

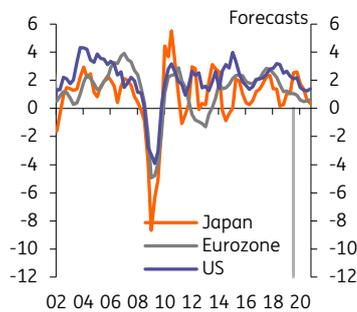
6 September 2019

Global

Monthly Economic Update

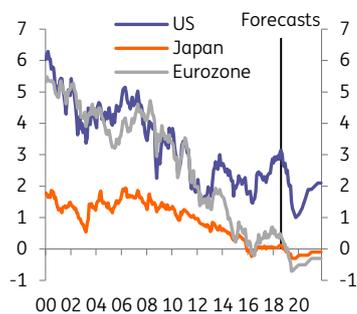
Getting Real on “No Deal”

GDP growth (%YoY)



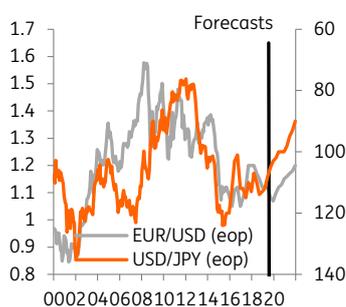
Source: Macrobond, ING

10yr bond yields (%)



Source: Macrobond, ING

FX



Source: Macrobond, ING

Mark Cliffe

 Head of Global Markets Research
 London +44 20 7767 6283
 mark.cliffe@ing.com

Carsten Brzeski

Rob Carnell

Padhraic Garvey

James Knightley

Raoul Leering

Iris Pang

James Smith

Chris Turner

The real world impact of the failure of politicians to agree on cross-border ‘deals’ is becoming obvious. Financial markets don’t like it, and investors are shifting into government bonds and safe havens. After months of talks, the US and China seem as far apart as ever on trade and market access, while the Brexit psychodrama has laid bare the divisions within the UK ahead of the latest deadline at the end of October. With business confidence sagging, pressure is on for politicians to get deals done. If they can’t, the economic ramifications could come back to haunt them at the ballot box.

The US consumer continues to spend, but the near-term outlook for the corporate sector is weakening. Manufacturing is in recession and with US-China tensions showing no signs of abating, this may drag other sectors down with it. The Federal Reserve has started to cut interest rates but argues that monetary policy can only do so much to offset the trade war damage. Further yield curve inversion looks probable which, in itself, adds to downside risks for growth.

President Trump continues to believe that ratcheting up tensions with China will deliver the concessions he desires, provide a long-term boost to the US economy and create a wave of euphoria that will get him re-elected. However, China is showing little sign of climbing down and President Trump may well need to backtrack to prevent an economic downturn from derailing his election chances. As it is, we have revised down our US 2020 growth forecast to 1.3% - a level well below the market consensus.

We believe that China has changed its strategy when it comes to the trade war, and that could lead to further market volatility. In terms of economic growth, it seems the strategy of boosting infrastructure projects is also working.

The eurozone economy is slowing down and with Brexit and the trade war continuing to weigh on confidence, especially in Germany, a further deceleration looks likely. If a hard Brexit were to materialise and Europe were targeted in the evolving trade war, it would be hard to avoid a technical recession. The European Central Bank is likely to act on its words with additional stimulus in September, keeping bond yields in negative territory for some time to come.

The UK appears to be heading for an election – the only real question is when. The chances of a ‘no-deal’ Brexit on 31 October appear to be receding, following legislative efforts to force a further Brexit delay. That doesn’t mean ‘no deal’ is off the table completely though, particularly if the Conservative Party can gain a majority in an election. In reality though, the results of a UK election are almost impossible to predict.

If we are to believe the rates market discount, these are the worst of times. Plus, things are discounted to remain bad, or even get considerably worse, for an extended number of years. A snapshot of current curves rings many alarm bells. The hold-out hope has been the US, but with the 30-year now below 2%, that hope is waning fast. We don’t like it, but the path of least resistance is still for lower market rates.

The cyclical slowdown continues to drive global FX trends. Unless we see some material improvement in trade relations, expect pro-cyclical currencies, including the euro, staying under pressure. Barring a much more aggressive Fed easing cycle, we fear EUR/USD could drop into a new 1.05-1.10 trading range into year-end.

Trade War: A turn for the worse

Although later than initially thought, we still expect a deal between the US and China

President Trump has ramped up the pressure on China with tariff hikes, but so far without success. The deterioration in the negotiating climate leads us to tweak our outlook. A deal before year end is no longer our base case.

We think China will stand firm on US demands

We think China will stand firm in its rejection of some US demands. It will not accept any deal that limits its autonomy in making laws regarding the protection of intellectual property. Neither will it accept interference in setting goals, like the intention to become a world leader in certain high tech markets. Further, China demands that all the tariff hikes are undone once a deal is cut.

President Trump will need to compromise given the economy is slowing

Over time, President Trump is likely to become aware that his high pressure strategy has not been effective. To be able to claim that he is delivering on his promise to improve the terms of trade for the US, Trump needs to show voters that he is capable of striking deals. For this, he needs to compromise.

Right now, we don't see many signs that President Trump is prepared to scale down his demands enough for a deal before year end.

We expect a deal at the start of the second quarter, 2020

However, we expect this will change. We forecast the US economy will slow down in the coming quarters and we think it's likely that the trade war will be blamed for that. We expect this to translate into polls moving against President Trump, which will encourage him to water down some of his demands.

We think this will lead to a deal at the start of 2Q20. We expect it to encompass a commitment by China to import at least \$70 billion more from the US, to lower import tariffs and to open markets for foreign (majority) investing. On the issue of intellectual property, we expect an agreement whereby China steps up its fight against the theft and forced transfer of intellectual property. But we suspect it will not offer any provisions which could give the US a stick to beat it with if President Trump is not satisfied with the progress.

We expect half of the tariff hikes that have been implemented by both sides will be reversed immediately in 2Q next year. The remainder will be phased out gradually during 2020 and 2021, conditional on both sides positively complying with the terms of a deal.

We assume that President trump will refrain from a trade war with the EU

It is a close call but we assume that President Trump will refrain from a trade war with the EU before the 2020 presidential elections. We don't doubt that President Trump would like to impose tariffs on European cars, as it would give him leverage in the negotiations. However, given our expectations that public sentiment about the trade war is set to deteriorate, we think he won't want another risk, which could potentially hurt his chances of being re-elected.

Raoul Leering, Amsterdam, +31 613 30 3944

US: Manufacturing a recession

The headwinds facing the US economy are building, as trade tensions intensify and evidence of global economic weakness spreads. The Federal Reserve has started to respond through cutting interest rates and pausing the run down in its balance sheet. But the President and financial markets remain impatient for more, with bond yields falling and the Treasury yield curve inverting on the 2-10 year section. Given this backdrop, we have cut our 2020 GDP growth forecast to 1.3% and have pencilled in an additional Fed interest rate cut.

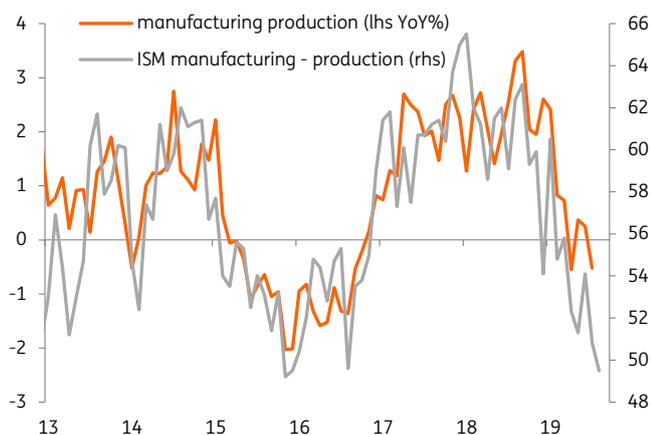
Signs of a US slowdown are spreading, with the outlook for manufacturing and investment spending looking particularly concerning

Tariffs are putting up costs and disrupting supply chains, which is hurting profits

Yield curve inversion has been a precursor to recession nine times over the last 65 years and evidence of another downturn is growing. The US manufacturing sector is an area of particular concern. Output is down 1.6% year-to-date and remains 5% below its November 2007 peak while the latest ISM manufacturing index points to further declines ahead. Excluding the volatile aircraft and defence components, durable goods growth is now negative in year-on-year terms, which suggests falling investment spending in three to six months' time.

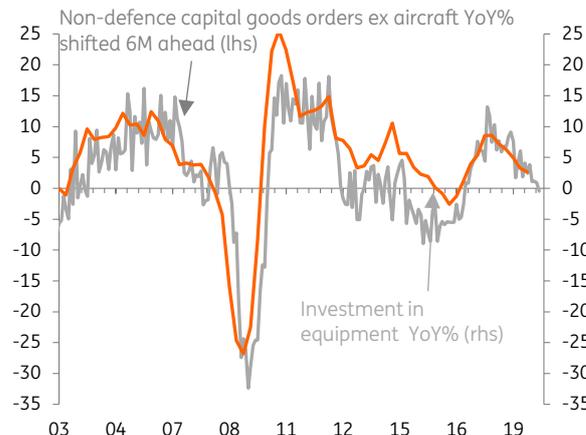
Worries over tariffs and the impact on supply chains at a time of weakening global demand along with dollar strength mean US firms are becoming more cautious. Profitability is being hit and firms in the sector are increasingly reluctant to put money to work through investment or hiring new workers. Net trade is also likely to remain a drag due to weak external demand and a less competitive exchange rate.

Fig 1 More downside risks for manufacturing output



Source: Macrobond, ING

Fig 2 With investment stalling



Source: Bloomberg

While concentrated in manufacturing, we are watchful for signs of contagion

Yield curve inversion is a threat but credit conditions so far have been unaffected

While manufacturing is a less important part of the US economy than it was 30 years ago and weakness here doesn't guarantee a broader recession, there is still the fear that the downturn could spread. Weaker sentiment is one avenue, but there is also the fact that an inverted yield curve, driven by recession fears, could potentially be self-fulfilling. Banks typically borrow short term and lend longer term, so when the yield curve is inverted, bank profitability is hurt. It also tends to lead to reduced risk tolerance, which implies tighter lending standards and reduced credit availability that potentially chokes off economic growth.

For now, credit conditions remain in decent shape with banks reporting little change in either lending standards or demand for loans. In fact, the plunge in Treasury yields has driven mortgage rates lower and prompted a surge in mortgage activity for both home purchases and refinancing at lower borrowing rates. Home sales have been edging higher too, which has boosted home builder sentiment, but it may not be enough to finally

The consumer sector is the key area of strength given the robust performance of the jobs market

generate a positive GDP contribution from residential investment after six consecutive quarterly declines.

But markets are increasingly pessimistic on the outlook

On the positive side of the equation, consumer spending remains the clear growth engine. Despite the volatility in financial markets and the negative headline on trade, consumer confidence remains firm and households are still keen to spend. Employment is at record levels, wages are rising and gasoline prices are falling. So consumers have the cash to spend, with high frequency data suggesting 3Q started strongly.

They are growing increasingly impatient with the Federal Reserve who argue that rate cuts are not the most effective tool when it come to the trade war

Markets are of the view that this resilience to bad news won't last and they continue to price in rate cuts. More than 100 basis points of cuts to the Fed funds target rate are expected by the end of 2020. So far the Federal Reserve has appeared reluctant to offer such aggressive action with Esther L. George and Eric S. Rosengren opposing the FOMC decision to cut rates in July and other members arguing for caution.

The Federal Reserve and in particular its Chair, Jerome Powell, have faced a torrent of criticism from President Trump for not doing enough to boost the US economy as he pushes hard to win concessions from China. Powell's response at the recent Jackson Hole symposium was to say that "while monetary policy is a powerful tool that works to support consumer spending, business investment and public confidence, it cannot provide a settled rule book for international trade". He is essentially saying that lower interest rates can't do much to alleviate the disruptive effect that higher tariffs have on global supply chains. Some officials are also concerned that if they acquiesce to the President's wishes, it will embolden him to push even harder against China, which could create even more near-term downside risks to growth.

A deteriorating growth outlook, dollar strength and benign inflation mean the Fed will cut rates further

Despite the current reticence we think the Federal Reserve will cut interest rates further. While 3Q GDP growth should post a respectable 2-2.5% annualised growth rate, we are worried that the attritional nature of market volatility, negative trade headlines, weaker global growth and worries about corporate profitability will result in weaker activity in 4Q. Inflation is also broadly in line with target, and with other central banks queuing up to send dovish signals, the strength of the dollar will be acting to tighten monetary conditions.

We continue to look for some sort of trade truce, but it is likely to be later than we had previously thought

Given the latest escalation of trade tensions, this clear headwind to growth is unlikely to abate as quickly as we had hoped. Rather than a deal or a climbdown in 4Q, it could be well into 2020 before an agreement or, more likely, a truce is reached. We continue to believe that President Trump, in a bid for re-election, will recognise the need for a strong economy and rising equity markets and will therefore be willing to get a deal done even if it doesn't include all of his initial demands.

Some kind of deal could lift sentiment and activity enough to help his re-election chances

A deal on trade plus Federal Reserve interest rate cuts may well be enough to stimulate a rebound in sentiment and stronger activity and employment numbers in the second half of 2020. Assuming President Trump is re-elected, we suspect he will re-double his efforts of renegotiating trade deals with both China and the EU in a second term.

Nonetheless we have cut our growth forecast and pencilled in an additional Federal Reserve rate cut. 10Y Treasury yields could hit 1%

Based on this potential outcome we have cut our 2020 GDP growth forecast to 1.3% from 1.7% versus the current Bloomberg consensus of 1.8%. We expect consumer spending to slow as hiring moderates, the pick-up in wage growth stalls and asset prices come under pressure. Given this backdrop we now expect an additional Fed rate cut in 1Q20 after earlier cuts in September and December 2019. However, this may not be quick enough or aggressive enough for President Trump and the financial markets, which are likely to become increasingly impatient with the Federal Reserve. Consequently, we think the 10Y Treasury yield could fall to 1% in the fourth quarter of this year, especially given negative eurozone rates.

If we are wrong and President Trump does not back off, the downside risks to our forecast will increase

There is an argument that being tough on China is a vote winner in itself and the electorate is prepared to accept a weaker economy in the short-term if they believe President Trump's actions will yield real economic returns in the longer term. As such, there is the possibility he keeps pushing hard on China right up to the election in November 2020. This would assume an even more negative growth story, weaker equity markets and even lower bond yields than we have currently priced into our forecasts. We will address this in more detail in our forthcoming *US Politics Watch* note.

James Knightley, New York +1 646 424 8616

Eurozone: Uncertainties are weighing on growth

The hoped-for growth acceleration is not happening...

The hoped-for acceleration in economic activity is not happening. A number of risks could further weigh on eurozone GDP growth in the second half of the year and the first half of next year. With inflation still moribund, the European Central Bank is set to loosen monetary policy again. However, the marginal impact of further easing is getting smaller. At this juncture, fiscal policy would likely be more effective, but for the time being the countries with the most budgetary space are dragging their feet.

...with the risk that weakness could spread

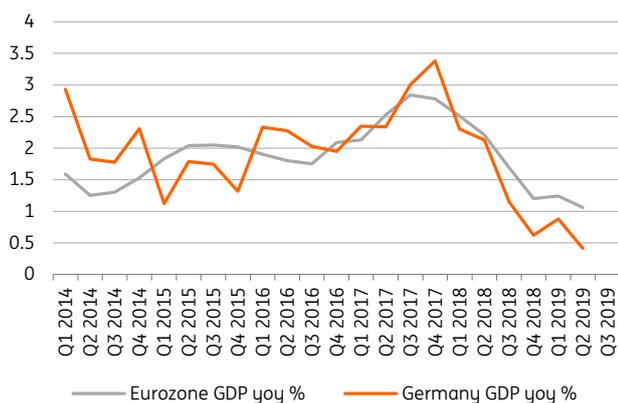
The eurozone economy grew by a non-annualised 0.2% in the second quarter after 0.4% growth in the first. But powerhouse Germany actually shrank 0.1% in the April-June period. This continues to reflect the dire situation in manufacturing, which has been hit by the trade war-induced softening of international trade (the manufacturing sector is relatively more important in Germany than in the other member states while the specific shock to the automotive sector also plays a role). Services are still holding up in the eurozone. And while the consumer still benefits from job growth and some increase in purchasing power, there is always the risk that a more uncertain economic environment leads to more savings instead of more consumption. The same story applies to business investment, which might suffer from uncertainty even if financing conditions remain extremely attractive. Also bear in mind that capacity utilisation in manufacturing is relatively high.

The Italian political situation is stabilising...

On a positive note, it seems that Italy is not heading for new elections after all, because an alternative majority between the 5 Star Movement and the PD is being put in place. This government would be led by current Prime Minister Giuseppe Conte and is unlikely to pick a fight with the European Union on the budget. The strong decline in Italian bond yields seems to corroborate this expectation. However, Brexit remains a major risk for the growth outlook in the eurozone. While numerous [studies](#) have tried to compute the long-term negative effect of a hard Brexit on the rest of the European Union (with figures ranging from 0.3% to 1.5% of GDP), it is obvious that trade distortions will have a negative impact in the short run. We could easily see a negative growth impact of 0.1% to 0.2% both in the last quarter of 2019 and the first quarter of 2020, which might push the eurozone into a technical recession.

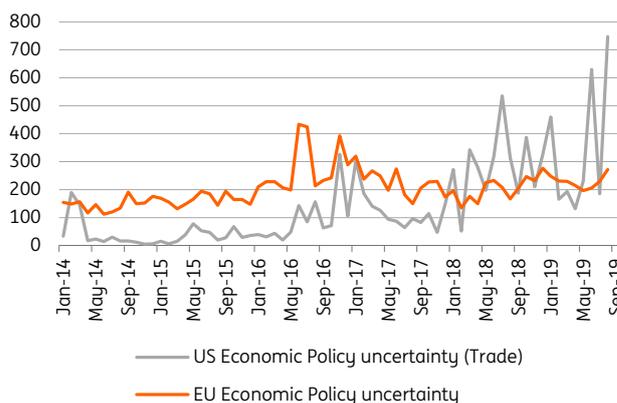
...but Brexit remains a major headache

Fig 3 The German locomotive is losing steam...



Source: Refinitiv Datastream

Fig 4 ...while economic uncertainty is increasing



Source: Refinitiv Datastream

The trade war is not over yet

At the same time the trade war is still not resolved. While Donald Trump might decide to delay his decision on tariffs on European cars, he will still the possibility open to put pressure on European negotiators during the trade talks. Even though 2020 would therefore not see higher tariffs, the uncertainty will continue to weigh on sentiment of European producers. If alternatively the trade war would escalate in 2020, we might easily lose another 0.2 percentage points in GDP growth.

Amid many uncertainties, GDP growth is likely to fall below 1% in 2020

For the time being, we are witnessing a growth slowdown, though the economy is certainly not falling off a cliff. August's economic sentiment indicator saw an unexpected uptick, while monetary aggregates also point to some underlying growth momentum. That said, even though a hard Brexit is not our base case right now and we think that Trump will not drive the trade hostilities to a point where they could jeopardise his re-election, we think it's wise to reflect some of these uncertainties in our growth forecasts. After all, the uncertainty itself could sap 'animal spirits'. We have therefore revised our 2020 GDP growth forecasts downwards to 0.7%, after 1.1% in 2019.

Moribund inflation and slowing growth will trigger additional ECB action...

Meanwhile, inflation seems to be stuck at 1%. With growth decelerating, it is hard to see much of an increase, even if labour markets remain relatively tight. Together with slowing growth, this should push the ECB into more easing. While we doubt that more monetary easing will generate much of a growth effect, doing nothing is not an option anymore, as markets have already priced in additional easing. We expect a 20 basis point deposit rate cut, a tiered interest rate system for excess liquidity, more generous TLTRO conditions and €30 billion per month of quantitative easing (though this last point is still being discussed and could be delayed to wait for the Brexit outcome). All of this means that bond yields are unlikely to rise much over the forecasting horizon. Some steepening of the yield curve is possible when the major uncertainties have finally lifted (and we might eventually also see some budgetary stimulus), but even then the 10yr bund yield is likely to remain firmly in negative territory.

...keeping bond yields firmly in negative territory

Peter Vanden Houte, Brussels +32 2 547 8009

UK: Britain prepares for an election

This is an abridged version of our note [‘Four thoughts on Westminster’s wild Wednesday’](#)

Legislation against ‘no deal’ looks set to pass

It’s been a wild week in Westminster, but as things stand, the chances of a ‘no deal’ exit on 31 October are slowly receding. Lawmakers have almost succeeded in passing a bill that aims to force Prime Minister Boris Johnson to ask for another Article 50 extension if he fails to get a Brexit deal through Parliament before 19 October.

‘No deal’ hasn’t been totally averted – the EU needs to agree to Article 50 extensions

Of course, this doesn’t mean a ‘no deal’ exit has been totally avoided. The EU is still needed to approve any Brexit delay, and while this seems more likely than not, European leaders may be reluctant to grant a long extension to keep pressure on the UK to make a decision. France, in particular, is likely to retain a hard-line.

Still, this week’s developments mean a UK general election looks almost inevitable.

An election looks likely, but the question of ‘when’ is still up in the air

At the time of writing, the real question is ‘when’. For an election to take place, the Labour party will almost certainly need to consent to it – putting them in the driving seat when it comes to the specific timing. Initial signals suggested the party would consent to Johnson’s preferred 15 October date, although Labour MPs reportedly favour a vote after the current 31 October deadline. The logic is that Johnson will have been forced to ask for an Article 50 extension, meaning he would have failed to achieve his “do or die” pledge to get the UK out of the EU before November.

An election would be impossible to call

But assuming we get an election, it will be incredibly hard to call. Based on headline polls alone, Johnson’s prospects look good. His party is polling around 33% based on a range of recent polls. And while this is a step down compared to the previous election, Labour has slipped further - the opposition party currently sits at just 25%.

Johnson is ahead in the polls

Under the UK’s first-past-the-post system, these polling numbers very crudely translate into a majority. Electoral calculus - a website that maps polling data onto the FPTP system, predicts Johnson could win 350 seats, well over the 320 he needs for a working majority in parliament.

But the Conservatives could lose seats in Scotland and to the Lib Dems in England

In reality though, it is unlikely to be this straight-forward and this election will be virtually impossible to call. As we noted earlier in the week, the Conservatives will come under pressure from the Scottish National Party, as well as the Liberal Democrats in certain areas of Southern England.

The economy will be a key battleground

So the key question will be whether the Conservatives can make up ground in Labour-held areas that voted to leave at the 2016 referendum. The economy will be a key battleground here - polling has shown that, while many Conservative and Labour leave voters share similar views on things like crime and immigration, they differ heavily on issues such as nationalisation and public spending.

Johnson will need to strike a fine balance on ‘no deal’

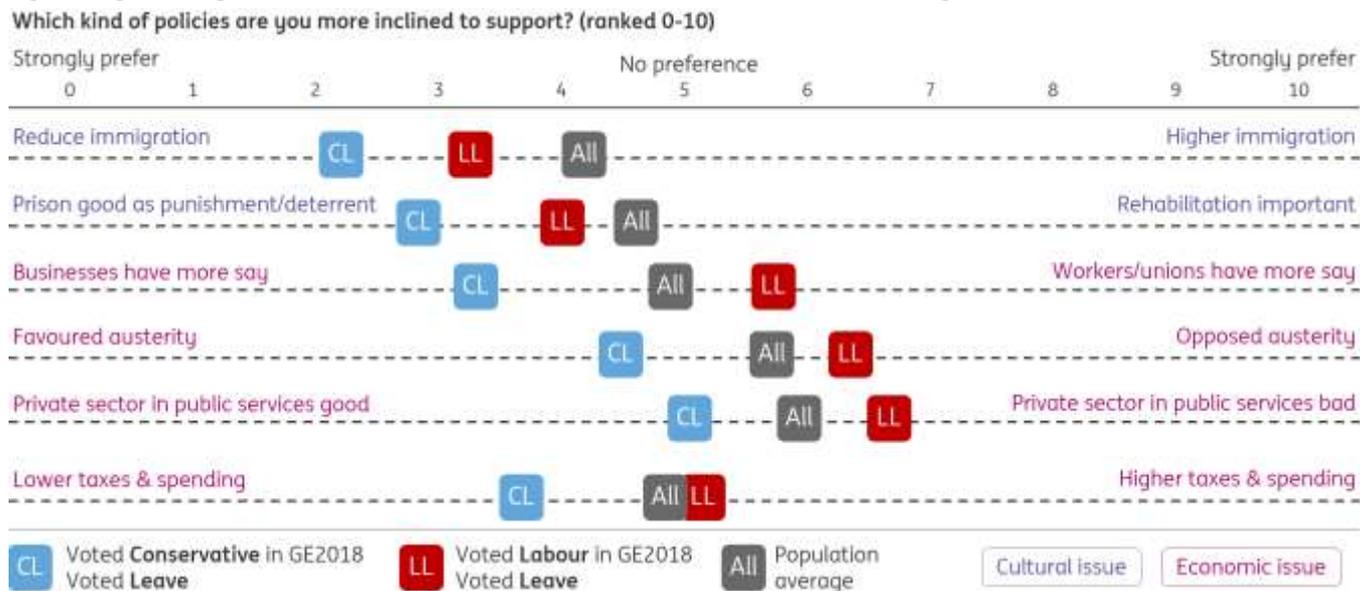
Johnson’s messaging on ‘no deal’ will also be key. A survey by Deltapoll last week suggested only 28% of the public think a ‘no deal’ is the best option - even if a majority of his own party’s voters do. If he campaigns hard on ‘no deal’, he risks amplifying losses of moderate voters. Take a nuanced line on ‘no deal’ though, and he will be more vulnerable to the Brexit Party in these key battleground constituencies.

In short, the outcome of the election is highly uncertain – and it may boil down to how successfully the Labour party manage to re-frame the vote in domestic policy terms, as opposed to down Brexit lines.

Don’t forget the former-PM Theresa May lost around four Labour seats for every one she gained, despite a huge lead in the polls at the start of the campaign.

Don't forget the former-PM Theresa May lost around four Labour seats for every one she gained, despite a huge lead in the polls at the start of the campaign.

Fig 5 Key challenge for Johnson will be to convince 'Labour leavers' on the economy



Voters asked to rank their preference between two statements on a scale of 0-10
 Source: Lord Ashcroft poll, April 2019

'No deal' risk could rise if Conservatives win a majority in an election

The bottom line is that uncertainty is likely to remain elevated and this will continue to exert pressure on the UK economy. Firms will be acutely aware that a 'no deal' exit may well still happen, albeit perhaps not at the end of October, if the Conservatives win a majority at the next election.

Underlying growth will remain under pressure

This means underlying growth is likely to remain fairly lacklustre. Investment has been falling more-or-less consistently since the start of 2018, a pattern that is likely to continue. Brexit uncertainty is limiting appetite to expand, but contingency planning activities ahead of 31 October may also limit resources available for possible investment projects. This is a key risk for the service sector, which makes up around 80% of economic output. The Bank of England's Agents summary of business conditions suggests that demand for professional and financial services has fallen as a result of reduced economic activity.

That said, the economy is unlikely to have slipped into a technical recession during the third quarter. We may see firms build stocks again ahead of the 31 October deadline, albeit at a slower pace than back in the first quarter (inventory levels are still reasonably high). This was a positive for economic output, although of course is ultimately a temporary phenomenon.

James Smith, London +44 20 7767 1038

The Chinese strategy is working

China retaliated strategically with "suddenness".

As we said in the July monthly note, it was hard to see a summer lull in the trade war. The trade war escalated on 23rd August when China surprised the market by retaliating American 10% tariffs on \$300 billion worth of goods. The retaliation came in so late that the market had forgotten that China could retaliate.

China's retaliation of 5%-25% on \$75 billion worth of US imports was indeed small, but it definitely caught the market and President Trump off guard, which led to the Trump Administration hastily reacting with an additional round of 5% tariffs.

We don't expect positive results from the October trade talk.

Even though the two sides have scheduled talks in October, we don't believe there will be fruitful results from it. As such, we have revised our USD/CNY forecasts from 7.10, 7.00 and 6.90 previously, to 7.20, 7.30 and 7.20 by the end of 2019, 2020 and 2021 respectively. However, we forecast a trading range of 7.05-7.50 for the rest of 2019.

This is partly because we don't expect meaningful outcomes from trade talks in 2019, so we don't expect USD/CNY to go back below 7.00. If there is positive news from the trade talks, USD/CNY could possibly return to 6.8-6.9 but the chances are very low.

The 7.50 upper bound of our forecast range could also create further market chaos, just as was the case when USD/CNY crossed 7.00. Creating sudden market chaos could be the Chinese strategy to upset President Trump's supporters.

Infrastructure stimulus projects are supporting industrial profits. It seems to us that the stimulus has eventually come into work.

On the economy, China's infrastructure stimulus projects appears to be making good progress. China's industrial profits turned positive in the latest data, mostly because of the support from infrastructure projects, which pushes up profits in the mining sector and electrical product sector.

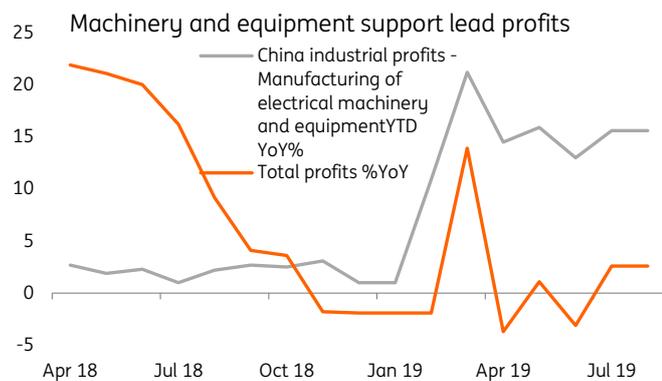
We believe that infrastructure projects can support the economy to achieve the 6% GDP target.

The government wants the PBoC to release more liquidity to the market, but the central bank has its concern.

The Chinese cabinet has already signalled that the PBoC should cut the required reserve ratio- RRR - to provide more liquidity to suppress the increasing interest rate trend, as there are an increased amount of local government special bonds to be issued.

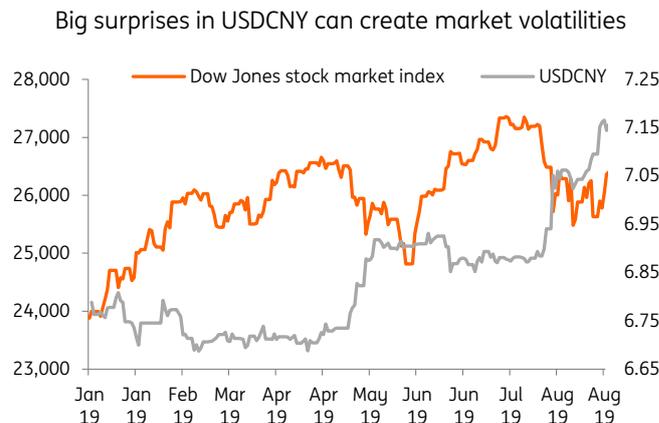
However it seems that the central bank is reluctant to flood liquidity into the system. It wants to make sure that the liquidity flows to infrastructure projects and smaller exporters. This could only be done via the banks' tracking after the loans are drawn down.

Fig 6 Infrastructure stimulus is in work



Source: ING, Bloomberg

Fig 7 Will China create another market chaos?



Source: ING, Bloomberg

Iris Pang, Economist, Greater China, Hong Kong +852 2848 8071

Japan: Toxic trade trouble

This is bad timing for another trade spat

Japan's removal of South Korea from its "Whitelist" is difficult to justify on grounds of security

It's not that these imports account for much of the total, but they are vital for production of hi-tech goods

You would think that with all the trouble in Asia spilling over from the US-China trade war, other countries in the region would be doing their very best to avoid making matters worse, or forging offsetting trade agreements.

Not Japan and South Korea. These two regional big-hitters have started a trade war of their own, sparked off by anger from Korea that Japan has refused to acknowledge its claim for greater compensation for some of its war-time activities relating in particular to the forced labour of Korean "comfort women".

Japan, for its part, has been quick to retaliate, taking South Korea off its "Whitelist" of export partners for certain chemicals vital to Korea's technology industries. The excuse given for this is the contentious claim that such exports are at heightened risk of ending up in the hands of North Korea.

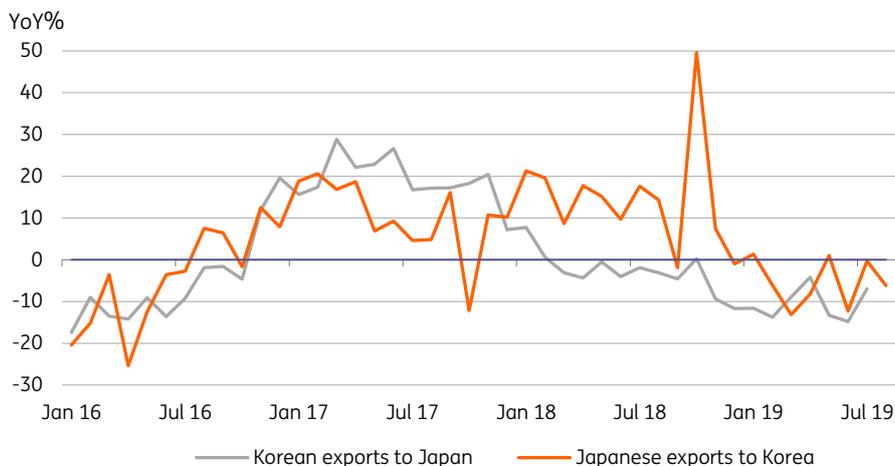
The three chemicals which Japanese producers may now have to wait up to around 90 days for approval for export licences to be granted are:

1. Fluorinated polyamide (used in the manufacture of displays);
2. Photosensitising agent resist (for use in chip manufacture); and
3. Hydrogen fluoride, used for cleaning chips.

Data from Massachusetts Institute of Technology shows not only export destinations by country, but also by product show that although Korea is a big market for disc chemicals for electronics – sopping up 17% of all such Japanese exports in 2017, chemicals as a whole made up only about 2% of Japan's exports to Korea, and a far smaller percentage of its total exports (Korea accounts for about 20% of all Japanese exports).

But the move has sparked anger in Korea, where consumer boycotts of Japanese goods is now underway.

Fig 8 Japan and Korea reciprocal trade



Source: CEIC

Neither Japan nor Korea is in great shape and both could do without this additional headache

The greater worry for South Korea, which has been struggling with the effects of the global tech slump, the tech war and the US-China trade war, is that this latest spat comes on top of all of these other problems. The size of these imports is not the main consideration, it is their importance for the much larger technology export segment.

Nationalism lies at the root of such squabbles

Likewise, Japan's industrial production and exports are hardly in great shape and could do without any additional impediments.

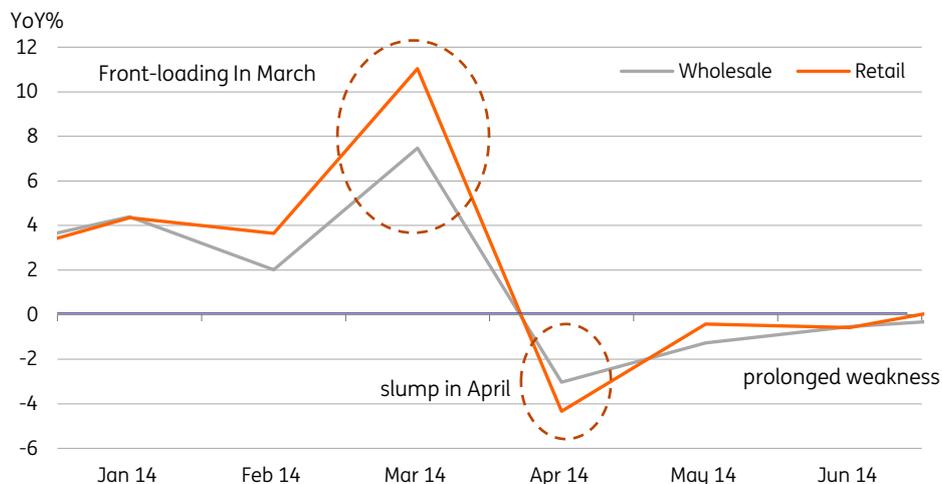
Although the catalyst for this trade dispute has its origins in Japan's colonial rule of the Korean peninsula from 1910 to 1945, it looks as if it has received a boost on both sides from the globally rising tide of nationalism. It's not at all clear how this dispute is going to be resolved, given that the one country that could probably bang heads together – the US – is currently in the vanguard of similar trade restrictions justified by its own veneer of national security concerns.

Neither Japan nor Korea have excessive growth to spare for a political squabble like this, though one can understand how each side in this conflict has become embittered by the actions of the other.

Finding an intermediary to resolve this conflict could be tricky

In Japan's case, with the consumption tax hike looming next month, it is particularly bad timing. These tax hikes have led to substantial disruption to activity in the past, and a spell of better "economic weather" would have been a more helpful backdrop to this difficult period. Right now, for example, the evidence for a front-loaded boost to consumption and investment is looking very hard locate, though that doesn't necessarily rule out a post-tax slump.

Fig 9 How retail and wholesale sales reacted to consumption tax hike in 2014



Source: CEIC

Rob Carnell, Singapore +65 6232 6020

FX: Going with the cyclical flow

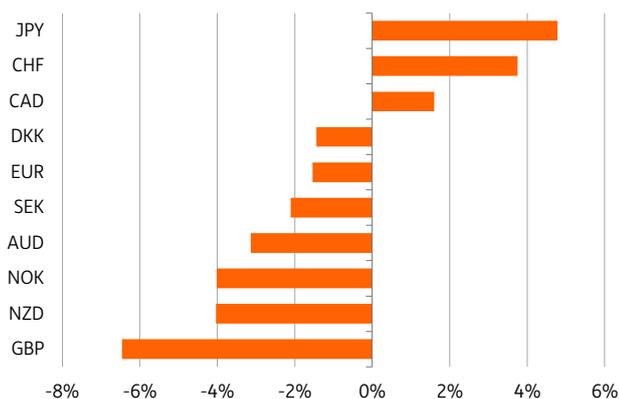
FX markets are very much trading in line with the global fears of secular stagnation. Those currencies most exposed to the global trade and manufacturing cycle are underperforming, while the counter-cyclical JPY and CHF continue to do well. Unless we witness a sea-change in trade relations or policy makers undertake sizeable stimulus, it looks like these trends will extend into year-end. This could mean EUR/USD starts to trade a 1.05-1.10 rather than 1.10-1.15 range.

When looking more broadly, the trade-weighted dollar is pressing the 2002 highs. So far President Trump has said that he can 'work with' the strong dollar, although he does remain sensitive to big figure breaks in key trading partners' currencies – e.g. USD/CNY trading through 7.00 and EUR/USD trading sub 1.10. However, his mechanism to reverse dollar strength still seems to be pressuring the Fed rather than FX intervention.

Current trends look unlikely to reverse until we see a change in: a) trade relations or b) massive enough stimulus to steepen yield curves and weaken the dollar. On the former, we tentatively expect US-China trade relations to improve in 1Q/2Q 2020 (the low-point in the US activity cycle) and look for a rebound in pro-cyclical currencies early next year.

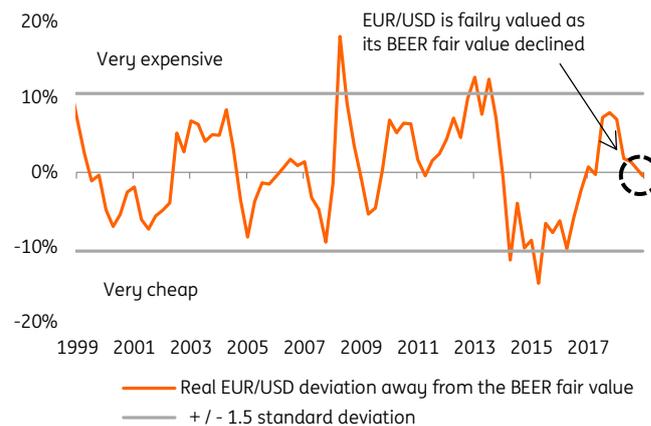
Alternatively, a turn in the dollar could come if the Fed were to act aggressively. That seems a tall order given that the market already prices 125bp of easing by end 2020. Of course, if the Fed were to cut 50bp on 18th September, suggesting a front-loaded easing cycle, that could put a stronger lid on the dollar. That seems unlikely at this stage. Instead it seems USD hedging costs (now 2.7% p.a for Europeans) will remain high for some time. In fact, we think US policy rates need to drop 50-75bp before rate spreads start to have a meaningful impact on the dollar.

Fig 10 FX performance against the dollar since 1st May*



Source: Bloomberg, ING. *May 1st 2019 when US-China trade truce collapsed.

Fig 11 EUR/USD is not particularly under-valued



Source: Bloomberg, ING

Heavily exposed to the global trade cycle, the EUR continues to sink. EUR/USD also faces the added threat of Washington turning its attention to EU auto imports in November – perhaps at a time when Brexit weakens Europe. At the same time, the ECB will be re-starting asset purchases, locking European interest rates to their new floors.

Can under-valuation save the EUR? Our medium-term models, designed to assess fair value over a 2-3 year horizon, actually suggest EUR/USD is fairly valued near 1.10. Given that EUR/USD can easily trade +/-15% around fair value, the ground beneath EUR/USD looks soft. That’s why we think EUR/USD may be breaking into a 1.05-1.10 range.

Elsewhere, Brexit continues to confound most scenario analysis although we are still happy with our 3Q19 calls of 0.95 for EUR/GBP and 1.18 for Cable. What happens thereafter is any-one’s guess, though we are more minded towards 1.00 and 1.10 for EUR/GBP and GBP/USD as ‘no-deal’ Brexit probabilities rise and the alternatives – a minority opposition government with attendant fiscal or Scottish independence risks – doesn’t look too attractive either.

Chris Turner, London +44 20 7767 1610

Rates: Sinister market discount

While there has been a keen and sensible focus on global central banks in recent months, there have also been some remarkable moves seen at the other extremity of core curves. Not only is the German 30-year yield below zero, but the US 30-year yield has broken below 2% in the past few weeks. That takes the US 30-year yield to a new cycle low, taking out the financial crisis and subsequent angst-period lows. If we are to believe the market discount, then these are the worst of times. Plus, things are discounted to remain bad or even get considerably worse, for an extended number of years.

These remarkable valuations have been heavily influenced by two key questions that are very difficult to answer.

1. The first question centres on core central bank policy, and to what extent central banks have the capability to influence activity, and by extension inflation. Central banks may (and indeed were) key in averting depression following the financial crisis, but their ability to influence has been severely impaired since. Japan has struggled, Europe is now struggling and while the US is in better shape, it is far from clear that the Fed has the control it once had.
2. The second issue revolves around politics and global policy disagreement. Here the immediate focus is on the future of Europe (and the eurozone) and by extension Brexit and trade relations. Overlaying that is the widening gap between the narratives coming out of the US and China with respect to the resolution of trade disagreement. Things on this front are getting worse, and likely to get even worse before a tone change is probable.

The preliminary answer to the first question, coming from the central market discount, is that central banks have lost considerable capacity to influence economies. And the second political issue is one that augments the answer to the first question, as political wrangling such as Brexit and trade wars makes it even more unlikely that central banks can have the impact that they could have. And in a way, central bank efforts to cushion economies in fact make more room for trades wars and allow the like to deepen.

Long end rates have long noses. Often the 30-year rate can behave differently from shorter tenors, as the 30-year will pick up on ultra-long trends. This can manifest in very steep 10/30-year spreads for example as the 10-year gets pulled lower by front end vagaries, but the 30-year maintains some degree of longer-term aloofness. This can be a comfort that all of the bad stuff being discounted today will go away eventually. There is an element of this in play on current core curves, where the 10/30yr is far steeper than the 2/10yr e.g. in the US the 2/10yr is flat while the 10/30yr is 50bp.

That said, there has also been a clear flattening tendency in play in recent months. And flatter curves imply a lower forward discount for higher rates in the future e.g. a completely flat curve implies no rise in rates, and an inverted one discounts cuts on fears for recession. A snapshot of current curves rings many alarm bells. The German 2/10yr curve is a mere 20bp, implying a minimal forward discount for higher rates, ever. The absolute 10yr yield at -65bp is even more sinister in terms of implied discount (imputes depression). The hold-out hope has been the US, but with the 30yr now below 2%, that hope is waning fast. We don't like it, but the path of least resistance is still for lower market rates, with most such room in long-tenor rates.

Padhraic Garvey, New York +1 424 646 7837

Fig 12 ING global forecasts

	2018					2019F					2020F					2021F				
	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)	2.6	3.5	2.9	1.1	2.9	3.1	2.0	2.2	1.4	2.3	0.3	1.3	2.0	2.0	1.3	2.0	2.1	2.0	1.9	1.8
CPI headline (% YoY)	2.7	2.7	2.6	2.2	2.4	1.6	1.8	1.8	1.9	1.7	2.3	2.0	2.1	2.2	2.1	2.1	2.0	1.9	1.8	2.0
Federal funds (% eop) ¹	1.50	1.75	2.00	2.25	2.25	2.25	2.25	1.75	1.50	1.50	1.25	1.25	1.25	1.25	1.25	1.25	1.50	1.50	1.75	1.75
3-month interest rate (% eop)	2.30	2.35	2.45	2.65	2.65	2.30	2.00	2.10	1.90	1.90	1.65	1.65	1.65	1.75	1.75	1.80	1.85	1.85	1.85	1.85
10-year interest rate (% eop)	3.00	3.00	3.00	2.80	2.80	2.30	2.00	1.30	1.00	1.00	1.10	1.30	1.60	1.90	1.90	1.90	2.00	2.10	2.10	2.10
Fiscal balance (% of GDP)					-4.0					-4.6					-4.7					-4.7
Fiscal thrust (% of GDP)					1.1					0.4					0.0					0.3
Debt held by public (% of GDP)					76.7					79.1					82					84.6
Eurozone																				
GDP (% QoQ, ann)	2.8	1.4	0.7	1.0	1.8	1.8	0.8	0.7	0.5	1.1	0.4	0.8	1.1	0.9	0.7	1.0	0.7	0.7	0.7	0.9
CPI headline (% YoY)	1.3	1.7	2.0	2.0	1.8	1.4	1.3	0.9	1.0	1.2	1.1	1.0	1.0	1.1	1.1	1.2	1.2	1.2	1.2	1.2
Refi minimum bid rate (% eop)	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
3-month interest rate (% eop)	-0.33	-0.33	-0.33	-0.33	-0.33	-0.32	-0.32	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50
10-year interest rate (% eop)	0.50	0.30	0.40	0.24	0.24	-0.07	-0.30	-0.70	-0.60	-0.60	-0.50	-0.50	-0.50	-0.40	-0.40	-0.30	-0.30	-0.30	-0.30	-0.30
Fiscal balance (% of GDP)					-0.5					-0.7					-0.7					-0.7
Fiscal thrust (% of GDP)					-0.2					0.1					-0.1					-0.1
Gross public debt/GDP (%)					87.8					86.5					85.6					84.2
Japan																				
GDP (% QoQ, ann)	-0.5	2.3	-2.5	1.8	0.8	2.8	-0.3	3.9	1.9	1.4	-0.4	0.2	0.8	0.8	0.9	0.8	0.8	0.8	0.8	0.8
CPI headline (% YoY)	1.3	0.6	1.1	0.9	1.0	0.3	0.8	0.2	1.3	0.6	1.8	1.8	2.2	1.1	1.7	1.1	1.0	0.9	0.8	1.0
Excess reserve rate (%)	-0.1	-0.1	-0.1	-10.0	-0.1	-0.1	-0.1	-0.2	-0.2	0.0	-0.2	-0.2	-0.2	-0.2	0.0	-0.2	-0.2	-0.2	-0.2	0.0
3-month interest rate (% eop)	0.00	0.00	-0.05	-0.05	-0.05	-0.15	-0.15	-0.15	-0.15	-0.15	-0.15	-0.15	-0.15	-0.15	-0.15	-0.15	-0.15	-0.15	-0.15	-0.15
10-year interest rate (% eop)	0.05	0.03	0.14	0.00	0.00	-0.10	-0.20	-0.30	-0.30	-0.30	-0.20	-0.20	-0.20	-0.20	-0.20	-0.10	-0.10	-0.10	-0.10	-0.10
Fiscal balance (% of GDP)					-3.0					-2.8					-2.5					-2.2
Gross public debt/GDP (%)					232.8					232.0					230.0					228.0
China																				
GDP (% YoY)	6.8	6.7	6.5	6.3	6.6	6.4	6.2	6.1	6.3	6.3	6.3	6.2	6.2	6.2	6.2	6.2	6.3	6.3	6.4	6.3
CPI headline (% YoY)	2.2	1.8	2.3	2.5	2.2	1.8	2.6	2.8	2.6	2.5	2.6	2.6	2.5	2.4	2.5	2.5	2.5	2.5	2.5	2.5
PBOC 7-day reverse repo rate (% eop)	2.55	2.55	2.55	2.55	2.55	2.55	2.55	2.50	2.45	2.45	2.40	2.40	2.40	2.40	2.40	2.40	2.40	2.40	2.40	2.40
10-year T-bond yield (% eop)	3.75	3.50	3.65	3.30	3.30	3.07	3.20	3.00	2.95	2.95	2.95	2.90	2.90	2.85	2.85	2.85	2.90	2.95	3.00	3.00
Fiscal balance (% of GDP)					-2.6					-4.5					-4.0					-4.0
Public debt, inc local govt (% GDP)					88.0					102.0					103					103
UK																				
GDP (% QoQ, ann)	0.2	1.6	2.8	0.9	1.4	2.0	-0.8	1.3	1.4	1.2	1.0	1.4	1.4	1.2	1.1	1.7	1.3	0.8	0.5	1.4
CPI headline (% YoY)	2.7	2.4	2.5	2.3	2.5	1.9	2.0	1.9	2.0	2.0	2.3	1.8	1.8	1.7	1.9	1.7	1.9	1.9	2.0	1.9
BoE official bank rate (% eop)	0.50	0.50	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	1.00	1.00	1.00	1.00	1.00	1.00	1.00
BoE Quantitative Easing (£bn)	445	445	445	445	445	445	445	445	445	445	445	445	445	445	445	445	445	445	445	445
3-month interest rate (% eop)	0.60	0.80	0.80	0.80	0.80	0.83	0.77	0.77	0.80	0.80	0.85	0.85	1.00	1.10	1.10	1.10	1.10	1.10	1.10	1.10
10-year interest rate (% eop)	1.45	1.48	1.57	1.30	1.30	1.00	0.80	0.45	0.30	0.30	0.40	0.60	0.80	0.90	0.90	0.90	1.00	1.00	1.00	1.00
Fiscal balance (% of GDP)					-1.4					-1.4					-1.2					-1.0
Gross public debt/GDP (%)					86.9					85.7					84.4					83.6
EUR/USD (eop)	1.20	1.17	1.15	1.12	1.12	1.12	1.12	1.08	1.07	1.07	1.10	1.12	1.13	1.15	1.15	1.16	1.17	1.18	1.20	1.20
USD/JPY (eop)	107	110	114	113	113	112	108	105	103	103	102	100	100	100	100	98.0	95.0	93.0	90.0	90.00
USD/CNY (eop)	6.28	6.67	6.87	6.88	6.88	6.74	6.90	7.18	7.20	7.20	7.23	7.28	7.30	7.30	7.30	7.27	7.25	7.23	7.20	7.20
EUR/GBP (eop)	0.88	0.88	0.89	0.90	0.90	0.85	0.90	0.95	0.92	0.92	0.90	0.88	0.85	0.85	0.85	0.85	0.85	0.85	0.85	0.85
Brent Crude (US\$/bbl, avg)	67	75	76	69	72	64	68	65	68	66	63	61	65	70	65	68	73	73	71	71

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

Source: ING forecasts

Disclaimer

This publication has been prepared by the Economic and Financial Analysis Division of ING Bank N.V. (“**ING**”) solely for information purposes without regard to any particular user's investment objectives, financial situation, or means. ING forms part of ING Group (being for this purpose ING Group N.V. and its subsidiary and affiliated companies). The information in the publication is not an investment recommendation and it is not investment, legal or tax advice or an offer or solicitation to purchase or sell any financial instrument. Reasonable care has been taken to ensure that this publication is not untrue or misleading when published, but ING does not represent that it is accurate or complete. ING does not accept any liability for any direct, indirect or consequential loss arising from any use of this publication. Unless otherwise stated, any views, forecasts, or estimates are solely those of the author(s), as of the date of the publication and are subject to change without notice.

The distribution of this publication may be restricted by law or regulation in different jurisdictions and persons into whose possession this publication comes should inform themselves about, and observe, such restrictions.

Copyright and database rights protection exists in this report and it may not be reproduced, distributed or published by any person for any purpose without the prior express consent of ING. All rights are reserved. ING Bank N.V. is authorised by the Dutch Central Bank and supervised by the European Central Bank (ECB), the Dutch Central Bank (DNB) and the Dutch Authority for the Financial Markets (AFM). ING Bank N.V. is incorporated in the Netherlands (Trade Register no. 33031431 Amsterdam). In the United Kingdom this information is approved and/or communicated by ING Bank N.V., London Branch. ING Bank N.V., London Branch is subject to limited regulation by the Financial Conduct Authority (FCA). ING Bank N.V., London branch is registered in England (Registration number BR000341) at 8-10 Moorgate, London EC2 6DA. For US Investors: Any person wishing to discuss this report or effect transactions in any security discussed herein should contact ING Financial Markets LLC, which is a member of the NYSE, FINRA and SIPC and part of ING, and which has accepted responsibility for the distribution of this report in the United States under applicable requirements.

Additional information is available on request. For more information about ING Group, please visit <https://www.ing.com>.