

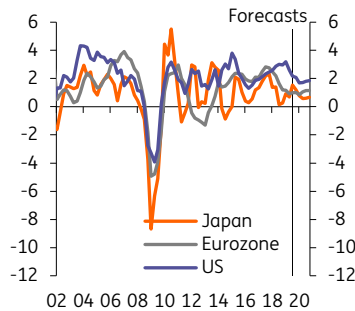
5 July 2019

Global

Monthly Economic Update

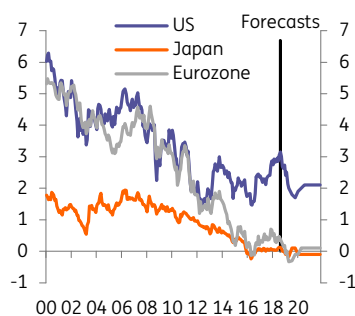
The Art of the Deal

GDP growth (%YoY)



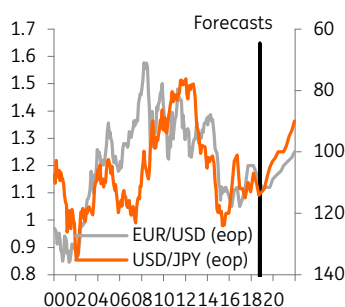
Source: Macrobond, ING

10yr bond yields (%)



Source: Macrobond, ING

FX



Source: Macrobond, ING

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Politics is increasingly driving economics, with escalating US-China trade tensions and subsequent ceasefire being a case in point. We doubt the truce will hold for long and Europe could get dragged into the conflict over the next few months. We believe a trade deal will finally be signed later this year, but not before the Federal Reserve has come to the economy's aid with interest rate cuts. The ECB is expected to offer stimulus of its own, and the nomination of Christine Lagarde as the bank's new president has added to this dovish view. Moreover, the political dealmaking in Europe, now under new leadership, looks set to be ramped up as Brexit looms large.

Despite the easing of trade tensions, the Federal Reserve is clearly indicating it is prepared to offer early support to the US economy. Activity data is showing signs of softening, inflation is benign and markets are keen for action. As such, we expect precautionary 25 basis point rate cuts in both July and September.

The market continues to look for more - a third move in 4Q19 with an additional fourth cut in 1Q20. We remain more cautious given our belief that President Trump wants to be re-elected and will therefore be prepared to sign a trade deal, probably in 4Q, that doesn't necessarily meet all of his initial demands. We assume Trump will want the optimal conditions of rising equity markets and decent economic activity going into the campaign proper, and a trade deal together with lower interest rates can deliver that.

Meanwhile, bond markets are enjoying the art of the steal. On one side of the balance sheet, core issuers are obligated to return less money than they have been lent right out to 10 years. On the other side, investors have eyed the 10yr US at 2% and concluded that that is a steal when compared with other (negative yielding) risk-free rates. Absolute yield levels are discounting all kinds of awful scenarios ahead, partly reflective of a perennial disinflation tendency, but also heavily influenced by a remarkable excess of demand over supply (which the ECB will likely augment).

The eurozone economy is still desperately seeking guidance and support. Confidence indicators have started to deteriorate again, and a rate cut is now a question of 'when' rather than 'if'. It's a close call, but barring a further deterioration in the data before the July meeting, we think the ECB is more likely to wait until September when it will have a new set of staff projections.

Concerns are growing that a new UK prime minister could pursue a 'no deal' Brexit, although we still think parliament would force a general election if there were no alternative way to stop it. All of this uncertainty is continuing to weigh on growth and a Bank of England rate hike this year looks unlikely.

Even after the China-US sideline meeting at the G20 in late June, it is still too early to say that the two sides are close to reaching an agreement. Technology is the big issue, but it seems to us little can be done. China needs more infrastructure investment, both for stimulus purposes and for achieving technology independence. The central bank needs to support these projects by adding more liquidity to the market. USD/CNY has been more affected by a weak dollar than the outcome of the G20.

The eight year dollar bull run is showing signs of fatigue - but is not giving up without a fight. We suspect that an escalation in trade tensions will prove the catalyst for a fresh bout of dollar losses - especially in USD/JPY.

US: Hope for the best, prepare for the worst

Trade tensions have eased, but not disappeared. The Fed stands ready to act

The US economy is experiencing its longest expansion since at least 1854,¹ with the ceasefire in US-China trade tensions suggesting it can continue for at least a few months more. But there are significant hurdles to clear before a formal deal can be signed, so the threat of another economically damaging round of tariffs remains high. As such, the Federal Reserve stands ready to embark on a round of precautionary policy easing.

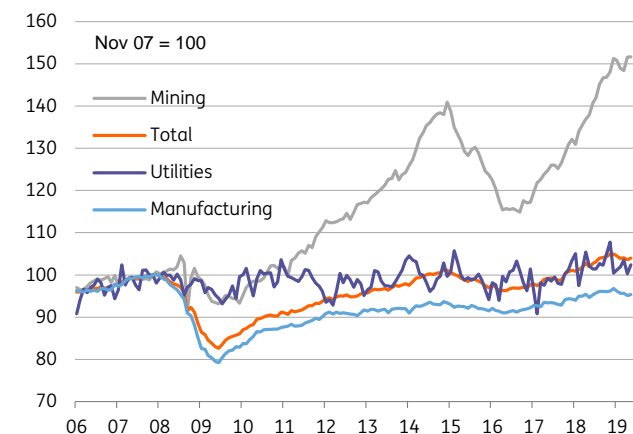
We suspect the trade ceasefire will be temporary

Talks between Presidents Trump and Xi on the sidelines of the recent G20 meeting went as well as we could realistically have hoped. Trade negotiations are restarting, there are no additional new tariffs and the Huawei issue has been de-escalated to a certain extent.

Manufacturing is feeling the pain while the trade balance is yet to see any benefits

The uncertainty caused by these prolonged global trade tensions is weighing on US sentiment and activity, most notably in the manufacturing sector. While industrial production in aggregate is up, this is primarily a mining and utilities story. Manufacturing output has actually fallen 1.5% since last December with the majority of sub-sectors experiencing declines. The latest ISM manufacturing index offered little comfort, with the new orders balance declining to the break-even 50 level. This is the weakest figure since December 2015 and underlines the anxiety within the sector. Moreover, the US's own trade position is deteriorating, with the deficit widening out in 2019 rather than shrinking as Trump had hoped. There are few winners in this trade war so far.

Fig 1 Industrial production component levels



Source: Macrobond, ING

Consumer spending and the service sector remain in decent shape though

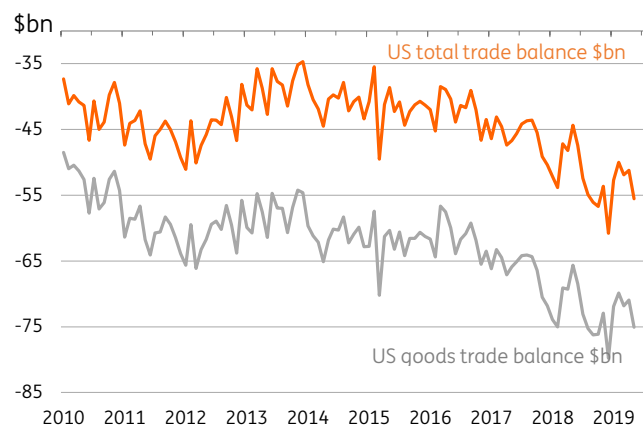
Outside of these areas, the economy is holding up better. The ISM non-manufacturing index is performing reasonably well while consumer spending continues to look healthy. Household confidence has weakened a touch recently, presumably reflecting worries about the economic outlook, but rising incomes and job security continue to offer solid foundations.

Jobs growth is slowing...

Employment growth has slowed, but this isn't down to weaker demand for workers. In fact the ISM manufacturing employment index is back above its 6-month moving average while the National Federation of Independent Businesses continues to report an incredibly strong appetite for finding additional staff. Instead, the problem remains the lack of available workers with the right skill sets.

... but it is more because firms can't find workers

Fig 2 US trade deficit



Source: Bloomberg

¹ 121st consecutive months based on the National Bureau of Economic Research's database

There are clear skills shortages in the economy...

Indeed, the latest Federal Reserve Beige Book, published just ahead of the June FOMC meeting, suggested that “stronger employment growth continued to be constrained by tight labor markets, with Districts citing shortages of both high- and low-skill workers.” Moreover, the NFIB survey indicates 38% of firms could not fill the vacancies they currently have. This is unsurprising when you consider that unemployment is at a 50-year low so the pool to draw workers from is pretty small.

... and this is pushing up pay and leading to improved benefit packages for those in demand

In turn, the competition to attract workers and to retain existing employees is pushing wages higher and leading to improved benefits packages. It may mean that inflation is stickier than many in the bond market expect.

We doubt the trade truce will hold

If the trade ceasefire holds, the outlook for the US economy remains decent but unfortunately, we are of the view that there will be a re-escalation of trade tensions in coming months. The US and China are far apart on key issues such as technological transfers, intellectual property rights, state aid and the trade dispute resolution mechanism, with neither side seemingly willing to make the required concessions to get a deal over the line.

Higher tariffs seem likely

China will not want to be seen as have been successfully bullied into agreeing to US demands and is prepared to use additional fiscal stimulus to support its economy. Meanwhile, President Trump believes that the US economy is solid and continues to pressure the Federal Reserve to cut interest rates. He also talks positively of the tax revenue benefits of higher tariffs, although it should be pointed out that these are paid by US businesses and consumers, not by Chinese manufacturers.

The Federal Reserve stands ready to offer support to the economy

A new round of tariff hikes in the second half of the year will contribute to more pronounced economic weakness through disrupting supply chains, putting up costs and hurting profit margins. Such an environment would be negative for equity markets and make US businesses more reluctant to invest and hire new workers. As such, the Federal Reserve is understandably moving in the direction of precautionary policy easing.

We look for 25bp rate cuts in both July and September

At the June FOMC meeting the central bank talked of increased “uncertainties” about the economic outlook which they will “closely monitor”. Federal Reserve Chair Jerome Powell subsequently repeated his comment “an ounce of prevention is worth more than a pound of cure”. Given the expectations of renewed trade tensions, we look for the Federal Reserve to implement a July rate cut of 25bp followed by a 25bp move in September.

The market expects more, so if we are correct there is the real risk of yield curve inversion

The chances of a 50bp move in July, which was the prevailing view in mid June, have certainly diminished given that St Louis Fed President, James Bullard, who was the only Fed official to have voted for a June rate cut, suggested such aggressive action “would be overdone”. Nonetheless, the market is pricing in three rate cuts this year with a further 25bp cut in early 2020. We suspect these expectations will be disappointed, leading to potential 2-10Y yield curve inversion with the long end of the curve doing some of the stimulus for the Fed by driving mortgage rates lower.

Nonetheless a trade deal remains our base case, limiting the need for such aggressive action

In terms of where we go from here on trade there are two possible directions. On the negative extreme, China refuses to do a deal with the US and uses domestic stimulus to offset the pain from trade. President Trump doesn't back down, the US economy slows markedly and aggressive interest rate cuts fail to stimulate the economy and markets enough to get Trump re-elected. China then gets to negotiate with a new Democrat President who may be less confrontational and with whom they can get a “better” deal.

President Trump wants to get re-elected and for that he needs a rising equity market and healthy economy

However, we take the position that given the often repeated suggestion that President Trump believes equity markets are a better barometer of his success than opinion polls, he will need to be wary about pushing China too far for too long. Otherwise he runs the risk of weakening his own 2020 re-election campaign. After all, lower interest rates can only do

We look for a deal to be signed in late 4Q to give President Trump the optimum conditions for re-election

so much to support the equity market if the core problem – trade – is not dealt with and global growth is deteriorating.

In terms of timing, we need to bear in mind that Super Tuesday – when 15 states will hold their presidential primaries – is on 3 March 2020 and that is when we should have a clear idea of who the Democrat candidate will be to take on President Trump. Therefore we assume that to be in the best shape to take on the challenger, Trump will want to see rising equity markets and strengthening activity data by that point. This suggests to us that the most likely timing for a deal to be finalised is late 4Q, even if it doesn't meet all of his initial demands.

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Eurozone: Desperately seeking guidance

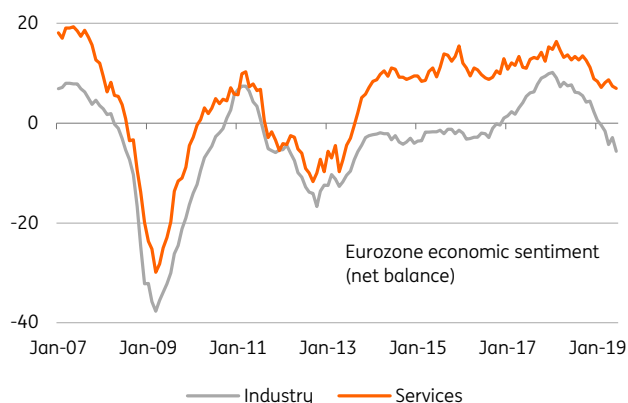
Risk of negative sentiment loop increases...

The eurozone economy is still desperately seeking guidance and support. After some bottoming out at the end of the first quarter, confidence indicators have started to deteriorate again on the back of continued trade uncertainty. Up to now, the slowdown of the eurozone economy has mainly been driven by the manufacturing sector, while domestic demand has held up reasonably well. The latest drops in confidence indicators can still be labelled as a bottoming out. However, with every single month that confidence weakens, the risk of a negative sentiment loop increases.

...and fate of eurozone economy mainly depends on two major questions

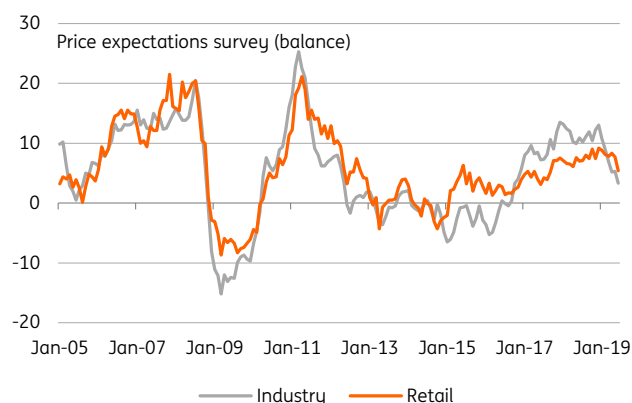
With increased and prolonged uncertainty, the fate of the eurozone economy will mainly depend on two major questions: (1) can domestic demand continue to defy the manufacturing downswing or will it start to budge and (2) will the global uncertainties eventually be resolved or are they here to stay? As regards the former, some fiscal stimulus, marginally increasing real wages and private sector investments, still argues against any recession scenario. At the same time, however, latest German data shows a clear loss of positive momentum in the labour market and dropping retail sales for two months in a row. These are tentative signs and warnings that the current decoupling of domestic and external demand should not be taken for granted. As regards the external uncertainties, our base case on trade remains one in which things will first get worse before they get better.

Fig 3 Eurozone sentiment has fallen



Source: Thomson Reuters Datastream

Fig 4 Eurozone price expectations



Source: Thomson Reuters Datastream

ECB hints at additional stimulus coming up...

All of this means that the eurozone economy is likely to float steadily with low but positive growth rates towards the end of the year, regularly flirting with recession. Against this background, it was no surprise that the ECB joined the choir of major central banks, hinting at fresh rounds of monetary easing.

...as inflation projections remain significantly below 2%

For the ECB, at least until Mario Draghi's term ends in October, there are two main factors driving its action: the price stability mandate and showing determination to act. In the eyes of the ECB, there is nothing worse than a central bank admitting it has run out of ammunition. Consequently, as long as inflation expectations and the ECB's own inflation projections for the next few years remain clearly below 2%, the ECB will fire on all cylinders, regardless of whether additional stimulus actually reaches the real economy. This explains Mario Draghi's dovishness at Sintra.

New ECB action could come as early as July...

The Sintra speech made clear that the question regarding the short-term outlook is no longer "what negative surprise is needed for the ECB to cut rates" but rather "what positive surprise could actually prevent the ECB from cutting rates". Predicting the exact timing is somewhat more complicated though. In fact, traditional ECB watching argues in favour of compiling more data, waiting for the release of 2Q GDP in mid-August and the next ECB staff projections and taking a decision only at the September meeting. Draghi's track record in overdelivering and trying to be ahead of the curve, however, could bring a rate cut already at the ECB's July meeting. In our view a very close call.

...even though September looks like the safer bet

Unless the days leading up to the July meeting bring more disappointing macro data, we think that the ECB will wait until the September meeting to deliver a 10bp rate cut in the deposit facility, combined with a clear commitment to restart QE. The reason not to use all ammunition at once is the UK's impending exit from the European Union and the need to have some policy measures left in case of a disorderly Brexit. Given that a lower negative deposit rate for a longer time to come will increasingly become a burden on bank profitability, a tiering system for excess liquidity is likely to be introduced as well.

A cut in the deposit rate by 10bp could be combined with commitment to restart QE

Amongst the likely options, a new corporate bond purchase programme would seem a sure bet, potentially including senior bank bonds as well. As for sovereign bonds, the headroom looks limited given the 33% issuer limits. We believe that the ECB would be more likely to diverge from the capital key, no longer buying in jurisdictions where it has already reached the threshold.

Change of guard from Draghi to Lagarde will hardly change anything

The nomination of Christine Lagarde as new ECB president provides little to no change for the ECB's monetary policy over the coming months. In fact, extended forward guidance, new dovishness and probably a new round of QE before she enters office have tied Lagarde to the Draghi chains going into 2020. Let's hope that the eurozone economy has found some stability by then so that Lagarde's willingness to do "whatever it takes" does not have to be tested any time soon.

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UK: Christmas cancelled?

Boris Johnson is odds-on to become the next prime minister

We think Parliament would use a vote of no confidence to block a 'no deal' exit

If an election did happen, it wouldn't be until December

Former Foreign Secretary Boris Johnson remains the odds-on favourite to become the next UK prime minister – and following a comment in an interview that the October 31 Brexit deadline is “do or die”, markets have become more nervous about the UK outlook.

But how likely is ‘no deal’ in reality? We took a closer look in [last month's update](#), but to recap, we still think the probability of a ‘no deal’ exit in October sits around 20%. Parliament remains heavily against it, and while lawmakers may lack the legislative tools to stop it, MPs could use a vote of no confidence to force a general election instead. For this to succeed, a majority of MPs in the House of Commons would need to back it.

While it may sound like a tough sell for the Conservatives to effectively vote themselves out of government, it wouldn't take many MPs to do so. If the Conservatives lose a by-election in Wales later this month, their working majority within the House of Commons would fall to just two.

In terms of timing though, it's hard to see a no confidence vote being successful unless a ‘no deal’ exit looks otherwise unavoidable. If an election is to happen therefore, it's unlikely to be triggered until fairly late in the day. Taking into account the minimum timings to hold an election suggests the earliest it could realistically happen is just before Christmas.

Fig 5 Scenarios for Brexit under PM Boris Johnson

	ING probability	How scenario could materialise	Article 50 extension?	Market reaction
Parliament forces a general election	35%	Parliament stops 'no deal' by passing no confidence motion. General election takes place in late Nov/early Dec	✓ At least 3 months	EUR/GBP: 0.95 GBP/USD: 1.18
Revamped deal	25%	To avoid election at all costs, pro-Brexit MPs reluctantly back tweaked deal given there's a Brexiteer in place for next stage of trade talks	✓ Possibly (for legislation)	EUR/GBP: 0.85 GBP/USD: 1.34
Second referendum	15%	Parliament may struggle to force a 'People's vote'. But can't fully rule out PM triggering one as “least worst” option versus an election	✓ At least 6 months	EUR/GBP: 0.82 GBP/USD: 1.40
No deal	20%	If EU rejects further A50 extension, or a new leader pushes for a hard Brexit, Parliament may lack the legislative tools to stop it	✗	EUR/GBP: 1.00 GBP/USD: 1.10
Revoke Article 50	5%	Parliament may prefer this over a 'no deal' exit, but like a 2 nd ref, MPs could lack a legislative tool to force the new PM's hand.	✗	EUR/GBP: 0.78 GBP/USD: 1.47

Source: ING

Manufacturing has fallen as firms grapple with what to do with their excess stock

In the meantime, all of this uncertainty is taking its toll on the economy. Second quarter growth looks set to come in flat, or possibly even negative. Much of this has to do with manufacturing, which saw production fall by a whopping 3.9% in April. Admittedly some of this is down to various car manufacturers bringing forward their annual re-tooling shutdown to the start of April. But the much bigger story is that new orders have slowed sharply following the stockpiling frenzy that took place ahead of the original March Brexit deadline.

These firms now face a tricky decision. Given the cost of holding this extra stock – both in terms of storage and working capital – many will choose to unwind some of this inventory and try and rebuild it ahead of the new October deadline.

Warehousing constraints ahead of Christmas pose challenges for retailers preparing for 'no deal'

However this is awkward timing for many firms, given that Christmas-driven demand means warehousing space is already very constrained. According to the UK

Warehousing Association, the inner-M25 (London) area has a vacancy rate of just 2.2%. For many retailers, the price of preparing for 'no deal' is being unprepared for the key Christmas trading period.

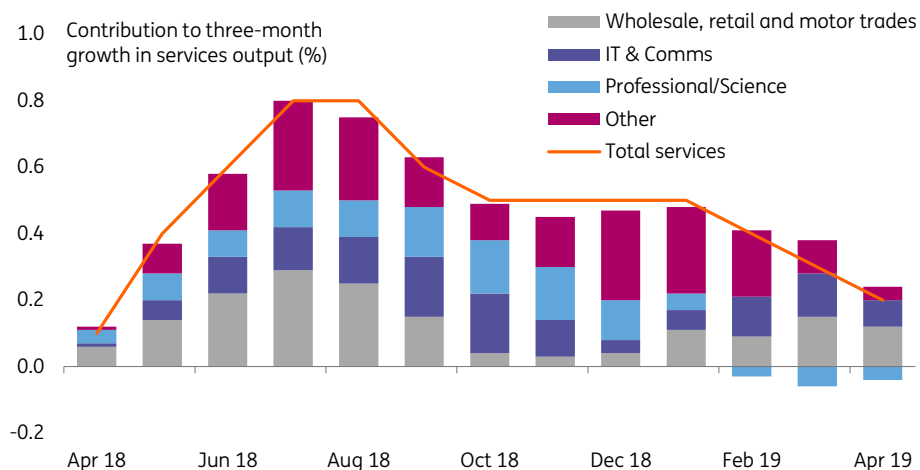
Retail has been poor this quarter

Things don't look much better in the much-larger service sector, where output has stagnated through the second quarter. While consumer-facing services had been performing a little better – offsetting weakness in some other services industries – the second quarter has been a tough one for retailers. Despite an improvement in real wage growth, confidence remains depressed and this appears to be weighing on bigger-ticket purchases.

We think a 2019 rate hike from the BoE is unlikely

Throw in the potential for a further escalation in global trade tensions, and all of this means it's hard to see the Bank of England increasing interest rates this year. That said, we disagree with the market's assessment that there is a 42% chance of a rate cut this year. While recent BoE commentary has become more cautious, recent rhetoric also hints that the bank would still prefer to tighten policy assuming Brexit uncertainty eases.

Fig 6 Improving consumer-facing services haven't fully offset weakness elsewhere



Source: ONS

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China: Too soon to close a deal

Xi and Trump met in G20, so?

Finally, the market can breathe a sigh of relief after China's President Xi met US President Trump in a side meeting of the G20 on 27-28 June. But we are not particularly positive on the outlook following this meeting.

The G20 side-line meeting didn't solve the problems faced by China's technology companies

At face value, the outcome of the meeting was positive – the US has put on hold its plans for even more tariffs on Chinese imports to the US. But it has not removed Huawei from the US's Entity List.

Interestingly, even though President Trump said during a media conference that Huawei could do businesses with US companies that are not critical to national security, defining what is or is not in US national security interests is not clear. President Trump may also be facing pressure domestically to allow US companies to trade with Huawei, even though Huawei remains on its Entity List.

China didn't promise to import more US goods, according to Chinese official media

Trump also told the press that China is going to import a lot of US agricultural produce. However, according to official Chinese media, the section related to China's exports from the US only states that the "US hopes China can import more from US".

Technology exports are being hammered

China will speed up its own technology development to achieve independence

More infrastructure needs more funding to avoid GDP falling below the 6% target

PBoC has added liquidity to push overnight SHIBOR below 1%, last seen in 2009

More PBoC easing to come to support fiscal stimulus

Jobs and wages are more our concern than GDP growth

USD/CNY hasn't been affected by the G20 but more by the dollar

These differences indicate that the two sides have not used the side meeting to solve their trade and technology war, but instead are leveraging the meeting to show to their own citizens that they have the upper hand in future negotiations.

Returning to the technology part of the negotiation. As confirmed by Huawei, the meeting has done little to change the tough situation still faced by the company, which suggests that technology-related exports from China will be severely damaged.

Our conclusion is that China will continue to accelerate its own technology development in nano chips, in smartphone's operating systems and applications. Most importantly, China will aim to be a pioneer in 5G infrastructure and in 5G applications, striving for technology independence before exporting this technology.

This will mean a lot of investment is needed, in addition to the announced fiscal stimulus-related infrastructure spending. We have therefore doubled the estimated amount of infrastructure spending (including telecommunication infrastructure) from CNY2trillion to CNY4trillion in 2019. Without this, the economy may not be able to achieve its 6% of GDP target, as technology-related investments and exports will take a severe hit.

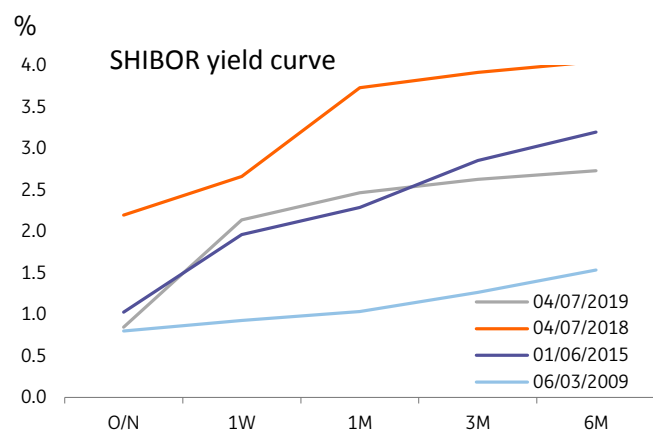
Of course, such investment needs funding, and this would ordinarily push up interest rates if the central bank didn't inject new liquidity into the banking system. We have already seen a liquidity injection of CNY107 billion in June after CNY550 billion a month earlier. This has pushed down overnight SHIBOR to below 1.0%, a level last seen in 2009.

We believe that when more investment projects kick off, there will be a new wave of funding needs in 2H19, which will lead to a 0.5 percentage point cut in the RRR (required reserve ratio) in 3Q and 4Q. We are aware that RRR cuts are rigid policy tools so if the funding needs are temporary, the central bank may opt to increase liquidity using the MLF (medium lending facility). If these tools can contain rising interest rate pressures, the central bank may save interest rate cuts until last.

With all the measures mentioned above in place, we believe that China's GDP will be able to avoid falling below the 6% target. But we still worry that some industries, especially export-related, will be hurt, and jobs and wages may not be as stable even if GDP grows at 6%.

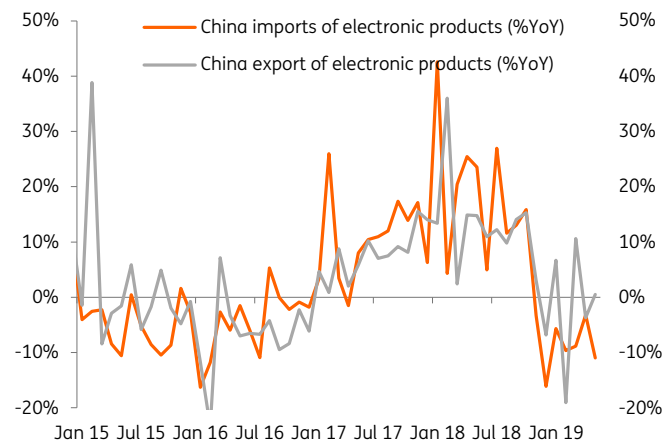
USD/CNY has been more affected by a weak dollar than the outcome of the G20. We still expect USD/CNY and USD/CNH to move closer, and to reach 6.90 by end of 2019.

Fig 7 SHIBOR curve at bad times in recent history



Source: ING, Bloomberg

Fig 8 Imports lead export of electronics. It has been weak



Source: ING, Bloomberg

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Japan: Not bad enough

2Q Tankan disappointment

The end of 2Q19 delivered a disappointing assessment for Japan in the form of the June Tankan survey. This survey, undertaken each quarter by the Bank of Japan, gives a good snapshot of the economy together with forward indicators that are both more timely, and in the past at least, more “accurate” than the GDP figures, which were, and at times still are, dominated by erratic stimulus packages or one-off spikes and troughs in volatile elements like inventories and trade.

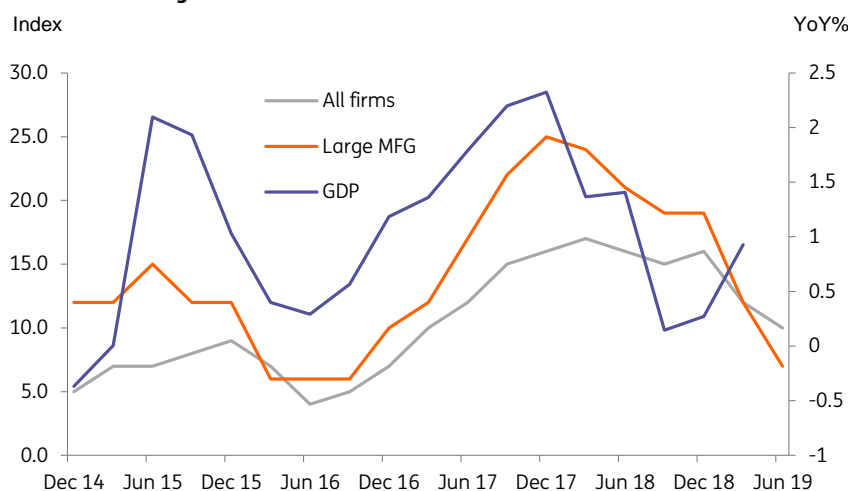
Manufacturing slowing, not collapsing

The Tankan headline large firm manufacturing index fell more than expected (to 7 from 12) which puts it only just above the 2016 trough. To put that into perspective though, this index fell to -58 during the global financial crisis, so manufacturing is softening, not collapsing.

No different to anywhere else in Asia...and for similar reasons

The forward-looking “outlook” series for the manufacturing industry also dimmed, which is not surprising given the issues facing Japan and the rest of Asia - Trade war, tech slump and slowing global trade.

Fig 9 Tankan survey and GDP



Source: CEIC, ING

2Q GDP will probably slow, maybe even decline

But while the direction of the Tankan was down, the speed of decline is not particularly alarming. 2Q19 GDP may well show a decline in both quarter-on-quarter and annual growth – but this looked likely anyway after the improbable bounce in 1Q19.

Probably not weak enough to postpone the consumption tax hike

But the main reason for opening this Japan report with a detailed description of the Tankan is not to predict GDP, but because the Tankan was possibly the only bit of economic data remaining, that, if sufficiently bad, might encourage a postponement of the October consumption tax hike.

The tax hike will mess up growth and inflation data for a year

This hike, which has already been delayed twice, will raise the consumption tax by two percentage points, adds a bit more than a percentage point to headline inflation (for 12 months) and will result in the usual front loading and then collapse in spending that has accompanied similar tax hikes.

It will probably go ahead

We had removed the tax hike from our forecasts many months ago as we felt the data was insufficiently supportive to allow it to go ahead. Right now, this decision does not look as if it was correct. And the figures will need amending at some point before long. We are allowing the latest figures time to percolate through senior politicians before formalising that change.

An upset at the 21 July Upper House elections is about the only remaining threat

The only other potential impediment to the consumption tax hike now is July elections. The 21 July election takes half of the Upper House members back to the polls. We don't envisage a major upset. The ruling LDP plus Komeito coalition partners currently hold 150 of the 245 seats in the Upper House. Retaining a majority looks relatively likely, though the coalition remains 13 seats short of a two-thirds majority to make major constitutional changes. And that probably will not change.

Nevertheless, a bad election outcome, even if not one changing the majority within the Upper House, might still cause a rethink on policies, and the consumption tax could yet be a victim of this.

Nothing new from the BoJ, but the money base is growing again and bond yields are falling

There are no new developments on the Bank of Japan, though it is worth noting that the monetary base, which had basically ceased to grow from the end of 2018, has picked up recently. There has been no announcement to accompany this, but it matches the steep decline in 10Y JGB yields over the same time period, and could be a deliberate, if covert policy measure aimed at preventing JPY appreciation against the growing likelihood of US Fed easing. More likely though, the fall in JGB yields is just a reflection of what is happening in US Treasury markets.

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FX: Wrestling with the \$ bull trend

It may take a while for a clean dollar bear trend to emerge

There are some signs that the dollar is topping out. And certainly President Trump would expect a weaker dollar to do some of the heavy lifting if the US economy required more stimulus. However, the dollar is not giving up its gains that easily and we expect it may take a while for a clean dollar bear trend to emerge.

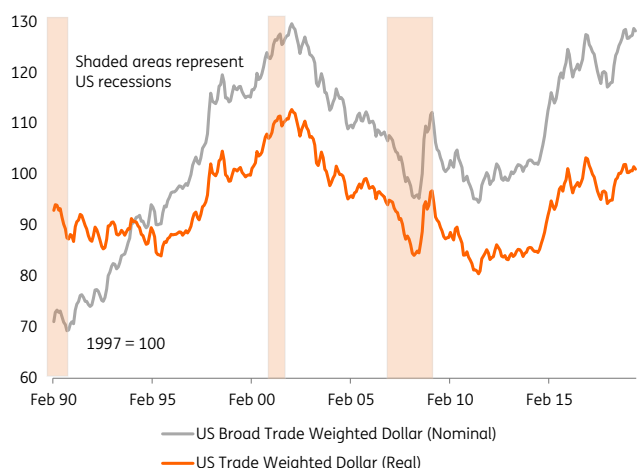
Institutional investors now see the dollar as the most over-valued since 2002

The past month has generally seen the dollar continue to edge lower – primarily against the defensive currencies of CHF and JPY. The decisive rally in Gold through \$1400/oz provides some backing to the view that the dollar trend is turning and institutional investors now see the dollar as the most overvalued since 2002 – coincidentally as the Fed's trade weighted, broad dollar index stalls at those 2002 highs.

We suspect trade tensions feed more directly into Fed easing expectations and generate further declines in the likes of USD/JPY

But what it would take to drive the dollar substantially lower? A 25bp Fed cut on 31 July is fully priced in and it is hard to see short-end US rates falling a lot more – unless, that is, the US-China trade war takes a turn for the worse. As it happens, an escalation in the trade war is our baseline view this summer. Instead of lifting the dollar broadly on safe haven inflows – we suspect trade tensions feed more directly into Fed easing expectations and generate further declines in the likes of USD/JPY and USD/CHF.

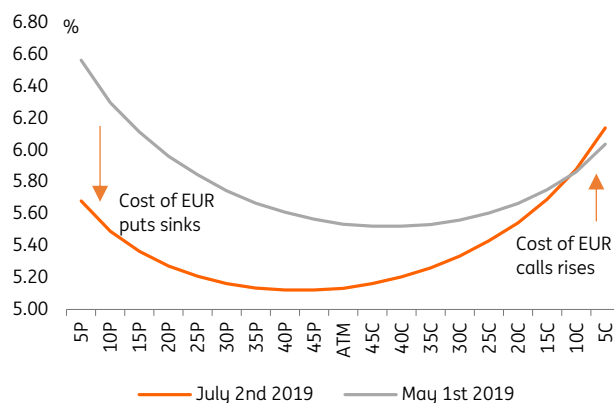
The nature of our expected 3Q19 dollar decline, one driven by trade tensions, warns that emerging markets FX may not repeat the kind of gains witnessed in June when reflationary Fed policy drove gains across the board. We would characterise the 3Q19 expected dollar decline as 'bad', rather than a 'good' dollar decline seen when the Fed frontruns a downturn.

Fig 10 Is the dollar topping out?

Source: Bloomberg, ING

The EUR/USD option market seems more impressed by the Fed story

We still expect EUR/USD to trade in a 1.10-1.15 range into year-end

Fig 11 EUR/USD 'smile' curve for 3m option prices

Source: Bloomberg, ING

We are also seeing a subtle shift in the FX option market's attitude to the dollar. In spite of President Draghi's threat to ease policy at the ECB council meeting on 25 July, the EUR/USD option market seems more impressed by the Fed story.

In only a couple of months, the cost to buy downside EUR/USD protection has fallen sharply and the cost to buy upside protection has risen marginally. Changes in the shape of the FX option 'smile' curve reflect the shifting pattern of demand and suggest the market is moving towards greater concern over an upside break in EUR/USD.

Yet it still looks far too early to call for EUR/USD to move higher given: i) ECB easing, ii) the threat of US auto tariffs on the EU and iii) Italy and Brexit – but certainly trends in the FX options market are worth monitoring. As such, we still expect EUR/USD to trade in a 1.10-1.15 range into year-end, with GBP/USD trading down to the low 1.20 into late summer.

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Rates: Why rates are collapsing

The cycle is turning. But it does not feel like it

What the ECB would do for a cycle, rather than a downward lurch

Negative to zero rates can actually act as a drag

The move of the German 10yr to -30bp is a capitulation to crisis-style level

One of the notable aspects of a likely easing from the Fed from the end of July is it effectively marks a turn in the cycle. While we argue that the cut will be precautionary and likely followed by just one additional cut, others argue that a July cut will be the beginning of a series of cuts. The 100+bp of cuts discounted by the markets is consistent with the type of policy response required into a marked macro downturn.

What troubles us more is the prognosis for the eurozone – the land that got left behind. While the US Federal Reserve has the luxury of cutting from a point of strength, the ECB is still cutting from a point of weakness. History shows that Fed policy has been a forward indicator of ECB policy but not this time, as it seems the ECB has missed out completely on the rates uplift part of the cycle.

From a market rates perspective, the important nuance here is the Fed managed to pull away from the zero-to-negative-rates-anchor that dominated post the financial crisis. So there was escape velocity. But two factors have limited the extent of the move. First, the likes of European and Japanese rates have acted as a magnet, and second, the underlying disinflationary tendency never really went away.

The magnet of other core rates has been important. When the US 10yr hit 3.25%, the German 10yr was in the 30-50bp area, and had previously (briefly) hit 1%. The move in the US 10yr from 3.25% back down to 2% coincided with the German 10yr reverting to

negative yields. That move down to -30bp was a massive one, as it was essentially a capitulation to crisis-style levels.

The only answer that the ECB has is more loosening

In consequence, we are staring down the barrel of an ECB gearing up to join the monetary loosening, and so skipping the tightening bit completely. It's a loosening beyond prior extremities, a deeper dive into the realms of what should be considered an abnormally inverted state. And a change at the top of the ECB (from a definite dove to a likely dove) implies maintenance of extreme policy, and thus extreme rates.

This leaves the US 10yr at (close to) 2% looking like value

When viewed in this light, a handle of 2 on the 10yr US yield is in fact a generous level. Sure it was even more generous at 3.25%, but the whole spectrum of global risk-free rates has shifted not just lower, but also deeper into negative rates territory – any return is better than paying a borrower for the privilege of lending cash to them. Hence, no great surprise that the US 10yr has slipped below 2%.

Rates are also low due to an excess of demand, and wider relative value

And as always it is circular. The US 10yr below 2% is a level that bears more relation to the German 10yr yield at -30bp than it does to contemporaneous US fundamentals, which is a remarkable thing to assert. Relative value vis-à-vis other risk free rates together with an excess of demand (including QE) over supply are dominant drivers of the absolute level of market rates, and by implication central bank rates.

Not just Japanification, as Germany offers safety

And then there is the phenomenon that is the German 10yr yield. At -30bp, the implied discount is for 10 years of pain; in fact a depression is imputed. The Japanification of Europe is the common jibe. It could be. But it also reflects a safety play for investment funds that seek to warehouse cash in a market-place that can take big volume, and has the assurance of proxy-deutschemark status should it all fall apart.

Issues such as Italy cannot be shelved at times like this

And this is why what happens in e.g. Italy is important. Not just for Europe, and German yields. But also for US yields, and risk free rates generally. Stress of any description can bring ECB QE, an excess demand for “safe” bonds, and thereby ever lower rates.

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Fig 12 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
United States																				
GDP (% QoQ, ann)	2.2	4.2	3.4	2.2	2.9	3.1	1.8	1.6	1.8	2.5	1.6	1.9	1.9	2.0	1.8	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	2.0	1.9	2.1	1.8	2.5	2.1	2.2	2.2	2.2	2.1	2.0	1.9	1.8	2.0
Federal funds (% eop) ¹	1.50	1.75	2.00	2.25	2.25	2.25	2.25	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75
3-month interest rate (% eop)	2.30	2.35	2.45	2.65	2.65	2.60	2.45	1.95	1.95	1.95	2.00	2.05	2.05	2.05	2.05	2.05	2.05	2.05	2.05	2.05
10-year interest rate (% eop)	3.00	3.00	3.00	2.80	2.80	2.30	2.00	1.80	1.70	1.70	1.90	2.00	2.10	2.10	2.10	2.10	2.10	2.10	2.10	2.10
Fiscal balance (% of GDP)					-4.0					-4.6					-4.7					-4.7
Fiscal thrust (% of GDP)					1.1					1.1					0.3					0.3
Debt held by public (% of GDP)					76.7					78.9					81.3					83.8
Eurozone																				
GDP (% QoQ, ann)	2.8	1.6	0.5	1.0	1.9	1.6	0.6	0.8	1.1	1.0	0.9	1.4	1.2	1.1	1.1	1.1	0.9	0.5	0.8	0.9
CPI headline (% YoY)	1.3	1.7	2.0	2.0	1.8	1.4	1.3	1.0	1.1	1.2	1.3	1.3	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4
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	-0.40	-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	-0.30	-0.10	-0.10	-0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
Fiscal balance (% of GDP)					-0.5					-0.8					-0.8					-0.7
Fiscal thrust (% of GDP)					-0.2					-0.1					0.2					-0.1
Gross public debt/GDP (%)					87.8					86.8					85.7					84.4
Japan																				
GDP (% QoQ, ann)	-0.3	2.2	-2.5	1.6	0.8	2.2	1.4	0.7	0.5	1.1	0.5	0.6	0.8	0.8	0.7	0.8	0.8	0.8	0.8	0.8
CPI headline (% YoY)	1.3	0.6	1.1	0.9	0.9	1.0	1.1	1.2	1.0	1.1	0.8	0.6	0.8	1.0	0.8	0.8	0.6	0.8	1.0	1.0
Excess reserve rate (%)	-0.1	-0.1	-0.1	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0	-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	0.00	0.00	0.00	0.00	0.00	-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	0.05	0.10	0.10	0.10	0.00	-0.10	-0.20	-0.20	-0.20	-0.20	-0.20	-0.20	-0.20	-0.20	-0.20	-0.20	-0.20	-0.20	-0.20
Fiscal balance (% of GDP)					-3.0					-2.8					-2.5					-2.2
Gross public debt/GDP (%)					235.0					233.0					232.0					232.0
China																				
GDP (% YoY)	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	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	2.5	2.6	2.6	2.4	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	3.05	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					
Public debt, inc local govt (% GDP)					88.0					102.0					103					
UK																				
GDP (% QoQ, ann)	0.2	1.6	2.8	0.9	1.4	2.0	0.1	1.1	1.7	1.4	1.5	1.6	1.2	1.1	1.4	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	1.8	1.9	1.9	2.3	2.1	2.1	2.0	2.1	1.9	1.9	1.9	2.0	2.0
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	1.00	1.00	1.25	1.25	1.25	1.25	1.25	1.25	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	0.85	0.85	0.85	0.85	0.85	1.05	1.10	1.30	1.35	1.35	1.35	1.35	1.35	0.95	0.95
10-year interest rate (% eop)	1.45	1.48	1.57	1.30	1.30	1.00	0.80	0.70	0.80	0.80	1.00	1.20	1.20	1.20	1.20	1.20	1.10	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	1.15		1.16	1.17	1.18	1.20		1.21	1.22	1.23	1.25	
USD/JPY (eop)	107	110	114	113		112	108	105	103		102	100	100	100		98.0	95.0	93.0	90.0	
USD/CNY (eop)	6.28	6.67	6.87	6.88		6.74	6.90	6.95	6.90		6.90	6.85	6.80	6.75		6.75	6.70	6.75	6.70	
EUR/GBP (eop)	0.88	0.88	0.89	0.90		0.85	0.90	0.92	0.92		0.90	0.88	0.85	0.85		0.85	0.85	0.85	0.85	
Brent Crude (US\$/bbl, avg)	67	75	76	69	72	64	68	69	73	69	70	74	76	74	74	72	77	77	74	75

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

Source: ING forecasts

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