ECONOMICS | Global

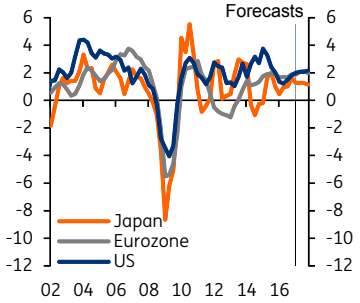
3 August 2017

Monthly Economic Update

A question of leadership

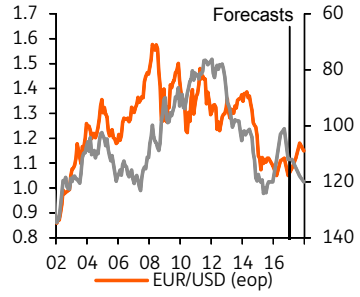
The travails of President Trump's healthcare and tax reforms together with Brexit and the risks for the UK economy are well recognised, but there appears to be political trouble brewing elsewhere. President Abe is looking increasingly vulnerable in Japan while upcoming elections in Europe and a potential Catalonia independence referendum could add to the uncertainty for financial markets. This puts more focus on the likely central bank reaction with the upcoming Jackson Hole central bank conference potentially providing a more dovish spin on the path of policy.

GDP growth (% YoY)



Source: Macrobond, ING

FX



Source: Macrobond, ING

President Trump denies there is any chaos at the White House, but the rapid turnover of key staff, the failure of healthcare reforms, the lack of progress on tax and ongoing questions surrounding ties to Russia suggest new Chief of Staff John Kelly will have a tough task steadying the ship. Tax reform now seems to be the administrations priority, but passing a bill to raise the debt ceiling and prevent a government shutdown will be the primary task after the summer break.

Politics doesn't appear to be negatively impacting the economy, but with little sign of any inflation threat the market will continue to doubt the Federal Reserve's own projections for the path of interest rates. We suspect that the market may be a little complacent on both the pace of hikes and the likelihood of yield curve steepening.

With politics on the backburner the Eurozone is enjoying a spell of upbeat economic data, putting the old continent firmly on a 2% growth path. However, after the summer political instability might stage a come-back in the run-up to Italian elections and a potential Catalonian independence referendum. The strengthening of the euro is likely to push the ECB's inflation forecasts down again, forcing the bank to announce a very dovish tapering and delaying the first rate hike until 2019.

Japan's economy continues to make slow but steady progress. But it is in the world of politics that change is more rapid. The LDP saw its control on the Tokyo Metropolitan Assembly decimated last month and some pundits are already suggesting that PM Abe may not hold onto power until the next scheduled elections in September 2018. There is the suggestion that Yuriko Koike may become Japan's next, and first female PM.

China's strong yuan has removed concerns over capital outflows, toghether with stronger growth, the government can focus again on deleveraging in August. The PBoC will either maintain or even tighten slightly in the interbank market, and interest rates should edge higher after softening in July.

There's been plenty of political infighting amongst the UK government, but one thing ministers are starting to agree on is the need for a transition period. But the EU wants to see further progress on citizen rights and the exit bill before agreeing to this, and until then, businesses are likely to remain cautious. Subdued investment and sluggish wage growth means the Bank of England is unlikely to hike rates this year.

It can only be described as "euro madness." We see the latest EUR/USD move above 1.15 as unjustified by short-term fundamentals, driven instead by sentiment / low summer liquidity. This situation is unlikely to change soon so we look for an overshot to/above EUR/USD 1.20 in coming weeks. But such levels should not be sustainable.

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US: Getting a grip?

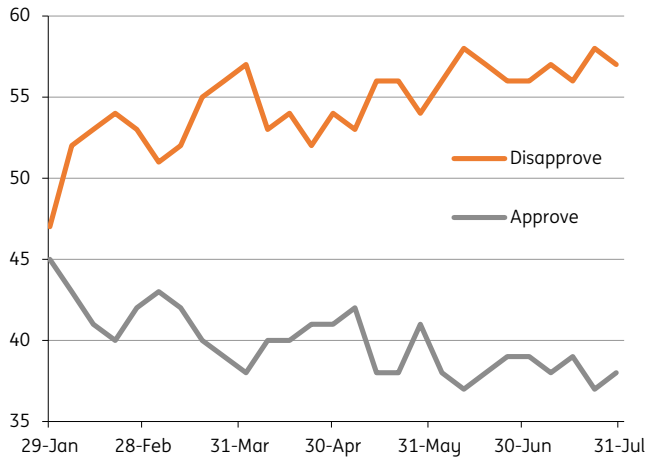
The Trump Presidency needs "wins" otherwise mid-term election defeat could scupper broader policy agenda

President Trump may well be tweeting that there is "no White House chaos", but to many people the evidence suggests otherwise. At the very least his administration in the midst of a deeply challenging period. The collapse of healthcare reforms, ongoing investigations into ties with Russia and what feels like a revolving door amongst key White House staff have seen his poll ratings plunge to new depths. This means progress on tax reform is of vital importance. With mid-term elections just 15 months away, Trump needs a major "win". Otherwise he risks losing the Republican majority in the House of Representatives, which will make delivering other election promises near impossible.

Failure on healthcare reform makes progress on tax reforms critical, but the prognosis isn't good

The suggestion has always been that the repeal and replacement of the Affordable Care Act would be followed up by major tax reform. However, failure on the former is leading to a growing sense that there is going to be nothing "major" about the tax reforms. Opponents, both in the Democrat Party and his own Republican Party have become emboldened by the healthcare defeat while fiscal hawks are opposed to the prospect of unfunded tax cuts that could see the deficit widen out further. Moreover, the last time there was a major overhaul of tax codes was back in 1986 and this needed bipartisan support, which will not happen this time.

Fig 1 President Trump's approval rating



Source: Gallup

Fig 2 Historical approval ratings at same point in Presidency

John F Kennedy 76% (Aug 1961)
Dwight Eisenhower 74% (Aug 1953)
George H W Bush 69% (Aug 1989)
Jimmy Carter 63% (Aug 1977)
Richard Nixon 62% (Aug 1969)
Ronald Reagan 60% (Aug 1981)
George W Bush 56% (Aug 2001)
Barack Obama 53% (Aug 2009)
Bill Clinton 44% (Aug 1993)
Donald Trump 38% (Aug 2017)

Source: Gallup

The risk of a dilution to the tax cuts that were initially proposed is growing...

As is the likelihood that they will be delayed well into 2018

Already, the Border Adjustment Tax, that would have supposedly raised US$1 trillion by hiking the costs of imported goods while incentivising export sales, has been dropped. This means that plans to cut corporation tax, potentially to as low as 15%, are being quietly scaled back. As for households, given the lack of detail in the tax plans so far, there are clearly major disagreements over how much individual tax rates can be cut and what tax breaks (which run over hundreds of pages within legislative documents) can be removed. This all gives the impression that tax cut aspirations are going to be heavily diluted and are going to be delayed well into 2018.

When politicians return the priority will be to raise the debt ceiling and prevention of a government shutdown

Little progress will be made over the summer and when politicians return on 5 September they will have to deal with bills to raise the US debt ceiling and to avoid a government shutdown. This is unlikely to help the hostile environment in Washington and will add to the sense that little will be achieved ahead of the November 2018 mid-term elections given campaigning will start well beforehand. Should the Republican's lose their majority in the House (the Democrats need to gain 24 seats with all 435 seats up for grabs), or the Senate (this is unlikely as there are only 8 currently Republican held

seats being voted on versus 23 Democrat seats), then Trump's ability to pass legislation will be heavily curtailed.

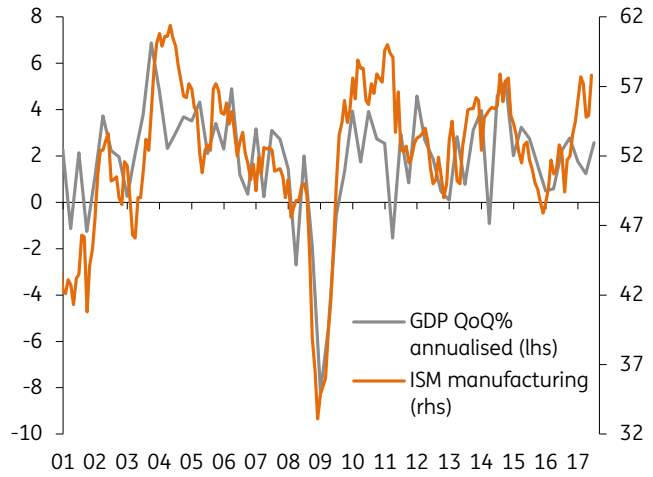
3% growth looks unattainable, but business surveys point to respectable growth of the order of 2-2.5%

The lack of tax reform and infrastructure spending means that the President's predictions of 3%+ GDP growth in coming years look unattainable. Instead, 2-2.5% growth looks the most probable scenario. After all, business surveys are in good shape, employment creation is healthy and the weakness of the dollar is boosting international competitivness. This is not bad, but in an environment where the perceived inflation threat is minimal, market interest rate hike expectations will remain muted.

However, the lack of inflation means the market doubts the Fed's projected hiking path

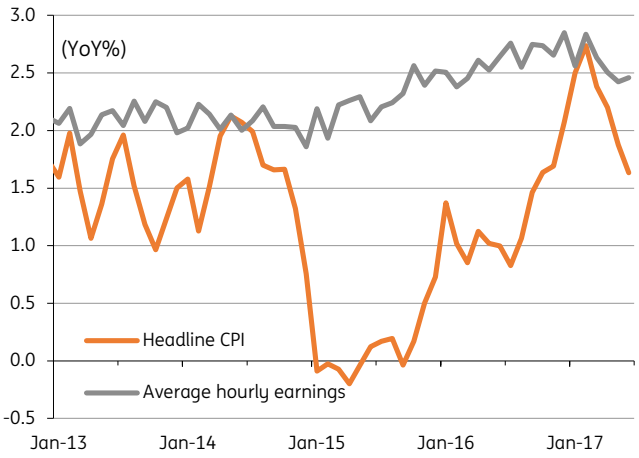
The June FOMC meeting saw the Fed restate that it felt the most likely path was for one more rate hike this year, followed up by three more 25bp increases next year. Fed funds futures contracts are barely pricing in just one move. We continue to think it will be somewhere in the middle.

Fig 3 Growth is respectable...



Source: Macrobond

Fig 4 But inflation pressures remain muted



Source: Gallup

We suspect wages will eventually respond to the tight jobs market and think inflation will rise back to the 2% target by the turn of the year...

We agree with the Federal Reserve in that the tightness of the labour market should eventually translate into higher wages, which should in turn exert upward influence on inflation more broadly. It is also possible that the weakness in the dollar (down nearly 10% since the start of the year) could also have some upward influence on prices. However, we have to remember that most trade contracts are priced in dollars and the likelihood is that the Fed's balance sheet reduction strategy will result in a steeper yield curve. Both factors mean that the upside risks to inflation appear limited at this stage.

... we look for one more rate hike this year and two next

We currently have one rate rise in our forecasts for 2017, followed by two more in 2018, but the risks are probably skewed towards less policy tightening rather than more.

The Fed's balance sheet reduction strategy looks set to start in October

With regards to the Fed's balance sheet plans, the Federal Reserve had already announced a strategy of gradually limiting the reinvestment of proceeds of maturing assets. The only question has been the timing. The July FOMC statement suggests it will begin "relatively soon", whereas previously they merely said it will begin "this year". We therefore look for the September FOMC meeting to formally say that balance sheet reduction will start in October.

If this steepens the yield curve it could limit the need for Fed hikes

Assuming this is correct, our debt strategists estimate that only US$197bn of the US$425bn in maturing Treasuries in 2018 would still be reinvested. With the market having to absorb more Treasuries we think there is some complacency regarding the potential for higher longer dated yields and a steeper yield curve.

We are still waiting to hear whether Yellen will stay on as Fed Chair

As for another issue that Trump needs to make progress on – whether to re-appoint Janet Yellen when her term ends in February next year and if not, who to replace her with - the outcome remains unclear. Given the lack of progress on tax and infrastructure

spending the President will not want to insert someone who could threaten a faster pace of interest rate hikes, which could potentially choke off growth. Indeed, while there is a lot of speculation that he wants to appoint someone who favours a rules-based approach to setting monetary policy, we have our doubts.

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Eurozone: the brutal euro appreciation

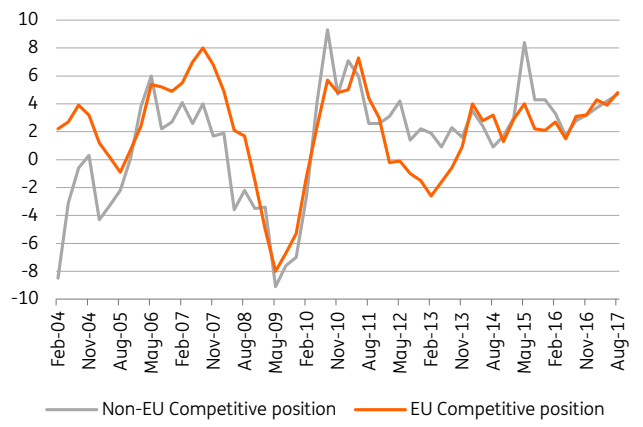
Several factors are pushing the euro exchange rate higher...

There is certainly no reason to panic yet, but the rapid appreciation of the euro exchange rate is making the ECB's task even more difficult than it already was, especially since some of the euro strength is due to developments in the US, something the ECB can hardly control. That said, the ECB isn't without blame either. When Mario Draghi showed himself more upbeat during the Sintra conference, suggesting that with a strengthening economy a constant monetary policy stance does actually equal a more accommodative monetary policy, markets logically saw this as a tightening announcement. Hence, it was no surprise that the euro exchange rate was pushed higher.

...potentially forcing the ECB to revise its inflation forecasts down again

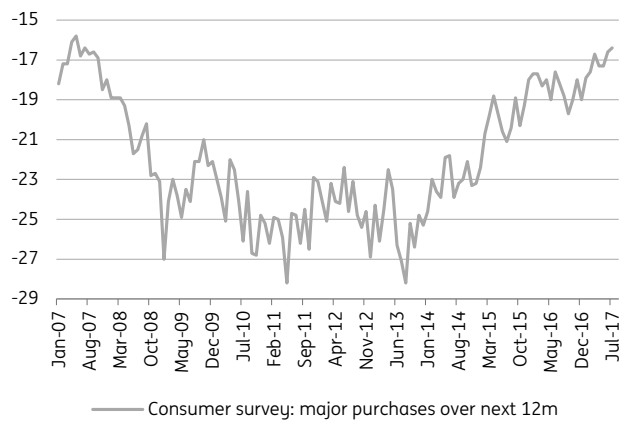
In the press conference after July's monetary policy meeting Draghi tried to correct this with a very dovish message. But this wasn't sufficient to stop the euro's ascent. Over the last 4 months the effective exchange rate has appreciated by nearly 7%. Research by the ECB shows that a sustained 1% euro exchange rate depreciation leads to 0.1% extra HICP inflation after 1 year. While it is not sure whether this impact would be of the same magnitude in the case of an exchange rate appreciation, there is little doubt that a stronger euro will tend to depress inflation. Bearing in mind that the ECB staff forecasts have been based on a 1.09 EUR/USD exchange rate for the period 2018-2019, it seems likely that the staff might have to revise its already low 1.3% and 1.6% inflation forecasts for 2018 and 2019, respectively, down again.

Fig 5 Euro is not hurting competitive position (yet)...



Source: Thomson Reuters Datastream

Fig 6 ...and upbeat consumers fuel domestic demand



Source: Thomson Reuters Datastream

The strong economic momentum continues...

As for growth, the stronger euro might have a tempering effect on growth, though for the time being it is certainly not the case yet. In the European Commission's quarterly survey of the manufacturing industry, businesses' assessment of the competitive position on markets outside the EU actually improved for the third quarter of this year, now significantly above its long-term average. With domestic demand fueled by upbeat

consumers, most economic sentiment indicators continue to hover around the highest level in 10 years. GDP growth came out at 0.6% in 2Q, after 0.5% in 1Q, putting the Eurozone economy on a 2% growth path. The eurocoin indicator, an indicator reflecting the underlying GDP growth pace, stood at 0.63% in July, signaling that the strong momentum continued into the third quarter.

...and politics are not on the front pages

While in Italy politics have cooled down somewhat over the summer months, in Spain tensions could increase with the potential, but illegal, Catalonian independence referendum in October. Greece managed to issue a bond on the markets, for the first time since 2014, though one shouldn't read too much into this modest success. Greek debt remains unsustainable and a clean exit from the bail-out programme in 2018 seems all but impossible without additional debt relief (which we think will still happen).

ECB will have to announce a "dovish tapering"...

...creating the impression that QE could last longer than expected

While the ECB has bought some time in terms of the announcement regarding the extension and tapering of its QE programme, at the latest in October something will have to be communicated. To prevent a further unwarranted tightening through an exchange rate strengthening, a "dovish tapering" seems required. That basically means that the ECB will have to create the expectation that the QE programme might well run beyond June 2018. Therefore it will have to announce another broadening of the scope of assets that can be bought, to make it possible to continue with its purchases for more than a few months without being confronted with eligible asset scarcity problems in certain member states. It is even possible that the ECB, following the Fed's example, makes the QE-extension open-ended, though according to some interpretations this way of proceeding could face legal challenges. On top of that, a number of important members within the Governing Council is certainly keen to see QE peter out as fast as possible.

Vocal intervention to stop the euro's ascent...

...and first rate hike only in January 2019

We also expect that the ECB will step up its vocal intervention against the strengthening of the euro. One should remember that Draghi's predecessor, Jean-Claude Trichet, several times tried to stop the euro's appreciation by stating that brutal currency moves were most unwelcome. But even then, the euro exchange rate might end up being a bit stronger than previously thought, which leads us to believe that the first deposit rate hike might now only come in January 2019.

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UK: Trading on transition

Ministerial infighting has picked up since the election

The UK parliamentary recess is well underway, but on the political front, it has been far from quiet. With Prime Minister Theresa May's position perceived to be weaker in the aftermath of June's election result, infighting amongst senior ministers on both sides of the Brexit debate has become increasingly public.

There's still plenty of disagreements on how the UK's formal exit in 2019 should be managed

Most of the latest rift centres round the potential transitional arrangement once the UK formally leaves the EU in 2019, in particular the immigration policy during this period. Chancellor Phillip Hammond has been vocally pushing for a 'long' period of transition, with free movement of labour only partially end in 2019. Liam Fox, who takes a relatively hard-line stance of Brexit, has publically disagreed with Hammond's vision saying this would "not keep faith" with the referendum outcome.

But even if ministers aren't agreed on the details, they do at least increasingly appear to be united on the need to avoid a "cliff edge" after Brexit in a post-Brexit transitional arrangement. Of course, there are still plenty of thorny issues to be resolved before the EU will agree to this. News reports following the latest round of negotiations suggest there are still "substantial differences" between UK & EU positions on citizen rights and

the divorce bill. The EU has said previously that progress is needed on both before a transition period can be agreed upon.

The divorce bill is still a major sticking point in Brexit talks

On the issue of the divorce bill, the UK's budget 'rebate', agreed by PM Thatcher in the 1980s on the basis that the UK accounts for a small share of agriculture subsidies, has reportedly been one recent source of disagreement. The UK's recent acceptance that it could continue contributing to the EU budget to maintain market access appears to have helped calm that particular debate. But the EU is pushing for more clarity here, something the UK has suggested it wants to tie to any agreement on exit costs.

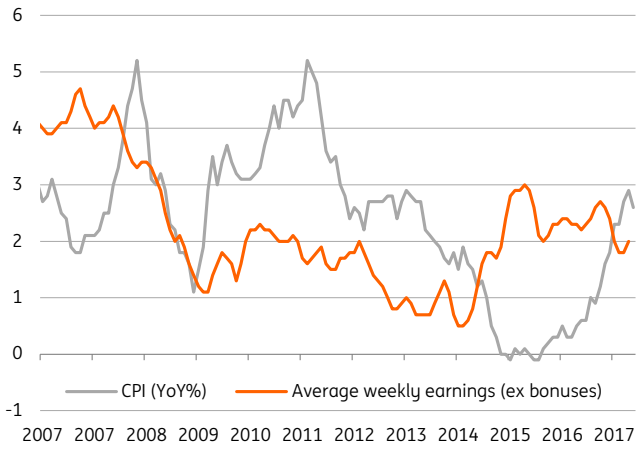
Until an agreement is reached on a transition deal, business will remain cautious

However all of this is resolved, it is unlikely to happen before the fourth quarter of this year at the earliest. It's not just about the timing of the announcement: for companies and markets, the length and framework of a transition period will be equally key. Until these details become clearer and as long as general uncertainty about the UK political climate prevails, investment is likely to remain subdued.

The Bank of England is still optimistic on wage growth

That has also negative implications for wage growth, which has become a key plank of the Bank of England's forward guidance on policy. The monetary policy committee have taken a relatively optimistic stance on wages, with some hawkish members pointing to the very low level of unemployment as likely to exert upward pressure on pay. The Bank have also highlighted a range of temporary factors (eg, pension changes, apprenticeship levy) as reasons for the recent decline in earnings growth.

Fig 7 Gap between inflation and wage growth is widening



Source: ING

Fig 8 Most BoE voters are yet to be convinced on rate hikes

Source: ING, Bank of England images

Whilst an element of that is probably true, firms' cost bases are rising with the pound's depreciation and given the economy is losing traction, businesses will have limited incentive to accelerate pay rises – or at least not the extent the Bank of England hopes.

We still don't expect a rate hike this year

At its August meeting, the BoE said that investors are too cautious on interest rates. That's despite a fairly noticeable steepening in the UK swaps curve following hawkish comments from Governor Carney and Chief Economist Haldane in June. We still think the Bank is unlikely to follow through on these signals and a rate hike this year looks unlikely. But if the MPC does opt to hike rates, we suspect this will be a "one (or two) and done" scenario rather than the start of a more substantial hiking cycle.

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China: Keep deleveraging

Strong growth and yuan support further deleveraging

In July, the two eye-catching points for China were strong GDP growth and CNY appreciation. Both these factors support the government's continued deleveraging process in the corporate and financial sectors.

China is a consumption story

GDP grew a higher-than-expected 6.9% YoY in 2Q17. Retail sales, fixed asset investments and industrial production data confirm our view that China is now a consumption-driven economy.

Consumption and exports will continue to drive growth in 2H

We revise upward our GDP forecast to 6.8% in 2017

Consumption and exports will continue to drive growth in 2H17, and these two categories of GDP will continue to support industrial production. Investment will play a smaller role in industrial production, especially as property developments in prime locations are likely to slow down. Altogether, this should mean slower GDP growth in 2H17 but to a lesser extent than we had previously thought. We have revised up our forecast for GDP for the whole of 2017 to 6.8%.

Yuan appreciated 0.8% in the month, taking advantage of the weakened dollar

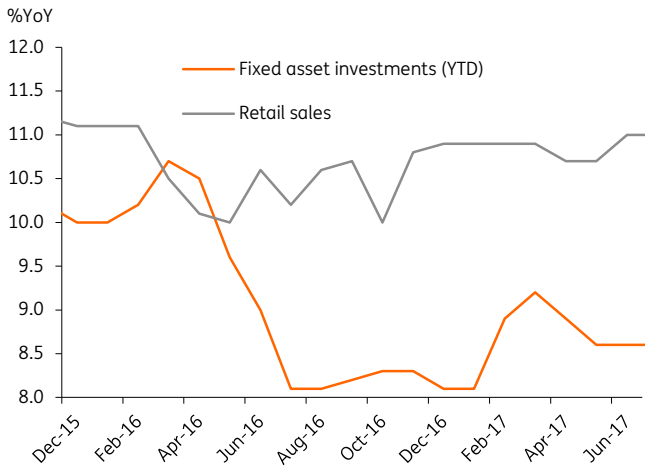
The CNY has also been very strong against the USD (6.7266 on 31 July), and heading close to our end-of-year forecast of USD/CNY 6.72. CNY appreciation of 0.8% in a month is a surprise to us even though our forecast has been at the high end of market consensus. It seems to us that the PBoC is taking advantage of the weak dollar to let the CNY appreciate, and this could have done the job for the central bank to slow down capital outflows.

But appreciation speed would not sustain for another month

We keep our forecast of USDCNY at 6.72 for end-2017

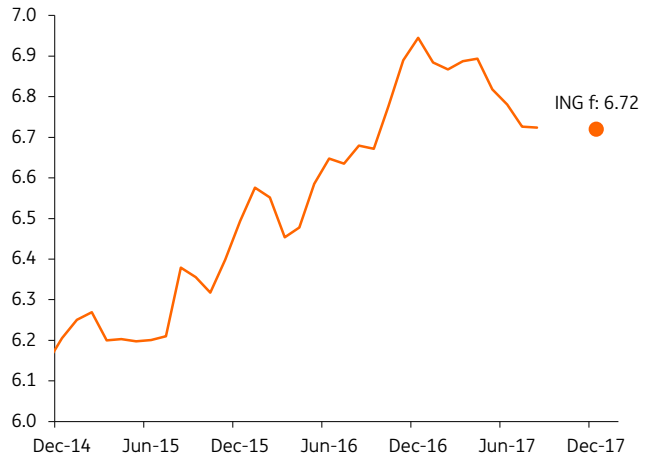
Looking forward, the central bank may wait to confirm that the stronger CNY has prevented net capital outflows. Therefore we do not expect the current appreciation speed to be sustained in August. The current strength of the currency should be enough to shift market expectation for 2H17 from CNY depreciation to appreciation, and change the course of capital flows. We therefore keep our forecast of USDCNY at 6.72 by end-2017.

Fig 9 China is now a consumption driven economy



Source: ING Bank, Bloomberg

Fig 10 Yuan should now appreciate slower after high-speed gains in July



Source: ING Bank estimate, Bloomberg

Expect deleveraging to speed up in August after the 5th Financial Working Conference finalise the reform agenda

As well as removing concerns over capital outflows, stronger growth and a stronger currency enable the government to worry less about the negative impacts from further deleveraging. We expect regulators to focus more on deleveraging in August. The 5th Financial Working Conference set a reform agenda for the coming 5 years, and highlighted the creation of a supervision entity, which is directly under the State Council.

This signals how the government values the importance of coordinated work across regulators during the deleveraging process.

Liquidity in 3Q should be at least as tight as in July, and interest rates to inch higher

Seeing that there is more room for deleveraging, we expect the PBoC will either maintain the current tightness in the interbank market or even tighten slightly further in 3Q17. For the same reason, interest rates should edge higher after softening in July. We believe the PBoC will guide short-end rates gradually higher to make it clear to the market that they are not ready to ease liquidity and regulatory measures. To do otherwise, would send a contradictory message when the central government focus is on deleveraging.

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Japan: Taking lessons from France?

The economy continues to slowly recover as political problems mount

There are two main themes to the Japan right now:

1) The slow burning but nonetheless perceptible pick-up in the macroeconomy, and stabilisation of the price level (though still way off improbable 2% inflation targets) and

2) The political problems of PM Shinzo Abe and his deeply unpopular cabinet that could undermine his hold on Japan's top job.

No big changes to our forecasts this month

The background economic improvements have been in place for a while now, and there are few important deviations from that trend, or indeed any notable changes to our macro-forecasts this month. So our main focus will be on point 2) and what this might mean for economic policy in the months and years to come.

It's worth just remembering that it wasn't so long ago that PM Abe was being hailed as a worthy successor to the highly charismatic and popular PM Koizumi, bringing his 3-prong Abenomics policies of fiscal stimulus, monetary easing and economic reforms.

A lack of structural reforms has meant a prolonged period of growth hasn't happened

Whilst the fiscal and monetary policies briefly helped push growth higher, and the JPY weaker, the absence of any meaningful economic reforms, and a focus rather on constitutional issues meant that the economic pick-up did not persist.

More recently, allegations of cronyism, involving claims that Abe favoured friends to gain special access to set up schools in special economic zones, as well as an alleged cover-up of the risks of Japan's peacekeepers in South Sudan, by his Defence Minister, have led to approval ratings for the Abe Cabinet to plunge.

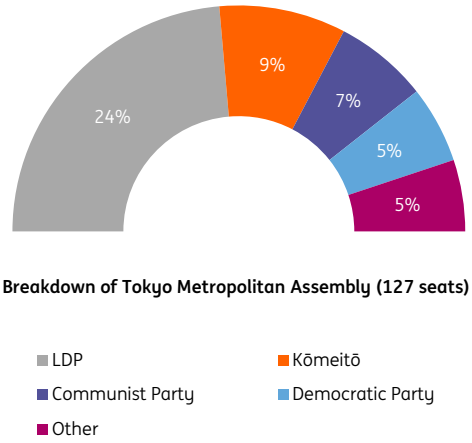
Coalition cracks threaten Abe's hold on power

Abe technically does not have to go to the polls until September 2018, but potential cracks with his coalition partners, Komeito, mean that he may not be able to hang on to power that long. If so, what is the future for Abenomics? The quick answer to this is, probably not much, but there are nuances depending on who would succeed Abe as PM.

Economic reforms look tricky, with or without Abe in power

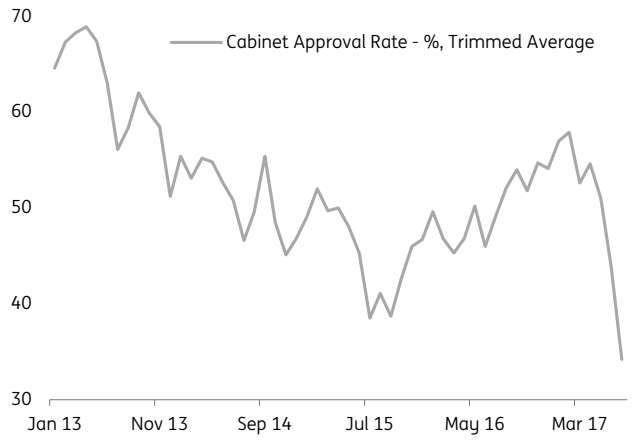
Even without Abe at the helm, the future for economic reforms looks pretty dim. Donald Trump's pulling out of the Trans Pacific Partnership (TPP) has left that free-trade deal in limbo, and this would have been one of Abe's main channels for economic reforms. The TPP looks challenged with Abe as PM or indeed anyone else. Likely LDP successors to Abe include Foreign Minster Fumio Kishida. Abenomics-Lite seems a likely outcome under a Kishida government.

Fig 11 Breakdown of Tokyo Metropolitan Assembly



Source: Tokyo Metropolitan Government

Fig 12 Cabinet Approval Rate



Source: Japan Macro Advisors

But there is a more radical alternative suggested by the recent drubbing of the LDP in the Tokyo Metropolitan elections last month. These saw the LDP kicked out of power and overturned by the Tomin First Party led by former LDP Defence Minister, Yuriko Koike.

Has populism spread to Japan?

An "En Marche" style overthrow of Japan's ruling elite LDP party may seem unrealistic, given their almost unchallenged hold on power since the late 1950s. But part of the Tomin First electoral triumph in Tokyo stemmed from a very familiar sense of, "they aren't the establishment", which resonates with the election of Emmanuel Macron, Donald J Trump, and the Brexit vote.

Although the challenges for Koike are considerable, not least, rolling out her Tokyo-focused party across the country, many are already considering her as a possible next PM, and Japan's first female Prime Minister.

Political change may be brewing, but don't hold your breath...

In terms of policy stances, and given her political background, Koikenomics may not differ on paper very much from Abenomics, but perhaps with a greater focus on labour market reform and female labour market participation. What would really distinguish her from Abe, and mark a clear difference from Donald Trump, would be if she actually managed to implement her reforms. For that, she will need not just to become PM, but to take control of Japan's Upper House too. And elections here are not due until 2019, shortly before the Tokyo Olympics. Depending on how these go, how big the almost inevitable overspend, and any allegations of corruption associated with the granting of construction contracts, this could either be an opportunity for Koike, or an impediment. In other words, political change may be coming to Japan, but don't hold your breath.

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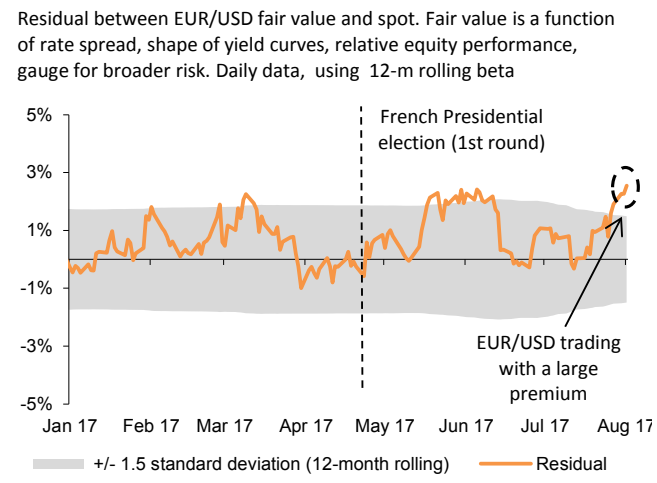
FX: The big "EUR madness"

It cannot be described other than the "EUR madness." We see the latest EUR/USD move above the 1.15 level as unjustified by short-term fundamentals (we estimate the EUR/USD is currently trading with a staggering 2.5% premium vs its short-term fair value – Fig 9). Rather, the EUR rally seems to be about sentiment, technicals and low summer liquidity – factors that are not sustainable for long. Yet, given that this is the name of the game for now, we look for an overshot to/above the EUR/USD 1.20 level.

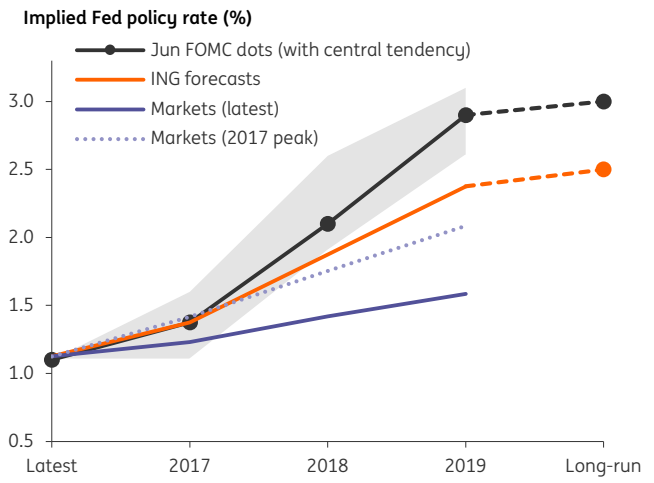
Indeed, the sentiment towards the EUR/USD changed so much over past months that it won't take much to break the psychological 1.20 level (even if bund yields are stable). The run-up to President's Draghi Jackson Hole speech (end-Aug), speculations about the ECB meetings in Sep and Oct and risks of softer US data provide potential catalysts.

Fig 9 EUR/USD overshot on a short-term basis



Source: ING

Fig 10 Market all but ignores Fed's rate guidance



Source: ING, Fed

After a big rally, there will be a pause for a breath

Yet, the EUR/USD 1.20 level is unlikely to be sustainable for the time being. We look for EUR/USD to return close to 1.15 by end-2017/early-2018 and stay there in 1Q18 due to:

1. The recent EUR strength is unlikely to be welcomed by the ECB (see the Eurozone section above). We therefore expect the ECB to deliver more **dovish form of QE tapering** vs market expectations to tame the currency upside.

2. We expect the run-up to the **Italian Parliamentary elections** (likely to be held at the end of 1Q18) to take the wind of the EUR sails primarily via the lower bund yields channel. Moreover, with EUR being no longer heavily undervalued and the speculative community no longer being decisively short EUR, the odds of some modest risk premia built-up into the common currency have risen.

3. **On a short-term basis, EUR/USD is already rich** (as per above), materially overshooting its short-term financial fair value. If (a) the upside to bund yields is to be limited due to the ECB delivering a dovish form of QE tapering; (b) bund yields decline by the year end/beginning of 2018 due to the Italian election uncertainty, then it will be difficult for EUR/USD to continue pushing higher and the cross should eventually correct to the fairer/more sustainable levels.

4. **Plenty of bad news seems to be already priced into USD**, in turn limiting the-dollar-weakness-led EUR/USD upside. Due to faltering US inflation dynamics, the market all but ignores the Fed's interest rate guidance, only pricing one-

and-half rate hikes by end-2018 vs 4 hikes indicated by the dotted diagram (Fig 10). This limits scope for an additional USD weakness via the Fed re-pricing channel.

EUR/USD to sustainably move above 1.20 next year and reach the 1.25 level

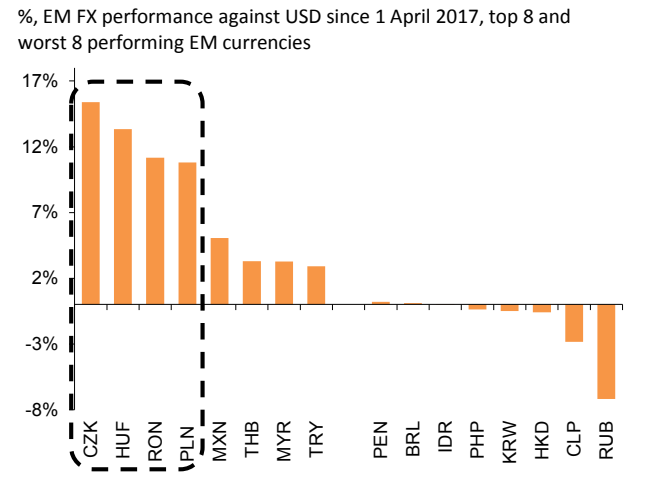
While the dovish form of the ECB QE tapering and Italian elections should cap the EUR/USD upside and lead to some correction lower in coming months/quarters, they are unlikely to alter the medium-term EUR appreciation trend. Once the dovish and the likely more prolonged QE tapering ends, markets should start prepositioning for the normalisation of the depo rate (in the same forward looking manner as the market had been prepositioning for the QE tapering over the past months). This should push EUR/USD higher later next year, towards the 1.25 level.

Going forward, one should also expect the EUR/USD upside to be more orderly and not on the scale of the cca 10% rise observed over the last four months. This is because the cross no longer shows the extreme mis-valuation levels it has been showing since the beginning of 2015, hence the scope for an additional abrupt correction is more limited.

European FX outperformance to continue for a while yet

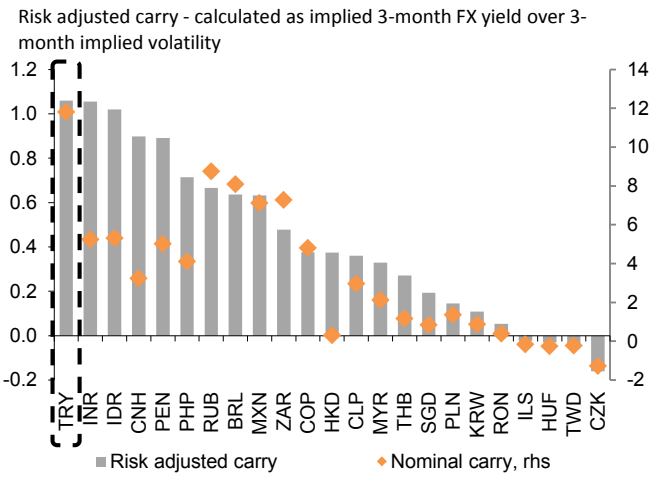
The spill-overs from the observed EUR rally are clear and obvious. European currencies (both within the G10 and EM FX segments) benefit vis-à-vis their USD-bloc peers. As Fig 11 shows, CEE FX indeed turned into a top performer (see CEE FX: The EUR/USD on steroids). As long as EUR remains bid in coming weeks, this trend of the past months should remain unchanged, with European FX outperforming the rest of the world.

Fig 11 CEE FX turned into an unbeatable outperformer



Source: ING, Bloomberg

Fig 12 TRY offers the highest risk adjusted carry



Source: ING

Dovish form of ECB QE tapering = still conducive environment for carry

Importantly, and despite the EUR strength of past months being in great part derived from building market expectations of ECB QE tapering, we don't expect a material and negative spill-over into the attractiveness of EM carry trades. As per above, the strong EUR will in our view translate into the ECB opting for a dovish form of QE tapering. This should in turn limit the upside to bund yields (and thus long-end core yields). In effect, this less aggressive form of ECB policy normalisation should further prolong the current carry-conducive environment. Our top pick remains TRY, given its highest nominal and risk adjusted carry in the liquid EM FX space (Fig 12).

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Rates – post-Sintra pause?

Bund sell-off has lost its steam

The sell-off in German 10-year Bunds that commmenced after Mario Draghi's speech in Sintra, Portugal, appears to have run out of steam. In fact, 10-year yields have recently slipped back to the 0.50% area – which marked the top end of the range that prevailed in the first six months of this year. ECB rhetoric, including that of the central bank president at the July policy meeting, has clearly turned more cautious, and markets seem to be bracing themselves for a 'dovish' ECB taper announcement in the autumn.

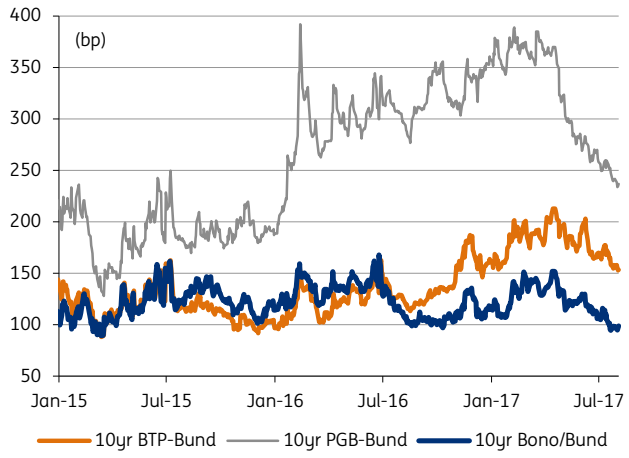
Carry trades in favour over the summer

Moreover, investors have shifted their focus to subdued new bond issuance over the summer, while wading back into riskier carry trades. This is clearly visible in the behaviour of sovereign yield differentials with Germany. We find 10-year Spanish spreads over Bunds trading at the lows seen at the time of the launch of QE in March 2015 (Figure 13), despite the growing clash between the Spanish central and Catalan government on the latter's desire to hold a referendum on independence on 1 October (which indicentally is already leading to higher yields on outstanding Catalan debt). The spread at which Italian bonds trade over Bunds has also narrowed, as if investors have forgotten about the elections that will take place within the next 9 months.

Peripheral spreads look vulnerable to ECB tapering

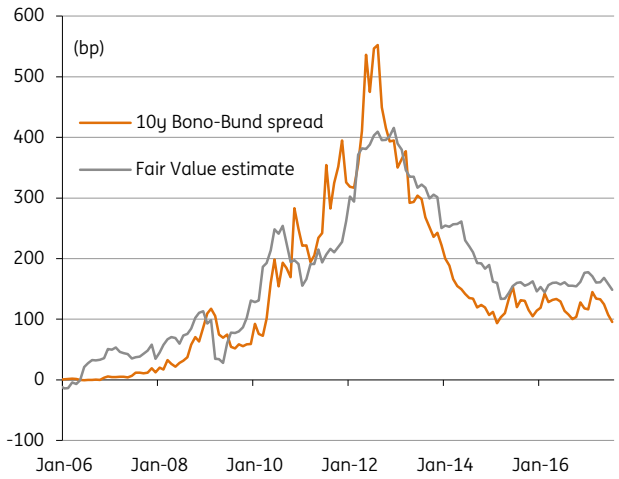
We still believe that peripheral spreads, Italian ones in particular, are vulnerable to any sign of real ECB QE tapering. Our fair value estimate for Spanish-Germany 10-year yield spreads, which is based off relative growth and fiscal differences amongst others, suggests that the tighening impact of QE is around 50bp at the moment (Figure 14).

Fig 13 10yr Spain/Germany spreads at lows seen in March 2015



Source: Bloomberg, ING estimates

Fig 14 10Y Bono-Bond spread



Source: Bloomberg, ING estimates

Open-ended ECB taper scenario could limit widening impact on spreads

While we do not think this will fully disappear after a taper announcement, much will depend on how long the tapering will take. In our view the ECB will be keen to avoid a scenario where investors quickly extrapolate the end of the net asset purchases (hence our house view for a 6 month extension to mid-2018 at a *constant* albeit lower purchase pace). To credibly signal that QE could be extended further, however, taking into account a scarcity of eligible debt, the ECB would have to tweak the modalities of the PSPP, eg, increase the issue share limit for non-CAC bonds.

All in all, the summer calm may well persist until Draghi's speech at the 24-26 August Jackson Hole Summit, which takes place two weeks before the September ECB meeting.

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Fig 15 ING global forecasts

	2016F					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	2.6	2.7	2.2	2.1	2.2	2.1	2.8	2.5	2.4	2.7	2.5	2.7	2.5	2.6
CPI headline (% YoY)	1.1	1.1	1.1	1.8	1.3	2.5	1.9	1.8	2.1	2.1	1.9	2.1	2.4	2.3	2.2	2.3	2.2	2.2	2.4	2.2
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	1.33	1.56		1.62	1.82	1.92	2.08		2.18	2.35	2.45	2.61	
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					76.4					77.0					77.2
Eurozone																				
GDP (% QoQ, ann)	2.1	1.4	1.8	2.1	1.8	2.3	2.1	1.8	1.8	2.0	1.8	1.7	1.7	1.7	1.7	1.5	1.5	1.5	1.4	1.5
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	1.9	1.9	1.8
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	0.25	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	-0.20		-0.15	0.00	0.10	0.20	0.20
Fiscal balance (% of GDP)					-1.5					-1.4					-1.3					-1.3
Fiscal thrust (% of GDP)					0.1					0.3					0.2					0.0
Gross public debt/GDP (%)					91.5					90.4					89.0					87.7
Japan																				
GDP (% QoQ, ann)	2.8	1.7	1.0	1.4	1.0	1.0	1.7	1.0	0.9	1.2	1.2	1.0	1.0	0.9	1.0	0.9	0.9	0.9	0.9	0.9
CPI headline (% YoY)	0.1	-0.4	-0.5	0.3	-0.1	0.3	0.5	0.8	0.6	0.6	0.8	0.9	0.9	0.9	0.9	1.0	1.0	1.0	1.0	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
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		0.1	0.1	0.1	0.1	
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	1.7	1.5	2.0	1.9	1.7	1.7	1.8	1.9	1.8	1.9	2.0	1.9
PBOC 7-day reverse repo rate (% eop)	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
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	0.9	1.2	1.0	0.9	1.5	1.1	1.4	1.8	1.6	1.2	1.9	2.1	1.7	2.2	1.8
CPI headline (% YoY)	0.3	0.4	0.7	1.2	0.7	2.1	2.7	2.8	2.9	2.6	2.7	2.6	2.7	2.7	2.7	2.7	2.5	2.3	2.2	2.4
BoE official bank rate (%, eop)	0.50	0.50	0.25	0.25		0.25	0.25	0.25	0.25		0.25	0.25	0.25	0.25		0.25	0.50	0.50	0.75	
BoE Quantitative Easing (£bn)	375	375	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		0.35	0.35	0.35	0.40		0.40	0.40	0.40	0.40		0.50	0.70	0.70	0.90	
Fiscal balance (% of GDP)					-2.3					-2.2					-2.1					-1.6
Fiscal thrust (% of GDP)					-0.6					-0.9					-0.7					-0.8
Gross public debt/GDP (%)					86.5					85.1					84.0					82.1
EUR/USD (eop)	1.05	1.11	1.12	1.05		1.08	1.12	1.18	1.15		1.15	1.20	1.22	1.25		1.27	1.28	1.29	1.30	
USD/JPY (eop)	112	103	101	112		112	115	118	120		118	120	120	120		115.0	115.0	112.0	110.0	
USD/CNY (eop)	6.45	6.65	6.67	6.95		6.89	6.78	6.73	6.72	6.72	6.70	6.68	6.65	6.60	6.60	6.50	6.50	6.50	6.50	6.5
EUR/GBP (eop)	0.80	0.84	0.88	0.87		0.87	0.88	0.90	0.85		0.83	0.85	0.83	0.80		0.80	0.80	0.79	0.78	
Brent Crude (US$/bbl, avg)	35	47	47	51		55	51	45	45		42	42	47	47		45	50	50	55	

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

Source: ING estimates

Disclaimer