ECONOMICS | Global

3 November 2017

Monthly Economic Update

Synchronising swimmingly

There is growing optimism that the global economy is showing synchronised growth. The US has long been the dominant driver, but there are encouraging figures coming out of Europe and Asia too. There also is the prospect of fiscal stimulus from some countries, notably the US, Germany and Japan. As such, the retreat from lax monetary policies is quickening and could accelerate if higher inflation figures more in policymakers' minds.

The US growth story keeps getting better. Consistently strong numbers continue to come through and we are now looking for full year 2018 growth of around 2¾%. With unemployment continuing to fall and signs that inflation is starting to rise a December rate hike looks probable. The one threat is that politicians reach deadlock on raising the government debt ceiling and trigger a potentially damaging government shutdown.

Nonetheless, this would likely be just a temporary setback and the Federal Reserve, under its new Chair Jerome Powell, will likely hike rates a minimum of two times in 2018. President Trump will also be keen to see the Fed's new management implement his vision of looser regulation to promote growth.

The Eurozone economy continues to surprise positively and is showing few signs of coming to an abrupt halt, even with some of the political risks on the horizon. But inflation is still low and any pick-up from here is going to be very gradual. That's why European Central Bank (ECB) President Draghi was at pains to stress that the road to 'tapering' of its bond purchases will be a dovish one.

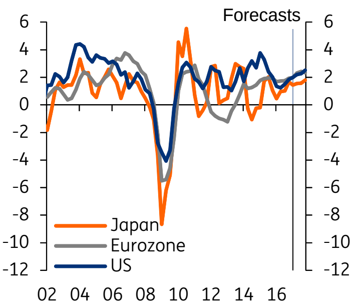
The Bank of England has delivered a historic rate hike, but we're still sceptical that it will be followed up by several more. There are some (very) tentative signs of Brexit progress, but there's still plenty of uncertainty. Throw in sluggish growth and the likelihood inflation is at a peak, and we think the policy committee will tread very carefully.

China's President Xi has successfully consolidated his power at the 19th Congress with credit reforms and his anti-graft campaign set to continue. While there is no longer an actual growth rate target, the three stages of the economic plan, set out from now to 2050, has the aim of China surpassing the US as the world's economic and political powerhouse.

Japanese PM Abe's gamble paid off and now has a "supermajority" that gives him greater scope for change. The biggest opportunity will be Constitutional reform, which could change Japan's pacifist constitution. This will require a referendum, but the North Korea stand-off means it is increasingly likely to pass.

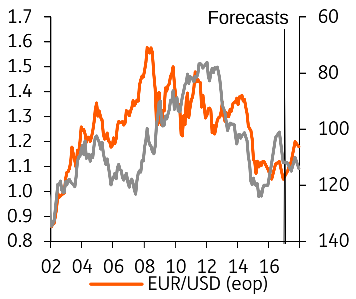
Market opinion is divided on the dollar. There is growing a sense that the US activity/rates story stands to drive a stronger dollar recovery. Yet we doubt that a modest and orderly Fed tightening cycle needs to trigger much of a dollar rally at a time when the global recovery is broadening. Instead we expect to see EUR/USD trading a 1.15-20 range into next year, before another leg higher next summer.

GDP growth (% YoY)



Source: Macrobond, ING

FX



Source: Macrobond, ING

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US: Powell… You're hired!

Positive data has led us to revise up our GDP forecast

The US economy is going from strength to strength. GDP growth recorded its second consecutive quarterly 3%+ reading, key business surveys are at decade highs and unemployment at 16-year lows so there is a lot to be positive about. With external demand also strengthening we have revised up our full year 2018 growth forecast to 2.7% YoY.

Tax reform offers an opportunity for even strong growth in 2018…

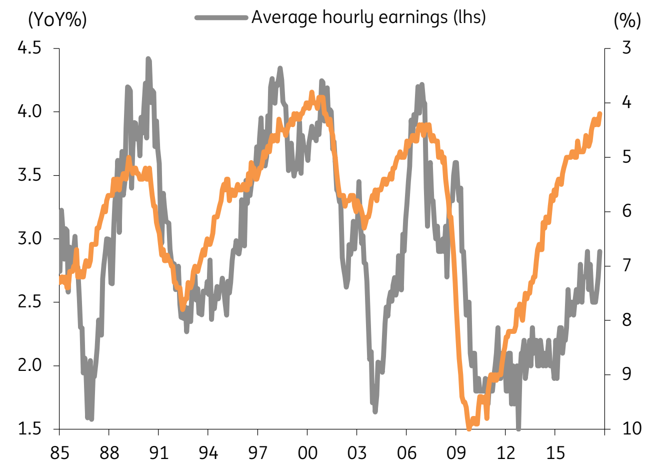
… although infrastructure spending remains a long way off

If anything, there is upside risk for this figure given growing optimism on the prospect of meaningful tax cuts for individuals and businesses. If they are delivered it would provide a boost to consumption by increasing disposable incomes. Cuts to corporation tax and reforms to encourage companies to repatriate foreign earnings may stimulate domestic investment spending. These measures could also lead to special dividends and share-buybacks, which may add a further fillip to consumer activity. As yet, there has been no real news on the infrastructure spending President Trump promised on the election trail. This is more likely to be a late 2018/2019 story.

Inflation pressures are gradually picking up

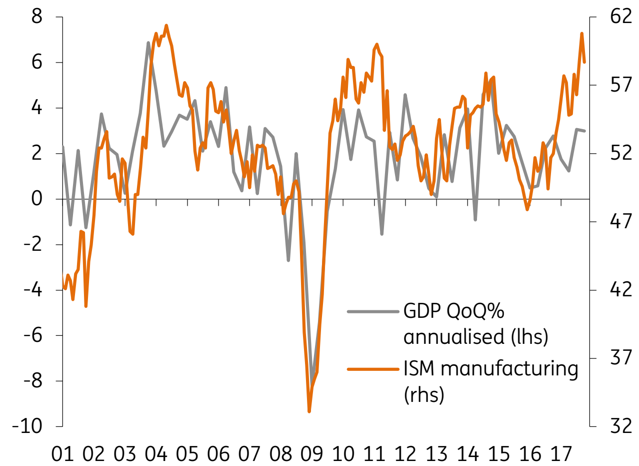
At the same time, there are tentative signs that inflation is starting to rise after having slowed through much of 2017. This is primarily a commodity story right now, but the lagged effects of dollar weakness and evidence of rising wages is giving us greater confidence that the Fed is right to assert that inflation will soon return to its 2% target.

Fig 1 Wages finally responding to jobs growth



Source: Macrobond

Fig 2 Business surveys highlight upside risks for growth



Source: Macrobond

A December interest rate rise is looking likely

These factors alone argue in favour of a December interest rate hike. Nonetheless, the Federal Reserve are broadening out the reasoning for tighter monetary policy, citing relatively loose financial conditions (softer dollar and fairly flat yield curve) whilst warning that "persistently easy monetary conditions" might have "adverse implications for financial stability". Caution over "somewhat rich" asset valuations also suggest an appetite for tighter monetary policy.

But the Fed could choose to delay should a failure to raise the debt ceiling lead to a government shutdown

The only factor that we see getting in the way of a rate hike next month is the potential for an economically damaging government shutdown. This would come in the absence of agreement to raise the debt ceiling. Previous instances of shutdowns prompted a sovereign rating downgrade, hundreds of thousands of workers being furloughed and equity markets falling sharply. If there is no agreement to raise the debt ceiling on Capitol Hill, the Fed could temporarily postpone the hike.

Mid-term elections may help focus politicians' minds

We are hopeful that politicians can set aside their differences and prevent such an unnecessary event from happening, either by raising the debt ceiling or agreeing to extend the current spending authority through fiscal year 2018. However, the latter would mean increased spending on the military being delayed. Failure by the 8 December deadline would not reflect well on the politicians involved, particularly with mid-term elections next year.

Jerome Powell will be the new Fed Chair and he may accept some loosening of financial regulations…

Assuming this situation doesn't materialise, the path of Fed policy next year is looking a little clearer now that Jerome Powell has formally been announced as President Trump's choice to take over from Janet Yellen. Yellen was reluctant to embrace Trump's vision of loosening financial regulation to boost lending and growth prospects. Her defence of the rules with comments like "material adverse effects of capital regulation on broader measures of lending are not readily apparent", will not have helped her case amongst Republicans who already wanted change.

… Janet Yellen was more reluctant to see changes

Powell, who had worked as Undersecretary of the Treasury for President George HW Bush, had hinted at a more relaxed attitude to the subject. He suggested in early October that "more regulation is not the best answer to every problem". With Randy Quarles appointed as the new Fed vice-chair for financial supervision, the new Fed management team is likely to be more accepting of a relaxation of lending conditions.

Powell and Yellen saw eye to eye on monetary policy, suggesting little change to the interest rate outlook

In terms of monetary policy Powell appears to be very similar to Yellen in both thinking and voting. So from a policy perspective the directives from the Fed's leadership are unlikely to alter markedly. He has never dissented at the FOMC meetings and is fully on board with the "gradual" increases in the Fed funds rate and the balance sheet shrinkage strategy.

We look for a December rate rise followed by two more hikes next year

Under the leadership of Powell we expect two more 25bp Fed rate hikes in 2018 rather than the three the Fed have currently pencilled in. This is mainly down to the Fed's balance sheet reduction strategy doing some of the heavy lifting to tighten financial conditions, reducing the need for hikes at the short-end of the curve. However, the balance of risks are skewed to more, not fewer hikes.

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Eurozone: Draghi nails it again

The expansion surprises in a positive way

The Eurozone economy has experienced a rocky recovery since the financial crisis, with a second recession on the back of the Euro Crisis. More recently though, the economy has shown a tendency to surprise positively. At the same time the ECB is anxious to avoid the mistakes it made in 2008 and 2011 when monetary policy was tightened at an unfortunate time.

Robust growth in 3Q and 4Q started on a strong footing

GDP growth came in at a fairly robust pace of 0.6% for the third quarter. The €-coin indicator, a good monthly proxy of the quarterly growth pace, stood at 0.72% in October. It was a similar story in the flash composite PMI indicator, which despite falling slightly in October, is still compatible with 0.7% QoQ growth.

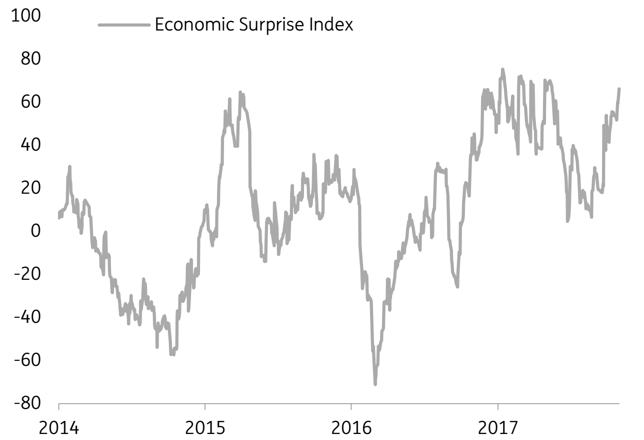
In terms of growth components, one can point to the fact that consumer confidence is now also at a level justifying an acceleration in consumption. At the same time the level of capacity utilization is pointing to further increases in business investment. This seems to be corroborated by the Bank Lending Survey, which signals net demand strengthening in all loan categories.

Political risks have not disappeared, but remain contained for now

Confronted with the amount of positive figures, the key question, as the OECD put it, is "can this short-term momentum be sustained? Could certain events shake confidence sufficiently to put the recovery at risk again? Well so far, the Eurozone has successfully weathered all recent political events, though it has to be said that nearly all of them, apart from Brexit, had a market-friendly outcome.

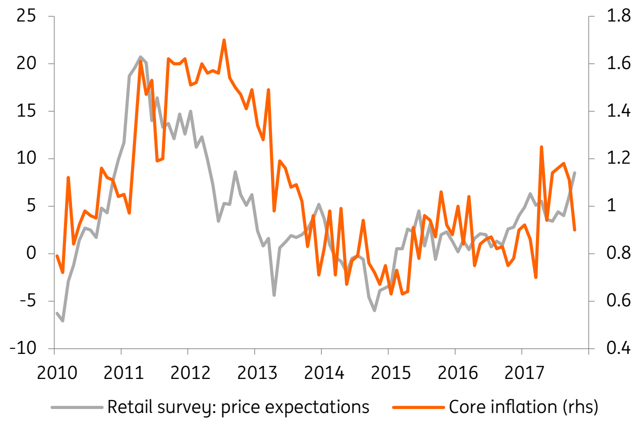
The current stand-off between the central government and Catalonia might affect the strength of the Spanish recovery to some extent, but the potential for contagion seems limited. Madrid has taken over the governance of Catalonia and called regional elections for 21 December. A recent poll shows that actually 55% of Catalans opposed a declaration of independence with 41% in favour. There is a genuine possibility that more regional autonomy might be granted within the Spanish state, but this is likely to be a slow process. At the same time, financial markets will closely follow the run-up to the Italian elections, likely to be held in the first quarter of 2017. But given the strengthening economy, the election campaign is likely to focus more on themes like immigration, rather than the Euro or the European Union.

Fig 3 The recovery surprises positively…



Source: Thomson Reuters Datastream

Fig 4 …while core inflation remains stubbornly low



Source: Thomson Reuters Datastream

Growth outlook revised upwards…

As the pace of structural reforms has slowed, potential growth in the Eurozone is still around 1.5% at best. But that doesn't exclude the possibility of seeing a number of years of above potential growth. For that reason, we feel confident enough to upgrade our growth forecast to 2.3% for this year, 2.0% for 2018 and 1.7% for 2019.

…while inflation remain contained

But inflation remains very subdued. Headline inflation fell back to 1.4% in October on the back of somewhat lower energy price growth. More surprising was the decline in core inflation to only 0.9%, with services inflation a mere 1.2%. While we believe that this is just a temporary blip and that inflation has troughed, it looks as if the upward trend will remain very gradual. Hence, the need for continuing monetary accommodation.

The ECB's dovish tapering announcement was well received…

The ECB was successful in making a tapering announcement actually sound dovish. By announcing a reduction of the monthly asset purchases from €60bn to €30bn from January to at least September 2018, Mario Draghi conveyed the "lower for longer" message to the markets. Importantly, the ECB also keep its easing bias in place and noted that QE remains open ended. Draghi even added that the programme will not stop suddenly, suggesting that there would be an additional period of tapering, extending the net asset purchases to at least the end of 2018.

…with the forward guidance delaying a first interest rate hike until mid-2019

That also shifts a potential rate hike further back in time as the ECB emphasized that key interest rates would remain at their present levels for an extended period of time, and well past the horizon of QE. We don't expect the first deposit rate hike before June 2019. In these circumstances, it was not surprising that the reaction on the bond markets was rather positive, despite the announced reduction in monthly bond purchases.

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UK: Just the start?

The Bank has implemented a historic rate hike

Just 15 months after implementing an emergency stimulus package, the Bank of England has taken the historic and fairly contentious step of increasing interest rates for the first time in 10 years. As the immediate economic and confidence shock of the Brexit dissipates, the Bank thinks there is less need for emergency stimulus.

The Bank will want to keep a lid on further sterling weakness

Privately, we also suspect that policymakers do not want to be the odd one out compared to the many other central banks who are moving away from ultra-loose policy. Recent Bank research suggests that the effect of exchange rate moves on inflation could be more persistent than previously thought, so the monetary policy committee (MPC) will probably want to limit further GBP weakness where they can.

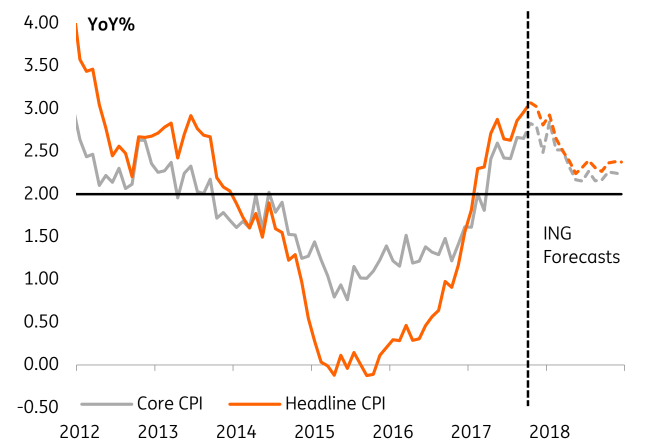
And they're saying more hikes are to come

The real question now is "what next"? Well, interestingly the Bank struck an unexpectedly cautious tone at its November meeting – no longer pointing to the fact that the curve is too flat. That implies that policymakers are comfortable with another hike towards the end of next year, with one more over the subsequent two years.

But the economy is still struggling

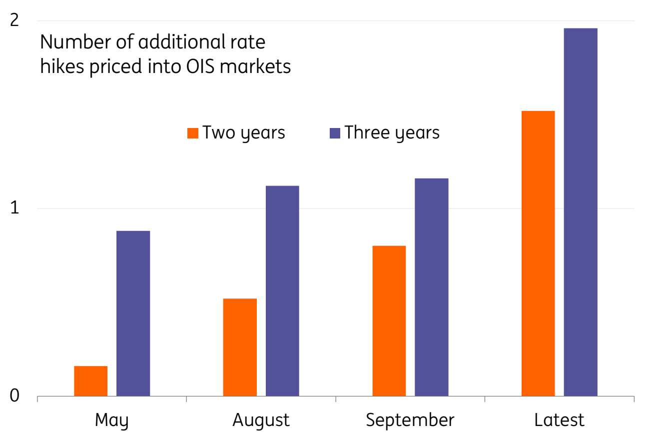
Based on that, we wouldn't rule out another move next year – although we're still not fully convinced. The economic backdrop is still fragile. Consumers are still cautious when it comes to discretionary spending, and even though inflation has virtually peaked, prices look set to continue to rise at a faster than wages for at least a few more months. On the latter, the Bank is still hopeful that the tight jobs market will translate into accelerated pay rises. But with given the considerable political uncertainty, and the fact that firm's margins are still being squeezed by higher import costs, suggests that wages may not pick-up as rapidly as the Bank is hoping.

Fig 5 Inflation is at its peak



Source: Macrobond, ING estimates

Fig 6 Markets have lifted their rate hike expectations



Source: Bloomberg

There has been some more positive Brexit noises

Then, of course, there's Brexit. Admittedly there has been some better news here lately. Whilst it only took the European Council 90 seconds to vote that there has not been "sufficient progress" to move negotiations forward, the bloc did agree to kick start the internal debate on trade talks, signalling that it hopes the EU-UK differences on exit costs and citizen rights can be resolved by the next Leader's Summit in December

The UK is reportedly open to compromise on the "exit bill"

There have also been some encouraging signs from the UK side that there may be room for compromise on the so-called "exit bill". According to *The Times*, Prime Minister May has privately indicated to European leaders that the UK is prepared to pay its future liabilities, and she has said publically that the UK is assessing the costs "line by line".

Trade talks look set to get underway after December

That gives us some confidence that talks will be able to move onto trade after the December summit, and that a transition period can be swiftly agreed. In principle, that should see the return of some delayed investment as we head into the new year, but there are still some reasons to be cautious.

But the government is still looking to get a deal by March 2019 – that's not long

The first stems from the fact that the UK government is still hoping to have the final Brexit deal wrapped up by March 2019 – which given the time needed for ratification, in practice means by this time next year. Given it took seven years to agree the EU-Canada deal, that's not long.

Firms will stay cautious under the details of any deal gets clearer

And until the direction of the trade talks gets clearer, the risk of "no deal" won't fully go away. Given that in all likelihood, the transition will be agreed before the details of the final trading arrangements, firms are likely to maintain an air of caution on more significant, longer-term investments in the UK. Put differently, the much-discussed "cliff edge" risk has been delayed, but not removed.

There are logistical challenges too

It's not just firms who worry about this, there are many logistical queues too. Many trade and customs have suggested that even a two year transition may not be enough to train the necessary staff and construct the required infrastructure to monitor the border.

We expect the Bank of England to ultimately tread carefully

So there's still a lot of "ifs", and until many of these uncertainties are cleared up, we suspect the Bank will continue to tread very carefully.

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China: 19th Congress Takeaways

Xi Jinping's New Era Socialism Thoughts allow continuity of deleveraging reform and anti-graft campaigns

The most important takeaway from the 19th Congress is that Xi Jinping has consolidated his power in the Party. Moreover, he did not name any successor. This indicates he has not found anyone that can implement Xi Jinping's New Era Socialism Thoughts (Xi's Thoughts) that have been put into the Party's Charter. In other words, Xi will have a longer tenure. We believe that "Xi Jinping New Era Thoughts" now represents the bible of the Communist Party, and this will allow Xi to implement political and economic reform even more easily.

Growth of the middle income class wealth through technology is the key for growth during 2020-2035

This has very significant meaning for the economy. Xi's Thoughts are in fact to grow the middle-class's wealth using technological means. As expressed in the opening speech, technology will be the centre of economic growth in the coming 15 years, via consumption, education, investment and even military power.

As Xi has consolidated power in the Party, it is also very clear to us that the anti-graft campaign will continue, which is positive for China's long-term growth. Xi used an hour of his speech to stress that there is a zero tolerance towards corruption within the Party, and there will be new laws to penalise corrupt behaviour. During the anti-graft campaign, there are likely to be changes in top management in SOEs, who are party members.

The continuation of economic reform also means that deleveraging will continue. We expect tight, if not tighter liquidity will continue in the years to 2020. It seems to us that by 2020 deleveraging reform would be largely completed in the corporate sectors but may start see higher risks in local government debts in order to raise living standards in rural areas.

Fig 7 The economic plan from Xi's 19th Congress speech

Source: ING

High-tech will become the main driver of economic growth

Consequently, by 2020, technology will play an increasing role as an important driver of economic growth (as cutting supply will no longer be appropriate). Without high-tech as the engine, it will be very difficult to increase the proportion of the middle-income class and to narrow living standards between urban and rural households.

Executing the plan means economic growth would be of higher quality

Anti-corruption would bring underground activity into GDP calculations, which will raise measured GDP. Furthermore, technological growth will bring more investment, production and consumption. Although Xi did not hint at any GDP growth target, executing the plan means economic growth would be of higher quality.

The government needs to build a complete social security system, and this involves fiscal reform

China has the ability to achieve this plan. But there is a risk that wages could stagnate outside the high-tech sector, slowing growth. Though the economy is set to be more consumption-based, workers in the service sector are usually among the more poorly paid. A more complete social security system across the whole nation could be one answer to this issue, but it would be very challenging given the current tax revenue sharing between central and local governments. In other words, the central government needs to implement fiscal reforms.

China could become the economic world leader sooner than Xi's vision

In our opinion, Xi's plan for 2035–2050 is an understatement. Between 2035 and 2040 China's input as an international economic and political leader will be clear if the economy follows closely the plan of 2020-2035. We do not need to wait until 2050 for this to happen. That suggests that somewhere between 2035 and 2050, the CNY will be used internationally just as other major currencies today. As a first step in that direction, the PBoC may start intervening less frequently in intraday FX markets.

External crises and protectionism may be hurdles for growth

One hurdle to the whole plan is that any external crisis may divert economic growth from the trend growth path. Another is that China's elevation in the ranks of global economic importance may induce protectionism from other big economies. And internationally, China's a rising military power could strike a nerve of its neighbours and other global powers.

Xi's consolidation of power poses its own risks to the economy. If the wrong decisions are made within the small group of people with absolute power, then this will put economic growth at risk. How quickly the government could correct any wrong decision will be critical to future growth.

Overall we are optimistic on Xi's plan

All in all, we are positive on China's long term growth, and keep our growth target at 6.8%, 6.7% and 6.7% for 2017-2019, respectively. With stronger fundamentals and rising foreign reserves, we believe that a stronger CNY is very likely. Our forecast on USDCNY is 6.5, 6.3 and 6.2 by the end of 2017, 2018 and 2019, respectively.

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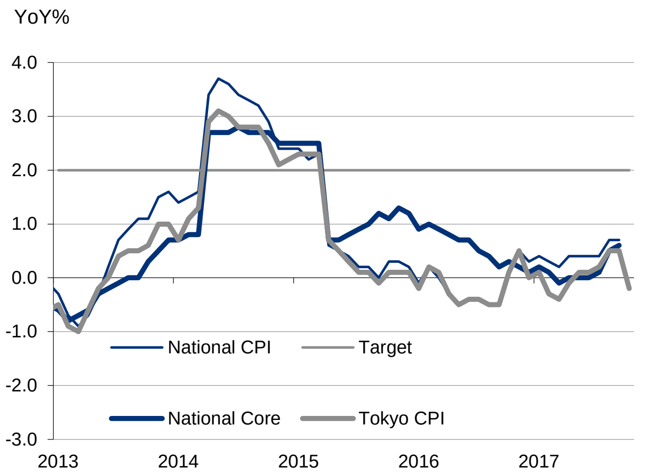
Japan: Carry on as before

He gambled, he won, but what does Abe do now?

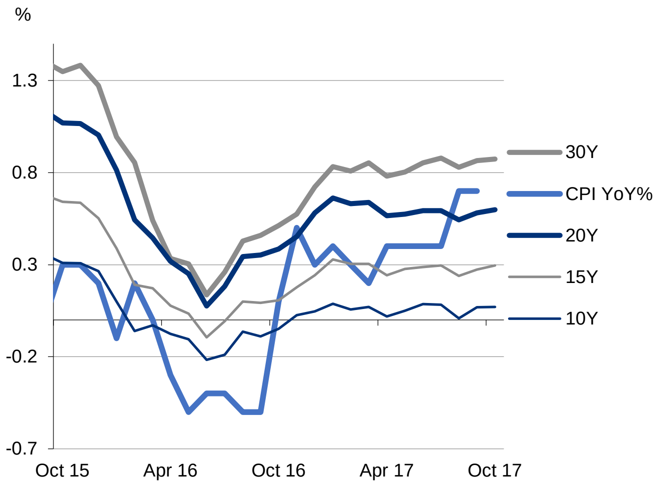
PM Abe gambled with the snap election in October, and it paid off, thanks to the lack of any credible opposition. Given that this was not far off a one horse race, the LDP should have done better. They in fact lost 6 seats of the 465-seat House of Representatives, winning 284 seats. But together with the 29 seats of their coalition ally, Komeito, this was enough to secure a two-thirds "supermajority" (310 seats needed, 313 seats won).

Fig 8 CPI inflation – one step forward, two steps back



Source: CEIC

Fig 9 Benchmark gov't bond yields and inflation



Source: CEIC, ING

The reallocation of consumption tax revenue is of marginal importance…

The question for Abe is what he does with this mandate for power. As we wrote last month, the notional excuse for holding a snap election was to re-apportion some of the prospective revenues from a 2019 Consumption tax hike to fund education, in particular pre-school child care to encourage female labour participation post child-birth. While perhaps laudable, this is fairly marginal in terms of the economic effect, given that Japan doesn't rank too lowly in terms of female participation compared to some of its G-7 peers.

…and will likely be lost in the noise of the dataflow

The proposal will deliver some JPY2tr (or 0.4% GDP) of additional spending, which in theory should be added onto our GDP forecasts. We find that such fiscal expansion in Japan tends to have a less than unitary multiplier (ie, you get less than you pay for) in GDP terms, and have since last month, incorporated a small boost to spending through spending on structures, whilst amending personal consumer spending lower, for a net effect of about half the JPY2tr stimulus.

Constitutional reform is now on the cards to change Japan's pacifist constitution

More likely though, this was all about revising the pacifist constitution, namely Article 9, though this would also require a referendum. Polls conducted earlier this year indicate that any such referendum would be extremely close, though the recent resurgent North Korean threat will likely have shifted opinion towards a constitutional change.

The BoJ are missing their target still, but nothing is likely to change

Besides this, nothing much has changed. The BoJ have just met and left policy unchanged, though their new member, Kataoka continues to dissent, arguing for a sub 0.2% target on 15Y JGBs. We can't see the logic or benefit of such a move. That said, Japan continues to miss its inflation target, and the headline inflation rate for Tokyo took a dive in October – the national CPI figures look almost certain to follow suite when they are released next month. In our view, it is not the policy stance that is the problem. The problem is an inappropriate target.

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FX: Divided on the dollar

Market opinion is split on the future path of the dollar

Market opinion is split on the future path of the dollar. Some are of the view that US activity and the extent of Fed tightening are being under-priced in 2018. Others are wary that the Trump administration has overseen an 8% year-to-date decline in the dollar – and that a stronger dollar won't be part of Donald Trump's 2018 play-book. We side with the latter camp, retaining the view that some modest Fed tightening, at a time of synchronised global growth, will not be enough to trigger a fresh bull run in the dollar.

October marked the second month of consolidation for EUR/USD. Marginally lower levels were seen after US short-dated rates pushed another 15bp higher and President Draghi managed to deliver dovish ECB tapering after all.

The market is under-pricing the extent of Fed tightening....

... a strong headwind to our baseline story of a higher EUR/USD by end-2018

Our US team agree that the market is under-pricing the extent of Fed tightening. Short-dated US rates could rise another 10-15bp if the market shifts to fully pricing Dec 17 and two further 25bp rate hikes in 2018 (our baseline view). A viable Trump tax plan could see the market move towards pricing three hikes in 2018. Clearly such a move would present a strong headwind to our baseline story of a higher EUR/USD by end 2018.

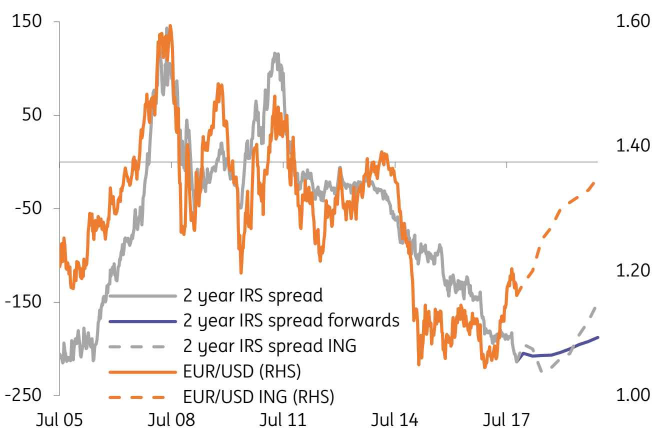
That said, the dollar needs to overcome a potential US debt ceiling impasse in December and potentially a pick-up in protectionist rhetoric into November 2018 mid-terms. We would also argue that any progress on US tax reform that encourages corporate repatriation of overseas earnings does not need to trigger a broad USD rally. Undoubtedly it would be good for US equities, but overseas earnings are already in USD.

We prefer to back the ECB normalisation story (the 2006-2007 EUR/USD story if you will

Instead we prefer to back the ECB normalisation story (the 2006-2007 EUR/USD story if you will), where after Italian elections probably in March 2018 and at a time of a recovering Eurozone activity, the market once again starts to speculate over the end of ECB PSPP in late 2018 and front-run the first adjustment in ECB policy rates in 2019.

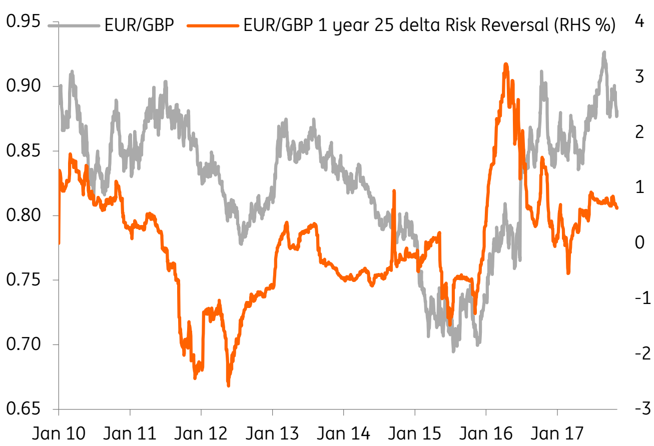
If we're wrong and USD rates have a greater say in EUR/USD pricing, we would see EUR/USD staying closer to 1.15 for a larger part of 2018. But the 1.10 level looks too low.

Fig 10 ING's EUR/USD view – battling with spreads



Source: Bloomberg, ING

Fig 11 GBP back from the brink...



Source: Bloomberg

GBP could enjoy some further upside into December

Elsewhere GBP has managed to recover from the lows, buoyed by the first BoE rate hike and some very cautious optimism on the Brexit process. Sentiment in the FX options market has not changed much over recent months, but we suspect GBP could enjoy some further upside on the view that a Brexit divorce bill does get signed in December.

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Rates: In denial

We find that the US 2yr yield trades quite rich versus the Fed's telegraphed rate hike ambition

Markets continue to struggle with the notion that this is a rising rates environment, in particular with respect to US rates. The Federal Reserve has effectively communicated an ambition to hike the funds rate by four times in the coming 12-15 months (including a December hike). Yet the 2yr yield sits at 1.6%, a mere 35bp above the fed funds ceiling. At best the market is discounting half of the Fed's rate hike ambition.

The 1/12mth money market curve is also exceptionally flat, based off a similar rationale

We think the Fed will hike in December and at least a couple of times next year. That would lift the fund rate ceiling to 2% within the coming 12 months, and thus 40bp above the current 2yr yield. Clearly the breakeven implicit in the 2yr yield is quite poor relative to that prognosis. We also find the money market curve is far too flat, with the 1/12mth at 50bp and thus quite deviant from Fed hike promises.

Meanwhile the 10yr continues to trade with a zero term premium, while the 5yr trades rich on the 2/5/10yr fly

If we progress further out the curve the valuation story does not get much better. The 5yr yield continues to trade a tad rich on the 2/5/10yr fly, and the 10yr yield continues to trade with a zero term premium. The only part of the curve that is close to offering value is the ultra-long end, with the 30yr in the value zone on any re-approach of 3%. Beyond that it is difficult to get enthused about valuations further down the curve.

Inability of the US to generate inflation has been a central underpinning to low market rates

One of the reasons for the rich valuations from 1mth to 10yr is inability of the US economy to generate inflation. While we are of the opinion that inflation is on a trend higher, that is just a forecast. The experience so far in 2017 has been one of frustration for inflation bulls. So far this year it has not paid to bet against the Fed in terms of hikes, but it has paid to bet against the Fed's inflation expectations.

In consequence there is virtually no inflation risk premium priced

This is the central rationale for the maintenance of quite a flat curve. The 10yr has been supported by a lower need for an inflation risk premium. This can be seen in its purest sense from the US inflation swap curve, which is virtually flat at 2%. Not only is this quite a benign inflation expectation, but there is no inflation term premium either. Only actual inflation prints to the upside will change this it seems.

And the flows have in fact been skewed to the long side, helping to flatten the curve from the back end

As a consequence, the flows in the past 4-6 weeks have been skewed to the long side. Assets under management in long end core bonds are up some 4% over this period. The weight of these flows have prevented the 10yr Treasury from breaking above 2.5% and the 10yr Bund from breaking above 0.5%. Indeed the approach of these levels have been seen as buy-signals, based off prior trading ranges.

Even the ECB's taper has been overshadowed by the lengthening of the program

The glass half full prognosis has also been seen from the reaction to the latest ECB quantitative easing adjustment, where the focus has been on the extension rather than on the taper. And the follow-through has been a further compression in what are already tight spreads, a theme that has extended right through investment grade market, from Eurozone sovereign spreads to corporate spreads.

That said, macro factors and QE unwind point to eventual pressure for higher rates

That all being said, the macro circumstances are also solidifying, both in the US and in the Eurozone. On top of that the technical underpinning coming from QE is by definition to wane as we progress through 2018, especially as the Fed engages in balance sheet unwind. This combination leaves ample room for a 30bp uplift to occur in both 10yr Bunds and 10yr Treasuries in the coming months.

But that needs validation from inflation, which is why these are the key data ahead

We maintain our view that inflation prints are the most important to monitor in the coming months. Payrolls will come and go but the only real call out there is on inflation. A solid 2-handle for inflation means the funds rate must match this at the very least. That's the crucial underpinning for the eventual evolution to higher rates.

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Fig 12 ING global forecasts

	2016					2017F					2018F					2019F				
	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)	0.6	2.2	2.8	1.8	1.5	1.2	3.1	3.0	2.8	2.2	2.6	2.5	2.6	2.7	2.7	2.7	2.6	2.7	2.6	2.6
CPI headline (% YoY)	1.1	1.1	1.1	1.8	1.3	2.5	1.9	2.0	2.4	2.2	2.3	2.4	2.6	2.3	2.4	2.3	2.2	2.2	2.3	2.3
Federal funds (%, eop)[1]	0.25	0.25	0.25	0.50		0.75	1.00	1.00	1.25		1.25	1.50	1.50	1.75		1.75	2.00	2.00	2.25	
3-month interest rate (%, eop)	0.62	0.65	0.81	1.01		1.15	1.30	1.35	1.55		1.60	1.85	1.90	2.10		2.20	2.35	2.45	2.60	
10-year interest rate (%, eop)	1.77	1.47	1.59	2.44		2.40	2.30	2.30	2.60		2.70	2.80	2.90	2.90		3.00	3.10	3.20	3.20	
Fiscal balance (% of GDP)					-3.2					-3.5					-3.0					-3.3
Fiscal thrust (% of GDP)					0.0					0.0					0.5					0.6
Debt held by public (% of GDP)					76.8					76.3					76.5					76.6
Eurozone																				
GDP (% QoQ, ann)	2.1	1.2	1.9	2.5	1.8	2.2	2.6	2.4	2.2	2.3	1.8	1.7	1.8	1.8	2.0	1.6	1.6	1.6	1.5	1.7
CPI headline (% YoY)	0.0	0.0	0.3	0.7	0.3	1.8	1.5	1.4	1.3	1.5	1.2	1.4	1.4	1.5	1.4	1.5	1.7	1.7	1.8	1.7
Refi minimum bid rate (%, eop)	0.05	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	0.25	0.25
3-month interest rate (%, eop)	-0.22	-0.26	-0.30	-0.31		-0.33	-0.33	-0.33	-0.33		-0.33	-0.33	-0.33	-0.33		-0.25	-0.15	0.00	0.10	0.10
10-year interest rate (%, eop)	0.15	-0.13	-0.05	0.30		0.45	0.40	0.45	0.45		0.50	0.60	0.70	0.75		0.80	0.90	1.00	1.10	1.10
Fiscal balance (% of GDP)					-1.5					-1.4					-1.3					-1.1
Fiscal thrust (% of GDP)					0.1					0.3					0.3					0.0
Gross public debt/GDP (%)					91.5					89.8					88.5					87.1
Japan																				
GDP (% QoQ, ann)	2.8	1.7	1.0	1.4	1.0	1.1	2.5	0.9	2.6	1.5	1.5	0.8	1.3	0.0	1.4	6.5	-4.1	1.0	0.8	1.2
CPI headline (% YoY)	0.1	-0.4	-0.5	0.3	0.8	0.2	0.4	0.6	0.2	0.4	0.7	0.5	0.7	0.8	0.7	0.9	2.4	2.3	2.3	2.0
Excess reserve rate (%)	-0.1	-0.1	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.00	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
3-month interest rate (%, eop)	0.09	0.06	0.04	0.02		0.05	0.05	0.05	0.05		0.05	0.05	0.05	0.05		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	
Fiscal balance (% of GDP)					-5.9					-5.3					-5.0					-7.1
Gross public debt/GDP (%)					212.0					213.0					213.0					212.0
China																				
GDP (% YoY)	6.7	6.7	6.7	6.8	6.7	6.9	6.9	6.8	6.7	6.8	6.7	6.6	6.7	6.7	6.7	6.8	6.8	6.6	6.6	6.7
CPI headline (% YoY)	2.1	2.1	1.7	2.2	2.0	1.4	1.4	1.6	1.5	1.5	1.5	1.5	1.6	1.7	1.6	1.7	1.8	1.9	2.0	1.9
PBOC 7-day reverse repo rate (% eop)	2.25	2.25	2.25	2.25	2.25	2.45	2.45	2.45	2.45	2.45	2.45	2.55	2.55	2.65	2.65	2.65	2.65	2.75	2.75	2.75
10-year T-bond yield (%, eop)	2.89	2.88	2.75	3.06		3.29	3.57	3.61	3.80	3.80	4.00	4.10	4.10	4.00	4.00	3.80	3.90	4.00	4.10	4.1
Fiscal balance (% of GDP)					-3.8					-3.5					-3.5					-3.5
Public debt (% GDP), incl. local govt.					60.4					50.0					52.0					54.0
UK																				
GDP (% QoQ, ann)	0.6	2.4	2.0	2.7	1.8	1.0	1.2	1.6	1.1	1.5	1.1	1.6	2.1	1.8	1.4	2.1	2.1	1.7	2.2	2.0
CPI headline (% YoY)	0.3	0.4	0.7	1.2	0.7	2.1	2.7	2.8	3.0	2.7	2.7	2.3	2.3	2.4	2.4	2.6	2.5	2.5	2.5	2.5
BoE official bank rate (%, eop)	0.50	0.50	0.25	0.25	0.25	0.25	0.25	0.25	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
BoE Quantitative Easing (£bn)	375	375	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	0.60	0.30	0.40	0.40	0.35	0.35	0.35	0.60	0.60	0.60	0.60	0.60	0.60	0.60	0.60	0.60	0.60	0.60	0.60
10-year interest rate (%, eop)	1.50	1.60	1.75	1.30	1.30.	1.15	1.10	1.35	1.40	1.40	1.40	1.45	1.50	1.50	1.50	1.60	1.60	1.70	1.70	1.70
Fiscal balance (% of GDP)					-2.3					-2.5					-2.5					-2.3
Fiscal thrust (% of GDP)					-0.6					-0.5					-0.4					-0.4
Gross public debt/GDP (%)					86.5					89.2					89.6					89.5
EUR/USD (eop)	1.05	1.11	1.12	1.05		1.08	1.12	1.20	1.18		1.20	1.25	1.27	1.30		1.31	1.32	1.33	1.35	
USD/JPY (eop)	112	103	101	112		112	115	110	114		114	114	114	115		115	115	112	110	
USD/CNY (eop)	6.45	6.65	6.67	6.95		6.89	6.78	6.65	6.50		6.45	6.40	6.35	6.30		6.25	6.20	6.20	6.20	
EUR/GBP (eop)	0.80	0.84	0.88	0.87		0.87	0.88	0.94	0.88		0.88	0.88	0.88	0.85		0.83	0.82	0.81	0.80	
Brent Crude (US$/bbl, avg)	35	47	47	51		55	51	52	57		50	50	52	52		45	47	50	50	

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

Source: ING estimates

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