

# Covid-19: The economic alarm bells ring loud

Don't expect the Fed to raise rates for another four years, the multi-trillion euro questions for the ECB, the UK's three scenarios amid the virus and Brexit, and worsening leverage metrics in credit markets - all examined by ING's economists in another alarming week for the global recovery

## In this bundle



FX | United States

### US: Fed says wait until 2024

The logical conclusion from the Federal Reserve's monetary policy review was that interest rates would remain lower for longer. Updated guidance now...

By James Knightley, Padhraic Garvey, CFA and Chris Turner



### Eurozone: ECB suffers from social distancing too

The drop in services inflation in the Eurozone shows that social distancing product categories saw the largest drop. Our social distancing price index...

By Bert Colijn and Carsten Brzeski



### UK Economic and Brexit Update

With a trade deal hanging in the balance, we examine the key sticking points in UK-EU negotiations, areas for possible compromise and ramifications for...

By James Smith



## FX | United Kingdom

### **Bank of England: No policy change but keeping its options open**

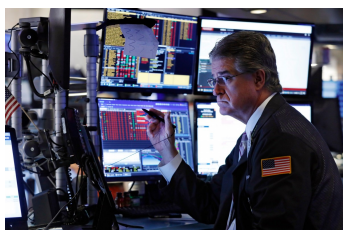
The BOE voted unanimously to leave policy unchanged today, in light of a broadly similar economic assessment compared to August. Further preparation for...



### **Listen: Emerging from the Covid-19 crisis**

The Covid-19 pandemic has ripped through the developing world this year with particular cruelty and ferocity, upending lives and livelihoods on a scale...

By Rebecca Byrne



## Credit

### **Worsening leverage metrics. Should we be alarmed?**

Worsening leverage metrics, deteriorating credit quality and substantial downgrades are all signals for long-term concern for credit markets. Yet based on...

By Timothy Rahill, Jeroen van den Broek and Oleksiy Soroka, CFA



## India

### **Phoney inflation war**

This week, markets in Asia and elsewhere will react to the latest hints from the US Fed about how they will deal with sub-target inflation. This obsession...

By Robert Carnell



## Belgium

### **Belgium: Virtual negotiations, but a real government in sight...**

The political situation in Belgium is evolving and should lead to the formation of a new government in early October

By Philippe Ledent



## New Horizons Hub

### **CBDCs and commercial banks: Evolution or Revolution?**

ING partnered with OMFIF's Digital Monetary Institute today in the ING DMI Digital Forum, a live webinar to discuss what the future holds for...

# US: Fed says wait until 2024

The logical conclusion from the Federal Reserve's monetary policy review was that interest rates would remain lower for longer. Updated guidance now...



Source: Shutterstock

## Cautious Fed still has dissent

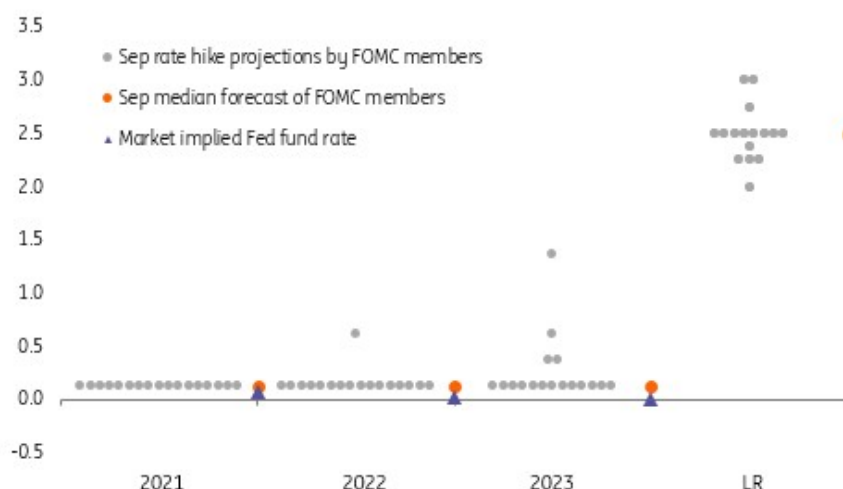
The Federal Reserve has left monetary policy unchanged today, which is unsurprising given the decent activity and employment backdrop and the recent rise in inflation. Nonetheless, the Fed remains wary, suggesting that the pandemic will “continue to weigh on economic activity, employment and inflation in the near-term, and pose considerable risks to the economic outlook over the medium term”.

The key part of the statement surrounds the updated guidance on policy in light of the publication of the Fed's monetary policy strategy review which heralded “average” inflation targeting. They have opted for “the Committee will aim to achieve inflation moderately above 2 percent for some time so that inflation averages 2 percent over time and longer-term inflation expectations remain well anchored at 2 percent.”

There wasn't universal agreement on this though. Robert Kaplan wanted the statement to emphasise “greater policy rate flexibility beyond that point” – i.e. suggesting rates could stay low for even longer. Neel Kashkari wanted to specify they wouldn't change rates until “core inflation has reached 2% on a sustained basis” – again, slightly more dovish than what was agreed (“sustained” versus “some time”). Neither of these are hugely significant deviations from what was

agreed and in any case the dot diagram of individual forecasts give us more specific views.

## The Fed's new "dot plot"



Source: Federal Reserve, ING

## Fed consensus suggests nothing before 2024

They have the median Fed funds rate projected to remain in the current 0-0.25% range through the whole of 2023 with just one out of 17 members looking for a hike before the end of 2022 and just four expecting a move at some point in 2023. Interestingly, they kept their long-term projection unchanged at 2.5% with all member clustering between 2% and 3%.

As such the Fed is telling us they don't think that rates will need to rise until 2024, which is understandable given the new policy strategy from the Fed – acknowledging inflation shortfalls can be just as bad as inflation overshoots – and their past track record on hitting the 2% target. This is an implicit acknowledgement that they ran policy too tight in recent years.

Since the beginning of 2010 the Fed's favoured measure on inflation, the core personal consumer expenditure deflator, has been at or above 2% in just 13 months – so a hit rate of one in 10 – posting an average of 1.6% year on year over the past decade.

In terms of their broader forecasts they have revised up 4Q GDP YoY growth for 2020 to -3.7% from -6.5%, but because of the earlier and more vigorous rebound have cut 2021 to 4% from 5% and 2022 from 3.5% to 3%. The core inflation numbers have also been revised a little higher with the core PCE deflator expected to end 2023 at 2%.

## New economic forecasts from the Fed

	2020	2021	2022	2023	Longer run
<b>Change in real GDP (Sep Fed forecast)</b>	-3.7	4.0	3.0	2.5	1.9
Previous projection (June)	-6.5	5.0	3.5	-	1.8
<b>Unemployment rate (Sep Fed forecast)</b>	7.6	5.5	4.6	4.0	4.1
Previous projection (June)	9.3	6.5	5.5	-	4.1
<b>Core PCE inflation (Sep Fed forecast)</b>	1.5	1.7	1.8	2.0	-
Previous projection (June)	1.0	1.5	1.7	-	-
<b>Federal funds rate (Sep Fed forecast)</b>	0.1	0.1	0.1	0.1	2.5
Previous projection (June)	0.1	0.1	0.1	-	2.5

Source: Federal Reserve, ING

## Economic slack to keep inflation and interest rates low

The shift in language and the new forecasts are fully understandable with officials emphasising that the US economy continues to face numerous challenges from Covid-19. Recent data reinforces our view that it will be late 2021 at the earliest before all the lost output is recouped, which points to a large lingering output gap. Meanwhile, the slack in the labour market means little prospect of imminent wage inflation so the chances of the Fed meaningfully improving on its hit rate for 2% inflation anytime soon don't look great.

Once again, Powell left the door open to further potential action, which would most likely involving additional QE, but emphasised that the Fed can't generate demand. For that, we will need to see additional fiscal stimulus and Powell again suggested more would likely be needed, but that isn't going to happen ahead of the 3 November elections and may not come before the end of the year.

## Implications for treasuries

The net impact on the bond and rates market has been muted. However, if we take the forecast revisions (which were to the upside) and add that to the commitment to keep the funds rate anchored, the net effect is to leave the long end less protected (by the Fed). In consequence, if there were to be a break-out from this meeting, it should be in the direction of a steeper curve from the back end. As it is though, the 10yr Treasury yield remains in sub-70bp territory and the 2/10yr spread is flat-lining in sub-55bp territory.

The curve remains very directional with respect to data going forward. The anchor on front end rates has been extended through to 2023, which mean that 2yr yields are going nowhere. These should break-even versus a projected fed funds rate, which is effectively in sub-10bp territory for the foreseeable. If anything, the 2yr yield should be lower from here, as compensation through a term premium out to the 2yr is pretty meaningless. The shape of the curve will come from where 10yr and 30yr rates go to.

Any break out of flattening from here would frustrate the Fed. Part of the rationale of average inflation targeting is to give the low fed funds rate environment the biggest possible bang for its buck. A flatter curve against that backdrop would imply that the Fed needs to do more. The interesting nuance here, though, is that if the Fed did have to do more it would likely include some longer duration quantitative easing i.e. more buying of longer dates. Therein lies the dilemma for the curve, and direction – still a mean-reverting process in consequence.



## Nothing to bother the dollar bear trend

Despite a flicker at the long end of the bond market, there was nothing really in the FOMC statement or the projections to un-nerve the conviction view that reflationary Fed policy is a dollar negative.

Key components to this summer's dollar decline have been the sense of recovery (today's Fed upgrades to 2020 GDP and employment forecasts help here) and ultra-low rates (unchanged policy Fed policy through 2023 also help) resulting in real yields deep in negative territory.

Instead the Fed spelling out that it aims to achieve inflation moderately above 2% favours asset classes like equities and commodities. Notable over the last two weeks has been the breakdown in key \$/Asia pairs, such as \$/CNY and \$/KRW. The Fed's reflationary policies supports an extension of these pro-growth FX trends. EUR/USD should also stay bid in a broad 1.17-1.20 range over coming weeks and months. The biggest challenge to the EUR/USD rally is probably positioning and US elections – not the Fed.

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Article | 17 September 2020

## Eurozone: ECB suffers from social distancing too

The drop in services inflation in the Eurozone shows that social distancing product categories saw the largest drop. Our social distancing price index...



Source: Shutterstock

### Inflation back in negative territory: Deflation alert!

Getting inflation back on track in the eurozone has been an enormous challenge for the ECB in recent years. Sluggish growth, negative output gaps and above all structural factors like digitalisation and globalisation have complicated the ECB's life.

In the current crisis, inflation has dropped further, currently on the back of lower energy prices, the VAT reduction in Germany and weaker economic fundamentals. Looking at the latest ECB staff projections, it almost seems as if 1% has become the new 2%. While headline inflation is still expected to increase significantly from 0.3% in 2020 to 1.3% in 2022, measures of underlying inflation remain at around 1% for the next three years.

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*The inflation outlook has become more complicated, which is why we stick to the ECB chief economist Philip Lane's more*

## *general warning against complacency*

The inflation outlook has become more complicated. On the one hand, there is the macro picture with a base case of a gradual recovery after the initial V-shaped rebound which would return the eurozone economy to pre-crisis levels in 2022. A scenario which underpins the gradual increase in headline inflation. On the other hand, there are the structural factors like supply chain disruptions, an uneven recovery across sectors and countries and behavioural changes which could affect prices in many and often opposing ways. Consequently, it is simply too early to conclude that there is no deflation risk or that inflation is back on track. We stick to the ECB chief economist Philip Lane's more general warning against complacency.

But what is there to be complacent about? The drop in German VAT and lower energy prices will not be the reason for the ECB to act forcefully, these are one-off effects on prices. The same holds good for the drop in goods prices, which is related to a change in the discount sales period in countries like Belgium, France and Italy. The bigger concern is the decline in services inflation, which has come down from 1.9% in November to 0.7% in August. This decline is more directly related to the economic situation and therefore something for the ECB to more seriously consider.

## **It's all about social distancing categories of inflation**

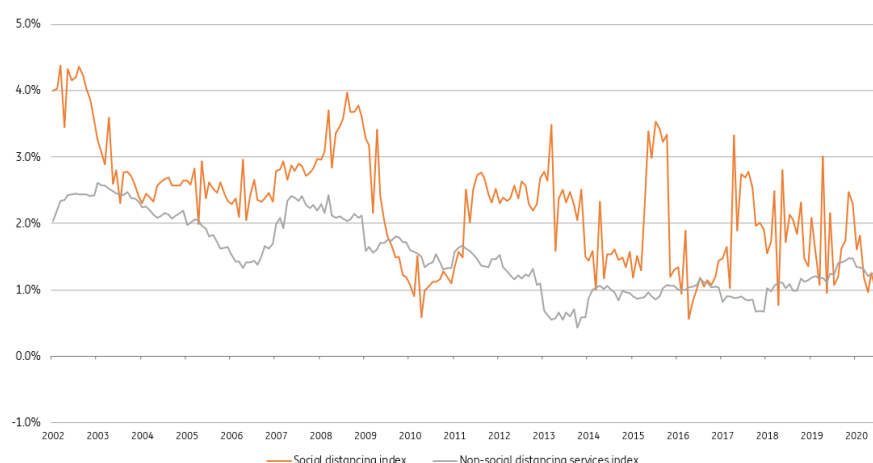
Funnily enough, a large part of the decline in services inflation is actually related to products in which sales are impaired by social distancing measures.

While one would expect social distancing rules to result in price markups due to supply limitations, it seems that concerns about the virus and practical problems related to social distancing are causing demand to fall so much that results in lower inflation for those categories.

To measure the social distancing impact on prices, we took several components from the HICP basket which in our view are most subject to social distancing and developed a social distancing price index.

## **Eurozone social distancing price service categories have fallen in the Covid era**

Source: Eurostat, calculations ING Research





The list is probably non-exhaustive but includes enough social distancing impaired categories to capture the general impact of social distancing on prices.

It comprises just under 18% of the total inflation basket and about 40% of total services inflation, indicating that social distancing affects a non-negligible part of the inflation figure.

- Transport services
- Catering services
- Recreational and cultural services
- Accommodation services
- Package holidays
- Hairdressing salons and personal grooming

This social distancing price index dropped significantly since the start of the health crisis.

In August, the price index declined for the first time ever as can be seen in chart 1. Interestingly enough, outside of these Covid-19 affected categories, services inflation has remained relatively stable in the recent period. The index was at 1.1% in August, down from just 1.3% in February, which means that there is a direct link between the more relevant decline in inflation and social distancing and that inflation for other services has remained relatively stable despite the corona crisis.

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*The supply constraints that social distancing brings indeed cause upward price pressure, but only if demand remains strong enough*

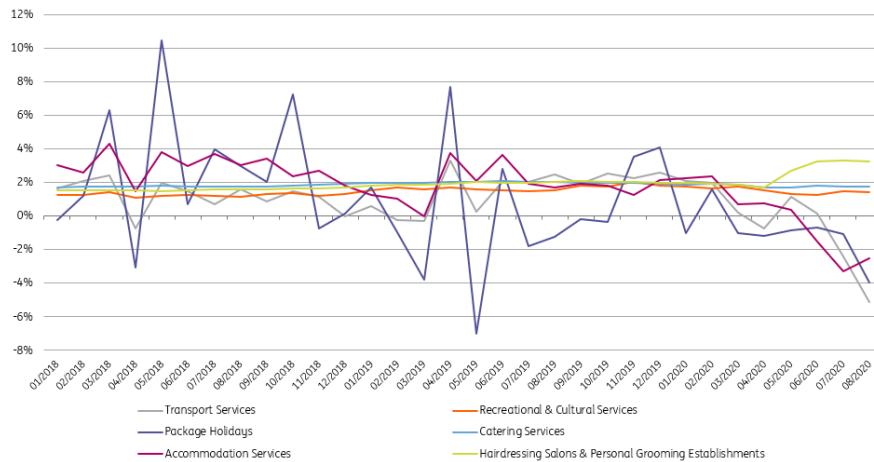
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It has to be said that not all of the components of our index move similarly though. There is downward pressure on most, but hairdressing salons and personal grooming stands out. That is the only one showing a sharp increase in prices, clearly, the one category where demand has increased with easing lockdowns and where new costs to actually open up businesses again have been passed through to consumers.

This indicates that the supply constraints that social distancing brings indeed cause upward price pressure, but only if demand remains strong enough.

## Not all social distance categories see declines, if demand is sufficient price pressures can return

Source: Eurostat, ING Research

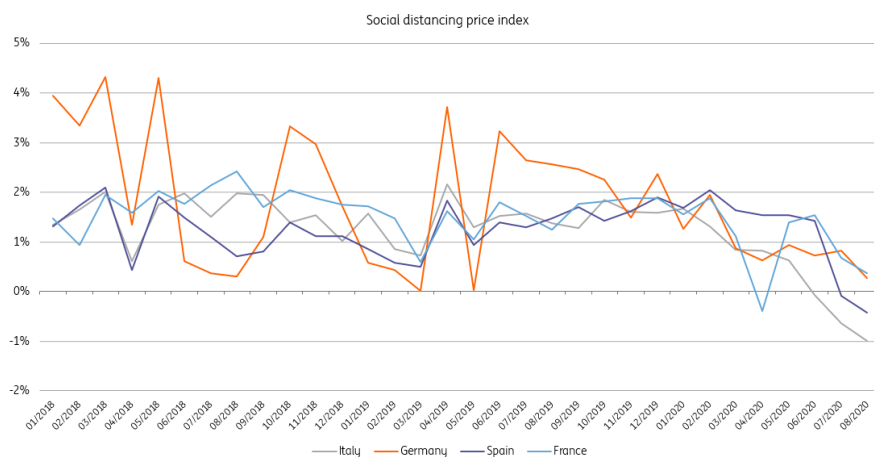


The largest declines come from transport services, package holidays and accommodation services, indicating that especially trips and holidays have seen prices fall considerably.

There are differences between countries though as larger tourist destinations experienced a bigger shortfall in demand over the summer months, causing differences in the decline in the social distancing price index between countries.

Looking at the four larger countries, we see Germany and France experienced a milder dip than Italy and Spain. Looking at accommodation prices specifically, we find a correlation between countries that usually receive more tourists over the summer and ones that usually receive less. A country like Germany now hosts many more domestic tourists than it usually does in summer when people travel elsewhere.

## Popular holiday destinations see social distance inflation decline more significantly over the summer



Ultimately, the index shows that currently the direct virus fears, measures and limitations are putting more downward pressure on prices than the macroeconomic consequences of the virus are as the drop in inflation is not as widespread as it would be otherwise.

## The ECB will have to take a position on vaccine availability

For the ECB, this decline brings a difficult decision with it.

Is this a fleeting issue that should be ignored like a drop in the oil price or a VAT decrease/hike? And what if social distancing measures are completely reduced next year if and when a vaccine has been rolled out successfully? Could there then be a price mark-up to make up for losses this year? And even if social distancing measures are not reduced, there is the risk that another year of staycations could also lead to demand-driven price increases in the Northern European economies. There is anecdotal evidence that many vacation destinations in Germany are already fully booked for the 2021 summer season, this would likely create a reverse effect in the Southern European economies.

*While the kneejerk response to the decline in core inflation would be to stimulate the economy even more, the situation is more complicated than that*

So while the kneejerk response to the decline in core inflation would be to stimulate the economy even more, the situation is more complicated than that.

There are two multiple trillion euro questions for the ECB now. The first is whether demand can outstrip supply in a social distanced environment when virus risks are still significant and the second is when will a vaccine become available that will eliminate this problem altogether. Doves and hawks will have to include takes on these questions when deciding on a possible next round of stimulus later in the year.

One thing is clear: even the ECB is currently affected by social distancing.

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Article | 15 September 2020

# UK Economic and Brexit Update

With a trade deal hanging in the balance, we examine the key sticking points in UK-EU negotiations, areas for possible compromise and ramifications for...



Source: Shutterstock

## Key takeaways

- **Brexit:** A deal is now at best a 50:50 probability. The key factor will be whether the Internal Market Bill makes its way through the Commons and Lords successfully. If so, the EU is highly unlikely to sign a free-trade agreement with the UK given the lack of trust, and threat of withdrawal agreement breach. However a deal shouldn't be completely ruled out, and is still possible if the bill fails/is watered down, but would require the UK to reluctantly relax its red line on state aid. It's clear the government won't do a deal at any cost.
- **Economy:** We expect a 17% jump in UK GDP in the third quarter, but this will still leave the economy some 8% below pre-virus levels. The recovery looks set to stall with unemployment expected to rise to 8-9% by year-end.
- **Bank of England:** Further QE round is likely in November. Negative rates are still a possibility, but we think policymakers are more likely to lower the rate on the Term Funding Scheme for SMEs as a first step.
- **Covid-19:** The UK's testing system has been comparatively stronger than many in Europe on a per capita basis. This has helped to keep transmission contained over the summer although cracks are starting to appear. For now, the government is likely to prioritise limiting gatherings over re-closing parts of the economy as cases begin to rise.
- **Markets:** Despite a slide recent sterling slide, a lack of risk-premium embedded into EUR/GBP and neutral speculative positioning suggests further downside potential. 'No deal' could see EUR/GBP head above this year's high of 0.95 and potentially toward parity.

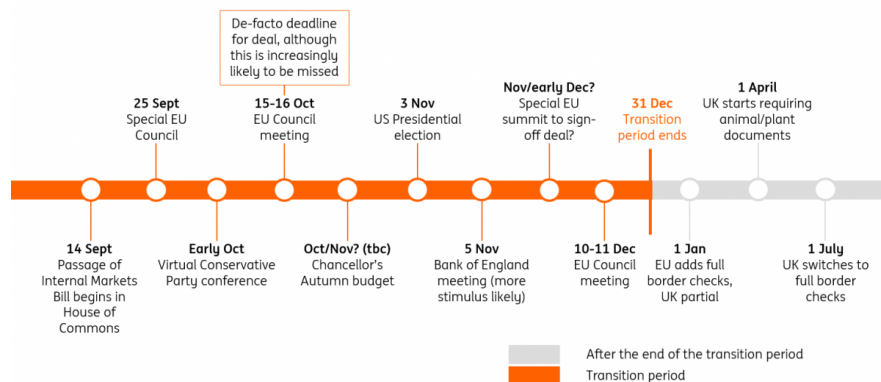
## Is a deal still possible? At best, we think it's 50:50 now...

- **The bold nature of the Internal Market Bill** has led many to conclude this is designed to inject pressure, or a sense of crisis, into talks to try and generate movement.
- **It has drawn comparisons to 2019**, when Parliament was prorogued (also ruled unlawful).
- **But the move will reduce trust between negotiators.** The EU won't agree to a new deal if there is any risk of the Withdrawal Agreement being breached, and may look at legal action if the bill is passed.
- **Key question now is whether this legislation passes through Parliament.** There is talk of amendments, although unlike last year the government has an ample majority in the House of Commons. It may, however, face trouble in the House of Lords.
- **A deal is still possible**, if the legislation fails to pass or is watered down. But even then it would require a compromise on 'state aid', and current UK rhetoric suggests it is highly reluctant to do so.
- If the bill passes, then it looks increasingly likely that 'no deal' will be the most likely scenario.

### What is the Internal Market Bill and why has it come about?

- State aid has long been the key dividing issue in negotiations. The UK wants full control to support industries in future. The EU wants reassurance, perhaps in the form of an independent regulator, that the UK won't abuse these powers and put European firms at a disadvantage.
- However the Northern Ireland Protocol (i.e. the backstop) says the UK must abide by EU state aid rules where it might affect NI-EU trade – something that is potentially far reaching.
- The UK government is therefore proposing to give ministers power to override this requirement, as well as on export summary declarations for goods leaving NI, and on the need for tariff payments on goods crossing the Irish sea.
- This is widely interpreted as a breach of international law

## Trade timeline: Key dates surrounding UK-EU negotiations



## What needs to happen for a deal to be done?

Issue	Possible compromise	Likelihood of agreement
<b>State aid</b>	<ul style="list-style-type: none"> <li>• Brussels drops insistence that the UK signs up to EU state aid rules with ECJ oversight permanently.</li> <li>• Britain sets up independent regulator to enforce a set of limits/rules on UK state aid, that EU leaders are satisfied won't lead to unfair competition.</li> <li>• This will take time to set-up, so in the meantime the EU may insist on a transition where UK continues to follow its rules with ECJ oversight</li> </ul>	<p><b>Questionable given Internal Market Bill</b></p> <ul style="list-style-type: none"> <li>• UK adamant it wants control over state aid, and has gone further by proposing to override these provisions in the Withdrawal Agreement.</li> </ul>
<b>Fishing</b>	<ul style="list-style-type: none"> <li>• Both sides drop initial proposals (EU maintaining status quo, UK wanting control over its waters).</li> <li>• It'll be a question of quotas, and how often these are renegotiated in future years.</li> </ul>	<p><b>Possible – but only if wider deal reached</b></p> <ul style="list-style-type: none"> <li>• UK exports majority of its fish, while EU fishing communities rely on access to UK waters.</li> <li>• A deal makes economic sense for both sides but would likely be the last thing to be agreed</li> </ul>
<b>Equivalence for financial services</b>	<ul style="list-style-type: none"> <li>• 'Enhanced' equivalence regime unlikely (the EU would need to offer this to other FTA partners)</li> <li>• The EU has signalled flux in its own rules may mean an equivalence assessment covering all areas may not be possible this year.</li> </ul>	<p><b>Likely if there's a deal – although scope unclear</b></p> <ul style="list-style-type: none"> <li>• While this is largely a technical, and unilateral, EU matter, agreement on a wider FTA would likely add political impetus for equivalence to be resolved.</li> </ul>
<b>Other issues</b>	<p><b>Governance</b></p> <p>UK uneasy about EU proposal for one overarching deal, enabling future sanctions that could link different areas</p> <p><b>Border bureaucracy</b></p> <p>Transit rights for lorry drivers, lower frequency of checks (eg for agri/animal), trusted trade schemes etc</p>	<p><b>Data sharing</b></p> <p>Data adequacy ruling likely, but concerns about future legal challenges</p>

## What does the new UK-EU relationship mean for 2021 growth?

We are unlikely to see a Covid-19 style collapse in GDP at the start of 2021. We'd need to see consumer spending fall for this to happen, and that's unlikely to be a direct consequence of the transition period ending.

But unlike the pandemic, Brexit is a more permanent drag on UK activity. Higher costs will hit firms, and this will compound the damage done by Covid-19 (see examples to the right).

The effect is likely to be a slower recovery relative to comparable European peers. It could also put additional strain on unemployment if the challenges broaden out to a wider range of sectors than those directly hit by the pandemic. We think it is likely that unemployment will reach 9% by late 2020/early 2021

**Brexit will hit some sectors less affected so far by the pandemic**

Example: **Agriculture**

**Covid-19 impact:** Production fell by only 5% in the second quarter, compared to 20% for the wider economy

**Brexit impact:** Typically the highest tariffs (30%+ for dairy/meat). Subject to more intrusive (health) checks at borders compared to other goods

**For sectors already hard hit, Brexit will compound existing costs**

Example: **Car manufacturing**

**Covid-19 impact:** Production fell by 70% in second quarter

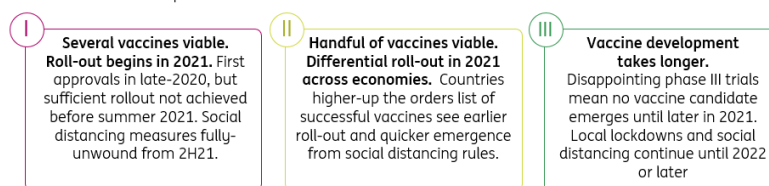
**Brexit impact:** 10% tariff if no FTA in place. But also vulnerable to disruption at the ports given just-in-time production. Could stockpile to compensate, but that's costly and many firms (especially SMEs in the supply chain) won't have resources

## Mapping the next phase of the economic recovery

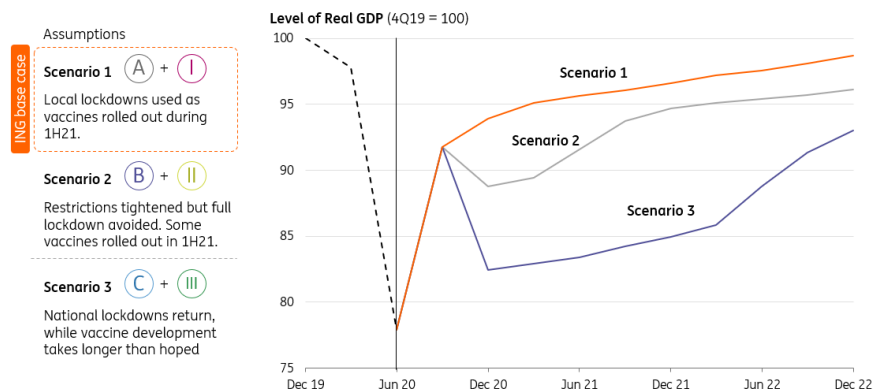
Phase 1: Covid-19 spread before vaccine



Phase 2: Vaccine development and roll-out



## Three scenarios for the UK economy





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# Bank of England: No policy change but keeping its options open

The BOE voted unanimously to leave policy unchanged today, in light of a broadly similar economic assessment compared to August. Further preparation for...



Source: Shutterstock

## Unanimous decisions to keep policy unchanged

The Bank of England unanimously decided to keep the Bank Rate at 0.1% and the size of its asset purchase facility (APF) unchanged today.

The absence of any dovish dissent in favour of an increase in the APF might have come as a surprise to some, but it is consistent with a committee that saw overall slightly less adverse economic developments than it expected in August. Risks, it noted, remain skewed to the downside.

Among the positives, the committee noted stronger than expected consumption, and slightly higher inflation. However, the tone was prudent to say the least. The phasing out of the Coronavirus job retention scheme is posing a key risk to the job market, although the Bank did not see a case to alter its forecast that the unemployment rate would peak at 7.5% in either direction.

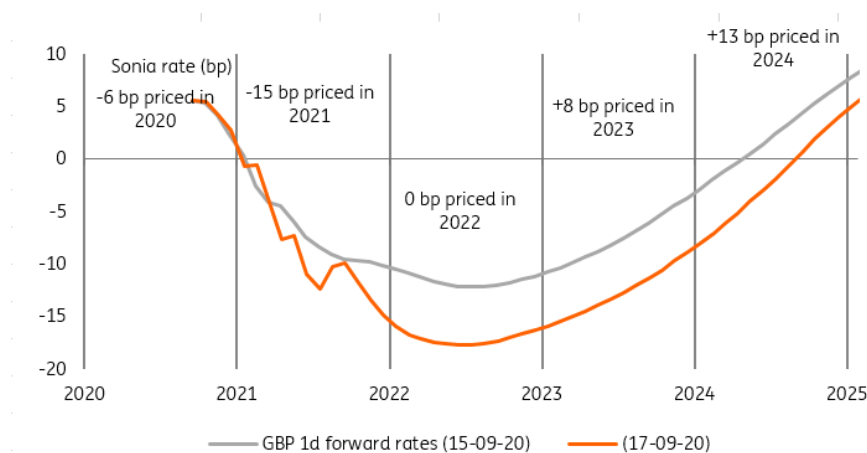
## No near-term policy signal, but negative rates expectations hotting up

There was little in this assessment to validate near-term expectations of more easing at the November meeting. The central bank's main scenario is premised on the UK signing a comprehensive trade deal with the EU before 2021. In light of recent developments, [this assumption is likely to be challenged](#) by investors, thus resulting in more dovish pricing than today's MPC might imply.

Given already high expectations of further easing, the debate about which tool the MPC might use has also gathered a lot of attention.

We remain confident that an increase in the APF is more likely in the near-term but, in its minutes, the MPC noted that the Bank is exploring plans to take interest rates below zero if necessary. It added that 'The Bank of England and the Prudential Regulation Authority will begin structured engagement on the operational considerations in 2020 Q4'.

## 2021 Sonia forwards are pricing NIRP with near-certainty



Source: Bloomberg, ING

## Rates: let's go negative!

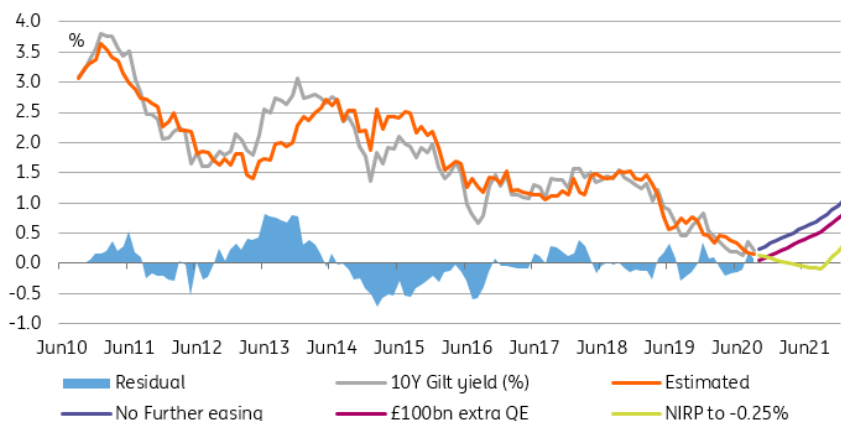
From the point of view of the rates markets, the escalation in the Bank's communication around negative interest rates policy (NIRP) is likely to be seen as a vindication of existing expectations. The timeframe for the implementation/operational study and engagement confirm that these would be more of a 2021 story.

Perhaps due to the worsening Covid-19 curve and to looming Brexit risk, the yield curve has already made up its mind about the odds of further easing, at least judging from the shape of Sonia forwards. To be consistent, we think gilt yields would have to drop significantly, likely below 0% for a time in 2021 to reflect negative Bank rate.

An increase in QE would also do the trick to lower GBP interest rates, but the impact is likely to be more limited. We show in the chart below the impact on the path of the 10-year gilt yield of a £100bn increase in the APF, and of a 25 basis point cut to the Bank rate.

As 2021 approaches, we think gilt will converge to zero, provided expectations of a more dovish central bank are not disappointed.

## 10-year gilt skewed to the downside, but NIRP is a lot more impactful



Source: Bloomberg, ING

## Pouring more oil into GBP fire

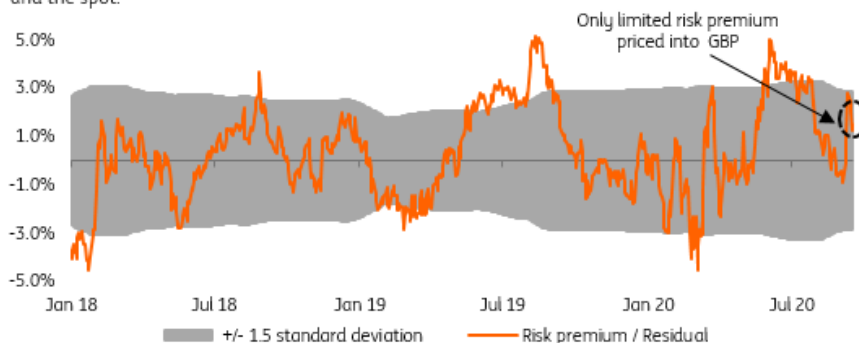
GBP took a hit as official discussed the effectiveness of negative interest rates. The market has already been pricing a modest chance of negative rates and today's meeting confirms this bias.

While clearly negative for GBP, we continue to see the UK-EU trade negotiations as the chief driving factor of GBP in coming weeks, with the success or the failure to agree on a (reasonable) trade deal also determining the odds of BoE negative interest rates.

This means that the potential GBP negative from the failed UK-EU trade negotiations would be further exaggerated by the BoE likely moving rates into negative, as we discussed in [Sterling unprepared as UK-EU trade deal hopes fade](#).

## Limited risk premium priced into GBP

The estimate of the EUR/GBP risk premium. Residual between EUR/GBP short-term financial fair value and the spot.



We continue to expect GBP trading on the soft side in coming weeks due to uncertainty

about the UK-EU trade deal with the probability of such a deal not being achieved increasing sharply following the introduction of the internal market bill by the government.

The damage to GBP has been done, and we don't see the recent softening in the UK government stance by giving parliament a veto over some measures of the bill as substantial enough to reverse or change the decreased perceived odds of success in the trade negotiations.

The odds of further negative headline news (or the lack of) trade negotiations are high and with GBP not exhibiting enough risk premium (only 1.5% based on our financial fair value model, vs 5% risk premium pricing in late June – see chart above). we see more downside risks for GBP.

We expect EUR/GBP to re-test the 0.9300 level again this month.

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Podcast | 18 September 2020

## Listen: Emerging from the Covid-19 crisis

The Covid-19 pandemic has ripped through the developing world this year with particular cruelty and ferocity, upending lives and livelihoods on a scale...



A collapse in tourism and trade, plunging commodity prices and a slowdown in investment have been a toxic cocktail for emerging markets this year, many of which were struggling with high debt levels before the pandemic hit and were ill prepared to deal with a health crisis.

Yet demand for stocks and bonds has improved since hitting a nadir in March, and the US Federal Reserve's plan to keep interest rates lower for longer could provide further relief. [In this podcast](#), ING's Emerging Market Debt Strategist Trieu Pham tells Senior Editor Rebecca Byrne what he's expecting from developing economies and markets in the months ahead.

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# Worsening leverage metrics. Should we be alarmed?

Worsening leverage metrics, deteriorating credit quality and substantial downgrades are all signals for long-term concern for credit markets. Yet based on...



Source: Shutterstock

## Key takeaways

- We recommend a conservative approach when considering credit risk, in particular, the lower-rated instruments and issuers and those from sensitive sectors. Technical factors such as quantitative easing will dominate the market but more diversification and caution is advised. Depending on QE in the meantime, a positive stance but a dangerous assumption as previous periods have proved.
- Spread comparisons to earlier credit spread widening time periods like late 2015 and late 2018 would indicate that the current crisis is something similar. Exponentially rising leverage would argue a different case.
- On the back of the crisis, collective corporate leverage measurements have been rising to unprecedented levels. This was particularly the case in 2Q20 when lockdowns were most prevalent.
- Leverage metrics have been worsening over the course of the last few years and 2020 has just been a catalyst in this trend. This is certainly something to be

monitored, with the potential for some concern.

- The quality of covenants within loans have been deteriorating over the past few years. The jump to default compensation should thus be higher as debt holders are offered a lot less protection.
- Downgrades in both Europe and the US have reached substantially high amounts in 2020, even compared to 2018 and 2015. And for non-financial corporates even the credit crisis downgrade numbers are benign.
- Current spread levels show the market is not pricing in these worsening metrics – particularly with the worsening trend in total debt to EBITDA numbers. Meanwhile, the lack of major spread widening that should have been expected is very evident when looking at the spread compensation over total debt to EBITDA.

## Leverage has increased, with gross measures looking even more elevated

As the Covid-19 pandemic continues to impact economies around the world, and the impact is felt across sectors and companies, it is natural that collective corporate leverage measurements have been rising, with a particularly telling impact experienced during the second quarter when lockdowns were the strictest across everywhere.

Additionally, energy prices have dropped as one of the additional and secondary effects, impacting the oil & gas sector and related sectors more specifically. Furthermore, given the heightened economic uncertainty, entities across the rating spectrum rushed to beef up their liquidity cushions, pre-fund and refinance existing debt.

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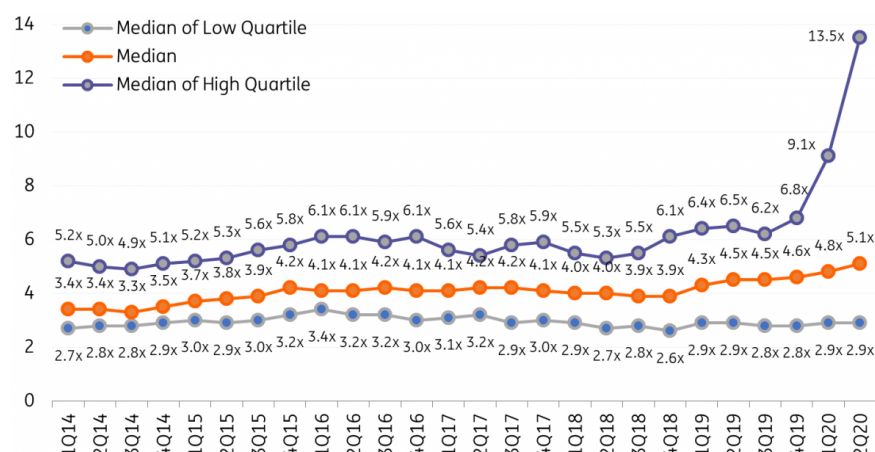
*The trend of rising leverage, already visible pre-Covid, has been given a serious boost whilst spreads seem comfortable in their ignorance*

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This was helped by the low-interest-rate environment and central banks' support extended to facilitate such liquidity hoarding. Therefore, gross debt measures have increased even more than the net debt ones, amplifying the visual impact on leverage from lower earnings.

Nonetheless, the trend of rising leverage, already visible pre-Covid, has been given a serious boost whilst spreads seem comfortable in their ignorance.

## US high-yield total debt to EBITDA



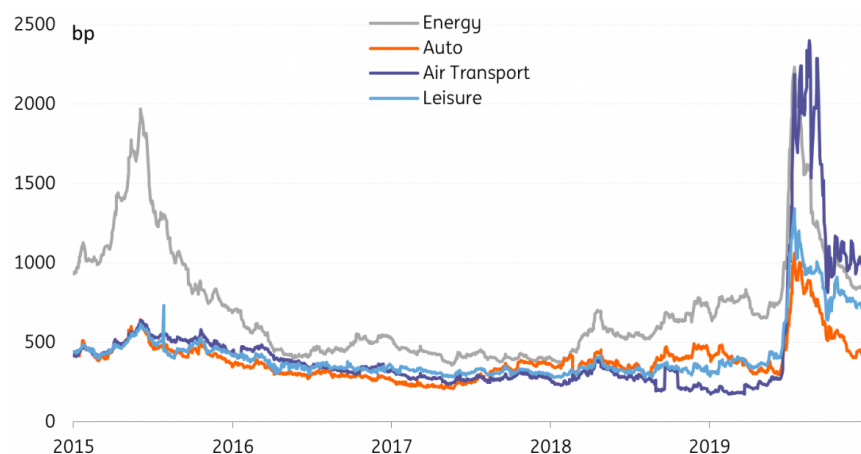
Source: ING

## Certain sectors are affected more than others

While the effects of the pandemic are quite pervasive and multi-faceted, certain sectors are prone to having a greater impact from the current economic dislocation. Those include leisure, hospitality, high street retail, air travel and related services, certain segments of business services, automotive and oil & gas.

Those sectors have experienced a disproportionate increase in leverage measures and are the most prone to restructuring and defaulting on their debt obligations.

## US high-yield spread to Worst



Source: ING, ICE

## How transitory is the current rise in leverage measures?

Given the current valuations, we understand that the bond markets, propped by ample liquidity and certain exogenous support, are currently willing to overlook the current spike in leverage and prefer to look towards a brighter post-pandemic future.

*Our expectation is that business across sectors will still position next year as a post-pandemic “transition” year, almost regardless of the underlying public health picture*

We're not completely dismissing such a market stance and have an open mind giving this perspective the benefit of doubt. As the worst of the Covid-19 could be well behind us as certain economies recover and with a potential to recover ahead of current expectations, it may well be that the current elevated measures may be on the way towards subsiding. While liquidity is ample and solvency is not imploding the worst may be avoided and defaults may not materialise to the same extent as was feared at the peak of the pandemic.

One word of caution is that while economies and individual sectors may be on the mend, the recovery may be more prolonged and laborious than is hoped for in the current relatively optimistic phase. The length may not have be “lethal” with proper ongoing policy measures, but pre-Covid year-end 2019 metrics may only really recover in a couple of years rather than in 2021.

In fact, we expect business across sectors will still position next year as a post-pandemic “transition” year, almost regardless of the underlying public health picture.

## US high-yield total debt vs EBITDA

	2Q14	4Q14	2Q15	4Q15	4Q16	4Q17	4Q18	2Q19	3Q19	4Q19	1Q20	2Q20
Basic Ind	3.4	3.6	3.9	5.0	3.8	3.8	3.5	3.9	3.9	3.8	4.5	4.2
Energy	3.0	2.9	3.8	4.7	6.1	4.5	4.0	3.9	4.3	4.4	4.6	5.2
Cap Goods	2.8	3.0	3.1	3.4	3.3	3.7	3.4	4.2	4.4	4.1	4.6	5.0
Media	4.2	4.7	4.3	4.5	4.8	4.7	4.1	4.7	5.2	5.1	5.5	6.0
Retail	2.6	2.5	2.7	2.6	3.1	3.2	3.0	4.4	4.6	4.6	5.4	6.4
Tech & Elec	2.5	2.4	2.9	3.5	3.8	3.2	3.7	4.0	4.0	4.2	4.4	4.2
Services	3.1	3.1	3.3	3.7	3.7	3.9	3.8	4.5	4.4	4.4	4.7	4.8
Healthcare	4.3	3.9	3.9	4.1	3.8	4.3	4.2	4.5	4.5	4.1	4.8	4.5
Leisure	4.2	4.7	4.8	4.3	4.3	5.0	5.2	5.2	5.5	5.6	6.8	12.1
Consumer Goods	3.3	4.1	3.9	3.7	3.5	4.8	5.0	5.0	4.9	4.9	5.2	4.8
Telecom	4.7	5.0	4.9	4.5	4.2	5.9	5.2	5.2	5.0	4.9	4.9	4.9
Real Estate	6.6	6.6	7.9	8.3	7.0	7.6	8.3	8.6	10.6	9.0	10.4	11.6
Autos	3.3	3.2	3.0	2.5	2.6	2.3	2.3	3.4	3.7	3.9	3.9	5.0
Transport	4.3	4.7	4.6	4.2	3.9	3.6	4.8	5.6	5.4	5.1	5.4	6.6
Utility	5.1	5.1	5.3	6.0	6.2	6.1	5.3	5.4	5.1	5.9	5.5	6.9

Source: ING

- Total debt to EBITDA now at highest levels ever
- Only Industrials, Technology and Healthcare are not
- Substantially high Leisure and Real Estate levels (double-digits)
- Energy leverage below late 2016 peak, but low in comparison to Utility & Transport

## Spread / US high-yield total debt to EBITDA per sector

	4Q14	4Q15	4Q16	4Q17	4Q18	4Q19	1Q20	2Q20
Basic Ind	18	39	16	9	27	16	45	29
Energy	51	29	14	12	31	16	49	33
Cap Goods	16	22	14	9	30	13	36	23
Media	12	24	15	10	23	12	28	22
Retail	31	41	15	10	27	12	30	17
Tech & Elec	16	19	10	6	16	9	31	21
Services	19	25	16	11	24	13	39	29
Healthcare	9	16	15	7	16	11	29	19
Leisure	24	28	14	8	20	12	71	22
Consumer Goods	10	18	13	6	15	9	30	20
Telecom	14	22	17	9	19	13	33	23
Real Estate	11	15	13	8	17	9	20	15
Autos	13	39	23	20	54	20	71	33
Transport	12	15	11	8	19	13	33	19
Utility	14	17	11	7	18	11	27	14

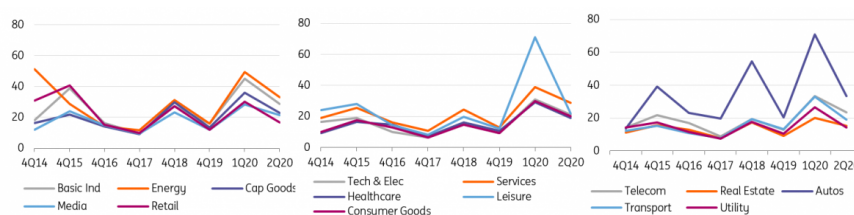
Source: ING

- Late March spreads resulted in high spread / leverage ratios
- Now close to late 2015 or late 2018 levels (tapering/ improving economic outlook, rise in yields and spreads)
- The comparison does no justice to pressure on revenues and credit metrics

## Spreads not pricing in the worsening metrics

At current spread levels, we believe the credit market is somewhat rich.

It is clear spreads have not priced in these worsening metrics. Particularly as illustrated below and in the tables above, whereby we can see the worsening trend in total debt to EBITDA numbers in the US. Additionally, the spread over the total debt to EBITDA shows the lack of major spread widening relative to the worsening metrics.



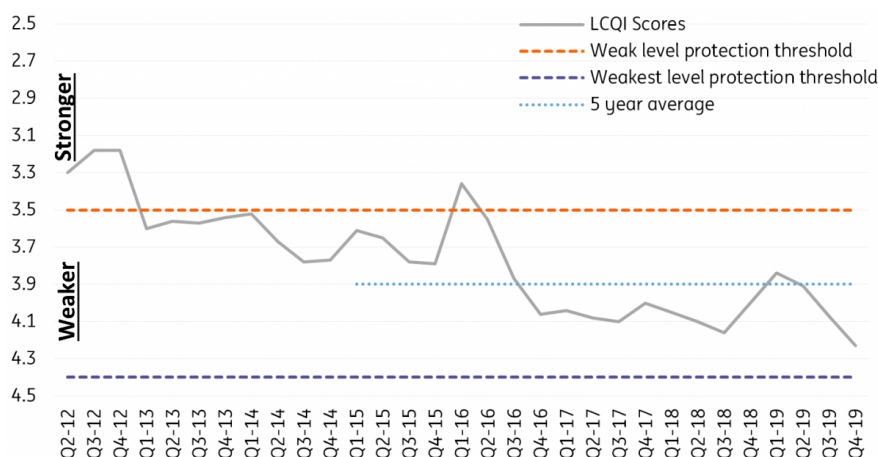
Source: ING

- Spread compensation since late Q1 has fallen dramatically and is comparable to late 2015 and late 2018 market “wobbles”
- Spread compensation for (rising) leverage has also seen a decreasing turn from pre-Covid 19 levels

## Covenant quality has deteriorated substantially

Moody’s Loan Covenant Quality Indicator assess the quality of covenants within loans. The quality of loan covenants are falling considerably and this is a worrying trend in the loan market as it offers little protection to investors and issuers. As illustrated below, the loan covenant quality indicator in the US has been falling over the past 8 years.

For some time now, the indicator has been below the weak level protection threshold which in itself is already worrying. However, in 4Q19 we were already approaching the weakest level protection threshold, which makes us more cautious on the loan markets.



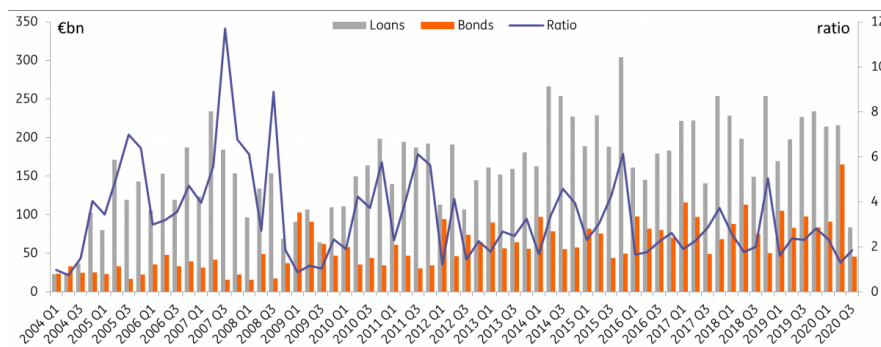
Source: ING, Moody's

## Loans much more dominant source of financing relative to bonds

Taking a look at the issuance levels of bonds and loans over the past 16 years as illustrated below, loans are a much more dominant source of financing relative to bonds, particularly up against the opposite in USD.

Despite Euro investment grade supply reaching new record-breaking amounts this year and last year, overall euro supply remains low relative to loans.

We expect bond supply in 2020 to approach €500bn, now standing at €356bn year-to-date. Euro high yield bond supply, on the other hand, has been lower YTD at just €43bn, highlighting lower ECB support and also a (subsequent) greater dependence on loan markets.



Source: ING, Dealogic

## More downgrades in 2020 as credit metrics worsen

Relative to late 2018 and late 2015, downgrades in both Western Europe and the United States have been considerably high this year on the back of the crisis.

In the US, year-to-date downgrades have already doubled that of full-year figures in 2018 and 2015, pencilling in 1,115 downgrades in total. Similarly in Western Europe, downgrades have amounted to 405, which is already considerably more than the full-year figures of 2018 and 2015.

The vast majority of downgrades have been in high yield. Furthermore, fallen angels have also



seen an increase compared to previous years. This is a prime illustration of the deteriorating credit metrics this year, further suggesting the market is not pricing in these worrisome signs.

## Downgrades in 2020 vs 2018 & 2015 in Western Europe and the US

	Europe			US		
	2020 YTD	2018 FY	2015 FY	2020 YTD	2018 FY	2015 FY
IG	104	62	131	134	131	141
HY	301	123	158	981	409	447
Fallen Angel	23	5	8	28	19	20
<b>Total</b>	<b>405</b>	<b>185</b>	<b>289</b>	<b>1115</b>	<b>540</b>	<b>588</b>

Source: ING

Despite the worsening leverage metrics and deteriorating quality, the market is still looking at the most optimistic outcome. Downgrades have indeed reached considerable levels, but defaults may not materialise to the same expectations that were being priced in at the peak of spread widening back in March.

However, now that current spread levels are looking somewhat rich and the market is not pricing in these worsening metrics, particularly with the worsening trend in total debt to EBITDA numbers and the spread over the total debt to EBITDA showing the lack of spread widening.

This may lead to some reason for concern.

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## Phoney inflation war

This week, markets in Asia and elsewhere will react to the latest hints from the US Fed about how they will deal with sub-target inflation. This obsession...



Source: Shutterstock  
Federal Reserve

### Headline inflation in the US is 1.7%

Last Friday, the US released its August inflation figures. The month-on-month change came in higher than expected at 0.4% taking the headline rate of inflation to 1.7%. You might well ask, so what's the big deal (which would not be a stupid question)? In fact, the Fed prefers to target a broader measure of inflation called the personal consumer expenditure deflator (PCE). In July, this was running at only 1.0%, a full 0.6pp lower than the equivalent July headline CPI.

That said, most countries use a headline or core CPI as their target, not some local version of PCE, begging several questions. Firstly, does this mean on average, and on a comparative basis, that the Fed is already targeting a higher rate of (equivalent) CPI inflation (it would certainly seem so), and therefore also, what is the "right" inflation target anyway? That last question almost never gets asked, but it is a pertinent one because if you target an inflation rate using interest rates, the residual of that outcome is credit growth, which affects things like asset prices. Get that wrong, and you end up with an asset price bubble, and eventually a bust. That is what worries me and a number of other commentators, but seemingly does not worry any central banks, who keep plugging away at the same old formula.

Another way of doing this, for a central bank, would be to target an appropriate rate of credit growth by setting interest rates and letting inflation vary as the residual. Absent structural shocks to the economy, that should deliver an appropriate credit growth although inflation might fluctuate a bit below or a bit above current target levels, it really doesn't matter - just as it doesn't really matter where you target inflation in an inflation-setting regime, so long as you target a rate you can *actually* achieve - which currently, doesn't seem to be the case for many central banks. Importantly, switching the target of policy, but leaving the policy lever unchanged, would considerably reduce the risk of inappropriate and unsustainable credit flows to asset markets, which have dominated the last number of decades.

Last Friday, despite the higher than anticipated inflation figures, US 10Y Treasury yields fell slightly, perhaps because markets are looking forward to some more soothing words from the Fed this week. This week's Fed meeting is [written up in much greater detail here by James Knightley](#). But interestingly, since his Jackson Hole speech hinting at average inflation rate targeting (an irritating irrelevance in my opinion), a number of FOMC members have suggested that they don't see any great need for changing the Fed's strategy any time soon. I don't really agree with them, I think the strategy needs a radical overhaul, but I would agree that what seems to be being suggested now is not only not necessary, but finessing a policy that is already inherently unsustainable. Moreover, it comes against a backdrop where low-inflation, at least on some measures, is looking less of a problem that it has done for a while, and certainly not a problem that needs addressing with even more accommodation.

## Asia Day ahead

It's a quiet day in Asia for economic releases. Prakash Sakpal has this to add on India's inflation numbers. "India's August CPI and WPI inflation data are due today. The Covid-19 supply shock to food prices and administrative hikes in fuel prices drove CPI inflation above the central bank's (Reserve Bank of India) 6% policy limit in April, which is where it has been since, including the 6.9% recorded in July. We believe there was no let-up in price pressure in August; our CPI inflation forecast for the month is 7.1%. The forecast for WPI inflation is -0.2%, up from -0.6% in July. We believe the RBI is done with its policy easing in this cycle. The next move in policy rates will be upward, though not in the foreseeable future as the worsening Covid-19 situation will delay economic recovery".

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## Belgium: Virtual negotiations, but a real government in sight...

The political situation in Belgium is evolving and should lead to the formation of a new government in early October



### A quick look at what happened until now

With the Covid-19 crisis, one would almost forget that following the federal elections of May 2019, no government agreement could be reached on a federal level. The former government, from which the N-VA nationalists withdrew in December 2018, therefore served as a caretaker government, despite very little support in Parliament (barely 38 out of 150 seats). Following the arrival of Covid-19 and the need to take swift action, all political families (with the exception of the Flemish nationalists of the NV-A and far left and far right) agreed to give confidence to the government led by Sophie Wilmès (Charles Michel, the former Prime Minister, having become president of the European Council).

This situation was unprecedented for three reasons: (i) outside the parties in government during the previous legislature, no other party giving confidence to the government was represented by one or more ministers. (ii) the parties granted special powers to the government, allowing it to make decisions more quickly, this for a limited period of time. (iii) the confidence given would be withdrawn at the end of the period of special powers, 17 September 2020. After this date, either a new government with a parliamentary majority can be put in place, or the lack of confidence in Parliament leads to new elections.

## Difficult negotiations...

The parties have been searching in vain for a new majority during the last few months, in order to be ready on 17 September. Different forms of alliances have been negotiated, but each time without success. In recent weeks, however, it seems that there is light at the end of the tunnel. Four political families (liberals, socialists, Greens and Flemish Christian Democrats), with the potential to form a majority in parliament, seem to want to negotiate a government agreement.

## ... delayed by Covid-19

Unfortunately, the main moderator of the discussions, Egbert Lachaert, President of the Flemish Liberals, has tested positive on Covid-19. This slows down the current negotiations because of the quarantine observed by the other negotiators and the need to organize negotiations virtually. Therefore, the deadline of 17 September (this Thursday) was too close to achieve this new majority. Fortunately, a political agreement between the parties was reached to extend the negotiations (and thus the life of the Wilmès government) until 1 October. The political situation will therefore more clear in the coming days.

## What to expect?

In present times, one can never be sure of anything. That said, there is every reason to believe that Belgium will have a new government in October, supported by a stable majority in parliament. A particular weakness is that this government will not have a majority in Flanders, which will force the Flemish parties that participate in the federal government to walk on eggshells. Moreover, the government would bring together four political families, implying that the government agreement will have to allow each family to achieve a few key victories to satisfy its electorate.

As a result, as it is often the case when Belgium needs a wide range of parties to form a government, structural reforms to the economy are less likely because there will always be a party to veto them. Or, if a compromise can be reached to put in place certain reforms, the package could be less coherent. It will also be necessary to assess the extent to which a balance can be struck between the strong willingness to increase public services and health care resources and the need to put public finances back on a better footing. If the formation of a new government succeeds, its work will therefore be particularly difficult, in a context where the virus is likely to inflict additional damages to the economy.

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# CBDCs and commercial banks: Evolution or Revolution?

ING partnered with OMFIF's Digital Monetary Institute today in the ING DMI Digital Forum, a live webinar to discuss what the future holds for...



## Will banks thrive in a Central Bank Digital Currency world?

The declining use of cash and the emergence of new digital tools could facilitate the introduction of digital currencies and prompt central banks to issue their own version of “digital cash”. Although big questions remain about how they’ll do it and how it will work in practice, the consequences could be revolutionary, especially for commercial banks. Today, ING partnered with OMFIF’s Digital Monetary Institute in the **ING DMI Digital Forum**, a live webinar titled “CBDC and commercial banks: Evolution or Revolution” to address some of the key issues we raised in the [article “Central Bank Digital Currencies: Challenges for Commercial Banks”](#) in the June Journal of [OMFIF’s Digital Monetary Institute](#).

## A two-tiered model may succeed but a reality check is needed

The panel discussed the potential division of labour between central banks, commercial banks and tech companies. It also touched upon how non-bank entities may participate in a CBDC roll-out and how this could impact traditional banks’ business model, strategy and operations. Tellingly, at the start of the seminar 78% of the audience thought the benefits of CBDC would outweigh the risks posed to the commercial banking sector, but this had dropped to 61% by the end of the webinar.

The consensus view among panelists was that central banks could distribute digital currencies through banks, following the design of the so-called *two-tiered model*. This would be a less disruptive scenario for banks and for the financial system more broadly, although availability of deposits would remain an issue for the supply and pricing of credit to businesses and households.



While preserving banks should never be a policy goal, preserving financial stability while introducing CBDC should be. This does not mean a no-go for CBDC but does imply a reality check, and a warning to proceed carefully.

**ING, through its New Horizons Hub, is a founder member of OMFIF's [Digital Monetary Institute](#). You can watch the full recorded version of the webinar on YouTube [here](#).**

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