14 June 2019
Global

# Monthly Economic Update

## Monetary policy to the rescue

**Financial markets are clamouring for policy stimulus as trade tensions and worries about global growth mount. Optimism that China and the US will settle their issues this month is fading fast, and it looks increasingly likely that central bankers will bow to both political and market pressure for rate cuts. However, we expect any easing to stop short of current market expectations. This may result in further equity market weakness and a renewed inversion in the yield curve before a trade agreement is eventually signed.**

Recent US data suggests the economy is becoming less resilient to the negative trade headlines and the Federal Reserve is signalling moving in the direction of policy easing. This is fuelling market expectations of aggressive stimulus – in line with President Trump's demands for 100 basis point of rate cuts. We think precautionary 50bp rate cuts from the Fed are likely.

Neither China nor the US seem willing to back down right now and it looks as though trade tensions will escalate further. But in the end, we believe President Trump wants to get re-elected and a deal will be done. After all, lower interest rates can only do so much to support the equity market (and Trump's perceived re-election chances) if the core problem – trade – isn't dealt with and global growth deteriorates further.

In China, we think the authorities will increase fiscal stimulus, as well as cut interest rates and the reserve requirement ratio (RRR) to support growth, in what is a difficult environment for Chinese companies in the trade and technology sectors.

Some of the green shoots we observed last month in the eurozone might be nipped in the bud if the trade war continues to escalate. The initial figures for the second quarter are mixed, though it's too soon to pencil in a stalling of the recovery. While the European elections were basically a non-event, the political risk in Italy is rising again. Slowing growth and declining inflation expectations have forced the European Central Bank to introduce an easing bias in its communication. The path forward now looks open for a rate cut in the coming months.

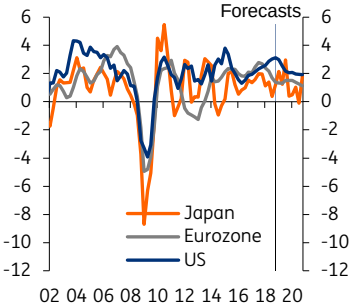
Boris Johnson is odds-on to become the next UK prime minister, prompting concern that he could push for a 'no-deal' Brexit. But a new leader will face the same hurdles as Theresa May, and parliament would likely trigger an election if a 'no-deal' is imminent. In the meantime, the uncertainty will continue to keep a lid on economic growth.

Japan's 1Q19 GDP was an impressive 2.2%, but the details behind that growth are far less impressive, and growth in 2Q and beyond could struggle. With the Fed looking more dovish, the Bank of Japan will be looking anxiously at the USD/JPY rate, and wishing it had some effective tools left in its monetary arsenal. Unfortunately, it has none.

The drop in US interest rates has undermined the dollar. If this is the start of the long-awaited dollar decline, we expect it will be USD/JPY that leads the charge. Macro-political challenges in Europe mean that EUR/USD will struggle to better the 1.15 level.

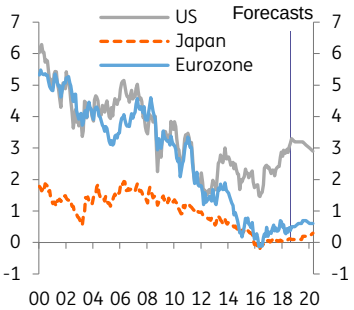
On market rates, one of the nuances that we identify is the likelihood that the Fed under-delivers on the market rate cut expectations. This could force long rates lower as the disappointment on the extent of the delivery of cuts prompts investors to switch out of risk assets into Treasuries, which still offer a positive yielding risk free rate.

**GDP growth (%YoY)**



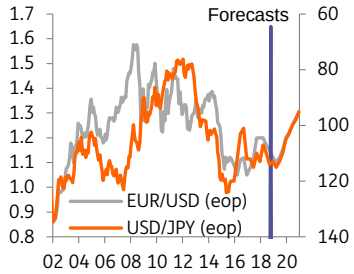

Source: Macrobond, ING

**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**

# US: About turn!

Intensifying trade worries, softer macro numbers and a shifting Fed stance lead us to change our forecast to rate cuts in 2H19

**Over the past month, the debate surrounding the outlook for Federal Reserve interest rate policy has swung from "if" they will cut to "when" they will cut rates. Trade tensions look set to persist and recent data suggests the economy is more vulnerable to the fallout than it was in the second half of 2018. With senior policymakers opening the door to action, we now expect implementation of the "Fed put" with pre-cautionary September and December rate cuts.**

The uncertainty regarding the outlook for trade shows no signs of easing, which risks making business more cautious

The combination of the US administration's more belligerent position on trade with China and the willingness to use the threat of tariffs as a means of achieving non-related political "wins" (such as with Mexico and immigration) has only intensified concerns about the prospects for the US economy. There is a growing risk that the uncertainty surrounding global trade leads to a sense of paralysis in corporate America that prompts a broader economic slowdown.

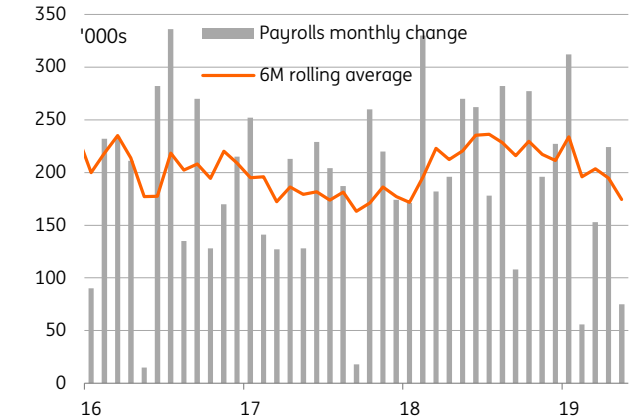
In turn this may result in weaker hiring and investment, which could spread weakness through the economy

Do firms go through the expensive process of on-shoring production back to the US or looking for non-Chinese suppliers only to find that President Trump has changed his position again? Or do they instead carry on with business as usual and risk higher tariffs that put up costs and hurt profit margins? Faced with such uncertainty many firms may simply sit on their hands and do nothing. This implies a slowdown in investment and hiring – and not just in the US – which in turn leads to lower consumer spending and the rising threat of recession.

Recent data suggests the economy is more vulnerable to the fallout than it was in the second half of 2018.

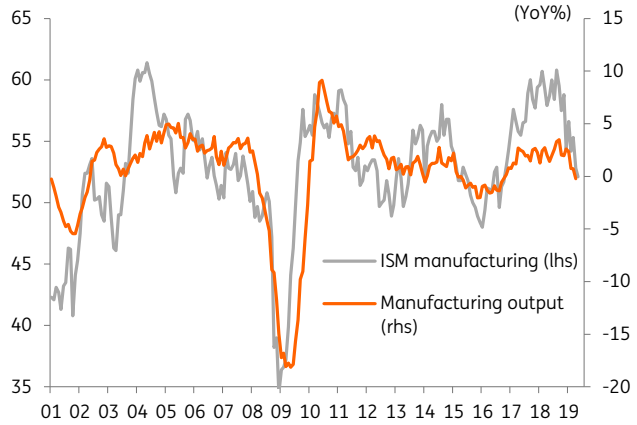
The narrative surrounding the attritional nature of prolonged trade tensions received support from the latest jobs report, showing a significant slowdown in hiring in May – 75,000 versus the consensus forecast of 175,000, while there was a further 75,000 downward adjustment in employment numbers for the previous two months. Weakness can also clearly be seen in the manufacturing sector, with the ISM report at its lowest level since October 2016 as high inventory levels led to softer new orders. Currently the Atlanta Fed GDPNow indicator is running at a rate consistent with 2Q GDP growth of just 1.4%, which would be the weakest outcome since 4Q15.

**Fig 1 Labour market losing some momentum**




Source: Bloomberg

**Fig 2 Manufacturing starting to hurt**




Source: Macrobond

Fed officials are laying the groundwork for possible rate cuts

At the same time, Fed officials appear to be laying the groundwork for another shift in stance. Having signalled a willingness to be "patient" on assessing whether a change in interest rate policy was going to be required, Fed Chair Jerome Powell stated last week that the Fed was now "closely monitoring" the implications of the protracted trade negotiations for the economy.

The Fed is no longer looking so "patient"

St Louis Fed President James Bullard (an FOMC voting member) was more direct, arguing that a rate cut "may be warranted soon" to provide some insurance in case of a sharper than expected slowdown". Other Fed officials, such as Charles Evans, President of the Chicago Fed, continue to talk about the US' "solid" fundamentals, but he too acknowledged that they can adjust policy "if that's necessary".

Markets have responded by pricing in 100bp of rate cuts over the next 12 months

The trade, macro, Fed talk and subdued inflation backdrop has led markets to price-in up to 100bp of rate cuts over the next twelve months. This coincidentally matches the demands of President Trump, which would, in his view, allow the US to lift off like "a rocket ship". Equities like what they hear and we are left with the bizarre situation whereby "good" economic data is ignored and "bad" economic data is seen as increasing the likelihood of a rate cut so both bonds and equities rally.

We will need to see a bounce in the data and a swift resolution to the trade conflict to prevent action

There is the possibility that rate cuts will not be required, but for this we would need to see a prolonged period of expectations-beating data and a swift positive conclusion to trade talks. In this regard, President Trump's decision to pull back from ramping up tariffs on Mexico has renewed hope that he and the Chinese president could strike a deal at the G20 summit later this month (assuming the latter turns up) . However, we think this is doubtful.

This looks unlikely

China will not want to be seen as have been successfully bullied into agreeing US demands while President Trump's view that tariffs are boosting US Treasury coffers and that the "strong" US economy can withstand near-term pain suggests he is not going to back down soon.

The worst case scenario is one of stubbourness from both sides, but this would be deeply damaging for Trump's re-election bid

This could go in one of two directions. On the negative extreme, China refuses to do a deal with the US and uses domestic stimulus to offset to pain from trade. Donald Trump doesn't back down, the US economy slows markedly and even aggressive rate cuts fail to stimulate the economy enough to get President 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.

An alternative outcome is the Fed acquiesces and cuts aggressively and Trump then agrees to a deal

On the positive extreme President Trump's hardline stance intensifies and the Fed delivers the aggressive rate cuts he has been demanding. He then swiftly ends the trade war (irrespective of whether he has won a "great" deal) and tariffs are slashed to zero. We then get a positive wave of sentiment with equities surging and the economy bouncing back right ahead of the election.

Teensions will mount before any resolution and the Fed looks set to cut rates

Either way the trade situation will get worse before it gets better and is likely to spread to Europe and Japan. Given the language shift from Fed officials we believe that they will use the June FOMC to signal an easing bias. This would perhaps be through repeating Chair Jerome's Powell use of the "closely monitoring" phrase and downward revisions to their economic projections and their "dot" diagram of rate expectations, which currently has a rate hike in for 2020.

But we think the market is being too aggressive in pricing in 100bp of easing...

... the economy remains in decent shape overall no real recessionary signals

Some in the market believe that this could be a catalyst for a July rate cut given Powell has said all meetings are "live", not just the ones where there are press conferences. However, outside of manufacturing, the US numbers don't look too bad. The ISM non-manufacturing index moved higher this month, consumer confidence is holding at strong levels and labour surveys suggest the slowdown in employment growth remains primarily because of a lack of suitable workers rather than a downturn in hiring. After all, the National Federation of Independent businesses reported that a net 21% of its members are looking to hire (highest since last December) while 38% of businesses can't fill the vacancies they currently have. These readings are not consistent with an imminent threat of recession.

Going too aggressively could be damaging for sentiment and lead to criticism over independence

Cutting rates in such an environment could be negative for corporate and household sentiment if it is interpreted as signalling the economy may be in worse shape than

believed. It would also leave the Fed open to criticism of caving into political pressure. Instead we suspect the Fed will favour waiting until September and follow up with another 25bp move in December.

We also belive that Trump wants to be re-elected and will get a deal done

This is a shift from our previous view that the Fed would keep policy on hold through 2019 and 2020, but we remain less aggressive than the market. Our more upbeat assessment centres on the strong US fundamentals, the tightness in the labour market and our view that President Trump will want deals to be done. Bond markets will be impatient for more so a temporary 2-10-year yield curve inversion is probable before a trade agreement is signed.

Interest rate cuts can only do so much if the core problem is left unaddressed

The often-repeated suggestion that equity markets are a better barometer of his success than opinion polls means that President Trump will need to be wary that pushing too far for too long runs the risk of weakening his re-election campaign. After all, lower interest rates can only do so much to support the equity market if the core problem – trade – is not dealt with and global growth is deteriorating. A weakening economy and plunging equity markets is an easy attack line for a Democratic challenger.

Our trade team believes the most likely timing for a deal is 1Q20

The hawks in Trump's team who are more focused on restraining China's global political ambitions will also be wary, because if Trump loses the election they will be out of the Administration and will not be able to influence the debate to anywhere near the same extent. As such, we think President Trump will make compromises to get a deal done, but with Europe and Japan also in the firing line our trade team believe it may be Q120 before there is a clear resolution.

**James Knightley, London +44 20 7767 6614**

# Eurozone: A rate cut is coming

Trade uncertainty is hurting the recovery

Just when it seemed that the eurozone economy was starting to improve, the escalation of the trade war between the US and China soured the mood once more. We mustn't forget that Europe and especially Germany is very exposed to international trade. Any trade slowdown will leave its mark on the eurozone economy. While some might argue that Europe could benefit from the US-China conflict through trade diversion, we think that the overall negative effect on world growth will be more important. What's more, Europe itself is likely to be in the line of fire itself if President Trump decides to impose import tariffs on cars later this year. No wonder that the European Central Bank (ECB) has introduced an easing bias in its monetary policy statement.

Still no reason to anticipate a recession...

...but GDP growth is likely to remain subdued

The strong drop in German exports in April was a testament to international trade troubles, even before President Trump decided to tweet about additional import tariffs. However, the weakness was probably exaggerated because of the end of stockpiling in the UK in the wake of Brexit. To be sure, domestic demand has done rather well on the back of a strong service sector and decent construction activity. Economic sentiment in the eurozone actually rose from 103.9 to 105.1 in May and lending picked up in April. So there is no reason to expect an economic standstill in the near term. However, forward-looking indicators like new orders point to slowing growth. There is also the fear that weakness in manufacturing might spread to the rest of the economy. We have marginally downgraded our GDP outlook both for this year and next year to 1.0%.

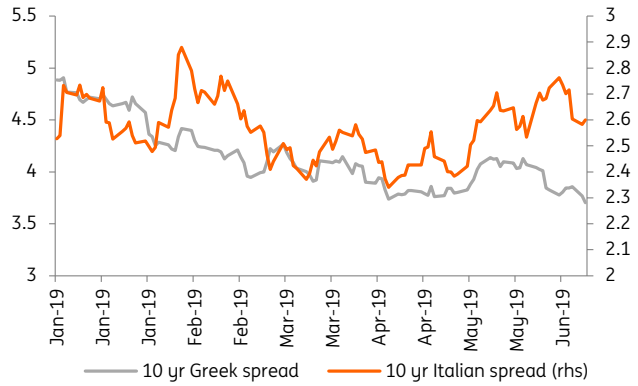
The Brexit story doesn't help...

...and an excessive deficit procedure against Italy could create some turmoil

While the European elections results were not really a shocker, there were some interesting local results, with the most direct consequence the announcement of a snap election in Greece. To be sure, political uncertainty has not disappeared. Brexit is far from resolved and the story is likely to linger on for a while, potentially weighing on business investment.

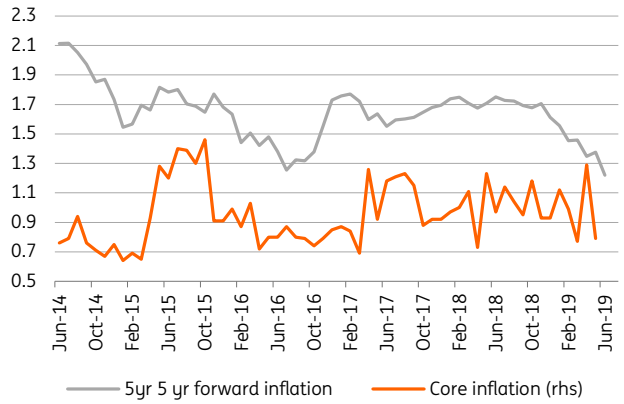
At the same time, things are heating up again in Italy, now that the European Commission has recommended starting an excessive deficit procedure against the country. A final decision on this matter is likely to be taken at the Ecofin meeting on the 9th of July, which is sure to create tensions within the Italian government if this necessitates the scrapping of a number of election promises. Therefore, we think that the likelihood of early elections in September has increased significantly, especially now that Lega strongman Matteo Salvini might be keen to capitalise on his very strong result in the European elections.

**Fig 3 Bond markets getting nervous (again) about Italy**




Source: Thomson Reuters Datastream

**Fig 4 Both inflation and inflation expectations fell**




Source: Thomson Reuters Datastream

Core inflation fell back below 1% in May

After the artificially higher inflation readings for April because of late Easter holidays, inflation fell back in May. Underlying inflation actually declined to only 0.8% in May with the closely followed 5yr 5yr forward break-even inflation rate now at the lowest level in years. With oil prices having declined lately, headline inflation is also likely to fall again in the coming months. We, therefore, reduced our headline inflation forecast to 1.2% for 2019 and 1.4% for 2020.

ECB puts in place an easing bias...

With inflation remaining stubbornly low and the economic expansion threatened by external shocks, the ECB had little choice than to suggest an easing bias. The targeted longer-term refinancing operations (TLTROs) were announced with a rather generous (though conditional) interest rate of deposit rate +10bp. At the same time, the forward guidance of keeping interest unchanged was lengthened through the first half of 2020.

With a 10bp rate cut likely to be in the offing

ECB president Mario Draghi also suggested the possibility of a further rate cut. We therefore believe that a 10bp cut is now on the cards in the second half of this year and could come as soon as the September meeting. Given that a lower negative deposit rate for a longer time will increasingly become a burden on bank profitability, a tiering system for excess liquidity is likely to be introduced in due course. And we wouldn't be surprised if the ECB suggests the potential of restarting net asset purchases, though it is unlikely that the maximum threshold on sovereign exposure would be altered.

Tiering system for excess liquidity would be the next step after a rate cut

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

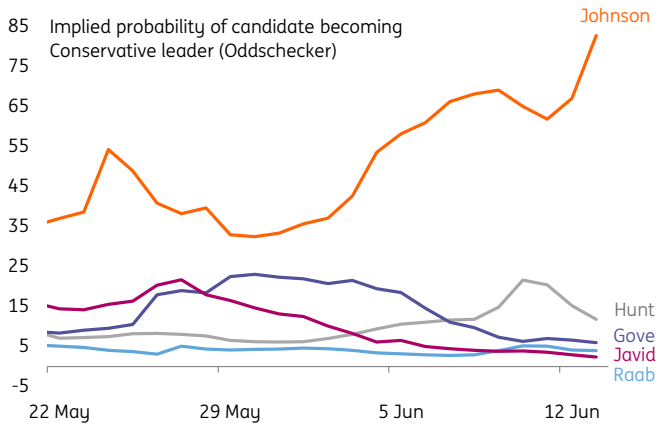
# UK: Scenarios for a 'Boris Brexit'

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

Former UK foreign secretary Boris Johnson is now odds-on to replace Theresa May as Conservative leader. But what would a 'Boris Brexit' really look like?

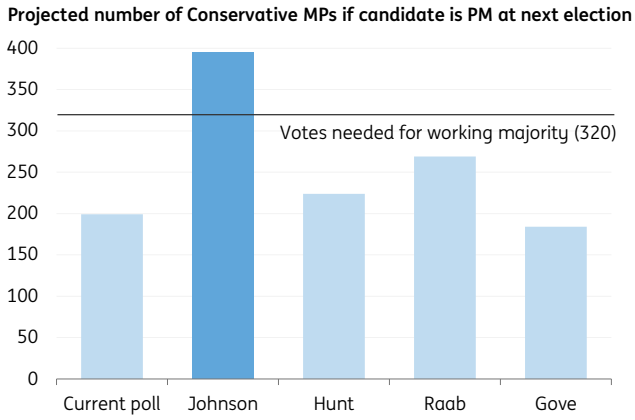
Markets, at least, have become more wary that it could result in a 'no deal' Brexit. In the first instance though, we assume that the first act of any new leader will be to return to Brussels, and at least attempt a renegotiation of the current deal.

**Fig 5 Johnson easily the favourite to become leader**




Source: Bloomberg, Oddschecker

**Fig 6 Polls suggest Johnson would win most votes in general election – but that could change…**




Electoral calculus have translated recent polling into projected seats under the first past the post system – although there are various caveats with this method

Source: Telegraph, ComRes, Electoral Calculus

The first act of a new PM will be to attempt a renegotiation…

Some candidates have gone one step further by saying they would try to seek a Parliamentary majority for an adapted deal upfront – e.g. one that adds a time-limit on the Irish backstop – to try and demonstrate to the EU that they have the necessary support to get their vision ratified at home.

… but this is unlikely to get very far

In reality though, it's very unlikely that a new leader will be able to achieve something Theresa May did not. The EU has been very clear that is not prepared to reopen negotiations on the withdrawal agreement, which includes the controversial Irish backstop.

If a new PM did push for 'no deal', Parliament would likely do all it can to stop it from happening. But unlike in earlier in the year, there may be few legislative mechanisms available to do so (for more, see this Institute for Government report). That's partly why we think the probability of MPs stepping in and revoking Article 50 is still only around 5%.

Having said that, we think the risk of 'no deal' is still relatively low (20% probability) and we think there are three main alternative scenarios that could prevail instead.

**Scenario 1: Parliament forces a general election through no confidence vote (35%)**

Parliament could force an election if a new leader pushes for 'no deal'

While the legislative options may be limited, there is one obvious way that Parliament could block 'no deal', and that's to try and force a general election. The leader of the opposition, Jeremy Corbyn, could put forward a motion of 'no confidence', and it wouldn't take many Conservative MPs to back it. Several moderate Conservative lawmakers have hinted they would be prepared to collapse their own government if that was the only way of stopping 'no deal'.

This poses two questions: when could an election happen, and what would be the result? On the former, the minimum time between a successful no-confidence vote to election

day is seven weeks. The first opportunity for a confidence vote would be at the start of September when MPs return after the summer, which could allow just enough time to hold an election before the end of October.

An election would most likely happen in late Nov/early Dec

In reality though, a no-confidence motion is unlikely to be successful unless 'no deal' is truly on the doorstep. That suggests that if an election does happen, it is unlikely to be triggered until mid/late October, and therefore wouldn't take place until late November/December at the earliest. Another Article 50 extension would be needed, although it's unlikely the EU would try to block it in this scenario.

Despite recent polling, Conservatives could find an election very challenging

Calling the winner of a late-2019 election is much trickier. At present, a simple mapping of recent polling onto the UK's electoral system suggests that Boris Johnson could hypothetically secure an absolute majority for the party at the next election (Figure 2). But that prediction comes with several caveats (electoral calculators can be relatively crude), and an election forced upon him by Parliament could prove very tricky for the Conservatives. A failure to live up to his promise of achieving Brexit by October would undoubtedly give leverage to the Brexit Party.

A lot would also depend on Labour's Brexit position - so far leader Jeremy Corbyn has been reluctant to back a second referendum. But polls suggest that if he is to become prime minister, he would need to join forces with several other political parties – almost all of which would set a second referendum as their price for a coalition/confidence and supply arrangement with Labour.

It's not impossible therefore that Labour opts to campaign for a second referendum from the start, to try to limit losses to other remain-supporting parties.**Scenario 2:**
**Scenario 2: 'Revamped deal' receives Parliament's backing (25%)**

Faced with an election risk, could a new candidate be more pragmatic in office?

The upshot is that there is a clear risk that a new leader could be knocked out of power if they try to push for 'no deal'. This begs the question: would Boris (or an alternative Eurosceptic candidate) be more pragmatic in office than current rhetoric suggests?

On the face of it, this sounds unlikely. Johnson said at his campaign launch that "we must do better than the current withdrawal agreement", but as we noted above, meaningful changes are unlikely to be forthcoming.

It's possible the Brexiteers pass a tweaked deal to move things on to trade talks...

But assuming Boris and other leading Brexiteers believe the election threat to be credible, it's not impossible that they'll be more open to approving May's deal (with cosmetic tweaks) than it currently seems. Don't forget that in the third meaningful vote back in March, a number of leading pro-Brexit Conservatives actually voted for May's deal – something that was unthinkable just weeks before - on the basis that they would have a 'true Brexiteer' in Number 10 for the next phase of trade talks.

... but getting a majority will remain as challenging as ever

That's not to say it will be easy to get a stable majority for the deal. There are a handful of MPs who want nothing short of 'no deal', while concern within the more moderate factions of the party could increase. It also seems unlikely that the DUP would sign up to a deal with the backstop. We therefore think this scenario is relatively unlikely, and if Boris fails to get Parliament fully on-board, he could quickly revert back to pushing for a 'no deal' exit.

**Scenario 3: The wildcard - Boris backs a second referendum (15%)**

Ultimately, a new leader may conclude that the current deal is just as unpalatable as the risk of a 'general election'. So what about a second referendum?

On the face of it, it sounds unthinkable that a Brexiteer prime minister could decide to initiate a second referendum. However according to the Eurasia Group, there is some

chatter in Westminster that Johnson may be more open to this option than he is prepared to publically admit.

Could a new leader decide a referendum is 'less worse' than an election? It would be risky...

This would undoubtedly be a high-risk strategy. While Boris Johnson would presumably push for a remain vs. no deal vote to try and maximise the leave share of the vote and gain a mandate for a harder vision of Brexit, Parliament could force a different choice of referendum question into the legislation, or even block it all together – perhaps culminating in an election after all. A botched referendum attempt, where either it took too long to arrange, or where 'remain' won, would spell disaster for the Conservatives at the ballot box.

A second referendum seems relatively unlikely as things stand

We therefore think it's unlikely a Eurosceptic prime minister would go down this route – and as we mentioned earlier, we think the legislative options for Parliament to force a second referendum upon the government are fairly limited. We currently put a 15% probability on one being triggered before October.

**The lesser of two evils: Losing power vs losing a hard Brexit**

Don't rule out a new leader trying to kick the can down the road for another six months either

The bottom line is that a new prime minister could easily find themselves boxed in by the same hurdles as Theresa May. Ironically, this means there is also a fairly good chance that a new leader will try and kick the can down the road for another six months, to allow more time to break the deadlock. There are question marks over whether the EU would grant more time without justification (France, in particular, is reluctant to allow further extensions), but even if they did, the leader will still arrive back at the same scenarios further down the road.

It boils down to what's worse: an election or losing hard Brexit?

In the end, it will come down to whether the new prime minister is prepared to risk losing a 'no deal' Brexit, in order to retain power and control of the next stage of negotiations. Taking recent comments from the leadership contenders at face value, we think there is a reasonable chance that a new Eurosceptic leader will attempt to push for a 'no deal' Brexit if they are unable to rework the deal before the end of October. That leaves a general election as the most likely scenario out of the ones we've considered, but a more pragmatic approach certainly shouldn't be ruled out either.

For the time being, the uncertainty surrounding the process will continue to restrict economic growth. As a result, we do not think the Bank of England will hike interest rates this year, particularly given the broader risks to global growth.

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

# China: Expect a long march

Escalation of trade tension in May 2019.

China-US trade tensions deteriorated quickly after President Xi requested dignity in the trade talks, and both sides increased tariffs on each other. The US raised tariffs from 10% to 25% on the existing $200 billion goods, and China has increased tariff rates to 10% to 25% on $60 billion goods imported from the US.

The tension between the two countries has extended from trade, technology to broader based businesses.

Away from trade, US added Huawei, the Chinese pioneer in 5G, into its 'entity list', which deters US companies from buying and selling goods and services with Huawei. The Chinese government reacted by creating its 'unreliable entity list' and may reduce exports of rare earths. Further, the Chinese government interviewed multinational companies that have businesses in China. The tension between the two countries has extended from trade, technology to broader-based businesses.

A new long march

President Xi calls this increase in tensions the 'new long march'. In early June, China signalled that it will increase its fiscal and monetary stimulus to support the economy during this new long march.

China expands infrastructure investments further.

On fiscal stimulus, the government has issued a document that encourages the issuance of local government special bonds to fund infrastructure projects, and it also welcomes financial institutions to invest in those instruments. The planned amount of issuance is around two trillion yuan. With the help of financial institutions, this amount can be leveraged to around two times, according to our estimates. That means infrastructure investments could increase to around four trillion yuan.

Together with tax and fee cuts of another two trillion yuan, the fiscal stimulus package may total six trillion yuan.

China is prepared to cut interest rates and the reserve requirement ratio to support liquidity needs

On monetary easing, the PBoC governor, Yi Gang, has claimed that the central bank has many tools to inject liquidity in the market. These include cuts in interest rates and reserve requirement ratio (RRR). Combining fiscal and monetary easing capacity, China should be able to withstand a long pause in the trade negotiations while maintaining GDP growth above 6%, which will be largely be stimulus-driven, unlike normal growth driven by business activities determined by market forces.

Combining fiscal and monetary easing capacity, China should be able to have a long pause on the trade negotiation and at the same time GDP growth can still be above 6%.

Yi Gang also mentioned briefly that no particular level of the USD/CNY is more important than other levels, signalling that the 7 handle of the USD/CNY is not a boundary set by the PBoC. But we still don't believe the PBoC will take the big risk to allow USD/CNY to pass the 7.0 handle. Last year, the PBoC didn't allow the USD/CNY to pass 7.0, because the central bank worried that it would create market chaos. Today, with the background of a trade and technology war, the central bank may be even more cautious not to let the exchange rate create chaos in other asset markets. Moreover, as we show in the chart, a depreciation of the yuan has no positive impact on trade.

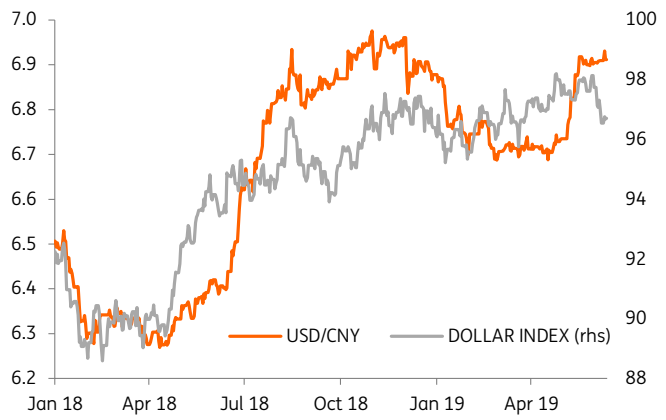
There is only a small chance for the PBoC to let USDCNY to pass 7.0.

As a result, we have revised the USD/CNY and USD/CNH exchange rates to 6.90 by the end of 2019. We also believe the central bank will cut 7D policy rate twice, each time by 5bps, with cuts the targeted as well as broad-based RRR by two times each.

Forecast revisions on exchange rate and monetary policies.

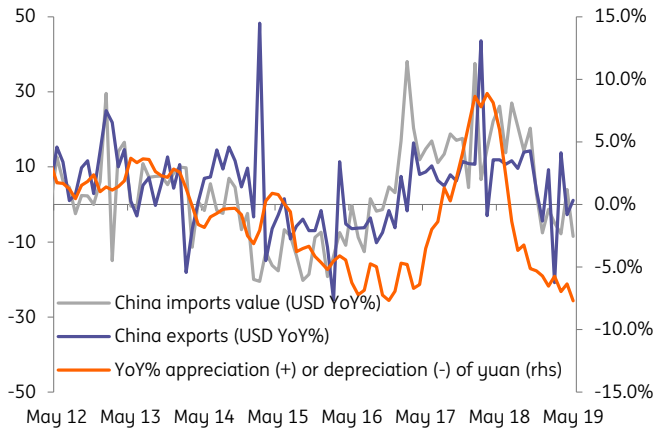
We maintain our GDP forecasts at 6.2%YoY in 2Q19 and 6.3% for 2019, as we believe that the tough stance on trade will be balanced by stimulus measures.

**Fig 7 USDCNY has diverted from the dollar but yet to pass 7.0**




Source: ING, Bloomberg

**Fig 8 Yuan depreciation did not help trade**




Source: ING, Bloomberg

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

# Japan: Not as good as it looks

Consumption tax hike still looks questionable later this year

A few months ago, we took the gamble of removing the scheduled October consumption tax hike from our forecast numbers. The effect of this was to smooth both the inflation figures (we no longer have a 12-month bump from 4Q19 to 3Q20), and also the GDP figures (we no longer have the front loading and subsequent consumption and investment lacuna).

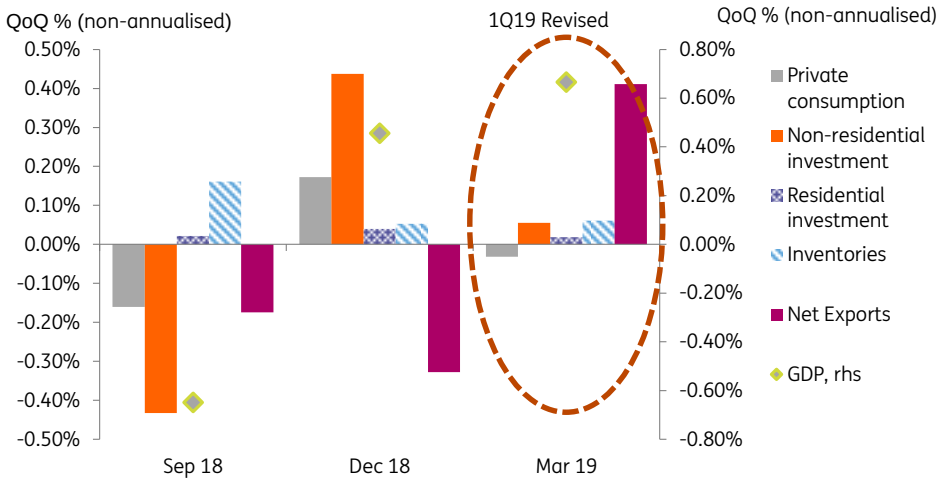
No tax hike leads to more stable growth and inflation forecasts

All of this is fairly cosmetic, and has very little bearing on overall annual GDP figures, though removing the tax hike does remove the temporary lift that inflation would otherwise get, and makes it harder to see by just how much the Bank of Japan is missing its 2% underlying inflation target.

1Q19 GDP growth was 2.2%, but qualitatively was weak

The revised 1Q19 GDP figure of 2.2% is being touted as the final nail in the coffin for those like us who speculated on a third delay to the scheduled tax hike. But this contrasts with the other message of this release. Namely: outside of some very modest business investment figures, which show few signs of remaining positive in the coming quarters, much of the 2.2% annualised GDP growth came from a rogue net export figure which had imports falling far more sharply than exports, and which in all likelihood, also presages a sizeable inventory drawdown in the quarters ahead.

**Contribution to GDP (QoQ%)**




Source: CEIC, ING

No rush to re-insert the tax hike

So although we concede that we may have to put the consumption tax hike back into the numbers, we won't rush this decision. Indeed, Japan's data remains moribund. Household spending started 2Q19 much softer than it ended 1Q19, which may also reflect the plunge in labour cash earnings, now running at a negative year on year rate.

2Q19 should show some unwinding

On the trade side, Japan is still running a marginal deficit, but there doesn't seem to be any noticeable improvement from 1Q19, so the likelihood this delivers any boost to 2Q19 GDP growth looks small. Indeed, unwinding the big boost in 1Q19 seems far more likely with the trade war showing no signs of easing and the technology slump still in full swing.

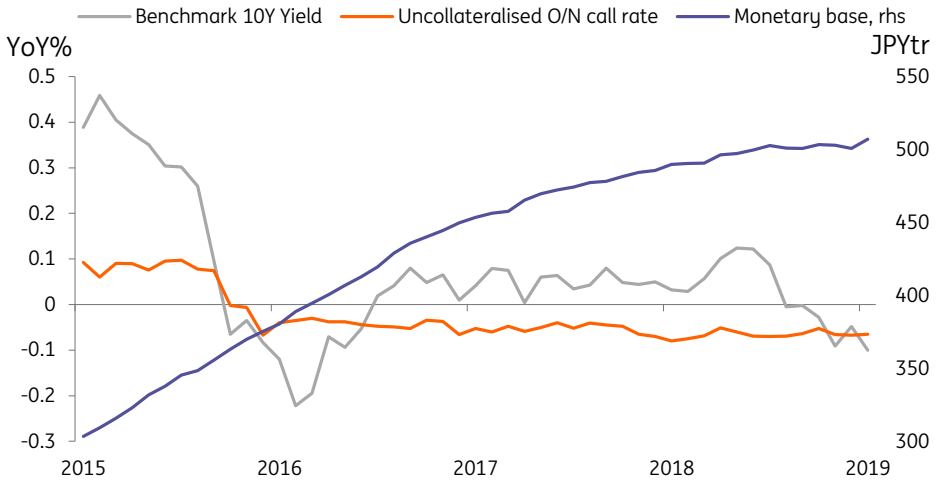
Furthermore, both construction orders and housing starts registered large declines in April, and will have their work cut out to claw their way back to positive growth by the end of the quarter.

BoJ may have to ease further if the Fed cuts...

For its part, Japan's central bank is still talking up their potential firepower should renewed stimulus be needed, though Governor Haruhiko Kuroda also stresses the need

to be wary of the unintended consequences of further easing. Kuroda notes that policy rates could be lowered still further (currently -0.1%), the target for 10-year bond yields could also be lowered, the monetary base could be expanded, or asset purchases could be boosted (which is almost the same as saying the monetary base could be expanded, so really three, not four options).

**The BoJ's policy options – none are easy**




Source: CEIC, ING

...though it might not do any good

If the Federal Reserve cuts rates in the coming months, as markets seem to increasingly believe, then depending on how the Japanese yen responds, we might well see the BoJ respond with some additional easing of their own. Though each of the measures outlined above comes with its own particular problems, and none are guaranteed to fully offset a generalised spell of USD weakness, should this follow a Fed rate cut.

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

# FX: Is this the big turn in the dollar?

Many of us in the market had felt that the dollar was going to peak this year

The market is now convinced that the Federal Reserve is going to embark on an easing cycle. Many of us in the market had felt that the dollar was going to peak this year, but is the recent dollar sell-off really the start of the big turn we're all expecting?

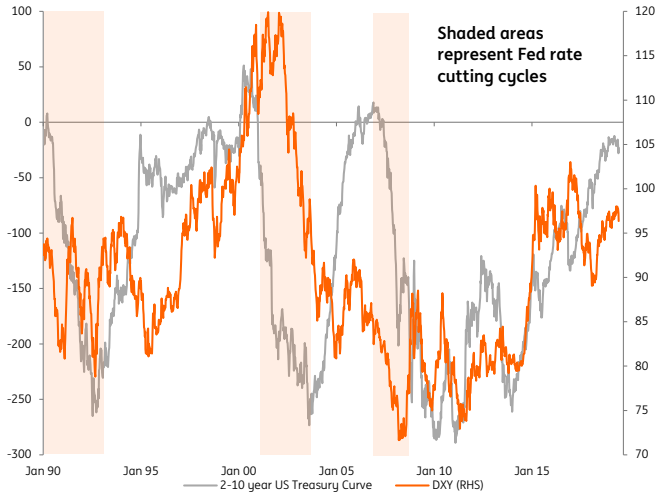
Despite the massive 60 basis point decline in US market interest rates at the short end of the yield curve, the trade-weighted dollar is less than 2% weaker. We believe that this is down to two main factors.

First, despite the recent narrowing, interest rate differentials are still very wide. We estimate two year US rates would have to fall another 25-50bp to drop into the zone where correlations between the dollar and rate differentials re-connect. Second, there needs to be a compelling story in overseas economies to attract funds away from the US. Given the nature of the current headwinds – global trade – those attractive stories overseas simply don't exist.

Is this the start of a major Fed easing cycle, typified by reflationary bullish steepening of the US yield curve and a weaker dollar?

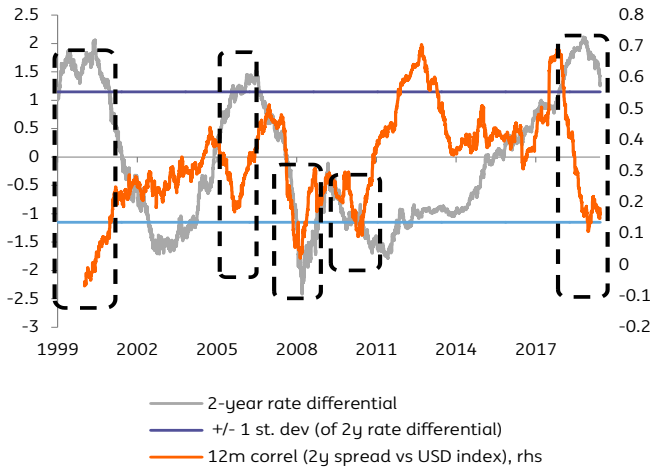
Also important to consider here is whether this is the start of a major Fed easing cycle, typified by reflationary bullish steepening of the US yield curve and a weaker dollar – or whether the 2H19 Fed easing we forecast is more like the quick insurance rate cuts that the Fed made in late 1998, which effectively prolonged the US expansion and the dollar bull trend into 2001? The prospect of a US bi-partisan infrastructure spending deal in 2020 means the latter scenario cannot be completely discounted.

**Fig 9 Bullish re-steepening typically means a weaker $**




Source: Bloomberg, ING

**Fig 10 $ correlation with differentials have been low...**




Source: Bloomberg, ING

If a major dollar bear trend starts, we would it expect it largely to be played out against the defensive currencies of JPY and CHF

However, we would say that if this is the start of a major dollar bear trend, we would expect it largely to be played out against the defensive currencies of JPY and CHF. This is premised on the view that the trade war continues to escalate and the associated secular stagnation fears. We are thus revising down our year-end USD/JPY forecasts closer to 100 and would expect the JPY to strengthen on the FX cross rates.

It is too early to revise our 2019/20 end year EUR/USD forecasts of 1.15 and 1.20 respectively

Softer US rates have lifted EUR/USD off the lows of the year, but we think it is too early to revise our end year forecasts of 1.15 and 1.20 for 2019 and 2020 respectively. Soft eurozone growth and inflation, the real prospects of fresh European Central Bank stimulus, auto tariffs, Italian political challenges and finally Brexit all argue that the EUR should not lead the FX charge against a weaker dollar.

We are also revising our GBP forecasts lower

This month we are also revising our GBP forecasts lower. We see EUR/GBP trading up to 0.92 (Cable to 1.22) and possibly to 0.95 ahead of the October 31st Brexit deadline as investors fret over 'no-deal' or early election risks – both perceived as GBP negative.

**Chris Turner, London +44 20 7767 1610**

# Rates: Safety flight too

The market discount for rate cuts is getting some support from recent data releases

These are exceptional times. The bond market is calling for rate cut - a sequence of them. The Federal Reserve took note and acknowledged the discount through various commentaries. And then we got a meagre 75k rise in US employment, signalling real evidence of some slowing in the labour market. Participants calling for rate cuts feel emboldened, and we've now pencilled a couple in, but the call for market rates is complex, and especially with so many cuts already discounted. We examine how low they can go.

A sub-2% 10yr US yield can be rationalized as a flight into risk free rates

Despite the fundamentals, a sub-2% 10-year US yield could be rationalised by safety flight. Given a choice of global risk free rates, US Treasuries remain in a class of their own; they offer a positive yield (compare that to negative yielding German and Japanese yields). In that sense a 2-handle could be viewed as a "steal", especially with the USD seemingly intent on remaining at the extremities of its fair value range. This combination as a stand-alone could rationalise a break into the 1.75% to 2.00% range, with all the trade war/Brexit/dis-inflation/uncertainty noises echoing in the background.

The ultimate flows driven move could see the 10yr in the 1.5% to 1.75% range

For a break into the 1.5% to 1.75% range, these safety flows would need to be significant. Again, this is perfectly possible should the verbal back and forth on trade take another turn for the worse, as we suggest, with associated freezes on corporate decision making. Note that it would imply the 10-year trading through the current 10-year break-even inflation rate on Treasury Inflation Protected Securities (TIPS) at 1.73%. At the extremity, the real 10-year yield would likely approach zero (currently 44bp). This isn't impossible, but it would imply quite a negative macro scenario for the coming years.

Such a valuation would imply a structural inversion of the curve

It would also likely imply a semi-permanent inversion of the yield curve. The 2-year would be anchored by the federal funds rate, in the sense that it should be a breakeven versus the funds rate in the coming two years, more or less. Meanwhile the 10-year could trade well through as there is no similar anchor, and especially if we have dis-inflation in the background (as inflation is the biggest issue in the 10-year).

As the Fed is still likely to under-deliver on the rate cuts

Leaving aside fundamentals for the moment, we know the Fed would prefer not to cut rates aggressively; as the more they cut, the closer they get to the ultimate floor of zero and a reversion back to quantitative easing (in the most extreme scenario). So it could make sense for the Fed to drag their heels on rate cuts, and instead let the market do the easing for them, dragging down mortgage rates etc. It would be oxygen for President Trump's criticism of the Fed, but could be a smart path for the Fed – let the aggressive market expectations and lower long tenors yields do the work of propping up the economy and risk asset markets.

Such a rate cut and lower long rates scenario paints a picture of continued economic worries

That narrative could support a scenario where the funds rate gets cut to 1.75%, but the 10-year temporarily trades through this to the 1.5%-1.75% range as worries peak (only to subsequently and slowly revert higher, eventually back above 2%). Such an outcome is still a significant undershoot versus current fundamentals, although the same could be said of the 2-year Schatz yield of -70bp, which is quite a large discount for the coming few years at the very least.

If the Fed under-delivers, flows would syphon into long rates

One of the nuances that we identify here is the likelihood that the Fed under-delivers on the market rate cut expectations. This could force long rates lower than otherwise since disappointment on the extent of delivery of cuts flow into Treasuries – which still offers a positive yielding risk free rate.

**Padhraic Garvey, New York +1 424 646 7837**

## Fig 12 ING global forecasts

| | 2017 | | | | | 2018F | | | | | 2019F | | | | | 2020F | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 1Q | 2Q | 3Q | 4Q | FY | 1Q | 2Q | 3Q | 4Q | FY | 1Q | 2Q | 3Q | 4Q | FY | 1Q | 2Q | 3Q | 4Q | FY |
| **United States** | | | | | | | | | | | | | | | | | | | | |
| GDP (% QoQ, ann) | 1.8 | 3.0 | 2.8 | 2.3 | 2.2 | 2.2 | 4.2 | 3.4 | 2.2 | 2.9 | 3.1 | 1.7 | 1.6 | 1.8 | 2.5 | 1.6 | 1.8 | 1.9 | 1.9 | 1.8 |
| CPI headline (% YoY) | 2.6 | 1.9 | 2.0 | 2.1 | 2.1 | 2.7 | 2.7 | 2.6 | 2.2 | 2.4 | 1.6 | 2.0 | 1.9 | 2.1 | 1.9 | 2.5 | 2.1 | 2.2 | 2.2 | 2.2 |
| Federal funds (%, eop)[1] | 0.75 | 1.00 | 1.00 | 1.25 | 1.25 | 1.50 | 1.75 | 2.00 | 2.25 | 2.25 | 2.25 | 2.25 | 2.00 | 1.75 | 1.75 | 1.75 | 1.75 | 1.75 | 1.75 | 1.75 |
| 3-month interest rate (%, eop) | 1.15 | 1.30 | 1.35 | 1.55 | 1.55 | 2.30 | 2.35 | 2.45 | 2.65 | 2.65 | 2.60 | 2.45 | 2.20 | 2.05 | 2.05 | 2.05 | 2.05 | 2.05 | 2.05 | 2.05 |
| 10-year interest rate (%, eop) | 2.40 | 2.30 | 2.30 | 2.40 | 2.40 | 3.00 | 3.00 | 3.00 | 2.80 | 2.80 | 2.30 | 2.00 | 1.80 | 1.60 | 1.60 | 1.70 | 1.90 | 1.90 | 1.90 | 1.90 |
| Fiscal balance (% of GDP) | | | | | -3.5 | | | | | -4.0 | | | | | -4.6 | | | | | -4.7 |
| Fiscal thrust (% of GDP) | | | | | 0.0 | | | | | 1.1 | | | | | 0.4 | | | | | 0.0 |
| Debt held by public (% of GDP) | | | | | 76.1 | | | | | 76.7 | | | | | 78.8 | | | | | 81.2 |
| **Eurozone** | | | | | | | | | | | | | | | | | | | | |
| GDP (% QoQ, ann) | 2.7 | 2.7 | 2.7 | 2.7 | 2.5 | 2.8 | 1.6 | 0.5 | 1.0 | 1.9 | 1.6 | 0.4 | 0.9 | 1.1 | 1.0 | 0.9 | 1.2 | 1.0 | 1.0 | 1.0 |
| CPI headline (% YoY) | 1.5 | 1.3 | 1.5 | 1.4 | 1.4 | 1.3 | 1.7 | 2.0 | 2.0 | 1.8 | 1.4 | 1.3 | 1.0 | 1.1 | 1.2 | 1.3 | 1.3 | 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 | -0.33 | -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 |
| 10-year interest rate (%, eop) | 0.45 | 0.40 | 0.45 | 0.42 | 0.42 | 0.50 | 0.30 | 0.40 | 0.24 | 0.24 | -0.07 | -0.20 | -0.20 | 0.00 | 0.00 | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 |
| Fiscal balance (% of GDP) | | | | | -0.9 | | | | | -0.5 | | | | | -0.9 | | | | | -0.8 |
| Fiscal thrust (% of GDP) | | | | | 0.2 | | | | | -0.2 | | | | | 0.3 | | | | | -0.1 |
| Gross public debt/GDP (%) | | | | | 89.2 | | | | | 87.8 | | | | | 86.5 | | | | | 85.3 |
| **Japan** | | | | | | | | | | | | | | | | | | | | |
| GDP (% QoQ, ann) | 1.9 | 2.3 | 1.6 | 1.3 | 1.9 | -0.3 | 2.2 | -2.5 | 1.6 | 0.8 | 2.1 | 0.5 | 0.7 | 0.5 | 0.9 | 0.5 | 0.6 | 0.8 | 0.8 | 0.6 |
| CPI headline (% YoY) | 0.2 | 0.4 | 0.6 | 0.6 | 0.5 | 1.3 | 0.6 | 1.1 | 0.9 | 1.0 | 0.3 | 1.0 | 0.6 | 0.3 | 0.6 | 0.8 | 0.6 | 0.8 | 1.0 | 0.8 |
| Excess reserve rate (%) | -0.1 | -0.1 | -0.1 | -0.1 | 0.0 | -0.1 | -0.1 | -0.1 | -0.1 | 0.0 | -0.1 | -0.1 | -0.2 | -0.2 | 0.0 | -0.2 | -0.2 | -0.2 | -0.2 | 0.0 |
| 3-month interest rate (%, eop) | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | -0.05 | -0.05 | -0.05 | 0.05 | 0.05 | 0.00 | 0.00 | 0.00 | 0.00 | 0.10 | 0.10 | 0.10 | 0.10 |
| 10-year interest rate (%, eop) | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 0.00 | 0.10 | 0.00 | 0.00 | -0.10 | -0.10 | -0.10 | -0.10 | -0.10 | -0.10 | -0.10 | -0.10 | -0.10 | -0.10 |
| Fiscal balance (% of GDP) | | | | | -3.0 | | | | | -3.0 | | | | | -2.8 | | | | | -2.5 |
| Gross public debt/GDP (%) | | | | | 233.0 | | | | | 235.0 | | | | | 233.0 | | | | | 232.0 |
| **China** | | | | | | | | | | | | | | | | | | | | |
| GDP (% YoY) | 6.9 | 6.9 | 6.8 | 6.8 | 6.9 | 6.8 | 6.7 | 6.5 | 6.3 | 6.6 | 6.4 | 6.2 | 6.3 | 6.3 | 6.3 | 6.3 | 6.2 | 6.2 | 6.2 | 6.2 |
| CPI headline (% YoY) | 1.4 | 1.4 | 1.6 | 1.8 | 1.6 | 2.2 | 1.8 | 2.3 | 2.5 | 2.2 | 1.8 | 2.5 | 2.6 | 2.6 | 2.4 | 2.6 | 2.6 | 2.5 | 2.4 | 2.5 |
| PBOC 7-day reverse repo rate (% eop) | 2.45 | 2.45 | 2.45 | 2.50 | 2.50 | 2.55 | 2.55 | 2.55 | 2.55 | 2.55 | 2.55 | 2.55 | 2.50 | 2.45 | 2.45 | 2.40 | 2.40 | 2.40 | 2.40 | 2.40 |
| 10-year T-bond yield (%, eop) | 3.30 | 3.55 | 3.60 | 3.90 | 3.90 | 3.75 | 3.50 | 3.65 | 3.30 | 3.30 | 3.05 | 3.20 | 3.00 | 2.95 | 2.95 | 2.95 | 2.90 | 2.90 | 2.85 | 2.85 |
| Fiscal balance (% of GDP) | | | | | -3.7 | | | | | -2.6 | | | | | -4.5 | | | | | -4.0 |
| Public debt, inc local govt (% GDP) | | | | | 50.0 | | | | | 88.0 | | | | | 102 | | | | | 103 |
| **UK** | | | | | | | | | | | | | | | | | | | | |
| GDP (% QoQ, ann) | 1.3 | 1.0 | 1.9 | 1.6 | 1.5 | 0.2 | 1.6 | 2.8 | 0.9 | 1.4 | 2.0 | 0.9 | 1.2 | 1.8 | 1.5 | 1.5 | 1.7 | 1.2 | 1.1 | 1.5 |
| CPI headline (% YoY) | 2.1 | 2.7 | 2.8 | 3.0 | 2.7 | 2.7 | 2.4 | 2.5 | 2.3 | 2.5 | 1.9 | 2.1 | 1.9 | 2.0 | 2.0 | 2.4 | 2.1 | 2.1 | 2.0 | 2.2 |
| BoE official bank rate (%, eop) | 0.25 | 0.25 | 0.25 | 0.50 | 0.50 | 0.50 | 0.50 | 0.75 | 0.75 | 0.75 | 0.75 | 0.75 | 0.75 | 0.75 | 0.75 | 1.00 | 1.00 | 1.25 | 1.25 | 1.25 |
| BoE Quantitative Easing (£bn) | 445 | 445 | 445 | 445 | 445 | 445 | 445 | 445 | 445 | 445 | 445 | 445 | 445 | 445 | 445 | 445 | 445 | 445 | 445 | 445 |
| 3-month interest rate (%, eop) | 0.35 | 0.35 | 0.35 | 0.50 | 0.50 | 0.60 | 0.80 | 0.80 | 0.80 | 0.80 | 0.85 | 0.85 | 0.85 | 0.85 | 0.85 | 1.05 | 1.10 | 1.30 | 1.35 | 1.35 |
| 10-year interest rate (%, eop) | 1.15 | 1.10 | 1.35 | 1.20 | 1.20 | 1.45 | 1.48 | 1.57 | 1.30 | 1.30 | 1.00 | 0.80 | 0.70 | 0.80 | 0.82 | 1.00 | 1.20 | 1.20 | 1.20 | 1.20 |
| Fiscal balance (% of GDP) | | | | | -2.5 | | | | | -1.4 | | | | | -1.5 | | | | | -1.5 |
| Fiscal thrust (% of GDP) | | | | | -0.5 | | | | | -0.4 | | | | | -0.4 | | | | | -0.3 |
| Gross public debt/GDP (%) | | | | | 87.0 | | | | | 84.0 | | | | | 83.0 | | | | | 81.5 |
| EUR/USD (eop) | 1.08 | 1.12 | 1.20 | 1.20 | 1.20 | 1.20 | 1.17 | 1.15 | 1.12 | 1.12 | 1.12 | 1.12 | 1.12 | 1.15 | 1.15 | 1.16 | 1.17 | 1.18 | 1.20 | 1.20 |
| USD/JPY (eop) | 112 | 115 | 110 | 113 | 113 | 107 | 110 | 114 | 113 | 113 | 112 | 108 | 105 | 103 | 103 | 102 | 100 | 100 | 100 | 100 |
| USD/CNY (eop) | 6.89 | 6.78 | 6.65 | 6.51 | 6.51 | 6.28 | 6.67 | 6.87 | 6.88 | 6.88 | 6.74 | 6.90 | 6.95 | 6.90 | 6.90 | 6.90 | 6.85 | 6.80 | 6.75 | 6.75 |
| EUR/GBP (eop) | 0.87 | 0.88 | 0.94 | 0.89 | 0.89 | 0.88 | 0.88 | 0.89 | 0.90 | 0.90 | 0.85 | 0.90 | 0.92 | 0.92 | 0.92 | 0.90 | 0.88 | 0.85 | 0.85 | 0.85 |
| Brent Crude (US$/bbl, avg) | 55 | 51 | 52 | 61 | 55 | 67 | 75 | 76 | 69 | 72 | 64 | 68 | 69 | 73 | 69 | 70 | 74 | 76 | 74 | 74 |

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

Source: ING forecasts

## Disclaimer