

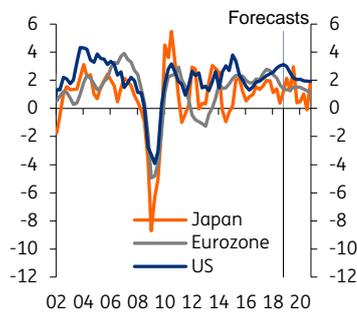
8 February 2019

Global

Monthly Economic Update

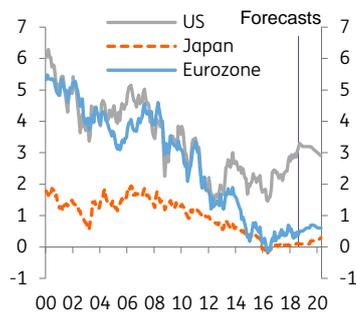
Stick or twist?

GDP growth (%YoY)



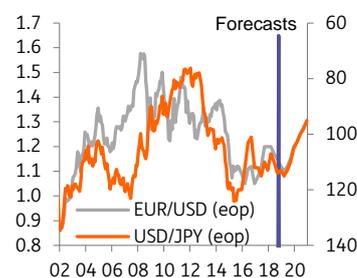
Source: Macrobond, ING

10yr bond yields (%)



Source: Macrobond, ING

FX



Source: Macrobond, ING

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A dramatic softening in the Federal Reserve's rhetoric on monetary policy, coupled with encouraging signals from the US-China trade talks have boosted market risk appetite, but we are approaching key dates that will be critical for the global economic outlook. Will President Trump stick with what he has won already or will he gamble for a bigger victory to take to the electorate for the 2020 election? The odds of the latter are rising. If we do see an escalation of trade tensions, the global growth story will deteriorate, having broad-based implications for financial markets and currencies.

The US economy remains in good health with the government shutdown having ended, employment rising strongly, pay picking up and the Federal Reserve signalling that they are in no hurry to tighten monetary policy further. This Goldilocks story has boosted both US equities and bond markets. Assuming a benign global trade story, the prospects of a Fed rate hike remain strong.

Even though this is our official base case for now, we are increasingly considering a more negative trade scenario. If President Trump chooses to move more aggressively he could win additional concessions from both China and the EU but this is likely to come at the cost of weaker near-term growth. If this scenario were to come true, it is possible that US interest rates have already peaked for the year.

The Eurozone continues to grow, albeit at a more subdued pace. A reversal of some one-off effects could bring slightly higher growth in the second quarter, but risks to the downside remain. US tariffs on European cars could yet be another brake on growth, in addition to the Brexit uncertainty. We don't see inflation picking up much, so there's little need for monetary tightening. On the contrary, we believe the ECB is likely to decide on new longer-term liquidity operations to avoid a tightening of credit conditions.

The Brexit impasse in the UK shows no signs of breaking. The EU is refusing to budge on the Irish backstop, while Prime Minister May is still reluctant to push for a cross-party solution. One way or another, an extension to the Article 50 negotiating period looks increasingly inevitable, which would prolong uncertainty for businesses.

The Chinese economy is weakening on several fronts and not just due to the US-China trade war. In response, the government is looking for ways to boost consumption. Tax cuts may not be enough, to avoid a softening in the labour market. Even worse, the People's Bank of China has continued to let USD/CNY follow the dollar index, and a stronger yuan could end up offsetting some of the stimulus.

We have identified a change in rates market psychology; it shows that rates are peering down, but we'd prefer to bet against this as a tactical view. Structurally there will indeed be rate cuts at some point down the line. But to accelerate towards this, a deeper deterioration would be required. It's worth remembering the current risk-on mood is implicitly pushing against this too.

The Fed pause and the US: China trade truce has improved the external environment and allowed under-valued currencies to recover. As long as the trade truce holds, we expect this positive environment to continue and the dollar to stay gently offered. However, a serious risk event this month is the threat of US tariffs on auto imports. If they materialise, EUR/USD would retest the 1.12 lows.

Global Trade: Downs and ups?

February could be the turning point in the ongoing trade war if the US and China cut a deal and if the US administration decides against hiking tariffs on cars. Unfortunately, we're increasingly inclined to think trade tensions will get worse before they get better.

There is a chance trade tensions could de-escalate, but we are increasingly pessimistic

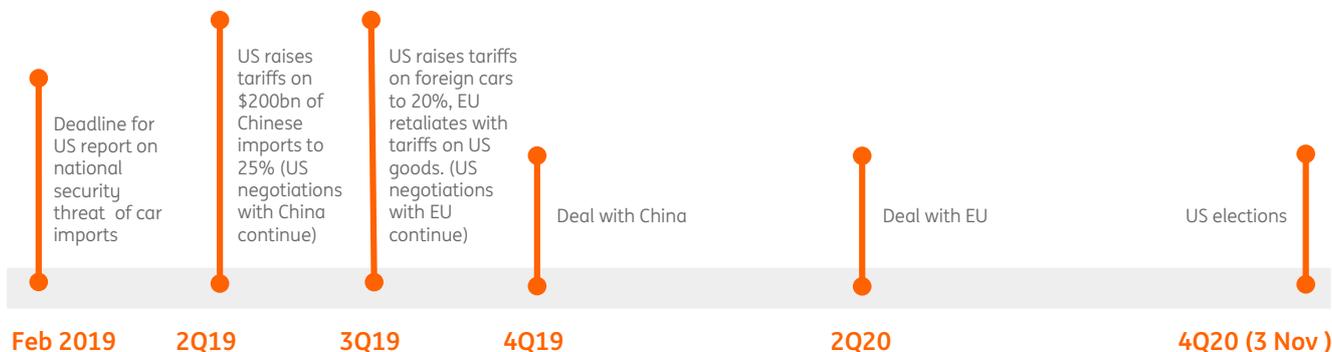
The odds increasingly suggest President Trump will hike tariffs as he turns up the heat on China...

... this could be enough to seal a deal before the end of the year

The ceasefire between the US and China meant that the scheduled 1st January 2019 implementation of an additional 15 percentage point hike of tariffs on US imports from China, worth USD 200 billion, has been on hold. It could disappear indefinitely if a trade deal is struck but in our view, the American wish list is too demanding for China to get a deal before the 1 March 2019 deadline.

Although an extension of the deadline is possible, we are inclined to think President Trump will look to increase the pressure by hiking tariffs on the USD 200 billion package to 25% in 2Q and threaten to impose further tariffs. We believe this will incentivise the Chinese to compromise just enough to make President Trump willing to compromise as well and cut a deal. After all, elections are coming up in 2020, and the US President needs to show that he has lived up to his promise of getting better terms of trade for the US. Moreover, retaliatory tariffs by China on soya beans and many other American products hurt US exports and the business of his voter base, so we expect a deal, but given the complexity of the negotiation agenda, nothing before 4Q this year.

Fig 1 Trade war timeline in case of no quick deal with China and a hike of US tariffs on car imports



Source: ING

The EU is also in the firing line with car tariffs a growing threat

February 17 could be the key date determining what happens

Employing a similar tactic to that employed against China could yield results...

...but maybe not until well into next year

Trump needs a deal with the EU as well. Our view that the US will not elevate car tariffs is increasingly under pressure. First, the gap between the US negotiation objectives and those of the EU has become larger since the US updated its targets. These go much further than the agenda that was set by Trump and EU President Jean-Claude Juncker last summer. Secondly, Trump is feeling increasing domestic pressure. After General Motors announced thousands of layoffs last November, the President tweeted that this wouldn't have happened with higher import tariffs on cars.

More clarity on the next step in the conflict will come with the Commerce Department's report on whether the import of cars is a threat to US national security. The report is due to be published by 17 February, at the latest and the President's response will be crucial.

If car tariffs are imposed, it will escalate the trade war because the EU has already said it will retaliate. But, similarly to the situation of China, we think Trump wants a deal, which means tariffs are directed at creating leverage in the negotiations. Although the EU is undoubtedly aware of this tactic, it doesn't want tariffs, which will result in some willingness to compromise. But even then expect negotiations to be far from quick and easy. In case of an elevation, it will take until 2Q of 2020 before a EU-US trade deal is struck.

US: Biding its time

Trade policy remains critical to the outlook. If the US strike deals with the EU and China the Fed will hike interest rates again. But if it fails, the story could be very different...

Risk appetite has returned in 2019

Data suggests no broad adverse impact on US economy from government shutdown

Trade talks seem to be progressing, but risks remain

The Fed has adopted a more dovish stance

Although the economy looks in decent shape

Markets are in a much more positive mood than they were at the beginning of the year. Equity indices having clawed back much of the losses seen through the final quarter of last year and high yield bond markets have surged with money clearly being put to work.

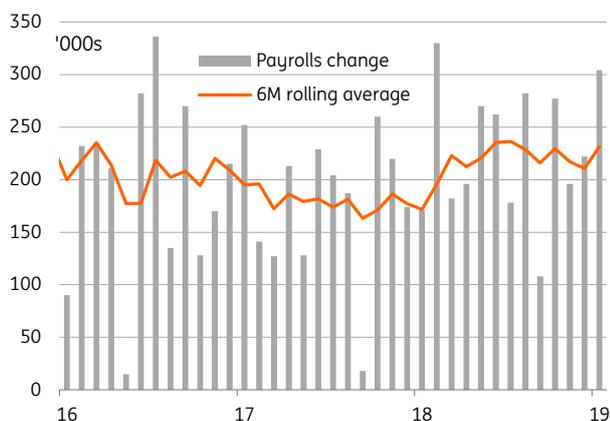
This is perfectly understandable given the news over the past four weeks. For a start, the government shutdown has ended and the 800,000 government workers directly impacted are being paid once again. There is a significant backlog of government work, but the data flow we have been seeing suggest no major damage to the broader US economy. After all, the economy created 304,000 jobs in January and the ISM manufacturing index bounced back, fuelled by a surge in new orders.

We've also had some encouraging newsflow on trade with positive sentiment expressed by both China and the US in terms of opening up markets following recent talks. The fact that President Trump has mentioned the possibility of a summit with President Xi has been taken well. Nonetheless, there is clearly still work to do, particularly surrounding intellectual property protection and the issue of technology transfer when entering Chinese markets.

Then there is the change of stance from the Federal Reserve. Having signalled back in December that 'further gradual increases' in the policy interest rate may be required, they dropped that description completely in January. The clear message is the Fed is on pause for some time with the FOMC commenting "the committee will be patient as it determines what future adjustments to the target rate... may be appropriate".

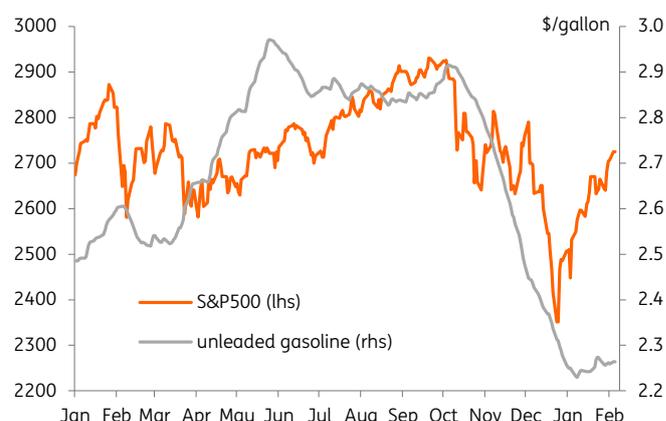
It appears that the unsettling effects of earlier market weakness, trade uncertainty and the government shutdown, (described as economic "crosscurrents" by Fed Chair Jerome Powell) gave them a reason to adopt a wait-and-see stance. However, given the newsflow on all three had been pretty positive in the build-up to the decision, the timing of this shift caught markets off guard. Given the economy is in decent shape with the jobs market described by the Fed as 'strong' and economic activity 'solid' and with no threat of an imminent interest rate hike, there was a lot for equity markets to like.

Fig 2 Jobs underpin consumer confidence



Source: Macrobond

Fig 3 The perfect combination – stocks up, gas down



Source: Bloomberg

One off factors could see sub-2% growth in 1Q19

Now, it is possible that the polar vortex, which has been economically disruptive by hurting road, rail and barge logistics, in combination with the government shutdown will pull annualised 1Q GDP growth below 2%. Inflation too is likely to be subdued at the

headline level thanks to the plunge in energy prices. However, the outlook for the US economy remains positive, especially if we can see encouraging developments on trade.

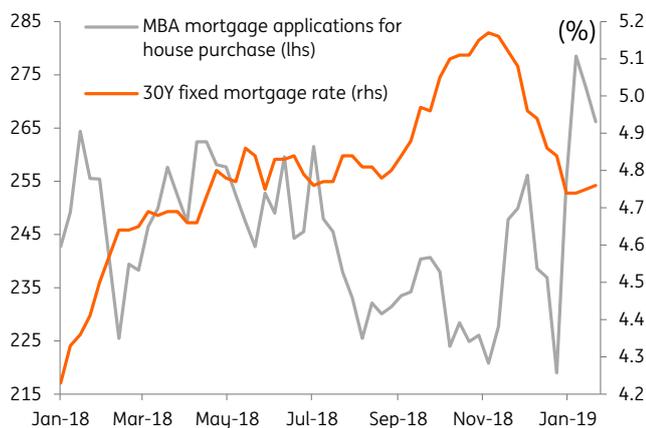
Strong labour market numbers will support consumer spending

The labour market remains very strong, and businesses continues to struggle to fill vacancies. The competition for labour means that, according to the Federal Reserve Beige Book, “wages grew throughout the country... across skill levels, and numerous districts highlighted rising entry-level wages as firms sought to attract and retain workers and as new minimum wage laws came into effect”. Average hourly earnings are already rising 3.2%, and for non-supervisory production workers they are increasing 3.5% YoY.

While lower gasoline prices and mortgage rates and higher equities should provide a boost

With worker pay on the rise and employees feeling secure in their jobs, consumer spending will likely remain firm while adding to inflation pressures in the economy. In addition, the plunge in gasoline prices means households have more cash in their pockets after filling up their vehicles’ fuel tank while the rebound in equities is positive for sentiment. We have also seen mortgage rates move lower with the 30-year fixed back down to 4.75% after peaking close to 5.2% in November, which appears to be tempting some people back into the property market.

Falling mortgage rates tempting buyers back

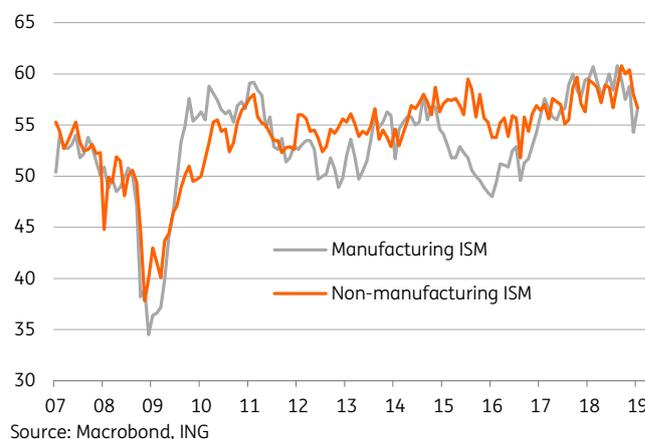


Source: Macrobond

Together with good business surveys we still think there is a case for higher US interest rates

Businesses also look in decent shape with both the ISM manufacturing and non-manufacturing surveys pointing to healthy growth over coming months. With the US economy experiencing shrinking capacity and rising pay, we look for inflation pressures to gradually build. Our house view has been that this combination of strong economic fundamentals and (hopefully) some better news on trade will be enough to convince the Fed to raise rates again over the summer. However, the more cautious tone from the Fed at the January FOMC meeting suggests it is more likely to be one interest rate rise than the two, as we had previously pencilled in.

Business surveys remain healthy



Source: Macrobond, ING

But should trade tensions escalate this is going to be far less likely

Unfortunately, our trade team believes the prospect of this positive trade scenario is receding (see page 2). If President Trump implements additional economically damaging sanctions against China and the EU, American businesses and consumers will face higher prices, disruption to supply chains and the likelihood of steep equity market falls as the bear market sentiment seen in late 2018 returns.

A short sharp shock may deliver the concessions Trump wants, but it will come at a near-term economic cost

Ahead of the 2020 election year, Donald Trump may be hopeful that a short sharp shock will be enough to deliver the concessions he seeks to claim victory on strengthening the US’ trade position. Nonetheless, this will come at the price of weaker near term growth. The hit to sentiment and squeeze on spending power it generates is likely to mean the Fed takes an even more cautious line on monetary policy. Under this scenario, we suspect the central bank will be on hold for more than a year with a clear risk that the Fed funds rate has already peaked.

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Eurozone: Don't mention the r-word just (yet)

Italy is already experiencing a technical recession...

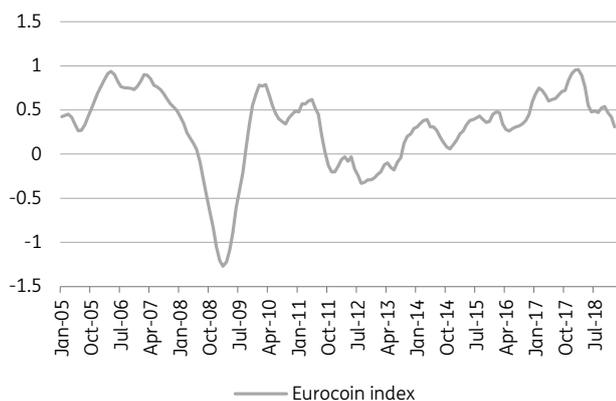
With Italy having seen two consecutive quarters of negative growth and Germany just narrowly escaping it, the recession-word is coming back into vogue. While some temporary factors have held growth back, it is fair to say that the underlying trend points to a further growth slowdown with the risks tilted to the downside. However, it remains too soon to pencil in a recession in the Eurozone.

...but the whole of the Eurozone is still growing...

With 0.2% quarter on quarter growth in the fourth quarter, the same growth rate as in the third, the Eurozone seems stuck in a lower gear. While the Italian economy has probably been hit by tighter financing conditions on the back of the spreads widening on the bond market, the weak German growth in the second half of 2018 was probably a one-off, related to production delays in the car manufacturing sector. When things get back to normal in Germany, we should see some growth acceleration. The big question is whether things will really get back to normal. Some (temporary) improvement in the growth figures is still likely, but at the same time, a number of downside risks remain. The Brexit saga will continue to create uncertainty (with a potential hard Brexit likely to be a big drag on growth for a quarter or two). On top of that, the trade negotiations between the US and the EU seem to be going nowhere, raising the likelihood of higher import tariffs on European cars (see page 2). Also taking into account the negative sentiment effect, this could shave off 0.2 percentage points of Eurozone growth.

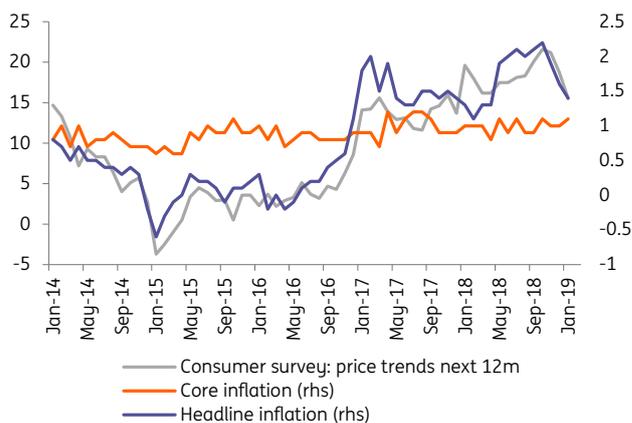
...albeit at a slowing pace

Fig 2 Eurozone growth slows further in January



Source: Thomson Reuters Datastream

Fig 3 Little evidence of rising inflation trend



Source: Thomson Reuters Datastream

The normalisation in Germany is taking longer than expected...

Meanwhile, Bundesbank President Jens Weidmann had to admit that Germany's economic weakness carried into 2019. The first economic indicators for January also saw little improvement for the rest of the Eurozone. The European Commission's sentiment indicator fell back further in January. Forward-looking indicators like order books and production expectations in the more cyclical manufacturing sector don't bode well for first quarter growth, while export order books took another hit. Industry mentioned a significant drop in the competitive position on foreign markets outside the EU, which is probably related to the relatively strong euro exchange rates in effective terms. It is also telling that the share of managers who see their current production capacity as more than sufficient, increased considerably in January - a warning sign that business investment might start to cool down. On a more positive note, consumers have become slightly less worried about unemployment, which could support consumption in the months ahead.

...with economic sentiment indicators still weak in January

We downgraded our GDP-forecast to 1.2% for both 2019 and 2020 with risks skewed to the downside

We don't expect underlying inflation to pick up much

No need for monetary tightening...

...and a few technical measures to prevent a credit tightening might be in the offing

In January the €-coin indicator, a gauge of the underlying growth momentum, decreased to 0.31, from 0.42 in December, falling to the lowest level recorded since July 2016. While the first quarter is therefore unlikely to see much growth acceleration, we expect a minor growth pick-up in the second quarter. That should result in 1.2% GDP growth for 2019, revised downward from 1.4%. For 2020, we also expect 1.2% growth, so no recession yet, but definitely a slowdown from the growth rhythm we saw in 2018.

Despite the lower growth profile, the ECB is still convinced that labour cost pressures are continuing to strengthen and broaden amid high levels of capacity utilisation and tightening labour markets, which will generate an upward path in underlying inflation. A recent [study](#) from the ECB finds positive demand shocks foster this transmission, not exactly what we expect. On top of that, in an environment of low inflation the transmission tends to be slower. So, yes, underlying inflation could increase somewhat over the next 12 months, but we are probably not going to see 1.5% this year.

In that light, there is no need for the ECB to start thinking of monetary tightening. However, the ECB is not entirely insensitive to the fact that the long period of negative rates and a flat yield curve is having a negative impact on bank profitability, which could eventually result in tighter credit conditions (A [study](#) on the effect of negative interest rates on credit in Sweden). In those circumstances a 'technical' 0.15 basis points deposit rate hike in the fourth quarter might still make sense, although the bank could also find other means to alleviate the banks' burden, such as remunerating a part of the excess liquidity at the refi rate. Apart from that, we are increasingly convinced the ECB will come up with a new longer term funding operation by June to avoid an increase in the banks' funding cost. So, in sum, we think the ECB will take measures to avoid monetary policy tightening than to embark on a tightening cycle.

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UK: The impasse continues...

Theresa May faces an uphill struggle to get a deal through Parliament

It's been a particularly noisy few weeks for Brexit, but the quest for a solution that can unite the British parliament remains as challenging as ever. To recap, Prime Minister Theresa May's Brexit deal was defeated in parliament by a heavy margin in January, and to turn things around, she'll need to convince around 115-120 lawmakers to get behind a new plan. That broadly leaves three main options – adjust the current deal to win Conservative votes, re-write the deal to get opposition MPs on board, or put the choice back to the voters in a second referendum.

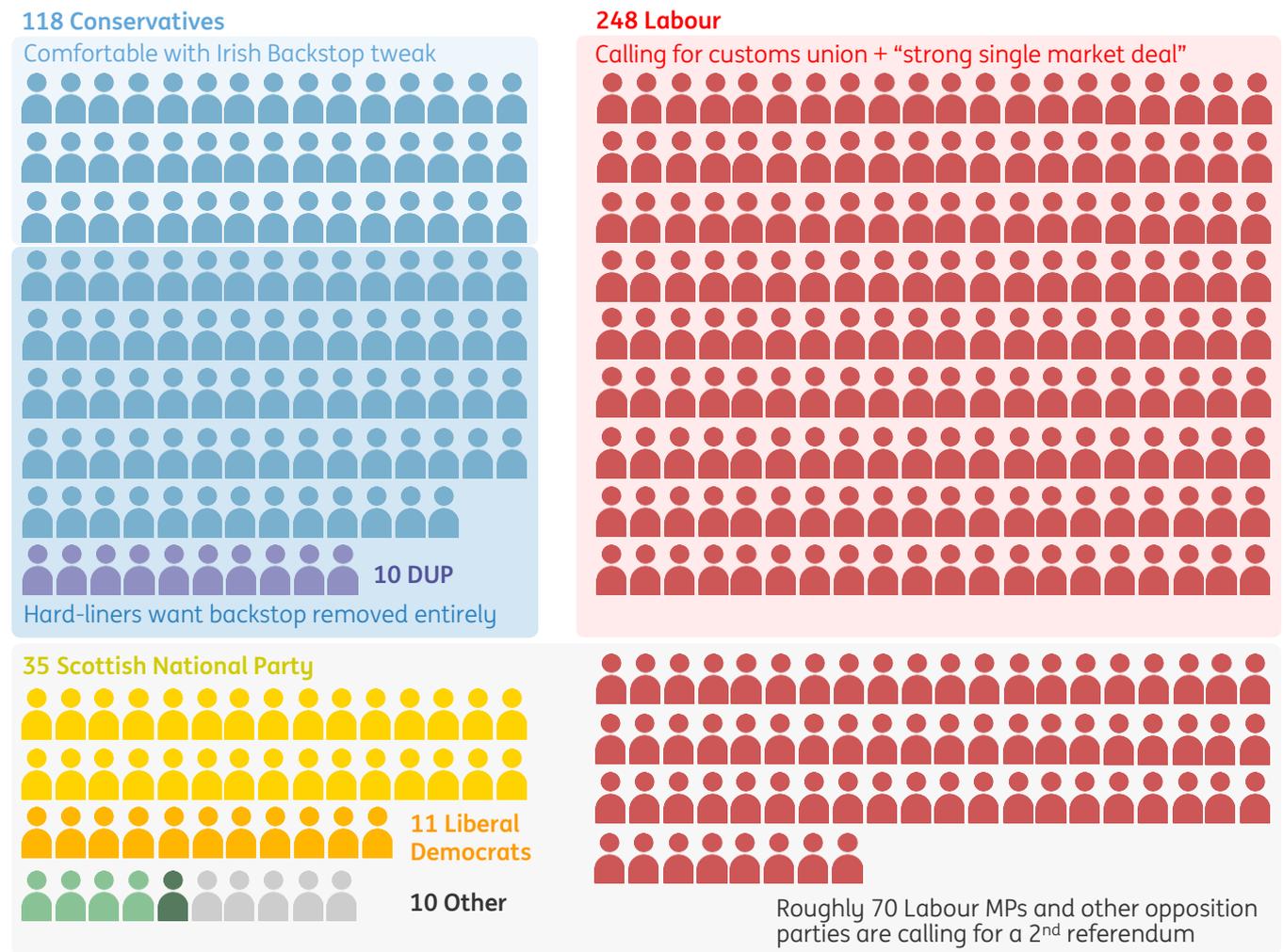
The Prime Minister has stuck closely to 'Plan A' to hold her divided party together

Despite the initial talk of cross-party cooperation on Brexit, Theresa May has stuck closely to 'Plan A' in a bid to win over pro-Brexit Conservatives, and thereby hold her heavily divided party together. Emboldened by a victory in the House of Commons, where a majority of MPs voted in favour of renegotiating the Irish Backstop, May has returned to Brussels to seek meaningful changes to her deal.

But Brussels is refusing to budge

Unsurprisingly though, Brussels is still refusing to budge. As it has said many times, adding a legally binding time limit on the Irish backstop would prevent it from being an 'all-weather' insurance policy against a hard border. There is also deep scepticism any 'alternative arrangement' involving technology would be enough to emulate customs and regulatory checks on the Irish border – or that it could be developed in time.

Fig 4 432 MPs voted down May's Brexit deal – but for differing reasons



Source: UK Parliament, ING

There's no guarantee that any concessions would be enough to get the deal through Parliament

But even in the unlikely event the EU was prepared to renegotiate, it would want to be sure any concessions it gives would make the crucial difference in getting backing from UK MPs. Don't forget the EU already made a big concession back in November by accepting the UK could stay in a temporary customs union if the Irish backstop ever kicks in - and that still wasn't enough to win over concerned British lawmakers.

The next Brexit vote is lined up for valentine's day

There is also no guarantee any changes would make the critical difference. While the 118 Conservatives and 10 DUP MPs that voted down the deal largely did so because of the backstop, there is a range of opinion on what needs to happen to it. Some would be happy with some legally binding tweaks, while many others won't support the deal unless the backstop goes entirely.

The upshot is that when Theresa May returns to the House of Commons on 14 February to update MPs, nothing is likely to have changed. Once again, this will be done in the form an amendable motion, which means that lawmakers will again be able to put forward their own suggestions on the way forward.

A second referendum lacks support, while the road to a different deal remains bumpy

This may include 'indicative votes' on different Brexit alternatives, although these are unlikely to be conclusive. A second referendum currently lacks the support of the bulk of the Conservative party, as well as many Labour lawmakers, several of whom represent Leave-supporting areas.

The road to a 'different' deal also remains treacherous. While an alternative plan (e.g. a commitment to a permanent customs union) arguably stands the best chance of

securing a majority in the House of Commons, getting there would see the Brexiteers in the Conservative Party rapidly lose patience. Labour Leader Jeremy Corbyn may well try and leverage this discontent in a repeat no-confidence vote. Even if this is unsuccessful, pro-Brexit MPs could attempt to frustrate the process of translating the UK's exit into law as the various Brexit-related bills move through parliament.

One way or another, article 50 will need to be extended

One way or another, the impasse looks set to continue for some time, although of course time is something that is running out fast. If a 'no deal' situation is to be avoided on 29 March, it looks increasingly inevitable that the Article 50 process will need to be extended. Lawmakers may try to lay the groundwork for this again on 14 February, by trying to force a repeat vote on the so-called 'Cooper amendment', that would give MPs a vote on extending Article 50, if the government's deal doesn't pass by the end of February.

It looks increasingly unlikely that EU states would object to a time extension

It's worth remembering the EU member states must unanimously approve the Article 50 extension – although it's looking increasingly unlikely that they would object. But while that might be true, nobody really knows how long any extension might last. Austria's Chancellor Sebastian Kurz said in January that any extension shouldn't go beyond the European parliamentary elections (due to take place in May), but there have also been suggestions it could last much longer.

2019 may only be a marginally better year for UK growth

Either way, it could be quite some time before we know which Brexit option will prevail. In the meantime, UK growth is likely to continue to stall as businesses prepare for a hard Brexit, as it may not be until March before we know for sure whether 'no deal' has been truly avoided.

Throw in growing concerns about the international trade outlook, and we suspect UK growth this year may only be marginally better than in 2018. All this means a rate hike from the Bank of England is highly unlikely in the first half of this year.

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China: The trade war is not over

Two key events that highlight the issues that the Chinese economy is facing

At the end of January 2019 there were two major events in China that caught our attention. The first was the trade negotiations with the US, which ended without a major breakthrough. The second was the announcement of a Targeted Medium Term Liquidity (TMLF) by the People's Bank of China. Under this facility, the central bank will lend to commercial banks at a lower interest rate, provided the commercial banks increase lending to smaller private firms. These two events highlight that the Chinese economy continues to face uncertainty from the trade war, and the government will continue to support the economy through this period.

Talk can easily morph into war of words again

Chinese vice premier and lead trade negotiator Liu He returned from Washington with some progress made, but without a final deal with the US. Negotiators have agreed some concessions on agricultural exports, but not resolved the key issues around intellectual property rights, the transfer of technology, and the role of state-owned enterprises. As outlined in the global trade section we do not think that the trade war will end by 1 March 2019.

President Xi emphasises that the government will protect the economy from key risks. Apart from fiscal stimulus, with more metro lines built at the city level, there will be ample funding for private firms to avoid another wave of defaults, which amounted to around CNY100 billion in 2018. Funds from the TMLF are likely to be used by private firms to repay maturing debts. These funds will therefore not do much to spur further growth,

Retail sales data shows that consumers are not spending as much

As such, tax cuts will not boost consumption and investment as effectively as looking for supportive measures that are effective at boosting spending

Damage could pass from exports to manufacturing and further to service sector

Trade talk results will drive the coming yuan trend

but without them, China would face a series of private firms closing down, seriously hurting the job market.

Retail sales have already been slowing down in some segments, with sales of automobiles particularly hard hit. Cars could be a special case as they are still considered a luxury item. But the falling trend of clothing consumption makes us worry that consumers are tightening their belts.

This suggests that tax cuts for salary earners may not yield a proportional rise in consumption. Individuals are likely to save some of the tax rebates during bad times. Corporates will behave in a similar way and are unlikely to invest as much as they do in good times, even with tax cuts.

Local government officials are turning to similar stimulus measures used in 2009. For those who remember, local governments in rural regions boosted consumption successfully in 2009 by promoting consumption on household electronic goods and cars. Now in 2019, the same measures are being used again to prop up spending in the rural regions. We doubt if this project will yield the same successful result because households already own those goods.

Without growing domestic demand, the trade war damage to the export and manufacturing sectors could be passed on to service sectors, e.g. retail sales.

We believe the trade war is not over yet, but the PBoC is reluctant to change its exchange rate policy (i.e. allowing USD/CNY to follow the dollar index). As such, we are revising our USD/CNY forecast to 6.75 from 7.3.

Fig 9 Falling retail sales and even worse for cars

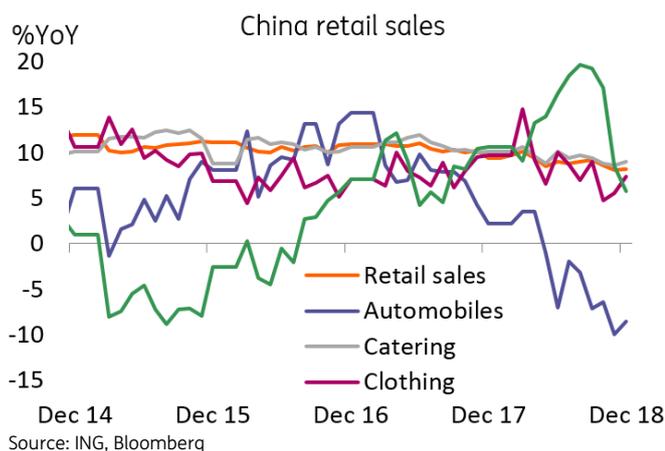
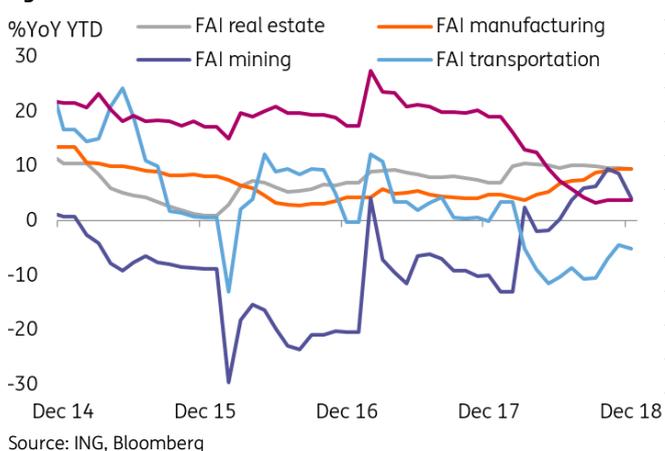


Fig 10 The Chinese government relies on infrastructure again



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

Japan: No bounce

Our optimism in Japan is looking slightly misplaced...

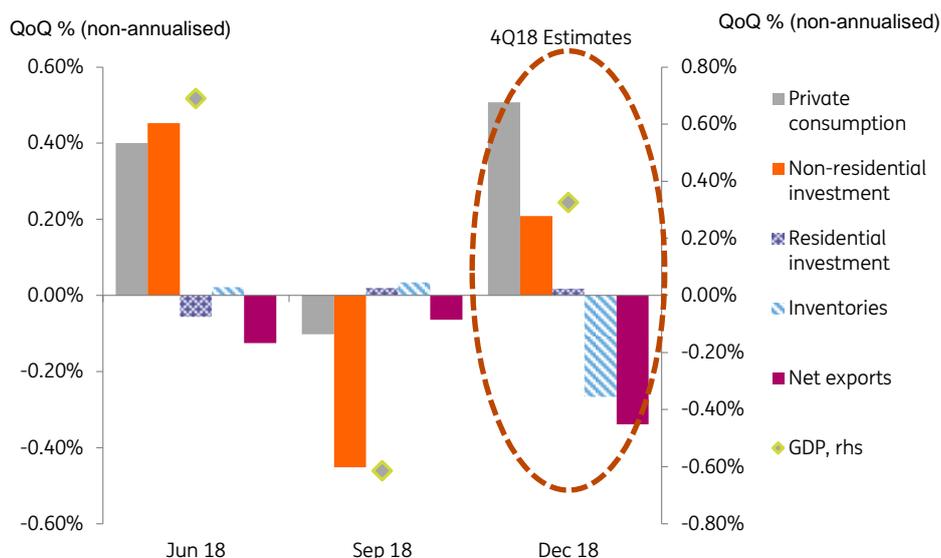
The big dip in 3Q18 looks to have permanently hurt GDP

For some time, we have been running with a more upbeat view on the economy than the Bank of Japan, who we felt were trying to talk the yen down.

But as we approach the release of the fourth quarter GDP release for 2018, we have to admit that things are not looking as good as we had hoped. 3Q18 was a terrible quarter for growth. But there were good reasons for that, namely terrible weather in the shape of Typhoon Jebi, the most powerful storm on earth in 2018.

Typically, when something of this nature happens, storm, flood, earthquake, volcano etc, we see a fairly dramatic drop in growth in that quarter, but then bounce back in subsequent quarters, and the GDP effect is often, thanks to rebuilding and replacement, better than the prevailing pre-crisis trend.

Fig 51 Estimates for 4Q18 GDP



Source: ING

Our estimates for 4Q18 show the post-3Q bounce was disappointing

Exports have only partly recovered...

...hampered by the poor trade backdrop

Consumer spending may be the only exception to this. At -0.2% quarter-on-quarter in 3Q18, spending was sharply down from the 0.7% growth that preceded it. 4Q18 will probably deliver something around 1.0% QoQ based on the two months of household spending we have for 4Q18 and some educated guesses about how the December figure will turn out. That puts us about where we would have been in a world without typhoons.

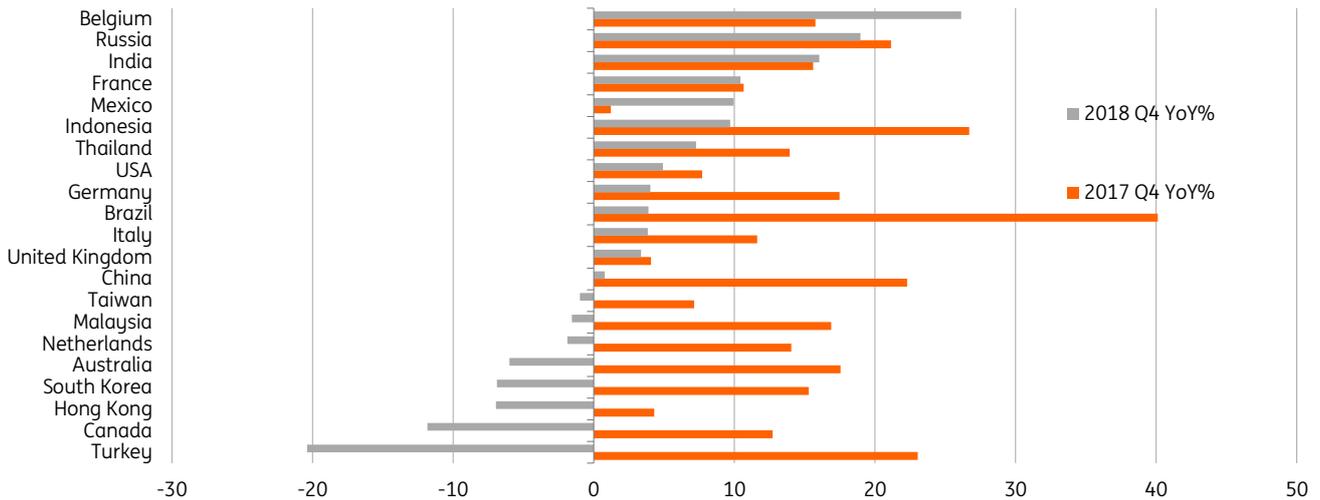
In contrast, non-residential investment fell 2.8% QoQ in 3Q18, but we see it recovering only about half of that in the fourth quarter.

However, it is trade (net trade to be precise), where we see scope for the biggest disappointment. 3Q18 saw exports falling 1.8% QoQ. But imports also fell 1.4% in the third quarter and the net trade impact was negligible.

It looks from the trade data already available as if the 4Q18 export figures didn't even make back the 3Q loss, whilst imports roared back with more than a 3% gain, leading to almost a 1% loss from the annualised GDP growth figure.

Perhaps it isn't that surprising to see trade damaging the growth backdrop for Japan given the poor global trade backdrop. The 3-month growth figures for Japan show almost no destination growing faster in terms of absorbing Japanese exports than in the same three months a year ago.

Fig 16 4Q18 vs 4Q17 Export growth by destination



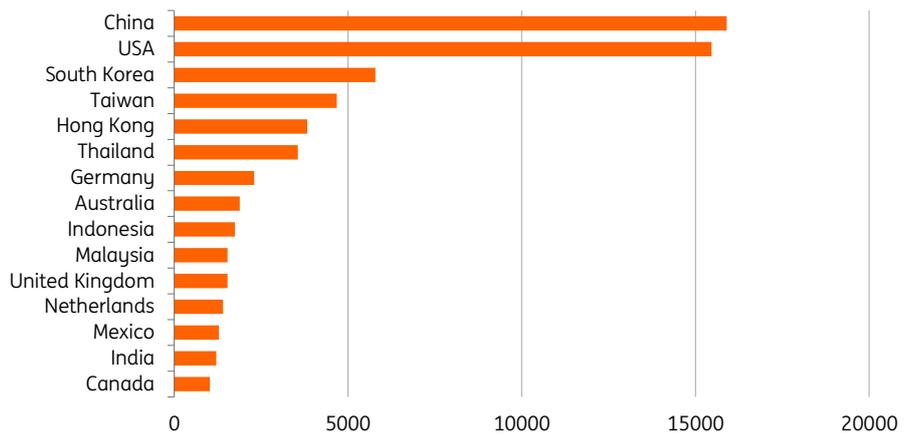
Source: CEIC and ING

Slower export growth to China is one of the most important factors

Combining the rate of growth in the chart above with the absolute absorption by country in the chart below, we can see that the slowdown in Chinese absorption is going to be the most important factor for the overall growth total. Moreover, our growth chart flatters the data. If we used the latest year-on-year comparison instead of the 3-month average, it would show that Japan's export growth to China is now negative.

Fig 13 12M sum of Japanese exports by top destination

12M sum, JPY bn



Source: CEIC, ING

But export growth across all of Asia is weak

Other Asian countries, South Korea and Hong Kong, are not helping, though the picture is likely reciprocated for them by Japan. Even exports growth to the US, Japan's second largest single country destination, has slowed substantially.

If there is not a positive outcome to recent trade talks, then Japan could be facing recession

In other words, the picture, even with no escalation in the trade war shows Japan's trade sector suffering. We know that across Asia, export flows have been hurt by the trade war, and it is not clear that we have yet seen the worst. We are assuming worse to come.

Were we to see the current 10% tariff rates on China replaced with 25% rates, then Japan would likely have serious growth issues to deal with, if not an outright recession. This isn't our base forecast. A more plausible extension of the current tariffs seems to be

a sensible working assumption. Even then, we suspect the consumption tax hike due later this year may be postponed (again) if the economy remains weak and the authorities see a need to support the economy.

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FX: Non-dollar opportunities

A common theme in the FX world has been of investors rotating out of defensive positions in the USD

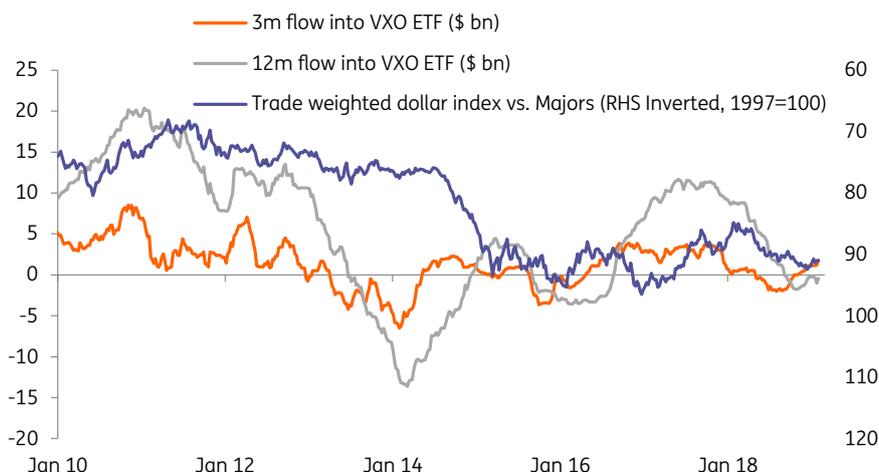
It has been a positive start to the year for risk-sensitive currencies, especially those backed by the commodity cycle. Despite much talk of slowing global trade volumes amidst weak growth in China and Europe, a common theme in the FX world has been of investors rotating out of defensive positions in the US dollar and into undervalued currencies – especially in emerging markets. We cautiously expect this theme to continue over coming months, but accept that Washington trade policy could easily pull the rug from under what has otherwise been a good year for risk assets.

A Star Wars analogy - if readers will allow it. Turbo-charged US growth last year saw the US play the role of the all-powerful Death Star in our galaxy. The relatively high returns offered in US – helped in part by Fed tightening – saw the tractor beam of US financial markets suck in global portfolio flows at the expense of most other economies. This supported the dollar across the board and left emerging markets – especially those in need of external financing – vulnerable.

The Fed pause has provided breathing room for other asset classes outside of the US

This year it is perhaps Fed Chair, Jay Powell, who has taken the role of Obi-Wan Kenobi and switched that US tractor beam off. The surprising switch to a neutral Fed stance in January – taking further tightening off the table – has allowed breathing room to emerge for other asset classes outside of the US and for portfolio flows to drift away from defensive positions in USD cash. Of course the temporary US-China trade truce has helped here as well.

Fig 7 Flows into EM Equity ETFs pick up this year



Source: Bloomberg, ING

A common refrain amongst the buy-side this year has been the switch into undervalued emerging market assets. Some evidence of this can be found in the flows into Exchange Traded Funds (ETFs), which track EM equities. One of the most closely followed ETFs in the EM space is the VXO, a Vanguard fund which tracks the performance of the FTSE Emerging Markets equity index. On a three month basis, this ETF is now seeing the largest amount of inflows since December 2017.

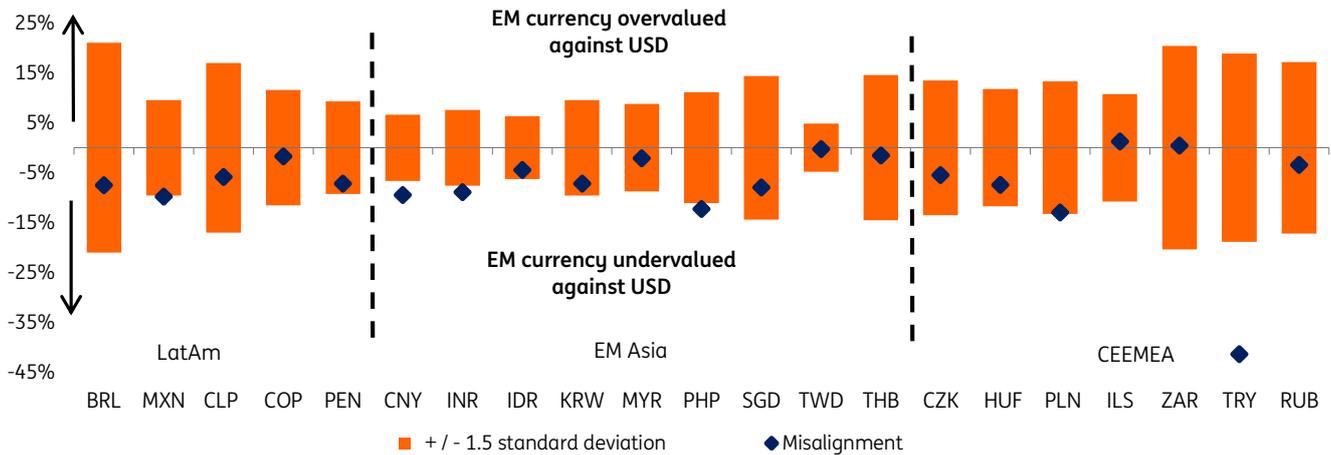
As long as the US-China trade truce holds, we would expect this theme of rotation away from the US to keep the dollar gently offered across the board – especially against the high yielding, activity currencies, many of which are found in emerging markets.

Sluggish growth in the eurozone and the Brexit debacle are preventing much of a recovery in European currencies

However, sluggish growth in the Eurozone and the Brexit debacle are preventing much of a recovery in European currencies. And it's hard to see that story changing substantially over coming months. As such we expect EUR/USD to languish in a 1.13-15 range through the early part of the year, before embarking on a move to 1.20 by year-end if the European Central Bank is in a position to hike the deposit rate in 3Q19. Clearer signs of a US slowdown would help this narrative too.

Fig 8 After a torrid year in 2018, EM currencies are still largely under-valued

%, Real exchange rates misalignments vs their BEER fair value. Bilateral EM FX mis-valuation against USD



Source: ING

Probably the biggest risk to all of the above is Raoul Leering’s potentially much more negative scenario on trade. A full revival of the US-China trade war – as we saw last summer – would pull the rug from the emerging market re-rating story.

A Commerce Department ruling by 17 Feb that US auto imports did indeed prove a national security threat would smash European currencies

Equally, a possible Commerce Department ruling by 17 February that auto imports prove a national security threat could smash European currencies. Whether President Trump chose to implement any recommendation would determine the full impact on the euro – but such a move would indeed represent the use of a big stick and likely send EUR/USD under 1.10. The sliding euro would also drag auto supply chain currencies in CE4 with it.

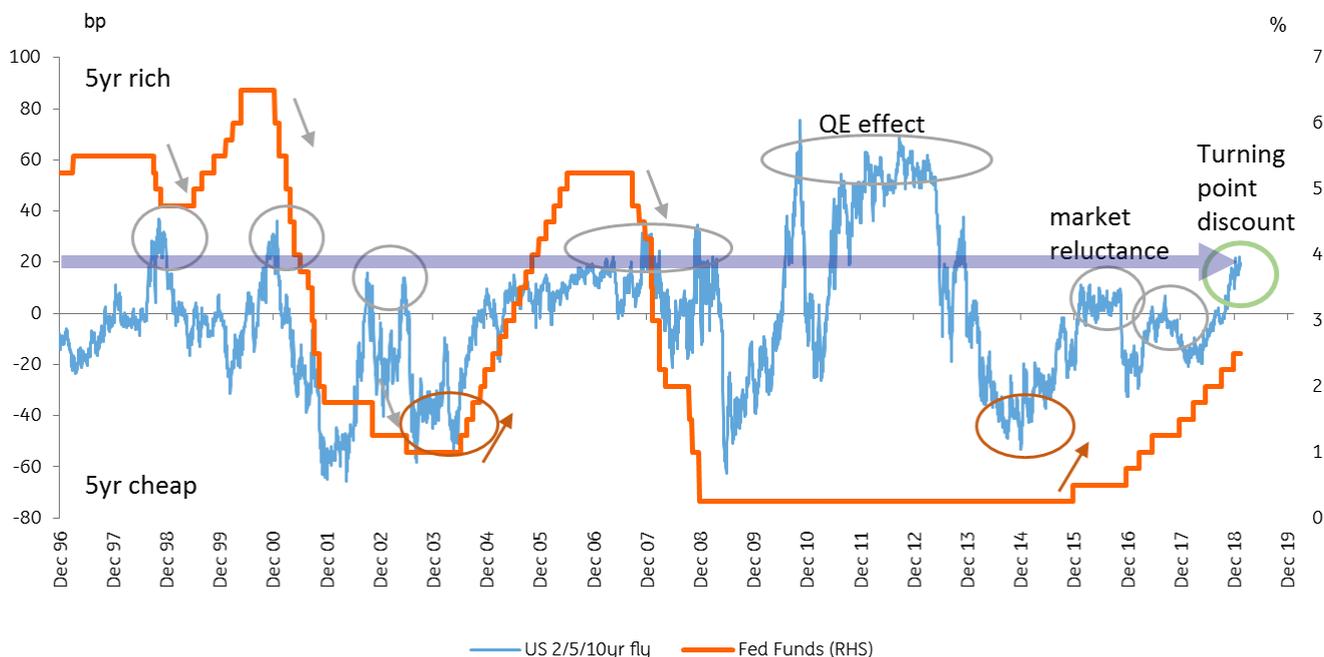
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Rates: Risk-on can't mean cuts

A rich 5yr on the US curve indicates a turning point

Take a look at the chart and large arrow below. It's an update of what we showed last month, but is worthy of a repeat as it illustrates that the market has steered towards valuations that are not out of sync with interest rate cuts. Why? Typically when the 5-year trades more than 20 basis points rich to the curve, the Fed is often cutting rates (or engaging in QE).

Fig 9 The 5yr versus a combination of the 2yr and 10yr – Key barometer of sentiment



Source: Bloomberg, ING estimates

But that does not mean the Fed is about to cut

Does that mean that the next move in the Fed funds rate is down? Not necessarily. The jury is still out on the extent of slowdown risks. We don't anticipate an imminent recession (at least not in the next two years), and the re-steepening of the yield curve (especially on the 10/30yr) supports that notion.

Market rates are also not in line with a rate cut discount

Also, market yields are still above the Fed funds rate. These would typically trade below the funds rate ahead of actual delivery of interest rate cuts. The 2-year is sitting just above the funds ceiling at 2.5%. History shows that even the 10-year would trade through the funds rate if cuts were seriously being contemplated.

The forwards are finely balanced, but tilt towards an eventual cut

The market discount is finely balanced though. Market probabilities do not contain a conviction view for the coming year. But after that, the bias is more towards a cut than a hike. The medium-term discount sees the funds rate settling in the 2% to 2.25% range, an implied cut of 25 basis points from current levels.

We agree rates will be cut, but first there is a higher hike risk to negotiate

We can agree with the medium-term discount, but the balance of risks still points to a residual rate hike risk later this year (see the US macro section). That is where we identify alpha versus the forwards, and we note that the ongoing rally in risk assets points in the same direction; the Fed can also hike to push against this.

There is alpha is going against the market discount, and the risk-on mode is in line here too

We have identified a change in rates market psychology; it illustrates that rates are peering down. But we'd prefer to bet against this as a tactical view. Structurally there will indeed be cuts at some point down the line. But to accelerate towards this, a deeper deterioration in growth would need to materialise. It's noteworthy that the current risk-on mood is implicitly pushing against this too.

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Fig 10 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	2.6	2.9	1.6	2.0	2.0	2.0	2.3	1.7	1.7	1.7	1.9	1.8
CPI headline (% YoY)	2.6	1.9	2.0	2.1	2.1	2.3	2.6	2.6	2.2	2.4	1.6	1.9	1.9	2.1	1.9	2.3	2.2	2.1	2.1	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	2.50	2.50	2.50	2.50	2.50	2.50	2.50	2.50	2.50
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	2.75	2.90	2.90	2.90	2.90	2.90	2.90	2.90	2.90	2.90
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	2.80	3.00	2.90	2.80	2.80	2.70	2.70	2.60	2.60	2.60
Fiscal balance (% of GDP)					-3.5					-4.0					-4.7					-5.0
Fiscal thrust (% of GDP)					0.0					1.2					0.5					0.8
Debt held by public (% of GDP)					76.1					77.4					80.2					83.3
Eurozone																				
GDP (% QoQ, ann)	2.7	2.8	2.7	2.7	2.5	1.6	1.8	0.7	0.7	1.9	1.1	1.6	1.4	1.4	1.2	1.1	1.2	1.0	0.9	1.2
CPI headline (% YoY)	1.5	1.3	1.5	1.4	1.4	1.3	1.7	2.0	2.0	1.8	1.4	1.2	1.2	1.5	1.3	1.6	1.6	1.7	1.7	1.7
Refi minimum bid rate (% eop)	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
3-month interest rate (% eop)	-0.33	-0.33	-0.33	-0.33	-0.33	-0.33	-0.33	-0.33	-0.33	-0.33	-0.32	-0.30	-0.30	-0.15	-0.15	-0.15	-0.15	-0.15	-0.15	-0.15
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	0.20	0.30	0.30	0.40	0.40	0.40	0.40	0.40	0.40	0.40
Fiscal balance (% of GDP)					-0.9					-0.6					-0.9					-0.8
Fiscal thrust (% of GDP)					0.2					0.0					0.1					-0.2
Gross public debt/GDP (%)					89.2					87.6					85.9					84.9
Japan																				
GDP (% QoQ, ann)	1.9	2.3	1.6	1.3	1.9	-1.3	2.8	-2.5	1.3	0.7	2.6	-0.6	5.8	-5.8	1.0	2.9	1.6	1.1	1.6	0.8
CPI headline (% YoY)	0.2	0.4	0.6	0.6	0.5	1.3	0.6	1.1	0.9	1.0	0.4	0.6	1.0	1.9	1.0	2.4	2.2	2.1	1.0	1.9
Excess reserve rate (%)	-0.1	-0.1	-0.1	-0.1	0.0	-0.1	-0.1	-0.1	-0.1	0.0	-0.1	-0.1	-0.1	-0.1	0.0	-0.1	-0.1	-0.1	-0.1	0.0
3-month interest rate (% eop)	0.00	0.00	0.00	0.00	0.00	0.00	0.00	-0.05	-0.05	-0.05	0.05	0.05	0.00	0.00	0.00	0.00	0.10	0.10	0.10	0.10
10-year interest rate (% eop)	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
Fiscal balance (% of GDP)					-4.8					-4.1					-3.6					-3.0
Gross public debt/GDP (%)					221					223					224					226
China																				
GDP (% YoY)	6.9	6.9	6.8	6.8	6.9	6.8	6.7	6.5	6.3	6.6	6.2	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	2.5	2.5	2.6	2.6	2.6	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	2.50	2.50	2.45	2.45	2.45	2.40	2.40	2.35	2.35	2.35
10-year T-bond yield (% eop)	3.29	3.57	3.61	3.90	3.90	3.75	3.48	3.63	3.30	3.30	3.25	3.20	3.15	3.10	3.10	3.10	3.05	3.05	3.00	3.00
Fiscal balance (% of GDP)					-3.7					-4.5					-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	0.3	1.7	2.5	0.6	1.4	1.3	1.5	2.0	1.6	1.5	1.5	1.7	1.2	1.1	1.6
CPI headline (% YoY)	2.1	2.7	2.8	3.0	2.7	2.7	2.4	2.5	2.3	2.5	2.1	2.0	1.8	1.8	1.9	2.0	1.9	1.8	1.7	1.8
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	1.00	1.00	1.00	1.25	1.25	1.50	1.50	1.50
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	1.05	1.05	1.05	1.30	1.35	1.60	1.65	1.65
10-year interest rate (% eop)	1.15	1.10	1.35	1.20	1.20	1.45	1.50	1.55	1.30	1.30	1.50	1.70	1.85	1.85	1.85	1.90	2.00	2.10	2.20	2.20
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	1.15	1.20	1.20	1.22	1.25	1.28	1.30	1.30
USD/JPY (eop)	112	115	110	113	113	107	110	114	113	113	110	110	105	100	100	99.0	98.0	97.0	95.0	95.0
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	6.85	6.85	6.75	6.75	6.70	6.60	6.70	6.70	7.10
EUR/GBP (eop)	0.87	0.88	0.94	0.89	0.89	0.88	0.88	0.89	0.90	0.90	0.87	0.85	0.85	0.85	0.85	0.85	0.85	0.85	0.85	0.85
Brent Crude (US\$/bbl, avg)	55	51	52	61	55	67	75	76	69	72	65	68	69	73	69	70	74	76	74	74

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

Source: ING forecasts

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