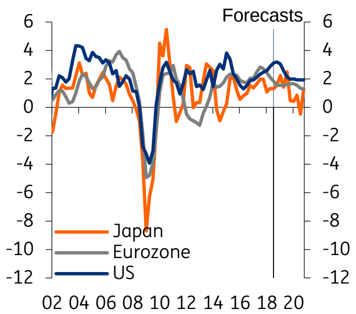
5 October 2018
Global

Monthly Economic Update

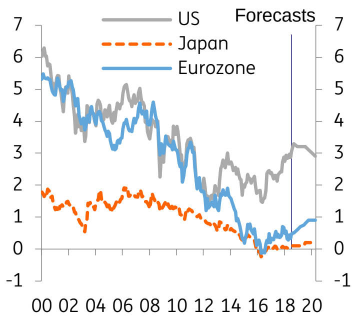
Looking for a silver lining

GDP growth (%YoY)



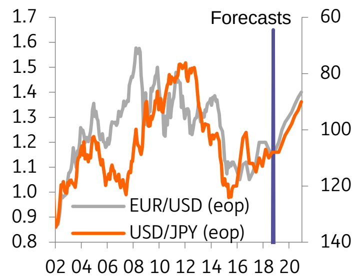
Source: Macrobond, ING

10yr bond yields (%)



Source: Macrobond, ING

FX



Source: Macrobond, ING

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While global growth is certainly respectable, political risk is casting shadows. Trade protectionism remains a key theme, and while a US-Canada-Mexico deal is encouraging, US-China-EU tensions linger. US mid-term elections in November could lead to President Trump focusing even harder on this issue. Europe has its own problems, with concerns about the Italian budget negotiations and "no-deal" Brexit noise growing. Emerging markets aren't immune with rising US borrowing costs and the strong dollar compounding domestic fundamental problems in key markets. Financial markets have a lot to consider in 4Q18.

Despite these concerns, the US economy continues to roar, and with inflation pressures rising, the Federal Reserve remains in tightening mode. Moreover, the US central bank continues to brush aside criticism that it doesn't consider the international implications of its policy decisions enough. We agree that there isn't a great deal the Fed can do to address the domestic challenges facing many emerging market economies, but a strong dollar and higher US borrowing costs certainly won't help their situation.

Politics-wise, the focus is on the 6th November mid-term elections, with opinion polls suggesting the Republicans face an uphill battle to retain control of the House of Representatives. This will make life more challenging for President Trump in terms of getting his legislative agenda passed. It also means he may focus even more attention on trade policy and getting other nations to treat the US "fairly".

With a proposal to refrain from any deficit reduction over the next three years, the Italian government has put the markets on high alert again. The bond yield spread with Germany jumped to above 300 basis points, though we still believe that a compromise with the European Commission can be found before year end. However, the lack of further Eurozone integration, means that this kind of tension will return, especially in case of growth slowdown. While Eurozone growth is still expected to descend next year, the downside risks to the economic outlook have clearly increased. At the same time underlying inflation remains subdued, limiting the scope for monetary tightening in 2019.

On Brexit, the UK government is reportedly set to propose a compromise on the contentious Irish backstop issue, but as ever, there is no certainty that MPs will back the Prime Minister's direction. We still think a fudge can be found that avoids the 'no deal' scenario, but we're unlikely to know for sure until 2019. This only promises more uncertainty in the short-run.

The upside potential to EUR/USD in the remainder of the year seems limited, but we still look for more gains next year as the European Central Bank gets closer to the deposit rate hikes. Sterling remains caught in the Brexit negotiations and we are cautious about the extent of the potential upside to EM FX as the trade war rhetoric may return again.

Market rates are on the rise, and it's no real surprise. The Fed may be at neutral, but still has some hiking to do, while phraseology at the ECB has turned more upbeat. And crucially some of the risk factors coming out of Turkey and Italy have been tamed, at least for now. More of this and rates should be tempted higher still.

US: A President under pressure?

Opinion polls suggest the Republicans are not seeing much of a benefit from the strong economy…

Should the Democrats win control of the House President Trump's legislative agenda looks vulnerable

The US economy continues to prove the doubters wrong. Activity is incredibly strong and job creation is vibrant while wages and asset prices are on the rise. As such it's no surprise that business and consumer confidence are at multi-year highs. Given the often repeated comment that elections are all down to "the economy, stupid" it would be fair to assume the Republicans should be riding high in the opinion polls ahead of the mid-term elections. But they aren't. In fact, polling analysts and bookmakers suggest it is likely that the Democrats will win control of the House of Representatives. This will have implications for President Trump's agenda, the outlook for trade policy and as a direct result, the economy and financial markets.

Fig 1 US election scenarios & potential implications

Source: ING

See our previous notes for detailed scenario analysis

We have written about what is driving polling and what could yet influence the election, as well as a scenario analysis of the possible outcomes. We won't repeat ourselves, but the potential implications of each can be seen in the infographic above.

Compromise is possible on some policy, but we see the President pursuing policy more directly

Our base case is that the Democrats win control of the House of Representatives from the Republicans, but fall narrowly short in the Senate. The key implication is that it makes it more challenging for President Trump to pass major legislation. That is not to say deals can't be done, but given entrenched political positions, getting both sides to compromise enough will be difficult. Faced with this, we suspect President Trump is likely to focus more on his executive powers, which include trade policy.

Pressure will be maintained on China to make trade concessions

China remains firmly in the spotlight, with the recent 10% tariff on $200bn of imports into the US set to be hiked to 25% in the New Year. China shows no sign of cracking on US demands for enacting policies that will slash the bi-lateral deficit and protect intellectual property in the US Administration's eyes. In fact those tariffs may well be expanded to all Chinese imports in 2019. While the Democrats are likely to push back against trade penalties for "allies" such as the EU, they have a history of being more protectionist and may well back the President to some degree on his attitude to China.

Compromise is possible…

… there are risks in pushing too hard

There have been some positives on trade, such as the new agreement with Mexico and Canada offering encouragement. If President Tump can forge a united front with the EU, Mexico, Canada and Japan regarding China, there are more likely to be concessions he can label a "win" for his stance. There are clear uncertainties though regarding this. If compromises are not forthcoming and the trade war intensifies this would risk impacting supply chains, rising prices, hurting growth and could lead to equity market price falls, which President Trump often views as a key barometer of his performance. A weaker economy and falling US household wealth would not put him in good stead for a defence of his presidency in 2020.

Fiscal stimulus will gradually fade through 2019

Domestically, further tax reform is possible, but new initiatives would need to be focused at the lower end of the income distribution to get Democrat support. A watered down version of the President's Infrastructure Investment plan may also be possible. However, this is not going to happen quickly, and we suspect the fiscal support for the US economy will start to fade through 2019. Moreover, the strong US dollar and gradual increase in interest rates will act as a brake on growth while trade uncertainty and emerging market fragility could also contribute to a gradual slow down.

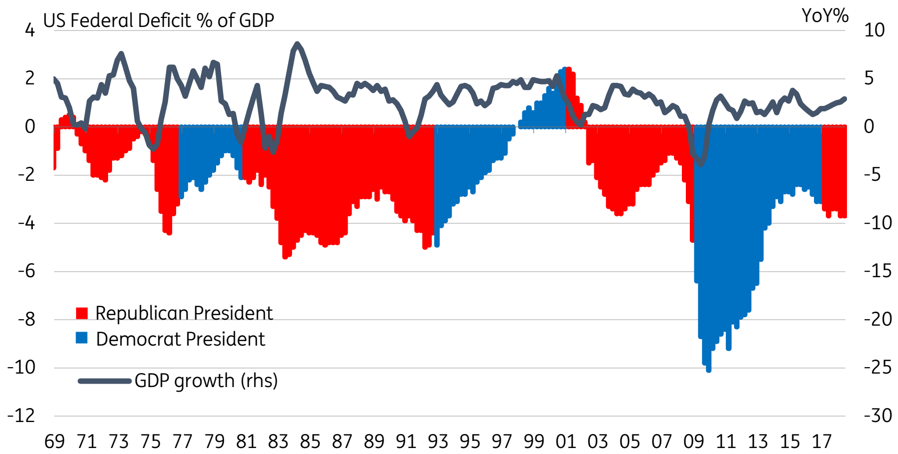
But there are possible upside risks to growth if the labour market continues strengthening as rapidly as it has been doing

That is not to say we are forecasting a recession. We still feel that there are strong underpinnings to the US economy with a key upside risk potentially coming from the labour market. The jobs story has clearly strengthened over the past twelve months with the pace of job creation currently averaging 207,000 per month in 2018 versus 182,000 last year and the demand for workers continues apace according to surveys. This is translating into higher pay and we look for wage growth to finally push above 3% year on year in 4Q18 – the fastest rate of pay growth since April 2009. If the shortage of workers leads to an acceleration in pay from here - there is likely to be more upside for consumer spending too.

We see four rate hikes before end 2019

In terms of interest rates, while the Fed no longer views monetary policy as "accommodative" it certainly can't be described as "restrictive". As such, the Fed suggests that the most likely course of action is a further rate hike in December taking it to a total of four 25bp interest rate rises in 2018, with an additional three hikes in 2019. This is a view that we now agree with. After all, the economy looks set to grow 3% this year and 2.5% next year, with inflation set to stay above the 2% target, thanks to wage rises, higher oil prices and some influence from higher tariffs. This is also likely to keep upward pressure on Treasury yields in the near-term with the 10 year possibly testing 3.5% at some point.

Fig 2 Federal deficits by party



Source: ING, Bloomberg

But fiscal fears are likely to persist

Another issue that could impact the Treasury market over the medium to longer term is lingering concerns over the US fiscal story. According to the Congressional Budget Office, the huge tax cuts and spending increases implemented by President Trump mean that the federal deficit is on course to rise to 5% of GDP over coming years. This deeply troubles fiscal hawks. If growth was to disappoint the risk is that the deficit could rise sharply. Given the polarisation of views on Capitol Hill this runs the real threat of government shutdowns, which could add to political, economic and market uncertainty.

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Eurozone: Italian turmoil

Italy's bold budget proposal frightens financial markets…

The Italian government's decision to deviate from last fiscal year's stability program was more or less anticipated, but the scope and, more importantly, the persistence of the deviation is a reason for concern. Where until recently it was assumed that the target deficit for 2019 could be set at just below 2% of GDP and that the subsequent decline would be slower than agreed by the previous government, the current Italian government announced a deficit of 2.4% for three years in a row. With a debt-to-GDP-ratio above 130%, this clearly increases risks to medium-term debt sustainability.

…though this is not necessarily going to be the final outcome

While the fine print of the deal isn't clear yet, the European Commission is unlikely to accept this without any alterations. On top of that, credit rating agencies will be tempted to cut Italy's rating. Of course, the current proposal is not necessarily going to be the final outcome (it seems that the Italian government is already backtracking a bit), but that markets have been put on high alert as the 10-year bond spread with Germany climbed above 300 basis points.

A compromise with the European Commission still looks likely…

We believe that the European Commission, while not playing hardball, is going to try to direct the Italian spending plans to the most productive expenditures, finding a balance between giving Italy some leeway to boost economic growth, while at the same time keeping debt sustainability in mind and a final outcome might have to wait until December.

Although we don't think we'll see extreme tensions in the Eurozone, but at this point in time, political developments in Europe are hardly conducive to a stronger monetary union.

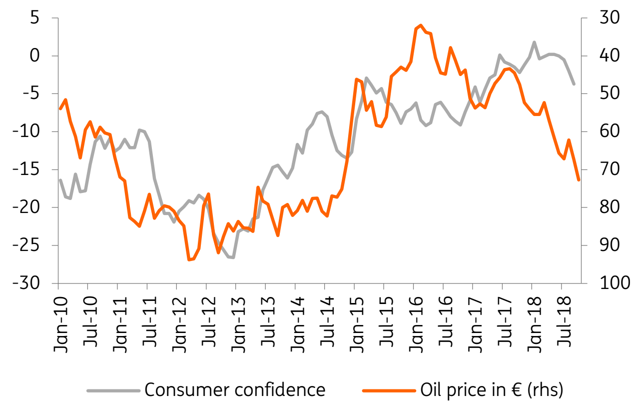
…but the conflict could return next year

Indeed, the German chancellor Angela Merkel is clearly weakened, and elections in Bavaria might put further pressure on the current coalition while the popularity of the French President Emmanuel Macron has dived. And unfortunately European leaders have been devoting a lot of time to the Brexit puzzle and immigration problems, leaving little time to make the Eurozone structurally stronger.

The cohesion of the monetary union might once again be tested when the next downturn comes. So while the current stand-off between the Italian government and the European Commission might end in a draw, things could get even more difficult next year, especially if the Italian government feels vindicated by strong results in the European elections.

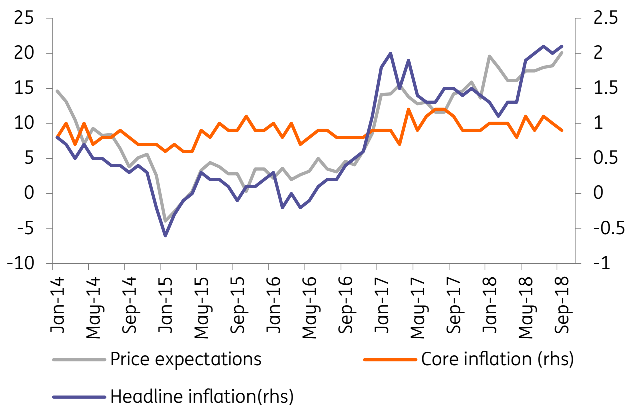
We therefore remain wary of the situation in Italy, even if things (temporarily) cool down a bit before the end of the year.

.Fig 3 Higher oil prices sap purchasing power



Source: Thomson Reuters Datastream

Fig 4 Rising inflation remains an oil story



Source: Thomson Reuters Datastream

The Eurozone expansion shows signs of tiring...

Market turmoil comes at a time when the Eurozone expansion is already showing some signs of tiring. The European Commission's economic sentiment indicator fell in September for the ninth month in a row. To be sure, at 110.9, the level is still comfortably above the long term average, but it is somewhat worrying that consumer confidence has been falling back over the summer months. The rise in energy prices might be one of the culprits, but apparently the confidence in the job market has taken a hit, despite the falling unemployment rate. Of course, every expansion goes through soft patches and the overall environment still looks OK. The Eurocoin indicator, which tracks the underlying quarterly growth pace of the Eurozone, actually increased in September to 0.52%. But as we've said before - the best of the expansion is now behind us and we feel that the downward risks to the outlook have clearly increased.

...and downward risks have increased

Headline inflation above 2%...

The 2.1% headline inflation in September remains largely an oil story. Energy prices increased 9.5% YoY on the back of higher oil prices. Looking at the oil price dynamics over the past 12 months to assess the base effects, it's very likely that energy will continue to keep headline inflation close to 2% for some time to come.

...but core inflation falls back below 1%

However, the European Central Bank looks through these temporary effects and pays more attention to the underlying price dynamics. ECB president Mario Draghi recently mentioned his belief in a "relatively vigorous" pick-up in core inflation on the back of tightening labour market conditions. But in September, underlying inflation actually fell back to 0.9%. The fact that services price inflation, which typically has a substantial wage component, remains at 1.3% is testament to the fact that tight labour conditions are not creating much inflation for the time being. We only expect a painfully slow upward trend in core inflation.

ECB will try to get rid of negative rates, but little more than that

We still believe the ECB will try to abandon of negative interest rates by the end of 2019. However, with the global economy likely to slow, the scope for further rate hikes remains limited.

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UK: Finally, a fudge?

Reports suggest the UK is preparing to compromise on the Irish backstop

Away from the noise of the Conservative Party conference, the big Brexit story is that Prime Minister Theresa May could be gearing up to propose a compromise with Europe on the contentious Irish border issue. So what does this mean in practice, and crucially, will it be enough to convince UK lawmakers?

First off, a quick recap of why the Irish backstop came about. The UK's long-stated intention to leave the single market and customs union would require new border infrastructure at UK ports - including along the Northern Irish land border. Exiting the single market would mean goods would need to be checked against EU rules, while sitting outside a customs union would require tariff collection and rules of origin checks.

For a range of reasons, checks on the Irish border are not plausible

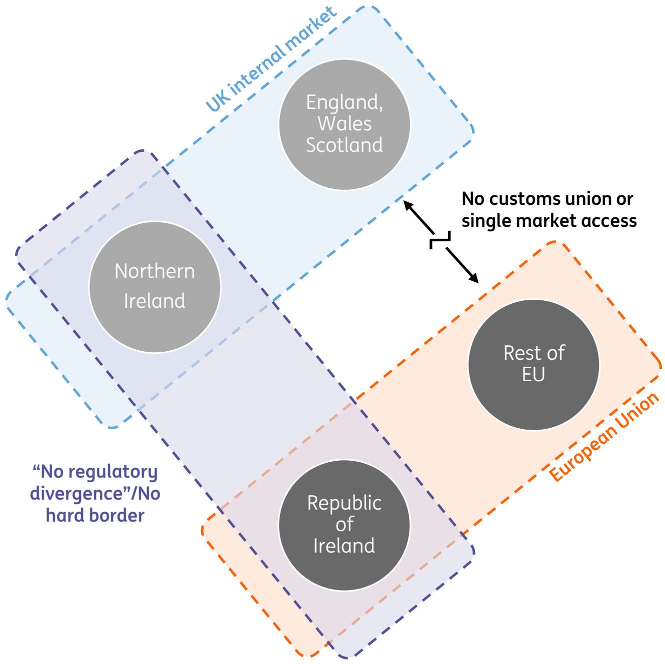
But for a range of political and practical reasons, introducing these processes on the border between Ireland and Northern Ireland is not plausible. For this reason, the EU has proposed a backstop solution that would see Northern Ireland effectively remain in a customs union and the single market for goods, if the rest of the UK does indeed push ahead and leave these arrangements.

The government is concerned the backstop will create barriers within the UK itself

That would avoid a hard border in Ireland, but the UK government – which relies on the Northern Irish Democratic Unionist Party (DUP) for its parliamentary majority – has long been concerned that this solution would instead simply create a customs and regulatory barrier between Northern Ireland and the rest of the UK.

Theresa May has said in the past that "no prime minister" could ever accept this arrangement. But with time running out, the Prime Minister appears to be preparing to blur that particular red line.

Fig 5 Squaring the circle - the Irish border challenge



Source: ING

But reports suggest the PM will accept the need for regulatory checks...

Several press reports on Monday indicated that the UK is now prepared to accept that goods flowing to Northern Ireland from the British mainland may need to be checked against EU standards. While this is unlikely to be popular among UK lawmakers, it isn't entirely unprecedented. Even now, cattle imports into Northern Ireland from Great Britain must go through the Port of Larne, where they are checked and various certificates must be presented before animals are granted entry. The EU has signalled these checks could be "de-dramatised" further, by moving them away from ports to the farms they originate from to reduce border frictions.

...if customs processes are avoided

In exchange, the Prime Minister is adamant that the UK as a whole - not only Northern Ireland - must be allowed to remain in a customs union for an extended period, or at least until an alternative technology-based solution comes along. That would prevent the UK being divided into two customs territories, avoiding the need for tariff/rules of origin barriers.

As ever, the big question is whether whatever is agreed between the UK and EU will be voted through Parliament - and the short answer is that nothing is guaranteed.

Conservative Brexiteers don't like it...

Conservative Brexiteers are likely to be vehemently against the UK remaining in a customs union for years to come as that would prevent Britain from striking its own trade deals. And given that any technological alternative is likely to take years to develop in reality, it may prompt concerns amongst MPs that the government is trying to keep the UK closer to the EU via a backdoor route. Incidentally, the EU shares the same concern, in that the UK may be trying to achieve a long-term customs union access without accepting all of the wider commitments that this normally requires.

...and neither does the DUP

The DUP has also made it clear it won't accept a backstop where there are regulatory checks between Northern Ireland and the rest of the UK - de-dramatised or otherwise. Theresa May could offer them some assurances that the backstop won't actually ever be needed, by indicating that she would be prepared to sign-up to the common rulebook for goods - effectively what is contained in the Chequers plan. If the rules are the same in the UK as the EU, then that would rule out the need for most regulatory checks at the border.

While this is likely to enrage Brexiteers further – who are pushing for the UK to ditch EU rules altogether – it may attract some Labour MPs to back the government, given that it is closer to the terms the opposition party set out at its conference last month.

But even if it would secure the critical votes to get the deal through Parliament, the EU would likely be reluctant to agree to this common rulebook plan. Remember Brussels is chiefly concerned about cherry-picking elements from the single market. Other commentators have suggested, Mrs May would at the very least need to sign-up to a wider range of regulations on goods (for example labour laws), as well as give ground on other commitments, for EU leaders to take the proposal more seriously.

A fudge is still possible – although it won't be easy, and we're unlikely to know for sure until the new year

In the end, we think some kind of mutually acceptable fudge will be found, although it won't be easy. After all, the bulk of trade negotiations will be left until after March 2019, so at this stage it will be a case of giving MPs just enough reassurance in the political declaration that the direction for trade discussions is acceptable. We also suspect Theresa May could try to leave agreeing a deal as late as possible, to focus minds in parliament and make the 'meaningful vote' a much more binary choice between her deal, and an economically risky 'no deal' scenario.

This means we're unlikely to know for sure that 'no deal' has been avoided until early next year. Before then, the road to Brexit is only likely to get bumpier.

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China: More retaliation on the way

Lower tariff rates only until end of this year.

On 18th September, China announced fresh tariffs on a list of $60 billion worth of US goods. The tariff rates are set between 5 to 10%, which is lower than the 5 to 25% that were proposed previously, following a US decision to initially limit tariffs to 10% on its list of $200 billion worth of goods. However, these lower tariffs are only set to last until the end of 2018 and if the US increases the rate to 25% in 2019, as it has suggested, we expect China to follow suit – as it initially suggested back at the start of August.

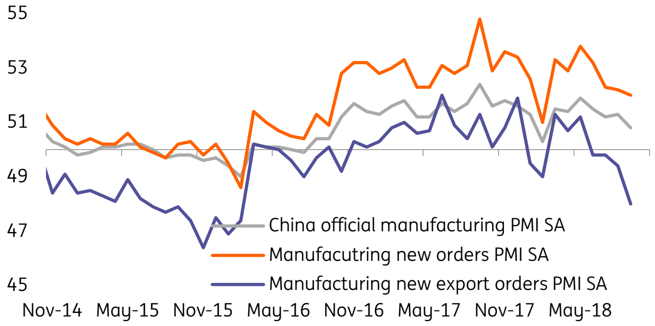
China reducing import tariffs weakening competitiveness of US companies operating in China.

But given that China imports less from the US than it exports, there is only so much China can do quantitatively. So the focus is now increasing on China's qualitative retaliations, which so far include the reinstatement of a 2013 WTO dispute and lowering import taxes on various goods - a move designed to weaken the competitiveness of US companies in China. This decision will benefit other countries' exports to China, while US imports suffer from the additional tariffs and this is a situation is similar to that of US automobiles, which face higher tariffs in China than imported cars from other economies.

We expect the trade war to continue into 2019.

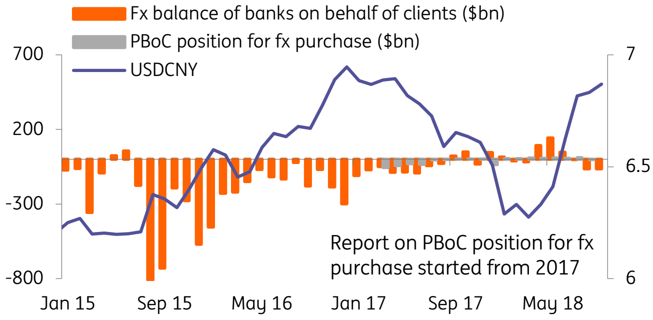
But the trade war doesn't end with tariffs. Geopolitical tensions in the South China Sea escalate at a time where China will not return to the negotiation table until after the US mid-term elections. The new trilateral trade bloc of US, Mexico and Canada (USMCA), would include a clause that allows any member to veto trade agreements between China and other members. With negotiations between China and the US delayed, the trade war is set to be a long and increasingly complicated process, which undoubtedly will continue into 2019.

Fig 6 PMIs show China still holding up domestically despite fall in export orders



Source: ING, Bloomberg

Fig 7 We believe that USDCNY is heading towards 7.0 by end 2018



Source: ING, Bloomberg

Fiscal stimulus coming to rescue but not the export sector.

Fiscal stimulus in China has started quietly as various local governments are starting infrastructure projects, and support from these economic activities should be seen in the months ahead but before that, industrial profits and PMIs, as shown in Figure 1, a slowdown in export activity, while domestic demand still appears to be holding up.

No massive capital outflows even yuan depreciates.

We don't believe that further yuan depreciation will trigger massive capital outflows as there were inflows into the onshore asset markets to offset regular outflows, and the cross-border regulator (SAFE) has closed illegal loops of outflows. Figure 2 shows that conversion from yuan to foreign currencies has been low compared to the 2015 level.

Yuan continues to weaken but at a moderate speed since July.

We expect the People's Bank of China to allow the yuan to depreciate to 7.0 by the end of this year (Spot rate was 6.88 at the time of writing this note).

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Japan: The third arrow

BoJ efforts to keep bond yields low are fading

Perhaps the most convincing confirmation that the Japanese economy is enjoying a strong spell, is the continued reduction of effort put into maintaining low bond yields by the Bank of Japan.

Asset purchases at the super long end of the curve are to be lowered

In September, a shortage of working days reduced the numbers of days per month during which the central bank conducted outright asset purchases from ten to nine. The latest schedule for October (with more working days) shows still only nine monthly operations. Moreover, purchases of 25-year and Japanese government bonds are reduced from JPY 50-JPY 150 billion per operation, to only JPY 10-JPY 100 billion.

Bond yields are rising, and there are plenty of reasons why

Yields on 30-year JGBs have risen from about 0.65% back in July to over 0.91% now, and may well drift higher. 10-year JGBs over the same period have seen yields rise too, though less than half as much from 0.02% to 0.12%.

But progression of the central bank taper is just one part of the bond yield story, there is more.

Inflation is higher than usual and should move higher still

Inflation in Japan is now running at 1.3% year on year – the last time it was this strong, Japanese prices were being lifted by a consumption tax hike (2014-2015). That isn't the case this time round. Instead, Japan's prices are buoyed by food and energy – factors that have little to do with domestic economic strength – and core inflation remains pitifully low otherwise.

The consumption tax has a high chance of being implemented...

Given that these external factors and base effects may become even more intense over the coming months, so a 1.5%YoY headline inflation rate is definitely on the cards and that is even before the government implements the next increase in the consumption tax in October next year.

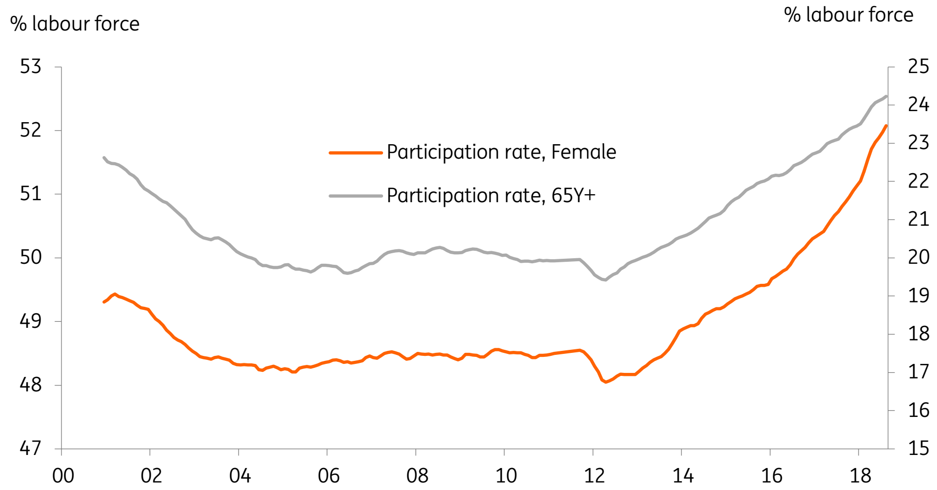
...now that Abe has decisively won a third term as head of the LDP

While the fate of the October 2019 consumption tax increasingly lies in the hands of data developments over the coming year, to some extent, the political news is nonetheless supportive. Prime Minister Shinzo Abe managed to secure a third term as leader of the Liberal Democratic Party, which has ruled Japan with only two brief interruptions since 1955. If he serves for another three years, Abe will become Japan's longest serving leader.

Wages growth is still good...

Although constitutional reform is one of the key elements of Abe's policy manifesto, raising the consumption tax is also a key element. Here, things are also looking up, as Japan's real economy is humming along nicely. We have written before about the positive effect of higher wage growth and the bulk of this still represents overtime, and not scheduled cash earnings. Nevertheless, back in June, hourly earnings growth for full time Japanese employees exceeded that for US workers (but have since been overtaken).

Fig 8 Japan's participation rate rising



Source: CEIC

...and structural reforms are swelling labour participation

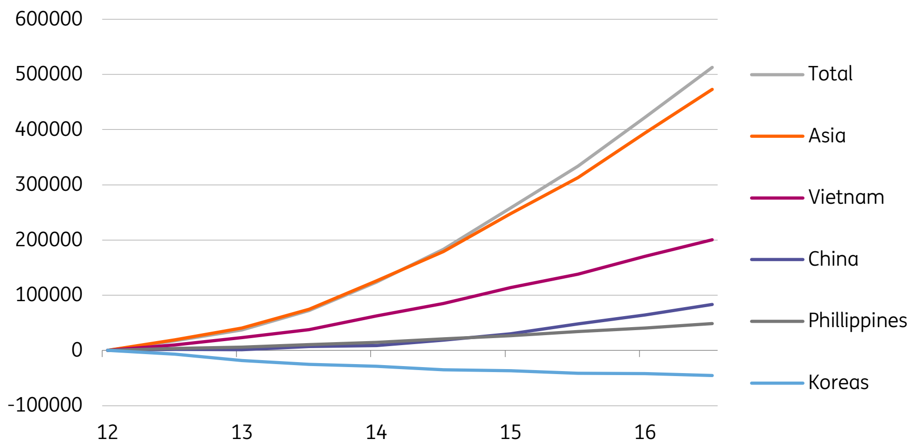
Low unemployment is an important factor too, Sure, the unemployment rate in Japan has been very low for years. But it is falling now against the backdrop of a rising participation rate – a combination of the already elderly and greater female participation, together with a little bit of immigration. This is an encouraging development and the product of what has until now been the elusive element of Abe's three arrow policy – structural reforms.

The main risk is trade, and a US – Japan tariff war

Will it last? It's hard to say. Recent Tankan survey evidence already points to an impact on the manufacturing sector from the overspill of the trade war, and that is before the US has really put Japan in its sights for tariffs. We suspect this is only a matter of time. Japan's bilateral surplus with the US was USD 60bn in the twelve months ending August 2018. The only thing that makes this less of an issue is that it has barely grown since 2012, and indeed, is lower than some years pre-global financial crisis.

But in due course, that may not be sufficient defence against the threat of tariffs from the US.

Fig 9 Cumulative immigration, 2012 = 0 (Abe becomes PM in 2012)



Source: CEIC

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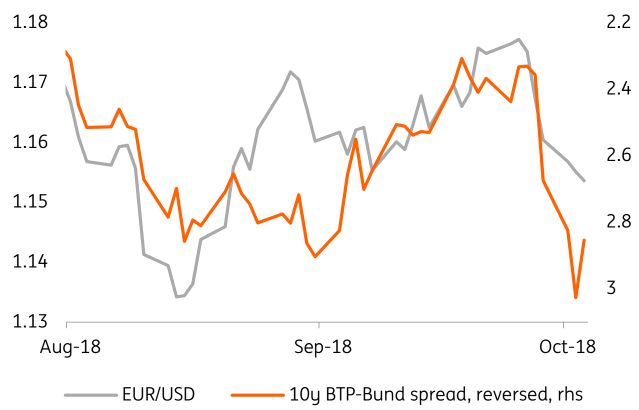
FX: Still a very clouded path ahead

Italy weighing on the euro yet again

Yet again, Italian politics hit the euro - and this time by the higher than expected Italian budget deficit plan which translated into the BTP sell-off and a lower euro. (Fig 10). But with the Italian authorities at least signalling their willingness to adjust the path of the deficit lower for the years beyond 2019, the worst for the euro may be behind, for now at least.

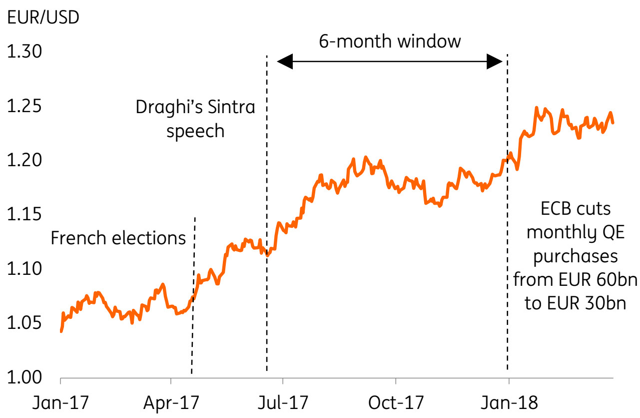
Our rate strategists expect the BTP-Bund spread to stabilise below the 300 basis point level. Still, this suggests a fairly limited upside for the common currency into the year-end, with EUR/USD broadly range trading around 1.15. This is in line with the euro "survival" experience so far this year whereby the EUR/USD negative factors such Eurozone politics, a period of higher US growth and interest rates didn't translate into a profound EUR/USD collapse.

Fig 10 Italian politics yet again sent EUR lower



Source: ING, Bloomberg

Fig 11 Markets front run the policy normalisation



Source: ING, Bloomberg

We continue to retain a constructive EUR/USD outlook for the next year, expecting the pair to move into the 1.25-1.30 area. The euro should receive a boost from the second step of the European Central Bank policy normalisation – the deposit rate hikes.

The 2019 euro outlook still constructive as the ECB lift the deposit rate…

But although a story for 3Q19, as was the case with the ECB quantitative easing tapering, (Fig 11) we expect markets to front-run the event and start pricing that in the undervalued euro (Fig 12) around six months ahead. The ECB President Mario Draghi's comments about the "vigorous" rise in the core inflation supports this view.

…. while a fair degree of tightening is already priced in for the Fed

On the dollar side, although the Federal Reserve is hiking, a fair degree of tightening is already priced in, meaning that the Fed rising interest rates three times next year (vs two hikes priced in – in addition to the one hike this year) is unlikely to change EUR/USD prospects much. Indeed, as Fig 13 shows the EUR/USD correlation with short-end rate spread collapsed this year (in fact it turned negative), supporting the view that it was largely one-off idiosyncratic factors driving EUR/USD lower (such the disappointing Eurozone data in April/May, Italian politics in May and the sell-off in the Turkish lira in August) rather than the market materially re-thinking the relative Fed – ECB outlook.

Ongoing hurdles for GBP, but hope for some upside potential

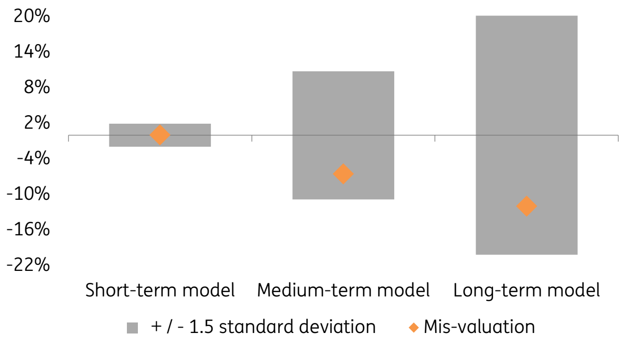
With Sterling safely navigating the Tory Party conference event risk relatively unscathed, the focus in October now turns to finalising a Brexit Withdrawal Agreement ahead of the EU summit later this month. Reports that Prime Minister Theresa May will make a concession on the Irish border backstop in the coming weeks – effectively allowing the whole of the UK to remain in a EU customs union beyond 2021, if there is no trade deal in place by then – has helped nudge the dial towards a deal being finalised by year-end.

But there are two hurdles that still need to be overcome before GBP markets can safely price out no-deal Brexit risks: (1) whether Brussels would be willing to play ball on a de facto extension of the transition period beyond Dec 2020; and (2) whether there are enough MPs in the House of Commons to support this type of deal, namely the Democratic Unionist party or the Brexiteer factions in the Tory party.

We continue to warn investors of the possibility of a GBP/USD rebound to 1.36-1.38 in the event of a deal being effectively wrapped up (both informally and legislatively). Any continued impasse would weigh on GBP crosses more meaningfully as we approach year-end.

Fig 12 EUR/USD is cheap on medium and long term basis

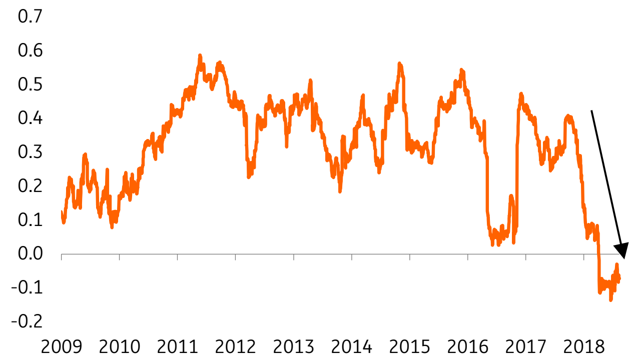
Mis-valuation of EUR/USD away from various iterations of its fair value (short-term financial fair value, medium-term BEER fair value and long-term PPP fair value)



Source: ING

Fig 13 EURUSD correlation with short-end rates collapsed

6-month rolling correlation of EUR/USD with 2-y EZ-US swap rate spread



Source: ING, Bloomberg

Cautious about the extent and sustainability of the EM FX rally

As for the emerging market FX segment, the currencies stabilised following the large sell off, partly due to credible responses from the local central banks (Turkey and Russia) and more attractive valuations. But more importantly, we have seen a tentative pause in the trade war rhetoric. The latter remains the key driver of emerging markets FX, given its negative implications for global trade. As noted above, there is non-negligible risk of a further escalation in trade wars after the US mid-term elections. This in turn means that investors should treat the recent emerging markets FX rebound with great caution given the downside risks ahead.

We also note the ongoing idiosyncratic risks in various emerging market countries. These include the October Brazilian elections (though the latest polls point to a more market friendly outcome), the risk of additional US sanctions on Russia and the latest question marks about how the Turkish authorities respond to the sharp rise in inflation (which was above 24%YoY) or sharply rising oil prices hurting currencies of emerging market oil-importers with substantial current account deficits – think the Indonesia rupiah or the Indian rupee.

Hence, despite the seemingly more attractive valuations, the case to turn fully bullish on emerging markets FX isn't strong enough, particularly where the domestically focused Fed is steaming ahead and continues to raise interest rates.

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Rates: Why the core rates are being slowly released

Some of the factors that had been holding core rates down have subsided.

Rates look to have an appetite to nudge higher. We expect more in the weeks ahead

1. Ever since Turkey hiked rates, a few weeks back, sentiment has turned more positive there, and slowly investors have uncoiled extreme risk hedges. This has coincided with a more positive tone across emerging markets, meaning less need to park cash in the core markets like Treasuries.

Rick factors like Turkey and Italy have been downsized, and are less of an imminent threat

2. After a run of troubling weeks for Italy which peaked with the posting of a 2.4% deficit target (should have been sub-2%) alongside blasé and sometimes provocative commentary, finally the choice of words from Rome turned more constructive and conciliatory. Hence Bunds have lost a residual bid too.

On top of that there has been a shift in central bank thinking:

The Fed is still on a rate hiking path, despite the assertion that neutrality has been reached

1. Following the latest Federal Reserve hike, Fed chair Jerome Powell has asserted that policy is no longer 'accommodative'. Initial reaction to this was bullish for bonds, but on reflection it is clear that Powell has simply stated that rates are now neutral. But the brakes still need to be applied, so the rate hike cycle continues.

And Draghi was as positive as he could be on inflation

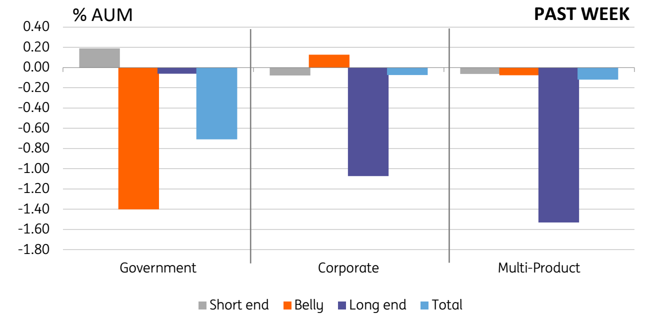
2. A week before that, ECB president Mario Draghi surprised all with his observation that core inflation was seeing a 'vigorous' pickup. This has been partly walked back by other ECB members, but it's out there now. Draghi appears to be preparing for a step away from extreme dovishness, even if not ready to be outright hawkish just yet.

Plus, it seems that investors are paring duration risk and positioning for higher rates

Then on a technical front, there are a number of items in play that point to higher rates.

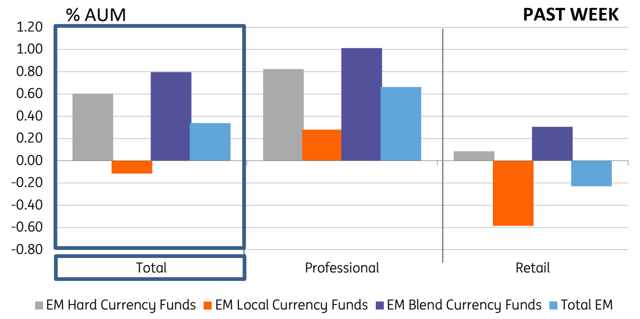
Latest fund flows show that investors have been reducing risk, at least as far as their core bond holdings are concerned. They've been nibbling in emerging (Figure 15) markets, but have been selling belly and long end investment grade funds (Figure 14). They are effectively positioning for higher rates.

Fig 14 Change in developed markets assets under management (%)



Source: EPFR Global, ING estimates

Fig 15 Change in emerging markets assets under management (%)



Source: EPFR Global, ING estimates

Add this to the QE paring narrative and there is a confluence that should result in rates to testing higher still

On top of all that, let's not forget that the Fed is allowing between $10 billion to $30 billion per month of its quantitative easing holdings of bonds to roll off the front end. And the ECB, once an €80bn per month buyer, is heading to being a pure balance sheet reinvestment play of €10bn per month.

It's never straightforward, but it does seem that the waters are parting in the direction of a further nudge higher in rates.

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Fig 16 ING global forecasts

	2017					2018F					2019F					2020F				
	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)	1.8	3.0	2.8	2.3	2.2	2.2	4.2	3.8	2.6	3.0	1.7	2.2	2.0	2.0	2.4	1.8	1.9	2.0	2.0	1.9
CPI headline (% YoY)	2.6	1.9	2.0	2.1	2.1	2.3	2.6	2.7	2.7	2.6	2.5	2.7	2.7	2.4	2.6	2.2	2.1	2.1	2.1	2.1
Federal funds (%, eop)[1]	0.75	1.00	1.00	1.25		1.50	1.75	2.00	2.25		2.50	2.75	3.00	3.00		3.00	3.00	3.00	3.00	
3-month interest rate (%, eop)	1.15	1.30	1.33	1.56		2.30	2.35	2.45	2.75		3.00	3.00	3.25	3.30		3.55	3.70	3.55	3.45	
10-year interest rate (%, eop)	2.40	2.30	2.30	2.40		3.00	3.00	3.00	3.20		3.30	3.20	3.20	3.20		3.20	3.10	3.00	2.90	
Fiscal balance (% of GDP)					-3.5					-4.0					-4.7					-4.9
Fiscal thrust (% of GDP)					0.0					1.2					0.8					0.0
Debt held by public (% of GDP)					76.1					77.2					79.3					82.5
Eurozone																				
GDP (% QoQ, ann)	2.4	2.9	2.9	2.8	2.5	1.5	1.5	1.6	1.5	2.0	1.6	1.6	1.7	1.7	1.7	1.6	1.2	0.9	1.3	1.5
CPI headline (% YoY)	1.5	1.3	1.5	1.4	1.4	1.3	1.7	2.0	1.9	1.7	1.8	1.7	1.5	1.6	1.7	1.8	1.8	1.8	1.8	1.8
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	0.25	0.25	0.25	0.50	0.50	0.50	0.50
3-month interest rate (%, eop)	-0.33	-0.33	-0.33	-0.33		-0.33	-0.33	-0.33	-0.33		-0.32	-0.26	-0.12	0.10	0.10	0.15	0.30	0.40	0.50	0.50
10-year interest rate (%, eop)	0.45	0.40	0.45	0.42		0.50	0.30	0.40	0.50		0.50	0.60	0.70	0.75	0.75	0.80	0.90	0.90	0.90	0.90
Fiscal balance (% of GDP)					-0.9					-0.6					-0.9					-0.9
Fiscal thrust (% of GDP)					0.2					-0.2					0.4					0.1
Gross public debt/GDP (%)					89.2					87.4					85.9					84.8
Japan																				
GDP (% QoQ, ann)	1.9	2.3	1.6	1.3	1.7	-0.9	3.0	2.2	1.9	1.4	1.9	-0.3	6.6	-5.9	1.7	1.7	1.4	1.1	1.1	0.5
CPI headline (% YoY)	0.2	0.4	0.6	0.6	0.5	1.3	0.6	1.2	0.9	1.0	0.8	1.4	1.1	2.2	1.4	2.3	2.1	2.1	1.0	1.9
Excess reserve rate (%)	-0.1	-0.1	-0.1	-0.1		-0.1	-0.1	-0.1	-0.1	0.0	-0.1	-0.1	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
3-month interest rate (%, eop)	0.00	0.00	0.00	0.00		0.00	0.00	-0.05	-0.05		0.05	0.05	0.00	0.00		0.00	0.10	0.10	0.10	
10-year interest rate (%, eop)	0.10	0.10	0.10	0.10		0.10	0.10	0.10	0.10		0.1	0.1	0.1	0.1		0.2	0.2	0.2	0.3	
Fiscal balance (% of GDP)					-4.8					-4.1					-3.6					-3.0
Gross public debt/GDP (%)					221.0					223.0					224.0					226.0
China																				
GDP (% YoY)	6.9	6.9	6.8	6.8	6.9	6.8	6.7	6.5	6.3	6.6	6.2	6.2	6.3	6.3	6.3	6.3	6.2	6.2	6.2	6.2
CPI headline (% YoY)	1.4	1.4	1.6	1.8	1.6	2.2	1.8	2.0	2.3	2.1	2.4	2.5	2.6	2.6	2.5	2.6	2.6	2.5	2.4	2.5
PBOC 7-day reverse repo rate (% eop)	2.45	2.45	2.45	2.50	2.50	2.55	2.55	2.55	2.55	2.55	2.50	2.50	2.45	2.45	2.45	2.40	2.40	2.35	2.35	2.35
10-year T-bond yield (%, eop)	3.29	3.57	3.61	3.90	3.90	3.75	3.48	3.65	3.55	3.55	3.50	3.50	3.45	3.45	3.45	3.40	3.40	3.34	3.35	3.35
Fiscal balance (% of GDP)					-3.7					-4.0					-4.0					-4.0
Public debt, inc local govt (% GDP)					50.0					87					100					100
UK																				
GDP (% QoQ, ann)	1.3	1.0	1.9	1.6	1.5	0.4	1.6	1.8	1.2	1.2	1.3	1.7	2.1	2.2	1.6	1.7	1.7	1.2	1.2	1.7
CPI headline (% YoY)	2.1	2.7	2.8	3.0	2.7	2.7	2.4	2.5	2.4	2.5	2.3	2.1	1.8	1.7	2.0	1.8	1.9	1.9	1.7	1.8
BoE official bank rate (%, eop)	0.25	0.25	0.25	0.50	0.50	0.50	0.50	0.75	0.75	0.75	0.75	1.00	1.00	1.00	1.00	1.25	1.25	1.50	1.50	1.50
BoE Quantitative Easing (£bn)	445	445	445	445		445	445	445	445	445	445	445	445	445	445	445	445	445	445	445
3-month interest rate (%, eop)	0.35	0.35	0.35	0.52		0.60	0.80	0.80	0.80	0.80	0.85	1.05	1.05	1.05	1.05	1.30	1.35	1.60	1.65	1.65
10-year interest rate (%, eop)	1.15	1.10	1.35	1.20		1.45	1.48	1.55	1.55	1.55	1.55	1.70	1.80	1.90	1.90	1.90	2.00	2.10	2.20	2.20
Fiscal balance (% of GDP)					-2.5					-1.8					-1.7					-1.4
Fiscal thrust (% of GDP)					-0.5					-0.4					-0.4					-0.3
Gross public debt/GDP (%)					87.0					86.5					86.0					85.5
EUR/USD (eop)	1.08	1.12	1.20	1.20		1.20	1.17	1.15	1.17		1.20	1.25	1.28	1.30		1.32	1.35	1.38	1.40	
USD/JPY (eop)	112	115	110	113		107	110	108	108		108	105	102	100		98.0	95.0	93.0	90.0	
USD/CNY (eop)	6.89	6.78	6.65	6.51		6.28	6.67	6.90	7.00		7.00	6.90	6.80	6.60		6.50	6.40	6.40	6.30	
EUR/GBP (eop)	0.87	0.88	0.94	0.89		0.88	0.88	0.90	0.88		0.88	0.87	0.86	0.85		0.85	0.85	0.85	0.85	
Brent Crude (US$/bbl, avg)	55	51	52	61	55	67	75	76	75		64	66	67	66		64	69	74	69	

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

Source: ING forecasts

Disclaimer