Bundles | 2 November 2018

# In case you missed it: Change of guard

With Merkel throwing in the towel, May trying to play for time pushing back the crunch vote on Brexit and the US mid-term elections next week, political change appears to be intensifying around the globe and is only likely to heighten uncertainty for financial markets. And don't forget sanctions are coming!

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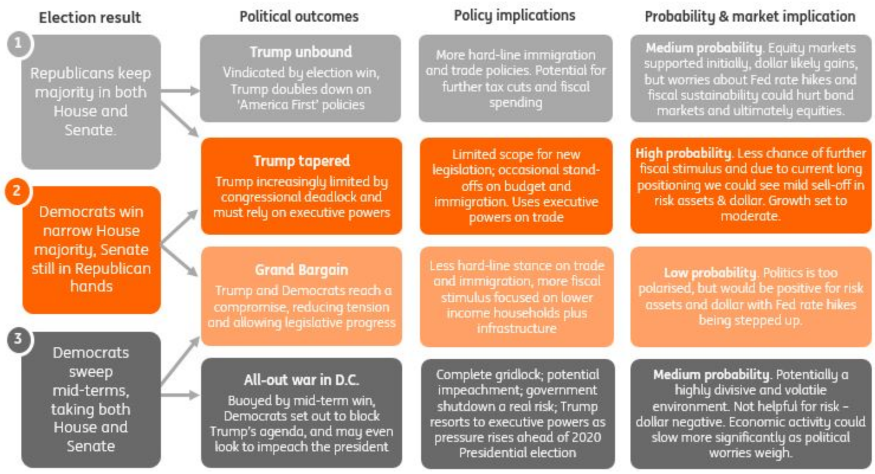
United States

# US mid-term elections: Feeling Blue?

The mid-term elections are less than a week away and opinion polls continue to suggest the Republicans are under pressure. The loss of Congressional control would make life increasingly difficult for President Trump and have major implications for policy. Here we revisit the possible election scenarios and assess their market implications

## Scenarios and market implications

We see four broad scenarios for the post-November landscape and it is through a prism of fiscal, monetary and protectionist policy that we should view the market impact.




Source: ING

## Setting the scene

The 6 November mid-term election offers the electorate the opportunity to give their assessment on the first two years of Donald Trump's presidency. Does the "Make America Great Again" policy thrust continue to resonate to the same degree, have legal issues taken their toll, or is it still all down to "the economy, stupid"? The outcome will have major ramifications for economic and trade policy, which will set the battleground for the 2020 presidential election.

Currently, the Republicans hold the Presidency and majorities in both the House of Representatives and the Senate, but Democrats will be looking to break this stranglehold. All 435 House of Representative seats are up for grabs along with 35 of the 100 Senate seats[1].

> *The Republicans hold 235 seats in the House of Representatives versus the Democrats' 193 while there are seven vacant positions. This means the Democrats need to make a net gain of 25 seats to wrestle control of the House from the Republicans*

In the Senate, the Republicans have a wafer-thin majority. They currently hold 51 of the 100 seats (plus the Vice President's vote if needed in a tied vote) while the Democrats have 47 and there are two independents, who vote with the Democrats. However, of the 35 seats being contested in November, the Democrats have 24 up for election along with the two independents, while the Republicans only have nine. As such, the Democrats need to win two of the nine Republican-controlled Senate seats, while holding on to all of the seats they currently occupy to gain control of the Senate.

National polls have remained broadly stable over the last month or so, showing Democrats ahead by 8-9%, though President Trump's approval rating has improved slightly (but his net approval remains negative). This points to a solid but not insurmountable advantage for Democrats in the House race, while Republicans remain favoured in the Senate thanks to the advantageous map.

Betting odds and polling analysts continue to believe the most likely outcome is that the Democrats will win control of the House of Representatives, but fall short in their quest for the Senate. The odds of a Democratic Senate majority have lengthened materially, with no more than a 10-15% probability now ascribed to that outcome. Democrats would need to win every close race in the Senate to make it to 51 seats (or perhaps score a surprise win in Texas or Tenessee).

*Betting odds and polling analysts believe the most likely outcome is that the Democrats will win control of the House of Representatives, but fall short in their quest for the Senate*

Still, even if the most likely outcome is a Democratic House and a Republican Senate, there is a fairly large chance of a surprise outcome. That's because there is virtually no chance of a Democratic Senate and a Republican House, so the probability of the two less likely outcomes (Democrats win the Senate, or Republicans hold the House) are cumulative. That means there is a 30-40% chance of a different outcome from the central expectation. To the extent that markets are expecting a Democratic House/Republican Senate, there may be scope for a sudden adjustment on the morning of November 7th if there is a different outcome.

**Odds of Democratic control of Congress after 2018 Mid-terms**

**(Figures as of 1 November in BOLD, and as of 26 September IN BRACKETS)**

| | **FiveThirtyEight** | **PaddyPower** | **PredictIt** |
|---|---|---|---|
| **House of Representatives** | **85%** (80%) | **4/9 ~69%** (4/11 ~64%) | **70%** (66%) |
| **Senate** | **15%** (31%) | **12/1~ 8%** 5/1 (~17%) | **12%** (31%) |

[1] Members of the House of Representatives serve two-year terms whereas the President has a four-year term and a Senator has a six-year term. Senators terms are staggered so one-third of the 100-member Senate are up for re-election every two years. This year there are 33 Senate seats being voted on in regular elections with two additional special elections due to Senators resigning before their term ended.

Read about the current standing and what could still influence the result?

## Key issues for the next two years

Donald Trump's first two years as President have seen a big win for him on tax reform, but a defeat on healthcare. He is fully immersed in trade right now and can also celebrate a strong jobs market, but he has made little progress on his infrastructure spending plan. Certainly, the economy is performing very well, and interest rates continue to rise in a "gradual" fashion.

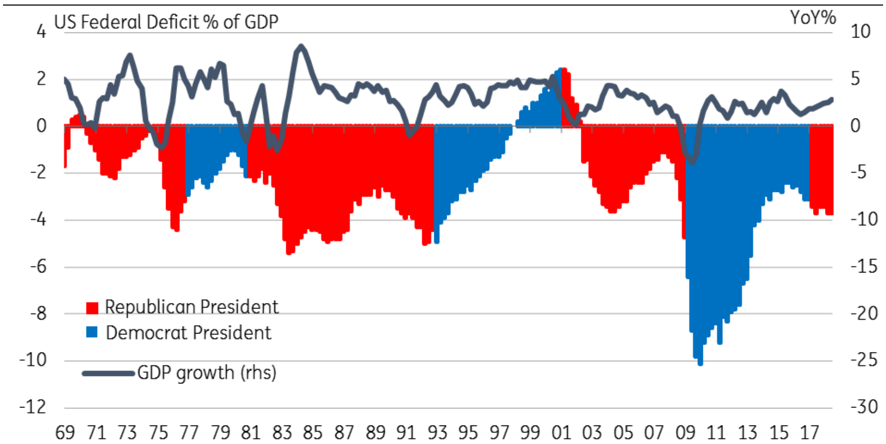
In the run-up to mid-term elections, global investors are quite heavily positioned; long dollars, long US equities and short US Treasuries even after recent market wobbles. The context here is a pump-primed US economy, whose loose fiscal and tight monetary settings have driven US rates and the dollar higher, while at the same time pressure testing the external balance sheets of some of the largest emerging market economies. Trade and infrastructure plus further tax and healthcare reform are likely to be his key policy thrusts in the second half of his term, but he will need support from Congress. This underlines the significance of these mid-term elections.

In this regard, we feel that there are three major issues we should focus on before diving into the scenarios since they will have a major influence on the likely successes and the market reaction.

**1) What happens to fiscal policy and fiscal sustainability?**

Historically the trend has been Federal budget deficits widens out during Republican presidencies and narrows under Democrat Presidents. President Trump has not bucked that trend with the Federal fiscal deficit approaching 4% of GDP despite the economy growing 3% this year. Even without any further fiscal boost, the Congressional Budget Office believes the Deficit will hit 4.6% of GDP in 2019 at a time when unemployment is approaching 50-year lows.

## US Federal deficits: Republicans vs Democrats




Source: Bloomberg, ING

As the chart below shows, the last time this divergence between a strong economy and weak government finances existed was 1968 when the US was spending nearly 10% of GDP on the Vietnam War – a very different situation to how the US finds itself today. If for whatever reason, growth starts to disappoint, questions about US government debt sustainability may start to adversely affect financial markets and feed into economic sentiment, possibly creating a vicious downward cycle.

## The Federal Deficit and unemployment 1956-2018


Source: Macrobond, CBO, ING

Loss of Republican control of Congress would limit Trump's ability to pass legislation, making further fiscal stimulus such as his $1.5 trillion infrastructure spending plan or changes to the US healthcare system less likely. However, if the Republicans retain control of Congress (both the House and the Senate), then there is scope for further fiscal expansion, which could put an additional strain on the medium- and longer-term government finances.

### 2) What happens to trade policy?

President Trump has been very vocal on trade, calling out what he believes are unfair practices and levying significant tariffs. China has received much of his ire, with a demand to more than half the current bi-lateral deficit of $370 billion, but the EU and Nafta partners are not immune.

The latest round of tariffs on $200bn of Chinese imports, combined with the threat that tariffs could be extended to all Chinese imports, reinforces the message that he will not back down until China changes its position. But this doesn't look its happening anytime soon with China's retaliation measures already coming into force.

> *The Democrats have a history of being more protectionist and may well back President Trump to some degree on his attitude toward China*

Though, after the mid-term elections, pro-trade Republican politicians and corporates, who have been quiet in the lead up to polling, may be prepared to make a more forceful stand against protectionist measures. The President may well listen if there is growing evidence of a negative impact on the economy – so long as he can still portray the result as a "big win". However, Democrats have a history of being more protectionist and may well back the President to some degree on his attitude toward China. They are likely to advocate a softer approach to US allies such as Canada, Mexico and the EU though.

The alternative argument is that Trump instead chooses to double down and implement further protectionist measures. In the near term at least he may feel that a strong economy and buoyant asset prices will act as a backstop to becoming more aggressive on trade and protecting intellectual property. But if concessions are not forthcoming and the trade war intensifies this would risk hurting growth and also equity markets, which he often views as a key barometer of his performance. A weaker economy and falling US household wealth would not stand him in good stead for a defence of his presidency in 2020.

**3) Could the President be impeached?**

This is a topic that is never far from the lips of media commentators. The most plausible scenario is if the investigation of Russian interference in the 2016 election by special Counsel Robert Mueller shows direct and incontrovertible evidence to support impeachment.

*Even with a Republican electoral "win", President Trump would, of course, remain vulnerable to new evidence from the Mueller investigation*

A simple majority in the House in favour of starting proceedings would result in a Senate trial. Given this would require a supermajority of 67 out of 100 Senators who are likely to vote on party lines largely, Trump would survive unless a substantial number of Republican senators turn on him. If the Democrats were to fail to make any gains in the Senate, it would require 18 Republican Senators to cross the floor and vote with the Democrats. This sounds unlikely, especially if they believe President Trump can pardon himself - as he has stated.

Even with a Republican electoral "win", President Trump would, of course, remain vulnerable to new evidence from the Mueller investigation. And the campaign for 2020 will in effect start as soon as the mid-terms end. That suggests political tension will remain high in the US.

## Republicans control both the House and the Senate: Trump Unbound (medium probability)

If the Republicans maintain control of both the House and the Senate, this will be seen as a major victory and would be taken as an explanation of President Trump's current policies. The President would push on with the 'America First' policy-mix, and with another electoral win under his belt could well get stronger support from the Republican party. This may lead to further tax cuts and deregulation, a more hard-line stance on immigration and trade, and a generally a more aggressive approach to politics both at home and abroad.

*Under this scenario, President Trump is likely to push on with the 'America First' policy-mix, and with another electoral win under his belt could well get stronger support from the Republican party*

In the near term, this could provide a renewed boost to equity markets and domestic demand, but concerns will likely increase around the US fiscal deficit, the impact from trade wars, and perhaps around the geopolitical environment and the role America chooses to play. As such we see this as something of a boom-bust story, which risks an increasingly aggressive response from the Federal Reserve in the form of higher interest rates, which could put Fed Chair Jerome Powell on a collision course with the President.

Longer-dated yields will also rise in response to wage gains and higher inflation resulting from stronger growth, while the question of longer-term fiscal sustainability could add further upward pressure. This will be a tricky situation to manage before the inevitable bust when we see longer-dated yields drop on expectations of a policy reversal from the Fed. Likewise, the dollar could strengthen further into 2019 under this scenario. However, investors will become increasingly concerned by growing twin deficits and will be looking to sell dollars at the first signs that the fiscal stimulus is wearing off and the US is left with the baggage of higher deficits. Putting timings on this is difficult, but if the economy holds up until 2020, it may be enough to secure a second term for President Trump.

## Democrats win control of the House but fall short in Senate: Trump tapered (high probability)

In this scenario – which betting markets and pollsters suggest is the most probable outcome - Democrats win control of the House with a modest majority but fall just short in the Senate. President Trump was already somewhat limited by congressional deadlock, but this situation becomes even more challenging for him, and he struggles to pass major legislation. Bi-partisan action may be possible in areas such as infrastructure spending, but for the most part divisions between and within the two parties remain material. Faced with this President Trump focuses on areas executive powers give him more leeway to set the agenda, such as trade policy.

This makes the outlook for trade policy difficult to call. If trade is the only real source of authority the President has, he could continue pushing hard for China to make concessions to get the bi-lateral deficit lower. Given China's response so far, this is unlikely to happen quickly. While trade is not necessarily a critical issue for the Democrats, it is unlikely they will support a trade war with traditional allies like the EU.

Likewise, withdrawal from the WTO is unlikely to get a lot of support from Democrats, so overall Congress is likely to put up more resistance regarding trade policy than it did previously. Our trade team believes that if Trump does attempt to pull out of the WTO, this will be challenged in court by Congress with the decision potentially settled by the Supreme Court.

> *This scenario will probably make things more challenging for President Trump as he'd struggle to pass major legislation. Faced with this, he's likely to focus on areas executive powers give him more leeway to set the agenda, such as trade policy*

Given there is a reduced prospect of additional fiscal expansionary policy in a split Congress, the fears on debt sustainability may subside. We are also likely to hear more Trump criticism of the Federal Reserve if the central bank continues raising interest rates, but given the strong growth environment and with inflation above target we expect the Fed to continue with their “gradual” policy hikes. We think this scenario will be fairly neutral for the economy, but there is the risk of government shutdowns given differences of opinion on government funding.

In terms of financial markets, there is heavy long positioning regarding the US right now even after recent volatility. This means that perceptions of a more limited room for fiscal manoeuvre might trigger some mild profit-taking on the dollar and US equities, but probably not a sharp sell-off. Rest of the World economies do not have particularly compelling growth stories right now and unless Trump surprises by scaling down protectionism it is hard to see a dramatic rotation into overseas asset markets.

If the Democrat-controlled House were to vote in favour of impeachment, there would likely need to be overwhelming evidence from the Robert Mueller investigation to get the required number of Republican Senators to cross the floor and vote to impeach their President. Given this challenge, the Democrat leadership may be reluctant to act quickly, and if they do pull the trigger, there is a strong likelihood Trump would be found not guilty.

## Democrats win control of at least the House: Grand Bargain (low probability)

If the Democrats win control of at least the House, their position will strengthen considerably. One possibility, though an unlikely result, could be that President Trump and his Democratic opponents choose to bury the hatchet and work together. Further fiscal spending (including infrastructure and potentially more tax cuts targeted at lower-income household) is at least in theory appealing to both sides. Compromise on trade (where Democrats are not necessarily opposed to some of Trump’s ideas) is also plausible.

> *This scenario is likely to be positive for the domestic growth story with political risks dramatically scaled back - and little likelihood of impeachment*

Further fiscal loosening with a benign backdrop may also lead to a slightly more aggressive Federal Reserve interest rate tightening cycle. Together with congressional consensus on the pursuit of the trade war with China, this should be a mild positive for US asset markets, but positioning probably restrains bigger moves. Worries about the medium-term fiscal sustainability could come more to the fore too with longer-dated yields pushing higher. Given these compromises, there would be little likelihood of impeachment.

## Democrats win big in the House and Senate: All-out war in D.C. (medium probability)

If the Democrats win big in the House and the Senate, Trump’s legislative position is in tatters as they can block the majority of the President’s agenda. This means complete gridlock, frequent risk of government shutdowns, and an even more volatile political environment ahead of the 2020 presidential campaign, which in effect begins as soon as the mid-terms are over. President Trump would be limited to Executive Powers only.

This scenario is not necessarily negative for growth but could pose major headwinds for risk assets given greater political uncertainty. If Robert Mueller does find evidence of a Russian link, the Democrats may use the resulting political momentum to start impeachment proceedings against the President. A strong Democrat majority in the House would likely vote in favour, but it would still need several Republican Senators to vote against the President to reach the 67 votes required to force him out.

*This scenario could leave President Trump's legislative position in tatters as the Democrats could block the majority of the President's agenda. This might not necessarily be negative for growth but could pose major headwinds for risk assets given greater political uncertainty*

The Federal Reserve may at the margin take a more cautious approach to policy tightening, particularly if the threat of shutdowns and impeachment are realised. Trump would also likely push his executive powers on trade, which may add to the headwinds for growth. However, he would likely be more restricted under this scenario.

Complete gridlock in Washington and a higher risk of government shutdowns and impeachment proceedings argue that the correction in US asset markets is more aggressive than under the Trump-tapered scenario. Impeachment may be more an issue of noise for the dollar (Clinton's impeachment process took over a year before being dismissed), but more impact would be felt were the Fed to acknowledge these headwinds and go slow/re-assess the need for future policy tightening.

An additional point to consider is that if Republicans lose their majority in the Senate as well as the House, Democrats will be able to block Trump's appointments to federal courts or any new cabinet members. Further appointments to the Federal Reserve would also be at risk, though historically Fed appointments have been less of a partisan issue.

## Final thoughts

President Trump has primarily targeted healthcare, taxation and trade in the first half of his Presidential term. January's State of the Union address suggested infrastructure and further tax reform would be the main thrust of the second half. The upcoming mid-terms could easily scupper that plan assuming the Democrats perform as well as pollsters expect.

Our base case is that a split Congress will mean his legislative agenda is curtailed, but not completely blocked though this will require working with the Democrats, such as on infrastructure. Trade policy will remain in focus, but if he can forge a united front with the EU, Canada and other key partners regarding China, there are more likely to be concession he can label a "win" for his stance. Further tax reform is possible, but new initiatives would need to be focused at the lower end of the income distribution to get Congressional support.

This is a relatively benign story for the economy and asset markets. However, the challenges the US economy faces will intensify. The fading support from the fiscal stimulus, the strong dollar and higher interest rates together with growing concerns about the prospects for emerging markets are all likely to weigh on activity. An all-out trade war would compound these problems and risk a downturn in US growth prospects and asset markets. Such a situation would pose even bigger challenges for President Trump if, as most analysts expect, he seeks re-election in 2020.

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# FX markets: Back from the brink?

News from President Trump that a trade deal with China is 'moving along nicely' has seen risk markets rebound and the dollar sell off. Whether this is a ploy to help US equities into the mid-term elections remains to be seen, but clearly, November will be a big month for the dollar

Source: Shutterstock

## A trade deal by the end of November?

Following a phone call with President Xi on Thursday, President Trump has said that a trade deal is moving along nicely and raises (modest) expectations that some kind of bilateral agreement can be reached by the end of November when the two presidents meet at the G20 in Argentina.

It's probably far too early to be shifting base-case views on protectionism – e.g. does Washington merely want to reduce the bilateral trade deficit or does it have more strategic ambitions to slow China's 'Made in China 2025' ambitions? - but the (limited) prospects of a trade deal at the end of November could prove a cushion for risk assets and catch out fund managers overweight cash – largely USD cash.

Today's news has served to drag USD/CNH away from the psychological 7.00 area – a level which had been protected by the People's Bank of China over recent months via: i) making forward Renminbi sales more expensive, ii) closing loopholes for capital outflows and iii) re-introducing greater PBOC control in daily USD/CNY fixings.

Today's market moves will prove a double-edged sword for the Chinese leadership. While some relief from the 'Sell China' market mentality will be welcome, the moves are a demonstration of the power of Washington policy on the world's financial markets.

## 'Sell China' takes a break

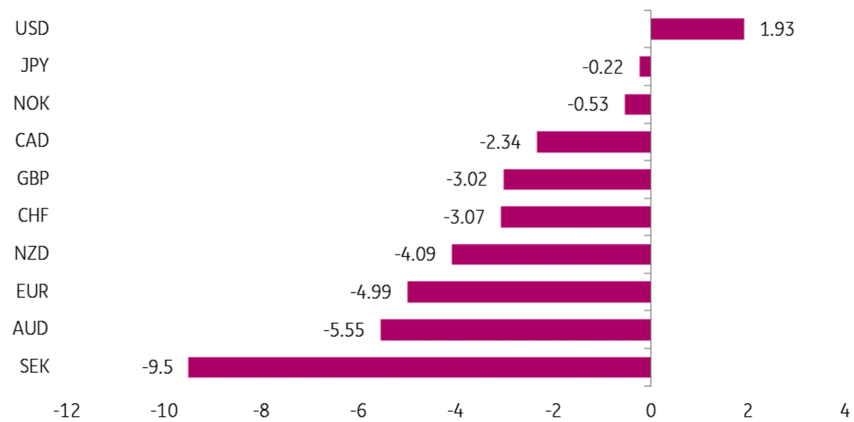

Source: ING, Bloomberg

## Activity currencies enjoy temporary respite

Some re-assessment of Washington's stance on China has allowed activity currencies to recover. The open economies of Europe and Australasia have suffered heavily on this year's protectionism.

The chart below highlights year-to-date performance versus the US dollar in terms of total returns. The Swedish krona has been a big underperformer in the G10 space, while the total return nature of the chart serves as a reminder that USD rates have delivered nearly 2% year-to-date. A similar chart for emerging markets shows significant outperformance of the Mexican peso, largely a function of improving relations with the US and high domestic interest rates.

## Year to Date Total Returns versus USD (%)




Source: Bloomberg

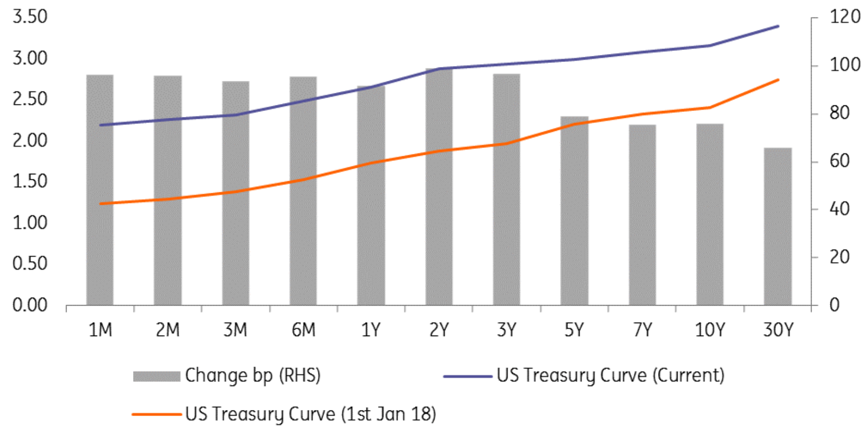
## Hold your horses

But before we get too gung-ho on the demise of the dollar and an aggressive recovery in activity currencies, we've got to remember the US rate story. US rates have risen 75-100 basis points across the US Treasury curve this year and arguably less aggressive US trade policy makes it more likely that the Fed delivers on four more hikes by the end of 2019. That's not particularly good news for EM or activity currencies.

While expectations of a trade deal might provide a little support to risk, we think US mid-terms will also have a big say in the next big trend for the dollar. A Republican loss of the House is the consensus now and a surprise hold in the House would be US dollar/equity/yield positive - so let's see what the mid-terms have to offer.

In short, it looks far too early to declare that the de-synchronised global growth story has run its course for the time being and we suspect the current adjustment in short activity FX/long dollar will be limited. That should mean EUR/USD struggles to break back above the 1.1550/1620 area in November.

## US Treasury Curve: Bear flattening




Source: Bloomberg

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Article | 1 November 2018 United Kingdom

# Brexit blog: Don’t count on the gift of a Christmas deal

Sterling has jumped on reports Brexit talks are inching closer to a conclusion, but the fundamental challenge of getting a deal approved hasn't gone away. Don't rule out Brexit talks stretching into December or even well into the new year, as the UK government tries to focus minds in Parliament

Source: Shutterstock

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

However, we'd caution this remains far from guaranteed, and to understand why it's worth going back to the crucial question in the Brexit debate. That is, will any UK-EU agreement be approved by British MPs?

Despite the latest encouraging news reports, the reality is we are no closer to knowing the answer.

## Theresa May's central challenge

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

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

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

## Plan B: Extend the transition period

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

> *Nobody really knows whether these compromises will be enough to secure the Parliamentary numbers*

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

## A third compromise - evolution clause

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

## The UK Government may play for time

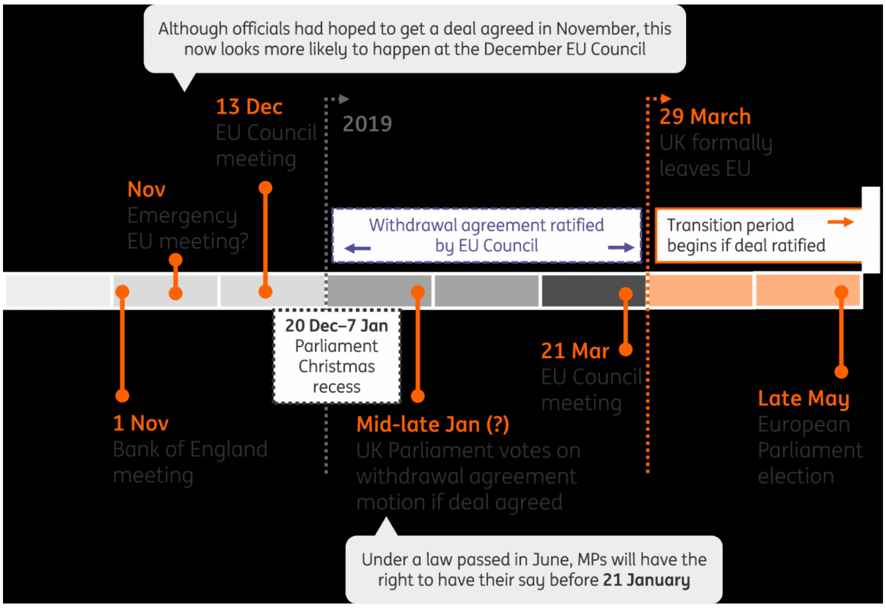
Nobody really knows whether these compromises will be enough to secure the Parliamentary numbers to pass a deal by British lawmakers – particularly given that, whatever fudge is agreed, the legally-binding backstop is still likely to be firmly embedded in the agreement.

But one thing looks increasingly clear. Given the limited scope for negotiators to pull out any more white rabbits, it looks increasingly likely that Prime Minister May will try and play for time.

By pushing back the crunch vote in the House of Commons on the final deal as far as she can, the hope is that this will help to focus Parliamentarians minds and make the vote a much more binary choice between deal and no deal as the time for renegotiation would almost be non-existent.

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

## The key dates with five months left




Source: ING

## The big questions: How 'late' is really 'late'?

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

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

*In principle, the PM is obliged to put any deal to Parliament by 21 January but we certainly wouldn't rule out an agreement much* *closer to the UK's exit date - as the ony real deadline is March 29*

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

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

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Article | 1 November 2018

# China: Yuan set to weaken further next year

President Xi emphasised the economy has been hit by external forces and needs measures to support growth. At the same time, the National Council announced a stimulus package. While the amount has not been disclosed, we estimate it to be CNY9 to 10 trillion. We also weaken our yuan forecasts for 2019

## Xi highlights external forces as drag on economy

President Xi emphasised that external forces have hit the economy, which we believe is a reference to the bilateral trade dispute between China and the US. The nature of the trade war has become clearer over time: as a technology war (the US avoids using China's technology, and avoids technology being transferred to China), an investment war (US imposes penalties on Chinese tech company in the US), and an additional geopolitical element (naval standoff in South China Sea and military sales to Taiwan).

Xi's message implies that the chance of getting a positive result from trade negotiations between China and the US is small. That means that the possibility of the trade war escalating and continuing to drag on the Chinese economy is high.

## Relying on infrastructure, again

This explains why, on the same day as Xi's comment, the National Council announced a stimulus package, most of which comprises infrastructure investment.

Infrastructure should be the fastest way to boost economic growth. We categorise the package into three parts:

1. Hardware investments, which include railway, highway, waterway, airports. This would increase the demand for building materials and labour. So even if the housing market continues to cool, building materials and labour could be diverted to infrastructure construction projects. These projects should have positive cash flow after completion, so the burden on fiscal support should be temporary. This seems to comfort the market in terms of the risk to local government finances.
2. Environmental protection. These projects include water management and pollution controls. We would describe these as the "software of the economy." It is uncertain to us how local governments could generate a future stream of revenue from these projects aimed at a clearer sky and cleaner air. But they are goals worth pursuing anyway.
3. Social benefits in the form of improving rural living standards, medical care and schooling. These again are software of an economy. The benefits are a higher quality future labour force. But it is difficult to measure if local governments will overspend.

## A lot of money needed but how much?

The stimulus package does not mention a monetary amount. We expect that it would be comparable to the 2009 package, but as GDP has more than doubled, the stimulus amount will also increase. We believe the total package will be around CNY 9 to 10 trillion.

The National Council requests that local governments issue bonds to finance the stimulus, and asks banks to lend to these projects. We expect some local governments will once again depend on local government financial vehicles to fund some of the projects. And we expect banks will lend to projects that are operated by state-owned enterprises. We believe that private enterprises may be involved in some of the smaller projects.

This announcement could increase the risk of higher non-performing loans or defaults in the future. But the authorities clearly believe that the more pressing need is for immediate stimulus now.

## Revising yuan weaker in 2019

The government requests a pool of future infrastructure projects. This means the government is prepared to dig in for a longer-term fight in the trade war with the US. This also implies that the Chinese government might depend on investment to support the economy for a longer time.

Our GDP forecasts are still intact as we consider the government's fiscal stimulus sufficient to provide support as trade tension escalates. We project GDP growth at 6.3%YoY in 4Q18, 6.2%YoY in 1H19, and 6.3%YoY in 2H19.

But we do expect USDCNY to continue to weaken if the trade war continues. We are keeping our forecast of USDCNY and USDCNH at 7.0 by end of 2018, but have weakened the yuan pairs to 7.30 by end of 2019 (previously at 6.50).

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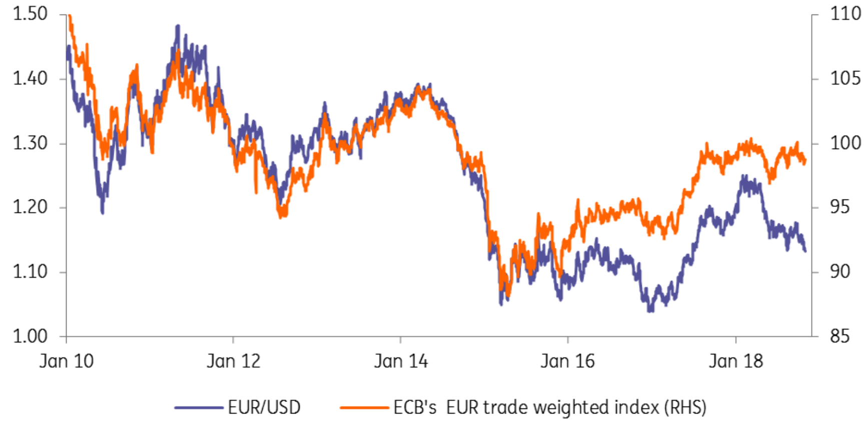
# The euro may need to cheapen a little more

EUR/USD is close to the lows of the year, largely as a result of widespread dollar strength. The EUR trade-weighted index is not far from cyclical highs, largely due to weakness in the Chinese yuan and British pound. Neither investors nor corporates may think the EUR is especially cheap at the moment, suggesting it may need to drop some more


## How weak is the EUR?

While EUR/USD is very close to the lows of the year, the EUR trade-weighted index is not. This is a result of the large weights given to the Chinese Renminbi (23%) and GBP (13%), both of which are suffering on politics and trade concerns. The dollar holds a 17% weighting in the ECB's trade-weighted EUR index, with the divergence of the dollar driving a wedge between EUR/USD and the EUR trade-weighted both in 2016 and 2018.

## EUR/USD weak, EUR trade-weighted less so




Source: ING, Bloomberg

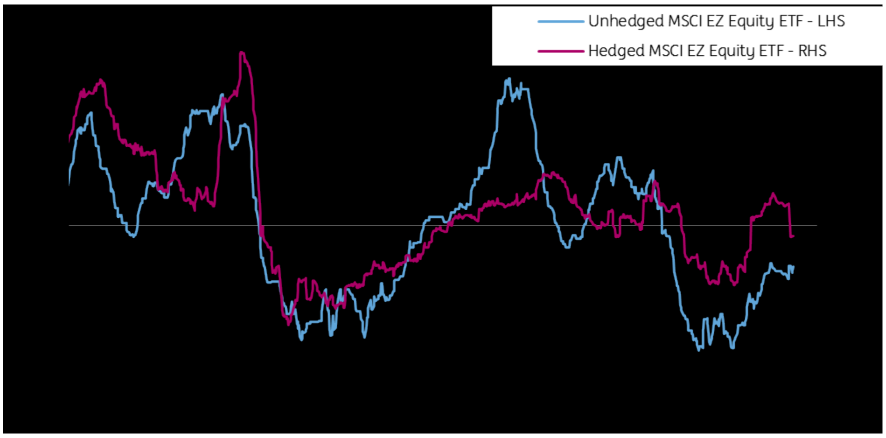
## Eurozone growth disappoints, investors lukewarm

De-synchronised global growth is very much the story of 2018. The US fiscal/monetary policy mix has delivered strong US outperformance, while eurozone growth has disappointed. An important factor in any EUR/USD recovery story will be growth differentials and what they mean for international portfolio flows – particularly equity flows. The US has delivered strong growth in both 2Q and 3Q 2018. The 6 November US mid-term elections will have a say in whether this fiscally-powered growth extends into 2019.

The most recent eurozone growth figures have disappointed, with 3Q18 growth at 0.2% quarter-on-quarter – a far cry from the 0.7% QoQ readings seen since last year. Our team believes that local political uncertainty may be weighing on investment trends, higher oil prices are hitting consumption and the open economy of Europe is suffering, as world trade slows. These trends are showing no signs of slowing.

For investors, the uncertain eurozone growth outlook raises doubts about rotating away from US equities (peak US corporate earnings?) and into Europe. We've updated one of our favourite charts below showing flows into iShares Eurozone Exchange Traded Funds (ETF) – tracking flows into both the non-FX-hedged and the FX-hedged ETF product. Compared to the surge in demand for unhedged eurozone equities last summer, 2018 has only seen lukewarm demand for FX-hedged exposure to eurozone equities – and even that has reversed recently.

## Demand for Eurozone equities wanes




Source: ING, Bloomberg

## European corporates may wait for a weaker EUR/USD

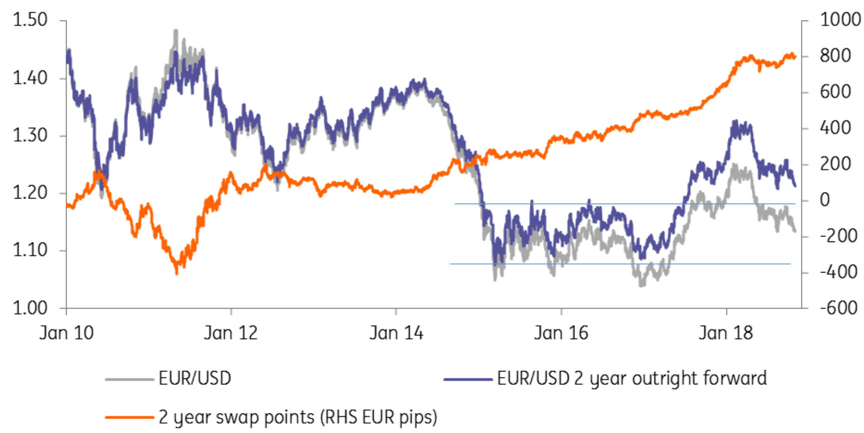
One of the major supporting factors for EUR/USD is the eurozone's large current account surplus, near 4% of GDP. And despite President Trump's protectionist push, tax cuts will only widen, not narrow the US trade deficit – presenting a greater supply of dollars on the trade account.

Near 1.13, EUR/USD also looks historically cheap. But when hedging USD receivables, European corporates take a longer-term view and the shape of the forward curve plays a significant role.

The current interest rate differential between the EUR and USD in the two-year part of the curve has never been wider than it is today at 330 basis points. That converts into 800 EUR pips in the FX forward market, meaning that the two-year outright forward near 1.22 is far more expensive than EUR/USD spot levels would suggest. European corporates in the market to sell their expected USD receivables two years forward (as many do) may not see the EUR/USD as especially cheap compared to the 1.08-1.18 levels that prevailed in the 2015-2017 period.

US mid-terms will have an important say in the dollar story for 2019. But the EUR story does not look especially encouraging right now and we are more worried by a potential break under 1.10 than we are by a move over 1.18.

## EUR/USD not so cheap in the FX forward market




Source: ING, Bloomberg

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# Germany: Merkel Dämmerung

Chancellor Angela Merkel just announced the end of her political career. The next federal elections in the autumn of 2021, at the latest, will mark the end of the Merkel era

Source: Shutterstock

German Chancellor Angela Merkel today announced that she will step down as party chair at the December convention of the CDU. She has been party chair since 2000. At the same press conference, Merkel also announced that she will end her political career at the end of the current term. She explicitly ruled out any personal ambitions for a European top job and would also not run at snap elections, neither would she take a seat in parliament.

## A surprise? Only at first glance

Even though Merkel has never hinted at a fifth term in office, she has never explicitly ruled one out, as she did today. Needless to say that after 18 years as party chair, this announcement is historic, as it marks the end of an era. At the same time, it is perfectly normal that such a long era would eventually come to an end. The decision looks driven by the last two election results but could also very easily be the result of a longer, more strategic, assessment. Normally, the CDU votes its chair every two years. The next party convention would come only half a year ahead of the next federal elections, giving very little time for any Merkel successor to build up a political profile. Even if the decision is a bit forced, as Merkel herself has always stressed that party and government leadership should be in the hands of one single person, it also has some upsides. She still holds the initiative and control over her political departure by giving the party enough time to prepare for the post-Merkel period.

## Succession race has already started

The race for a successor to Merkel at the top of the CDU has already started. This morning, three candidates announced their ambitions:

- Party secretary-general Annegret Kramp-Karrenbauer
- Health minister Jens Spahn
- Former parliamentary leader when Merkel started as party chair, Friedrich Merz.

A new chair of the CDU party will clearly have to lead the discussion on the future strategy of the party. Will they move to the political right again or continue the Merkel strategy of capturing the political centre.

## Unpretentiously pulling the strings

In our view, Merkel's announcement remains less of a risk for the German government than the SPD's losses in the last elections. The CDU has no interest in Merkel stepping down as chancellor or a snap election before any successor has been able to build up a profile. The SPD, however, remains in an existential crisis which could easily lead to the decision to leave the coalition next year.

As historic as today's announcement is, the approaching end of an era also holds the potential for positive developments. Not so much because new is always better but rather because it could give Merkel the freedom and the tailwind- freed from party ties- to put a final stamp on her legacy, possibly with bolder steps to reform the German economy and the monetary union. Three years of a lame duck government would clearly be harmful, not only for Europe but also for Germany. Somehow, the announced end is typical for the entire era Merkel: unpretentiously pulling the strings.

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# Brazil: Fiscal policy in the driver's seat

Election results triggered an improvement in the fiscal outlook that should help extend the rally in local assets. The stronger currency helps the inflation outlook and reduces the central bank's incentive to end, prematurely, the monetary stimulus. We expect the SELIC rate to remain unchanged until the end of 1Q19, at least

Source: Shutterstock

## Monetary policy to react to fiscal policy in the foreseeable future

The most immediate implication of Jair Bolsonaro's election over the weekend has been the improvement in the outlook for fiscal consolidation in the coming years, validating and reinforcing, in our view, the rally in local assets seen over the past month.

The rally in the Brazilian real (BRL), meanwhile, instantly improved the inflation outlook and reduced the central bank's incentive to end, prematurely, the ongoing monetary stimulus. In its latest policy meeting, central bank authorities kept the policy rate on hold at 6.5% but altered the guidance from neutral to hawkish. They indicated that they would be open to considering a "gradual" policy tightening programme, but only if the inflation outlook deteriorated further. That would have been the case, for instance, if the BRL had weakened further due to the political/fiscal uncertainties.

This was not the case. As a result, we expect the central bank (BACEN) to keep the SELIC rate unchanged tonight and acknowledge the somewhat improved inflation outlook. In fact, we now have higher conviction that inflation will stay close to the target and that the SELIC policy rate should remain unchanged, at 6.5%, until the end of 1Q19, at least.

6.5% SELIC rate

monetary policy on hold for now

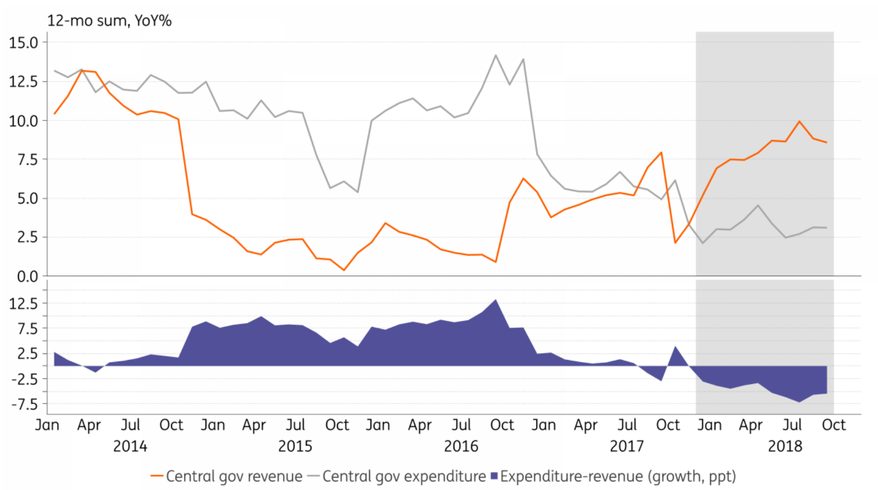
After that, should the approval of the fiscal austerity agenda fail to gain traction in Congress, local assets should suffer, hurting the outlook for inflation and ultimately forcing the central bank to react accordingly, raising rates.

In other words, without concrete confidence-boosting progress in the social security reform by early 2Q19, the BRL should weaken, worsening the inflation outlook and likely triggering the start of a monetary tightening process.

Alternatively, credible progress in the fiscal consolidation front would support local assets and allow the central bank to keep the monetary stimulus in place for an extended period of time

## Fiscal tightening has already started

Fiscal policy has already turned markedly tighter over the past year, with fiscal expenditure rising at a much slower pace than fiscal revenue. As the chart below shows, after two years of massive fiscal expansion (2015-16), fiscal policy turned more neutral last year and only now has turned decidedly contractionary.




Source: ING, Macrobond

And should fiscal tightening continue, or even deepen, under Bolsonaro, it could pave the way for monetary policy to stay expansionary for at least a couple more years, without the risk of turning the policy mix excessively expansionary.

Apart from the "help" from fiscal policy, our dovish monetary policy outlook reflects the fact that, given Brazil's stage in the business cycle, imbalances such as high inflation and/or excessive current account deficits, are unlikely to resurface any time soon.

Brazil's output gap is unlikely to close for quite some time, while the outsized spare capacity, in terms of labour and capital utilisation, suggests that demand-side price pressures should remain soft for an extended period of time.

As for the external accounts, with the current account deficit trending at less than 1% of GDP, there's much room for the deficit to rise, especially in the context of a favourable outlook for financial FX inflows, which would be the case if Bolsonaro succeeds in re-anchoring fiscal accounts, reigniting investor optimism that Brazil is finally on track to recover its lost investment grade.

## Rally in local rates could endure

Local rates have rallied substantially over the past month, in line with the rally in the Brazilian real and the reduction in sovereign's risk premium. But, if the pro-reform scenario is realised, there's considerable room for the rally to extend much further, given that the local curve is still pricing a 3.5 percentage point increase in the SELIC rate, from 6.5%, until the end 2020.

The near-term inflation outlook has improved, with the recent announcement of a cut in electricity prices in November (due to improved hydrology) and the stronger currency, while longer-term inflation expectations remain fully anchored. But, ultimately, the outlook for local rates depends chiefly on the success, or failure, of Bolsonaro to deliver the fiscal adjustment he and his economic advisor have advocated.

As we've said before, it's still too soon to say whether Bolsonaro will be able to re-anchor Brazil's fiscal accounts, but the signs have been encouraging. Bolsonaro's ability to negotiate with Congress is untested, so we would be especially reassured if the new administration is able to garner enough support to approve an important piece of legislation already this year, during the transition period.

The social security reform proposed by President Temer and the central bank's independence appear to be under consideration for an immediate Lower House vote, while a pending auction of oil exploration rights ("cessão onerosa") could be approved by the Senate.

Informal polls with newly-elected congressmen also suggest that resistance to social security reform has fallen sharply, while the opposition is not large enough to block its approval.

More importantly, the new administration appears to understand the urgency and the stakes involved in the approval of this reform, which is a pre-condition for fiscal sustainability and the economic recovery. Failure to approve it would inevitably create enough uncertainty and financial market instability to threaten governability and the administration's own survival. It may not be a smooth process, but Bolsonaro should eventually be able to persuade hesitant but, in principle, swayable Congressmen to support his legislative agenda.

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Article | 1 November 2018

# Coal: The market awaits China

Thermal coal prices have surprised the market once again this year, with stronger imports from China proving supportive for the seaborne market. Chinese policy will be key for how prices evolve over the winter

Source: Shutterstock

## What will China do next?

China remains key to the seaborne coal market, and government policy is clearly going to dictate price direction as we move deeper into winter.

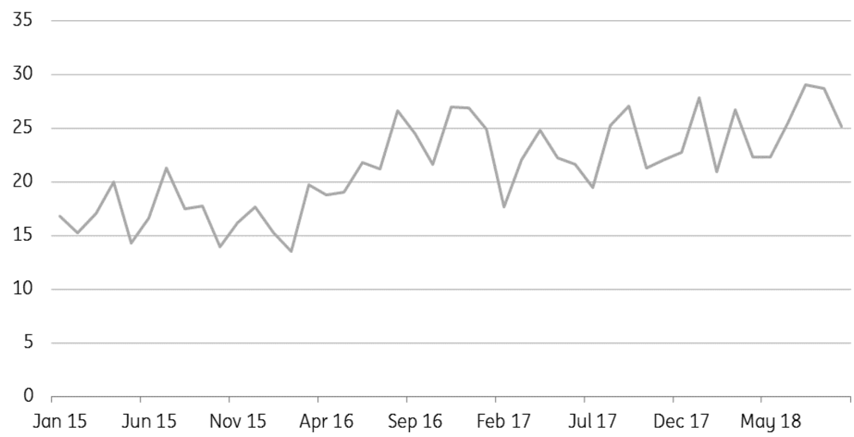
Chinese coal imports over the first 9 months of this year totalled 228mt, up 11% YoY, and these stronger imports have offered support to the market for much of the year. This has particularly been the case for higher calorific coal, with the spread between Newcastle 6,000 kcal/kg and 5,500kcal/kg coal widening to US$44/t, from around US$25/t at the start of the year.

However, port restrictions have meant that the seaborne market has edged lower recently from levels seen earlier in the year. The Chinese government has been keen to keep domestic coal prices within a range of CNY500-570/t. However, they have failed to do this for much of the year- at the moment prices are trading around CNY648/t. The government will take comfort in the fact that domestic prices have trended lower since early October, but this could change as we enter peak demand. This does leave many questioning whether the Chinese government would take any action to bring prices lower. If the government wants a weaker domestic market, one solution would be to relax import restrictions, which would obviously be constructive for the seaborne market. For now, the government says it will not relax current restrictions.

Looking at domestic supply, it has struggled to grow by any significant amount this year. Domestic output over the first 9 months of the year totalled 2.59b tonnes, just 2.91m tonnes more than the same period in the previous year. China's National Energy Administration is targeting coal production of 3.7b tonnes over 2018, up 4% YoY. But based on current production trends, the country will fall short of this target. Meanwhile, according to SteelHome, thermal coal port inventories in China have declined in recent weeks, falling from 22.85m tonnes towards the end of September to 18.61m tonnes as of the end of October. In fact, port stocks have fallen to their lowest level since early June.

How tight the coal market will be over the winter will largely depend on seasonal demand but for now, China' s National Climate Center is forecasting a warmer winter over most parts of the country. Furthermore, the National Development and Reform Commission (NDRC) believes that while the domestic LNG balance will be tight this winter, there should be adequate supply for residential use. However, if we do see a repeat of last year, where LNG supplies were not sufficient, expect increased volatility in seaborne coal prices.

## Chinese coal imports (m tonnes)




Source: China Customs

## The European carbon effect... well not just yet

In Europe, coal prices have been supported by a buoyant energy complex. Initial strength would have come from the Asian market, but stronger cooling demand over the European summer has been supportive for API2, which has seen the Newcastle/API2 spread narrowing from US$23/t in early August to a little over US$6/t currently.

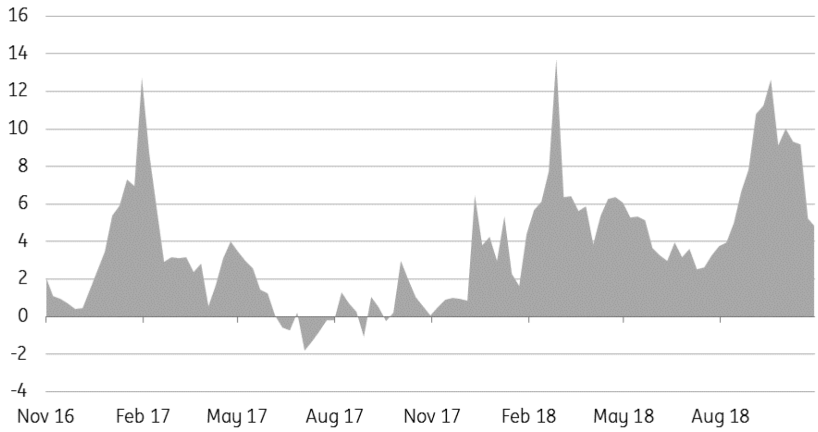
European natural gas prices also rallied strongly over the summer, on the back of strong demand and restocking, offering further support to the coal market. Natural gas injections over the summer totalled 735TWh, compared to a 5 year average of 564TWh, helping to push stocks back above the 5-year average.

Looking ahead, coal prices may find some short-term strength, with inland buyers starting to restock, with water levels on the Rhine starting to rise once again. Low water levels over the summer restricted barge movements along the river.

A factor that may be an obstacle for stronger European coal prices in the longer term, is the general strength that we have seen in European carbon prices. Carbon prices traded to a high of

€25.2/t in early September, from just over €8/t at the start of the year. Although more recently prices have fallen back below €16/t. This general strength has certainly pushed up power generation costs. But for now Dutch clean dark spreads are still relatively more attractive than clean spark spreads, further strength in carbon prices will need to be seen in order to drive a change.  Assuming constant feedstock prices, carbon prices will need to trade up towards €30/t to make gas power generation relatively more attractive than coal power generation.

## Dutch clean dark-spark spread narrows (EUR/MWh)



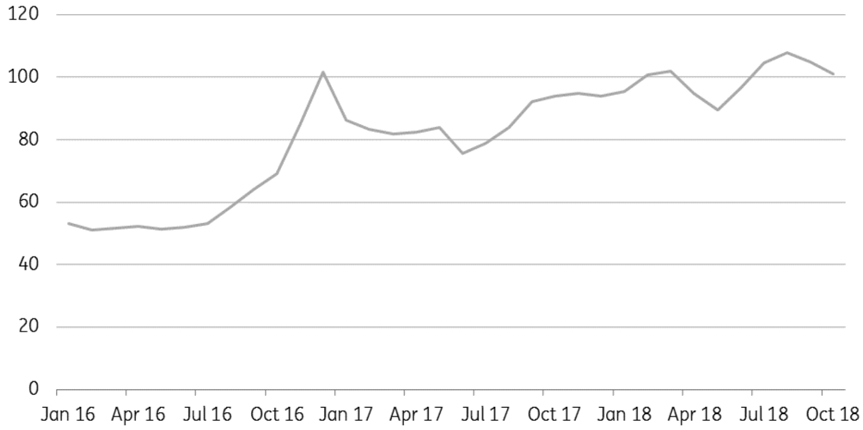

Source: Bloomberg, ING Research

## Indonesia keen to shift supply

The Indonesian Rupiah has struggled this year, much like other emerging market currencies, depreciating by almost 15% since late January.  As a result, the government is keen to rein in a growing current account deficit. While part of this is through increasing import duties on a number of goods, the government is also keen to increase exports, and coal is one obvious avenue that the government will focus on. Indonesian coal prices are at relatively attractive levels for buyers, with the Indonesian reference price currently at just under US$101/t, compared to the Newcastle benchmark, which is trading at around US$108/t. The discount for Indonesian coal has been as wide as US$20/t at stages through the year, which should prove supportive for demand.

Indonesia sets production targets every year, and recently the government increased their target from 485mt to 507mt. However given that production over the first three quarters of the year totalled 319mt, and there are reports of miners struggling to get hold of equipment, it may be quite a challenge for miners to reach this production target for 2018.

## Indonesian coal reference price HBA marker (US$/t)




Source: Bloomberg, ING Research

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# Above-potential growth in the Netherlands: The Dutch Economy Chart Book

A solid domestic foundation supports above-potential growth for the Dutch economy. Overnight deposits offer room for consumer spending, production capacity is becoming an issue while the recent house-price increase is not credit-driven


Shoppers in Amsterdam

This and more is shown in the ING Dutch Economy Chart Book, which provides an overview of the most important developments in the Dutch economy in more than 100 charts.

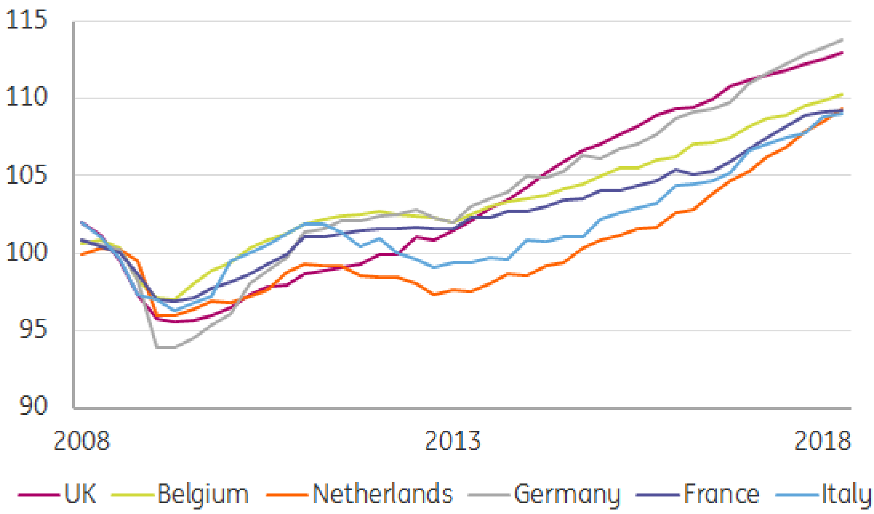
## Catch up underway in GDP development

The aftermath of the global financial crisis has been deeper and longer for the Netherlands than for a number of other European economies. The Dutch economy experienced a second considerable dip in 2012-2013, one which was avoided by most of its neighbours. Dutch private consumption performed especially poorly in international comparisons because of the (deeper) housing market crisis, adherence to a funded pension system and a larger austerity operation. In recent years, however, the Dutch economy turned from a growth laggard into a growth leader, making up much of the lost ground in terms of GDP development since 2008. Even though the Dutch economy is not immune to global tensions and weakening optimism, we expect that Dutch GDP figures will continue to stay higher than the Eurozone growth rate in the quarters ahead.

Read our latest forecast for the Netherlands in the Eurozone Quarterly here

## After years of lagging behind in GDP-development, the Netherlands is catching up

Gross domestic product, constant prices, index 2008 = 100



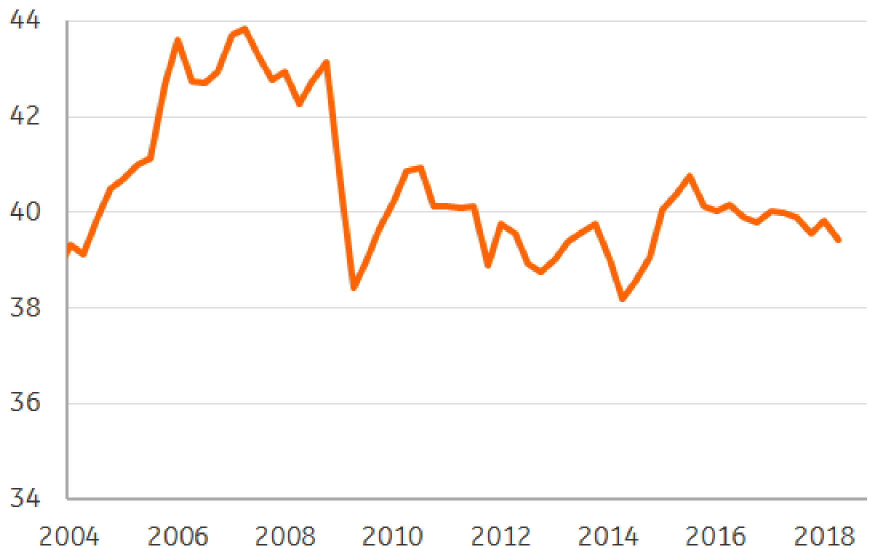

Source: Eurostat via Macrobond

## Profitability of non-financial corporations stagnating

While total (gross) profits of non-financial corporations measured in euros are currently at record levels, the picture changes once profits are presented relative to the size of the economy. It then appears that while the gross operating surplus as a percentage of gross value added is higher than during the crisis, it is nowhere near the level of 2006-2008. In fact, the profitability of non-financial corporations is stagnating. While the labour market shows increasing signs of tightening and stronger wage increases are expected, the mediocre profitability performance limits the room for wages to make a huge jump.

## Profitability stagnating

Gross operating surplus as percentage of gross value added of non-financial corporations (excluding small unincorporated businesses) at basic prices, seasonally-adjusted



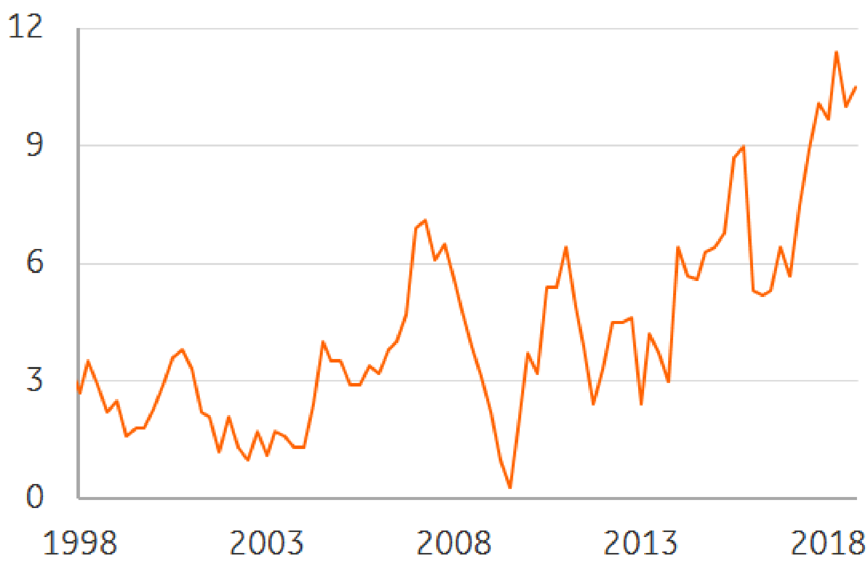

Source: Statistics Netherlands

## Capacity increasingly becomes an issue

The Dutch economy has shown seventeen consecutive quarters of growth, which is increasingly translating into more scarcity. The share of firms in industry reporting shortages of materials and/or equipment as an important factor limiting current production has increased sharply. For that reason, investment projections still remain quite upbeat.

## Equipment and materials more scarce

Percentage of industrial firms reporting a shortage of materials and/or equipment as a main factor limiting production (seasonally adjusted)



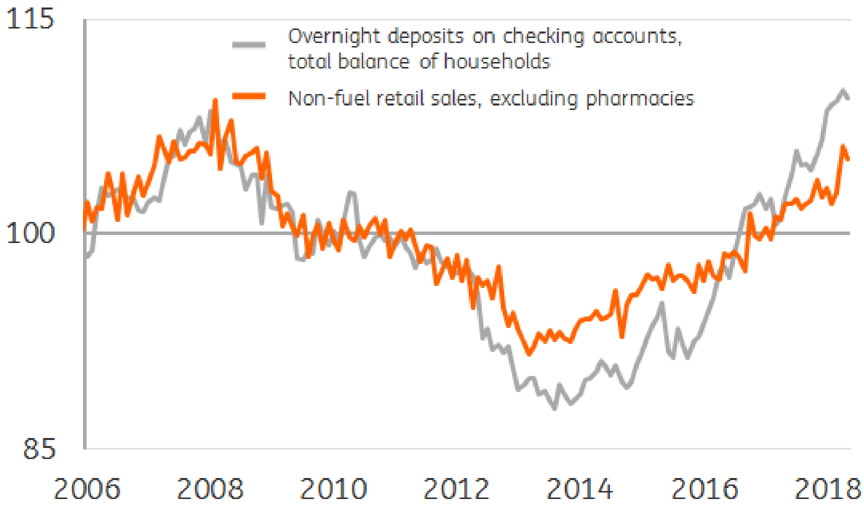

Source: DG ECFIN via Macrobond

## Overnight deposits offer room for consumer spending

The amounts of overnight deposits on checking accounts of households are at record highs. Higher deposits often go together with higher retail sales' volumes (excluding fuel and pharmacies). This indicates that consumer spending will continue to rise in the period ahead. For many years private consumption had been the weakness of the Dutch economy.

## Overnight deposits offer room for consumer spending

CPI inflation-adjusted index of overnight deposit balance of households and volume index for retail sales, both 2010=100 and seasonally adjusted




Source: DNB and Eurostat via Macrobond

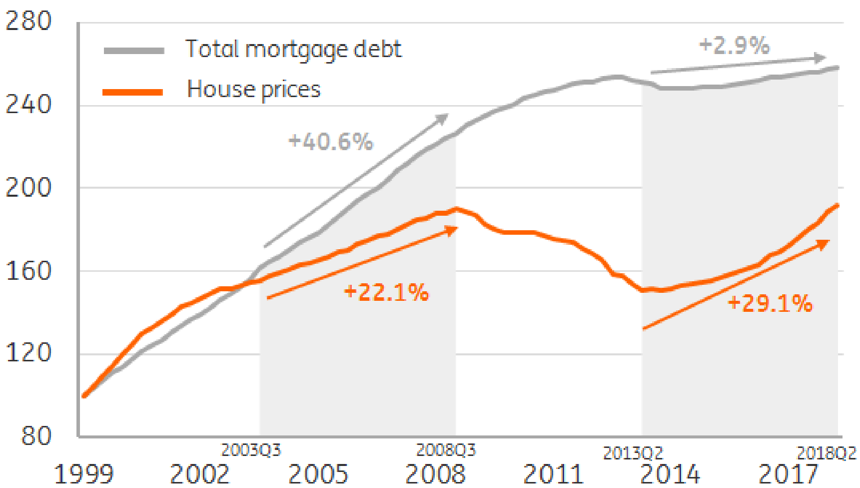
## Current house price increase not credit-driven

In the period prior to the global financial crisis, house prices rose fast. This was fuelled by an even stronger growth in mortgage debt. In the past few years, house prices have again shown a sharp increase, but without an accompanying credit boom. Policy measures introduced after the start of the global financial crisis, such as a lowering of the maximum LTV-ratio and a reduction of the extent of mortgage interest rate deductibility, have curtailed mortgage debt growth, while the share of investors buying homes with equity has increased strongly.

Read here about the highlights of the Dutch government budget for 2019

## Previous sharp increase in house prices was credit-fuelled, this time mortgage debt barely increased

Mortgage debt stock and house prices, index, 1999 =100




Source: Statistics Netherlands

## Conclusion: solid domestic foundation for growth

"*The Dutch Economy Chart Book shows a solid domestic foundation for continuing above-potential growth for the Netherlands*," according to Marcel Klok, macro-economist at ING Economic Research. "A*ccordingly, we are forecasting strong economic growth for this (2.9%) year and next (2.4%) year, which like in 2017 is driven by growth in almost all industries. Obviously, there is a number of risks looming outside the Netherlands, such as a hard Brexit, a debt crisis in Italy and an escalating trade war. In fact, the Q3 GDP figure for the Eurozone of 0.2% was already below our expectations. However, we expect growth in the Netherlands to outperform the Eurozone in the near term. We are looking forward to the 3Q figures for the Netherlands, which will be released in two weeks time.*"

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## Disclaimer