

The Covid-19 crisis: Finally, some good news

'Stupendous', 'joyous', 'stunning' - Donald Trump can't quite believe the latest US jobs numbers and our man in New York nearly fell off his chair when the NFPs came in. But the week was dominated by more crisis help from the ECB and increasing concerns for Europe's periphery. We also look at the prospects for the US election and, er, Brexit's back

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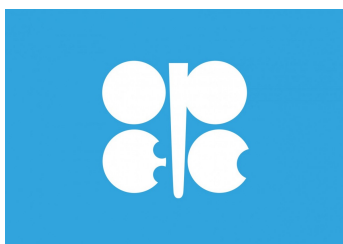
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US: Jobs - simply astonishing

Somehow the US jobs market has come back from the brink with employment surging 2.509 million despite none of the labour demand surveys suggesting this was remotely possible



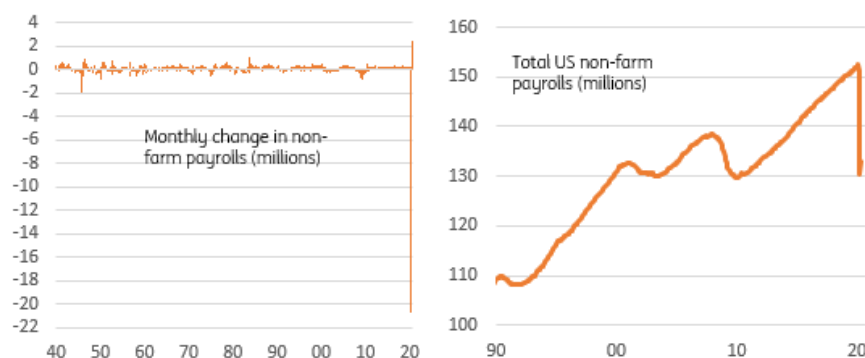
2.509mn Number of net jobs created in May

The biggest data surprise in history?

Apologies - this has taken a little longer to write having just fallen off my chair and broken it. US non-farm payrolls have risen 2.509mn in May versus a consensus estimate of a 7.5 million fall. This was so far away from what anyone was expecting. It is simply astonishing given the slow pace of reopening and the fact that more than 12 million people filed a new unemployment claim during the survey period. The ADP payrolls survey had come in stronger than expected, but even that still had a payrolls decline of 2.76mn so this is one of the biggest economic data shocks in history, if not the biggest.

The details show private payrolls rose 3.09mn with a 1.239mn increase in leisure/hospitality, a 368,000 increase in retail, a 464,000 increase in construction and a 225,000 increase in manufacturing. The only sector to experience a fall was in government (-585,000).

US non-farm payrolls



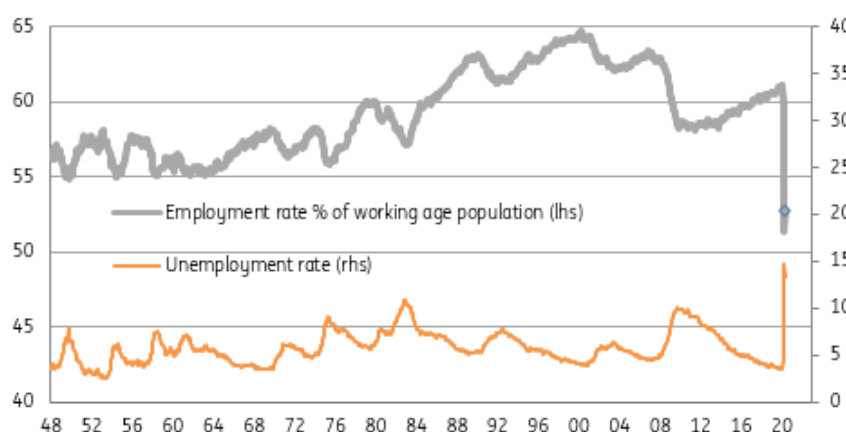
Source: Macrobond, ING

Unemployment down to 13.3%

The household survey, which is used to calculate the unemployment rate, was even stronger. It reported those saying they were employed as rising by 3.839 million, but there are some oddities in here given unemployment fell only 2.09mn so new workers appear to have been magicked up out of no-where. The response rate was well down on usual levels so this could be adding to the sense of confusion as well as how people self identify in the range of responses available to them in the survey. Either way, the unemployment rate has fallen to 13.3% from 14.7% and the proportion of 16-65 year-olds in work has risen to 52.8%.

Rounding out the numbers we have average hourly earnings falling 1%, which again reflects the distortions when you don't mix-adjust the data. Millions of relatively low-paid people now earning a wage will automatically drag down the average hourly earnings rate so this number should be ignored.

Unemployment and employment ratios



Source: Macrobond, ING

The recovery could get bumpier

There will naturally be some doubt lingering about these figures given they are telling such a

different story to all other data on the labour market, but these are the official ones and on the face of it are fantastic. It suggests the American economy can bounce back very vigorously and we all need to massively revise up our economic projections.

The rebound in hiring should continue, particularly as consumer-orientated retail and hospitality-related industries continue to reopen. Nonetheless, caution is still warranted. Most restaurants and retailers are unlikely to need as many staff as they had before the pandemic hit given social distancing limiting customer numbers at any given time. Many businesses may simply take the view that it isn't economically viable for them to open at this stage and remain closed, particularly in big cities where office blocks will remain shut for some time to come and there isn't a flow of customers.

Furthermore, given the downturn in global economic activity, many manufacturing and professional service firms may also not need as many staff as they face up to the new economic environment of weaker corporate profits and higher debt levels. We also have to remember that even after today's great numbers, US employment is still 19.55mn lower than it was in February. We still have a long way to go...

Author

James Knightley

Chief International Economist, US

james.knightley@ing.com

US Politics Watch: Biden – His Time?

The Covid-19 pandemic, and protests over the police killing of George Floyd, have transformed the political and economic landscape in the US. In our latest update, we have again teamed up with Oxford Analytica to examine how the turmoil could influence the presidential election in November



Coronavirus damages President Trump's election hopes

The coronavirus pandemic has transformed the political landscape in the US. President Trump, who has long portrayed the strength of the economy and stock market as his signature success is now challenged by an unprecedented economic downturn. The highly polarised criticism of his handling of the crisis has been given a dramatic twist by his response to the violent protests over the police killing of George Floyd in Minneapolis. As a result, Trump has failed to enjoy the bounce in popularity experienced by other global leaders.

For now, Joe Biden, who is on course to be confirmed the Democratic Party nominee, is well ahead in the polls for November's election, and the Democrats are hopeful of securing control of the Senate as well as the House of Representatives.

The US economy is in a huge recession, with nearly 40 million Americans having already lost their job. Washington has responded to the Covid-19 crisis with a series of rescue packages

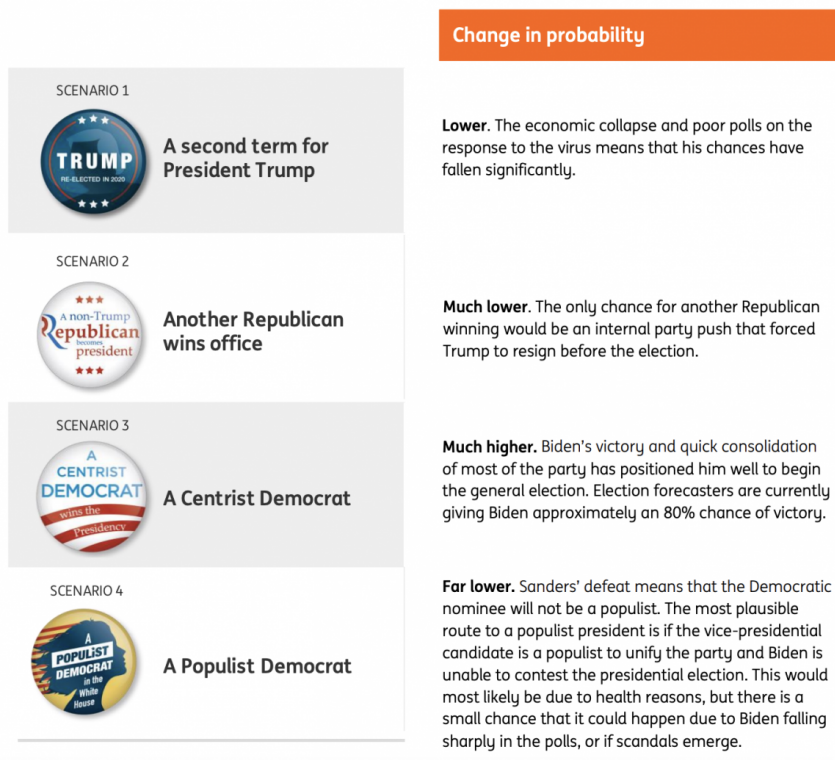
and stimulus bills, but more will be necessary. Most state and municipal governments' fiscal years end in June, which may lead to another round of layoffs of police, firefighters and teachers, thus driving the unemployment rate even higher.

So it is clear that the pandemic has had a dramatic effect on the probabilities for the four scenarios of the 2020 election that we outlined in our foundation report in April 2019 '[US politics watch: Four scenarios for 2020](#)'. For now, it appears that Biden is ahead in a two-horse race for the White House. Nevertheless, uncertainties about the evolution of the pandemic and its economic and social consequences will cloud the campaign, so it would be premature to call the outcome. Given the sharp differences between the Biden and Trump policy agendas, this is shaping up to be the most consequential election in decades.

Impact of the coronavirus on the 2020 election scenarios

The rapid move from it being an unclear Democratic choice to Biden being Trump's challenger affects the four election scenarios outlined in our initial report published in April 2019 '[Politics watch: Four scenarios for America's next presidential election](#)', in the September update '[US politics: Trump weathers the storms](#)' and in the December update '[US politics watch: Impeachment deepens the divide](#)'. We now have greatly reduced the chances of a progressive Democrat and another Republican nominee, as President Donald Trump has been winning the perfunctory Republican nominating contests.

Impacts of the primary on different 2020 scenarios



Source: Oxford Analytica

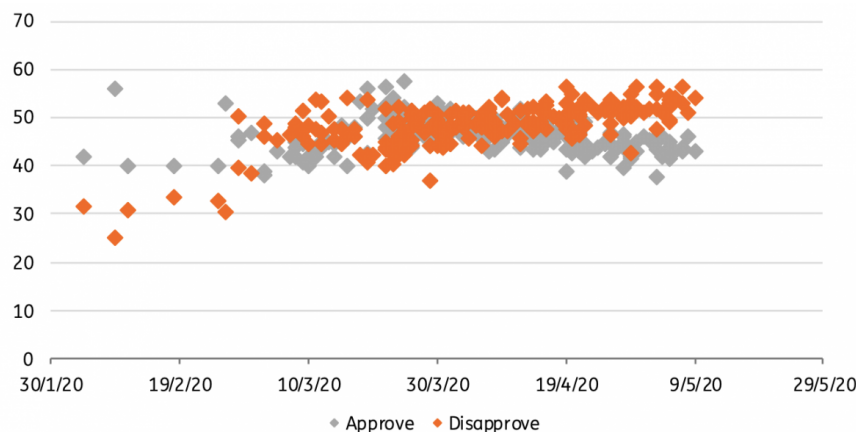
Trump's approval bounce fades

Presidential approval ratings are one of the most direct proxies for assessing the likelihood for re-election. Trump benefited from a 'rally-round-the-flag' effect at the start of the coronavirus crisis. His approval ratings spiked to 45% in early April, higher than it had been since his first month in office. However, it just as quickly dropped. It is now below 43%, a little higher than the 40-42% range seen throughout most of 2019. However, these differences could be viewed within the margin of polling error: Trump's bounce was small, and his decline has been equally small. Furthermore, his core support remains solid. This suggests that, so far, the coronavirus has had little impact on the president's approval ratings. But while his ratings have scarcely changed in 2020, they might yet do so.

On the question of Trump's handling of the coronavirus crisis, the public has moved towards disapproval. Although the data is noisy, there is a clear trend towards greater disapproval since early April.

Trump might yet recover his approval ratings position in the event of a rapid turnaround in federal performance on Covid-19. However, there is another scenario in which other countries around the world begin to reopen their economies and recover while US deaths still rise – particularly given Trump's clear desire to press ahead with an aggressive reopening of the economy despite the reservations of his health experts. There is no precedent for how the public would interpret these facts, but with more than 100,000 deaths, while countries like Italy, Germany and South Korea have almost fully suppressed the virus, it will be difficult to spin this as a story of federal success.

Fig 1: COVID-19 approval ratings



Source: Polling data

This uncertainty makes it all the more likely that Trump will try to make the election a referendum on Biden and to deflect blame for the economic and human cost of Covid-19 onto China.

Trump will seek to paint Biden as an extremist, unreliable, or personally unfit for the presidency. These attacks have already included his eldest son, Donald Trump, Jr. "jokingly" accusing Biden of being a paedophile on social media. The president himself has repeatedly called Biden "Sleepy Joe", while Trump campaign Facebook ads accuse Biden of senility.

Biden investigation

President Trump will look to benefit from likely Congressional and media investigations of Biden himself. The process that culminated in the impeachment vote in February was spurred by President Trump asking Ukraine to investigate a company which had paid Biden's son to sit on its board.

With Trump acquitted by the Senate, many of those who testified at the hearings have been dismissed from their posts and Senator Ron Johnson, Republican of Wisconsin, is pushing for a vote to subpoena Hunter Biden. Even Senator Mitt Romney, the only Republican to vote for impeachment, has signalled his support for investigating Hunter Biden.

This could serve as a constant drag on the Biden campaign, in the same way that Hillary Clinton's emails dominated coverage of her in 2016. A similar story is one of sexual harassment from former staffer Tara Reade. Whilst the story has been neither proved nor disproved, news coverage has begun to mimic the Clinton email story, with meta-coverage (ie, stories about "how it will play" rather than the facts of the case) appearing in major newspaper editorials.

This election may also revolve around China. Trump has blamed China for Covid-19 and a White House advisor falsely accused Hunter Biden of taking a billion dollars from China. Biden's campaign has released ads quoting Trump's comments from earlier in the year praising Xi Jinping. While the tactic may not move many voters, it will ensure that the coronavirus is at the centre of the election debates.

The widespread protests over the police killing of George Floyd have coincided with the continued decline of his approval ratings. Trump may continue to rely on a law and order message that tends to support conservative parties. He may look to emulate the success of Richard Nixon in his presidential campaign in 1968. However, unlike Nixon, Trump is the incumbent, so this will be harder to pull off. He also has little or no credibility with those groups protesting, which means that mayors, governors and cultural figures will be the voices of restraint.

He faces pressure to formulate a communications strategy that avoids dealing with the specifics of each city's protests. This will be difficult to achieve, given the sensitivity of the issues involved. The greater use of law enforcement may be inevitable and inflammatory, leading to protests continuing throughout the summer. If Trump is seen to mishandle the situation and delays a meaningful reconciliatory response, it will damage his chances.

President Trump's first national broadcast on the issue occurred at the same time as Attorney General Bill Barr ordered the tear gassing of peaceful protestors, an act which has already triggered Congressional calls for investigation. Regardless of the outcome, investigations in Congress through the summer will keep the images of peaceful protestors being attacked on television screens.

Trade War 2.0

If President Trump's polling shows no sign of turning soon, he may feel he needs to revert to being

“Tariff man”. Given his fury over what he has termed the “China virus” he may decide to carry through with threats to rip up the US-China trade deal signed only in January on the pretense that China has not fulfilled its commitment to its obligations.

If President Trump is to embrace tariffs it would need to include a sense of injustice about China’s behaviour rather than merely “they didn’t spend as much on soya as they said they would” since the US’s trade deficit with China has declined rapidly. Therefore, intelligence (including from international allies) would likely be used to lay the blame for the spread of Covid-19 on China.

Such a decision would likely see equities fall sharply, the dollar surge and the economic outlook darken as business costs are increased and supply chains further disrupted at a time of already huge economic upheaval. Remember, it is US businesses and households that actually pay the tariffs, and US exporters would also be fearful of retaliatory tariffs from China.

It is possible that internationally-exposed corporate America is much more critical of such a stance this time given the not insignificant probability that Trump will lose his bid for re-election. Business may be more willing to fight its corner if Biden has a decent lead and the president’s actions help reinforce a narrative that “it’s all about Trump” and his re-election rather than the best interests of the American people. As such, this could be interpreted as a last throw of the dice to try and swing the election in his favour.

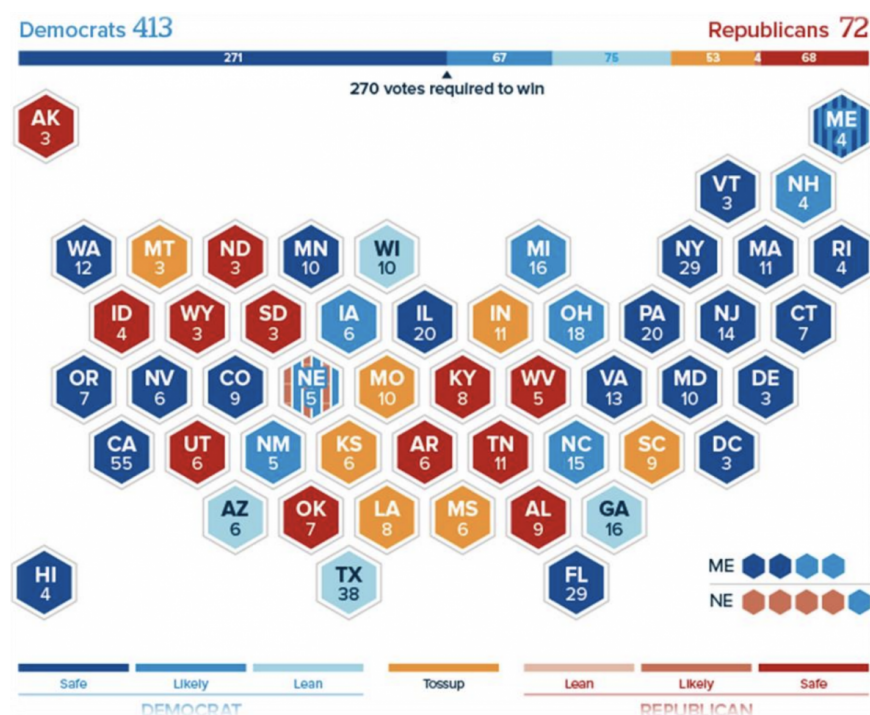
That is not to say Biden would be necessarily “softer” on China, but he is more likely to operate within the international framework and work with partners rather than declare unilateral tariffs.

A recession with unprecedented impact

An election-year recession normally damages an incumbent president’s prospects of re-election. Prior to the economic crisis of 2020, Trump himself proclaimed that a buoyant equity market and record low unemployment rates are the true barometers of his success. However, the coronavirus shock is so sudden and so steep, and the American electorate so polarised, that it is difficult to model the effects.

We can use a simple linear model based on presidential approval ratings and economic growth in the second quarter of the year to forecast the election winner. Under the case of a 20% annualised economic decline, Biden would win 413 Electoral College votes to 72 for Trump (with 53 in the ‘toss-up’ category) (Figure 2). However, when talking about a base case of 40% annualised economic contraction, or of any comparably precipitous drop, a linear model is not suitable. While the effects are large, the question is one of scale, and to what extent negative partisanship will buoy Trump’s chances.

Fig 2: Electoral college



Source: <https://www.270towin.com/maps/7DVPb>

The economic ramifications are also dependent on the duration of the decline in output and the impact on employment. If there is a rapid bounce back in the third quarter, Trump may be able to use the rebound to point to conditions improving. This would be similar to the way that President Ronald Reagan used a falling unemployment rate in 1984, despite it being still high, as a signal that he was succeeding in office.

However, the combination of ongoing social distancing measures, travel restrictions, consumer anxiety concerning the virus and the legacy of nearly 40 million Americans out of work suggests this will be a challenge to achieve. Remember, it took the US economy 14 quarters to recover the 4% lost output following the Global Financial Crisis. Despite the unprecedentedly large fiscal and monetary responses to the current crisis, a recovery of the 13% loss of output that we expect as a result of the Covid-19 containment measures, is likely to take much longer.

Trump needs to support the states

In this context, the significance of the pandemic’s impact on state and municipal finance is especially great. The timetable matters given that most governments’ fiscal years end in the summer and that 49 out of 50 US states operate under various forms of balanced-budget requirements or understandings, almost all municipal governments are unable to run deficits, and for all governments below the federal level running deficits is a practical impossibility. Moreover, such governments’ ‘rainy day funds’ – reserve pools which they can tap as needed – are small, comprising only about 11% of annual operating costs.

This combination of circumstances means that states and cities are preparing for large budget cuts for FY21. California alone is facing a 54 billion-dollar budget deficit, which is 3.5 times larger than its rainy day fund. Of that 54 billion dollars, 41 billion is accounted for by reduced revenues from the

economic downturn; the remainder flows from Covid-related expenditures.

During the Great Recession and in the years afterwards, state and local governments were a net drag on the economy. Unless the federal government offers states and local governments a major rescue package, we can expect to see the same result in 2020. While a major stimulus package to states and cities would not necessarily save Trump's re-election chances, it would likely be a necessary precursor.

Can the Democrats win the Senate?

If economic and Covid-19 concerns contribute to a sharp downward slide in Trump's approval ratings, which we would ordinarily expect given the historical correlation between presidential approval and economic conditions, this should worry Republican candidates in Senate elections. Even a small drop in presidential approval ratings would be enough to bring seven Republican Senate seats into play. Democrats likely need to flip four seats (or to win three and hold on to Alabama) to take control of the Senate.

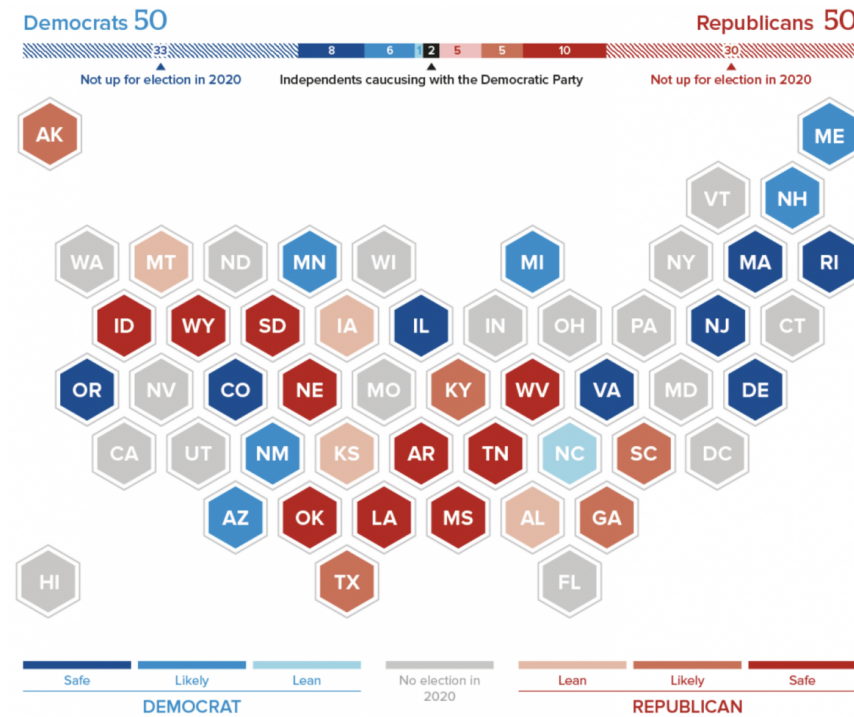
Fig 3: Senate seats

State	Incumbent	Cook Rating	Trump net approval rating (February 2020)
Alabama	Democrat	Lean Republican	28
Arizona	Republican	Toss-up	1
Colorado	Republican	Toss-up	-13
Iowa	Republican	Likely Republican	-5
Kansas	Republican	Lean Republican	4
Maine	Republican	Toss-up	-6
Montana	Republican	Lean Republican	6
North Carolina	Republican	Toss-up	4

Source: Oxford Analytica, various sources

Based on current projections, the map in Figure 4 is the likeliest path to a Democratic-controlled Senate, with Montana and the two seats in Georgia as possibilities in a Biden landslide.

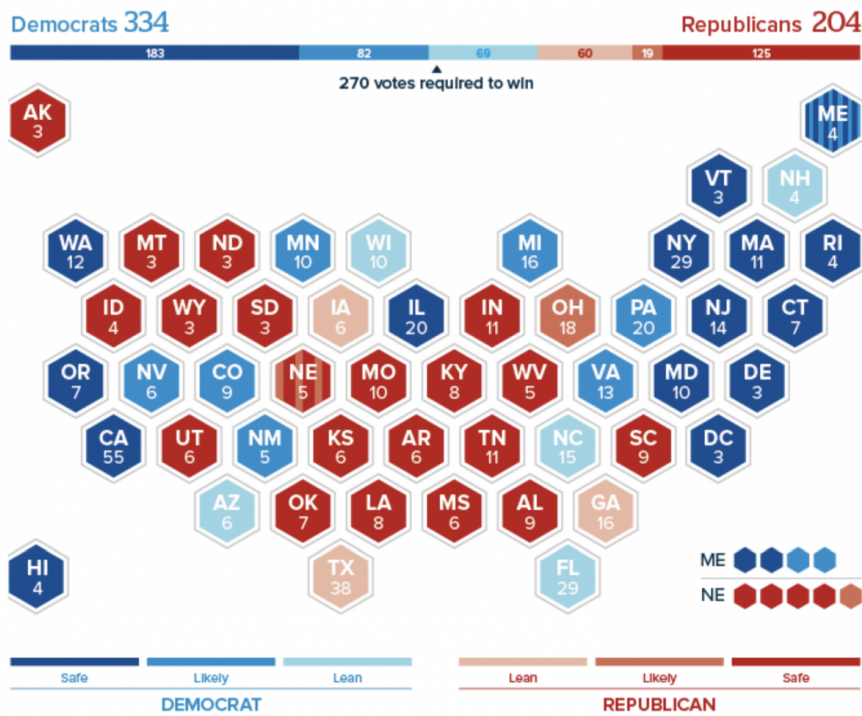
Fig 4: The likeliest path to a Democratic-controlled Senate



The House of Representatives is projected to stay in the Democrat's hands, with the majority party likely to pick up some seats.

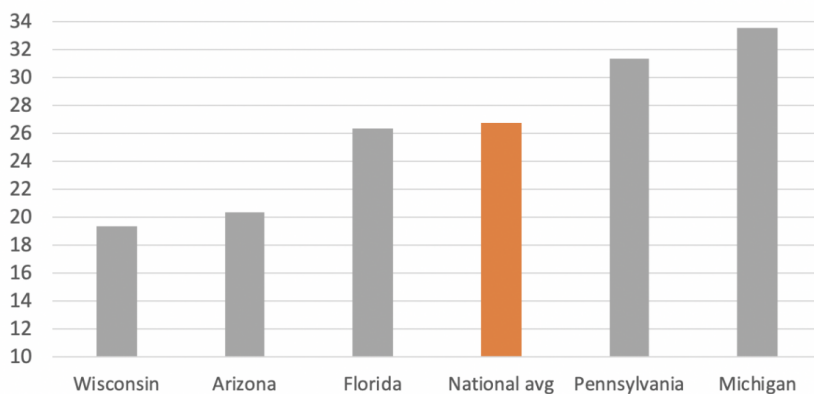
If current polling continues, this November election would result in the map illustrated in Figure 5, with a Biden victory of 334 Electoral College votes to Trump's 203.

Fig 5: Biden victory



While the closest swing states are in the Upper Midwest, with Wisconsin projected to be the ‘tipping point’ state, Biden’s lead has expanded the competitive map to include Arizona, Florida, and North Carolina. This provides Biden with more paths to victory, and minimises the importance of any one issue in the campaign, since the battleground map spans from the suburbs of Phoenix to the post-industrial northern Wisconsin.

Fig 6: Proxy for % of jobs lost*



Source: ING, Macrobond (*cumulative initial jobless claims as a percentage of February state employment)

Who will Biden pick as his running mate?

Biden’s most important decision of the next few months will be the selection of his vice presidential candidate. This can help unify the party, if the choice appeals more to the Sanders wing, and could

help in a swing state, if from a competitive state or region.

Although Biden's platform is more progressive than Clinton's and Obama's before him, the party has shifted to the left as a whole. While third-party defections or abstentions are unlikely to be as high as in 2016, they may still pose a threat to his election and require a progressive candidate to help him balance the ticket and ensure high turnout. Polling indicates that, whilst some progressive demographic groups' (especially the young) lack of enthusiasm for Biden will harm him, those groups are concentrated in states that are safely Democrat. That is not to say that (for example) such lack of enthusiasm could not damage Biden in swing states – such as Pennsylvania where the task of mobilising such groups in Pittsburgh and Philadelphia will be especially important.

While the more progressive candidates may not 'play' as well in swing states, vice presidential picks rarely change the course of an election, and matter far less than the perceptions of the presidential nominee. The question of the vice presidential nominee matters for mobilising partisan enthusiasts on the left of the party and assumes greater importance because of the likelihood that Biden will not run again in 2024 whereby the vice president immediately becomes the front-runner.

Biden has previously said that he will choose a woman, and, in the aftermath of the George Floyd killing, there is a high chance that he will choose an African-American woman. While vice presidential candidates rarely have large effects on a campaign (except where they go badly wrong as was the case with Eagleton in 1972 and Nixon coming close to damaging Eisenhower's campaign in 1952), they may indicate the direction a presidency may take. A known progressive like Senator Elizabeth Warren will indicate a much more forceful administration on regulatory issues. Senator Kamala Harris would likely indicate a more centrist path.

However, the candidate chosen will likely be designed to help the campaign in November. Former Georgia gubernatorial candidate Stacey Abrams could help move that state into being competitive, which would help the Democrat candidates for the two Senate races there. Current Michigan Governor Gretchen Whitmer could help in the Upper Midwest. Representative Val Demings would help in Florida. Demings, a former police chief and impeachment manager, Harris, a former Attorney General, and Warren, who campaigned on anti-corruption policies, also have an advantage in the policy discussions they would highlight against Trump.

Demings would be particularly helpful if issues of police brutality continue to dominate news coverage. This may be a difficult issue for Biden to address. He needs to identify with the victim in this case and others, and declare that such killings are and ought to be understood as constituting violations of the American creed without seeming to ally himself with looters, rather than the protestors. Biden could argue that the Justice Department should, as it has in previous administrations, lead a campaign to bear down on institutionalised police racism. Such a move would be consistent with his established views, could be presented as pursuing the public good through the institutions of law and order, and would be difficult for the president to oppose. He can here point to his work in the Obama Administration and the progress that had been made then against police brutality.

Could Trump survive a second wave of Covid?

A second wave of the virus would likely reflect badly on the president, particularly if it is viewed that his push to reopen the economy "too fast too soon" in the face of his advisory team's arguments for a more cautious stance, contributed in any way. Widespread street protests, partly

fuelled by perceived inequities of the pandemic response, may turn out to be ‘superspreader’ events that seed new infection hotspots.

A new wave of the virus could upend traditional voting patterns. There are opposing arguments for which party this would benefit. On the one hand, Democrats are traditionally more variable voters, and suffer more in cases of reduced turnout. On the other hand, seniors are more likely to vote Republican and be vulnerable to the virus.

The issue may be moot by the fall anyway: California has already moved to a vote-by-mail system to obviate the need for in-person voting. Other states are considering similar reforms. Even if a state as a whole does not adopt vote-by-mail, cities may do so. In the state of Washington, vote-by-mail became a statewide issue when heavily Democratic King County adopted it. Republicans in the state legislature approved of the system so as not to disadvantage themselves. The City of Milwaukee in Wisconsin has adopted vote by mail, and Democratic cities in swing states may follow. If so, their states are likely to adopt vote-by-mail.

Trump has already complained about vote-by-mail. He is likely to push Republican states not to adopt it further, but this could also hurt Republican prospects by making senior citizens (GOP-leaning) less likely to mail in ballots. If they do not show up to the polls because they are at risk of Covid, that would hurt his cause.

What if the candidates fall sick?

Senior government officials, including members of Congress and White House officials, are particularly vulnerable to Covid-19. They frequently meet with many people throughout the day and many are of advanced age. More than 25% of the Senate is over the age of 70, as are the two remaining presidential candidates.

The virus has infected people within the White House, including one of the president’s valets. If both Trump and Vice President Mike Pence were to contract the virus and die within quick succession, Democrat House Speaker Nancy Pelosi would take office. While extremely unlikely to happen, it would speed up the passage of new stimulus packages because her deputy would take over for her and reduce one point of conflict.

Such an eventuality would necessitate the Republican Party to quickly find a new nominee. This would likely be someone from the 2016 field who has been reliably pro-Trump but has a chance of winning in November, like Florida Senator Marco Rubio or Arkansas Senator Tom Cotton.

On the other hand, if Trump and Pence were merely incapacitated by the virus and sidelined, it might lead to a wave of sympathy and positive sentiment that may boost Trump’s chances. However, this would give Biden a few weeks to drive the narrative with Trump out of the spotlight, provided he remains well and able to campaign either in public or more effectively via social media.

If Biden were to fall ill or have to be replaced, then the nominee would be chosen by party delegates at the convention. While it is unclear who would be the nominee – there are competing

arguments for legitimacy among the many frontrunner candidates – it is likely that party leadership would try to form a ‘unity ticket’ with a moderate and progressive as candidates for president and vice president. Senator Bernie Sanders would be a natural choice for the presidential slot, since he has the second-largest number of delegates, but Biden’s delegates may turn to his vice president to move up to the slot, if he has already made his pick and she was a presidential candidate.

Policy in 2021

A Trump re-election would see him moving even faster towards withdrawal from many world organisations, with a new round of action against China possible – potentially even before the election (see subsequent section). This may involve new tariffs, Executive Orders on divestment, and diplomatic manoeuvres.

Trump would also seek to respond to the recession by radically reducing regulations on business, particularly the oil and gas sector. The corporate world may also expect more bailouts and targeted measures like payroll tax cuts.

Biden has already promised that his administration will be “Rooseveltian”. This implies a major stimulus package and a series of reforms from across the party. If appointed Treasury Secretary, Elizabeth Warren would seek to impose new regulations on the financial sector and more generally investigate corporate fraud and tax evasion. The tech sector will likely continue to see bipartisan scrutiny as ‘techlash’, which has paused during the coronavirus crisis, will resume albeit with some shift in emphasis.

However, it is clear that without the tech sector, the loss of output and employment due to Covid-19 would have been even bigger. It appears unlikely that anxieties about social media and privacy will be resolved to the satisfaction of critics but the economy’s dependence upon leading tech companies (and their disruptive emerging competitors) is greater than ever.

A new Cabinet position on climate change, perhaps headed by John Kerry, would push for a re-entry to the Paris Accord and green infrastructure. And progressive members of the Administration and Congress will press for the inclusion of elements of Bernie Sanders’ platform.

A Biden Administration may roll back some of the tariffs on China, but is likely to continue an adversarial or competitive approach. Intellectual property will continue to be a major source of contention between the US and China. There will likely be a return closer towards the policy of the Obama Administration, of conflict in some areas, while attempting to bind China closer economically to the global order. Climate would be an area of active cooperation.

Should the virus return again, necessitating new lockdowns, more government economic support will be required. The federal government would need to fill the gap in economic demand but may do so through a Universal Basic Income, since traditional stimulus projects, like infrastructure spending, may not be possible in a period of continued lockdowns.

Conclusion

The race remains unpredictable. Although Biden has a large lead at this point, the dislocations and disruptions from the coronavirus make him far from a guaranteed winner.

The outcome of the presidential and congressional election may be the most consequential in

decades, given the daunting agenda that the next administration will face over the next four years. It will be tasked with helping the economy recover from its deepest depression in nearly a century, confront or accommodate a rising China in a changing global order, and deal with a Congress and Supreme Court that are working on policy changes towards healthcare, climate, and an aging infrastructure system. The choices made will have a profound impact on the outlook in the US and beyond.

Author

James Knightley

Chief International Economist, US

james.knightley@ing.com

Podcast | 5 June 2020

Listen: Biden - His Time?

America is facing a national crisis. Gripped by mass protests over the police killing of George Floyd and a pandemic which has killed thousands and ravaged the economy, President Trump must overcome historic challenges to win the election in November. In this podcast, ING's James Knightley looks at how the race could unfold



Mass protests over the police killing of George Floyd, 100,000 deaths from the coronavirus pandemic, an unprecedented economic downturn and 40 million of Americans out of work. Rarely has an election year looked this bad for a sitting US president. And yet the outcome remains unpredictable, with no guarantee that Democrat rival Joe Biden will win in November. [In this podcast](#), ING's Chief International Economist James Knightley tells Senior Editor Rebecca Byrne how the turmoil could influence the race to the White House.

Author

James Knightley

Chief International Economist, US

james.knightley@ing.com

Rebecca Byrne

Deputy Global Head of Editorial and Supervisory Analyst

rebecca.byrne@ing.com

Snap | 4 June 2020

ECB: More bang and the return of the compass

The ECB has increased its PEPP programme by 600bn euro but the weak inflation outlook leaves the door open for additional stimulus in the future



The European central bank just added to the Eurozone policy fireworks of recent days, increasing the size of its pandemic emergency purchase programme (PEPP) by 600bn euros to a total of 1350bn euro.

The purchases will last at least until the end of June 2021, and in any case, until the Governing Council judges that the corona crisis is over.

Also, the ECB will reinvest the proceeds from the PEPP purchases until at least 2022. The APP purchases and reinvestments, as well as low-interest rates and forward guidance, remain unchanged.

Macro-economic assessment: The ECB doesn't have a crystal ball

The macro-economic assessment illustrates that the ECB is in no better position than all other forecasters trying to get a grip on the depth of the economic crisis and the pace of the recovery. In

its base-case scenario, the ECB sees a bottoming out of the downswing in the month of May, followed by rebound leading into the second half of the year.

We fully agree.

In its base-case scenario, the ECB staff projections predict the eurozone economy to contract by 8.7% this year and then to rebound by 5.2% in 2021 and 3.3% in 2022.

Needless to say that this is a significant downward revision for 2020 compared with the March projections. The world looked very different back then. Interestingly, the ECB added the typical risk assessment to the growth outlook, which had disappeared in the April communication. The balance of risk is tilted to the downside. In two alternative scenarios, the economy would contract by 5.9% or 12.6% this year.

With regards to inflation, the ECB staff projections predict headline inflation to come in at 0.3% in 2020, 0.8% in 2021 and 1.3% in 2022. This muted inflation forecast was the main driver behind today's decision to increase the size of PEPP. Remember that not too long ago, Executive Board member Isabel Schnabel called the inflation outlook the single most important factor. Call this the return of the one-needle compass.

The German Court and the return of the compass

Before today's meeting, there was speculation about how the ECB would react to the German Constitutional Court's ruling on QE. During the press conference, Christine Lagarde more or less showed the Court the ECB's cold shoulder, emphasizing that the ECB falls under the jurisdiction of the European Court of Justice, which had judged that QE has been in line with the ECB's policy mandate. In her view, the German Court's ruling was directed at the German government and German parliament. She hoped that a good solution was found, which would not compromise the ECB or the primacy of European law.

Today's decision should dent any future speculation about whether or not the ECB is willing to play its role of lender of last resort for the Eurozone

For the time being, the ECB today has added to the recent tailwinds for the eurozone economy. After the announcement of the European Recovery Plan and last night's powerful German fiscal stimulus package, today's decision should dent any future speculation about whether or not the ECB is willing to play its role of lender of last resort for the Eurozone.

Despite this cold shoulder, it was remarkable that Lagarde referred to the ECB's single mandate, inflation projections and bringing back inflation more often than during previous press conferences. A safe way to avoid any future legal challenges. Even though asked by a journalist that inflation was not mentioned at the start of PEPP Lagarde answered that PEPP was also aimed at easing financing conditions in the whole eurozone, ensuring a smooth transmission of monetary policy.

In our view the emphasis on inflation means that the good old one-needled compass from Jean-Claude Trichet is back. In turn, this also means that with inflation forecast clearly below 2% in 2022,

more monetary stimulus further down the road should not be excluded.

Author

Carsten Brzeski

Global Head of Macro

carsten.brzeski@ing.de

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Periphery in peril: Lockdowns, weaker safety nets and structural challenges pose grave risks to the recovery

The initial shock to the eurozone economy from the Covid-19 pandemic was very symmetric as all countries went into lockdown at roughly the same time. But the pace of recovery will be far more asymmetric, with many peripheral economies at risk of a longer lasting slump



A few factors drive potential recovery paths from this crisis

The single most important driver of the depth of the recession - the severity of the lockdown - was already evident in the first quarter growth figures. The more restrictive the lockdown, the deeper the contraction. In turn, the speed with which the lockdown measures are lifted should determine how quickly economies recover, though this is not the case entirely. In our view, there are multiple drivers that will play an important role in determining the path of recovery for countries, many of them relating to the lasting damage from the lockdowns. Some businesses will simply not survive the lockdown period. A rise in bankruptcies and unemployment will hamper the recovery, as the producing capacity of the economy has been hit and so too has demand, as people have lost their main source of income.

To get a sense of which countries are vulnerable to more lasting damage from lockdown periods, we look at multiple relevant factors:

- Depth and length of the lockdown
- Fiscal response including automatic stabilisers
- Sectoral and company size sensitivity to the corona crisis
- Financial position of the corporate sector
- Financial position of households
- Global value chain vulnerability

These factors all contribute to the pace of recovery and are likely to have a profound impact on how well economies bounce back from the historically sharp downturn. Which factors are most important depends on how the crisis continues to develop, meaning that it is still hard to tell which ones will be the most relevant. Many assumptions can be made, but we prefer to remain agnostic on this, as most factors point to similar conclusions anyway: the eurozone periphery will have the hardest time recovering quickly from this recession.

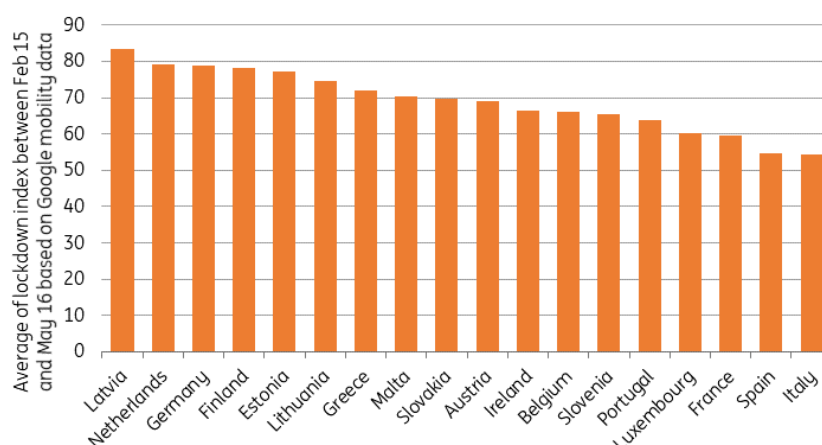
Most drivers of the speed of recovery favour the old “core” countries

Going over the factors mentioned above, a rather consistent picture emerges. There are very few scenarios imaginable in which southern eurozone economies manage to recover as quickly as their northern counterparts. Below we'll list the drivers and differences between the North and South.

Length and depth of the lockdown is worst in most peripheral economies

The cumulative impact of the lockdown on the economy is largest in most southern economies. The first serious outbreak of the virus was in Lombardy, causing Italy to go into a hard lockdown. France and Spain followed the Italian example quickly, while the more northern economies experienced smaller outbreaks of the virus at first and opted for more lenient lockdowns. The depth of the lockdown proved to be the main driver of economic growth in the first quarter and is therefore strongly linked to the impact on activity. The longer it lasts and the more restrictive it is, the greater the chance of bankruptcies and higher unemployment, which are likely to make the recovery more difficult.

The lockdown impact has been largest in Italy, Spain and France



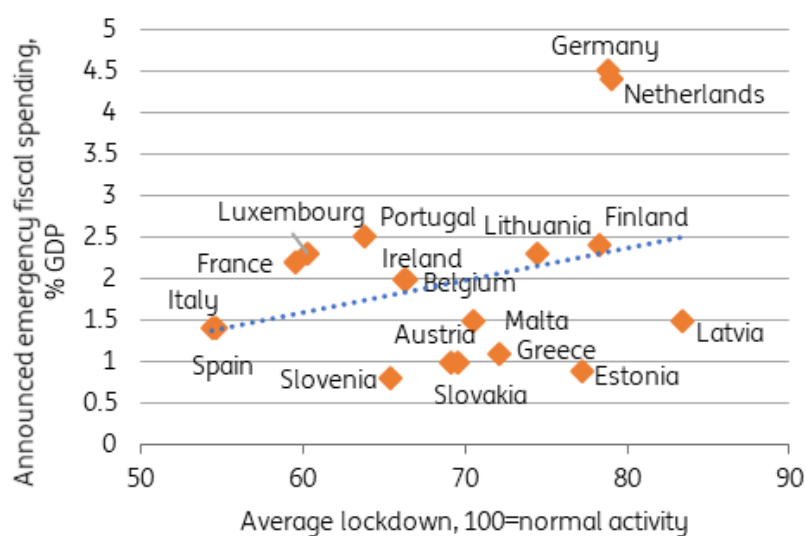
Source: Source: ING Research, Google Covid-19 Community Mobility Reports

Chart 1 shows the average of our lockdown index for the period starting 15 Feb and ending 15 May. Over this period, the impact on the economy has been the largest in Italy, Spain and France, with Portugal also below average. Germany, Finland, Netherlands and the Baltics are all above average. As restrictive measures are now gradually easing, the countries with stricter measures still remain further away from normal daily life as we see from the latest activity data. This implies that the risks of more lasting damage to the economy continue to be more significant in Italy, Spain and France.

The countries with the stricter lockdowns have weaker fiscal responses and social safety nets in place

As stricter lockdowns cause larger economic harm, the countries that experienced them need more emergency government spending and would benefit from larger social safety nets to cushion the steep decline in economic activity. This has not been the case so far. While it is difficult to compare countries, there does not seem to be a clear correlation between the size of the emergency plans and how hard economies have been hit. In fact, in terms of direct fiscal spending announcements, the countries with looser lockdowns have announced the largest fiscal injections, at least so far.

The softer the lockdown, the higher the emergency government spending



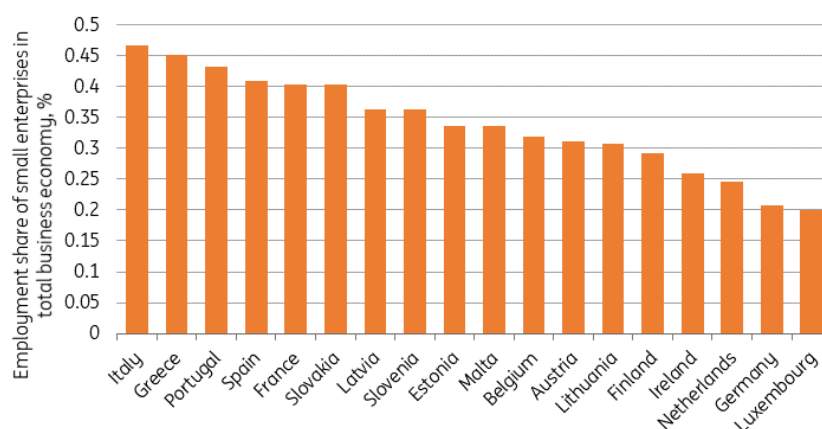
Source: Source: ING Research, Google Covid-19 Community Mobility Reports

There are also large differences in the safety nets that are in place for economic downturns. The automatic stabilisers of income are largest in Austria, Ireland and the Benelux and are weakest in Spain, Malta and the Baltics. A 100% shock to economic output translates to 62% drop in income in Germany but a 74% drop in Spain, according to the European Commission. The lower income retention during this period means less spending power during the recovery phase. That's a concern for countries with lower automatic stabilisers as they will experience a slower recovery, all else equal.

The structure of the economy matters

Some sectors have been harder hit than others by the corona crisis, so in order to gauge how quick the recovery will be, it's important to look at the sectoral composition of individual countries. To get a sense of how sectors have been affected by the crisis, we take the sectoral output loss estimates from the ECB Bulletin Issue 3/2020 and use the size of sectors within individual countries to estimate how vulnerable they are to their sectoral composition. Luxembourg, with a very large financial sector, is the least exposed to this specific shock followed by France and Finland. The Baltics, Slovenia and Austria are the most vulnerable.

Southern eurozone economies rely more on small enterprises



Source: Source: Eurostat, ING Research

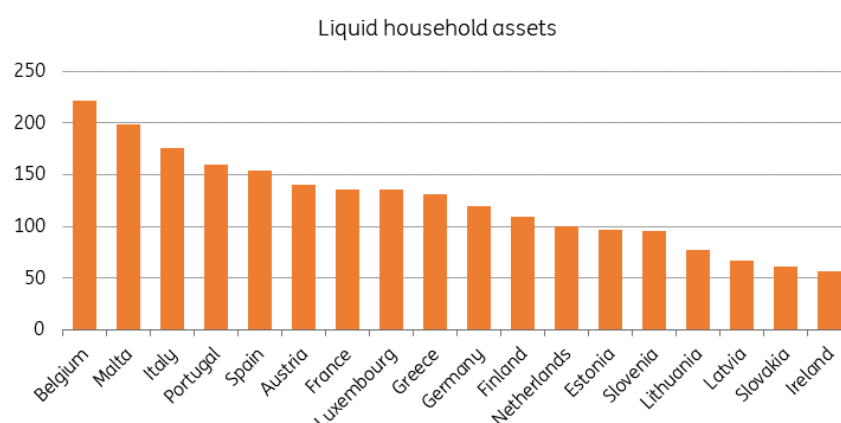
It's not just sectors that matter but the size of companies, too. A larger share of small businesses in a country could increase the risk of more bankruptcies and therefore a weaker recovery. Roughly a third of total business employment in the eurozone comes from small businesses – under 10 employees – with large differences between countries. The share is 47% in Italy and just 21% in Germany, for example. Assuming that the more permanent damage to economies takes place in these small businesses, a higher share of employment could hamper the recovery.

The financial situation of corporates in some countries is more vulnerable than others

To bridge the period of lower or non-existent demand, companies obviously need to be in a sound financial position. Whether non-financial corporations had sufficient liquid buffers at the start of the lockdown to make it through the crisis is key. To get a sense of how vulnerable companies are to lower revenues over the course of the recovery, we can look at whether firms are net borrowers and what their liabilities are compared to their financial assets. The weaker the corporate sector, the longer it will take to recover from the lockdown period.

The same holds true for the liquidity of households. In countries with larger household buffers, consumer behaviour is less likely to be affected for a longer period of time, which means that a bounceback could happen more quickly. There are significant differences between countries here, with Belgium holding a particularly high amount of (semi-)liquid assets and the Central and Eastern European countries holding relatively little. This is also the case for the Netherlands and to some extent Germany and Finland, which could potentially hamper the recovery in the northern economies.

Northern eurozone households have relatively small liquid buffers



Source: Source: Eurostat, ING Research

Note: index of activity since 15 February for retail & recreation, groceries & pharmacies and workplaces using Google Covid-19 Community Mobility Reports with data through 16 May. 100 equals to baseline of activity between 3 Jan and 9 Feb.

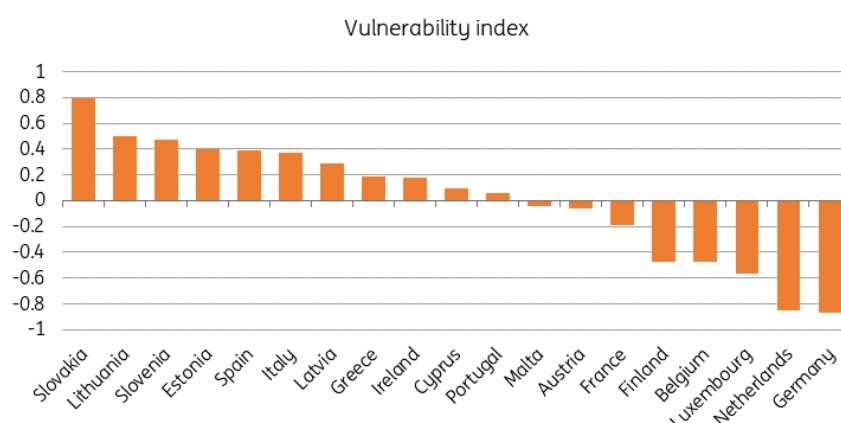
Open economies could be burdened in the aftermath

Being an open economy could be problematic to the recovery if foreign demand and/or production does not pick up quickly. More trade-dependent countries could be hit through supply chain problems, subdued exports if the main export destinations remain depressed for a longer period of time, and longer-lasting restrictive measures on trade. Countries like the Netherlands and Germany are more vulnerable to this recovery risk.

Old eurozone periphery is most vulnerable to prolonged slump

Taking all of these factors together, we can create an index measuring vulnerability to a prolonged coronavirus slump. Without applying any weights, the index is essentially agnostic about which factors are most significant. The countries that are most vulnerable, according to the index are those in Central and Eastern Europe, followed by Spain and Italy, while Portugal, Greece, Slovenia and Cyprus also rank as more vulnerable than average. The countries that are more likely to bounce back quickly are the northern eurozone economies. This sounds a lot like the old familiar lines drawn around the “core” and “periphery” of the euro crisis.

The “core” is better set up for a swift recovery than the “periphery”



Source: Source: ING Research, Google Covid-19 Community Mobility Reports

Note: index comprises an average of normalised indicators: automatic stabilisers, emergency fiscal spending as a percentage of GDP, percentage employment of small enterprises (under 10 employees), average of the three financial conditions factors mentioned in the text, liquid household assets as a percentage of GDP, sectoral composition and the average for our lockdown index.

A longer slump in southern eurozone economies could have worrying implications

If indeed southern eurozone economies are in for a much longer economic slump on the back of the Covid-19 crisis, this could have worrying implications from a debt perspective. While some countries have committed to smaller than average support packages, debt as a percentage of GDP will still be significantly higher if GDP does not recover for a longer period of time. It is not unthinkable that debt-to-GDP ratios rises faster by mid-2021 in countries that have spent a smaller share of GDP on the crisis, simply due to the diverging trends in economic growth.

Those higher debt levels could cause concern in the aftermath of the crisis. For now, the European Central Bank's Public Sector Purchase Programme and Pandemic Emergency Purchase Programme form an effective backstop to any financial market turmoil related to concerns about specific eurozone countries, but whether that will remain the case longer-term is unclear. The ruling of the German Constitutional Court on the ECB's PSPP has cast doubt on a possible extension to the ECB's government bond buying, which could mean that euro break-up risk returns in 2021 if economic divergence increases again.

These concerns about debt levels already seem to have played a role in the size of the support packages by individual governments. The size of announced fiscal spending by country so far links best with market yields for government bonds and the level of government debt prior to the crisis, rather than the depth of the lockdown or automatic stabilisers, for example. This indicates that despite the historic steps taken within the EU, such as activating the “general escape clause” in the stability and growth pact by the European Commission and the ECB's PEPP bond buying programme, governments have still been wary about longer term debt worries while fighting this crisis.

The recent discussion and latest proposals on a European Recovery Fund indicate that there is a growing awareness of the longer-term problem an asymmetric recovery could create. A pan-European fiscal response on top of the already agreed package of European Investment Bank support, loans for short-time unemployment schemes and a possible European Stability Mechanism credit line, could alleviate this problem to a certain degree. This is particularly true if the fund uses grants rather than loans, though there could still be a potential problem with moral hazard. The message to financial markets concerned about debt sustainability and euro break-up risk would be loud and clear: the EU leaves no country behind.

Author

Bert Colijn

Chief Economist, Netherlands

bert.colijn@ing.com

Carsten Brzeski

Global Head of Macro

carsten.brzeski@ing.de

Watch: Are the markets right to be worried about Brexit... again?

We're expecting another update on the torturous Brexit negotiations between Britain and the European Union on Friday. While there are some hopes of minor breakthroughs, the markets are clearly worried about the possibility of a 'no-deal' and the pound is not liking that prospect one bit



Brexit: Are the markets right to be worried... again?

Brexit is back in the spotlight amid growing concerns that negotiations between the UK and the EU aren't going particularly well. And that's putting pressure back on the pound. So are markets right to be worried? Well, it's tempting to say that the chances of a free trade agreement being stuck later this year looks fairly slim. But we aren't so sure. Don't forget, meaningful progress was always pretty unlikely before the autumn anyway. And there are subtle signs that both sides may actually compromise in some places, notably fishing. The prospect for some initial disruption at the start of 2021 is putting pressure on the UK government to extend the post Brexit transition period. Both sides have until the end of June to agree on an extension. But it's looking pretty unlikely. And that means there's further downside ahead for the pound. And our FX team reckon fears of an abrupt end to that transition period could see the pound trade at ninety-one pence to the euro by the end of June.

[Watch video](#)

Author

James Smith

Developed Markets Economist, UK

james.smith@ing.com

USD: Wake up and smell the (bearish) coffee

The continuing rally in commodity currencies and a generally weaker dollar across the board could still feel like a short squeeze in those accounts positioned for recession. But the options markets suggest a larger dollar decline may be brewing



More than just a short squeeze?

The latest CFTC positioning data for the week until 26 May suggests that despite AUD, NZD, and CAD currencies already having rallied to USD/0.6630, USD/0.6200, and 1.3775/USD respectively in the reporting week, speculative accounts were still running large short positions. The chart below shows that net short positioning in these currencies was still sitting at the lower one standard deviation band of the five-year range.

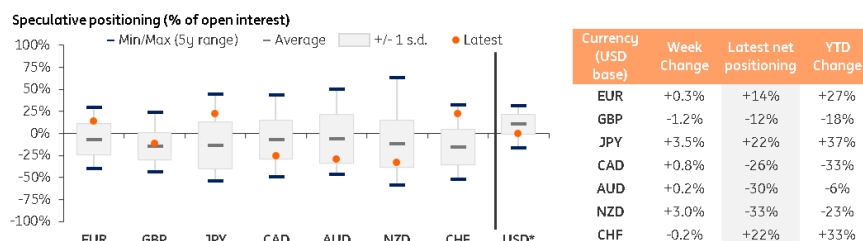
There are signs that the dollar bear trend is becoming more broad-based

One could then attribute the recent rally in commodity FX (2%+ over the last two weeks) merely to a short squeeze triggered by a further turn around in the oil story and perhaps, more importantly, a sense that, as a continent, Europe will contribute to the global rebound (as it did in 2017) rather

than be a drag.

But as we [discussed last week](#), there are signs that the dollar bear trend is becoming more broad-based and that even EUR/USD, where the speculative market is already substantially long EUR, is considering a top-side break-out.

Latest speculative positioning: Still short commodity FX



*Note: Aggregate USD positioning versus G10 FX. As of 26 May 2020 (data reported with a lag).

Source: ING, CFTC

Signs in the FX options market bear watching

There are some interesting signals emerging in the FX options market.

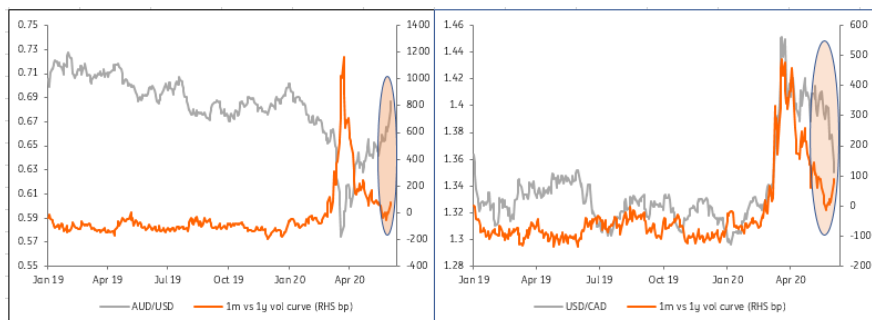
The shape of the traded volatility curves can provide some indication of the mood of the market. A gently sloping positive volatility curve shows effectively a term premium – or investors prepared to pay more for risk over the long term. Inverted curves are typically associated with risk-off episodes and shocks, where the market is prepared to pay up for short-term protection, fearing market dislocation.

Certainly, the events in March saw [enormous dislocation in FX markets](#), massively inverted volatility curves, and a stronger dollar as corporates rushed to hoard dollar cash after US commercial paper markets seized up. Equally, the subsequent calming in financial markets and a modest re-rating of global growth prospects after aggressive intervention from policymakers have started to see volatility curves normalise and the dollar weaken.

What interests us the most at the moment are developments over the last week. Here volatility curves have started to invert again – triggered by both buying of front end and selling of back end volatility – even as the dollar has continued to weaken.

We demonstrate this for the AUD/USD and USD/CAD markets below. This may be just a symptom of the short squeeze by leveraged accounts as the dollar weakens through big technical levels (e.g. the 0.6685 mid-March high in AUD/USD) or perhaps warning that a greater conviction is emerging that the dollar is ready to start on a more significant trend decline.

AUD/USD and USD/CAD and their one-month vs. one-year volatility curves



Source: Bloomberg, ING

EUR/USD: Let's watch the volatility curve too

These trends have not exactly been the case in the EUR/USD market.

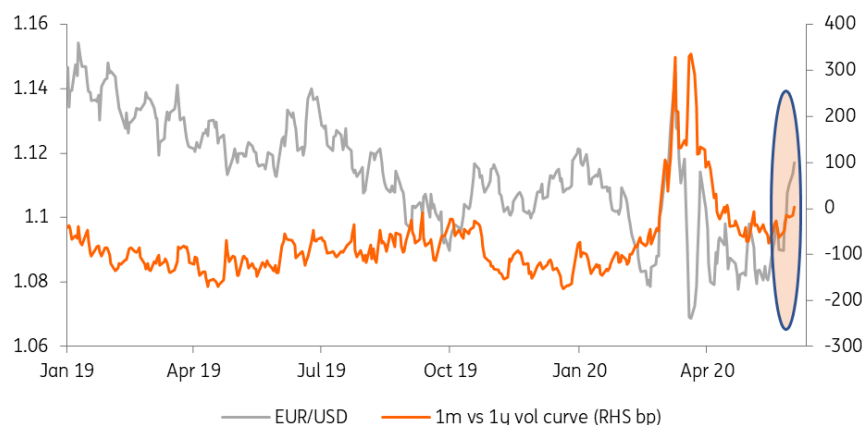
Yes, one-year traded volatility has fallen over the last week, but are yet to see a pick up in the 1-month volatility – which would probably represent the active buying of EUR calls/USD puts given that that one-month risk reversal skew has recently moved in favour of EUR calls.

Of course, these currencies (especially commodity FX) have come a long way already and substantial risks remain – most pressingly in US-China tensions and whether the White House administration rips up last year's trade deal.

But for the time being, the momentum is against the dollar and if EUR/USD starts to trade above the 1.1230/40 area on a sustained basis – especially backed by the buying of front end volatility – then EUR/USD could be embarking on a trend towards our year-end target of 1.20 earlier than we expected.

[Why we thought the dollar was overpriced](#)

EUR/USD and its one month vs. one year traded volatility curve



Source: Bloomberg, ING

Author

Chris Turner

Global Head of Markets and Regional Head of Research for UK & CEE

chris.turner@ing.com

Francesco Pesole

FX Strategist

francesco.pesole@ing.com

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US Treasury FX report preview: Three and a half manipulators

The Treasury is delaying its currency manipulation report, possibly on the back of new tensions with China - which might be labelled again despite not meeting the criteria. We estimate that Vietnam, Taiwan and Thailand all exceed the thresholds, while Switzerland is dangerously close. However, we don't exclude some "free passes" being granted



Source: shutterstock

US Treasury manipulation report: another suspicious delay

The US Treasury publishes a report to Congress twice a year in which macroeconomic and exchange rate policies of key trading partners are examined in detail. The aim is to identify countries that artificially manipulate their currencies to gain a competitive advantage to the detriment of the US.

In order to designate a country with the manipulator tag, the Treasury provides that three criteria must be met, along with the related quantitative thresholds (Figure 1). Countries that only meet two criteria are put in a "monitoring list" that merely implies further scrutiny.

Figure 1 - US Treasury criteria

Criteria	Benchmark	Threshold
Major Trading Partner Coverage	Total Bilateral Goods Trade (Imports plus Exports)	\$40 billion
Significant Bilateral Trade Surplus with the United States	Goods Surplus with the United States	\$20 billion
Material Current Account Surplus	Current Account Balance	2% of GDP
Persistent One-Sided Intervention in Foreign Exchange Markets	Net FX Purchases	2% of GDP
	Persistence of Net FX Purchases (months)	6 of 12 months

Source: US Treasury, ING

The only country to receive the manipulator tag in the past 20 years was China – despite not meeting the quantitative criteria – in August 2019, as trade tensions with the US escalated and USD/CNY breached the 7.00 mark. The tag was lifted as part of the Phase One trade deal in January 2020.

[Here's our commentary on the January 2020 report](#)

The new US Treasury report was originally expected to be published in May, covering data for the period 1Q-4Q 2019. We estimated the evaluation criteria for each country in the report and found that three countries exceed all thresholds: Vietnam, Thailand and Taiwan. A fourth one, Switzerland, meets all of the criteria but one – the size of intervention – which is however very close to the threshold.

Our estimates

Figure 2 shows our estimates of the US Treasury criteria for the period 1Q-4Q 2019. Data for the goods trade balance with the US is provided by the US census, the current account and official reserves by the IMF and GDP figures by Bloomberg.

The Treasury also uses staff and external estimates that add a degree of discretion, in particular when it comes to gauging FX intervention. We had previously attempted to account for a valuation effect when looking at the variation in FX reserves to measure FX intervention. We have found that the simple change in reserves over the 12 months in consideration provides a closer estimate to the UST figures.

Fig 2 - ING estimates on US Treasury criteria

	Bilateral Trade	Current Account	Foreign Exchange Intervention	
	Goods Surplus with US (USD bil.)	Balance (% of GDP)	Net Purchases (% of GDP, Trailing 4Q)	Net Purchases (6 of 12 Months)
China	346	1.0	0.6	Yes
Mexico	102	-0.4	0.4	Yes
Japan	69	3.6	0.0	No
Germany	67	7.5	-	-
Vietnam	56	5.0	9.4	Yes
Ireland	53	-9.5	-	-
Italy	33	3.0	-	-
Malaysia	27	3.3	0.5	Yes
Canada	27	-2.0	0.0	No
Switzerland	27	12.2	1.9	Yes
India	23	-0.9	0.1	Yes
Taiwan	23	10.6	2.7	Yes
Korea	21	3.7	0.3	Yes
Thailand	20	7.0	3.3	Yes
France	20	-0.7	-	-
Singapore	-5	17.0	-2.2	Yes
UK	-6	-3.8	0.0	No
Brazil	-12	-2.7	-1.0	Yes
Belgium	-15	-1.2	-	-
Netherlands	-21	9.9	-	-
Hong Kong*	-26	6.1	4.6	Yes

Monitoring List: China, Japan, Germany, Italy, Malaysia, Switzerland, Korea, Singapore

*HK does not meet the criteria to be included in the report
Source: ING, US Census, IMF, Bloomberg, National sources

China: Below the thresholds, but another label may be on the way

China has been the central topic in the recent editions of the Treasury report and the recent resurgence in geopolitical tensions with the US suggests it will take centre stage in the forthcoming edition too. According to our estimates, China only met one of the three criteria in the period under review. But this was also the case in August when the UST designated China a manipulator, suggesting that this won't necessarily protect the country from being labelled again.

The delay in the publication of this edition of the report may be a consequence of some indecision on whether to tag China a manipulator. If this is the case, there is a high chance that the report will not be published before the US-China diplomatic spat takes a clearer direction.

The yuan is currently trading at around 7.11 vs the USD, well above the 7.00 level that triggered the Treasury reaction in August. At the same time, the yuan has partly re-appreciated after hitting 7.17 last week as markets became less concerned about trade tensions.

In August, the impact of the manipulator label was rather limited. This is because the designation simply provides for a period of talks with the country's monetary authorities and if negotiations fail, actions such as tariffs can be taken: at that time, tariffs were already in place. Now, after the Phase One deal lifted part of the US tariffs on Chinese exports, the market implications may be more significant, as it could be read by investors as a move by the US to convert the diplomatic spat into a new trade war. Should such a move occur in the current environment, where markets retain a rather complacent approach to US-China tensions, the impact could be magnified.

Vietnam, Taiwan and Thailand meet all criteria...

Vietnam was another focus of attention in previous editions as the central bank had been rather active in building FX reserves, heightening the risk of the country receiving the manipulator label. In January, despite a significant increase in FX reserves in 2Q18-2Q19, the Treasury reported that “Vietnamese authorities have credibly conveyed to Treasury that net purchases of foreign exchange were 0.8% of GDP”. Our estimates were at 2.8%.

At that time, Vietnam would have been saved in any event by the current account staying below the 2% of GDP threshold. Data from the Vietnamese central bank (State Bank of Vietnam) shows, however, that the country’s current account spiked in 2H19 (Figure 3). Our estimates show that this brought the current account surplus for 2019 to 5% of GDP, well above the UST threshold (2%).

FX reserves also increased significantly in 2H19, and the variation over the entire year was around 9.4% of GDP. We overestimated the FX intervention in the previous report, but it will surely be hard for Vietnam to prove that less than 2% of the approximate 9% increase in reserves (all in % of GDP terms) should be considered as FX intervention.

Taiwan has also met all three criteria, according to our estimates. The country already presented a large current account surplus to the world but also saw a jump in goods exports to the US (meeting the first quantitative criteria) as well as in FX reserves. We estimate FX intervention at around 2.7% in 2019, with the country having made net purchases for at least six months (like Vietnam and Thailand). In January, the Treasury had shown concerns over the possibility of Taiwan using FX swaps to intervene in the FX market, [after an October 2019 analysis by the Council for Foreign Relations](#) suggested a “shadowing” of around USD130 billion in intervention, as the country does not report its derivative positions. Taiwan denied such allegations.

Thailand only met the current account criteria in the January report, but was close to hitting the other two. US census data shows that goods exports in 2019 were just above the USD 20 billion mark and we estimate the variation in FX reserves amounted to 3.3% of GDP.

Fig 3 & 4 - Vietnam reserves, C/A and currency dynamics



Source: State Bank of Vietnam, IMF, Bloomberg

... but may get a free pass

In recent times, the US Treasury report has taken on very strong political overtones. The Treasury “bending” the three criteria rule in labelling China (which only met one condition) a currency manipulator was a case in point.

In times when tensions with China are high, it is fair to assume that the decision to designate a

country a manipulator will first be filtered through an assessment of any geopolitical implications. The three countries that have hit the thresholds, according to our estimates, are all in a geographical position that connects them with China.

Vietnam is often identified as the key alternative to China as a hub for US companies' supply chains. [A recent media report](#) indicated that Apple shifted 30% of AirPods production from China to Vietnam. If the US continues with plans to loosen its economic ties to China, designating Vietnam a manipulator may be self-defeating. On the currency side, the dong (figure 4) has recently appreciated after the initial pandemic shock, which may suggest less FX intervention is being carried out.

In the case of Taiwan, reasons to give a “free pass” are mostly political. As China attempts to tighten its control over Hong Kong, Taiwan represents an important ally of the US as the island has shown increasing aversion towards the One-China policy. From an economic standpoint, TSMC (world leader in semiconductors, based in Taiwan) has announced a plan to build a chip plant in the US, which is also seen as a move to reduce US dependency on Asia. The manipulator tag may create unwanted frictions in the company's plans.

Thailand may be the least likely to get a free pass as the country has a smaller role from a political point of view. However, the Thai central bank has recently eased back on currency intervention and the Thai baht has been the second best performing Asian currency since the start of May (+2.5% vs USD). Incidentally, the large current account surplus has likely contracted quite significantly in the past few months as a result of the pandemic.

As a general consideration, we suspect that the UST will be reluctant to designate any of the three countries a manipulator while sparing China the same label. At least as long as the current administration intends to use the manipulation report as a geopolitical tool.

Rest of the world: Switzerland is dangerously close, HK might join monitoring list

Some eurozone countries have long been on the monitoring list, but the lack of FX intervention by the European Central Bank makes it impossible to meet the third criterion. Germany and Italy are set to remain on the monitoring list in the next report, but Ireland should be removed as it failed to meet at least two criteria for two consecutive reports.

Switzerland, instead, is dangerously close to hitting all thresholds. The large current account surplus is not news and goods exports to the US increased to USD 27bn (in 2019). However, the Treasury tends to “trust” the amount of FX intervention published by the Swiss central bank (SNB) in [its annual report](#) (page 14): in 2019, CHF 13.2bn of FX purchases were reported. For consistency purposes, we have only used GDP data in USD and therefore converted the amount of FX purchases in USD, using the average exchange rate in 2019 (almost at parity, 1.007). The result is FX intervention amounting 1.9% of GDP.

With the threshold set at 2%, and some discretion on what GDP and exchange rate to use, we cannot fully exclude that Switzerland will already meet the thresholds in the forthcoming report.

What may also play a role is how Switzerland engaged in very large FX intervention in the first few months of 2020 to counter the Swiss franc's appreciation. We estimated (in the article: "[EUR/CHF: The case for parity](#)") those interventions to have been approximately 15% of GDP through April 2020 (figure 5), which makes it virtually impossible for Switzerland to avoid hitting the 2% threshold in the Autumn report, which will cover the period 2Q19-2Q20. This may build some additional speculative interest in CHF longs to bet on a softer stance by the SNB, which may let CHF appreciate more freely.

Fig 5 - Switzerland is well above the thresholds in 2020

	Bilateral Trade*	Current Account*	Foreign Exchange Intervention**	
	Goods Surplus with US (USD bn)	Balance (% of GDP)	Net Purchases (% of GDP, Trailing 4Q)	Net Purchases (6 of 12 Months)
Switzerland	30	12.2	15.1%	Yes

*Data for March 2019 - March 2020
 ** Data for April 2019 - April 2020. FX interventions calculated from the change in the SNB sight deposits

Source: ING, SNB, US Census, Bloomberg

Elsewhere, Malaysia and South Korea met the first two criteria but we did not find enough evidence that the two countries exceeded the thresholds for FX intervention. They should simply remain on the monitoring list. Singapore will also remain on this list because while it no longer meets the FX intervention criteria, it will need to do so for another report before being removed. Japan is also set to remain on the list though there is no chance of it being labelled a manipulator, as the Bank of Japan is not currently engaging in FX interventions.

Hong Kong has not been included in the latest report as it did not meet the very first requirement: total trade in goods with the US exceeding USD 40 bn. In 2019, this was still the case, as the US census reported it to be at USD 35 bn. If the UST decides to include HK in the report anyway, the country may well be put onto the monitoring list due to its large current account surplus and large currency intervention. However, it must be noted that HK has a deficit (a very large one too: USD 26 bn) in goods trade with the US, so there is no possibility it will hit all three thresholds.

The decision to put HK on the monitoring list has no tangible implications, but may well resonate loudly in the markets after President Trump announced plans to remove Hong Kong's preferential trade status.

Author

Francesco Pesole

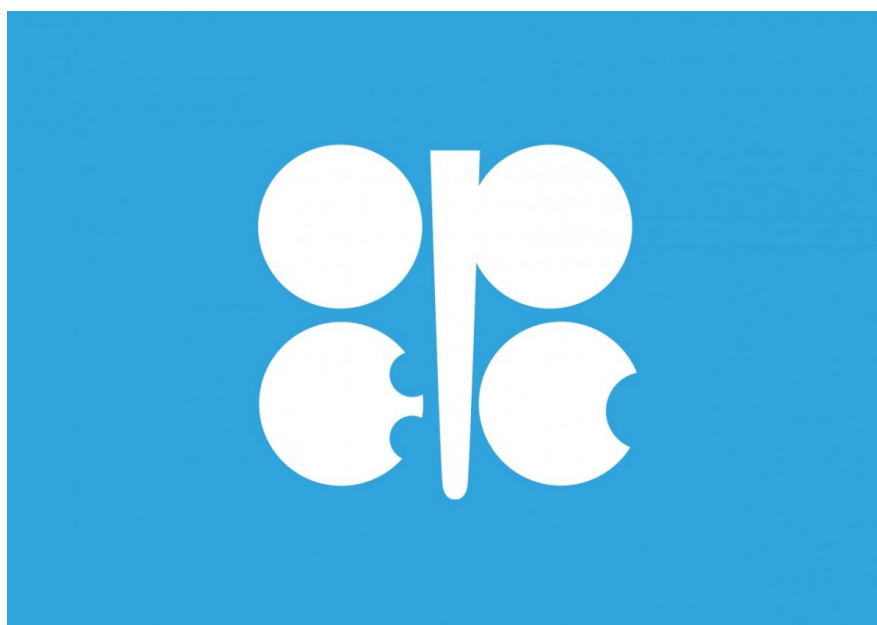
FX Strategist

francesco.pesole@ing.com

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OPEC+ set to meet again

There are growing expectations that OPEC+ will prolong current cuts for at least another month, which will help to speed up the rebalancing of the oil market. The alliance are expected to come to a decision at their next meeting, which is currently scheduled for 9-10 June, although there have been suggestions that it could be brought forward to 4 June



The current OPEC+ deal

Having seen talks break down between Russia and Saudi Arabia in March, the broader OPEC+ group met again in April, forced to take significant action, given the massive amounts of demand destruction as a result of Covid-19 related restrictions.

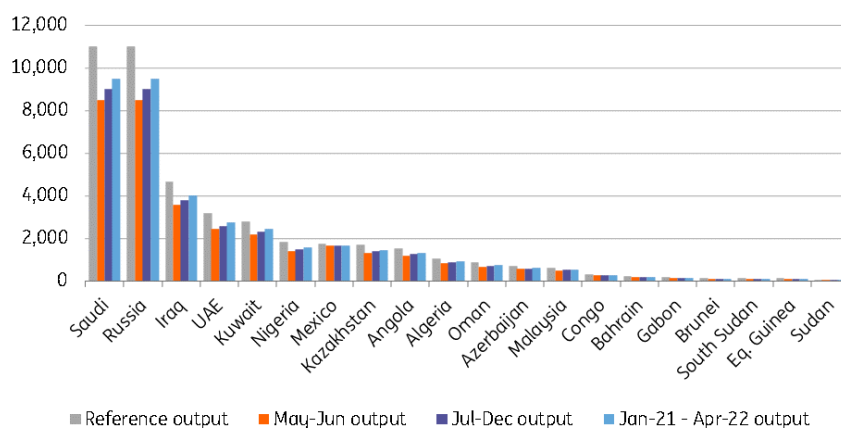
The alliance in April put their differences aside and agreed to cut output by 9.7MMbbls/d over the months of May and June, after which the cuts would be reduced to 7.7MMbbls/d from July through until the end of this year, and then finally from January 2021 through until the end of April 2022 the cuts would be further reduced to 5.8MMbbls/d.

The baseline for these cuts are their October 2018 production levels, with the exception of Saudi Arabia and Russia, who are using a baseline figure of 11MMbbls/d. The baseline production used is higher than their actual production over 1Q20, and so, in fact, the cuts are not as large as the

headline numbers suggest.

Despite this, the agreement certainly is historic, with the group agreeing to cut output by record levels. However, OPEC+ cuts alone are not enough for the market. Market-driven declines from producers outside of OPEC+, along with recovering demand has helped to soften the scale of the surplus over 2Q20.

OPEC+ production cut deal (Mbbbls/d)



Source: OPEC, IEA, ING Research

OPEC+ performance so far

Supply numbers for OPEC members over May are already starting to come through, and in the first month of the deal, OPEC members failed to comply with the deal.

OPEC compliance came in at around 77%, and it was the usual culprits who fell short. Iraq and Nigeria had a compliance of 42% and 33% respectively. In fact, even the largest OPEC producer, Saudi Arabia did not meet its production quota of around 8.5MMbbbls/d, with the Kingdom's output averaging 8.7MMbbbls/d.

Supply numbers for OPEC members over May are already starting to come through, and in the first month of the deal, OPEC members failed to comply with the deal

However, for June, we would expect compliance to continue improving, particularly given that Saudi Arabia, UAE and Kuwait agreed to cut by an additional 1.18MMbbbls/d over June. This additional cut is an attempt to speed up the rebalancing process in the market, whilst it will also help to make up for the poorer compliance from other members.

Looking at producers outside of OPEC, and according to the Russian energy ministry, crude oil production in the country averaged 8.59MMbbbls/d in May, leaving it very close to its quota of 8.5MMbbbls/d. Russian compliance was around 96%, which is stronger than the 92% compliance seen from Saudi Arabia.

What is the new proposal?

Initial reports were that some members were keen to extend the current level of cuts through until the end of this year. However, there have been clear obstacles to such an extension, specifically Russia, who prefers to take more of a wait and see approach.

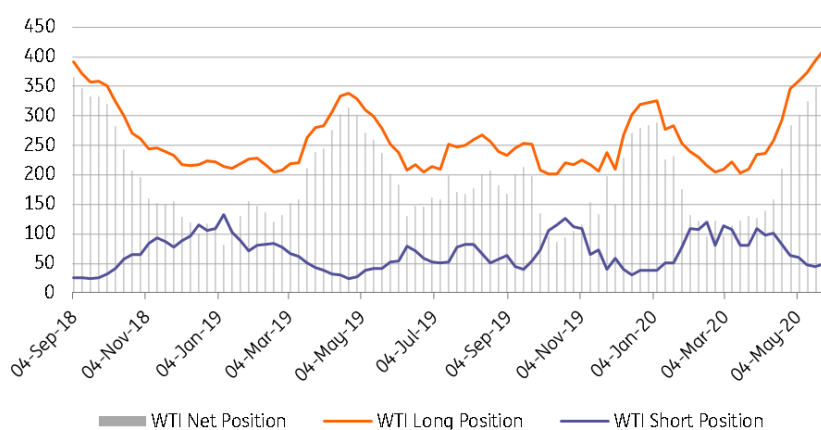
Therefore there will be the need for compromise, and more recent media reports suggest that the alliance will look to now extend cuts from anywhere between one to three months, which would make it more palatable to the Russians.

Is an extension really needed?

The key question though, is if extended cuts are in fact needed. The fundamentals in the oil market are improving, thanks to action taken by producers, and recovering demand. This is reflected in price action, with ICE Brent trading back around the US\$40/bbl level, whilst time spreads have also strengthened significantly over the last month. The market is already set to transition from surplus to deficit as we enter the second half of this year, and so an extension of the deal will only speed up the pace that the market rebalances.

A short extension to the deal, will unlikely change the outlook for the market by year end, and we would still expect ICE Brent to average US\$50/bbl over 4Q20. However, deeper cuts over part of 3Q20, would mean a moderately more constructive outlook for the third quarter.

NYMEX WTI managed money net position (000 lots)



Source: CFTC, ING Research

What are the downside risks for the market?

There are some clear downside risks for the market. The most obvious at the moment is that a failure of OPEC+ to extend current cuts could weigh on sentiment, particularly after the noise over an extension in recent weeks.

Secondly, refinery margins are still very weak, suggesting that the crude rally we have seen over the last month has got a bit ahead of itself. Weak refinery margins leave very little incentive for refiners to increase throughput rates, and so clearly not positive for crude oil demand.

Thirdly, is the risk of supply starting to return with strengthening prices. In recent days a couple of US producers have already said that they will bring back shut-in production in the coming months.

Finally, speculators do seem to be overstretched at the moment in NYMEX WTI, particularly in the current environment. The managed money net long position in NYMEX WTI stands at 362,724 lots as of 26 May, which is the highest net long seen since September 2018, which is when the global market was much tighter, and WTI was trading above US\$70/bbl. Admittedly for ICE Brent though, speculative positioning is not as stretched.

Author

Warren Patterson

Head of Commodities Strategy

Warren.Patterson@ing.com

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