Confused by Yellen's direction? You're not alone

Our answers to this month's big questions

Economic and Financial Analysis

26 June 2017

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Our top **five** themes this month

Global Economics
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June 2017

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Economic and Financial Analysis

#1 Everything you need to know about the Fed's balance sheet plans

#2 Markets aren't buying the Fed's dots. But we still expect another hike this year

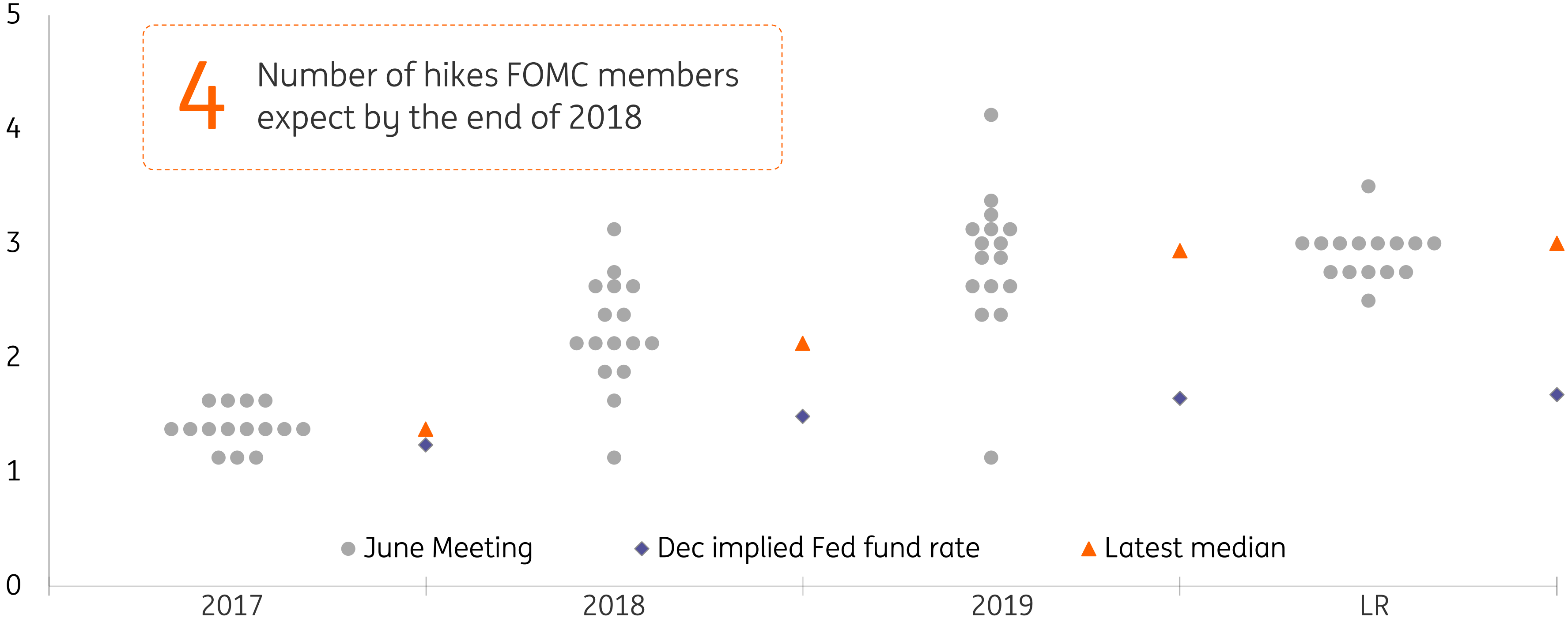
#3 Inflation is still proving to be a headache for the ECB

#4 What the UK election result means for Brexit

#5 Hawkish Haldane raises possibility of a UK rate hike – but we aren't so convinced

Markets aren't buying the Fed's dots…

We still expect a September hike, but weakening core inflation is confusing markets about the outlook

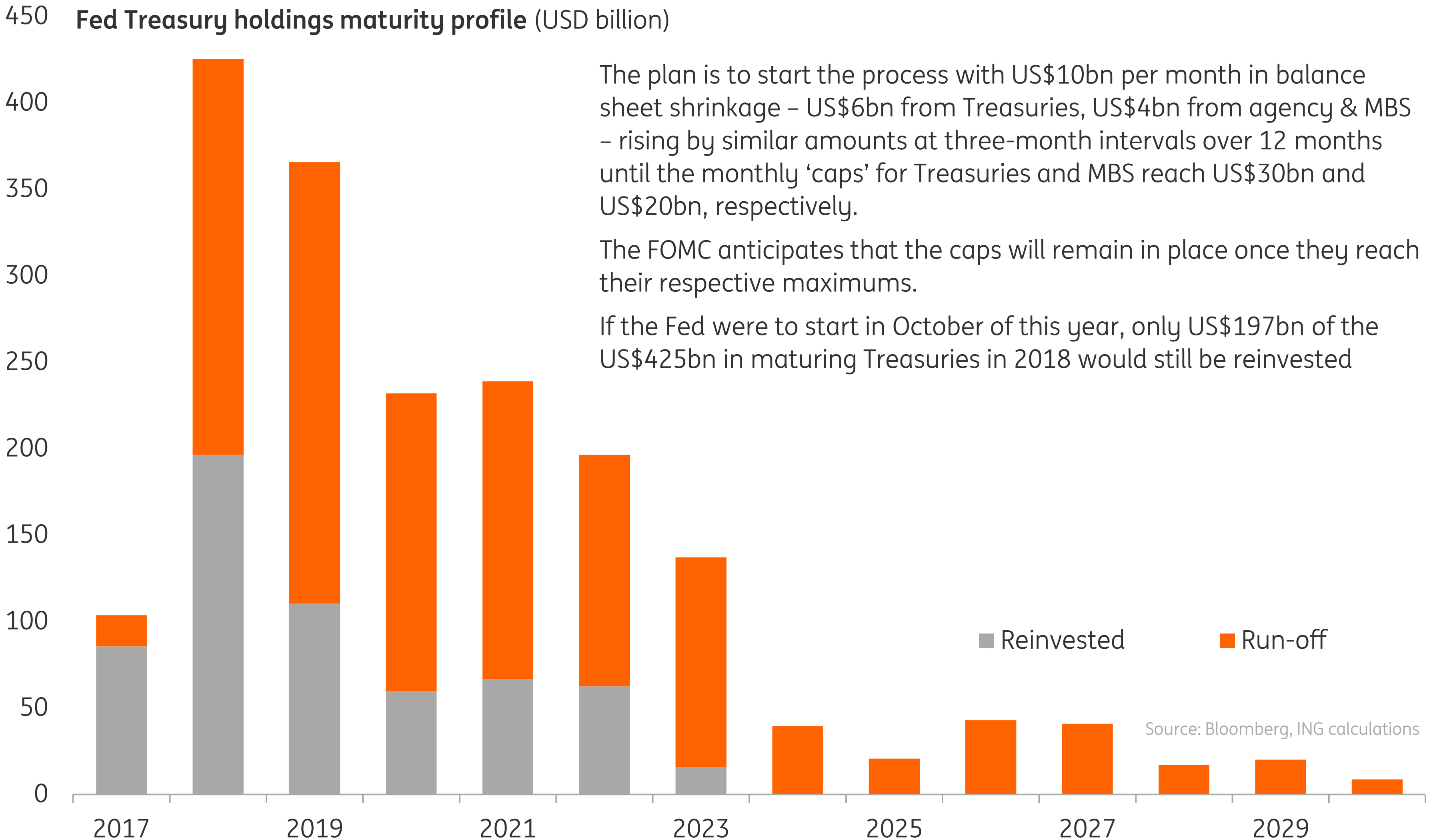


- The Fed remains upbeat on economic prospects despite a disappointing 1Q GDP growth figure. Officials believe "economic activity will expand at a moderate pace" with the risks to this assessment appearing "roughly balanced".
- They do acknowledge the recent softness in inflation stating that it will "remain somewhat below 2% in the near term, but [will] stabilise around 2% over the medium term".

What we know about the Fed's balance sheet plans so far…

1) Fed will let a capped amount of Treasuries roll-off each month

Fed Treasury holdings maturity profile (USD billion)



The plan is to start the process with US$10bn per month in balance sheet shrinkage – US$6bn from Treasuries, US$4bn from agency & MBS – rising by similar amounts at three-month intervals over 12 months until the monthly 'caps' for Treasuries and MBS reach US$30bn and US$20bn, respectively.

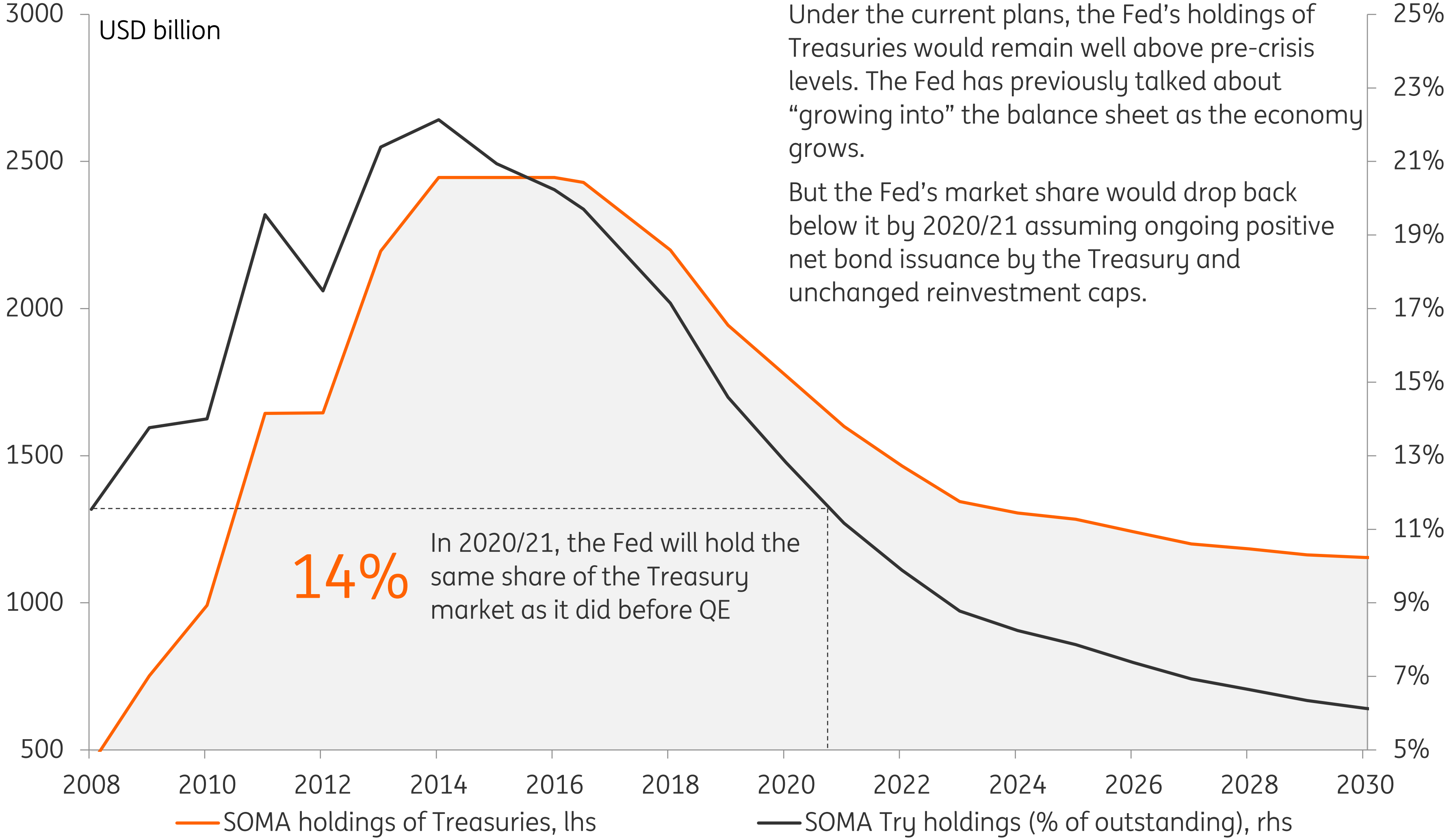
The FOMC anticipates that the caps will remain in place once they reach their respective maximums.

If the Fed were to start in October of this year, only US$197bn of the US$425bn in maturing Treasuries in 2018 would still be reinvested

Source: Bloomberg, ING calculations

What we know about the Fed's balance sheet plans so far…

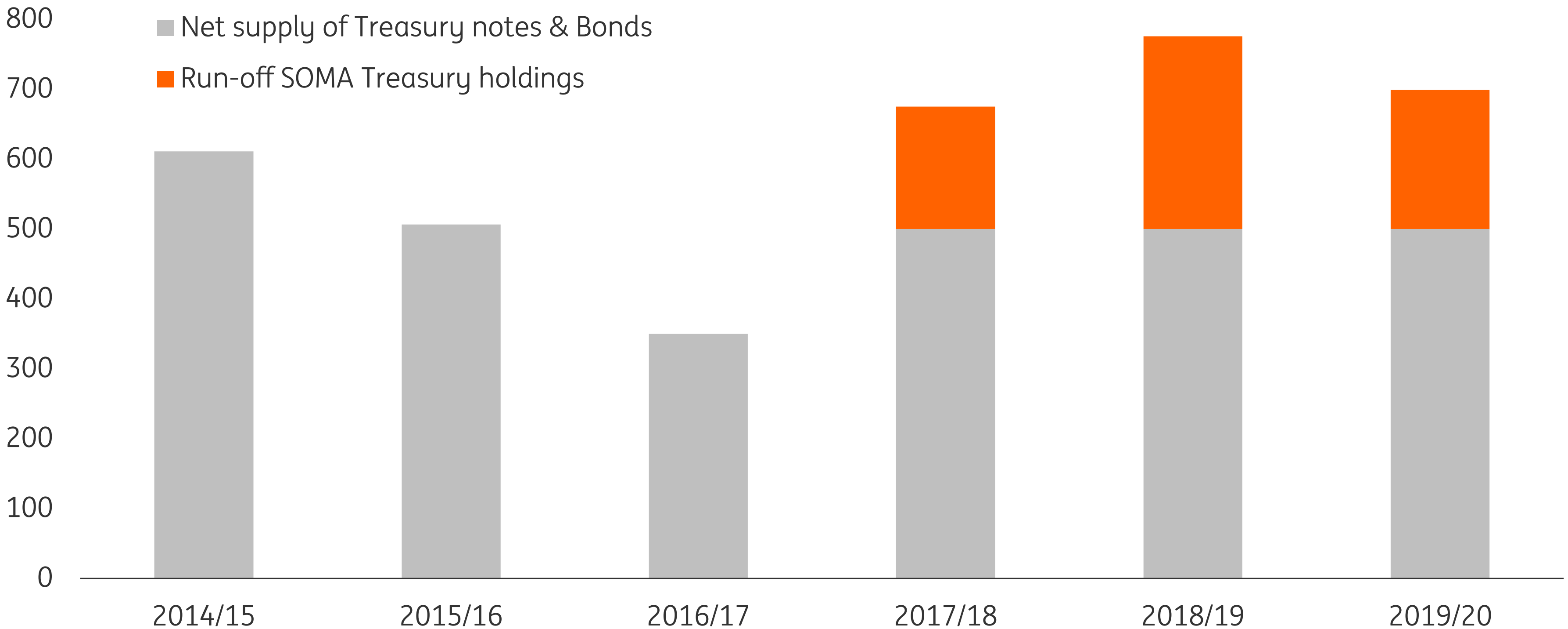
2) Fed will let a capped amount of Treasuries roll-off each month



Under the current plans, the Fed's holdings of Treasuries would remain well above pre-crisis levels. The Fed has previously talked about "growing into" the balance sheet as the economy grows.

But the Fed's market share would drop back below it by 2020/21 assuming ongoing positive net bond issuance by the Treasury and unchanged reinvestment caps.

For markets, this means a risk of steeper yield curves



- Given the size of the market, the Fed's reinvestment changes should result in a gradual, but relatively limited, increase in the share of Treasuries held by private investors. The flow effect could be more significant. Indeed, whatever is assumed about net supply of debt from the US Treasury, it is clear that the Fed's balance sheet normalisation will leave a sizable chunk of extra bonds for the market to absorb.
- On balance, we see a risk of higher Treasury yields and a steeper curve, especially given the recent commodity-price led curve flattening. We estimate the isolated effect on 10yr yields (and the spread to 2yr yields) to be around 5-10bp.

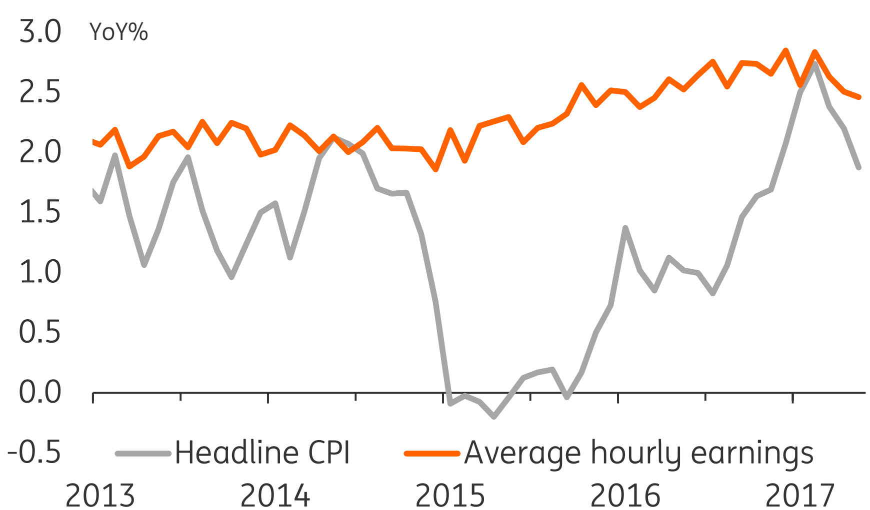
The outlook for the Fed

"Transitory" is a word the Fed has been using a lot recently. The Committee is seemingly thinking that **poor activity data in 1Q17 isn't a prelude to a broader slowdown in growth.**

It also believes inflation will respond to a tightening labour market and healthy domestic demand.

However, there are disagreements brewing. Neel Kashkari voted against the last two rate hikes due to low inflation and Robert Kaplan is having doubts.

> "I want to see more evidence [that inflation is heading back to 2%] before taking the next step"
>
> Robert Kaplan
> Dallas Fed President & FOMC Voter



High frequency numbers suggest that **2Q GDP growth could come in around 3%,** while soft MoM inflation readings 6-12M ago should make it more likely we see rising annual rates of inflation in coming months.

With import prices also starting to rise we think there is a **strong chance economic conditions will support a September hike**.

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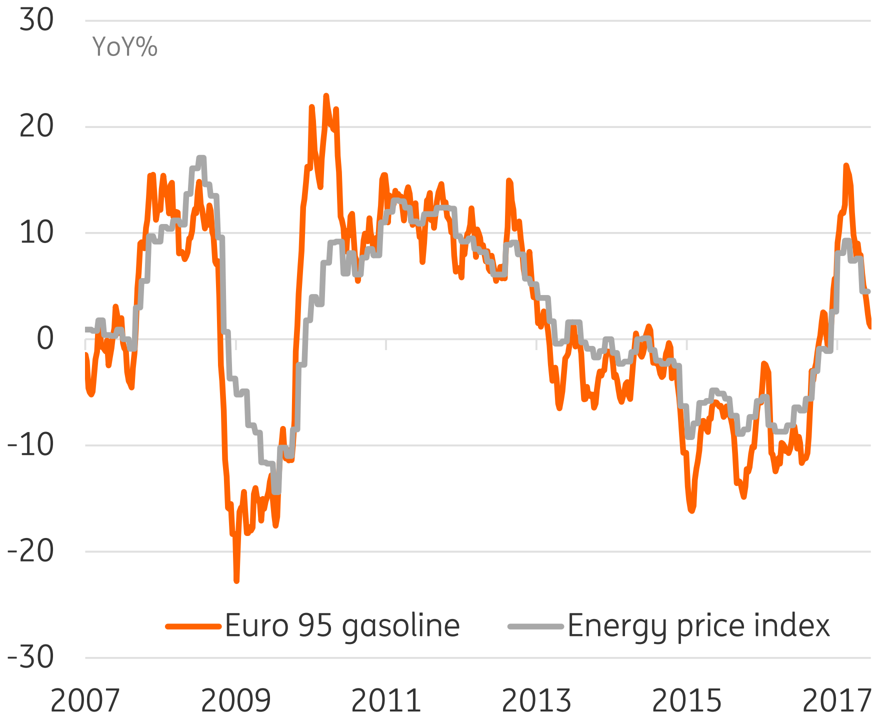
Inflation is still proving to be a headache for the ECB



- While the risk outlook and forward guidance have been changed as the economy is improving, inflation is not yet moving in the right direction
- Energy price moves are set to cause inflation to dip again in the summer months.
- Meanwhile wage growth, Draghi's new key indicator, continues to stay near all-time lows.

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Brexit negotiations have kicked off. Here's the latest…

Sequencing of the talks

It was set to be the "row of the summer", but the disagreement over the sequencing of the talks has reportedly been settled on day one.

The UK had previously been pushing for "parallel" discussions on exit arrangements and future deals. But it now looks like EU Lead Negotiator Barnier's preferred timetable, of reaching an agreement on exit costs, citizen rights before anything else, will prevail.

Assuming this is completed by December, as Barnier is targeting, then both sides would likely move on to discuss at least the framework of a transition period and trade talks.

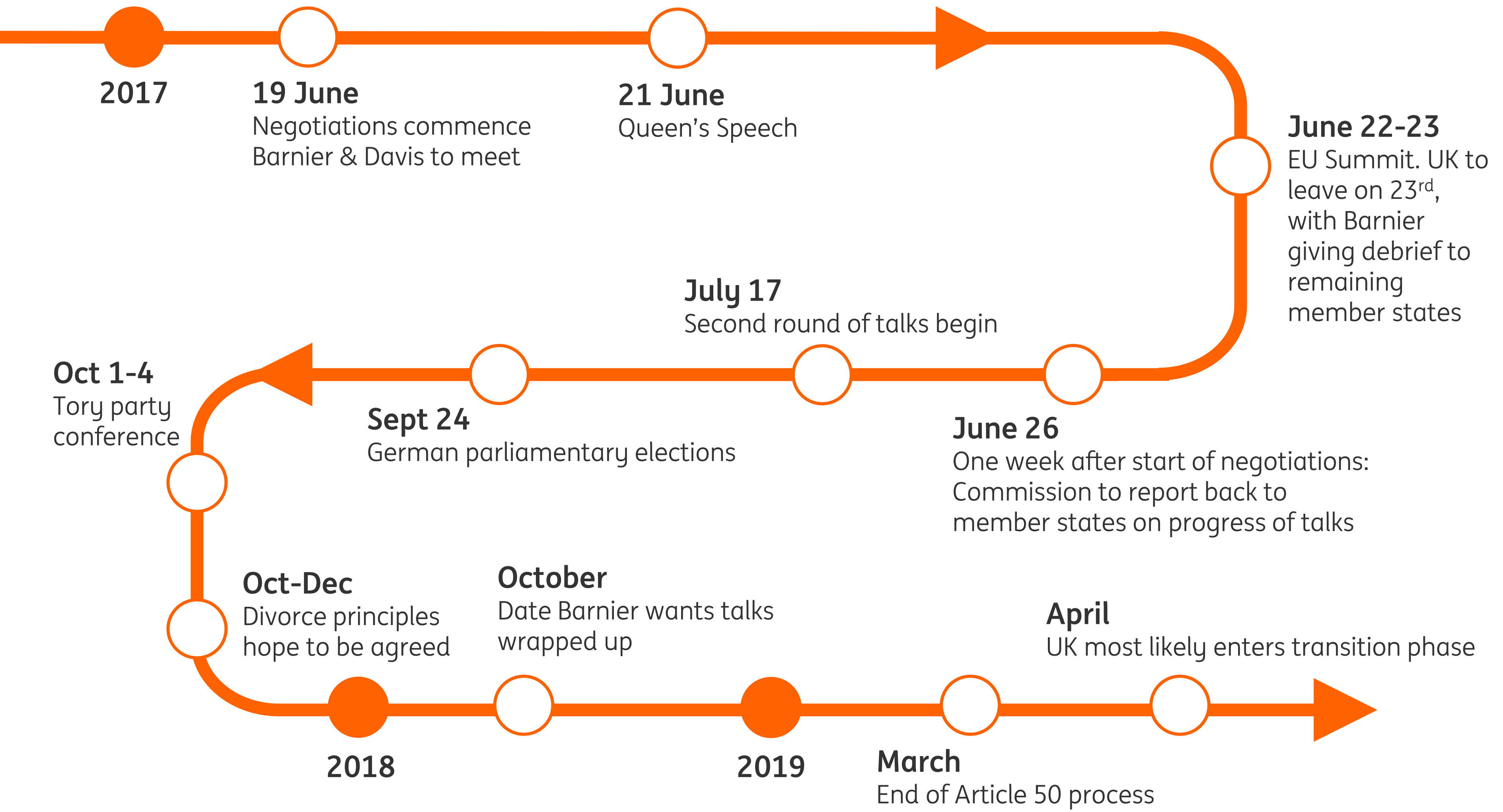
Cross-party Brexit co-operation

According to *The Times*, Brexit Secretary David Davis is pushing to get his Labour opposite number, Sir Keir Starmer, onto the Privy Council.

This means he would gain access to sensitive information on the negotiations, and would in effect mean Labour are bound more closely into the talks.

This is another sign that there will need to be more cross-party cooperation through the Brexit process. That's partly to ensure that Brexit issues can pass through parliament, but also to maintain consistency in the UK's stance if there were to be another election.

What comes next? The Brexit calendar is packed!



How the UK election result could re-shape Brexit

Under pressure: Initial UK position softens

Theresa May has been weakened and needs to gather support from both wings of her party. The DUP will also want ensure an open border with Ireland, which will limit the scope for hard Brexit.

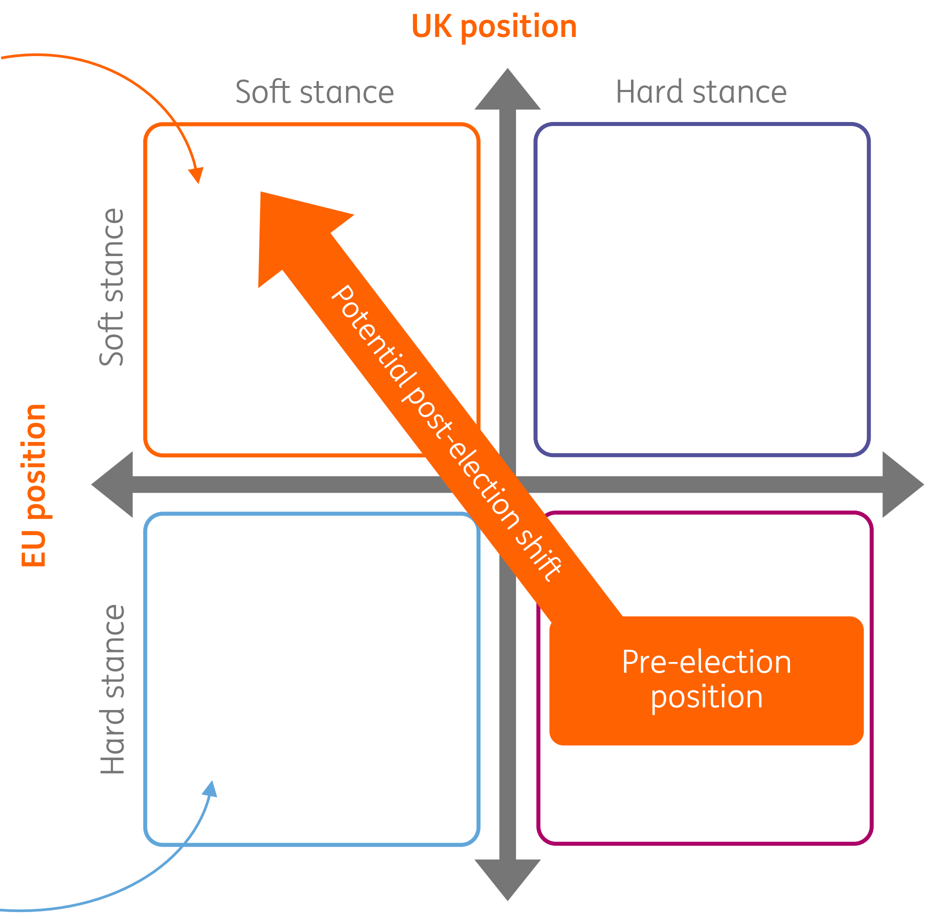
An opposition that is decidedly less hostile towards Europe also means the Conservatives don't have to compete on a harder Brexit. The government appears to be considering a softer stance to secure parliamentary passage of the Brexit legislation.

An early win for the EU on sequencing of the talks also appears to represent a softening of the UK's initial stance towards the negotiations.

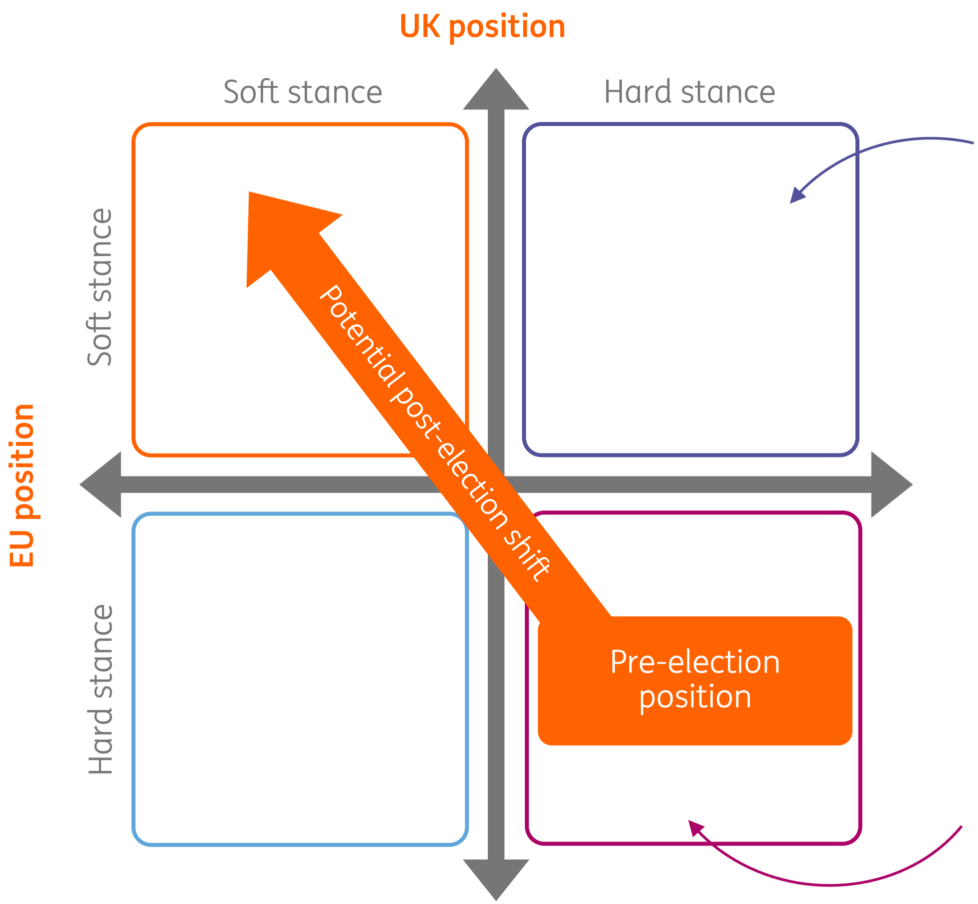
Toxic politics return

Even if the UK softens its stance, the potential for Italian elections to result in an anti-EU government could see the EU respond by showing that leaving the EU is incredibly painful.

EU politicians might also calculate that a hard line could lead the UK to reconsider its position, or destabilise the minority Conservative government in such a way as to trigger another election.



How the UK election result could re-shape Brexit



Defections destabilise fragile government

We could find ourselves here if elements of a softer Brexit stance continue to emerge over the next few months.

This could frustrate the harder-line Brexit supporters in the Conservative party, and could potentially see threats of defections to a resurgent UKIP. This in turn could see the Conservative's fragile majority erode to zero, raising the possibility of an immediate election.

Awkward timing of such a move during the negotiations would spell trouble.

Starting position: Stalemate

This is arguably where we were before the election.

The UK government had been taking a tough stance on migration and the divorce bill. Meanwhile, Europe was refusing to back down on free movement of people and had doubled its initial estimate of the potential "divorce bill".

Haldane the hawk throws Bank of England curveball

Markets now think a 2017 hike is 50:50 – but we still think it would be unlikely

"…beginning the process of withdrawing some of the incremental stimulus provided last August would be prudent moving into the second half of the year."

Andy Haldane
Chief BoE Economist
21 June 2017

BoE Chief economist Andy Haldane has broken rank with the other internal Bank of England MPC members and suggested rates could soon rise. Three external members voted for a hike in June, but one of those is leaving the MPC at the end of this month.

Our house view remains that the BoE won't hike until the outlook for post Brexit Britain becomes clearer with the BoE "looking through" a temporary, FX induced spike in inflation. However, Haldane's hawkish switch, based on growth coming in stronger than he expected, a better global outlook, higher inflation and reduced political threats is a major threat to that view.

20 June
20.4%

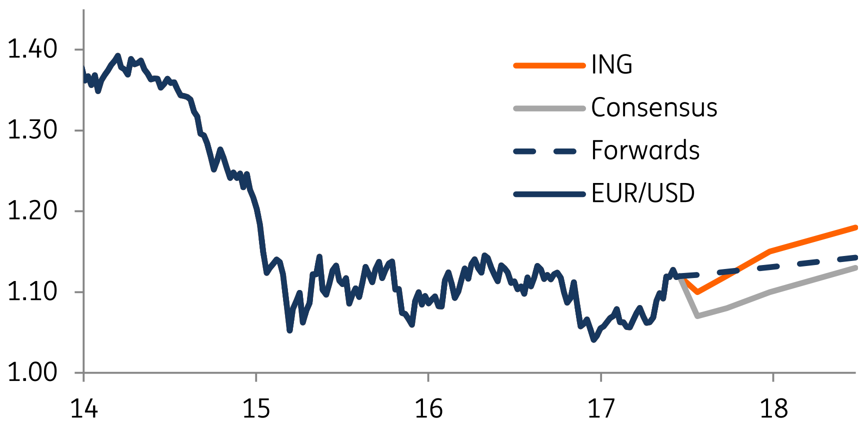
Probability of a **rate hike** before the end of the year

Latest
47.2%

Our global forecasts

All data sourced from Bloomberg/ING forecasts

EUR/USD



1M: **1.12** 3M: **1.15** 6M: **1.15** 12M: **1.20**

EUR/GBP

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

USD/JPY

1M: **115** 3M: **118** 6M: **120** 12M: **118**

Oil (Brent Crude)

2Q17: **50** 4Q17: **45** 2Q18: **45** 4Q18: **40**

Our global forecasts

	2016F					2017F				
	Q1	Q2	Q3	Q4	FY	Q1	Q2	Q3	Q4	FY
United States										
GDP (% QoQ, ann)	0.8	1.4	3.5	1.9	1.6	1.2	3.6	3.2	2.7	2.4
CPI headline (% YoY)	1.1	1.1	1.1	1.8	1.3	2.6	2.2	2.5	2.6	2.5
Federal funds (%, eop, lower bound)	0.25	0.25	0.25	0.50		0.75	1.00	1.25	1.25	
3-month interest rate (%, eop)	0.62	0.65	0.81	1.01		1.15	1.30	1.55	1.60	
Eurozone										
GDP (% QoQ, ann)	2.2	1.3	1.7	1.9	1.7	1.9	1.9	1.6	1.8	1.8
CPI headline (% YoY)	0.0	0.0	0.3	0.7	0.3	1.8	1.7	1.5	1.4	1.6
Refi minimum bid rate (%, eop)	0.05	0.00	0.00	0.00		0.00	0.00	0.00	0.00	
3-month interest rate (%, eop)	-0.22	-0.26	-0.30	-0.31		-0.33	-0.33	-0.33	-0.33	
Japan										
GDP (% QoQ, ann)	2.8	1.7	1.0	1.4	1.0	2.2	0.5	1.0	0.9	1.2
CPI headline (% YoY)	0.1	-0.4	-0.5	0.3	-0.1	0.3	0.5	0.8	0.6	0.6
Excess reserve rate (%)	-0.1	-0.1	-0.1	-0.1		-0.1	-0.1	-0.1	-0.1	
3-month interest rate (%, eop)	0.09	0.06	0.04	0.02		0.05	0.05	0.05	0.05	
China										
GDP (% YoY)	6.7	6.7	6.7	6.8	6.7	6.9	6.7	6.6	6.5	6.7
CPI headline (% YoY)	2.1	2.1	1.7	2.2	2.0	1.4	1.8	2.5	2.2	2.0
PBOC 7-day reverse repo rate (% eop)	2.25	2.25	2.25	2.25		2.45	2.55	2.55	2.55	
UK										
GDP (% QoQ, ann)	0.6	2.4	2.0	2.7	1.8	0.7	1.5	1.0	0.7	1.5
CPI headline (% YoY)	0.3	0.4	0.7	1.2	0.7	2.1	2.8	2.9	3.0	2.7
BoE official bank rate (%, eop)	0.50	0.50	0.25	0.25		0.25	0.25	0.25	0.25	
BoE Quantitative Easing (£bn)	375	375	435	435		435	435	435	435	
3-month interest rate (%, eop)	0.60	0.60	0.30	0.40		0.35	0.30	0.35	0.40	

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