12 April 2019

Nick Kounis
Head Financial Markets Research
Tel: +31 20 343 56165
nick.kounis@nl.abnamro.com

From Trade War to Trade Talks?

- **The EU and Japan look set to start trade talks with the US, following on the heels of the negotiatons between the US and China**
- **Although encouraging, the threat of an escalation of protectionist measures remains, as the proposed US tariffs on the EU show**
- **While there is also a looming risk of US tariffs on cars, which would hit the EU and Japan hard, while also having wider effects on confidence**
- **Signs of a bottom in global cycle rather mixed, though conditions for modest improvement in future are coming into place**
- **Financial conditions have eased in the US and Asia and the ECB this week signalled its readiness and ability to provide additional stimulus**

Talks on trade between the US and EU and Japan look to be on the cards

The spectre of a trade war has haunted a global economy this year already struggling with the lagged effects of the tightening of financial conditions of last year. However, the main players in global trade appear to be moving towards the negotiating table. Talks between the US and China have been ongoing for some time and look set to have a successful outcome, at least in cementing the trade truce between the two countries. On Monday, EU governments look likely to rubber stamp the opening of formal trade negotiations with the US, despite opposition from France. The scope of the talks looks set to be narrow, with the main focus non-auto industrial goods (see note from our Eurozone Economist Aline Schuiling here). Meanwhile, Japan will hold talks with the US in Washington next week, with agriculture likely to be a key focus.

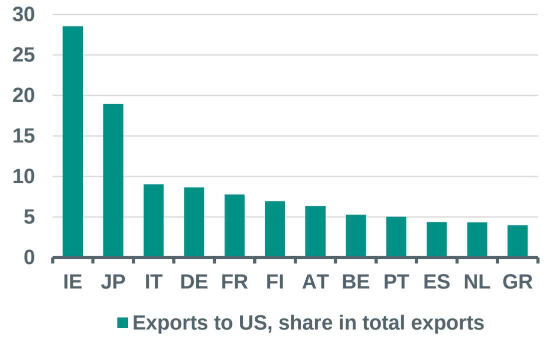
Threat of escalation of protectionist measures remains

It is always good to talk, however the risk of a trade war continues to linger. This was emphasised this week, when the US proposed tariffs on a range of EU products in the civil aviation sector, including Airbus, as well as other products, including various types of cheese. The US government's rationale is that EU subsidies to Airbus have had an adverse impact on the US economy, which it estimates at around USD 11bn, hence these measures are worth around that amount. The EU responded by announcing that it is ready to retaliate in kind. This follows US tariffs on imports of steel and aluminium last year, and the EU retaliating with tariffs on US products, such as bourbon whisky and motorcycles.

The scope of the tariffs so far is relatively limited, but it triggers concerns that there is more to come, which would undermine business confidence and sentiment in financial markets. The main risk is that US imposes tariffs on imports of cars and car parts, which would have a more significant impact (see charts below) and would lead to more forceful retaliation from the EU and Japan. The US has conducted an investigation into the imports of cars and vehicle parts and a report has gone to the President. He has until 22 May to decide on whether he will take action.

Exports to the US

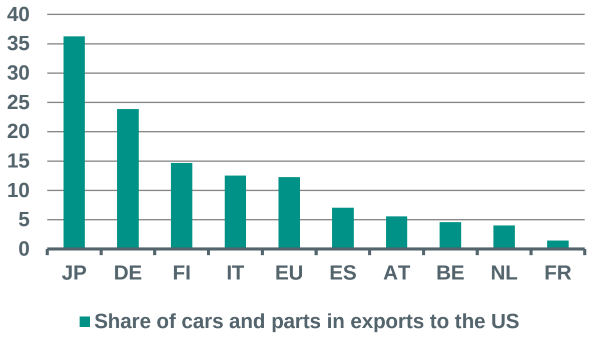
Share of total exports, %



Source: Thomson Reuters Datastream, ABN AMRO Group Economics

Share of cars and car parts in exports to US

%



Source: Thomson Reuters Datastream, ABN AMRO Group Economics

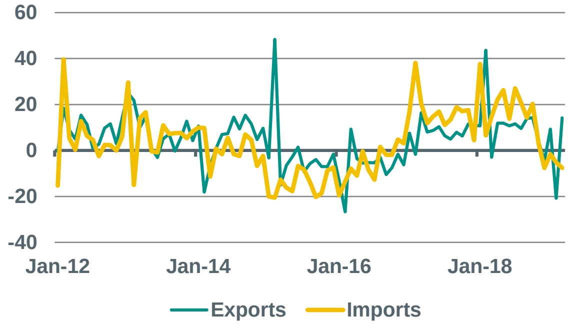
Signs of bottom in the industrial cycle are rather mixed

From being uniformly poor, recent industry and trade data have been more mixed. The more positive signs have come from the China, with a rebound in exports in March (+14.2% yoy from -20.8% yoy in February) following on the heels of the improvement in PMIs. However, Chinese data can be volatile, while imports actually contracted at a faster pace last month (-7.6% yoy from -5.2%).

In addition, elsewhere, the weakness in industry and trade appears to be persisting. For instance, Japan's machine tool orders shrank at a jaw-dropping 28.5% yoy in March (previous: -29.3%), while German industrial orders remained in the doldrums in February. The new exports orders component of the global manufacturing pace PMI fell at a slightly faster pace in March, while it was deep in contraction territory already in February. Overall, we think it is too early to call a bottom in the global trade and industrial cycle.

China trade

% yoy



Source: Bloomberg, ABN AMRO Group Economics

Japan machine tool orders

% yoy

Source: Bloomberg, ABN AMRO Group Economics

Conditions for modest improvement in the future coming into place

Our base case remains that there will be a modest improvement in global trade and industry later in the year. Financial conditions are easing. The minutes of the March FOMC meeting confirmed that the rate hike cycle is over, while balance sheet reduction will also end in the next few months. The Chinese authorities have been following a targeted easing policy. These steps are starting to show through in money and credit data. For instance, China's M1 money supply growth accelerated in March. However, there are two caveats. First, the scale of the easing of global financial conditions is moderate compared to the past. Second, it will take time to come through and activity still looks like it is being dampened by the tightening of financial conditions we saw last year. Monetary policy works with long and variable lags and there is a risk that it will take longer for the global economy to turn.

ECB signals it is willing and able to act

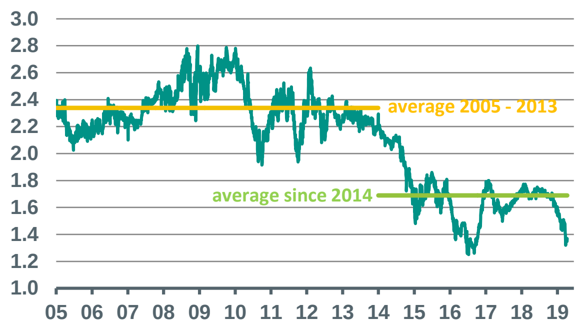
The ECB changed its forward guidance in March to signal a longer period of unchanged rates as well as reinvestments of the proceeds of maturing securities purchased under its asset purchase programme. It also announced new long-term loans for banks (TLTRO-III). At its April meeting, the ECB signalled it was ready and able to go further if necessary in the coming months. ECB President Mario Draghi said that the mood in the meeting was one of the Council acknowledging the weakening of the economic cycle, which would 'extend into the rest of the year' and a 'readiness' to respond and that it was 'willing to use all instruments. All instruments'.

Concerns about inflation expectations

As well as the economic slowdown and ongoing downside risks to the economy, the ECB seems to be concerned about inflation expectations. On the surface, Mr Draghi played down the decline in the 5y5y inflation swap rate, claiming that it was due to risk premiums rather than de-anchoring. However, he subsequently spent a lot of time trying to explain to investors why they were wrong about the ECB's commitment to meeting its inflation goal (which suggests he might have been more concerned about inflation expectations than he let on). He said that concerns that the ECB had run out of ammunition where wrong. In addition, he stressed that the central bank's definition of price stability (below but close to 2%) did not imply a ceiling, but rather that the inflation goal was symmetrical.

Eurozone inflation expectations

5y5y inflation swap, %



Source: Bloomberg, ABN AMRO Group Economics

Next steps for the ECB

We expect the ECB to further push out its forward guidance on the period of unchanged policy rates and ongoing reinvestments. The modest trajectory for economic growth will not be sufficient for underlying inflationary pressures to build. We think that ECB forecasts for growth and inflation remain too high despite recent downgrades. Our base case is that ECB policy interest rates will remain on hold through to the end of 2020 and that reinvestments will continue to the end of 2021. Second, we think that the ECB will announce relatively easy terms on the new TLTRO-III in June. The pricing will probably be similar to TLTRO-II so banks can borrow at rates as low as the deposit rate if they meet certain lending benchmarks.

Beyond these steps, there is a rising chance the ECB will need to do more. There has been speculation that a tiered deposit rate system could open the door for further cuts in the deposit rate. We are not convinced by that at this stage. We think the ECB is looking into this issue now because it expects the current level of negative rates to last for much longer, rather than because it is looking to cut rates further. If rate cuts are off the table, then the ECB may revive what has been its main stimulus tool of choice over the last few years: QE. Indeed, we think the probability of QE-II has risen significantly, though it is not yet our base case. To do this the ECB would need to raise its issue(r) limit from the current 33% on sovereign bonds. It was introduced so that the ECB would not have a deciding vote in case of a debt restructuring due to collective action clauses. However, the ECB has shown some flexibility on issue(r) limits in the past. For instance, the issue(r) limit on supranational bonds was raised to 50%. Although raising the limit would likely be an uncomfortable situation for the ECB, it would be willing to do this in our view given the lack of other alternatives.

Main economic/financial forecasts

GDP growth (%)	2017	2018	2019e	2020e	3M interbank rate	4-4-2019	11-4-2019	+3M	2019e	2020e
United States	2,2	2,9	2,3	1,9	United States	2,59	2,60	2,60	2,60	2,50
Eurozone	2,5	1,8	0,8	1,3	Eurozone	-0,31	-0,31	-0,30	-0,30	-0,20
Japan	1,9	0,8	0,9	0,7	Japan	0,07	0,07	-0,10	-0,10	-0,10
United Kingdom	1,8	1,4	1,1	1,8	United Kingdom	0,83	0,83	1,00	1,00	1,25
China	6,9	6,6	6,3	6,0						
World	3,7	3,6	3,3	3,4						
Inflation (%)	**2017**	**2018**	**2019e**	**2020e**	**10Y interest rate**	**4-4-2019**	**11-4-2019**	**+3M**	**2019e**	**2020e**
United States	2,1	2,4	1,6	2,0	US Treasury	2,51	2,50	2,6	2,60	2,50
Eurozone	1,5	1,7	1,2	1,2	German Bund	-0,01	-0,01	0,0	0,20	0,50
Japan	0,5	0,9	1,1	1,6	Euro swap rate	0,52	0,50	0,6	0,80	1,10
United Kingdom	2,7	2,5	1,4	1,8	Japanese gov. bonds	-0,06	-0,07	0,1	0,10	0,30
China	1,6	2,1	2,5	2,5	UK gilts	1,09	1,15	1,7	1,50	1,80
World	3,0	3,5	3,8	3,2						
Key policy rate	**11-4-2019**	**+3M**	**2019e**	**2020e**	**Currencies**	**4-4-2019**	**11-4-2019**	**+3M**	**2019e**	**2020e**
Federal Reserve	2,50	2,50	2,50	2,50	EUR/USD	1,12	1,13	1,10	1,16	1,25
European Central Bank	-0,40	-0,40	-0,40	-0,30	USD/JPY	111,7	111,7	110	108	105
Bank of Japan	-0,10	-0,10	-0,10	-0,10	GBP/USD	1,31	1,31	1,30	1,35	1,45
Bank of England	0,75	0,75	0,75	1,00	EUR/GBP	0,86	0,86	0,85	0,86	0,86
People's Bank of China	4,35	4,35	4,35	4,35	USD/CNY	6,72	6,72	6,65	6,60	6,60

Source: Thomson Reuters Datastream, ABN AMRO Group Economics.