Week in Focus

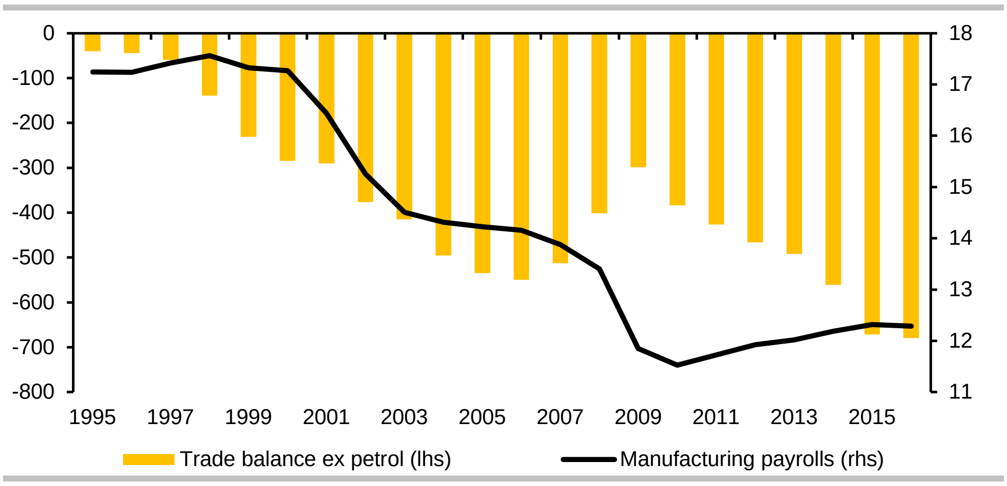
3 February 2017

The risk of a trade war

President Trump wants to put an end to the allegedly unfair treatment of the US economy in global trade and reduce the foreign trade deficit. However, the Republicans' destination-based cash flow tax is too complicated, and broadly-based import tariffs directed against China would be hazardous given that China can retaliate. In our baseline scenario, this culminates in trade policy skirmishes without breaking into a full-blown trade war, even though the risk of an escalating trade dispute has increased recently. Trump apparently sees international trade as a zero-sum game and is therefore likely to act tough to gain advantages for the US. **Page 2**

The **Week in Focus** in 100 seconds
Please follow this link for video summary.

US: Trade deficit rises, costs US jobs, Trump says
Goods trade balance (excluding petrol), in $bn. Manufacturing payrolls, in million. Annual data.



Source: Global Insight, Commerzbank Research

Outlook for the week of 6 to 10 February 2017

Economic data: December data from the German manufacturing sector are likely to come in on the weaker side due to distortions resulting from the timing of the Christmas holidays. However, this should not be interpreted as a sign of renewed weakness, since business sentiment has remained healthy until recently. **Page 7**

Bond market: Euro area bond markets are at a crucial crossroads as the renewed focus on elections and US policy risks compound the pressure from rising inflation. Some headwinds will fade over the coming weeks, but this should only make an impact once 10y Bund yields have climbed above the pivotal 0.50% mark. **Page 10**

FX market: The US government is talking the dollar down. Although it is not certain that it will be successful over the medium-term, this departure from traditions practiced for decades suggests that the recent USD weakness will continue near-term. **Page 11**

Equity market: Despite individual exceptions, the Q4 2016 results and 2017 outlooks released in the current reporting season have been convincing so far. Consequently, analysts are likely to make fewer downside revisions to their 2017 earnings expectations, which should provide additional support to the German equity market. **Page 12**

Commodity market: Oil will not be able to hang to its recent gains for long as it becomes evident that the supply-side shortfall in the wake of production cuts is not as great as first assumed. On the base metal markets, lower Chinese copper imports in January are likely to hit sentiment whilst gold continues to respond to dollar fluctuations. **Page 13**

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The risk of a trade war

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President Trump wants to put an end to the allegedly unfair treatment of the US economy in global trade and reduce the foreign trade deficit. However, the Republicans' destination-based cash flow tax is too complicated, and broadly-based import tariffs directed against China would be hazardous given that China can retaliate. In our baseline scenario, this culminates in trade policy skirmishes without breaking into a full-blown trade war, even though the risk of an escalating trade dispute has increased recently. Trump apparently sees international trade as a zero-sum game and is therefore likely to act tough to gain advantages for the US.

Countries with surpluses are targeted

President Trump believes the core economic problem facing the US is the decline of manufacturing, the roots of which lie in the alleged unfair treatment of the United States in global trade deals. He intends to put an end to this and countries with large trade surpluses with the US are in the firing line. Trump first focused on Mexico and now his administration has criticized Germany and Japan, which have slightly higher trade surpluses with the US than Mexico. The next country could be China, which accounts for almost half of the US total goods trade deficit (see chart 1).

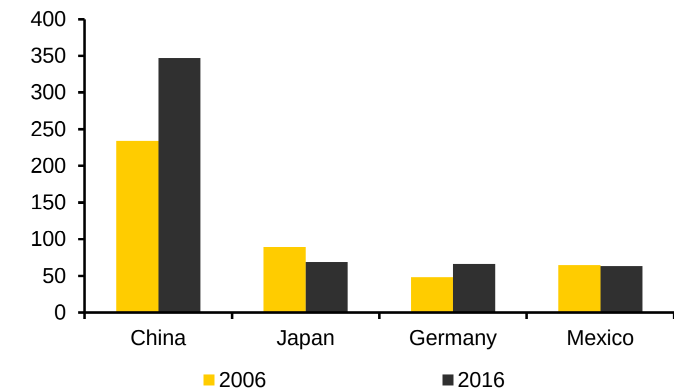
Trump's tool box: Instead of tax reform …

The Republican's believe one reason for the problem in foreign trade is the current tax system, which allegedly penalises exports and favours imports. The Republican Party therefore wants to introduce a border tax adjustment as part of a comprehensive corporate tax reform, which exempts exports from tax and fully taxes imports. According to supporters of this reform, this is similar to the VAT systems in many countries. The new corporate tax would be a hybrid between direct taxation of corporate cash flow and an indirect consumer tax. However, the resulting unequal treatment of imports and exports (see box on page 3) could breach WTO regulations. Furthermore, the planned reform will be difficult to implement quickly given its complexity, and would likely counter strong resistance from potential losers from the reform. As a result, the foreign trade imbalance will not be reduced rapidly.

… and WTO complaints …

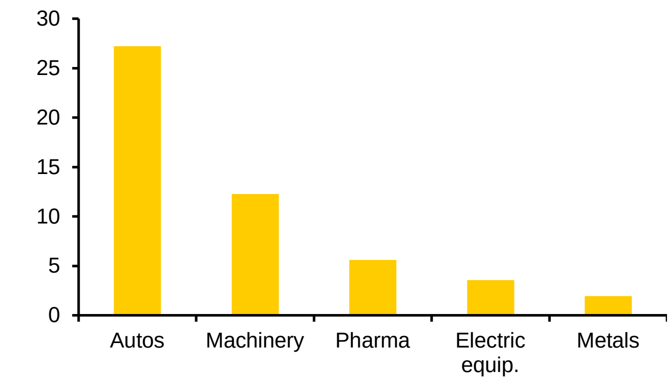
The same applies to complaints at the World Trade Organisation against countries where the US government identifies practices such as dumping or trade subsidies. Such a procedure would take a long time and the outcome would be uncertain. Under WTO regulations, the complaining party must provide evidence of dumping or subsidization and show by how much the export price is lower than the exporter's price on its domestic market. Moreover, it has to be proven that this has harmed the domestic industry. Only after this process has been completed can an import surcharge be imposed as a penalty on the specific product from the specific country.

`CHART 1: **USA – Large deficit = unfair trade advantages?**
US deficits in goods trade, various trading partners, annual data, in billion dollars



Source: Global Insight, Commerzbank Research

CHART 2: **Germany's surplus in US trade mainly with cars**
Balance in foreign trade with the USA by sectors, 2015, in billion euros



Source: Federal Statistical Office, Commerzbank Research

… import tariffs are more likely

Trump is probably hoping for quicker success by raising customs duties, which he would impose without the blessing of the WTO. Although the USA as a member of the WTO is bound by tariff agreements, Trump has already shown that he does not readily comply with such international agreements. Furthermore, he is unlikely to be put off by the expected complaints of other WTO members, as it usually takes years before the process allowing the "wronged" party to take retaliatory action is completed. By that time, those countries could be under pressure to reach a "deal" with the USA that responds to US demands.

Germany is cited as a "currency manipulator"

The US government could find a pretext for such action by labelling certain countries as currency manipulators. While China has been accused of currency manipulation for some time, the Chair of Trump's new "National Trade Council", Peter Navarro, has now also accused Germany of "exploiting" the US with a strongly undervalued currency. The US Treasury Department suspects that a currency is being manipulated when the country concerned (i) has a trade surplus with the US that exceeds 20 billion dollars; (ii) has a current account surplus greater than 3% of GDP and (iii) there is constant and one-sided intervention on the currency market. Points (i) and point (ii) are indeed the case with Germany, but not point (iii). Even so, Navarro's criticism could be a first signal that the Trump administration has its sights set on Germany. Particularly striking is Germany's substantial trade surplus with the US in cars and car parts (chart 2). Should the US government target certain sectors, this one would be the first.

Box: Republican tax reform plans

The core of the reform planned by the Republicans in Congress is to tax corporate cash flow rather than tax corporate income, based on the destination principle. Consequently, it is no longer decisive where the income is generated but whether a product is sold in the USA or abroad. Exports are tax exempt, while imports are fully taxed. The tax rate is to be set at 20%; the current corporate tax rate is 35%.[1]

At first sight, this system is similar to the VAT systems in Europe. The decisive difference is that the proposed "destination-based cash flow tax" treats imports and products manufactured in the USA differently. In the case of imports, the total value of goods is liable to tax, while in the case of domestic products, the labour costs incurred and other domestic outlays can be deducted.[2]

The supporters of the reform expect the dollar to appreciate after such a tax reform, thus compensating for the disadvantages of higher import prices. This is by no means certain, however, as exchange rates also depend on other factors such as interest rate differentials. Without this hoped-for offset of a stronger dollar, companies with a high share of imports (retail companies or refineries) would be hit hard. These businesses – and their employees – will therefore strongly oppose this reform. Koch Industries, which has been the biggest Republican Party donor and also operates in the refinery business, has already clearly positioned itself against these plans. There is also likely to be resistance against other parts of the planned reform, for example that businesses can no longer declare their net interest expenses for tax purposes. This would hit real estate companies for example.

Main scenario: no general trade war

The US administration is likely to act tough towards some countries, the prime example being Mexico, for whom the US market is much more important than Mexico's market is for the USA. Mexico would therefore be hit hard if the NAFTA agreement were to be terminated. Many companies in the car industry have only invested in Mexico to use it as a base from which to export cars to the USA. Consequently, there are several factors suggesting that Trump will ultimately be successful with the strategy of creating threats in order to conclude favourable bilateral "deals".

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[1] For a detailed analysis of Republican tax plans, see: David A. Weisbach "A Guide to the GOP Tax Plan – The Way to a Better Way", University of Chicago, January 2017.
[2] Cf. William Cline: "The Ryan-Brady Cash Flow Tax: Disguised Protection, Exaggerated Revenue, and Increased Inequality", Peterson Institute for International Economics, January 2017.

Where countries are less unilaterally dependent on the US, it will be much more difficult. China is unlikely to accept the US government imposing broad tariffs on Chinese imports and more likely to take retaliatory measures in areas that are sensitive for the Trump administration, such as agriculture. The USA exports agricultural products worth over 20 billion dollars to China. What is more, these products largely come from Midwestern states, which was the source of Trump's decisive election-winning votes. Agricultural tariffs would weigh on the economy of these US states and it would soon become very unpleasant for the US government, especially as the agricultural lobby in Washington is very powerful. Another counter-measure would be tariffs that primarily hit companies that are resident in the electoral districts of US politicians who decide on trade policy. Given these risks, the US government is unlikely to risk a full blown trade war with the major global economic blocs.

Even so, Trump's policy will still contribute to a considerable slowdown in global trade compared to the 1990s and the decade thereafter. The impetus from earlier agreements on the liberalisation of global trade is abating and new agreements are not in sight. Under Trump, the US has withdrawn from the planned free trade Trans-Pacific Partnership (TPP) and Trump is unlikely to further purse the Transatlantic Trade and Investment Partnership (TTIP) – though this did not really have much support in the EU in any case.

Risk scenario: Trade dispute escalates

The main risk lies in the fact that, contrary to the dominant opinion amongst economists, the US president apparently sees international trade as a zero-sum game. Exports increase domestic growth and create jobs, imports cost growth and employment. The positive effect of imported goods – whether as a lower-priced intermediate product for businesses or as cheaper consumer goods – clearly do not play a role for Trump. The Trump administration could therefore be prepared to accept a substantial fall in foreign trade as the price for a narrowing US trade deficit. This is also suggested by the fact that, according to Peter Navarro, a priority for the US government is the unwinding and repatriation of international supply chains (the build-up of which was a main driver of globalization in the last few decades). The strict pursuit of such a strategy would radically change the business foundations of multinational companies – including many US firms. The devaluation of foreign production facilities, a sharp rise in uncertainty, and the costs and inefficiencies connected with a repatriation of production pose a significant risk for US companies – and the rest of the world.

This risk is increased by the fact that the negotiating strategy of the US government shows several features of "brinkmanship", i.e. a strategy that uses the threat to go to the limits and hopes that the other party is not prepared to do the same and therefore gives in. Should Trump miscalculate, a trade war could inadvertently break out.

President Trump has been in office for just under two weeks. It is too early to make any conclusive judgements. However, the hardline approach he has shown so far suggests that the risk of events escalating towards a trade war is greater than we had previously thought.

Major publications from 26 January – 2 February 2017

Economic Insight: Euro zone – Who is afraid of rising rates?

In recent years, falling interest rates have helped governments in the euro zone to reduce their budget deficit. However, rates have increased recently and might rise further. Nevertheless, the interest burden should drop further in most countries in the near term as current yields are still much lower than the coupons of bonds maturing in the next few years. Only if yields continue to rise sharply would the interest burden rise before 2020. Only Portugal is at risk of a higher interest burden in the event of even a moderate interest rate rise. more

Economic Insight: Germany – New SPD candidate – a challenge for Merkel?

Judging by the latest polls, Martin Schulz, the new chancellorship candidate of the German Social Democrats (SPD), will pose a serious challenge for Angela Merkel in the general elections in September. However, his good poll results so far seem to be owed mostly to the usual bonus accorded to politicians focused on foreign affairs in Germany. Concerning the topics of Europe and refugees, where Merkel has recently been under pressure, Schulz even advocates more unpopular positions. What remains unclear is his domestic and economic policy stance. more

Economic Briefing: FOMC meeting – Fed takes a pass

The Federal Open Market Committee left monetary policy unchanged at last Wednesday's meeting. The target corridor for the fed funds remained at 0.50%-0.75%, and the Fed maintained its policy of reinvesting the proceeds from maturing bonds. The Fed, like everybody else, is waiting for information on the extent of fiscal measures before taking another step on the normalization path. more

FX Insight: Are US import tariffs good or bad for the dollar?

The new US president is following a protectionist stance and has threatened to introduce tariffs on imports. We analyse whether that is positive or negative for the US dollar. more

FX Hotspot: Alternative Facts from the US government

The Director of the US National Trade Council today accused Germany of exploiting other countries by undervaluing its currency. Apart from being misleading, this statement has to be considered as another salvo in the US administration's currency warfare. Buckle up for a currency war that might become nasty. more

FX Insight: ARPI² update – Trump caused some mild irritations

Compared to last Wednesday, the ARPI² rose 0.2 index points. This was in particular due to slightly higher equity, emerging-market and FX risks. Our index of global risk perception rose in particular at the beginning of this week. Apparently, US President Trump's order to tighten immigration rules caused some modest unrest in financial markets. more

Commodity Spotlight Agriculturals: Grains, oilseeds, cotton: Running out of breath?

Four years of surpluses still exert pressure on wheat prices. And all the signs have so far pointed to another high global wheat harvest in 2017/18 – but only if it is confirmed that frost damage in the northern hemisphere will be moderate. In corn, too, the supply situation remains relaxed, though US farmers may react to lower prices with notable reductions in acreage, whereas the soybean acreage will probably be expanded. A higher supply of oil seeds overall should depress prices. Over the last few years, China has made some changes to its agricultural policy and we also discuss important changes in the Chinese grains sector. more

Preview – The week of 6 to 10 February 2017

Time	Region	Indicator	Period		Forecast	Survey	Last
Monday, 6 February 2017							
7:00	GER	Industrial orders	Dec	mom, sa	0.0	0.5	-2.5
				yoy	3.5	4.1	3.0
Tuesday, 7 February 2017							
3:30	AUD	RBA interest rate decision		%	1.50	1.50	1.50
7:00	GER	Industrial production	Dec	mom, sa	-1.0	0.4	0.4
				yoy	1.2	2.5	2.2
13:30	USA	Trade balance	Dec	USD bn	-45.0	-45.0	-45.2
Wednesday, 8 February 2017							
20:00	NEZ	RBNZ interest rate decision		%	1.75	1.75	1.75
23:50	JPN	Order intake manufacturing	Dec	mom, sa	2.5	3.5	-5.1
Thursday, 9 February 2017							
7:00	GER	Exports	Dec	mom, sa	-2.0	-1.6	3.9
13:30	USA	Initial claims	Feb 4	k, sa	250	–	246
Friday, 10 February 2017							
7:45	FRA	Industrial production	Dec	mom	-1.0	–	2.2
9:00	ITA	Industrial production	Dec	mom	-1.0	0.2	0.7
9:30	GBR	Industrial production	Dec	mom, sa	-0.2	-0.2	2.1
15:00	USA	Consumer confidence (University of Michigan), preliminary	Feb	sa	98.5	97.7	98.5

*Source: Bloomberg. Commerzbank Economic Research; *Time GMT (subtract 5 hours for EST. add 1 hour for CET). # = Possible release; mom/qoq/yoy: change to previous period in percent. AR = annual rate. sa = seasonal adjusted. wda = working days adjusted; (p) = preliminary; • = data of highest importance for markets*

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Economic data preview:

Germany: Poor December data despite healthy sentiment

December data from the German manufacturing sector are likely to come in on the weaker side. However, this should not be interpreted as a sign of renewed weakness, which is supported by the fact that business sentiment has remained healthy until recently. Instead, the particular timing of the Christmas holidays is likely to have distorted the results to the downside.

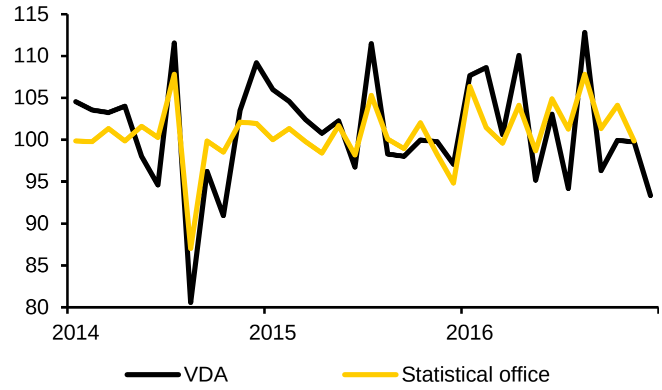
While employers cheered, employees did not: Two of the three Christmas days last year fell on a weekend, and New Year's Eve – another non-working day in most sectors – also fell on a Saturday. This will also be reflected in next week's December figures for the manufacturing sector. Owing to this calendar set-up, the month of December had 21 official working days, i.e. two more than the past five years' average. In practice, however, people did not work more in December 2016 than in former years. After all, many factories close down in the week between Christmas and New Year, implying that more working days "fell victim" to such plant holidays this time. However, the number of official working days is relevant for the seasonal adjustments, which means that the performance in December 2016 is likely be distorted to the downside.

This effect is also reflected in the production figures from the automobile association, which came in more than 6% lower month-on-month in December, based on our own seasonal adjustment (see chart 3). After all, given recent strong orders data, car manufacturers are unlikely to have driven down production deliberately. There should be a similar effect in other sectors as well, implying that we are looking for industrial output to drop by 1% on the month (consensus: 0.4%). Nevertheless, the German economy is likely to have grown at a strong rate in Q4, by at least 0.5% on the quarter.

This "Christmas effect" is also likely to have an impact on order intake. Hence, the only reason why order intake did not drop in December (Commerzbank forecast: 0.0%, consensus: 0.5%) is the fact that orders in the very volatile "other vehicles" sector are unlikely to have repeated their low November reading.

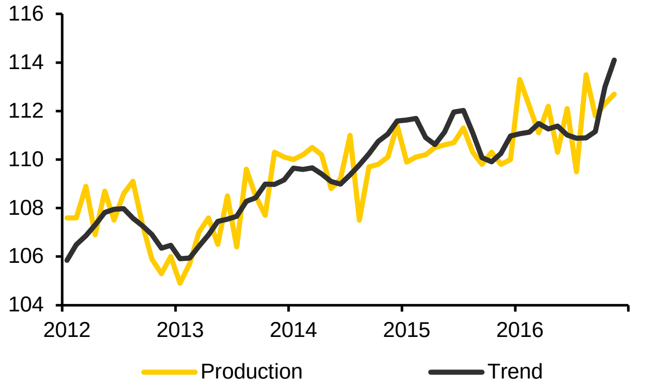
Bottom line: As usual, one should not read too much into December's data from the manufacturing sector as they (similar to January's data) are always very much influenced by the timing of Christmas. Even if they were to live up to our low expectations, this will do nothing to change the significant uptrend in the manufacturing sector which has been evident from very strong order intake in recent months (chart 4).

CHART 3: **Weak December …**
Vehicle production, index 2014=100, seasonally adjusted



Source: VDA, Global Insight, Commerzbank Research

CHART 4: **…despite uptrend**
Industrial production, index 2010=100 and trend calculated on the basis of recent months' order intake



Source: Global Insight, Commerzbank Research

Central Bank Watch (1)

Fed

The Fed left its key rates on hold at this week's meeting, as expected, with the target range for the federal funds rate remaining at 0.50%-0.75%. Also, the central bank will prevent a contraction of its balance sheet in the near future by reinvesting any inflows from maturing securities on the bond market.

The Fed made only a few changes to its post-meeting statement. While it mentioned the recent improvement in sentiment indicators, it again pointed to weak business investment. As a consequence, it still considers the risks to the economic outlook to be "balanced". This suggests that the Fed intends to continue with monetary policy normalisation. However, it gave no indications as to the timing of its next rate hike.

The US central bank's current reticence may not least be due to the fact that it has as yet no information on the extent of the tax cut promised by President Trump. However, the strength of fiscal stimulus is a key determinant of monetary policy. We therefore reiterate our forecast that the next rate hike will only come in June.

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CHART 5: **Expected interest rate for 3-month funds (USD)**

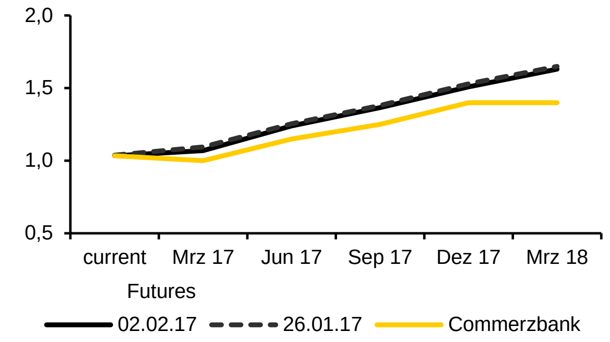

TABLE 1: **Consensus forecasts Fed funds rate (upper bound)**

	Q1 17	Q2 17	Q4 17
Consensus	0.75	1.00	1.25
High	1.25	1.25	1.75
Low	0.75	0.75	0.75
Commerzbank	0.75	1.00	1.25

Source: Bloomberg, Commerzbank Research

ECB

According to ECB's Visco, the ECB must maintain an accommodative stance on monetary policy to avoid deflation risks and ensure price stability. "There are as yet no clear indications of any inversion of trend in the core components driving developments in consumer prices and wage growth," Visco said.

In contrast, ECB's Knot said that due to rising inflation, higher oil prices and the impact of Trump's economic policy, there is no reason to continue quantitative easing. However, "this doesn't mean you can stop it right away". "I'm still not a big fan of quantitative easing, and I doubt whether it had the desired impact. You can see some positive impacts, but you can doubt whether this weighs against the unusual character of this instrument."

According to ECB's Nowotny, the ECB will definitely not discuss tapering of QE at its next meeting in March, but the Council will "surely" have to take decisions about future of QE before the end of 2017. The most recent changes to its bond-buying programme should ensure that the ECB has enough assets to buy, even when it begins tapering. Removing QE too early could hurt economic growth, Nowotny said. He added that any rate hike would only come after the start of "tapering", citing the policy adopted by the US Fed.

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CHART 6: **Expected interest rate for 3-month funds (EUR)**

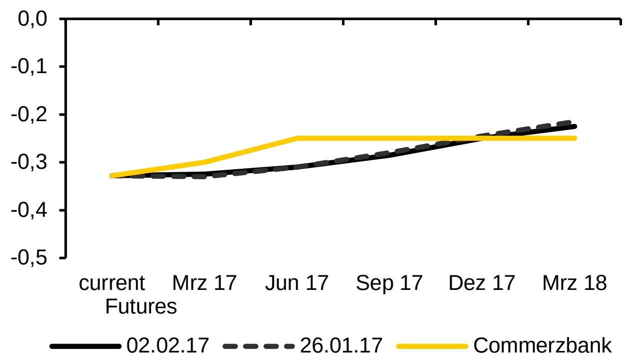

TABLE 2: **Consensus forecasts ECB minimum bid rate**

	Q1 17	Q2 17	Q4 17
Consensus	0.0	0.0	0.0
High	0.0	0.0	0.0
Low	0.0	0.0	0.0
Commerzbank	0.0	0.0	0.0

Source: Reuters, Bloomberg, Commerzbank Research

Central Bank Watch (2)

BoE (Bank of England)

The projections released in yesterday's Inflation Report showed a significant upward revision to the 2017 forecast, with GDP growth now expected at 2% compared to a November forecast of 1.4% and a rate of just 0.8% in August. One of the most important reasons for the revision was the fiscal stimulus announced in the November Autumn Statement, which Governor Carney reckons accounts for half of the forecast change. The exchange rate also plays a crucial role in the economic outlook. On the one hand, the recent depreciation is assumed to give some support to export competitiveness, with the result that net trade gives a small boost to growth. Against that it will result in a sharp acceleration in inflation, which is projected to peak at 2.8% in mid-2018. This implies a slowdown in real household income growth which acts as a drag on household consumption and drives GDP growth below 2% in 2018 and 2019. On the face of it, a decent growth rate this year and an inflation rate above the 2% central target might be viewed as conditions which would justify a modest monetary tightening. But with Brexit-related concerns remaining in play, there is potential for a sharper slowdown than is currently anticipated and the BoE is likely to continue to act cautiously by keeping rates on hold.

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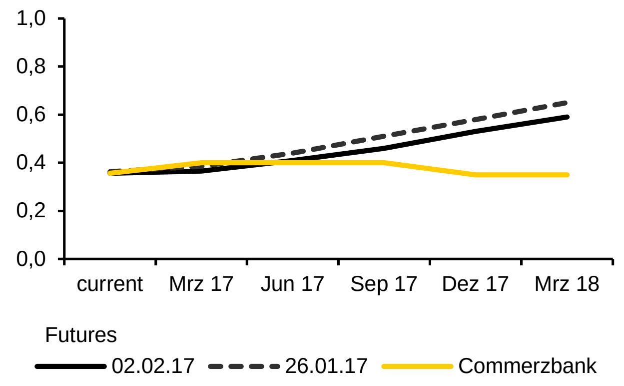
CHART 7: **Expected interest rate for 3-month funds (GBP)**



Source: Bloomberg, Commerzbank Research

RBA (Australia)

The RBA has held its key rate at a record low of 1.5% for a year, and this is unlikely to change at its rate-setting meeting next week. Given the surprisingly sharp fall in Q4 GDP (-0.5% on the quarter), the RBA may see its view confirmed that it needs to support growth with low interest rates. A glimmer of hope comes from stronger demand for commodities and noticeably higher commodity prices. Rising demand from China and better terms of trade are improving the growth outlook for Australia. This also benefits the AUD (probably to the RBA's displeasure). Since the AUD appreciated noticeably versus the USD in January and is again approaching its 2016 highs at 0.78, the RBA may not want to provide the market with further arguments for increasingly trading the AUD. It has for some time been expressing the concern that a strong currency could hinder the "adjustment process of the economy" away from the mining industry. Besides the sub-target inflation rate, the currency also argues against an overly optimistic RBA stance in the coming week.

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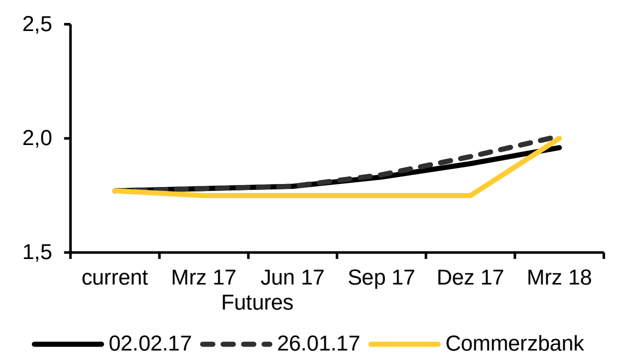
CHART 8: **Expected interest rate for 3-month funds (AUD)**



Source: Bloomberg, Commerzbank Research

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Bond market preview:
Bunds: No escaping the downward spiral?

Euro area bond markets are at a crucial crossroads as the renewed focus on elections and US policy risks compound the pressure from rising inflation. Some headwinds will fade over the coming weeks, but this should only make an impact once 10y Bund yields have climbed above the pivotal 0.50% mark. Sovereign spreads should remain vulnerable, but we expect France to recover somewhat over the coming weeks.

TABLE 3: **Weekly outlook for yields and curves**

	Bunds	US Treasuries
Yield (10 years)	Higher	Higher
Curve (2 - 10 years)	Steeper	Steeper

Source: Commerzbank Research

Outlook for the Bund future, 6 to 12 Feb	
Economy	↓
Inflation	↓
Monetary policy	→
Trend	→
Supply	→
Risk aversion	↑

The start of the year underscores that bond investors are facing a tough time with virtually all segments of the euro area fixed income markets recording losses. Bunds are not immune to this, with the 10y benchmark recording ongoing losses at the start of the year rather than a strong rally as in the two previous years (see chart 9).

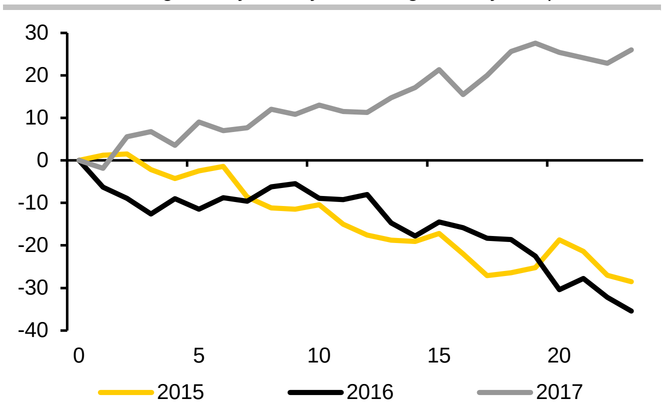
Likewise, the other sovereign issuers remain under severe pressure, with the spreads of French OATs and Italian BTPs in particular widening sharply (chart 10), which is also backed by decent turnover on cash and futures markets. This underscores that political risks remain in the driving seat, particularly as the markets' euphoria on Trump is cooling off markedly given the measures announced and plans of the new US administration (see also p.2).

In addition, the renewed upside surprise in the euro area inflation rate highlights that ECB support will not last forever. With the ECB thus facing pressure to taper its bond purchases not only due to the program's legal limits, markets are questioning which structural buyer will replace the PSPP at times of heightened political risks.

Finally, the ongoing issuance activities, particularly from semi-core countries, continue to weigh on the market's capacity to absorb risk. This holds especially true for France, which has been the most aggressive in terms of bond issuance this January – but also the worst performer in the € sovereign universe.

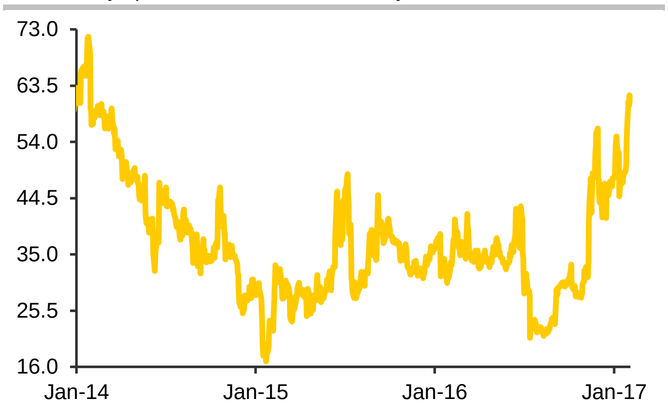
This factor will fade over the coming weeks in line with the typical seasonal pattern, and at least for France we expect sentiment regarding election risk to stabilize. However, the macro data will likely remain resilient and euro area inflation is set to rise further this month, to 2%. We therefore expect 10y Bund yields to move above the key 0.5% level in coming weeks, but to stabilize thereafter as inflation reaches its peak. Peripheral spreads look set to remain under pressure as the outlook for Italian politics remains unclear.

CHART 9: **Bund investors have to deal with a new reality**
Cumulative change in 10y Bund yield during January, in bp



Source: Bloomberg, Commerzbank Research

CHART 10: **France suffers increasing focus on election risks**
Generic 10y spread of France vs Germany



Source: Bloomberg, Commerzbank Research

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FX market preview:
Trump is talking the dollar down

The US government is talking the dollar down. Although it is not certain that it will be successful over the medium-term, this departure from the tradition practiced for decades suggests that the recent USD weakness will continue near-term.

TABLE 4: **Expected trading ranges for next week**

	Range	Trend		Range	Trend
EUR-USD	1.0600-1.0900	↗	EUR-GBP	0.8450-0.8750	→
EUR-JPY	119.00-123.00	→	GBP-USD	1.2300-1.2800	↗
USD-JPY	110.00-116.00	↘	EUR-CHF	1.0600-1.0800	→

Source: Commerzbank Research

US President Donald Trump and National Trade Council Director Peter Navarro have made it more than clear that they want a weak dollar. The noble restraint with which previous US governments followed the movements of the USD is now obviously a thing of the past. And this impresses the FX market (see chart 11).

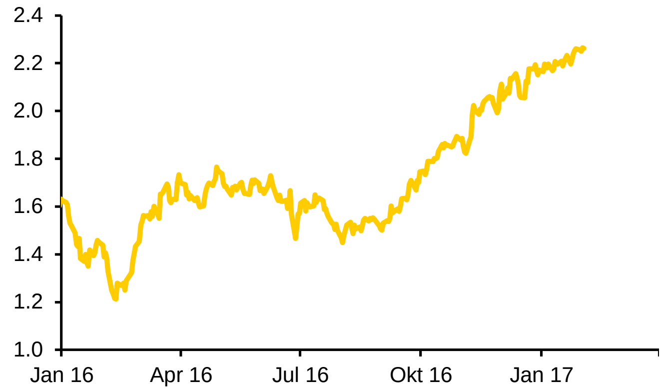
Of course, it is by no means a foregone conclusion that the dollar will eventually weaken as much as the White House obviously wants. A combination of the announced protectionism and verbal intervention against the home currency would be the perfect recipe for higher inflation (chart 12), which would prompt the Fed to raise rates more quickly and thereby support the dollar. Only if the Fed failed to react in this way would US policy really weigh on the greenback overall. And even then, the exchange rate trajectory over the medium-term would depend on the reactions of other governments and central banks. If others also abandoned the consensus among G7 governments and central banks that exchange rates should be left up to the market, the US would be left with the short end of the stick. In particular, those central banks that still pursue a hard-line expansionary policy would hold the better cards in such a currency war.

But all this is still in the future. The Fed remains in wait-and-see mode (as became clear again this week), and it is likely that the other countries' governments and central banks will not react near-term, hoping instead that they will be able to uphold the G7 consensus after all. The FX market is therefore driven by the latest comments from Washington. It has certainly not overreacted to the US government's recent verbal intervention, for a dollar depreciation of 3% since the start of the year is certainly not extreme, given the departure from traditions practiced for decades. Further verbal intervention would surely exert additional pressure on the dollar. On a short-term perspective, we therefore rather see the risk of further USD weakness as the US administration fleshes out its exchange rate policy.

CHART 11: **Dollar suffering from verbal intervention**
USD index of ICE (DXY), daily candlestick chart

Source: Bloomberg, Commerzbank Research

CHART 12: **USA – inflation expectation have risen sharply**
Inflation expectations calculated from 5-year inflation swaps, in %



Source: Bloomberg, Commerzbank Research

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Equity market preview:

Q4 results likely to reduce negative earnings revisions

Despite individual exceptions, the Q4 2016 results and 2017 outlooks released in the current reporting season have been convincing so far. Consequently, analysts are likely to make fewer downside revisions to their 2017 earnings expectations, which should provide additional support to the German equity market.

TABLE 5: **German equities remain robust**

		Performance (%) since			Earnings 2017e				P/E 2017e	
					Index points		Growth (%)			
	Index	01/01	30/09	30/06	current	01/01	current	01/01	current	01/01
DAX 30	11,660	1.6	10.9	20.5	858.4	855.1	11.1	10.8	13.6	13.4
MDAX	22,577	1.8	4.6	13.8	1313	1308	14.6	14.4	17.2	17.0
Euro Stoxx 50	3,259	-1.0	8.6	13.8	233.4	233.3	11.9	11.8	14.0	14.1
S&P 500	2,280	1.8	5.1	8.6	130.2	130.4	11.2	11.6	17.5	17.2

Source: Commerzbank Research, I/B/E/S

The Q4 reporting season is slowly gaining traction. So far, 24% of DAX companies and 10% of MDAX companies have already reported (see table 6):

- **DAX:** While 29% of the companies have exceeded our expectations so far, 43% were in line and 28% of the results underperformed. The distribution of results is thus much better than in the Q4 2015 reporting season – although this was also a very weak period – but it is worse than the long-term average.
- **MDAX:** So far, the MDAX companies performed even better than their DAX peers. Just under 80% of MDAX companies exceeded our expectations, and none came in disappointing. So far, the reporting season has thus outperformed both the previous year and the long-term average.

Despite individual disappointments, such as Daimler, earnings and 2017 outlooks have been convincing overall so far. Consequently, 2017 earnings expectations are likely to see less downside revisions, which should support the German equity market.

TABLE 6: **Q4 results have been convincing overall so far**
Distribution of Q4 quarterly results in %

DAX Quarter	Above Expectations	Change y-o-y in %pts	In Line Expectations	Change y-o-y in %pts	Below Expectations	Change y-o-y in %pts
Q4 2016	28,6%	11,3	42,9%	-19,2	28,6%	7,9
Q3 2016	24,1%	-13,8	72,4%	24,1	3,4%	-10,3
Q2 2016	37,9%	-3,4	44,8%	10,3	17,2%	-6,9
Q1 2016	37,9%	-6,9	48,3%	3,4	13,8%	3,4
Q4 2015	17,2%	-20,7	62,1%	13,8	20,7%	6,9
Q3 2015	37,9%	-3,4	48,3%	-3,4	13,8%	6,9
Q2 2015	41,4%	17,2	34,5%	-17,2	24,1%	0,0
Q1 2015	44,8%	10,3	44,8%	3,4	10,3%	-13,8
Q4 2014	37,9%	6,9	48,3%	6,9	13,8%	-13,8
MDAX Quarter	**Above Expectations**	**Change y-o-y in %pts**	**In Line Expectations**	**Change y-o-y in %pts**	**Below Expectations**	**Change y-o-y in %pts**
Q4 2016	80,0%	46,0	20,0%	-32,0	0,0%	-14,0
Q3 2016	32,0%	0,0	48,0%	-4,0	20,0%	4,0
Q2 2016	38,0%	-2,0	52,0%	-2,0	10,0%	4,0
Q1 2016	32,0%	-2,0	42,0%	-2,0	26,0%	4,0
Q4 2015	34,0%	2,0	52,0%	-6,0	14,0%	4,0
Q3 2015	32,0%	-10,0	52,0%	20,0	16,0%	-10,0
Q2 2015	40,0%	14,0	54,0%	2,0	6,0%	-16,0
Q1 2015	34,0%	-6,0	44,0%	-2,0	22,0%	8,0
Q4 2014	32,0%	0,0	58,0%	6,0	10,0%	-6,0

Source: Companies, Commerzbank Research

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Commodities market preview:
Buoyant mood may not last

Oil is unlikely to be able to hang to its recent gains for long. The energy agencies should make it clear next week that the supply-side shortfall in the wake of production cuts is not as big as first assumed. On the base metal markets, lower Chinese copper imports in January are likely to hit sentiment, as this would indicate a drop in demand in by far the biggest consuming market. Gold is still responding primarily to dollar fluctuations. On the agricultural markets, USDA estimates will probably have little impact, as attention is already moving to initial estimates for the next season, due out at the outlook conference on 23/24 February.

TABLE 7: **Trends in important commodities**

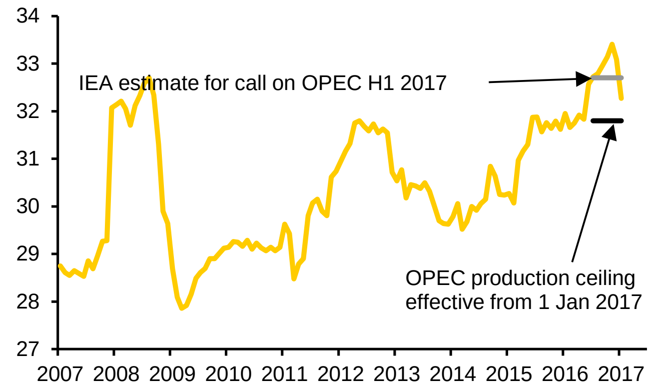
	Per cent change				Tendency	Commodity specific events
	Feb 2nd	1 week	1 month	1 year	short-term	
Brent (USD a barrel)	56.9	1.1	0.1	73.8	↘	EIA (7.), IEA (abridged text) (10.)
Copper (USD a ton)	5952	1.6	7.5	30.8	↘	CHN: Trade balance Jan. (10.)
Gold (USD a troy ounce)	1215	2.2	5.4	7.6	↗	
Wheat (USD a bushel)	169	-0.3	0.6	5.0	→	WASDE (9.)

Source: Bloomberg. Commerzbank Research

Oil market players were satisfied with the (independent) survey-based OPEC production estimates by the news agencies: The cost of a barrel of Brent rose to USD 57. However, it will not stay there for long. as the increase is no doubt due largely to speculators further expanding their net long positions (already close to (ICE), or at, record highs (Nymex). Next week, the US Energy Information Administration (EIA) and the International Energy Agency (IEA) will confirm in their monthly reports that OPEC output is currently falling short of the call on OPEC (see chart 13). Yet at some 400k barrels per day, the shortfall is only about half the size the IEA had suggested was likely in the first half of the year. Consequently, inventory levels are also falling less rapidly than expected. If in addition the EIA responds to the latest monthly figures by raising its US oil output forecast, sentiment would receive a further setback. A political risk factor could, however, render the fundamentals invalid: The new missile test in Iran could put sanctions back on the agenda.

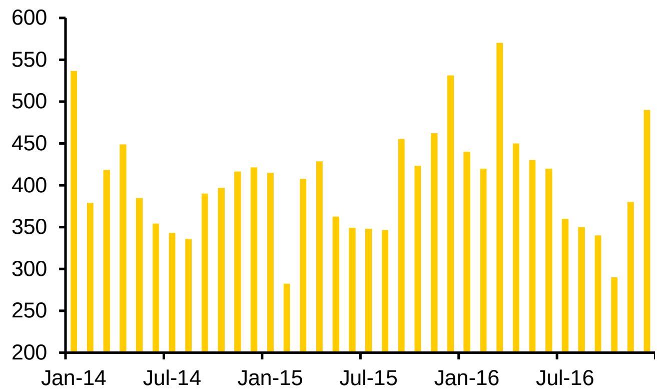
At just under $6,000 per tonne, copper is 35% more expensive than at the seven-year low just over a year ago, owing in part to major speculative interest. The price has been boosted not just by the hopes for stronger US demand raised by Trump's presidency, but also by the recent sharp rise in China's copper imports (chart 14). However, we expect the strength of the Chinese economy to have been only a temporary phenomenon and envisage imports declining once more. Another pointer to lower Chinese imports is the sharp rise in prices and the low level of economic activity in the run-up to Chinese New Year.

CHART 13: **OPEC output falling below demand**
Million barrels a day



Source: Reuters, IEA Commerzbank Research

CHART 14: **China's copper imports far higher of late**
In thousand tonnes



Source: China Customs Office, Bloomberg. Commerzbank Research

Commerzbank forecasts

TABLE 8: **Growth and inflation**

	Real GDP (%)			Inflation rate (%)		
	2016	**2017**	**2018**	**2016**	**2017**	**2018**
USA	1.6	2.3	2.3	1.3	2.5	2.5
Japan	1.0	1.0	1.0	-0.1	1.0	1.0
Euro area	1.7	1.8	1.6	0.2	1.3	1.2
- Germany	1.9	1.6	1.5	0.5	1.7	1.6
- France	1.3	1.6	1.7	0.2	0.6	0.8
- Italy	0.8	1.0	1.1	-0.1	0.7	0.9
- Spain	3.3	3.0	2.5	-0.5	1.3	1.4
- Portugal	1.2	1.2	1.1	0.6	1.3	1.5
- Ireland	4.4	3.5	3.0	-0.2	0.8	1.3
- Greece	0.4	2.1	2.3	-0.8	0.7	1.0
United Kingdom	2.0	1.6	1.7	0.7	**2.4**	2.8
Switzerland	1.5	1.5	1.7	-0.4	0.4	0.8
China	6.7	6.5	6.3	1.8	2.0	2.2
India	6.8	7.3	7.4	5.2	5.3	5.1
Brazil	-3.4	**0.1**	**2.0**	8.8	**5.0**	**4.9**
Russia	-0.6	1.3	2.0	8.0	5.5	5.5
World	2.8	3.3	3.4			

- Having corrected its imbalances, the US economy continues growing at decent rates.
- Growth in China is decelerating due, among other things, to high corporate indebtedness and industrial overcapacity.
- The ECB's expansionary monetary policy glosses over the structural problems of the euro zone and allows the economy to grow more strongly.
- EMU has survived the sovereign debt crisis, but is gradually evolving into an "Italian-style monetary union" – structural weaknesses are preserved by the loose monetary policy.
- The German economy is experiencing a consumption-driven boom; below this glossy surface, however, its competitiveness is gradually eroding.
- High unemployment in most EMU countries is keeping inflation low for the time being.

TABLE 9: **Interest rates (end-of-quarter)**

	02.02.2017	**Q1 17**	**Q2 17**	**Q3 17**	**Q4 17**	**Q1 18**
USA						
Federal funds rate, upper bound	0.75	0.75	1.00	1.00	1.25	1.25
3-months Libor	1.03	1.00	1.15	1.25	1.40	1.40
2 years*	1.20	1.10	1.30	1.50	1.70	1.90
5 years*	1.92	1.80	2.10	2.30	2.50	2.60
10 years*	2.46	2.50	2.60	2.70	2.80	2.85
Spread 10-2 years	126	140	130	120	110	95
Swap-Spread 10 years	-8	-20	-15	-15	-15	-10
Euro area						
Minimum bid rate	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40
3-months Euribor	-0.33	-0.30	-0.25	-0.25	-0.25	-0.25
2 years*	-0.73	-0.60	-0.65	-0.65	-0.65	-0.60
5 years*	-0.32	-0.30	-0.35	-0.35	-0.30	-0.30
10 years*	0.45	0.50	0.25	0.30	0.40	0.50
Spread 10-2 years	118	110	90	95	105	110
Swap-Spread 10 years	38	35	35	35	35	35
United Kingdom						
Bank Rate	0.25	0.25	0.25	0.25	0.25	0.25
3-months Libor	0.36	0.40	0.40	0.40	0.35	0.35
2 years*	0.12	0.20	0.20	0.20	0.30	0.30
10 years*	1.42	1.70	1.70	1.75	1.80	1.85

- With the Fed having approached its targets, the speed of rate hikes seems set to increase. We expect two hikes in 2017 by 25 bps each.
- Mr Trump's election victory exerts upward pressure on US long-end yields via higher inflation expectations and a looming supply increase.
- As euro zone core inflation should stay below ECB expectations, we forecast the ECB will take further measures.
- Contrary to the US setting, 10y Bund yields seem unlikely to increase significantly.
- The multi-year trend of falling periphery spreads has run out of steam. With ECB support reaching limits and political risks on the rise, we anticipate rising risk premia.

TABLE 10: **Exchange rates (end-of-quarter)**

	02.02.2017	**Q1 17**	**Q2 17**	**Q3 17**	**Q4 17**	**Q1 18**
EUR/USD	1.08	1.05	1.03	1.04	1.04	1.03
USD/JPY	112	112	114	116	118	120
EUR/CHF	1.07	**1.06**	**1.05**	**1.04**	1.00	1.00
EUR/GBP	0.86	0.86	0.86	0.87	0.87	0.87
EUR/SEK	9.42	**9.40**	**9.35**	**9.30**	**9.30**	**9.20**
EUR/NOK	8.86	9.05	9.00	8.95	8.95	8.85
EUR/PLN	4.31	**4.35**	**4.40**	**4.45**	4.50	4.55
EUR/HUF	309	**310**	**315**	**317**	320	325
EUR/CZK	27.02	27.00	27.00	**25.50**	**25.00**	**25.00**
AUD/USD	0.77	0.74	0.72	0.73	0.73	0.74
NZD/USD	0.73	0.70	0.68	0.69	0.69	0.70
USD/CAD	1.30	1.35	1.35	1.34	1.34	1.33
USD/CNY	6.88	6.95	7.05	7.10	7.15	7.20

- Initially the monetary policies of the Fed and ECB will continue to drift further apart, putting pressure on the EUR-USD exchange rate. The ECB will be forced to reduce the volume of its monthly bond purchases towards year-end 2017, however. That will have a positive effect on EUR short term.
- With a view to Brexit negotiations, our working assumption is that ultimately there will be an amicable agreement. However, uncertainty will remain high for a long period so that sterling will not recover for the time being.
- Basically, CNY seems set to further depreciate against the dollar.

*Source: Bloomberg. Commerzbank Economic Research; bold change on last week; * Treasuries, Bunds, Gilts*

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