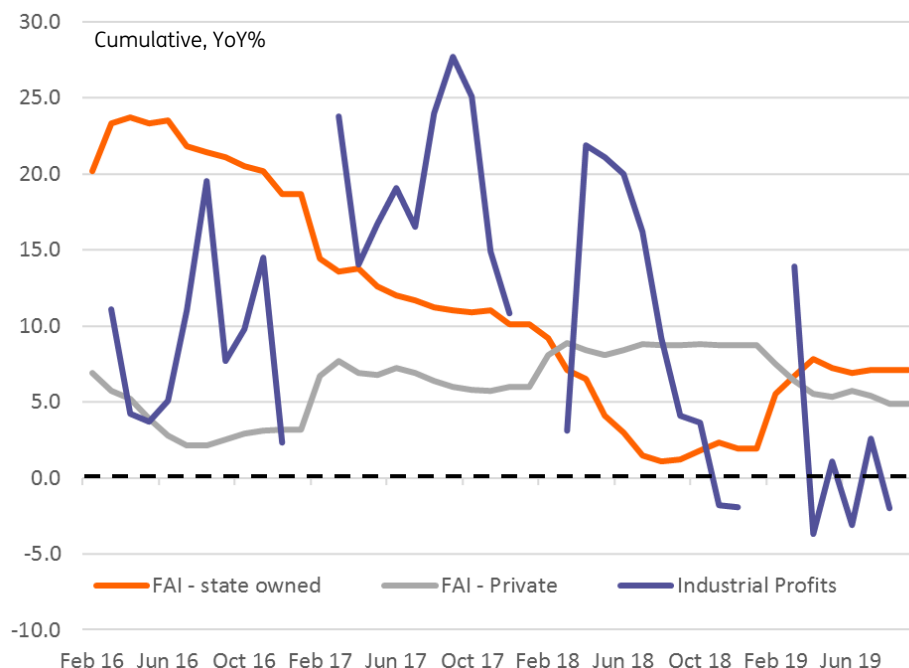
**The trade war is hurting China**

All this may help in time, though lags make it hard to judge the efficacy of measures already undertaken. In the meantime, the run of data has been mixed to poor. Hard data – fixed asset investment, industrial profits and industrial production have come in substantially weaker than expectations recently. Softer survey data, PMIs, and others have been more mixed with some recent upside surprises. The net conclusion, though, remains that the trade war is hurting China’s economy, and it is taking a substantial policy effort to keep things moving forward.

concerning.



**Hard data has been mainly bad**



Source: CEIC, Bloomberg

**Further stimulus likely**

Additional policy efforts look pretty much like a done deal. China's strategic pork reserves have been utilised to try to keep food prices down. But further direct support measures for households will likely become necessary. Additional purchases of US pork will also likely be necessary, weakening the Chinese position in the trade war, though this can be presented as a favourable shift to foster trade dialogue, as it has been recently.

**The yuan is now a policy lever in its own right**

One additional policy lever that can be brought to bear is the yuan. For a long time, this was left out of the policy arsenal as being either too political or too prone to negative side effects such as capital outflows. The firming of China's capital account restrictions has plugged the outflow problem, while ironically, the decision to label China a currency manipulator in early August and escalate tariffs, removed the disincentive for a more activist currency policy.

A weaker CNY doesn't do much to shield China from tariffs, but it does serve as a clear snub to any US escalation, and we would anticipate this forming a part of any future retaliation. Recent movements of USD/CNY seem to have mirrored market sentiment about a possible trade deal, and recent CNY behaviour has appeared to be more market-driven than at any recent juncture.

Our forecast for USD/CNY for the end of 2020 is predicated on further trade trouble ahead and remains at 7.30.

## Japan: Trying times

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After all the speculation, Japan's government has imposed the consumption tax hike. The coming months will be heavily distorted by this and it may not be until the New Year before we have clarity on how this plays out



**10%** New consumption tax rate  
Up from 8% (as expected)

### Fiscal consolidation in Japan

Japan's public finances are the worst in the developed world. Measures of gross debt to GDP top 240% on some measures (OECD), and even netting out the considerable amount owned by the government itself, is far in excess of 120%. At this scale, the exact numbers lose a lot of their meaning. Government debt is huge, and it does not seem unreasonable to try to bring this under some control.

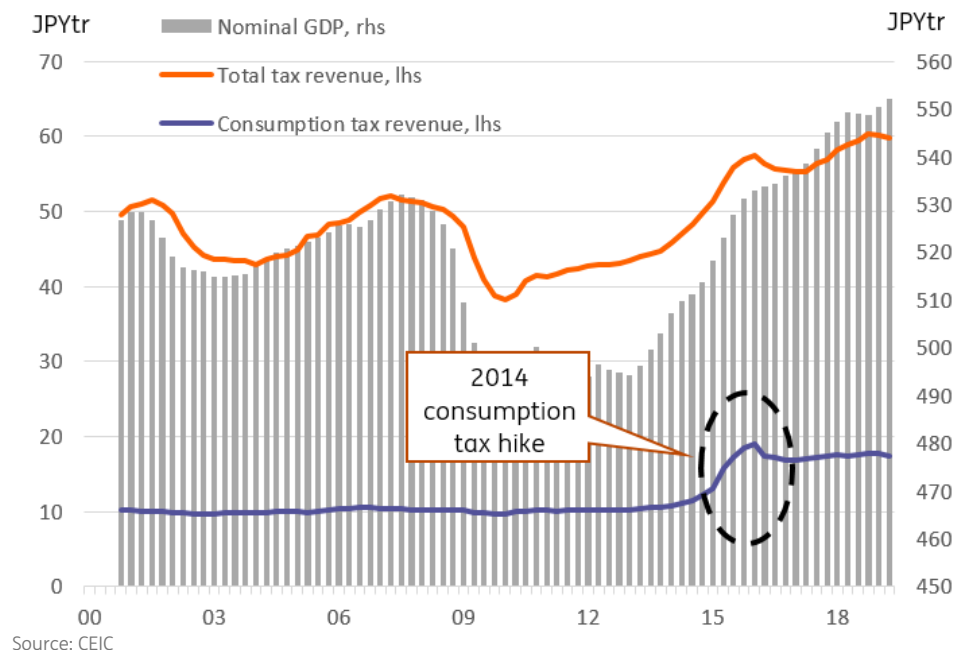
### Is this the right thing to be doing?

That said, there may be better ways of Japan going about this than a consumption tax hike. Especially when most of its peer group is belatedly coming to understand that monetary policy has lost most, if not all, of its potency and fiscal policy is the only way to give growth a helping hand.

### Consumption tax revenues static

The chart below shows total tax revenues on an annualised basis and nominal GDP. Total tax revenues track nominal GDP more or less. But consumption tax revenues are virtually a constant, with the exception of the bump in revenues following the 2014 April consumption tax hike.

**Fig 1 Tax revenues and nominal GDP**



**A lot of distortion for not much fiscal benefit**

A two percentage point increase in this tax would add about JPY 5.4 trillion annually to total tax revenues (about 1% of GDP) though the total effect on the budget deficit will be considerably less than this, due to the numerous offsetting measures that have been put in place to mitigate the impact of the tax on activity, and the numerous opt-outs that mean the full 2ppt increase will never be brought to bear.

**Some front-running, but not much**

In the short-run, the biggest impact of the tax hike will be to distort spending and inflation data. We don't have much to go on, but the front running so far seems fairly muted. August retail sales spiked up 4.8% month-on-month, and we can expect an elevated figure for September, too before the October figures drop sharply back. In 2014, they fell far more than they rose, though they fairly quickly returned to the pre-hike trend.

**BoJ to buy more short tenor, fewer long tenor bonds**

Japan's bond yields have retreated from the -0.3% level they reached at the end of August and were on the way to returning towards in the latter part of September. The 10-year yield now sits at about -0.164%.

**BoJ schedule for outright bond purchases**

	August	September	Difference
< 1y	100-1000	100-1000	0
> 1 ≤ 3	<b>2500-5000</b>	<b>3000-5500</b>	<b>500</b>
> 3 ≤ 5	2500-5000	200-4500	-500
> 5 ≤ 10	2500-5500	2000-5000	-500
> 10 ≤ 25	1000-2500	500-2000	-500
> 25	100-1000	0-500	-500
Inflation indexed	250	250	0
Floating rate bonds	1000	1000	0
<b>Max total</b>	<b>21250</b>	<b>19750</b>	<b>-2500</b>

Source: Bank of Japan

### **Reverse Twist**

The central bank has refrained from changing its official policy stance, but the announced bond purchases suggest the Bank is engaging in a sort of reverse twist operation, buying more shorter-dated assets, and fewer longer-dated ones. Along with an announcement by the Government Pension Investment Fund that currency-hedged foreign bonds could be viewed as similar to domestic government bonds, this has added to the yield curve steepening, and given the currency a little upwards push too.

## FX: Dollar remains in demand

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Having proven to be the strongest G10 currency over the third quarter, the dollar should also perform well in 4Q. Keeping the dollar bid are familiar themes such as expensive dollar hedging costs and unattractive investment stories outside of the US. We can't see these themes changing anytime soon and expect EUR/USD to trade between 1.05 and 1.10 in 4Q



### Dollar hedging costs remain exorbitant

Dollar hedging costs have marginally increased over recent weeks on the back of the tightness in US repo and money markets. Unless the Federal Reserve looks to address these concerns through the meaningful addition of permanent liquidity, any further spikes in short-term dollar rates should add to dollar strength. Indeed, there are some further US tax deadlines in October (contributing to tight liquidity conditions) and EUR/USD has actually declined in each of the last five Octobers.

From the euro side of the EUR/USD story, the European Central Bank will restart asset purchases in November. In addition to increasing excess reserves at the ECB, asset purchases and forward guidance should root euro area interest rates to the floor and keep USD hedging costs above the 2.5% level. With the yield pick-up on a 10-year US Treasury versus a German Bund 'only' 2.25%, hedging the FX exposure for European investors holding US debt is clearly too expensive.



**EUR/USD versus 3m annualised FX hedging costs**



Source: Bloomberg

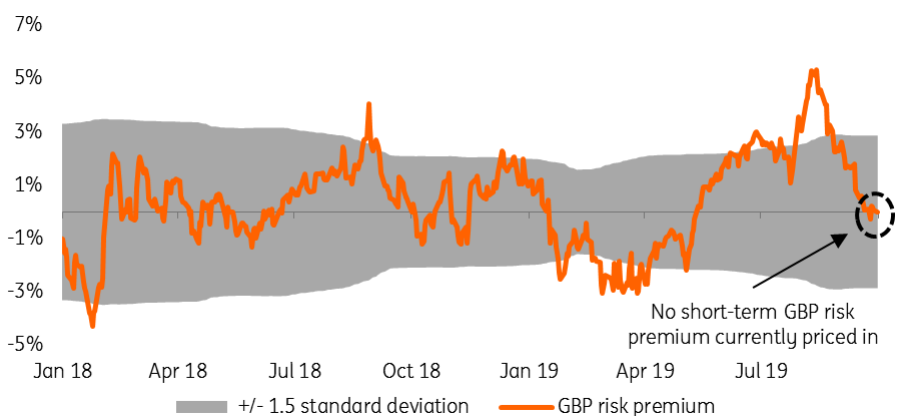
**Alternative ideas**

As we discussed last month, it will probably take some better news on trade relations (we struggle to see any before year-end) or some collapse in the US outlook (prompting a much more aggressive Fed easing cycle) to take the shine off the dollar. A US equity correction could prove a risk here, but with the Fed having applied the handbrake to further easing (if the Fed Dots are to be believed) the bar for a major dovish re-assessment from the Fed is high.

An additional very low-probability, very high impact FX risk would be if Washington’s trade war with China were to spill over into the financial sector. The suggestion, quickly denied by the US Treasury, that Washington could restrict Chinese firms’ access to US equity listings would mark a serious deterioration in relations and in the first instance send USD/CNH and USD/Asia sharply higher.

Elsewhere, the Brexit drama continues. The likelihood of Article 50 being extended into 1Q20 postpones but does not remove the risk of a No Deal Brexit. In fact, we think there is too little political risk premia priced into GBP currently. Typically, political risk premium can easily be worth 5-6% for GBP and as such, our bias is for EUR/GBP to trade towards the 0.94/95 area amid confidence votes, elections and No Deal risks throughout the quarter.

**EUR/GBP risk premium - the residual between EUR/GBP short-term financial fair value and spot**



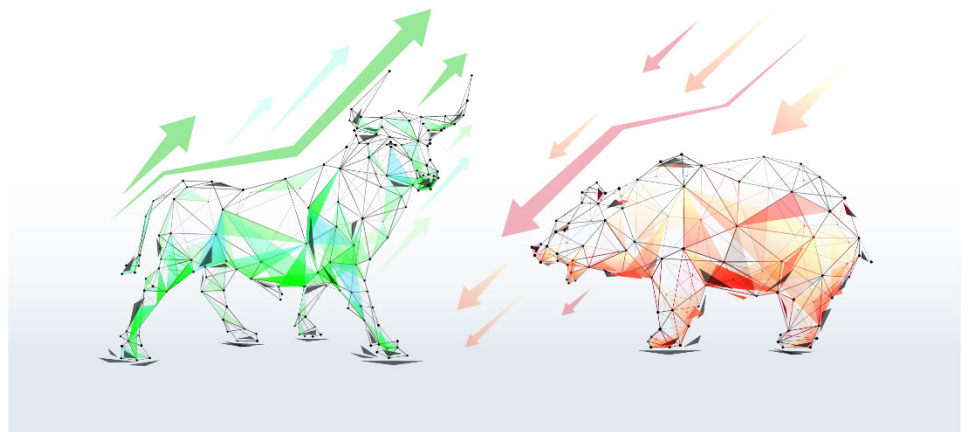
Source: ING

## Rates: The twilight zone

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We get accustomed to extreme levels as we hit them, but a 1.5% US 10-year inflation break-even and a practically zero 10yr real rate is worth paying attention to. German real yields at -1.5% is another one. These are not just levels, they are also market discounts painting a gloomy picture for the future. And these implied expectations are only getting worse



The outlook for inflation is a key factor underpinning interest rate policy decisions. That outlook can be derived from forecasts, but it can also come from the market discount.

Billions if not trillions of dollars underpin that discount, typically with long-term investments. Right now that market discount is quite remarkable - the US 10yr breakeven inflation rate is at a mere 1.5%. This is remarkable as it is so low. It is telling us that US inflation will average just 1.5% per annum over the coming decade. While the ECB could only dream of such a discount, for the US, this is an exceptionally low inflation expectation at the tail end of a cycle upswing.

This tame discount for inflation is all the comfort that the Federal Reserve needs when it comes to pulling the rate-cut trigger. Market rates are impacted in a similar manner. Swap rates or conventional yields are nominal in nature. In other words, they consist of a real rate plus an inflation expectation.

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*“Think about this for a moment. A US 10yr real yield at zero or lower paints a very poor picture for the future; it implies, at best, very subdued growth prognosis. And that’s for the US, where things have been relatively rosy in recent years”*

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In simplistic terms, if the US 10yr rate is at 1.6% and the breakeven inflation rate is 1.5% then the implied real yield is about 10bp (as can be gleaned from inflation-protected Treasury yields). A few weeks back the 10yr real yield had, in fact, turned negative. While moderately positive now, further compression of nominal yields lower would likely force 10yr real yields

back into negative territory.

Think about this for a moment. A US 10yr real yield at zero or lower paints a very poor picture for the future; it implies, at best, a very subdued growth prognosis. And that’s for the US, where things have been relatively rosy in recent years. In Europe, the 10yr inflation breakeven is 0.75%, and nominal core yields are negative right out to 30yrs. Moreover, if nominal yields are negative, then by definition real yields are even lower.

And they are; trading at a staggering -1.2% for 30yr Germany. The only silver lining here is there is an implied 30yr breakeven inflation rate of 1.3% underpinning that. But that's of little comfort.

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*“No wonder the ECB is worried. They are all in, and practically begging governments to loosen fiscal policy - anything to steer the eurozone away from the abyss”*

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No wonder the ECB is worried. They are all in, and practically begging governments to loosen fiscal policy - anything to steer the eurozone away from the abyss. Whisper it quietly, but within that abyss lies a eurozone existential risk scenario that needs to be steered well clear of.

While the discount from the US is one of mediocre growth, the discount from Europe, on the face of it, is for depression. Let's be clear, we are not calling for that. But the market discount is consistent with it (notwithstanding bond market supply/demand/QE dynamics).

For market rates, the prognosis is circular. Lower nominal rates generate a lower inflation breakeven, which in turn justifies rate cuts and lower real rates as core economies slow.

The pull of the eurozone (and Japan) is almost irresistible as they push against the extremes to the downside. This, in turn, exposes US market rates as being relatively high in risk free space. And we go on. In consequence, the next target for the US 10yr is a break below 1.5%. After that, we are into the 1% to 1.5% zone. That may not appear extreme as low rates have in effect snook upon us.

But we are now heading for new lows, taking out all of the lows seen since the financial crisis. As market discounts go, that's quite a bleak one.

**ING global forecasts**

	2018					2019F					2020F					2021F				
	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)	2.6	3.5	2.9	1.1	2.9	3.1	2.0	2.0	1.5	2.3	0.3	1.3	2.0	2.0	1.3	2.0	2.1	2.0	1.9	1.8
CPI headline (% YoY)	2.7	2.7	2.6	2.2	2.4	1.6	1.8	1.8	1.9	1.8	2.3	2.1	2.1	2.1	2.2	2.1	2.0	1.9	1.8	2.0
Federal funds (% eop) <sup>1</sup>	1.50	1.75	2.00	2.25	2.25	2.25	2.25	1.75	1.50	1.50	1.25	1.25	1.25	1.25	1.25	1.25	1.50	1.50	1.75	1.75
3-month interest rate (% eop)	2.30	2.35	2.45	2.65	2.65	2.30	2.00	2.10	1.75	1.70	1.70	1.65	1.65	1.65	1.65	1.75	2.05	1.85	2.10	2.10
10-year interest rate (% eop)	3.00	3.00	3.00	2.80	2.80	2.30	2.00	1.70	1.20	1.20	1.30	1.50	1.60	1.90	1.90	1.90	2.00	2.10	2.10	2.10
Fiscal balance (% of GDP)					-4.0					-4.6					-4.7					-4.7
Fiscal thrust (% of GDP)					1.1					0.4					0.0					0.3
Debt held by public (% of GDP)					76.7					79.0					81.9					84.4
<b>Eurozone</b>																				
GDP (% QoQ, ann)	3.1	1.5	0.8	1.2	1.9	1.7	0.8	0.6	0.5	1.1	0.4	0.9	1.3	1.0	0.7	1.1	1.0	1.0	0.9	1.0
CPI headline (% YoY)	1.3	1.7	2.0	2.0	1.8	1.4	1.3	0.9	1.2	1.2	1.2	1.0	1.1	1.2	1.1	1.2	1.2	1.3	1.3	1.3
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	-0.32	-0.32	-0.41	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40
10-year interest rate (% eop)	0.50	0.30	0.40	0.24	0.24	-0.07	-0.30	-0.60	-0.60	-0.60	-0.50	-0.40	-0.40	-0.30	-0.30	-0.30	-0.30	-0.25	-0.25	-0.25
Fiscal balance (% of GDP)					-0.9					-0.7					-0.7					-0.8
Fiscal thrust (% of GDP)					-0.2					0.1					0.1					-0.1
Gross public debt/GDP (%)					87.8					86.7					85.9					84.5
<b>Japan</b>																				
GDP (% QoQ, ann)	-0.5	2.3	-2.5	1.8	0.8	2.2	1.8	3.8	-4.6	1.3	1.4	0.0	0.9	0.9	0.2	0.9	0.9	0.9	0.9	0.8
CPI headline (% YoY)	1.3	0.6	1.1	0.9	1.0	0.3	0.8	0.2	1.3	0.6	1.8	1.8	2.2	1.1	1.7	1.1	1.0	0.9	0.8	1.0
Excess reserve rate (%)	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2
3-month interest rate (% eop)	0.00	0.00	-0.05	-0.05	-0.05	-0.15	-0.15	-0.15	-0.15	-0.15	-0.15	-0.15	-0.15	-0.15	-0.15	-0.15	-0.15	-0.15	-0.15	-0.15
10-year interest rate (% eop)	0.05	0.03	0.14	0.00	0.00	-0.10	-0.20	-0.30	-0.30	-0.30	-0.30	-0.30	-0.30	-0.30	-0.30	-0.10	-0.10	-0.10	-0.10	-0.10
Fiscal balance (% of GDP)					0.0					-0.2					-0.3					0.2
Gross public debt/GDP (%)					232.8					232.0					230.0					228.0
<b>China</b>																				
GDP (% YoY)	6.8	6.7	6.5	6.3	6.6	6.4	6.2	6.1	6.3	6.3	6.3	6.2	6.2	6.2	6.2	6.2	6.3	6.3	6.4	6.3
CPI headline (% YoY)	2.2	1.8	2.3	2.5	2.2	1.8	2.6	2.8	2.6	2.5	2.6	2.6	2.5	2.4	2.5	2.5	2.5	2.5	2.5	2.5
PBOC 7-day reverse repo rate (% eop)	2.55	2.55	2.55	2.55	2.55	2.55	2.55	2.50	2.45	2.45	2.40	2.40	2.40	2.40	2.40	2.40	2.40	2.40	2.40	2.40
10-year T-bond yield (% eop)	3.75	3.50	3.65	3.30	3.30	3.07	3.20	3.00	2.95	2.95	2.95	2.90	2.90	2.85	2.85	2.85	2.90	2.95	3.00	3.00
Fiscal balance (% of GDP)					-2.6					-4.5					-4.0					-4.0
Public debt, inc local govt (% GDP)					88					102					103					
<b>UK</b>																				
GDP (% QoQ, ann)	0.2	1.6	2.8	0.9	1.4	2.0	-0.8	1.3	1.4	1.2	0.8	1.4	1.4	1.2	1.1	1.7	1.3	0.8	0.5	1.3
CPI headline (% YoY)	2.7	2.4	2.5	2.3	2.5	1.9	2.0	1.9	2.0	2.0	2.3	1.8	1.8	1.7	1.9	1.7	1.9	1.9	2.0	1.9
BoE official bank rate (% eop)	0.50	0.50	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	1.00	1.00	1.00	1.00	1.00
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)	0.60	0.80	0.80	0.80	0.80	0.83	0.77	0.77	0.80	0.80	0.85	0.85	0.85	1.10	1.10	1.10	1.10	1.10	1.10	1.10
10-year interest rate (% eop)	1.45	1.48	1.57	1.30	1.30	1.00	0.80	0.50	0.30	0.30	0.40	0.60	0.80	0.90	0.90	0.90	1.00	1.00	1.00	1.00
Fiscal balance (% of GDP)					-1.4					-1.4					-1.2					-1.0
Gross public debt/GDP (%)					86.9					85.7					84.4					83.6
EUR/USD (eop)	1.20	1.17	1.15	1.12	1.12	1.12	1.12	1.08	1.07	1.07	1.10	1.12	1.13	1.15	1.15	1.16	1.17	1.18	1.20	1.20
USD/JPY (eop)	107	110	114	113	113	112	108	108	103	103	102	100	100	100	100	98	95	93	90	90
USD/CNY (eop)	6.28	6.67	6.87	6.88	6.88	6.74	6.90	7.18	7.20	7.20	7.23	7.28	7.30	7.30	7.30	7.27	7.25	7.23	7.20	7.20
EUR/GBP (eop)	0.88	0.88	0.89	0.90	0.90	0.85	0.90	0.89	0.92	0.92	0.90	0.88	0.88	0.88	0.88	0.88	0.88	0.88	0.88	0.88
Brent Crude (US\$/bbl, avg)	67	75	76	69	72	64	68	62	65	65	60	58	62	67	62	64	70	70	68	68

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

Source: ING forecasts

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