Will politics stop the Fed in its tracks?

Our answers to this month's big questions

THINK Economic and Financial Analysis
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Our top **six** themes this month

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#1 Will politics stop the Fed in its tracks?

#2 Who's hired? The runners and riders for next Fed chair

#3 Why one hike from the Bank of England in November might be it

#4 Is populism on the return? Latest on elections in Austria, Germany and Italy

#5 "No bail-out" vs. fiscal union: The debate on the future of the Eurozone

#6 What is happening with EUR/USD and USD/JPY?

We're looking for another Fed hike in December…

Political risks
Debt ceiling deadline clash with December meeting could cause market volatility at tricky time for the Fed.

Wages
The tight labour market and increasing job-to-job flows should continue to push up wage growth, but this will take time. Avg. hourly earnings is unlikely to push above 3% this year.

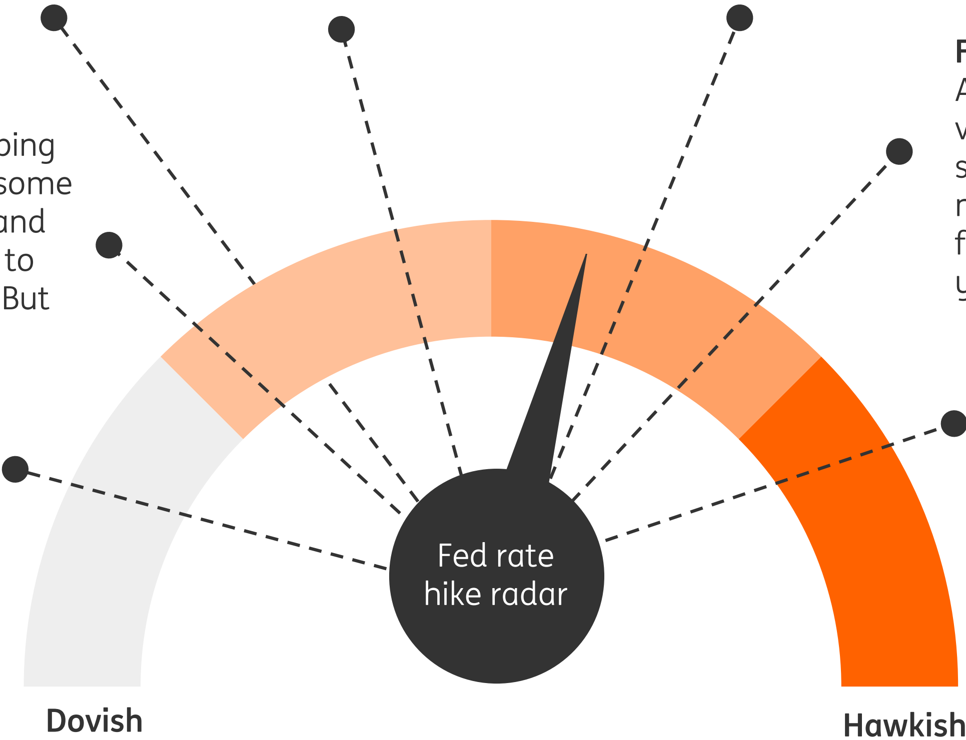
Growth
Confidence remains buoyant, despite fiscal policy disappointments and recent hurricanes. 3Q Growth should again come close to 3%, mainly led by a big pick up in inventories

Inflation
Core PCE at 1.3% is not helping the Fed's cause. There are some temporary factors at play and we expect dollar weakness to help core inflation recover. But this will take some time.

Financial conditions
A range of key metrics – volatility (VIX), credit spreads, stock prices and bond yields to name a few – all point to financial conditions at multi-year lows.

Market expectations
Markets are still unconvinced about the Fed's 2018 hike plans, given low inflation and politics.

Asset prices
Fed voters have recently pointed to stretched asset valuations, as a way of broadening out reasons for hiking rates. Yellen has described asset prices as "somewhat rich"



Debt ceiling deadline to come at a tricky time for the Fed

As little as **two days** between Fed meeting and debt ceiling deadline

13 December

December
Fed
Meeting

15 December

Debt ceiling
Deadline
(Current estimate)

The US debt ceiling was raised in the aftermath of the hurricanes and the new deadline looks set to fall just after the December Fed meeting.

If there is no agreement to raise the debt limit, the US government will be unable to borrow money. In the past, we have seen hundreds of thousands of workers furloughed because of this.

During the 2013 crisis the US lost its AAA rating with S&P and the Dow Jones equity index fell 17%.

If this results in significant market volatility, the Fed may opt to defer a rate hike into 2018.

Who's hired? The runners and riders for the next Fed Chair

Kevin Warsh
A former Fed Governor, he supports Trump's tax plans, but also has a history of being more hawkish and he has offered some backing to the Taylor rule.

The perception is that he could be less interventionist and more in favour of tighter policy than Yellen.

Jerome Powell
A current Fed Governor, he is the continuity candidate should Trump decide against re-appointing Janet Yellen.

He is likely to be of a similar mind set on the interest rate outlook to the current incumbent.

Gary Cohn
Director of the National Economic Council and a key play in Trump's tax agenda. He's perceived as a less likely choice, but in the past he has criticised the Fed for talking too much. If appointed, he's also likely be less interventionist

Janet Yellen
Historically viewed as having more dovish leanings, this has been less evident recently. She is keen to maintain financial regulation standards and would likely fight back against President Trump's efforts to water them down.

President Trump has said he will choose the next Fed chair in the next 1-2 weeks

Achieving “sufficient” Brexit progress

What’s currently preventing Brexit talks from moving onto the next stage.

“Divorce” bill + Irish Border + Citizen rights = Sufficient Progress

“Divorce” bill

This is the major sticking point. Germany and France in particular are reportedly keen to yield further financial commitments from the UK.

See the next slide for more info

Irish Border

The UK proposes a continuation of common travel, and wants to avoid a ‘hard border’. The Northern Irish secretary has noted that most trade is local not international over the border.

But there are still questions about how trade and labour movement will be monitored after Brexit.

Citizen rights

The UK has said that EU citizens who have been resident for at least five years will be able to apply for settled status. But the EU wants wider-reaching guarantees, including on family immigration rights, before moving talks forward

Oct 19 — European Council Summit

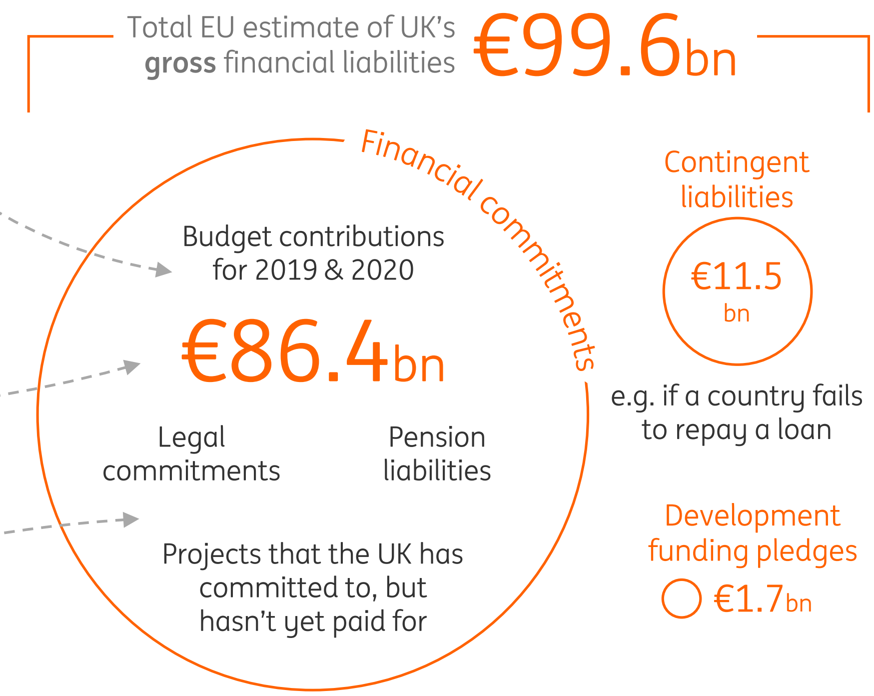
Key vote on whether enough progress has been made on issues like exit costs and citizen rights to move onto trade talks.

The “divorce bill”: The key areas of disagreement

Although the UK is willing to honour its budget commitments, this is contingent on the UK retaining single market access in the transition. This latter point is reportedly more contentious in Europe.

There's also the contentious issue of whether the UK's rebate, negotiated by Margaret Thatcher, should be included - and by extension, whether the UK should continue paying for farm subsidies, which the rebate was originally linked to.

The big sticking point is that the European side wants further commitments to honour longer-term costs, including pension liabilities, legal commitments and contingent liabilities, set aside in case a member state defaults on a loan.

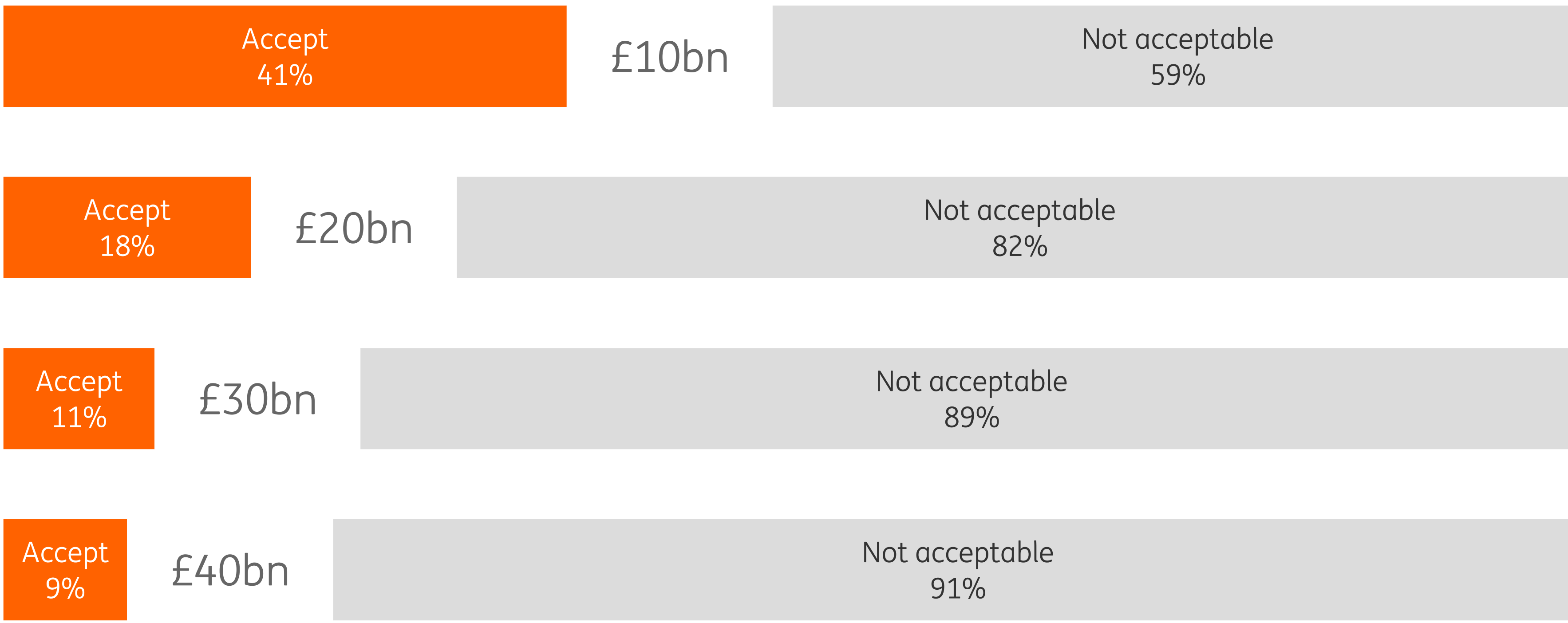


Source: Guardian, FT

Exit costs are also contentious in the UK…

Idea of an exit bill will be a tricky political issue to navigate in the UK

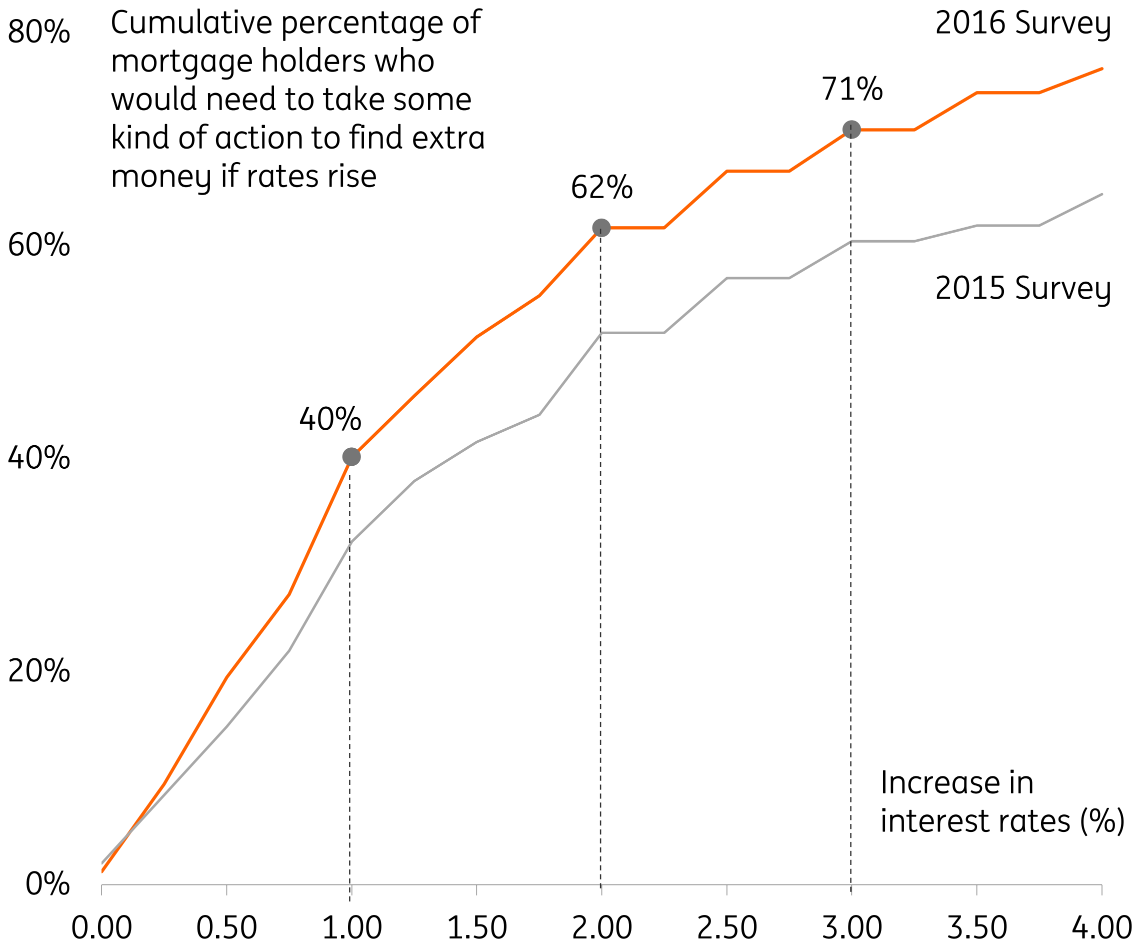
Would the following amounts be acceptable or not as a one-off exit fee, as the UK's contribution to spending commitments made by the EU when the UK was a member?



Source: Guardian/ICM poll

Household debt a key reason to tread carefully on rates

Around 40% of variable mortgage holders would need to raise extra cash if rates went up by 1%



Source: Bank of England 2016 NMG Survey
Survey answers based on those with variable, discounted or tracker mortgage. ING calculations

Consumer spending has been on a rollercoaster ride since Brexit. But there's been one constant through all of it: borrowing.

Unsecured lending, fuelled in no small part by car financing, has continued to rise at a near-10% rate and has underpinned spending as real incomes have fallen.

With consumer spending already fragile, the Bank will be keen to tread carefully as it begins hiking rates.

So will the Bank of England hike rates?

We only currently expect one or two rate hikes from the Bank

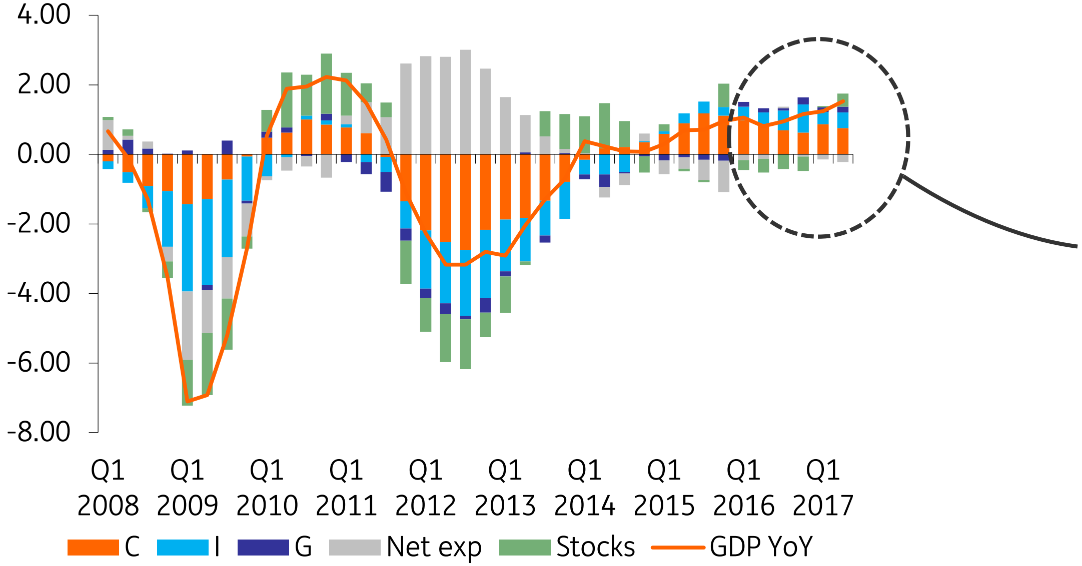
The Bank of England's increasingly hawkish tone means that a rate hike increasingly looks like a question of "when" and "how much", rather than "if".

The choice of the phrase "next few months" to describe rate hike timing puts November firmly on the table.

It seems the Bank is very keen to get out of "emergency mode" as the initial shock of Brexit subsides. It also seems that the committee is trying to be more forward-looking given the lags involved with tightening policy.

But there's also likely a desire to avoid being left in the dust by the global race to tighten policy, as a result amplifying the pound's weakness. But whilst we're now penciling in a November hike, we think the chances of a series of hikes thereafter are low.

Better Italian growth outlook ahead of key 2018 election



1.5% Economic growth in the second quarter

The economy is looking in better shape, albeit still lagging the rest of the Eurozone.

Domestic demand is a key driver, but exports have been better too.

Investment has been recovering, and new orders data point to a bigger contribution from machinery in coming months.

The latest on the election

There's a last attempt to reform the electoral law ahead of an election in the Spring of 2018 – although the timing of an approval may be affected by a regional vote in Sicily in early November. This could also affect the choice of alliances at a National level.

If there's no agreement on the law, Italians will vote using a quasi-proportional system, following two earlier separate rulings by the constitutional court.

Based on recent opinion polls, no party would win a clear majority. The formation of a new government would therefore call for some form of enlarged coalition.

The ECB's options for tapering

'Lower for longer' scenario likely to be announced at the October meeting

1

Fed Style

Gradual tapering with linear scaling-back of asset purchases on a monthly or quarterly basis – the latter being more flexible.

2

Staircase

Reduce QE purchases by €20bn in January, keep them unchanged until June then reduce by another €20bn in September.

3

Lower for longer

Reduce monthly purchases by more than markets currently expect to €20/25bn whilst simultaneously extending QE until the end of 2018.

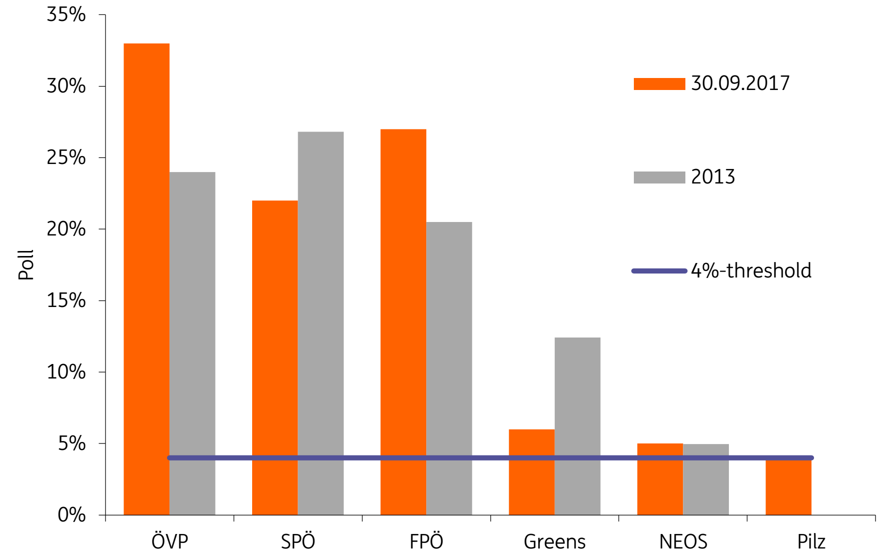
We think the ECB will opt for the **'lower for longer'** option as it follows the pattern of the 2016 tapering decision, but also could help anchor interest rate expectations and immunise against further exchange rate moves.

Austrian elections could bring double precedent

In less than a week, Austria will hold an early parliamentary election

Who will win the race?

- Most likely candidate is Foreign Minister Sebastian Kurz' ÖVP.
- No party has committed itself to a coalition partner. With the FPÖ scoring well in polls, the party might tip the scales.
- Kurz is not thinking of forming any coalitions but to instead work on shared visions with as many parties as possible (French-styled model).



Source: Spectra/OÖN, Neuwal

The Austrian election could be an interesting hint for the Eurozone

- Election could be an example of how a Macron-like movement can happen within an established party.
- The next stage of populism with a populist party could be potentially re-joining the government.
- Austrian growth should continue as all party programmes imply more stimulus. But tensions between the EU and Austria might heat up with all parties trying to restrict labour market access.

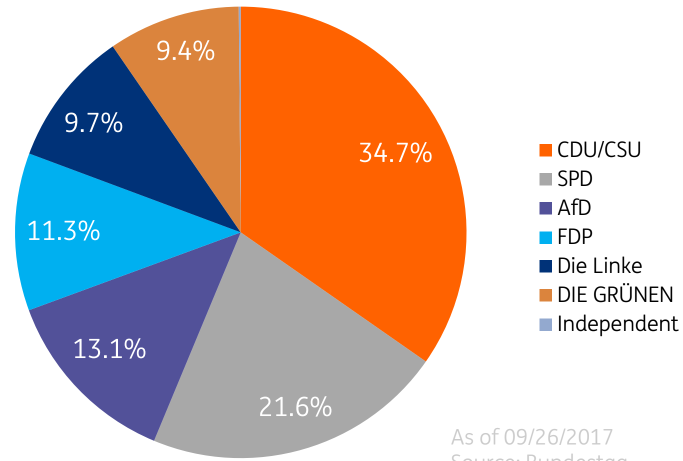
Complicated Jamaica

Merkel wins a fourth term, but there's uncertainty over who she will form a coalition with

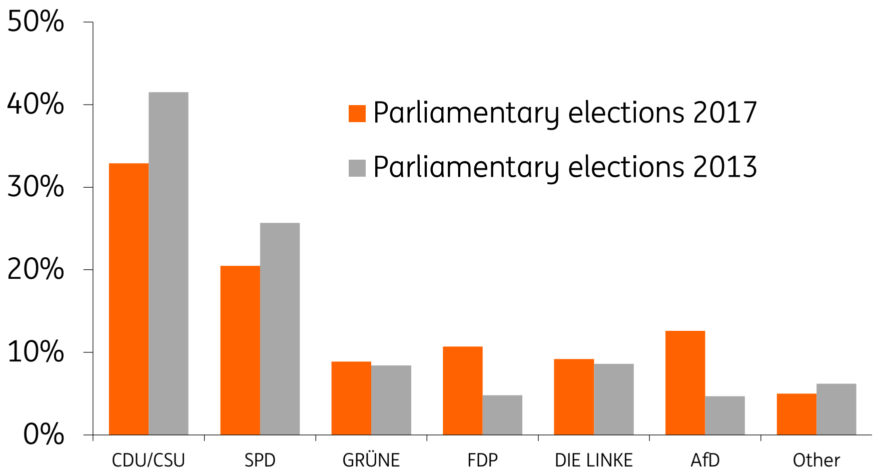
Merkel's fourth term starts with complicated coalition negotiations…

- Merkel's position has weakened - losses to her party, the current coalition party (SDP) and gains to the Afd.
- Debates about CSU's, Merkel's Bavarian sister party, future have started as many votes were lost.
- The SPD ruled out joining the next government, leaving the 'Jamaican' coalition (CDI/CSU, FDP and Greens) as the only option. Minority government is however unlikely.

Distribution of seats in the 19th German Bundestag



As of 09/26/2017
Source: Bundestag



Quelle: Wahlrecht, ING DiBa Economic Research

…Even though a Jamaica coalition could bring some fiscal stimulus

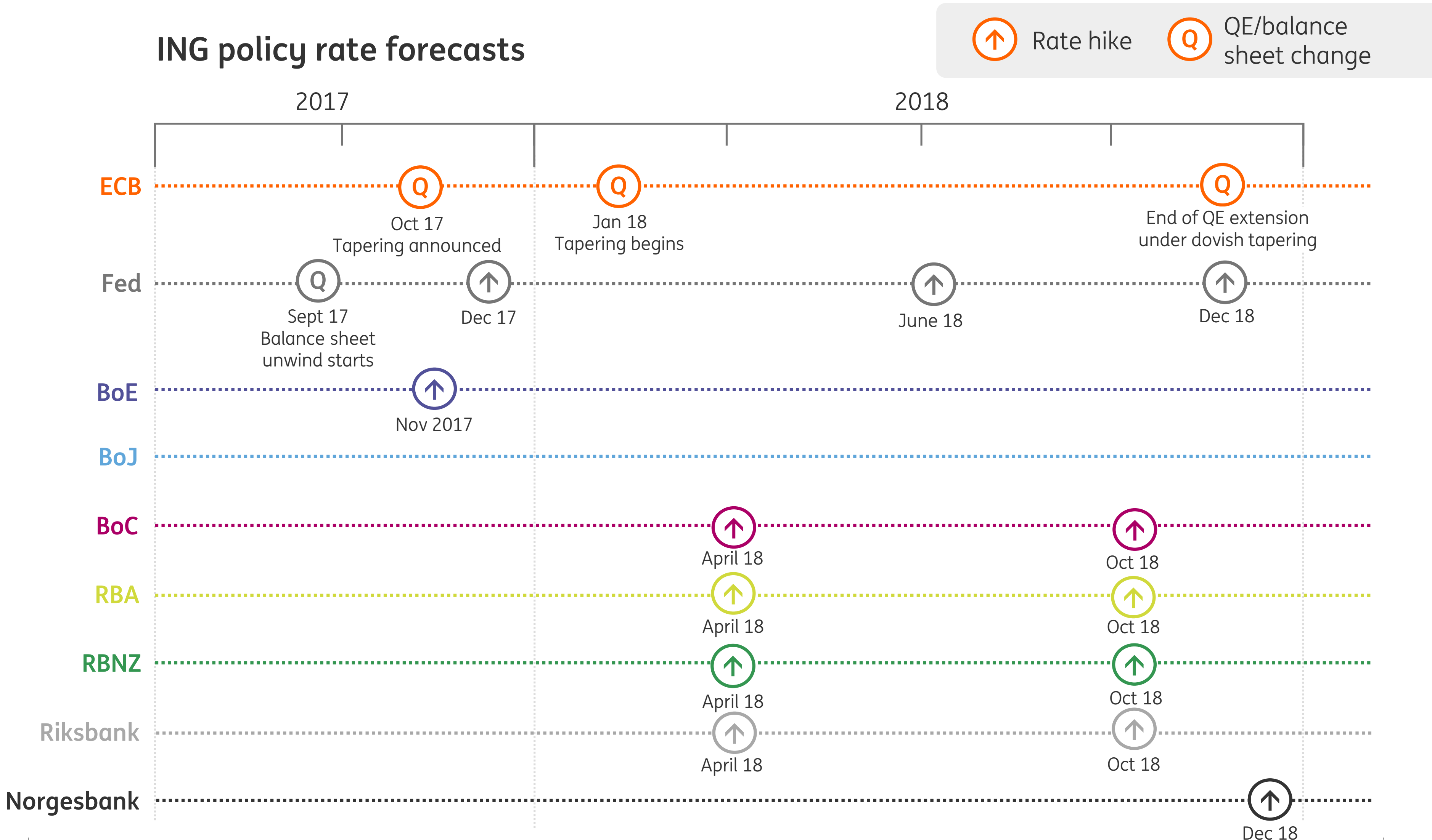
- Fiscal stimulus in the form of tax relief and investment spending.
- Potential conflicts regarding energy transition, refugees and automotive industry's future.
- Possible cold shower for Macron's Eurozone integration plans. At best, Germany could agree on a conditional "money for reforms" fiscal capacity and upgraded ESM.

The debate has begun on the future of the Eurozone

	Return to 'no-bail-out' union	Towards fiscal and political union
Characteristics	• Sovereign debt restructuring mechanism • Strict no-bail-out clause • Fully-fledged banking union • Make (temporary) exit from monetary union possible	• Limited fiscal sharing (project bonds) • Cyclical fiscal stabilization (rainy day fund, youth unemployment scheme) • Centralised decision-making • Banking union
Challenge	• No financial market discipline in good times • Market speculation about no-bailout and euro-exit • No-bailout clause hard to combine with SGP rules • Discontent electorate may opt for euro-exit • How to boost investment in with permanent exit threat	• How to convince "stronger" countries of necessity for fiscal transfers • Moral hazard

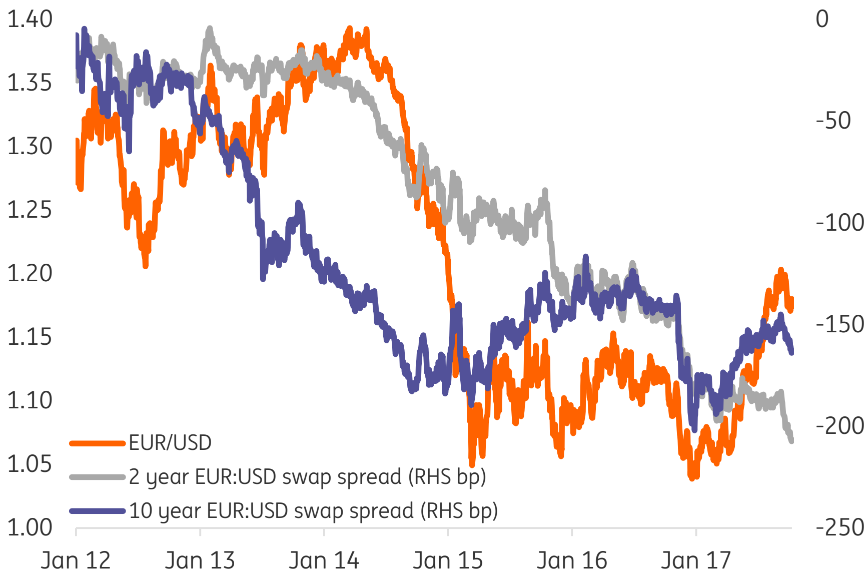
Most likely common denominator: "loans for reforms" fiscal capacity, banking union and morphing ESM into EMF

Who's next in line to tighten monetary policy?



FX: US rates drive USD correction, Korea risk starts to fade

EUR/USD versus 2 and 10 year spreads



USD/JPY 10 delta one year butterfly option (%)

Short-dated spreads have dragged EUR/USD lower from 1.20.....

...but the ECB meeting on 26 October should re-focus attention on 10 year-spreads, taking EUR/USD back above 1.20.

One gauge of N.Korea risk is a look at the USD/JPY options market. A 'butterfly' is a FX options strategy that looks to benefit from a major range break-out – in either direction.

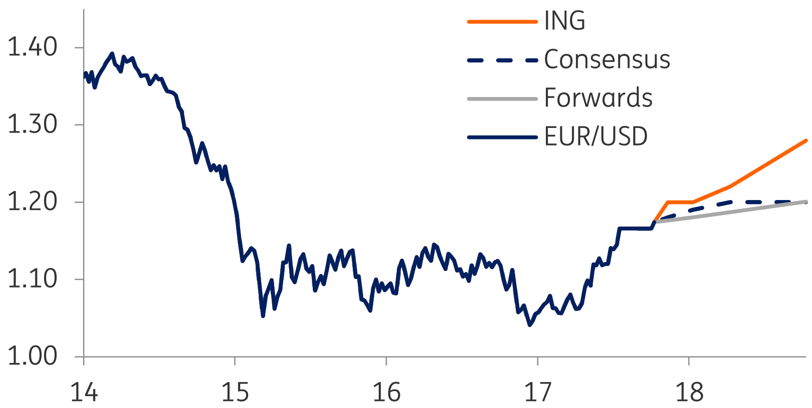
Prices have corrected lower over recent weeks, but remain off their lows.

Source: Bloomberg/ING forecasts

Our global forecasts

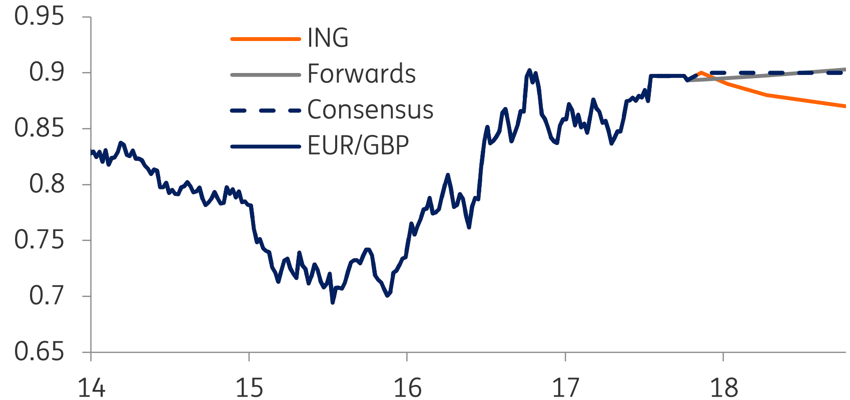
All data sourced from Bloomberg/ING forecasts

EUR/USD



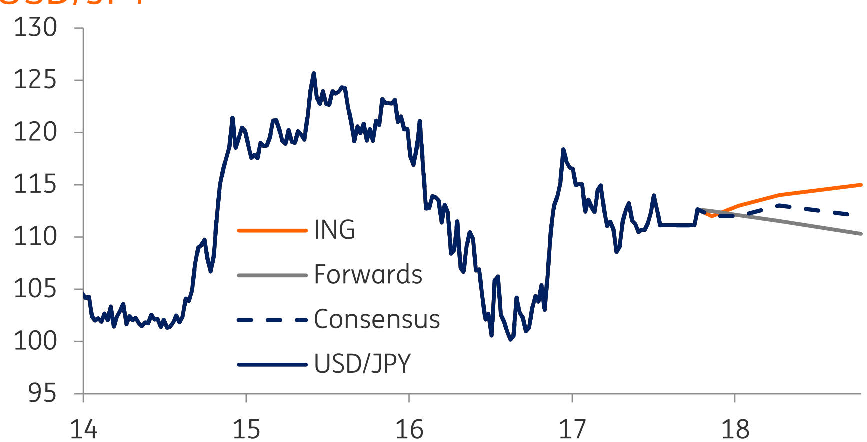
1M: **1.20** 3M: **1.20** 6M: **1.23** 12M: **1.27**

EUR/GBP



1M: **0.90** 3M: **0.88** 6M: **0.88** 12M: **0.85**

USD/JPY



1M: **112** 3M: **113** 6M: **114** 12M: **115**

Oil (Brent Crude)

4Q17: **45** 1Q18: **42** 2Q18: **42** 4Q18: **47**

Our global forecasts

	2017F					2018F				
	Q1	Q2	Q3	Q4	FY	Q1	Q2	Q3	Q4	FY
United States										
GDP (% QoQ, ann)	1.2	3.1	2.7	2.5	2.2	2.3	2.1	2.5	2.7	2.5
CPI headline (% YoY)	2.5	1.9	1.9	2.3	2.2	2.1	2.2	2.5	2.3	2.3
Federal funds (%, eop, lower bound)	0.75	1.00	1.00	1.25		1.25	1.50	1.50	1.75	
3-month interest rate (%, eop)	1.15	1.30	1.33	1.56		1.57	1.87	1.91	2.08	
Eurozone										
GDP (% QoQ, ann)	2.2	2.5	2.2	1.9	2.2	1.8	1.7	1.7	1.7	1.8
CPI headline (% YoY)	1.8	1.5	1.4	1.3	1.5	1.2	1.4	1.4	1.5	1.4
Refi minimum bid rate (%, eop)	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	-0.20	
Japan										
GDP (% QoQ, ann)	1.3	3.9	0.6	2.5	1.8	1.5	0.8	1.3	0.0	1.5
CPI headline (% YoY)	0.2	0.4	0.5	0.7	0.5	0.8	0.8	0.9	1.0	0.9
Excess reserve rate (%)	0.0	0.0	0.0	0.0	0.00	0.0	0.0	0.0	0.0	0.0
3-month interest rate (%, eop)	0.05	0.05	0.05	0.05		0.05	0.05	0.05	0.05	
China										
GDP (% YoY)	6.9	6.9	6.8	6.7	6.8	6.7	6.6	6.7	6.7	6.7
CPI headline (% YoY)	1.4	1.4	1.4	1.5	1.4	1.5	1.5	1.6	1.7	1.6
PBOC 7-day reverse repo rate (% eop)	2.45	2.45	2.45	2.45	2.45	2.45	2.55	2.55	2.65	2.65
UK										
GDP (% QoQ, ann)	1.0	1.2	1.1	1.6	1.5	1.2	1.6	2.1	2.1	1.5
CPI headline (% YoY)	2.1	2.7	2.8	3.0	2.7	2.7	2.4	2.4	2.4	2.5
BoE official bank rate (%, eop)	0.25	0.25	0.25	0.50	0.50	0.50	0.50	0.50	0.50	0.50
BoE Quantitative Easing (£bn)	445	445	445	445		445	445	445	445	
3-month interest rate (%, eop)	0.35	0.35	0.35	0.51	0.51	0.51	0.51	0.51	0.51	0.51

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