Economic and Financial Analysis

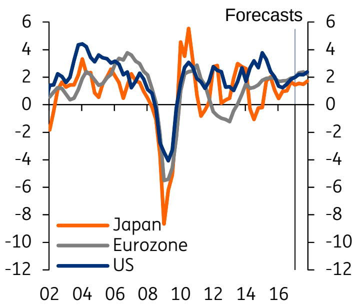
ECONOMICS | Global

6 October 2017

Monthly Economic Update

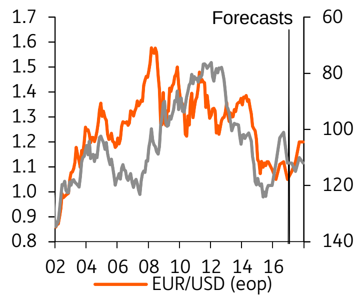
Actions speak louder than words…

GDP growth (% YoY)



Source: Macrobond, ING

FX



Source: Macrobond, ING

Central bankers have been warning of higher interest rates since the summer. The Federal Reserve says markets are too complacent, the Bank of Canada has done a swift about face and hiked rates twice and the Bank of England will soon follow. Meanwhile, the European Central Bank is on the verge of tapering its asset purchases and there is even speculation Japan could do so. Nonetheless, political risk remains high. Referendums, elections and a potential government shutdown suggest nothing can be taken for granted, leaving doubts about how far central banks can push ahead.

The US growth story is looking very positive with a strong domestic economy boosted by a relatively weak dollar and improving global demand. If President Trump can make progress with tax reforms this should add to the upside potential. Inflation is likely to soon turn higher so the Federal Reserve is still backing the case for four rate hikes over the next 15 months.

However, the Federal Reserve has historically tended to over predict where rates will end up. Its management could also see major changes given there are four vacancies on the Board of Governors while there is no guarantee Janet Yellen will remain in post after February. Then there is the potential for an economically damaging government shutdown in December. As such, some scepticism regarding the path of monetary policy is justified.

Even with a less integration minded German government and political turmoil in Spain, the Eurozone recovery maintains momentum. However, inflation continues to undershoot. The ECB will have to taper its bond purchases to address the scarcity issue, while at the same time keep policy loose enough to reach the inflation target. Lower amounts of purchasing, but for a longer period than the markets are expecting could prove to be the way out, shifting the markets' expectation for a first rate hike to 2019.

A November UK rate hike is now firmly on the table as the Bank of England seeks to avoid being left behind in the global race to tighten policy. But Brexit noise is as high as ever, and the sluggish economic outlook means there could be few hikes to come.

China's 19th Congress will consolidate Xi Jinping's power in the Party, meaning reform and the anti-corruption campaign will continue. This is positive for future economic sustainability. We expect a more aggressive target for growth to "around 6.5%" per year through 2025.

Japan's PM has taken a gamble in calling a snap election to capitalise on opposition disarray, and a fleeting rise in his popularity ratings during the North Korea crisis. The main policy issue at stake is the implementation of another consumption tax hike, with revenue proceeds to be funnelled into education and pre-school child care. Despite considerable scepticism about any new tax hike, we have formally incorporated this policy into our revised GDP and inflation forecasts.

Firmer US rates at the short end of the yield curve and positioning have driven the EUR/USD correction below 1.20. Yet this move could easily be reversed by the ECB meeting on 26 October, where concerns over EUR strength are trumped by the practical challenges of scarcity in the bond buying programme. We remain constructive on the EUR.

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US: The case for higher rates

The Federal Reserve has retained a hawkish bias…

The September Federal Open Market Committee (FOMC) meeting suggested that in the Federal Reserve's view the monetary policy stance remains "accommodative" and "gradual increases" in the Fed funds rate are warranted. Moreover, the updated forecasts showed individual members sticking to their guns in predicting rates will be raised again before the end of the year and that we should be prepared for three more rate rises next year. In a subsequent speech, Fed Chair Janet Yellen went further, suggesting officials should be "wary of moving too gradually" and that it is "imprudent" to wait until inflation is above 2% before raising interest rates.

… suggesting that delaying rate hikes too long is a clear risk

But markets think the Federal Reserve is overly aggressive in predicting four rate rises by end 2018

Nonetheless, markets remain sceptical. They are only fully pricing in one rate rise by the end of next year with a second 25bp hike given only a 50:50 chance. This is a major difference from the four hikes the Fed are indicating, but in fairness, there are factors to justify caution.

The Fed has been over predicted before

Firstly, the Fed has overpredicted the path of the policy rate on several occasions, and in an environment with low inflation and subdued wage growth there is little to suggest the need for major policy tightening

While a change of Fed leadership could result in a different path for policy

Then there is the fact that the FOMC is changing. Vice Chair Stanley Fischer has resigned, effective 13 October and Yellen's term as Governor ends in February 2018. It will be another "two to three weeks" before Trump decides whether to re-appoint her. There are already three other vacancies on the Fed Board so President Trump has the option of radically changing the makeup of the FOMC, which could significantly change the prospects for rate hikes.

Then there is the debt ceiling and potential government shutdown to consider…

Another factor that makes the market doubt the Fed's predictions is the proximity of the next FOMC meeting in December (13th) to the debt ceiling extension date (15th). If there is no agreement to raise the debt limit, the US government will be unable to borrow money and will instead have to default (given tax revenues aren't enough to cover expenditure), either to workers or suppliers or on its debt payments.

… which has the potential to increase market volatility and pose economic risks

In the past, we have seen hundreds of thousands of workers furloughed because of this and during the 2013 crisis the US lost its S&P AAA rating and the Dow Jones equity index fell 17%. Given politics is so divisive in Washington right now, the possibility of another shutdown can't be ruled out. This may prompt the Fed to tread cautiously, not wanting to add potential financial market strains by tightening monetary policy.

However, the economy is looking strong

While Fed's forecast for the path of policy may look aggressive to to the market, we feel it can be justified by the underlying health of the US economy. The latest ISM manufacturing survey is at levels historically consistent with 7% annualised growth, indicating that the sector is benefiting from a strong domestic economy, a weak dollar and a stengthening global economy.

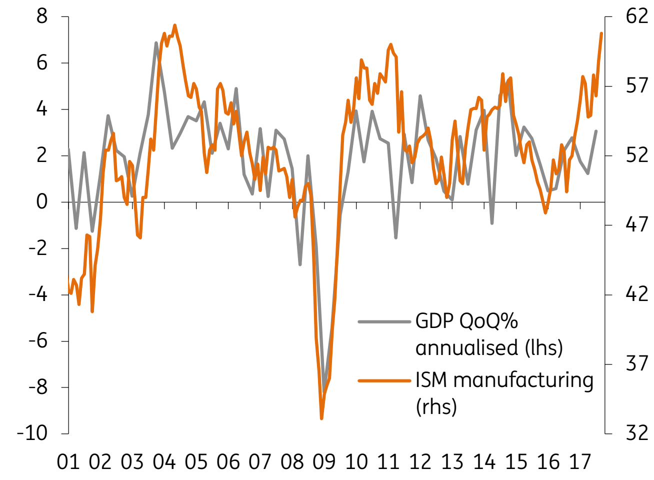
Meaningful tax reform would boost economic prospects

Meanwhile, unemployment is at a 16-year low, confidence is at healthy levels, the economy expanded at a 3% annualised rate in 2Q17, and it may do the same again in 3Q17. If Donald Trump can soon deliver on tax reform, resulting in meaningful cuts that could boost consumer and business spending, this will add to the upside for growth.

Inflation could also make a return thanks to energy, currency and employment effects

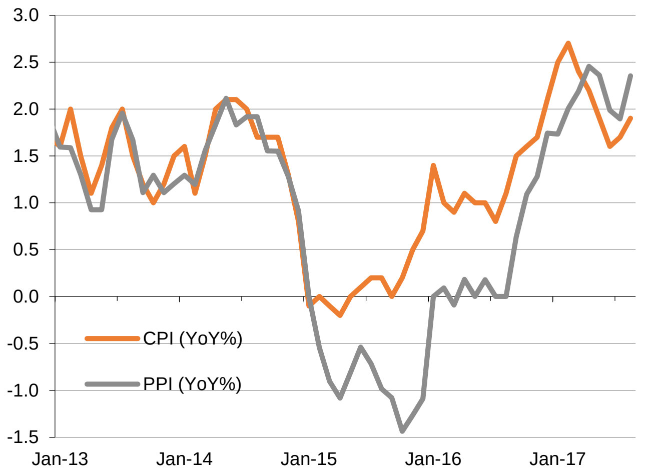
Then there is inflation. It's likely to rise and push above the 2% target quite soon. Refinery outages (because of Hurricane Harvey) have pushed up gasoline prices and with oil prices hitting new highs it looks as though the energy component will support overall inflation. The dollar's 10% depreciation on a trade-weighted basis is contributing to higher import prices with producer price inflation accelerating sharply. We are also seeing some signs that wages may tentatively be responding to the tightness in the labour market, which will push up service sector inflation in particular.

Fig 1 ISM surge boost hopes for GDP growth



Source: Macrobond

Fig 2 PPI & CPI heading higher



Source: Macrobond

Yellen is wary of the inflation threat

In this regard, Yellen has warned that "without further modest increases in the federal funds rate over time, there is a risk that the labour market could eventually become overheated, potentially creating an inflationary problem down the road that might be difficult to overcome without triggering a recession."

But there are other factors the Fed use to justify action

At the same time, the Fed has cited other factors that justify the tighter policy. These include relatively loose financial conditions for which we can point to dollar weakness and the relatively flat yield curve. Some Fed officials have suggested that this gives them greater scope to tighten monetary policy through a higher Fed funds rate.

Loose financial conditions, asset valuations, debt levels and financial stability have also been cited as factors in their thinking

Then there is the issue of asset valuations. In June, Yellen suggested that asset prices on some valuation metrics were "somewhat rich", but her warnings appear to have fallen on deaf ears with equity prices continuing to grind higher. The Fed has little ammunition to deal with the fallout from any sharp correction so early action to try and prevent bubbles forming seems to be on their agenda. In this regard, Janet Yellen also warned "persistently easy monetary policy might also eventually lead to increased leverage and other developments, with adverse implications for financial stability."

A December rate hike is looking likely assuming a government shutdown can be averted

Taking this altogether, with the economic data looking in decent shape, inflation likely to rise in the near-term and both the Fed's dot diagram of rate expectations and Yellen's subsequent speech suggesting an inclination to hike again this year we continue to look for a December rate rise. A debt ceiling crisis is the main threat but President Trump has recently shown he can work with both Republicans and Democrats, which could avert disaster.

The Fed's balance sheet strategy could limit the need for more hikes

For next year we are more cautious than the Fed. We anticipate two hikes. The global growth story is improving, and inflation pressures are likely to build gradually. However, the Fed's balance sheet reduction strategy means the market will have to absorb more Treasury supply, which could push up longer-dated yields more quickly than the Fed might hope. This would in itself tighten monetary conditions, limiting the need for rate hikes at the short end.

While the economic cycle feels mature, there are still positives that could keep the growth story going for longer

Looking longer term the economic outlook is more uncertain. By historical standards the cycle is mature and in an environment with the Fed hiking rates, rising indebtedness and questions about how much longer asset prices can keep rising there are legitmate concerns about the prospects. Nonetheless, there are positives. Despite higher US interest rates, our FX team believe the dollar will underperform other economies, supporting competitiveness. Also, it will take time for tax cuts to come through and if we do see a significant proportion of the US$2-3 trillion of corporate earnings sat overseas return to the US this should boost the prospect for investment in the US economy (or incomes if special dividends are paid). Then there is the US$1 trillion of infrastructure spending that Trump promised. If we can see progress here too this should keep the growth story continuing for longer, admittedly to the detriment of the budget.

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Eurozone: Economics trump politics

Economic news remains upbeat…

Eurozone economic indicators continue to surprise to the upside. The recovery is now firmly underway, with all GDP components contributing to the expansion. While the relatively robust growth pace is also likely to reduce tensions within the Eurozone, politicians will need to seize the occasion to structurally strengthen the Monetary Union.

…though political worries have increased somewhat…

However, with Chancellor Merkel's power reduced after the German elections and the less Eurozone integration-minded FDP likely to step into the coalition, the chances to see bold steps towards deepening European ties look slim. While French President Macron presented ambitious proposals to advance the European Union, his proposal of a common Eurozone budget, needed to dampen asymmetric shocks within the Eurozone, is probably a no-go for the new German government. This will not matter much as long as healthy growth continues. But the next slowdown could reawaken some of the centrifugal forces within the Eurozone.

…with a shrinking probability of significant Eurozone reform

One shouldn't forget either that Italian elections will have to be held before May 2018. And even though Italian growth is now also picking up, the country continues to lag the rest of the Eurozone, which still underpins the chances of the more populist parties coming out on top. The economic recovery in Spain has been much stronger, but the escalating conflict between Catalonia and the central government is also likely to lead to more nervousness amongst investors, even though an independent Catalonia is unlikely to be the final outcome of the current turmoil.

Fiscal policy remains stimulative

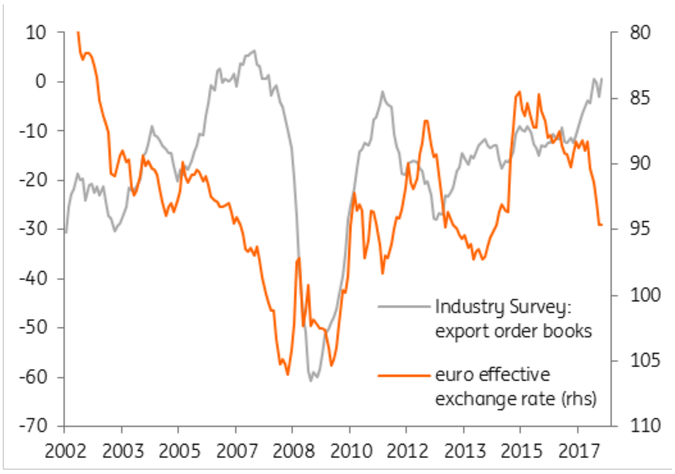
While the potential three-party (some even argue four as there are inner tensions within the political group of Merkel's CDU and the Bavarian sister party CSU) coalition in Germany is likely to remain rather hesitant in terms of further Eurozone reform, there seems to be an opening for a fiscal boost, something that would strengthen the Eurozone recovery. We expect some fiscal stimulus in Germany to boost investment in digital infrastructure and education. Fiscal policy in the Eurozone in general has been more supportive over the last two years and will continue to be in 2018.

The recovery has momentum…

…justifying an upward revision of our growth forecasts

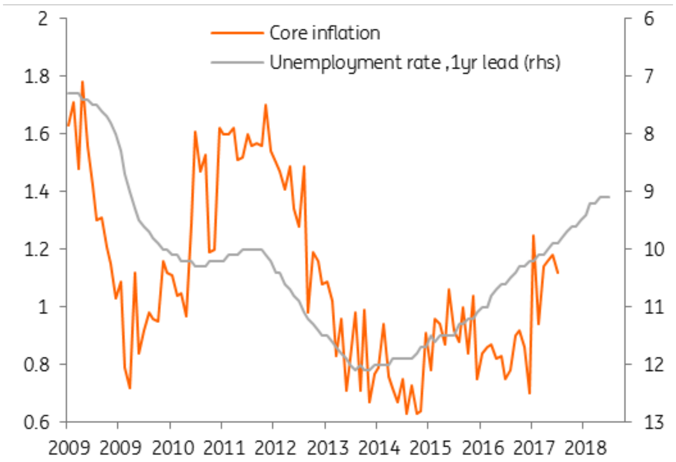
The Eurocoin indicator, reflecting the underlying GDP growth pace in the Eurozone, rose to 0.71 in September from 0.67 in August, increasing for the fourth consecutive month. Most forward looking indicators confirm the economy's momentum. The assessment of order books in manufacturing in the European Commission's survey rose to the highest level in 10 years in September. Interesting to note is that the export orders assessment also surged in September despite the strengthening of the euro exchange rate. September also saw a further increase of consumers' intentions to purchase big-ticket items over the next 12 months to a level compatible with above 2% growth in consumption expenditure. Against this backdrop we believe our growth expectations were a bit too conservative and we have decided to lift our GDP forecasts to 2.2% for this year and 1.8% for 2018, with still some upward surprise risk.

Fig 3 Exports have not been hurt by stronger euro…



Source: Thomson Reuters Datastream

Fig 4 … while core inflation is expected to rise very slowly



Source: Thomson Reuters Datastream

Inflation surprises to the downside…

Preliminary inflation figures for September surprised on the downside. Headline inflation remained stable at 1.5%, while core inflation defined as inflation excluding energy, food, alcohol & tobacco prices fell back to 1.1% from 1.2% in August. However, the European Commission survey clearly indicates increasing pricing power amongst European businesses, while wage growth is also likely to pick up somewhat on the back of the falling unemployment rate. That said, the upward trend in core inflation is likely to remain gentle. Our estimate of the Eurozone Phillips curve (which shows the inverse relationship between unemployment and wage growth) sees core inflation increasing to 1.6% at most by the end of 2018.

…making tapering a challenging exercise

We see much lower QE, but lasting longer than the markets expect.

October's meeting is likely to be one of the greatest balancing acts in the ECB's history. On the one hand, the ECB will have to announce some kind of tapering of its bond purchases, given the increasing scarcity issues in terms of bonds to buy. At the same time it will have to try to avoid the market misinterpreting the announcement as overly hawkish, thereby leading to a premature tightening of financing conditions. We indeed believe that the ECB will reduce the monthly amount of purchases (it could be quite drastically to about €20bn to €25bn), but could surprise the markets in terms of the length of the programme, potentially lasting until the end of the year. This would follow the same pattern as the ECB's first tapering decision in late 2016, when it announced the reduction of the monthly purchases from €80bn to €60bn for longer than markets had anticipated: another 'lower for longer'. At the same time, the ECB will continue its efforts to shift the emphasis of monetary policy to interest rates again, soothing the markets with the implicit promise that a deposit rate hike is not to be expected before the end of 2018.

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UK: Carney's conundrum

A November rate hike is looking increasing likely

The big story in the UK this month is when, and by how much, the Bank of England will hike rates given the increasingly hawkish tone it has taken of late. And now that the Bank has said a hike may be needed in "the next few months", a November move is firmly on the table. But the thing that has had analysts and investors scratching their heads is the fact that the economic outlook has not changed noticeably in recent months.

Wage growth isn't showing signs of taking off

The Bank has pointed to a tentative pick-up in wage growth, after a particularly lacklustre start to the year. But we suspect this may just be the unwinding of some temporary factors and we doubt wages will take off from here – or at least not to the degree the Bank forecasts. Likewise, whilst the real wage squeeze may have reached its worst, the gap between headline inflation and wage growth looks set to stay fairly wide into early next year, keeping pressure on household spending.

The Bank is keen to exit "emergency mode"

So why is the Bank looking to tighten policy? Well, 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 taking a leaf out of the Bank of Canada's book, by taking a more forward-looking approach to policymaking 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.

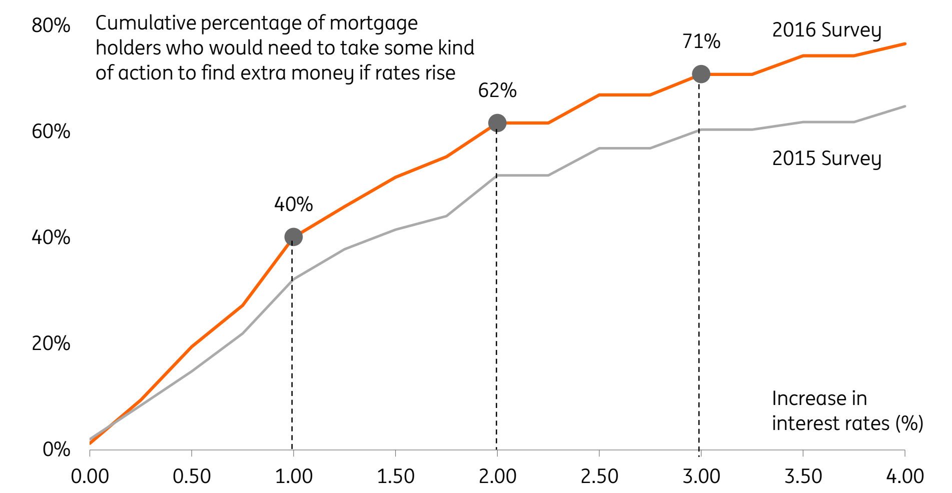
But a series of rate hikes looks unlikely at this stage

But whilst we're now pencilling in a November hike, we think the chances of a series of hikes thereafter are low. Aside from the sluggish economic backdrop, we are also seeing few signs of domestically-generated inflation once the currency effect is stripped out. By one measure, which deconstructs the inflation basket by import intensity, core inflation would be just 1.6% without the pound's depreciation and oil price effect.

Borrowing has fuelled much of the rise in consumer spending of late

There's also a financial stability angle. Consumer spending has been on a rollercoaster ride since Brexit – surging into the end of 2016 before coming to a standstill in the first half of this year. 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.

Fig 5 Effect of rate hikes on variable mortgage holders



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

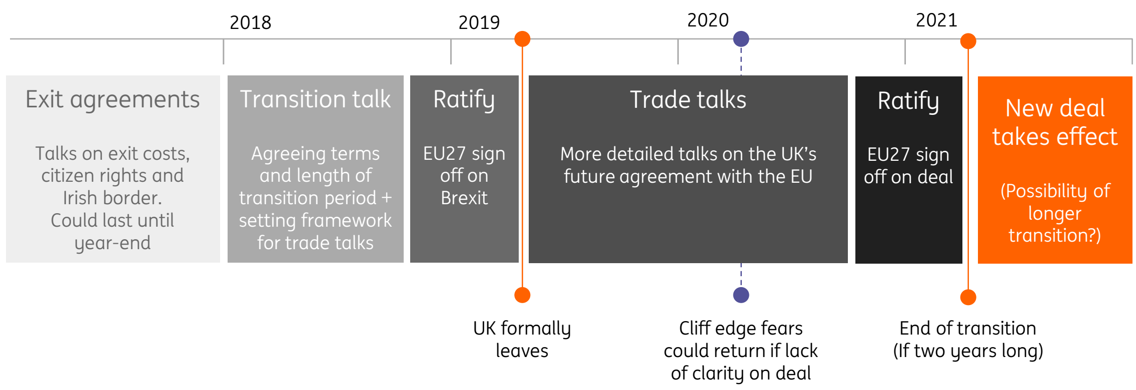
Households are very sensitive to rate rises

This is a major consideration when hiking interest rates. A survey by the Bank of England at the end of 2016 found that 40% of variable/tracker mortgage holders would need to take "some kind of action to find extra money" if interest rates rose by 1% from current levels. With consumer spending already fragile, the Bank will be keen to tread carefully as it begins hiking rates.

Transition deal talk helps, but clarity on the details is key

But as ever, perhaps the biggest consideration is Brexit. The fact the UK government is increasingly coalescing around the idea of a two-year transition deal for leaving the EU could begin to unlock some short-term hiring and capital spending by firms. That said, there are still plenty of obstacles to be overcome in the negotiations before a transition period is signed and sealed.

Fig 6 Brexit timetable based on two-year transition



Source: ING

Without concrete agreement on the trading environment and length of the transition, some firms will inevitably have to remain cautious. To take one example, the airline industry will want clarity very soon on their ability to continue flying freely between the UK and Europe if they are to start planning schedules, hiring and selling tickets for 2019.

Cliff edge risks delayed, but they could come back

There's also a risk that cliff edge fears could still make a comeback. In the same way businesses will need advance warning of the form the transition will take, they will also need to know what the UK's ultimate trading relationship will be well in advance of the transition coming to an end. If the post-Brexit overlap is indeed two years, then this deadline could come into focus pretty quickly after the UK formally leaves the EU in 2019 – though of course the transition timeframe could be longer or extended.

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China: The 19th Congress

What do we look for in the 19th Congress beyond reforms?

The Chinese government has set the scene for the Politburo in terms of introducing more State Owned Enterprise (SOE) reform cases. We need to now think ahead to what else we can expect from the 19th Congress.

We expect Xi Jinping to consolidate his power in the Party

The most important point to note in the Party Congress is changes of Party members in the Politburo. We expect any changes to consolidate Xi Jinping's power at the top of the Party. And this suggests that reform and anti-corruption campaigns will continue.

So, reform and anti-corruption campaign will continue, which is positive for future economic growth

Xi Jinping will draw attention to still solid GDP growth even though the Chinese economy has been under supply-side reform, which has cleaned up companies in overcapacity sectors. In other words, from the viewpoint of the government, supply-side reform could be positive for future growth. We agree on this point, as signaled by strong growth in industrial profits (21.6% YoY YTD in August 2017).

If Xi fails then anti-corruption campaign will stop, and will put sustainability of economic growth at risk

If Xi Jinping cannot line up party members who are in his camp for roles at the top of the Party, then the anti-corruption exercise will likely stop. This would also risk the continuation of SOE reforms, and would put the sustainability of economic growth at risk for the next five years. If the anti-corruption exercise were to stop, there would be revitalisation of retail sales because of likely return of lavish spending.

The main target was doubling GDP between 2010 and 2020

The market largely expects that the government to reaffirm its economic growth target of doubling GDP between 2010 and 2020 (which was set in the 18th National Congress in November 2012). But we think that the government will be more aggressive on this target because Chinese GDP reached 90% of the 2020 target in 2016. Our forecast of real GDP growth is 6.8%, 6.7%, 6.7% and 6.5% for 2017 to 2020. If GDP growth is in line with our forecasts, then Chinese GDP would be around CNY96 trillion in 2020.

This target is too loose to be applicable. We expect an aggressive target of "around 6.5%" by 2025

As the target of doubling the economy by 2020 is well within sight, we believe that the government will be more aggressive on growth. It may not set a specific growth rate but using the same wording as in the Government Working Report of "around 6.5%" for the decade into 2025.

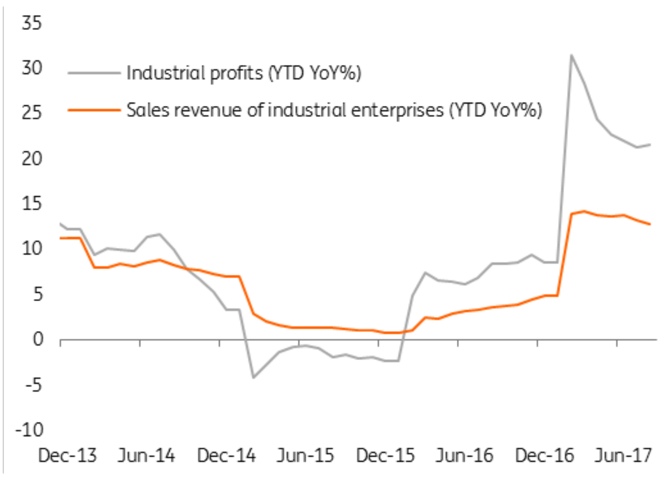
If there is no GDP target then look for highlights of reforms, which is good for longer term

If there is no reference to any GDP target, then the tone may change to highlighting reforms. One of the possible targets could be setting an upper limit of leverage ratios for SOEs and local governments. This might be seen as good news for the longer term (over 5 years) at the cost of short- to medium-term growth (2-3 years).

Expect plan on increasing prevalence of high-tech and greater use of clean energy

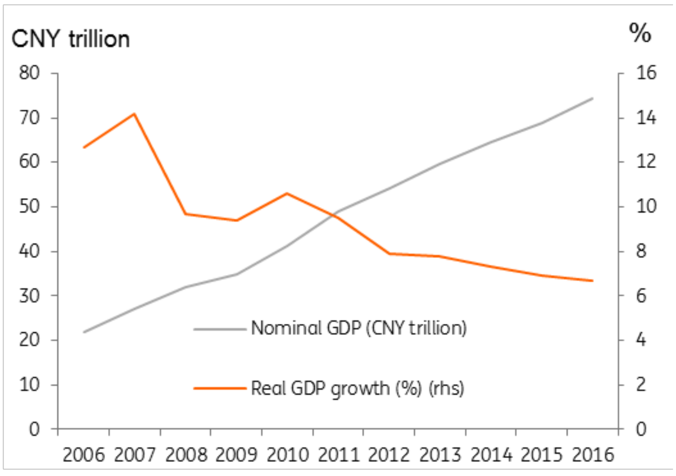
We also expect to see plans to boost the economy by increasing the prevalence of high-tech and greater use of clean energy. Specific targets may be set for these industries. We do not expect any specific time frame or details on RMB internationalisation reform. Despite this, if the announced economic growth target is around 6.5% then it would give a sturdy fundamental background for CNY appreciation.

Fig 7 Still high industrial profit growth even companies undergo clean up reform



Source: ING Bank, Bloomberg

Fig 8 We expect the 19th Congress to announce GDP target as "around 6.5%"



Source: ING Bank, Bloomberg

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Japan: Abe's gamble

Will the snap election gamble to push through PM Abe's policy agenda pay off?

Japan's PM Abe has gambled that a snap election will return him as PM, and give him the mandate to push through his policy agenda. Prompting this move was a sense that Abe had benefited from a recovery in public opinion, following North Korea's recent display of belligerence. He is also no doubt aware that the opposition party, the Democratic Party of Japan (DPJ), is in deep disarray.

Strong GDP gives favour to PM Abe, but it may not have been his doing

Recent Japanese data has also been strong. Abe will claim credit for this, though Japan's strength is mirrored elsewhere in the region, and Japan seems to be riding on the crest of global demand for Asian goods, including its own. Japan's GDP is strong (for Japan) and unemployment is very low. Even the inflation rate seems to be slowly heading higher, it remains well south of the BoJ's utterly non-credible 2.0% target.

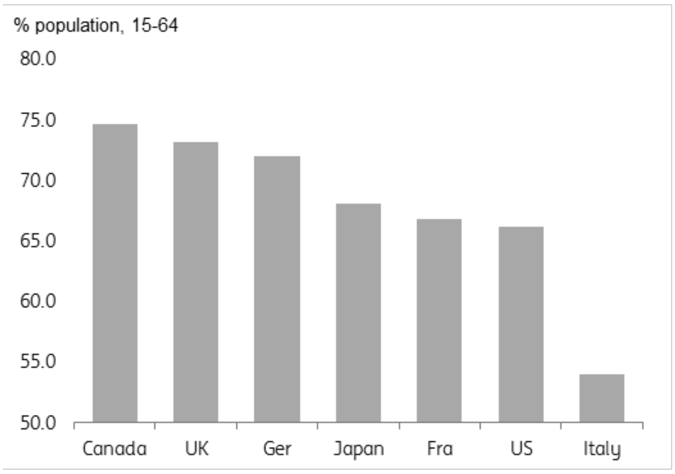
Abe has pledged to raise the consumption tax to enhance education, not reduce the deficit...

If he wins the election, Abe has pledged to raise the consumption tax by 2ppt to 10% (not an obvious vote winner) in 2019. Instead of using the proceeds of the tax hike to work down Japan's deficits, as previously promised, Abe has promised to spend the money on enhancing education, especially pre-school care for would-be returning mothers.

...this makes some sense as a policy move

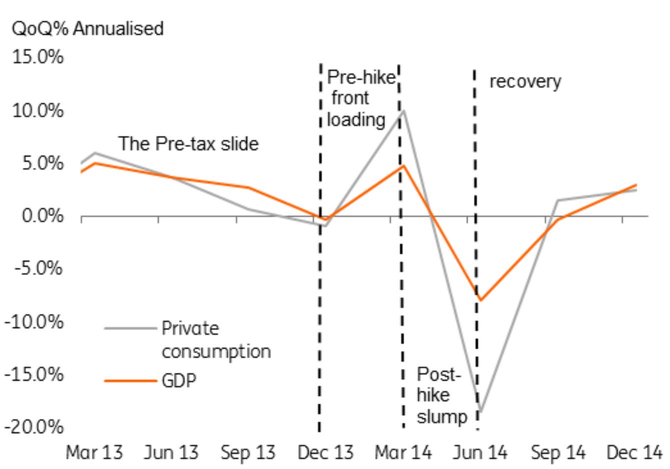
As a policy move, this makes some sense. Japan's weak potential growth is a function of a shrinking labour force. Japan's female participation rates are lower than they could be, though on an international context, Japan compares favourably with some of the bigger European countries on this metric.

Fig 9 Japan and other female labour participation rates



Source: CEIC

Fig 10 The 2014 consumption tax hike



Source: CEIC, ING

It will likely cause a small boost to potential output but a dampening hit to demand

From a macro perspective, such policies will provide a boost to potential output, but probably a very small one. The construction of facilities to provide these services will, however, deliver a bigger short-term bounce.

Even so, it is difficult to see a rise in the consumption tax being neutral with respect to the economy, and at best, we envisage the re-distributed revenues and ensuing activity dampening the hit to demand.

Having been through these tax hikes before, there is a well-worn path for forecasting the outcome, which entails a pre-April 2019 spike in consumer spending and construction to front-run the tax hike (anything from new homes to toilet rolls will be pre-stocked), followed by a slump, and a slow grind back to previous growth rates.

But will Abe go through with the tax hike? Past experience says he might not

Abe has pulled back from implementing tax hikes before, and it is possible he does so again. He has built in an opt-out into his pledge, saying that the tax hike will go ahead unless it is likely to weaken the economy. And there remains considerable scepticism in the region about a 2019 tax hike. But with growth currently strong, we are now formally incorporating the consumption tax hike and spending pledges into our growth and inflation numbers.

The election is still a gamble with a new political order shaping up in Japan

Despite no coherent opposition, this election is still a gamble for Abe. As we wrote two months ago, a new political order is shaping up in Japan, resulting in the sweeping Tokyo election victory for Mayor Juriko Koike. Her Tokyo movement is now trying to join forces with the disbanded DPJ to form a national "Party of Hope", to challenge Abe.

But it is still likely Abe will win

With the election on 22 October, we think her chances are slim, even though there are some parallels between what she is trying to do, and Emmanuel Macron's "En Marche" victory, and also between Abe's gamble, and the failed gamble of UK PM May earlier this year. Moreover, in terms of policies, there is very little to separate Koike from Abe on policy grounds. This is more about personalities, and so far, Koike is about the only personality in her fledgling party. In four years' time, the Party of Hope will likely give the LDP a run for its money. But they face a very difficult task at this election.

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FX: Temporary reprieve for USD

The recent EUR/USD correction below 1.20 looks to have been driven more from the USD side. Here greater confidence in a December Fed rate has pushed short-term interest rate spreads to new wides – at a time when the market was positioned heavily short the dollar. Yet we very much view the EUR/USD sell-off as a bull market correction. We continue to see the 1.15/17 area as the low end of a multi-quarter trading range.

At various times this year, different maturities of the EUR versus USD yield spread have determined EUR/USD pricing. In July and August, the sharp narrowing in 10-year spreads (led by higher Bund yields) was the story. Over the last month it has been the widening of short-end spreads – driven by confident Fed policy – that has weighed on EUR/USD.

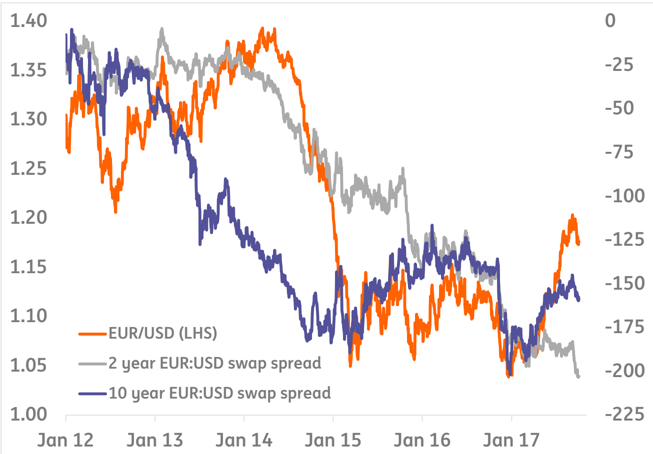
The biggest driver of EUR/USD this month should be the ECB meeting on 26 October

What next? Barring a major escalation in the Korean dispute or a very credible Trump tax plan, the biggest driver of EUR/USD this month should be the ECB meeting on 26 October. As Peter notes above, the ECB will have to tread the narrow path between forward guidance to keep monetary conditions in check, whilst at the same time addressing genuine scarcity issues in its PSPP bond purchasing programme.

The ECB may not be as worried about EUR strength as the market believes

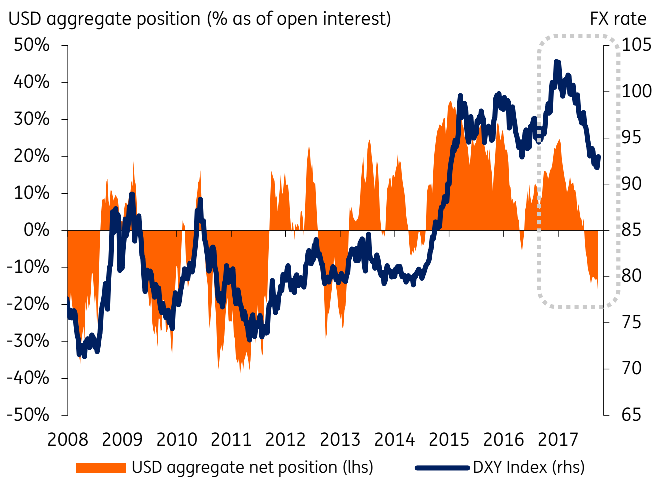
Our sense (we will publish analysis on this shortly) is that the ECB may not be as worried about EUR strength as the market believes. Instead we suspect that investors and the long end will react more to the large cut in PSPP monthly purchases, than the EUR short end reacts to forward guidance that the ECB does not raise policy rates until late 2018/early 2019. This scenario could potentially be very positive for the EUR.

Fig 11 Two year EUR:USD swap spreads drag EUR/USD lower



Source: Bloomberg, ING

Fig 12 If the dollar is turning, it has a long way to fall....



Source: CFTC, ING

At the same time the market looks well on its way to pricing a December Fed hike and has already priced one of the further two 25bp hikes we expect in 2019. A major rise in the US yield curve is not a given from here. Instead, debate over Yellen's succession plus fresh concerns over the US debt ceiling in December could actually see US yields retrace.

We remain very comfortable with our above consensus call of EUR/USD ending 2018 at 1.30

In all we remain very comfortable with our above consensus call of EUR/USD ending 2018 at 1.30 – having consolidated around the 1.20 area in 4Q17/1Q18. The softish dollar story should also be welcome news to the Trump Administration in a mid-term election year – especially with the threat of protectionism looming ever larger.

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Rates: Focus on CPI, not activity

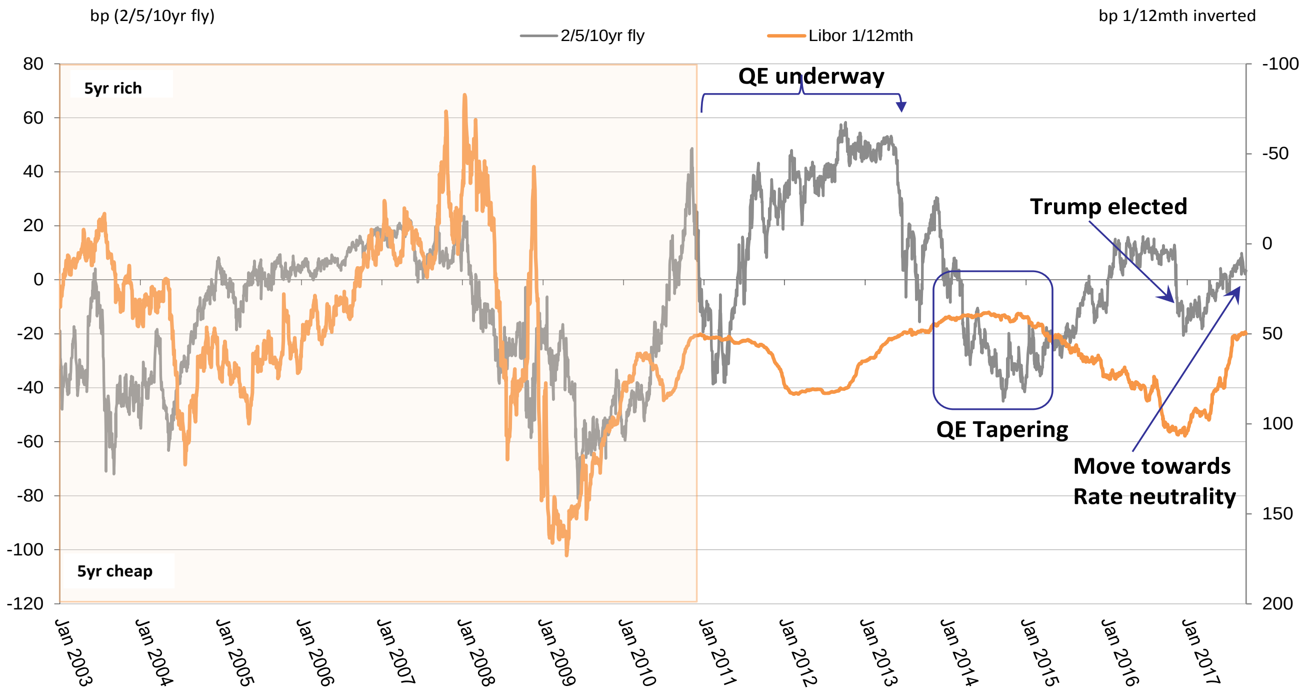
US Treasury yields have seen a significant 30bp rise. Retracement risks are there, unless counteracted by higher CPI inflation

The move from 2.05% back to 2.3% for the 10yr Treasury yield in the past month has been relatively abrupt, but also moves the yield back to a level that we view as appropriate. Factors that could tempt a retracement from here include: (1) Geo-politics (Korea), (2) Hurricane impacted data and (3) Euro stress coming from Catalonia (and potentially Italy). Pitted against that is a pure macro focus centred on the prognosis for CPI inflation to edge higher in the coming quarters, forcing nominal rates higher with it.

We highlight the 5yr on the 2/5/10yr fly as a barometer of market psychology

On the front end markets continue to refuse to place much credibility in Fed rate-hike ambitions. There are many ways to measure this; one that we like is the positioning of the 5yr on the curve. Before Donald Trump was elected president, a moderate richness was attached to the 5yr (Figure 13) which equates to rate hike rejection by the markets.

Fig 13 The position of the 5yr on the curve as a barometer of market sentiment (bullish when 5yr trades rich)



Source: ING estimates, Bloomberg

The recent re-richened in the 5yr gels with an interest rate strip that remains significantly deviant from Fed hike ambitions

This quickly changed as the Trump was elected. The re-cheapening of the 5yr to the curve correlated with the marketplace inputting more belief that Fed hikes could be delivered. That said, once the Fed delivered the first hike, the market had to be bullied into discounting further hikes. The Fed has delivered two hikes since, but at the same time the 5yr has re-richened to the curve. As a measure of market psychology this shows that the market is pricing in a very benign interest rate prognosis again.

But watch for higher CPI to validate Fed ambitions to least deliver a zero real funds rate and for balance sheet unwind to add to upward pressure on longer tenor rates

There are two factors that risk disrupting this balmy backdrop. First, we are of the opinion that US CPI inflation will head into the 2% to 2.25% area in the coming quarters – which is important as to hit a zero real Fed funds rate the nominal rate would have to be hiked by another 100bp (currently 1.00% to 1.25%). Second, while balance sheet unwind eases in with just US$10bn a month, within a year that will be up at between US$30-50bn per month. That equates to between one-quarter to one-third of net issuance. The combination of the two has the capacity to disrupt core markets, to the tune of 10yr rates rising by 25-50bp.

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Fig 14 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	2.9	2.8	2.2	2.4	2.3	2.6	2.7	2.6	2.6	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	1.9	2.3	2.2	2.1	2.2	2.5	2.3	2.3	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	1.33	1.56		1.57	1.87	1.91	2.08		2.18	2.35	2.44	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					76.3					76.7					76.9
Eurozone																				
GDP (% QoQ, ann)	2.1	1.2	1.9	2.5	1.8	2.2	2.5	2.2	1.9	2.2	1.8	1.7	1.7	1.7	1.8	1.5	1.5	1.5	1.4	1.6
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	0.25	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					-1.4					-1.0
Fiscal thrust (% of GDP)					0.1					0.3					0.2					0.0
Gross public debt/GDP (%)					91.5					90.8					89.7					87.4
Japan																				
GDP (% QoQ, ann)	2.8	1.7	1.0	1.4	1.0	1.3	3.9	0.6	2.5	1.8	1.5	0.8	1.3	0.0	1.5	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	0.5	0.7	0.5	0.8	0.8	0.9	1.0	0.9	1.0	2.5	2.4	2.4	2.1
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		0.1	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	1.4	1.5	1.4	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		2.45	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	1.0	1.2	1.1	1.6	1.5	1.2	1.6	2.1	2.1	1.5	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	2.4	2.4	2.4	2.5	2.5	2.4	2.4	2.3	2.4
BoE official bank rate (%, eop)	0.50	0.50	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	
3-month interest rate (%, eop)	0.60	0.60	0.30	0.40		0.35	0.35	0.35	0.51	0.51	0.51	0.51	0.51	0.51	0.51	0.51	0.51	0.51	0.51	0.51
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	1.20	1.20		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	112		113	114	114	115		115.0	115.0	112.0	110.0	
USD/CNY (eop)	6.45	6.65	6.67	6.95		6.89	6.78	6.60	6.40	6.40	6.40	6.35	6.30	6.25	6.20	6.45	6.40	6.35	6.30	6.3
EUR/GBP (eop)	0.80	0.84	0.88	0.87		0.87	0.88	0.94	0.90		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	45	51	42	42	47	47	45	45	47	50	50	

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

Source: ING estimates

Disclaimer