

December Economic Update: Prepare to be disappointed in 2020

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THINK Economic and Financial Analysis

5 December 2019



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Trade: Glass half empty

For months now, market sentiment around a phase one US-China trade deal has flitted between optimism and pessimism. Last month, the optimistic mood prevailed but, as we warned back then, things appear to have changed direction.

US: Beware of the risks

Financial markets remain in a positive mood, but with the headlines on trade looking less encouraging and the global backdrop and strong dollar acting as headwinds for growth, we are less sanguine on the economic outlook. We continue to forecast sub-consensus growth of 1.4% and expect the Federal Reserve to cut rates twice more in the first half of 2020

Eurozone: Signs of a bottoming out

There are gradually more signs that the Eurozone economy is bottoming out after a deceleration that started in January 2018. However, for the time being, a strong upturn doesn't seem to be in the offing implying that 2020 is unlikely to see stronger growth than in 2019

UK & Brexit: It's still all to play for in the UK's election

Markets are primed for a Conservative majority when UK voters head to the ballot box. But a week is a long time in politics, and a hung parliament definitely can't be ruled out. Whatever happens, 2020 looks set to be another uncertain year for Brexit and the UK economy.

China: How alarming is the default risk?

We have seen default cases rising in China's bond market. But is it really a bad thing?

Japan: Smoothly does it

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FX: A different kind of USD decline

The end of US exceptionalism is sparking calls for a weaker dollar in 2020. We think the dollar decline will be far more differentiated than broad-based. We do not think the dollar is particularly overvalued against the euro and Japanese yen. If the dollar does turn lower in 2020, we think it will be probably be against the battered commodity currencies

Rates: Tox-tail soup

It does not take much to coax market rates lower. Re-heat a US-China trade war, add a pinch of US impeachment concern, toss in another UK vote on Brexit and then simmer in a mix of corporate angst and 2020 uncertainties. Market rates are then ready to test lower as soon as risk assets judge that the brewing cocktail is toxic enough to call it a day for 2019.

Trade: Glass half empty

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Still a lot to be done

The road from a cursory understanding to a concrete, detailed trade deal was always going to be a bumpy one. By splitting the negotiations into various phases, President Trump had already taken a step back in an effort to prove that he's tough on America's trading partners but also capable of cutting a deal with them which improves the terms of trade for the US.

Trump's problem, however, is that the phase one deal needs to have enough substance to be able to deflect accusations from Republican and Democratic congressmen that he's gone soft on China.

China, on the other hand, seems to be standing firm on the red lines it has drawn.

Keeping promises

China's willingness to give in to President Trump, and perhaps even to trust what he says, was put to the test this week.

For China, the question is what it gets in return for any concessions. Trump could hold back from following through with the scheduled tariff hike in mid December, and maybe even unwind some of the tariff hikes of the last 18 months. But even if China succeeds in securing this, events this week have shown that the value of a deal with Trump is often limited. The US announced that it would re-install tariff hikes on steel imports from Argentina and Brazil, even though Brazil has been living up to its end of a steel deal struck with the US last year.

Mexico experienced a similar turn of events in the summer when Trump, shortly after agreeing to a new free trade agreement with Mexico and Canada, threatened to reimpose tariffs on Mexico if it didn't take swift action to curb illegal immigration into the US.

A mini-deal is therefore no guarantee that tariff hikes are a thing of the past.

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US: Beware of the risks

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Markets are looking to the positives

Just four months ago equities were selling off, the yield curve was inverted - historically a strong predictor of recession - and activity data was starting to soften. Since then we have had three interest rate cuts from the Federal Reserve totalling 75bp and there has been talk of a phase one trade deal with China. With the economic data seemingly having stabilised we have seen a major turnaround in market sentiment with the yield curve re-steepening and equities rising more than 10% from those August lows.

There has been a shift in sentiment at the Federal Reserve too with officials suggesting that after their “insurance” policy easing the economic is in a good place and they are happy to wait and see the effects of those rate cuts in July, September and October. The market agrees, pricing in just one more rate cut in this cycle (and not until late 2020).

Fig 1 US equities versus the 10-2Y yield curve



Source: : Macrobond, ING

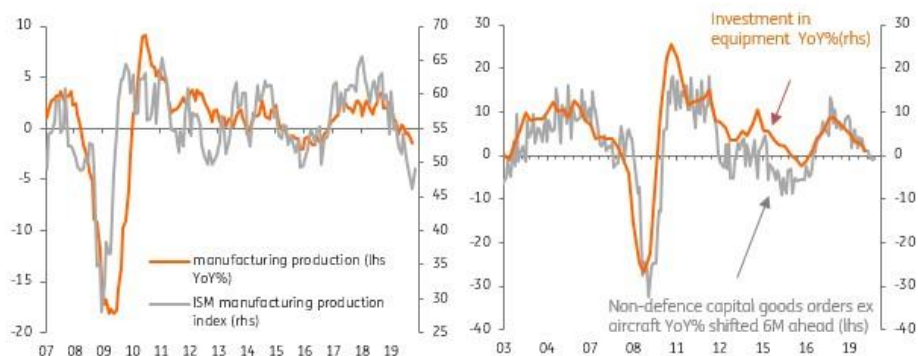
But we are more worried about the negatives...

We are less sanguine. Instead we see significant threats to this narrative and prefer to stay on the softer side of consensus, predicting 2020 GDP growth on 1.4% versus the 1.8% the market expects. We also see the risks skewed towards two further 25bp interest rate cuts in the first half of 2020. After all, global activity remains subdued, inflation is benign and the latest news on trade is hardly encouraging so we struggle to see where meaningful upside momentum is going to materialise from.

Regarding trade policy, via a tweet, President Trump has promised to restore tariffs on steel and aluminium imports from Brazil and Argentina in response to his perception that they have generated “massive depreciation of their currencies, which is not good for our farmers”. At the same time tensions are escalating with France and the EU. The US has threatened tariffs on \$2.4bn of French exports to the US in retaliation for a digital tax imposed by France (replicated elsewhere) that is primarily raising revenues from American tech companies.

Additionally, the prospects for the phase one trade deal with China, which was initially announced all the way back in October, are looking less positive. President Trump suggested that he has no deadline and would be prepared to wait until after the 2020 election. This implies a diminished prospect that some of the already enacted tariffs will be rolled back and raises the threat that another wave of 15% tariffs on \$156bn of consumer goods from China will go ahead as scheduled on December 15. With China likely to respond in kind, trade looks set to remain a major headwind from growth in 2020 by disrupting supply chains, hurting profitability and damaging sentiment.

Fig 2 US equities versus the 10-2Y yield curve



Source: Macrobond, ING

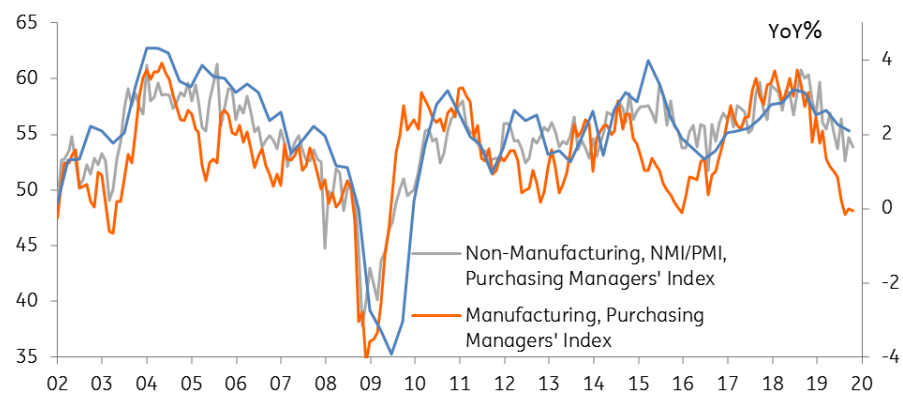
Slowdown set to continue, but recession avoided

Domestically, the economy’s growth rate is slowing. Payrolls growth that averaged 233,000 per month in 2018 is now average 168,000 while the ISM manufacturing index has been in contraction for four consecutive months. Moreover, the production sub-component is at levels consistent with output falling 5% YoY.

Capital expenditure fell in both 2Q and 3Q with lead surveys, such as the durable goods report, suggesting a third consecutive contraction in the fourth quarter. With trade worries set to linger and firms seemingly willing to “wait and see” given divergent political policies and priorities of the respective presidential candidates, we are doubtful of a major rebound in capex in 2020.

There has also been evidence of a slowing in service sector output and in consumer spending despite confidence holding up relatively firmly. Retail sales have been disappointing in recent months with auto sales also looking like they have peaked. This may be temporary, but with the economic news looking subdued, politics remaining divisive and mortgage rates on the rise again the outlook is, at best, uncertain. Consequently, we suspect 4Q GDP and 1Q 2020 GDP will come in below the 2.1% rate of 3Q19, especially if firms begin to run down some of the inventories they have built up in recent quarters.

Fig 3 ISM business surveys point to GDP slowdown



ISM surveys ask major US companies what they are seeing in terms of output, order, employment, inventories, supplier delivery times and comes up with an aggregate index of performance. #>50 = expansion #<50 = contraction

Source: Macrobond, ING

Downside risks for interest rates

With the inflation backdrop looking benign this allows for the Federal Reserve to offer more support to the economy with a couple more interest rate cuts. Recent comments suggest a strong reluctance at present, but with the trade backdrop looking less favourable, the key ISM series on a downward trend and the global backdrop and strong dollar hurting export performance and business confidence, we think they will. It is probably going to be later than we had previously been thinking, straddling 1Q and 2Q 2020 rather than concentrated in Q1. We also see downward risk for longer dated treasury yields, targeting 1.40% for the 10Y yield in 1H20.

Election uncertainty continues

In terms of politics, the impeachment process against the President is gaining pace with the House of Representatives having published their report that concluded President Trump had abused his position to pursue “personal and political interest above the national interests of the US” with regards to dealings with Ukraine. The Democrat-controlled House looks set to vote in favour of impeachment, which will lead to a trial in the Senate. Nonetheless, with 20 Republican Senators required to vote in favour to get a two-thirds majority for conviction this looks highly unlikely given none have hinted at voting in favour so far. As such Donald Trump will get to stand for re-election.

The field of Democrat candidates remains sizeable with fifteen still in the race. In terms of noted names, early front runner Kamala Harris has dropped out while former New York mayor Michael Bloomberg has entered the fray. Former Vice President Joe Biden remains the lead, but he is closely followed by the more progressive (and interventionist) Elizabeth Warren and Bernie Sanders according to recent polling.

Opinion polling suggests the election will be close, but that a centrist Democrat is more likely to defeat President Trump than a progressive. If this is the case we will likely see more emphasis on infrastructure spending versus tax cuts from Trump as the key policy thrust, with more regulatory oversight of tech industries and a focus on greener energy to boot. Another four years under Donald Trump would likely result in broader use of tariffs as a tool for generating trade “wins”.

Under a centrist Democrat, we suspect that the US would be prepared to work more closely with Europe to get a re-orientated global trade policy with less emphasis on tariffs as the starting point.

Please click on this [link](#) for a collection of our latest views on US politics.

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Eurozone: Signs of a bottoming out

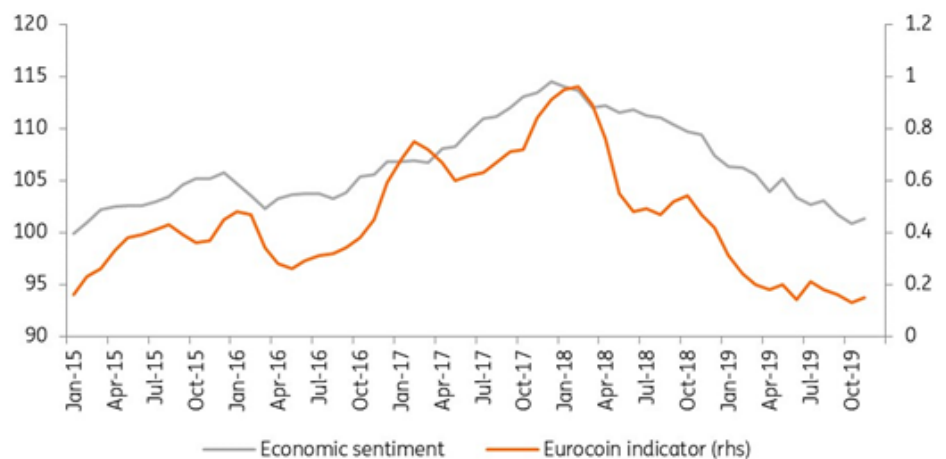
There are gradually more signs that the Eurozone economy is bottoming out after a deceleration that started in January 2018. However, for the time being, a strong upturn doesn't seem to be in the offing implying that 2020 is unlikely to see stronger growth than in 2019

Living on trade hopes

An increasing number of indicators suggest that the downturn is coming to an end. The German Ifo-indicator rose for the third month in a row in November, while the European Commission's economic sentiment indicator registered a stronger than expected increase last month. The eurocoin indicator, a real-time estimate of the underlying growth pace, rose slightly from 0.13 in October to 0.15 in November, although this still suggests rather weak growth.

A phase one trade agreement between China and the US would be good news for Europe too. The eurozone is, as a matter of fact, a more open economy than both China and the US, which explains why the fall in international trade on the back of the trade war provoked significant collateral damage in Europe. Other positive news was the fact that President Donald Trump didn't announce higher tariffs on European cars. This would have been an additional blow to the already battered German car industry.

Fig 4 Signs of a bottoming out



Source: Refinitiv Datastream

Subdued upturn

While the news flow has been improving, we don't expect a robust upturn. The more cyclical business climate indicator even decreased to -0.23 from -0.20 in October. This chimes with a further fall in the assessment of order books in the industrial sector. Employment expectations declined in all sectors in November, which might have a dampening effect on consumption.

Several big German firms announced significant lay-offs over the last month.

Admittedly, German unemployment figures remain reassuring, but such headline news might make the consumers more cautious. German retail sales actually dropped by 1.9% month-onmonth in October, from 0% in September. On the year, retail sales were still up by 0.8%, but this is a significant deceleration from previous months. We are therefore looking at quarterly growth rates for the eurozone close to 0.1% in both the last quarter of 2019 and the first quarter of 2020. Even with a gradual acceleration from

2Q20 onwards, the eurozone will struggle to print an average growth rate above 1.0%. We pencil in 0.7% GDP growth in 2020 and 1.0% in 2021.

Limited pricing power

Inflation increased from 0.7 to 1% in November with core inflation rising from 1.1 to 1.3%. Except for energy prices, all the underlying series increased, with the largest jump happening in services prices. Could this be the start of an upward trend?

Looking at wage dynamics, which have been strengthening over the last year, it is tempting to say that the Phillips curve is finally reasserting itself with the tighter labour markets finally leading to stronger inflation. However, this process is unlikely to gain much traction over the coming year. As a matter of fact, in the consumer surveys labour market perspectives have been deteriorating over the last few months, a phenomenon that is likely to temper wage inflation. At the same time selling price expectations have been falling in both industry and services, a sign that Eurozone businesses still have little pricing power. To be sure, we think indeed that inflation is likely to creep higher, but it will happen at a snail's pace. Both for 2020 and 2021 it still looks unlikely that average inflation is going to come out above 1.5%

Monetary policy on hold

On monetary policy, little change is to be expected over the next two years. A lot of attention will focus on the strategic review, but it can take a while before any conclusions are reached and we doubt whether this will induce any short term policy change. As for bond yields, we have the feeling that the worst is behind us.

With monetary policy having reached its limits and more calls on fiscal policy to play its role, bond yields are likely to settle in a gentle upward trend. However, the short run is still likely to see some volatility, as the short term dataflow might temper the expectations on the strength of the upturn.

Fig 5 Selling price expectations



Source: Refinitiv Datastream

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UK & Brexit: It's still all to play for in the UK's election

Markets are primed for a Conservative majority when UK voters head to the ballot box. But a week is a long time in politics, and a hung parliament definitely can't be ruled out. Whatever happens, 2020 looks set to be another uncertain year for Brexit and the UK economy.

A week is a long time in British politics

With a week to go until the UK election on 12 December, you'd be forgiven for feeling a sense of déjà vu.

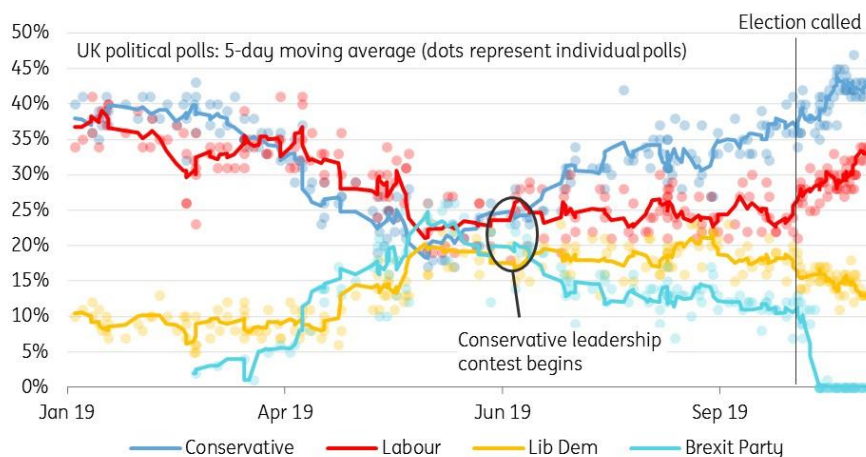
Markets are increasingly positioning for a Conservative majority outcome, following a number of polls showing prime minister Boris Johnson's party is consolidating their lead. A closely-watched YouGov polling model recently predicted the Conservatives could secure a solid 69 majority.

Betting company PaddyPower betting odds imply a 73% probability of a Conservative majority, while our FX team believes there is now a 2% positive risk premium in sterling relative to the euro.

This implies that investors are already pricing a market-friendly outcome.

But as we learnt back in 2017, a week is a long time in politics. There is still plenty of time for things to go wrong for PM Johnson's party, and markets may be underestimating the risk of another hung parliament.

Fig 6 Conservatives and Labour consolidating their poll positions



Brexit Party has fallen as a result of their decision not to stand in Conservative held seats
 Source: YouGov, Suvation, Opinium, ComRes, Ipsos, BMG

Conservative majority likely, but don't rule out another hung parliament

In a trend reminiscent of the previous election, the opposition Labour party has gained ground in the most recent polls. According to the FT's tracker, Labour is now up at 32% in the polls – admittedly still 10 points behind the Conservatives, but noticeably higher than the 25% level the party was tracking through most of the second half of the year.

Where the Conservatives have benefitted from the Brexit party's retreat, Labour has been helped by the downfall of the Lib Dems, whose 'revoke' Article 50 policy hasn't resonated as much as hoped among voters.

That said, one key difference between this and the previous election is that Labour leader Jeremy Corbyn’s favorability rating has fallen significantly. And while Labour’s bold policy proposals will resonate in key battlegrounds, some recent polling for The Times suggested voters aren’t all convinced that the party’s pledges are deliverable.

But even so, the polls may not need to narrow much for the balance to swing back towards a hung parliament. As a rule of thumb, pollsters reckon the gap between the two major parties would need to narrow to six points or less over the final few days.

One way this might happen is via shifts in turnout – the notoriously unpredictable part of any polling model. With the Conservatives ahead in the polls, there is a chance that their target voters become complacent – around a third of the electorate believes a Conservative majority is the most likely outcome according to Ipsos MORI. Only 10% expect a Labour majority government.

The recent YouGov MRP model indicated that the majority of seats projected to be gained by the Conservatives would be tight. It therefore probably wouldn’t take massive changes in turnout to generate quite a different outcome at next week’s election.

Fig 7 Seven scenarios for Brexit after the UK election

	No deal exit on/after 31 Jan	Abrupt end to transition period in Dec 2020	Second Brexit referendum	Scottish referendum	Economic policy
Large Conservative majority	Unlikely Deal set to be ratified	Fairly unlikely PM has political space to extend transition	Very unlikely Deal set to be ratified	Very unlikely Government not relying on SNP support	Neutral Fiscal rules tweaked and modest investment
Thin Conservative majority	Unlikely but possible Deal ratified but bill could meet tricky amendments	Low possibility EU budget payments may prove too controversial	Unlikely Deal likely to be ratified	Very unlikely Government not relying on SNP support	Neutral Fiscal rules tweaked and modest investment
Conservative (+DUP) minority government	Possible Deal rejected, but MPs could block 'no deal' again	Possible But Parliament may try to force extension	Low possibility Deal fails, Johnson opts for this as 'least worst' option	Very unlikely Government not relying on SNP support	Neutral Modest spending increase but risk MPs block budget
Conservatives try to 'go it alone'	Very possible Govt could fall apart. Risk of accidental 'no deal'	Possible But Parliament may try to force extension	Unlikely but possible Govt vulnerable – risk of another election	Unlikely but possible If there's another election & SNP holds key to power	Neutral Without majority, budget gets stuck in Parliament
Fragile Labour-led minority government	Unlikely but possible If government falls apart, 'no deal' risk could return	Fairly unlikely Transition extended if voters back deal in 2 nd ref	Likely Can opposition parties agree on the process?	Likely Q is whether it happens before/after 2 nd Brexit ref	Modest changes Expansionary policy, but scope of reform limited
Solid Labour-led minority government	Unlikely Second referendum likely. Article 50 extended	Unlikely Transition extended if voters back deal in 2 nd ref	Highly likely Choice between softer deal and 'remain'	Reasonably likely Depends if SNP hold key to power	Some changes Some bold reform, looser fiscal policy
Labour majority	Unlikely Second referendum likely. Article 50 extended	Unlikely Transition extended if voters back deal in 2 nd ref	Highly likely Choice between softer deal and 'remain'	Unlikely Government not relying on SNP support	Big changes Nationalisation, changes to share ownership

Source: ING

2020 set to be another choppy year for Brexit and the UK economy

The bottom line is that, while a Conservative majority is undoubtedly the most likely scenario, it is far from guaranteed. But whatever the outcome, we think the uncertain political climate will continue to weigh on economic activity as we head into 2020. For instance, even if the Brexit deal is ratified early next year, concerns about the length of the standstill transition period will quickly resurface.

This is particularly true if the Conservatives gain only a small majority at the election. PM Johnson will be under heavy pressure from the hardline pro-Brexit lawmakers within his party not to extend further.

There are already early signs that the ongoing uncertainty and persistent sluggishness of UK growth could be translating into something more worrying. Admittedly the activity numbers have been volatile over recent months, thrown around by stock building activity among other things. But investment has been consistently weak, and there are early signs that the resulting fall in order levels is beginning to noticeably reduce hiring appetite among firms.

So whatever happens at next week’s UK election, 2020 looks set to be another turbulent year for the Brexit process and UK economy.

[Click here to read our full analysis of the forthcoming UK election](#)

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China: How alarming is the default risk?

We have seen default cases rising in China's bond market. But is it really a bad thing?

Is this a fall off the cliff or a healthy clean up?

As always defaults are eye-catching and bad news for investors, issuers and the market.

For the economy, if poor credits can access funding to cover existing debts, and rollover "forever" then accumulating these debts, without defaults, isn't a great situation as it has the potential to create a default time bomb.

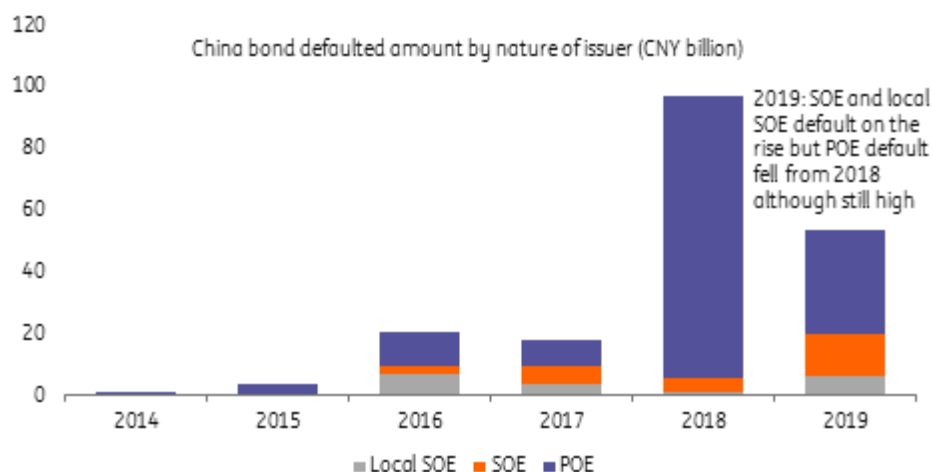
Therefore, the question is if the recent round of defaults is a large scale fall-off-the-cliff event that will rock the market or just a cleanup of bad credits.

China bonds default cases have increased

We think there are three reasons why the number of defaults in China has increased:

- 1) Lots of local government special bonds - around CNY2.5-3 trillion - have been issued in 2019 to support infrastructure projects. The market has started to question if this influx could generate a series of defaults, which would be on what are by nature corporate bonds and therefore not guaranteed by the local government.
- 2) Land sales revenue for some local governments has been small while relief measures have increased due to the trade war. The combined effect of these factors impacts local governments' ability to pay. Default from local SOEs jumped from nearly zero in 1Q18 to more than CNY6 billion in 3Q19.
- 3) Defaults on bonds issued by privately-owned enterprises have been high though these have fallen since 2018. Then, the government aimed to clean up POE bonds after the cleanup of SOE loans in 2016-2017. The issue with POE is more complicated as major shareholders usually pledge their shares as collateral for loans. Should the company be unable to repay the loan, the stock market then reflects this through a lower share price, in turn making repayment more difficult.

Fig 8 China bond default on the rise



Source: ING, Bloomberg

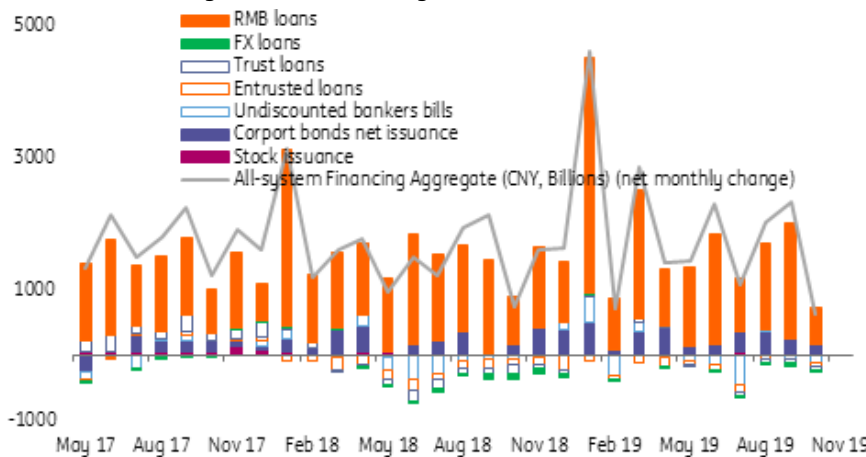
Shadow banking is shrinking at the same time

This view is confirmed by shrinking shadow banking activities.

Shadow banking activities have been shrinking since early 2018, thanks to the efforts of the central government to restrict these. In 2019, the shadow banking activities most affected have been peer-to-peer (P2P) lending platforms, which accepted loans drawn by mostly smaller firms that were facing difficulties. Trust companies then packaged the P2P loans and sold these to investors seeking yields.

In 2019, the central government has driven most P2P activities out of business. The Chinese central bank has increased incentives for banks to lend to smaller firms.

Fig 9 Shadow banking has been shrinking



Source: ING, Bloomberg

More defaults to come in 2020

We expect more local state-owned enterprises to default in 2020 - land sales will be limited by restrictive housing measures and the credit ratings of local governments will continue to be diverse.

Local government special bond issuance has increased since late 2018. Usually, these bonds have maturity of five to 10 years. The concern isn't about these credits defaulting in 2020, but rather in 2023. By that time infrastructure projects should be completed and should begin to generate cash flows to repay the debts. In 2019, the rate of local stateowned company defaults has been faster than in 2018, also reflecting the government's intention to stop overlending at the local government level.

We also expect the default of private-owned enterprise bonds to continue at a high level of around CNY35 billion in 2020, similar to the level expected in 2019. Critical here is that shareholders pledge shares to get loans, which in turn has the potential to increase risk correlation between the share prices and the loan and bond markets.

China's sovereign bonds will remain intact as these are seldom affected by state-owned players' default situations.

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Japan: Smoothly does it

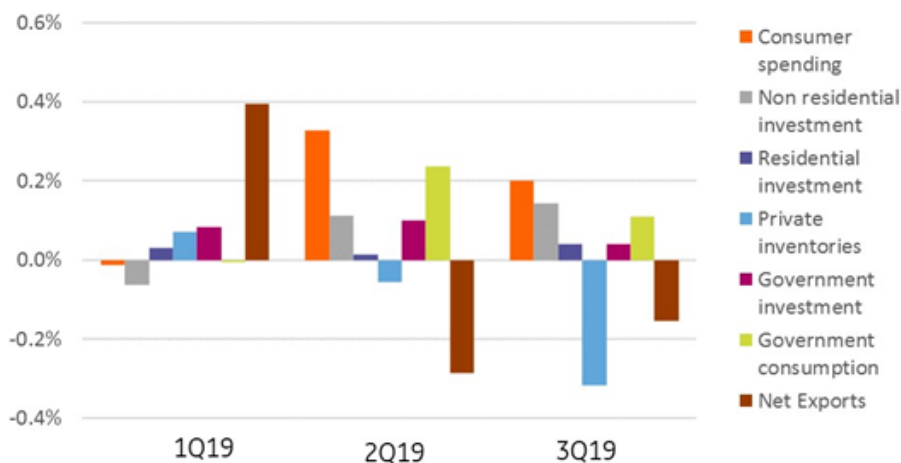
So far, Japan's consumption tax hike seems to have gone down far more smoothly than its previous equivalents in terms of both GDP growth and inflation. Though the coming months could still see some fallout even if the front-loading was smothered by inventory fluctuations

3Q19 GDP rises only 0.1% QoQ

Japan is now in the midst of an adjustment phase following on from its consumption tax hike from 8% to 10% in October. So far, this has gone far more smoothly than the previous episodes of this tax hike. The 3Q19 GDP result was only 0.1% QoQ, or 0.2% annualised, down from the previous quarter despite front-loading of consumer spending in September on some items affected by the hike.

The GDP figures were also negatively affected by a big drawdown in inventories. The QoQ contribution of private inventories was -0.3%. That was enough to totally offset the growth in private consumption. Net exports stripped a further 0.2pp from the total, with the result that the front loading of residential and non-residential investment, which in any case was fairly subdued, was totally offset.

Fig 10 Contributions to QoQ GDP growth



Source: CEIC, ING

Front-loading buried, but a big drop still probable

But if the front-loading was denatured, does that mean that 4Q19 figures will escape the big drop that usually follows the front loading? In our view, probably not.

For one thing, it seems a stretch to rebuild inventories against a known background of likely weak 4Q19 demand. Sure, if it were involuntary, then it could happen, but it is not as if a weak quarter of demand in 4Q19 is likely to be a surprise. More probable, inventories will be roughly unchanged rather than fall sharply as they did in 3Q19. Their contribution might rise to something closer to zero, so it gives 4Q19 GDP a better starting point. But that is likely to be offset by falling household consumption and falling investment.

Retail sales for October fell by 17.4%YoY, having risen by 11.0%YoY in September. Compared to 2014, this means that sales rose slightly less just ahead of the tax hike, and have also fallen slightly less too immediately afterwards. So perhaps the 4Q19 collapse will not be as abrupt.

The other hope is for a bigger decline in imports and recovery in exports. That is not impossible. Though exports are still likely to struggle against a weak global demand backdrop, some softer imports may at least soften the blow of weak domestic demand.

The JPY 13 trillion support package arrives

Looking beyond the immediate period of economic disruption, prime minister Shinzo Abe has just announced a large fiscal stimulus package of JPY13.2tr, or about \$121bn. That is about two to three per cent of GDP, though we expect the effective element of this will be far smaller in terms of 2020 GDP as it is to be spent over 15 months, and will likely contain some spending already accounted for, or include soft loans, not real spending.

The spending could help Japan get over another hump – namely the end of construction investment following the conclusion of next year’s Olympic Games. Exactly what the package will entail is not yet public knowledge, but it will likely contain a number of natural disaster protection elements, (flood defences etc) as well as infrastructure.

Typically, it is not a good idea to bump up GDP forecasts in response to stimulus packages such as this, though they also tend to provide very lumpy support and it may well be that 2020 is every bit as bumpy as we thought 2019 would be.

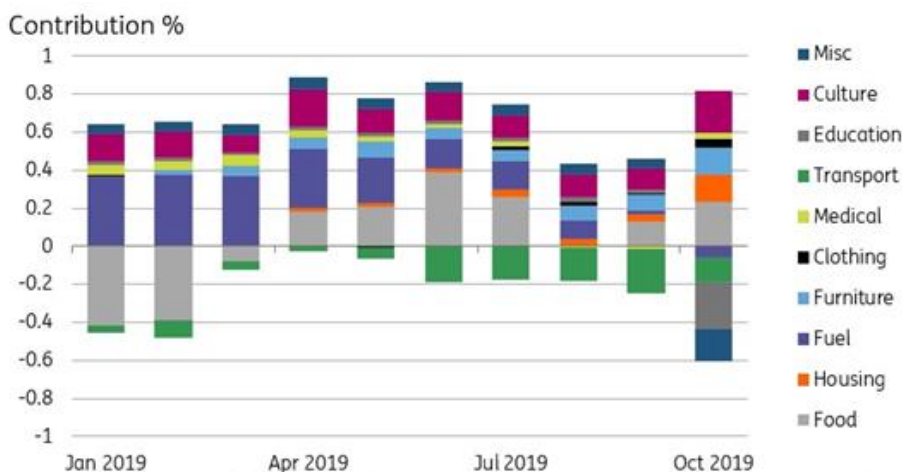
Our previous forecast treated the consumption tax in the same was as previous hikes, which led to a 12-month price spike and raised inflation that then dissipated. This time, there has been no such price spike – well there has – but it has been almost totally offset by the impact of pre-school childcare, which has been made free. So in October, alongside a rise in clothing and footwear costs of 1.6% (on top of 4.1% the previous month), a 0.9%MoM medical care spike, 2.2%MoM education increase and 1.1% increase in transport and communication costs, education prices fell 8.4%.

The other big change to our forecasts for 2020 is in terms of inflation

From the previous month, national CPI inflation remained unchanged in October. And we have had to drop our inflation profile for next year substantially to reflect this offsetting price reduction. Saying that there was no change in Japan’s price level in October is a bit of a simplification though. Considering how few people in Japan have children of pre-school age, for most households, prices have risen quite a lot without any offsetting declines.

In other words, the lack of movement in Japan’s price level is a statistical simplification for the majority of households.

Fig 11 Japanese inflation dampened by education



Source: CEIC

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FX: A different kind of USD decline

The end of US exceptionalism is sparking calls for a weaker dollar in 2020. We think the dollar decline will be far more differentiated than broad-based. We do not think the dollar is particularly overvalued against the euro and Japanese yen. If the dollar does turn lower in 2020, we think it will be probably be against the battered commodity currencies

2019 has been a good year for the dollar

2019 has generally been a good year for the dollar. Marginal new highs have been seen in the rally which started in February 2018 – when the White House fired the opening salvos in the trade war. The dollar rally has largely been concentrated against pro-cyclical currencies with occasional exceptions in G10 (Canadian dollar, British pound) and in emerging markets (rouble, Thai baht).

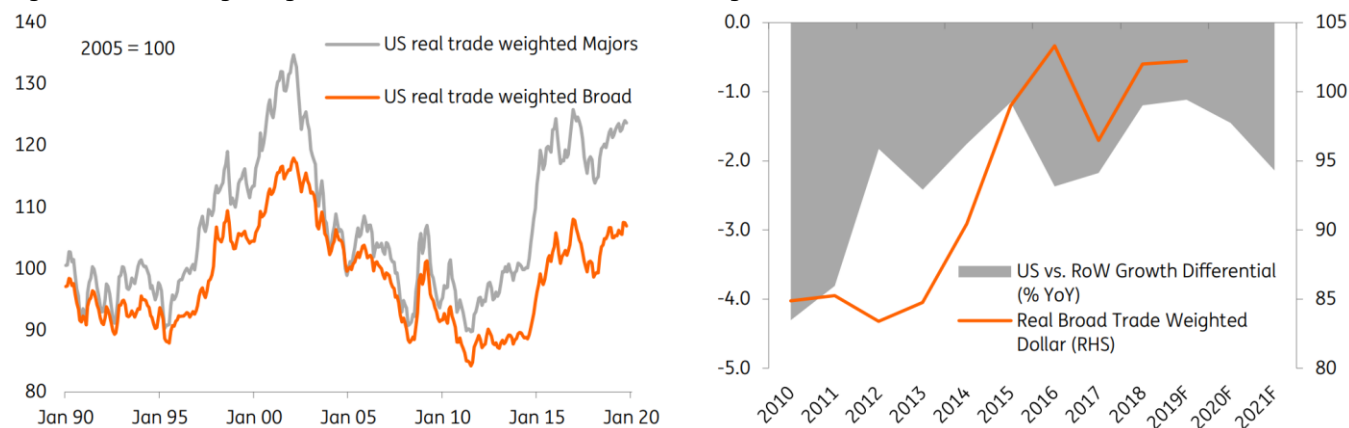
A common expectation for 2020 now seems to be one of broad dollar depreciation. Fund managers are most bearish on the dollar since September 2007 and the familiar narrative is that the end of US exceptionalism spells trouble for the dollar. Certainly we subscribe to the view that the US growth differential against the Rest of the World (RoW) will shift against the US over the next couple of years.

The difference is that we expect the growth performance in the RoW to be far from uniform. Most importantly, 2020 will not be a repeat of 2017 when the world economy was firing on all cylinders (even Europe participated). Back then, synchronised global growth saw trade volumes growing 5% year-on-year and the dollar embarking on a broad decline.

Given our view that Europe will not be a particularly attractive investment destination in 2020 and that the popular DXY is 77% weighted towards European currencies, we are not looking for a major DXY decline next year.

Based on our view of only modest upside for EUR/USD in 2020 (1.13 end 2020) we expect DXY to fall just over 2% next year. If EUR/USD is closer to 1.10 rather than 1.13 at the end of 2020, then that DXY decline is cut to just under 1%.

Fig 12 Dollar nudges higher in 2019, but should it decline as US growth slows?



Source: Bloomberg, ING

The dollar is not particularly overvalued

We also take issue with some views that the dollar is materially overvalued. Our medium term fair value measures have it nowhere near as overvalued as it was in early 2017, largely because we see EUR/USD's fair value having fallen to 1.10.

Additionally, we think that the Federal Reserve has to deliver at least three independent cuts (relative to other central banks) to bring rate differentials back into a range that makes a difference for dollar pricing. One of the core stories in 2019 has been that, despite three Fed rate cuts, dollar hedging costs have still been too expensive to make a difference. For example, the costs for European investors to hedge USD exposure have fallen 100 basis points this year, but, at 2.5% per annum, they are still too high in a low yield world.

The yield story is probably more important than we think. Looking at the portfolio flow both from ECB and US Treasury data suggests hot money – or short term financial flows – could be driving exchange rates. For example, we talk about US exceptionalism and the US sucking in capital, but data does not bear this story out.

Through the 12 months to September 2019, foreigners bought only a net US\$41 billion of US securities (Treasuries, corporate bonds and equities) versus US\$334 billion in the 12 months to September 2018. Instead then we believe short term financial flows are driving dollar strength. Unless the Fed cuts very aggressively in 2020 (e.g. three or more times) we do not see a stampede out of USD deposits.

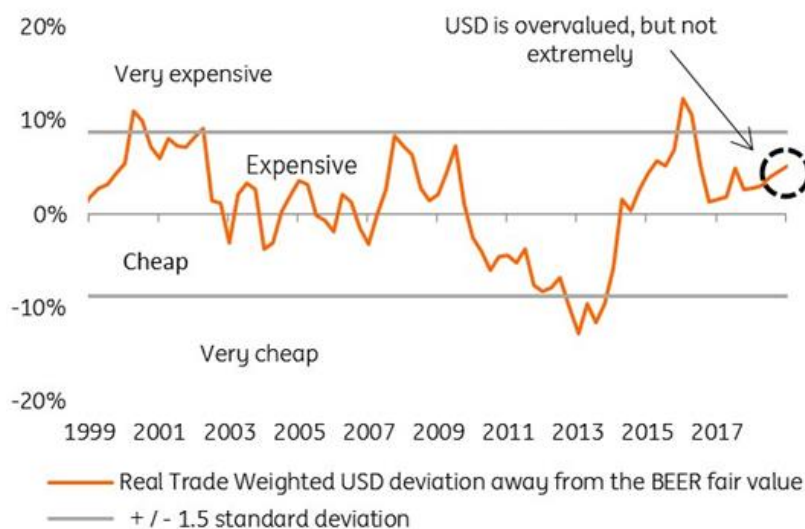
Will the White House target a lower dollar in 2020?

When it comes to Washington’s FX policy, it is fair to describe this as mercantilist. The White House occasionally rails against the strong dollar, but its biggest bug-bears are the cheap currencies of China and Europe that have contributed to the huge US trade deficit. Should a phase one trade deal with China be signed, look out for any currency clause.

Such a clause may mirror the one suggested in the US-Mexico-Canada deal, which effectively backs a free-float and transparency on FX intervention. In theory, this would prevent massive FX intervention from the Chinese to support USD/CNY should the dollar trend turn lower. Interference with an orderly Balance of Payment adjustment is Washington’s concern.

We doubt that President Trump would turn to physical FX intervention to weaken the dollar – though he does have the authority. And occasional bills in Congress to effectively tax short term capital inflows are unlikely to gain much cross-party support – where capital flow measures are more frequently associated with emerging economies.

Fig 13 Dollar valuation based on medium term fundamentals



Source: ING

G3 currencies relatively subdued, commodity currencies to rebound

[In our recently released 2020 FX Outlook: Diamonds in the rough](#), we made the case that the fresh injection of central bank liquidity from the Federal Reserve, European Central Bank and Bank of Japan would likely depress interest rates and volatility, while also keeping G3 currencies quite range-bound. We roughly see EUR/USD trading in a 1.10-1.15 range (ending 2020 at 1.13), while USD/JPY should roughly trade in a 105-110 trading range.

On a total return basis, we see the Norwegian krone, Canadian dollar and New Zealand dollar performing the strongest against the US dollar through 2020, while in the emerging markets space we see the Brazilian real as the top performer in 2020.

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Rates: Tox-tail soup

It does not take much to coax market rates lower. Re-heat a US-China trade war, add a pinch of US impeachment concern, toss in another UK vote on Brexit and then simmer in a mix of corporate angst and 2020 uncertainties. Market rates are then ready to test lower as soon as risk assets judge that the brewing cocktail is toxic enough to call it a day for 2019.

The call on rates in the coming months (that morph from 2019 into 2020) is complicated by a remarkable mix of digital extremes. Either there will be a China-US trade truce or not, either there will be a resolution of the UK Brexit dilemma or not, either there will be a viable impeachment process or not, either the sub-50 PMIs are signalling a recession or not, either corporates lift the seeming embargo on investment plans or not, and we could go on.

There are diverging signals too. The US consumer is hot, and confidence still off the charts, while at the same time corporate America is far less certain, curtailed by narrower margins and expectations that remain muted at best. But impacted too by policy uncertainty, in the US, in Europe and in supply chains that spaghetti junction their way through both developed and emerging markets. Holding off on big investment decisions is then is not a bad strategy, but not good for growth.

Meanwhile, the US labour market is tight, but there is no (material) wage inflation. There is also no manufacture of inflation generally. The European central bank continues to struggle to generate inflation and may even consider adding housing costs to their CPI measure in an effort to create some. US Treasury inflation-protected securities trade with an inflation discount, rather than the premium they have typically commanded, as market participants just don't see value in paying for inflation protection.

“These days you can pitch market rates virtually wherever you want, and you'd find a decent rationale for that level”

Market flows also show that participants continue to buy duration. To do so they buy in longer tenors, and implicitly then take on a bet that inflation will not rise. They also by definition then bet that key central banks will

not be raising rates any time soon. And market flows on the demand side these days include central bank buying, with the ECB continuing their quantitative easing program, and the Federal Reserve too as they too rebuild their balance sheet by buying bills.

These days you can pitch market rates virtually wherever you want, and you'd find a decent rationale for that level. The most undisputed level is where rates currently trade – that's always the starting point. A 10-year Bund yield of -35bp is hardly sustainable. But then again, a 10-year US Treasury yield of 1.7% looks incongruous against inflation expectations at the same rate i.e. a zero

10-year real yield (rounded). So, they should be higher eventually. But they are where they are right now.

But an equally valid question is where are they heading to in the next couple of months. Based off a supply/demand trade-off that has delivered the current price, or market rates, as a starting point, then the odds are that market rates test lower again before any real ability shows to muster a material move to the upside. There is a complex sauce being concocted; it does not smell that pretty and is more likely to brew net trouble than a run of positive solutions to our numerous digital outcomes.

ING Global Forecasts

	2018					2019F					2020F					2021F				
	1Q	2Q	3Q	4Q	FY	1Q	2Q	3Q	4Q	FY	1Q	2Q	3Q	4Q	FY	1Q	2Q	3Q	4Q	FY
United States																				
GDP (% QoQ, ann)	2.6	3.5	2.9	1.1	2.9	3.1	2.0	1.9	1.3	2.4	0.8	1.4	1.9	1.9	1.4	1.9	1.8	1.9	1.9	1.9
CPI headline (% YoY)	2.7	2.7	2.6	2.2	2.4	1.6	1.8	1.8	1.9	1.8	2.3	2.0	2.1	2.1	2.1	2.1	2.0	1.9	1.8	2.0
Federal funds (% eop) ¹	1.50	1.75	2.00	2.25	2.25	2.25	2.25	1.75	1.50	1.50	1.25	1.00	1.00	1.00	1.00	1.00	1.25	1.25	1.50	1.50
3-month interest rate (% eop)	2.30	2.35	2.45	2.65	2.65	2.60	2.3	2.1	1.87	1.87	1.62	1.35	1.35	1.35	1.35	1.46	1.75	1.56	1.80	1.80
10-year interest rate (% eop)	3.00	3.00	3.00	2.80	2.80	2.40	2.00	1.65	1.60	1.60	1.40	1.50	1.70	1.90	1.90	1.90	2.00	2.10	2.10	2.10
Fiscal balance (% of GDP)					-4.0					-4.6					-4.7					-4.7
Fiscal thrust (% of GDP)					1.1					0.4					0.0					0.3
Debt held by public (% of GDP)					76.7					78.9					81.8					84.2
Eurozone																				
GDP (% QoQ, ann)	3.2	1.5	0.8	1.4	1.9	1.7	0.8	0.9	0.4	1.2	0.4	0.9	1.2	1.0	0.7	1.0	1.0	1.0	0.9	1.0
CPI headline (% YoY)	1.3	1.7	2.0	2.0	1.8	1.4	1.3	0.9	0.8	1.1	1.0	0.9	1.1	1.2	1.1	1.3	1.3	1.3	1.3	1.3
Refi minimum bid rate (% eop)	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
3-month interest rate (% eop)	-0.33	-0.33	-0.33	-0.33	-0.33	-0.32	-0.32	-0.41	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40
10-year interest rate (% eop)	0.50	0.30	0.40	0.24	0.24	-0.07	-0.31	-0.57	-0.40	-0.40	-0.40	-0.30	-0.20	-0.20	-0.20	-0.15	-0.15	-0.10	-0.05	-0.05
Fiscal balance (% of GDP)					-0.5					-0.7					-0.8					-0.7
Fiscal thrust (% of GDP)					-0.2					0.1					0.1					0.0
Gross public debt/GDP (%)					87.8					87.0					85.9					84.9
Japan																				
GDP (% QoQ, ann)	-0.6	2.2	-2.0	1.5	0.8	2.0	1.8	0.2	-2.0	0.9	3.6	0.1	1.3	0.1	0.8	1.1	1.8	-0.6	2.3	0.9
CPI headline (% YoY)	1.3	0.6	1.1	0.9	1.0	0.3	0.8	0.3	0.6	0.5	1.0	1.1	1.3	1.1	1.1	1.1	1.0	0.9	0.8	1.0
Excess reserve rate (%)	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
3-month interest rate (% eop)	0.00	0.00	-0.05	-0.05	-0.05	-0.15	-0.15	-0.15	-0.15	-0.15	-0.15	-0.15	-0.15	-0.15	-0.15	-0.15	-0.15	-0.15	-0.15	-0.15
10-year interest rate (% eop)	0.05	0.03	0.14	0.00	0.00	-0.10	-0.20	-0.20	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.20	-0.20	-0.20	-0.20	-0.20
Fiscal balance (% of GDP)					0.0					-0.2					-0.3					0.2
Gross public debt/GDP (%)					232.8					232.0					230.0					228.0
China																				
GDP (% YoY)	6.8	6.7	6.5	6.3	6.6	6.4	6.2	6.0	6.3	6.2	6.0	5.9	5.9	5.8	5.9	6.1	6.2	6.3	6.4	6.3
CPI headline (% YoY)	2.2	1.8	2.3	2.5	2.2	1.8	2.6	2.8	2.6	2.5	2.6	2.6	2.4	2.0	2.4	2.2	2.0	2.0	2.2	2.1
PBOC 7-day reverse repo rate (% eop)	2.55	2.55	2.55	2.55	2.55	2.55	2.55	2.55	2.50	2.50	2.45	2.45	2.45	2.45	2.45	2.45	2.45	2.45	2.45	2.45
10-year T-bond yield (% eop)	3.75	3.50	3.65	3.30	3.30	3.07	3.20	3.14	3.20	3.20	3.00	3.10	3.15	3.40	3.40	3.10	3.20	3.40	3.50	3.50
Fiscal balance (% of GDP)					-2.6					-4.5					-4.0					-4.0
Public debt, inc local govt (% GDP)					88					102					103					105
UK																				
GDP (% QoQ, ann)	0.2	1.6	2.8	0.9	1.4	2.3	-0.9	1.2	1.2	1.3	1.0	1.6	1.4	1.3	1.1	1.8	1.3	0.8	0.5	1.4
CPI headline (% YoY)	2.7	2.4	2.5	2.3	2.5	1.9	2.0	1.8	1.5	1.8	1.9	1.7	1.7	2.0	1.8	2.0	2.0	2.0	2.0	2.0
BoE official bank rate (% eop)	0.50	0.50	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	1.00	1.00	1.00	1.00	1.00
BoE Quantitative Easing (£bn)	445	445	445	445	445	445	445	445	445	445	445	445	445	445	445	445	445	445	445	445
3-month interest rate (% eop)	0.60	0.80	0.80	0.80	0.80	0.83	0.77	0.77	0.80	0.80	0.85	0.85	0.85	1.10	1.10	1.10	1.10	1.10	1.10	1.10
10-year interest rate (% eop)	1.45	1.48	1.57	1.30	1.30	1.00	0.80	0.50	0.70	0.70	0.70	0.80	0.90	0.90	0.90	0.90	1.00	1.00	1.00	1.00
Fiscal balance (% of GDP)					-1.4					-1.4					-1.2					-1.0
Gross public debt/GDP (%)					86.9					85.7					84.4					83.6
EUR/USD (eop)	1.20	1.17	1.15	1.12	1.12	1.12	1.12	1.09	1.10	1.10	1.10	1.11	1.12	1.13	1.13	1.14	1.15	1.18	1.20	1.20
USD/JPY (eop)	107	110	114	113	113	112	108	108	108	108	108	108	108	108	108	107	106	105	100	100
USD/CNY (eop)	6.28	6.67	6.87	6.88	6.88	6.74	6.90	7.15	7.00	7.00	7.05	7.00	6.95	6.85	6.85	6.80	6.70	6.60	6.50	6.50
EUR/GBP (eop)	0.88	0.88	0.89	0.90	0.90	0.85	0.90	0.89	0.83	0.83	0.83	0.85	0.85	0.82	0.82	0.82	0.82	0.82	0.82	0.82
Brent Crude (US\$/bbl, avg)	67	75	76	69	72	64	68	62	65	65	60	58	62	67	62	64	70	70	68	68

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

Source: ING forecasts

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