

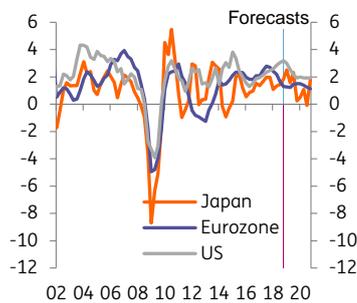
1 November 2018

Global

# Monthly Economic Update

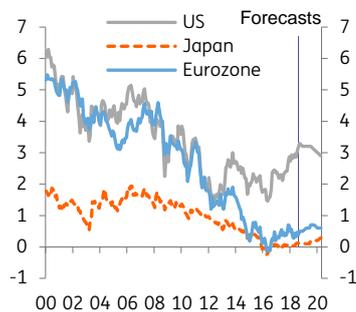
## A changing of the guard...

### GDP growth (%YoY)



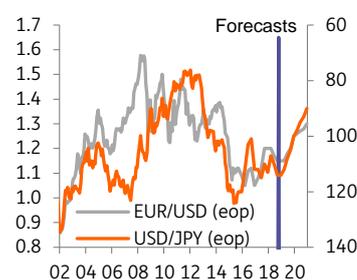
Source: Macrobond, ING

### 10yr bond yields (%)



Source: Macrobond, ING

### FX



Source: Macrobond, ING

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Political change appears to be intensifying around the globe and this will only heighten the uncertainty for financial markets. In the US the likely Democrat mid-term election gains could curtail President Trump's legislative agenda with the risk that he steps up his attacks on trade partners. The Italian fiscal saga continues with the government at loggerheads with the EU while Angela Merkel calling time on her German Chancellorship could create a political vacuum at the heart of Europe. Meanwhile the growing prevalence of "strongman" leaders in emerging markets is likely to be another factor that will stoke geopolitical tensions and potentially lead to even greater market volatility.

The US economy remains very strong, but the prospect of additional fiscal stimulus will be diminished if, as expected, the Democrats win control of the House of Representatives at the 6 November midterms. This will undoubtedly make it more difficult to implement further tax cuts and spending increases so could see President Trump intensify his focus on "unfair" Chinese trade practices.

US Growth will likely slow through 2019 though as the support from fiscal stimulus fades and tighter monetary conditions and trade uncertainty weigh on activity. Nonetheless, the tight jobs market, rising worker pay and above target inflation suggest the Federal Reserve will remain in tightening mode for much of 2019.

With the Italian government not yielding to the European Commission's pleas to alter the budget and Angela Merkel loosening her grip on German politics, Eurozone governance is becoming increasingly hard. The slowing growth momentum is not helping either, with 2019 and 2020 now expected to see GDP growth below 1.5%. This hasn't stopped the ECB from confirming the end of its net asset purchase for December 2018, though interest rate hikes might now be further away than previously thought.

Japan is gradually strengthening relationships throughout Asia. China is now Japan's single largest trading export destination ahead of the US and all the other top export destinations are Asian. So Japan doesn't want to get in a fight with Trump, but can't afford to side against China.

Both the trade war and geopolitical tensions continue to escalate between the US and China. The respective relationships with Taiwan are increasingly in focus and risk intensifying the situation.

There is increasing risk that Brexit talks slip into December, or even the New Year, as the UK government tries to convince lawmakers to approve a deal. We still think there will be an agreement, that in the end is voted through in Parliament. But there's a risk we won't know for sure for quite some time, which could see the economy slow over the winter.

US mid-terms will test the conviction levels of a market generally bullish on the dollar. We cannot rule out a modest dollar correction, but given growth challenges facing the Eurozone and China into 2019 it looks too early to call a turn in the dollar trend. Downward revisions to Eurozone growth and ECB policy see us cut our EUR/USD profile.

In terms of rates, an issue of increasing relevance to markets is that Libor is only guaranteed until end 2021. This is a massive item for attention in the coming years for all participants that have a link to current Libor markets. And that extends beyond the financial markets to all types of consumer and corporate product that are currently referenced against the Libors.

# US: What now for the President's plan?

The US economy continues to roar ahead, fuelled by tax cuts...

... but protectionist policies aren't yielding any gains

The 6 November midterms will be critical for the outlook for trade and fiscal policy

The US economy continues to boom, outperforming other major developed markets thanks to the support from the massive fiscal stimulus. This has lifted consumer spending and investment, but has also meant that President Trump's second policy thrust on the economy – trade protectionism – has got less traction than he perhaps hoped. In fact the trade balance on goods widened out to its largest deficit ever in September. Significant tariffs on imported goods have been introduced this year, but when you hand households an average \$900 tax cut it shouldn't come as a surprise that a large proportion of this being spent on cheap imported consumer goods.

President Trump would clearly like to turn the screw tighter on China to extract concessions that would make the trade relationship “fairer” while protecting US intellectual property rights. He is also keen to make further progress on tax reform and deliver on his promise on improving US infrastructure. Whether he can do this will greatly depend on the outcome of the 6 November mid-term elections. We have previewed this in several recent notes, but our base case remains one where the Democrats win control of the House while the Republicans hold onto the Senate with a wafer thin majority.

**Fig 1 US election scenarios & potential implications**



Source: ING

In the polarised Washington environment bi-partisanship will be hard to achieve

Trump may therefore focus on trade policy

China will remain in the spotlight with further tariffs likely

Figure 1 shows our views on the different potential scenarios, but under our base case “Trump tapered” the key implication is that a split Congress makes it more challenging for President Trump to pass major legislation. He will need to get Democrats in the House to support his initiatives and in the polarised world of Washington politics this will not be easy. That is not to say deals can't be done, but given entrenched political positions, getting both sides to compromise enough will be difficult.

As such, any further fiscal stimulus is likely to be modest and there is the real possibility of government shutdowns as issues over the budget arise. Faced with this we suspect President Trump is likely to focus the bulk of his attention on his executive powers, which includes trade policy.

China will remain firmly in focus with the 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 sufficiently protect intellectual property in the US Administration's eyes. In fact officials are already signalling those

There would be more chance of success if a united front could be formed with the EU

tariffs may well be expanded to all Chinese imports later in 2019. Democrats may support President Trump on this initiative, but would likely be reluctant to back sanctions against key allies such as the EU. Moreover, we suspect the US administration would prefer to get the EU “onside” in order to provide a united front that would stand a better chance of getting concessions from China.

Should the Republicans spring a surprise global trade tensions could quickly escalate

However, should we be proved wrong and the Republicans actually retain control of both the House and the Senate, President Trump could see this as a vindication of his trade policies and actually double down. This would risk a rapid escalation of global trade tensions with sanctions spreading to Japanese and EU products and a heightened risk that the US pulls out of the World Trade Organisation.

China still has some ammunition...

President Trump may feel that because the Chinese-US bilateral trade relationship is so one-sided the Chinese will eventually crack, but we have to remember that the Chinese are not without options to fight back. The US fiscal position is poor with the Congressional Budget Office suggesting the Federal deficit could rise to 5% of GDP in coming years. At the same time the Federal Reserve is running down its balance sheet holdings of US Treasuries. China remains a key buyer of Treasuries so one option is not to turn up to some Treasury auctions. Failed government bond auctions could see bond yields spike, putting up borrowing costs across the country and adding to volatility and uncertainty. Admittedly it wouldn't be great for the Chinese either given it holds close to 20% of the US debt, but used in moderation could be an effective tool to send a warning shot across the bow of President Trump.

... It can have a significant influence on the US Treasury market

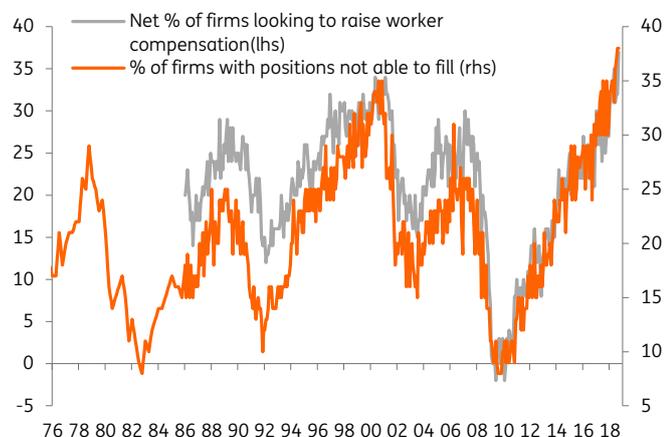
If the US pushes too hard it could end up hurting itself

Moreover, if compromises are not forthcoming and the trade war intensifies this would risk impacting supply chains, putting up 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 stand him in good stead for a defence of his presidency in 2020.

Trade tensions will likely continue to bubble

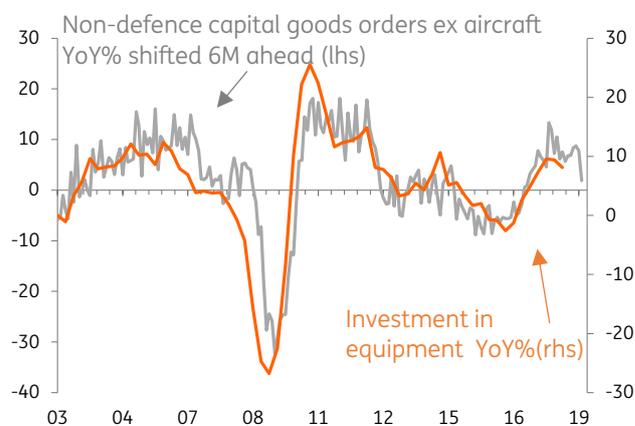
Overall, our view remains that trade tensions will remain a slow burn, creating concern but not causing enough damage to the US economy to see the US administration throw in the towel and reverse course in the near-term.

**Fig 2 National Federation of Independent Business survey on labour market 1976-2018**



Source: Macrobond

**Fig 3 Investment slowdown ahead?**



Source: Macrobond

US growth will slow next year as trade, monetary conditions and a lack of additional stimulus result in a loss of momentum

This view is consistent with our forecast of a slowdown in US growth over 2019 and 2020. Trade uncertainty is creating a headwind for activity and as the support from the fiscal stimulus fades and the lagged effects of higher US interest rates and a stronger dollar are increasingly felt the US will lose some momentum. Significantly we are also seeing some signs of slowdown in durable goods orders, which is not encouraging for investment spending (Figure 3).

Nonetheless the Fed will remain in policy tightening mode given rising inflation pressures

However, there continues to be some positives, most notably in the jobs market. Figure 2 shows that the proportion of companies that can't fill their job vacancies and the proportion of companies looking to raise pay are at record highs. This should be supportive of consumer spending but it also suggests there are clear pipeline price pressures. Given inflation is already above the Federal Reserve's 2% target on all the main measures this suggests that the Fed will remain in tightening mode for much of 2019. We continue to forecast a 25bp rate rise in December with three more rate hikes in 2019.

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## Eurozone: Politics in motion, weaker growth momentum

ECB qualifies current situation as a loss of growth momentum

At its October meeting the Governing Council of the ECB decided to proceed with the phasing out of its net asset purchases notwithstanding some signs of decelerating growth. The ECB downplayed the recent turmoil on financial markets and characterised the current situation as a loss of momentum, but not a downturn. We tend to agree, although a loss of momentum will already bring Eurozone growth rates to a level that could create new discussions regarding the need for a more expansionary budgetary policy.

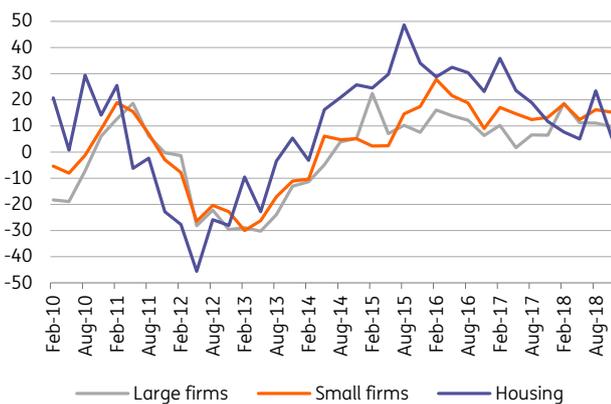
3Q growth was a disappointing 0.2%...

What's in a name? Whether you call the recent batch of less upbeat economic indicators a loss of momentum or a downturn, it all boils down to lower growth figures. The first estimate of third-quarter GDP growth was only 0.2%, a clear disappointment. There are without a doubt a number of headwinds with the still undecided Brexit deal, the tensions between Italy and the European Commission and international trade tensions as the usual suspects. But more recently the tensions on financial markets, if sustained, could also constitute a brake on growth.

...and several headwinds remain

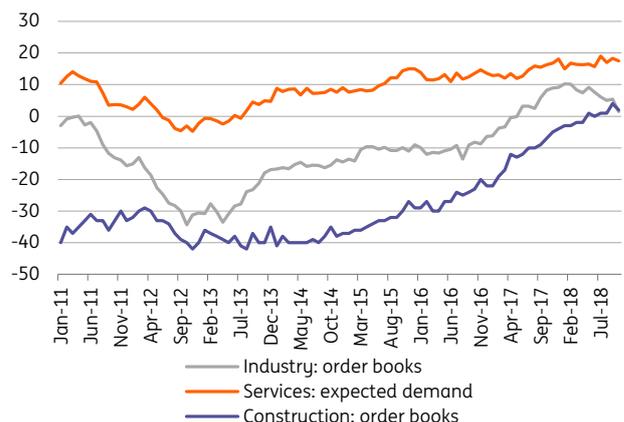
While the wealth effect is in general smaller in the Eurozone than in the Anglo-Saxon economies, it is not negligible either. Recent work by the ECB estimates a 0.1% impact on consumption from a 10% change in the stock market. So, even if a 20% stock market correction would not derail the recovery, it would surely dent the growth outlook. The flash Eurozone Composite PMI fell to 52.7 in October, down from 54.1 in September and reaching its lowest since September 2016, with especially the manufacturing sector losing momentum. So there is definitely already some pain and the fourth quarter is unlikely to see a strong growth rebound.

Fig 4 Loan Survey: net change in credit demand



Source: Thomson Reuters Datastream

Fig 5 Slowdown mostly in industry for now



Source: Thomson Reuters Datastream

Underlying momentum remains strong enough to keep growth in positive territory

Shouldn't we consider the risk that the headwinds will bring the economy to a standstill? While this is not impossible, it's still rather unlikely for the coming quarters. The ECB's bank lending survey still paint a relatively upbeat picture, corroborated by healthy credit growth. Net credit demand continued to increase across all loan categories in the third quarter of 2018. A high level of capacity utilisation and the low general level of interest rates continues to drive credit demand for fixed investments. And the same holds true for mortgage loans and consumer credit, boosted by a supportive economic environment and a very low level of interest rates. In October 2018, consumer confidence actually increased slightly in the Eurozone, not a sign that consumers are particularly depressed. The eurocoin indicator, which tracks the monthly GDP growth pace, rose for the second month in a row in October.

We expect a softening of the growth pace, resulting in sub 1.5% growth both in 2019 and 2020

So our scenario pencils in a continuation of the growth story. That said, we feel that the underlying growth momentum is likely to soften further. Whereas in 2017 quarterly growth still hovered around 0.7% and in the first half of 2018 around 0.4%, we believe that this will weaken to 0.3% in the course of 2019-2020. Because of base effects, this still keeps our 2018 GDP forecast at 2.0%, but we downgraded our 2019 and 2020 forecast to respectively 1.4% and 1.3%.

Chancellor Merkel, an important unifying voice in Europe, might not stay on for a full term...

At the same time the political backdrop is not helpful either. While some observers already see the end of Angela Merkel's government in Germany, after disappointing state elections in Bavaria and Hesse, we would caution against jumping to conclusions too quickly. Indeed, the significant electoral losses of both centrist government parties are testimony of the fragmentation of the political landscape, not only in Germany, but in most European countries, which makes governing more difficult. At the same time, neither Merkel's CDU nor the social-democrats have an incentive to seek general elections now. That said, the fact that Merkel is no longer candidate for the party leadership, shows that a generational change is being prepared and that Merkel might not necessarily stay on as chancellor for the full mandate. With Merkel, one of the unifying German voices within the European Union, would go.

....while the Italian government remains on a collision course with the European Commission

Meanwhile the Italian government remains on a collision course with the European Commission. The Commission's demand for a redraft of the budget was rejected by the Italian government. It remains to be seen whether the Commission will be ready to launch an Excessive Deficit Procedure on the back of too slow a decline in the debt ratio. But even then the whole process will take months. Within the Italian government some voices are looking for a compromise and the European Commission will try to avoid to start a fight in the run-up to the European Elections. Bottom line is that the uncertainty will continue to linger for some time to come. At the same time we doubt that the fiscal push will have a big impact on Italian growth as some of its positive effects will be neutralized by higher interest rates on credit to the private sector on the back of the higher government bond yields.

The ECB is sticking to its exit policy as far as QE is concerned...

The ECB is also unlikely to come to Italy's rescue with additional QE. That said, a new TLTRO in June 2019 to help the banking sector might be feasible. We have also changed our interest rate call on the back of the weaker growth outlook. While inflation came out at 2.2% in October, underlying inflation is still only 1.1% and the pick-up looks to remain very gradual. We now expect only one deposit rate hike in 4Q 2019, meaning that money market rates will remain negative throughout 2019. A second rate hike (both deposit and refi) might come in 1Q 2020, but that is a close call. Anyway, we don't see it going further afterwards. The low-interest rate environment is thus going to remain with us for quite some time.

...but interest rate hikes could be delayed

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## UK: Don't count on a Christmas deal

Brexit talks have gone eerily quiet

After all the ups and downs of the October EU Council meeting, things had gone eerily quiet on the Brexit front in recent days. That was until Thursday, when reports emerged suggesting the UK government remains hopeful a deal can be agreed at an emergency EU Leaders' meeting later in November.

Theresa May's challenge is to convince lawmakers that the backstop won't be needed

But we'd caution this remains far from guaranteed, and to understand why, it's worth going back to the crucial question in the Brexit debate. That is, will any UK-EU agreement be approved by British MPs? Despite the latest encouraging news reports, the reality is we are no closer to knowing the answer.

One option is to keep the UK as a whole in a customs union, if the backstop were to kick-in

Given that EU is unlikely to back down on the controversial Irish backstop – an insurance policy designed to rule out a future hard border on the island of Ireland – the central challenge for Prime Minister Theresa May is to find a way of convincing Parliament that it will never have to come into effect.

Over recent weeks, there have been a few hints at what sort of compromises are being considered to help her achieve this. Last month we discussed one proposal to allow the whole of the UK to remain in a customs union, at least temporarily, in the event of the Irish backstop kicking in. That would remove the potential need for tariff collection on goods travelling between Northern Ireland and the rest of the UK, but would still require items to be checked against EU standards. The hope is that these regulatory processes could be “de-dramatised”, for instance by performing agricultural checks at farms rather than at the ports themselves.

However, the Northern Irish Democratic Unionist Party (DUP) (for whom the government relies on for its majority in the House of Commons) have said they won't accept any solution where there could be regulatory barriers between Northern Ireland and the rest of the UK.

Option two is to simply extend the transition period, to give further time to find a more workable solution...

With that mind, Theresa May has opened the door to a potential plan B: simply extend the transition period for as long as is needed to find a more permanent solution. This would mean that nothing would really change compared to the current trading relationship, in which the UK participates in the single market and customs union. In any case, at just 21 months, few people expect the current length of the transition to be long enough to either negotiate a wide-ranging trading relationship (whatever form that may take), or to give firms time to adjust.

But this has raised the hackles of pro-Brexit MPs

But while an extended transition may help appease some of the DUP's concerns, it has raised the hackles of pro-Brexit MPs in the Conservative Party. Their fear is that UK will effectively remain in the EU for many years to come, without any say in European law during this period. It's also likely that any extended transition period would require further UK contributions to the EU budget, which is also unpopular.

The EU may also make it clear that the UK can still change its mind in future

Given all of this, the EU has hinted at a third compromise - a so-called “evolution clause”. While the goal is to agree on a political declaration – a very vague & short document outlining the scope of future trade negotiations - this clause would give the UK a mechanism to change its mind in future. The hope is that this will help convince lawmakers to approve the overall withdrawal agreement, safe in the knowledge that all the options on future trade are still effectively on the table.

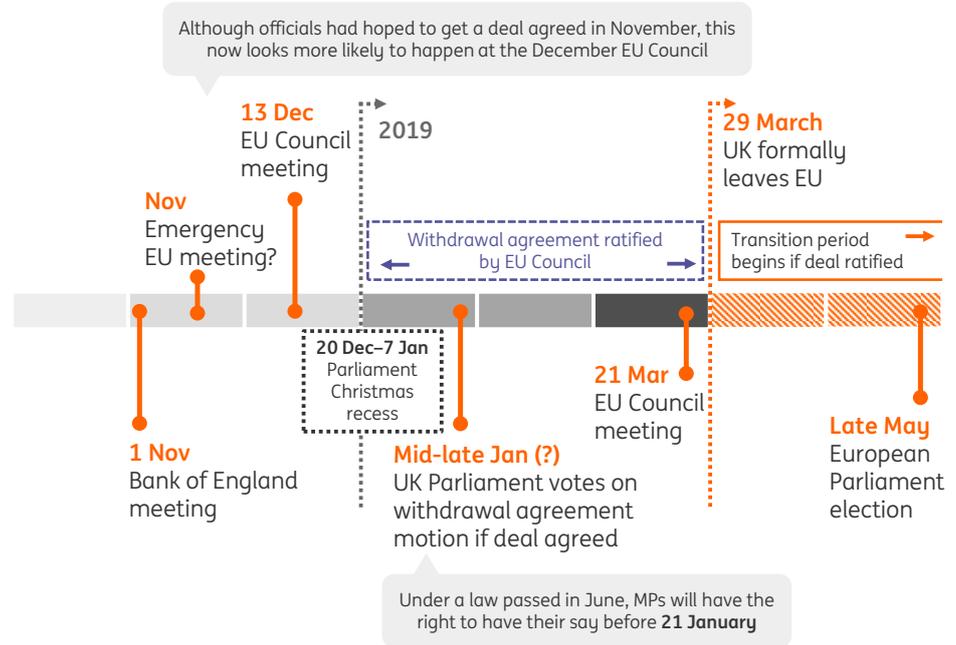
Nobody really knows whether these compromises will be enough to secure the parliamentary numbers to get a deal passed by British lawmakers – particularly given that, whatever fudge is agreed, the legally-binding backstop is still likely to be firmly embedded in the agreement.

One thing's for sure: this could take time to sort out

But one thing looks increasingly clear. Given the limited scope for negotiators to pull out any more white rabbits, it looks increasingly likely that Prime Minister May will try and play for time. By pushing back the crunch vote in the House of Commons on the final deal as far as she can, the hope is that this will focus minds in Parliament and make the vote a much more binary choice between deal and no deal. Time for renegotiation would be much more non-existent.

This tactic may also encourage some opposition MPs to vote with the government, particularly given that in the case of the Labour Party, the hints about future customs union membership are not ever so far away from their own Brexit policy.

**Fig 6 The road to Brexit**



Source: ING

The goal still seems to be to get a deal sorted by December

The big question now is exactly how “late” is “late”. There is still a possibility that both sides come together and reach a deal in time for the December EU summit. That would probably tee-up the vote in the House of Commons for mid-January when MPs return from Christmas breaks. In principle, the Prime Minister is obliged to put any deal to Parliament by 21 January.

But don't rule out talks slipping well into the New Year

But that said, we think there is an increasing risk that things slip further and we certainly wouldn't rule out an agreement much closer to the UK's exit date. After all, the only true deadline in the process is March 29th when the Article 50 ends – and even here, when push comes to shove there may willingness to extend the period, if purely to create more time for ratification/the legalities.

Either way, it could be quite some time before firms know for sure that 'no deal' has been avoided

Whatever happens, our central message is that it may still be quite a while before we know for sure whether 'no deal' has been avoided. Even though we think the odds of the UK crashing out on WTO terms are perhaps 20%-30% at this stage, most firms don't have the luxury to wait to find out for sure. This means we're likely to hear about more companies executing contingency plans or preparations over coming weeks.

From an economic perspective, we think this could see growth begin to slow over the winter as uncertainty increases. This makes it look pretty unlikely that the Bank of England will hike before May 2019, at the earliest.

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# China: Trade war and geopolitics

US threatens to impose more tariffs on China

The US administration has threatened China that if there is no constructive outcome from the Xi-Trump meeting in the upcoming G20 gathering then the US would expand tariffs on Chinese imports to a total \$505bn, though it has not yet mentioned the tariffs rate.

Stalemate is the likely outcome in Xi-Trump meeting during G20 meeting

In terms of what we already know on future tariffs, from 2019, the tariff rates on \$200 billion of Chinese imported goods are set to increase to 25% from 10%. We expect China to reciprocate on imports from the US, (ie, to 25% as announced on 3 August 2018).

Trade war develops as geopolitical tension between China and US

It seems that the US would like to get some concessions from China during the Xi-Trump meeting. How likely this happens will largely be determined on if the two sides insist on their points on trade (US states that Chinese imports is the driver of the US trade deficit, while China does not think narrowing the bilateral trade deficit would help), technology (US does not like how China gets its technology from business partners, but China insists that those are business practices) and geopolitics (US keeps sending military vessels around Taiwan that China will not tolerate for long).

US plays the Taiwan card is equal to playing with fire

As we have emphasised, the trade war doesn't end with tariffs. It is now increasingly tied to geopolitical tension. The US is putting up hurdles for its trade allies (Mexico and Canada) to sign trade agreements with China. More, the US has sent militaries to Taiwan, and provided military arm sales to Taiwan. This is a risky strategy the US has played with China. In the Chinese media, Xi has ordered the military to be prepared for war ([here](#) and [here](#)). Xi's action should not be taken lightly. The One China principle, which means Taiwan is part of China, is a foundation stone for China's Taiwan policy.

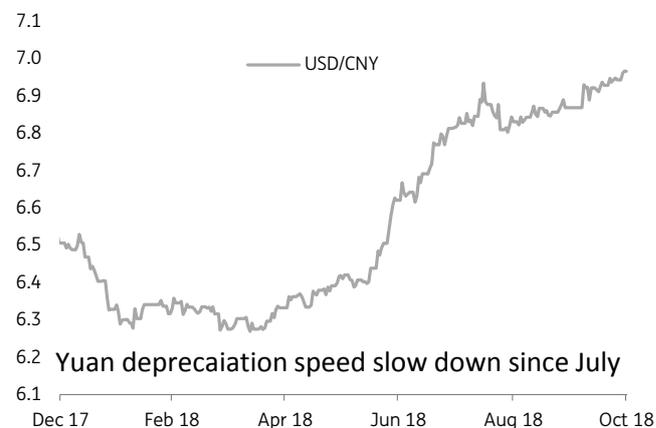
The US administration is playing with fire if it plays the Taiwan card to get more chips for negotiation. China is very unlikely to give any concessions on trade if the US continues to send military forces around Taiwan.

**Fig 7 Trade war has damaged the Chinese economy**



Source: ING, Bloomberg

**Fig 8 After the yuan cross the 7.0 handle it will continue to depreciate slowly**



Source: ING, Bloomberg

USDCNH crossing the 7.0 handle is a high probability scenario

If the outcome of Xi-Trump meeting yields no improvement on tariffs, then we see the yuan edging weaker. USDCNH crossing the 7 handle would not be a surprise. Recently, the central bank has allowed the USDCNH to test 7. This would increase market expectation that USDCNH could cross 7.0 anytime soon.

After crossing 7.0 the yuan would continue to depreciate slowly. In fact, the yuan has slowed down its depreciation speed. The fastest depreciation happened in June (3.28%) followed by July (2.96%), and has moderated since then to around 1.43% in October.

Crossing 7.0 does not imply then there would be fast depreciation. The claim of having massive capital outflows if the yuan cross the 7 handle is illogical. If this were to happen then the regulator could tighten capital outflows when the yuan continues to weaken.

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## Japan: Tilting towards Asia

Japan is one of the few spots of calm in the World today

Compared to what is going on in the rest of the world, Japan looks positively tranquil. Relationships in the Asia region are being fostered. Sustainable growth is being nurtured, economic reforms are being implemented, and policy changes are slowly and almost imperceptibly being altered. This does not make for exciting reading, but maybe, it makes for better long-term investment.

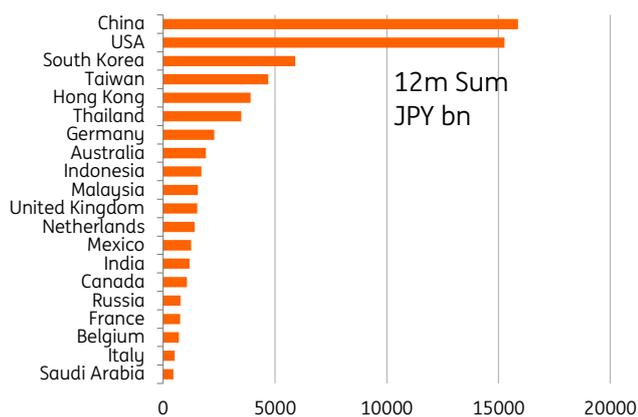
Weather effects could be a mild drag on 3Q growth, but this should be temporary

Marring the tranquillity, earthquakes and typhoons have hit Japan in 3Q18, and this could cause a brief and minor downtick to GDP growth figures in the short-term, whilst nudging up inflation for a while. But these are distractions. The main story remains one of ongoing consumer resilience, supported by extremely low unemployment, and continued growth in wages.

Inflation is low and will remain low

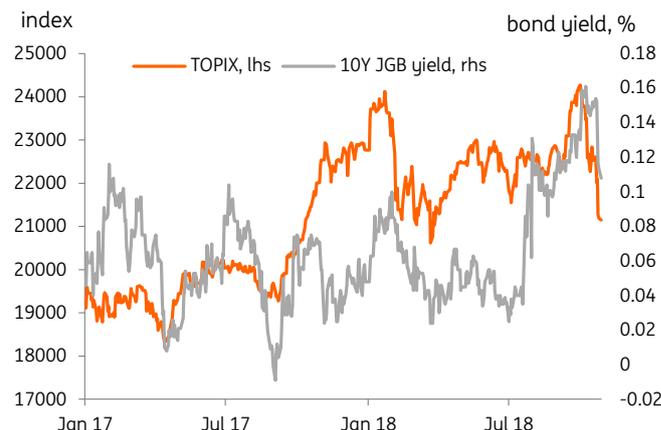
Inflation remains predominantly absent, with inflation rates excluding energy and typhoon-affected fresh foods at only 0.1%YoY. But the authorities are choosing to focus on the broader core measure, which excludes only fresh foods. Thanks to higher oil prices, this is a relatively robust-looking 1.2%. Though not for long. 1.2% is still way off the official 2.0% target. But it is sufficiently close for the Bank of Japan (BoJ) and government to suggest no pressing need to chase this further.

Fig 9 Japanese export destinations



Source: Macrobond

Fig 10 Japan equities & 10Y yields



Source: Macrobond

Monetary policy is likely to be left unchanged for now

BoJ policy, according to Governor Kuroda, will eventually be altered through changes to the 10 year Japanese Government Bond (JGB) target. With the target currently at 0.1%, the benchmark issue was recently trading at about 0.14%. A fairly rapid reversal has taken it back to 0.1% in recent weeks. No hint, therefore, that a change in the target yield value is being planned imminently.

Risk aversion has also impacted Japanese markets

Equity markets in Japan have not been immune to global forces. The Nikkei 225 is down more than 7% Ytd in yen terms, with the broader TOPIX index down 12.4%. This compares with a fall of only 0.6% Ytd in USD for the S&P500. This might explain why the 10Y JGB yield has been brought back into line with the official target, instead of being allowed to drift higher.

Japan is looking to improve relations in the region...

... but also doesn't want to upset the US

This is economic pragmatism rather than an emotional issue

Japan's tilt towards Asia looks set to continue

Japan's PM Abe has used his re-election as head of the LDP to pursue a pattern of relationship building in the region. A state visit to Beijing should not be viewed as merely cosmetic. 500 business deals were signed on the trip, valued at about JPY260bn, and including a \$US30bn currency swap arrangement with China. The trip also marked an end to Japanese foreign aid to China, but a commitment to partnership in infrastructure projects, including the Belt Road Initiative, which Japan has avoided until now. The rapprochement with China is significant, as it signals a choice between good relations with China, at the potential expense of those with the US. Abe won't want to sour Japan's relations with the US, but he can't afford to take sides with the US against China, even if that may incite a reaction from President Trump.

Rather than driven by emotion, Japan's actions come across as reassuringly pragmatic. In the last 12 months, Japan has exported more to China than the US, and China is Japan's number one unique export destination. As recently as six months ago, the US had the top spot.

After the US in position 2, South Korea absorbs almost a third as many Japanese exports as the US, followed shortly thereafter by Taiwan, Hong Kong, and Thailand. It is only then that the rest of the G-7 becomes involved, as Germany enters the ranks, and then we are quickly back to the Asia Pacific region with Australia, Indonesia and Malaysia. In short, in the words of Barack Obama, it looks like Japan has tilted towards Asia.

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## FX: Mid-terms are key for the dollar

US mid-term elections will test the conviction levels of USD bulls

Global investors continue to back the US growth story and the dollar. And several measures of the trade weighted dollar are pushing to new highs for the year. There is not a strong case for altering that positioning right now, but the outcome of the US mid-term elections – and its implications for the US fiscal-monetary policy mix – will test the strength of those convictions. At the same time a re-assessment of the Eurozone growth/monetary policy story is causing us to downgrade our EUR/USD profile.

The 2018 de-synchronised global growth story rolls on. US growth continues to outperform the Rest of the World and we suspect we are at the point in the US cycle where the Phillips curve re-asserts itself and US wages break higher. Such a development will support Fed tightening expectations and, without further US fiscal stimulus, help characterise the US as a late-cycle economy. That's not necessarily bad news for USD.

However, US mid-term elections will play a crucial role in USD pricing. Consensus expects the Democrats to win the House, raising expectations of: (i) fiscal impasse in Congress (be it no fresh stimulus and/or a battle over the debt ceiling); and (ii) possible impeachment of President Trump. This looks a modest dollar negative, but not a knock-out blow since protectionism and pressure on European and Chinese growth will continue into 2019.

More US fiscal stimulus, delaying the point at which US converges on weaker global growth, would keep the dollar stronger for longer

The surprise package would be the Republicans retaining Congress. More fiscal stimulus, delaying the point at which the US converges on weaker global growth, would keep the dollar stronger for longer. Perhaps even into 2020. For the time being, we assume no new US fiscal package, US market interest rates topping in 1Q/2Q19 and the dollar trending lower into 2H19 as the US growth premium erodes. That story is probably best shown in our USD/JPY profile, which we see staying firm into 1Q19 before turning lower.

**Fig 11 Dollar Index pushes to a new high for 2018**



Source: Bloomberg

**Fig 12 US yield curve flattening keeps USD/JPY supported**



Source: ING, Bloomberg

**The EUR has unique challenges**

The EUR, however, has more unique challenges. Our prior call for EUR/USD ending 2019 at 1.30 looks untenable at this stage. It was premised on a normalisation of ECB policy and the convergence in US and European economies, which would allow equity investors to rotate eastwards across the Atlantic.

**A surprise Republican hold of the House and fresh US stimulus could see sub 1.10 EUR/USD forecasts make a surprise come-back**

This month our Eurozone team are taking a big chunk out of Eurozone growth forecasts for 2019/20, plus delaying the first ECB rate hike into 4Q19. If EUR/USD is to move higher through 2019 it looks increasingly as if it will have to be driven by a weaker dollar rather than a stronger Euro. We now see EUR/USD staying pressured near 1.15 into year-end 2018 and making a weaker recovery by late 2019. And a surprise Republican hold of the House and fresh US stimulus could see sub 1.10 forecasts make a surprise comeback.

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## Rates: Tainted Libor

**Libor is only guaranteed until end 2021. After that Libor may cease to exist**

Regulatory authorities have had it in for Libor ever since the banking crisis. A decade on and we are at a point where the horizon sees the beginning of a move away from Libor to new risk-free rates (RFR). The ultimate deadline is end-2021; after that it is far from clear what type of Libor will exist. The trick between now and then is to negotiate a path of least intrusion. In the meantime debate continues on the methodology on the floating side of a RFR-referenced swap; a final decision here is central to kick-start volumes in the new RFR swap market.

**The replacement to the lbors will be risk free rates with an overnight tenor**

- Risk free rates (RFR) have been chosen to replace Libor and Euribor and “lbors” of all guises. They have in common a reference point that is ultra-short in tenor. And by excluding (or at least minimising) credit risk, they can be properly deemed to be risk-free rates. The provision of submissions to Libor is only guaranteed through to end 2021; time is ticking.

**The new reference rates have been chosen, and futures operate in the US and UK**

- The new reference rates have been chosen for the major global players, and both the UK and US versions have futures capabilities. But hedging volumes done in the new risk-free rates to date are still quite low. Volumes in Libor in fact continue to grow despite its projected demise, and at this juncture remains the dominant reference for the vast bulk of interest rate swap trades.

- Most market players are waiting and seeing at this juncture. In the US a concerted effort kicked off this month to encourage market players to beef up volumes in the new products spanning cash and futures markets. In the UK, there has been

Efforts are being made to beef up volumes in the new swaps

But Europe is behind the pace, and a debate is ongoing as to whether the Term RFR will be set in advance or arrears

We feel that a reset in advance Term RFR, although theoretically less appealing, is most likely to help beef up volumes

movement seen among some ALM players, with some preferring to exercise new swaps in SONIA.

- For EONIA, an added urgency comes from the notion that it will not meet new EU Benchmark Regulation (BMR), effective from Jan 2020 (although a two-year extension has now been called for). The EMMI is endeavouring to make a hybrid Euribor BMR compliant, but either way it is a tad inconvenient to say the least that the ESTER project is also the least prepared.
- In terms of reset in advance versus reset in arrears, in many ways the latter is a purer reflection of the floating rate position. A futures overlay can make the transformation implying derivation of forward looking RFRs. There is a debate in full flow on this front however. Many participants advocate for forward-looking term RFRs, where the RFR is set in advance, highlighting cash markets where parties may favour knowing interest payments in advance is important.
- If the reset (or compounding) in arrears (OIS-type) convention is acting to mute interest in new RFR swaps, then that likely nods in the direction of going with reset in advance as the adopted convention. The sooner that the appropriate methodology is settled upon, however the sooner volumes will pick up, as that decision will likely decide the new benchmark IRS product on a global scale.

Bottom line, this is a massive item for attention in the coming years for all participants that have a link to current Ibor markets. And that extends beyond the financial markets to all types of consumer and corporate product that are currently referenced against the Ibors. Get ready; the Sonia's and Ester's of this world are set to strut into town.

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Fig 133 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
<b>United States</b>																				
GDP (% QoQ, ann)	1.8	3.0	2.8	2.3	2.2	2.2	4.2	3.5	2.9	2.9	1.5	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	2.6	2.5	2.5	2.4	2.6	2.6	2.5	2.5	2.3	2.1	2.1	2.1	2.1
Federal funds (% eop) <sup>1</sup>	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	2.64		2.95	3.26	3.43	3.43		3.43	3.43	3.43	3.26	
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					-5.0
Fiscal thrust (% of GDP)					0.0					1.2					0.8					0.0
Debt held by public (% of GDP)					76.1					77.3					79.5					82.6
<b>Eurozone</b>																				
GDP (% QoQ, ann)	2.4	2.9	2.9	2.8	2.5	1.5	1.5	1.6	1.2	2.0	1.4	1.7	1.5	1.4	1.4	1.4	1.2	1.0	0.9	1.3
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	1.7	1.7	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	0.00	0.00	0.25	0.25	0.25	0.25	0.25
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	-0.25	-0.10		0.15	0.15	0.15	0.15	0.15
10-year interest rate (% eop)	0.45	0.40	0.45	0.42		0.50	0.30	0.40	0.50		0.50	0.50	0.60	0.60		0.70	0.70	0.60	0.60	
Fiscal balance (% of GDP)					-0.9					-0.6					-0.9					-0.9
Fiscal thrust (% of GDP)					0.2					0.0					0.3					0.0
Gross public debt/GDP (%)					89.2					87.5					86.0					85.1
<b>Japan</b>																				
GDP (% QoQ, ann)	1.9	2.3	1.6	1.3	1.7	-0.9	3.0	2.8	2.4	1.4	1.8	-0.7	5.9	-5.7	1.6	2.9	1.6	1.1	1.6	0.8
CPI headline (% YoY)	0.2	0.4	0.6	0.6	0.5	1.3	0.6	1.1	0.8	1.0	0.8	1.4	1.3	2.5	1.5	2.4	2.2	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	-0.1	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
<b>China</b>																				
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	2.3	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	3.63	3.50	3.50	3.45	3.40	3.35	3.30	3.30	3.25	3.20	3.15	3.15	3.15
Fiscal balance (% of GDP)					-3.7					-4.5					-4.5					-4.0
Public debt, inc local govt (% GDP)					50.0					88.0					102					103.0
<b>UK</b>																				
GDP (% QoQ, ann)	1.3	1.0	1.9	1.6	1.5	0.4	1.6	2.1	1.2	1.3	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	2.3	2.5	2.3	2.1	1.8	1.8	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		0.85	1.05	1.05	1.05		1.30	1.35	1.60	1.65	
10-year interest rate (% eop)	1.15	1.10	1.35	1.20		1.45	1.48	1.57	1.55		1.55	1.70	1.80	1.90		1.90	2.00	2.10	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	1.15		1.15	1.18	1.20	1.25		1.26	1.27	1.28	1.30	
USD/JPY (eop)	112	115	110	113		107	110	114	114		112	108	105	100		98.0	95.0	93.0	90.0	
USD/CNY (eop)	6.89	6.78	6.65	6.51		6.28	6.67	6.87	7.00		7.10	7.20	7.30	7.30		7.30	7.20	7.10	7.00	
EUR/GBP (eop)	0.87	0.88	0.94	0.89		0.88	0.88	0.89	0.87		0.87	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	

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

Source: ING forecasts

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