

## In Case You Missed It: Confidence and cracks

Who said central banking was dull? The ECB threw markets a curveball this week, Fed Chair Jay Powell mixed things up and China confounded investors by doing nothing at all. At least Brexit and the global trade talks are all going to plan...

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By Warren Patterson

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Article | 14 June 2018

## ECB: Solomonic end to QE

With an unprecedented communication twist, the ECB today more or less announced the end of QE. While the real motivation of this step remains unclear in light of increased uncertainty, the door to extend QE into 2019 has not entirely been closed



Source: Shutterstock

After last week's speech by ECB Chief Economist Peter Praet, today's decision did no longer come as a surprise. The ECB just took another important step towards a gentle end of QE. In fact, the ECB made three important announcements:

1. **A de facto end of QE in December.** Today's key message was that the ECB "anticipates" an extension of QE from September to December at €15 billion per month, from currently €30 billion, before ending the net purchases in December. All of this being subject to incoming data.
2. **Stronger forward guidance.** The announcement that the ECB expects interest rates "to remain at their present levels at least through the summer of 2019 and in any case for as long as necessary to ensure that inflation is back at target" is a signal that sequencing is clearly longer than the six months markets had been anticipating for a long while. A rate hike before September 2019 looks highly unlikely.
3. **Re-introduction of easing bias.** While previously the ECB had dropped the possibility of stepping up QE, it today re-introduced a kind of easing bias by stating that "the Governing Council stands ready to adjust all of its instruments as appropriate to ensure that inflation

continues to move..." towards target.

Today's decision was taken against the background of what the ECB described as "substantial" progress "towards a sustained adjustment in inflation." A clear change in the ECB's assessment compared with the last meeting. Particularly in light of hardly any changes in the ECB's own macro-economic assessment.

As regards growth, the ECB actually sent a mixed message. On the one hand, ECB president Mario Draghi emphasised the strength of the eurozone recovery despite a soft patch, while on the other hand pointing to recent disappointments in incoming data, new downside risks stemming from financial market volatility and a downward revision of the ECB's staff growth projections for 2018 (from 2.4% to 2.1%. For 2019 and 2020, the staff projections for GDP growth remained unchanged at 1.9% and 1.7% respectively). As regards inflation, Draghi stated that "measures of underlying inflation remain generally muted" and the staff projections also did not point to any imminent inflationary pressure. As expected, the inflation forecasts for 2018 and 2019 were revised upwards significantly to 1.7% in both years, on the back of higher oil prices. Interestingly, the longer-term inflation forecasts for 2020 remained unchanged at 1.7%.

Admittedly, today's ECB decision leaves a bit of an aftertaste. At least for ECB watchers who try to read the ECB's internal reaction function. Moving from not having discussed the outlook for monetary policy at all to a de facto end of QE within six weeks' time comes as a bit of a surprise. Particularly given that in these six weeks there have been hardly any upside or positive surprises to growth and inflation. To some extent, it seems as if the ECB was getting cold feet and that the rising tensions within the Governing Council had to be calmed down.

Even though technically speaking today's ECB meeting did not present an actual decision but only a declaration of intent, the symbolic meaning of the meeting is high. The meeting marks another important step towards a gentle end to QE but at the same time, it does not mark the start of monetary tightening. A first rate hike is still far out. In our view, the economic reasoning leading to today's decision might not necessarily win a beauty contest. The decision is a truly Solomonic compromise between the hawks and the doves. The hawks finally got their end-date for QE, while the doves still have their open door for more if needed. Everyone's a winner...

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# The euro sell-off after the ECB: All a bit much?

EUR/USD has sold off hard on the announcement that the ECB 'anticipates' ending QE in December this year and keep rates unchanged at least through the summer of 2019. This has come as a disappointment to the rates market, which had priced close to 10bp of ECB rate hikes by June 2019. The EUR sell-off feels a bit much, though

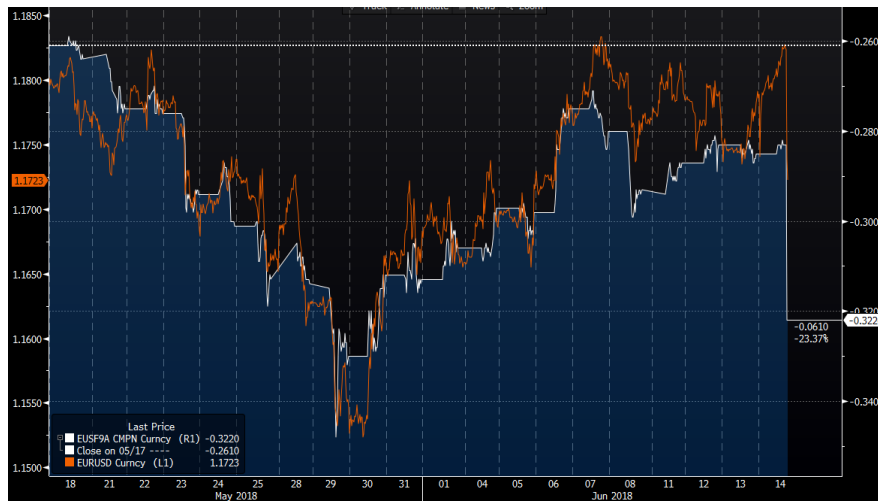


## Will the end of QE be the bigger priority?

While the forward rate guidance should see US:EU policy divergence continue for another twelve months, this story looks largely priced in and it feels like the euro sell-off is a bit of an over-reaction. Of course, the ECB has to manage the exit from QE very carefully – which they're doing through aggressive forward guidance. But we tend to think that, over time, the announcement of the end of QE will emerge as a bigger story – and that in the last quarter of this year and 1Q19 the short end of the EUR curve can start to narrow the spread with its US counterpart. EUR/USD should be pushing back above 1.20, possibly to the 1.25 area by that time. Helping this story should be the return of portfolio flows – particularly long-term debt portfolio flows – to the Eurozone. These were sent off-shore by the ECB's QE programme starting in 2015 and the anticipation of their return should support the EUR over the coming 1-2 years. In general, we see the lower end of EUR/USD trading range in the 1.15/16 area this summer.



## EUR/USD v June 2019 pricing for EONIA



Source: Bloomberg. Note: EUR/USD 30 minute intraday (orange); EZ OIS contract for June 2019 ECB meeting (white line)

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# Federal Reserve sticks to the plan, despite global risks

Our three key takeaways from the June Federal Reserve (Fed) meeting



Source: Federal Reserve

Despite the risks presented by trade wars and emerging market difficulties, the Fed appears confident in the outlook and has opted to increase rates by a further 25 basis points. Assuming the economy continues to perform well, and inflation/wage growth continues to pick-up, we expect the Fed to hike a further two times in the second half of this year.

Here are our three main takeaways:

## 1 The Fed now forecasts a total of four 2018 rate hikes

With growth rebounding following the typical first quarter soft patch, and inflation continuing to accelerate, we have been pencilling in a total of four hikes for this year. Looking at the latest 'dot plot', it seems the Fed is increasingly heading in this direction too.

The closely-watched median 2018 dot has moved up a notch to 2.375, indicating that the committee overall favours two further hikes this year. Previously the Fed had a median of three 2018 rate rises pencilled in, although admittedly the committee were evenly split back in March.

## No mention of trade or EM risks suggests Fed focused on domestic story

It's been a bumpy few weeks since the last Fed meeting. Emerging markets have been buffeted by higher dollar borrowing costs and a stronger USD, while trade tensions have flared. But judging by the latest statement, the Fed remains relatively unfazed. The Fed again simply described the risks to the outlook as “balanced”, with no explicit reference to these external developments.

On emerging markets, Governor Powell said recently that he thinks the effect of US monetary policy on foreign economies is “often exaggerated”. Unlike earlier stages of the Fed's tightening cycle, where China-related concerns saw the committee take a pause, we doubt that recent overseas developments will have the same effect while the domestic economy is outperforming.

On trade though, Fed speakers have been sounding more cautious, and it's clear the negative growth impact of any trade war would have a greater impact on interest rates than the effect of higher prices.

But for now at least, firms and consumers appear to have largely brushed off concerns about trade. Until we see what happens next, we suspect the Fed will follow suit.

### 3 Powell shakes things up – hawkish or dovish?

Three months into Powell's tenure, he's chosen to mix things up a bit.

Firstly, the Fed has dropped its previous guidance that rates were expected to remain “below levels... expected to prevail in the longer run” – something which it had said for quite some time. On one hand, some might view this as the Fed accepting that policy is near ‘neutral’, theoretically meaning we are nearing the end of the current tightening cycle.

But we aren't so sure. In recent weeks some Fed speakers have suggested rates may need to go “somewhat beyond neutral” in future. We had wondered whether this might be reflected in a higher 2020/‘longer run’ dot, although both were kept unchanged on this occasion.

Separately, with the Effective Fed Funds Rate trading towards the upper end of the band, Powell's committee have opted to tweak the way they achieve their target. By hiking the rate of Interest on Excess Reserves (IOER) by slightly less than before, to 1.95%, it hopes to keep the effective rate closer to the mid-point of the targeted band.

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## GBP: Theresa May's impossible Brexit trinity

A tricky summer of Brexit politics lies ahead, with PM Theresa May facing an impossible Brexit trinity. While the pound still remains a good value play, we have some sympathy for investors wanting to shy away from the currency until there is political clarity. We provide three scenarios for GBP based on how Brexit political risks unfold in the near-term



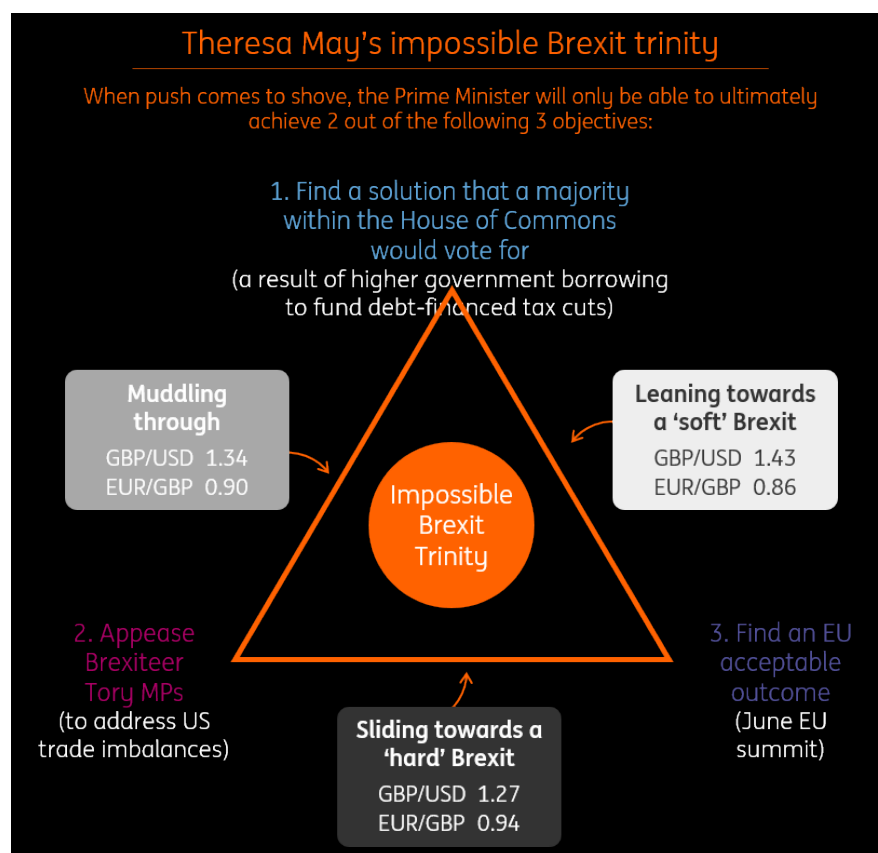
Source: Shutterstock

## Theresa May's Impossible Brexit Trinity

While more recent GBP-specific ebbs and flows have been driven by the sharp re-pricing of Bank of England policy expectations, we expect the focus for sterling over summer to shift back to Brexit politics ahead of a crucial Commons Withdrawal Bill vote (tomorrow) and the 28-29 June EU leaders' summit.

Theresa May's predicament can be characterised as an impossible Brexit Trinity – with the Prime Minister trying to achieve three simultaneous objectives: (1) appease Brexiteer MPs within her own party; (2) find a solution that a majority of MPs in the House of Commons would back; and (3) find an outcome that is politically suitable for all EU members to accept.

When push comes to shove, we think the PM will only be able to choose two of these three objectives – and the broader trajectory for GBP will be a function of her choice.



Source: ING

## Nervous times as May attempts to square the impossible Brexit Trinity

While our house view is currently leaning towards the UK government ultimately opting for a more benign (or a 'softer') Brexit customs union and trade solution – that is one that would ultimately pass the House of Commons and EU hurdles – this is a fairly low conviction call at this stage. Moreover, the risks of this outcome could be rebel Tory Brexiteers pushing for a leadership contest – or even a general election (though we place a low probability on either event occurring).

The focus of this note, however, is not to form a judgement on the likely political outcome ([our](#)

[economists do a good job at tackling this impossible task](#)). Instead, we provide some scenario-based estimates for GBP/USD and EUR/GBP - modelling the outcomes based on the level of Brexit risk premium we expect to be priced into the currency within each scenario:

1. **Leaning towards a 'soft' Brexit** (negligible risk premium): PM May forced down the path of a more benign and smooth Brexit transition that lifts GBP sentiment and allows the currency's focus to shift firmly on the UK data and Bank of England policy tightening story (note in this scenario the probability of an August BoE rate hike increases – assuming UK data remains in line with the Bank's expectations).
2. **Muddling through** (2-3% risk premium): Clarity on the government's Brexit strategy remains vague as the Prime Minister attempts to appease both Brexiteer ministers in her own Tory party and the majority within the House of Commons. The likelihood here is that any solution that unites both groups will be rebuffed by the EU.
3. **Sliding towards a 'hard' Brexit** (6-8% risk premium): Theresa May opts to align with the Brexiteer Tory MPs – and pushes talks with the EU towards a 'hard' Brexit. The likelihood of a 'No Deal' picks up – with material risks that the UK could exit the EU in March 2019 without a transition in place.

## Brexit risk premium assumptions under each scenario

Impossible Brexit Trinity Scenarios	Brexit Risk Premium	GBP/USD	EUR/GBP
1. Leaning towards a 'soft' Brexit	Negligible	1.43	0.86
2. Muddling through	2-3%	1.34	0.90
3. Sliding towards a 'hard' Brexit	6-8%	1.27	0.94

Source: ING

## Short-term Brexit uncertainties keeping GBP sidelined for now

We estimate that GBP/USD is trading with a 2.5-3.0% discount at present – which is indicative of a 'muddling through' Brexit risk premium. This is unsurprising given the near-term focus on the Commons Withdrawal Bill vote (tomorrow) and the 28-29 June EU leaders' summit. We would expect this uncertainty premium to remain in the price of GBP until further clarity on the Brexit front.

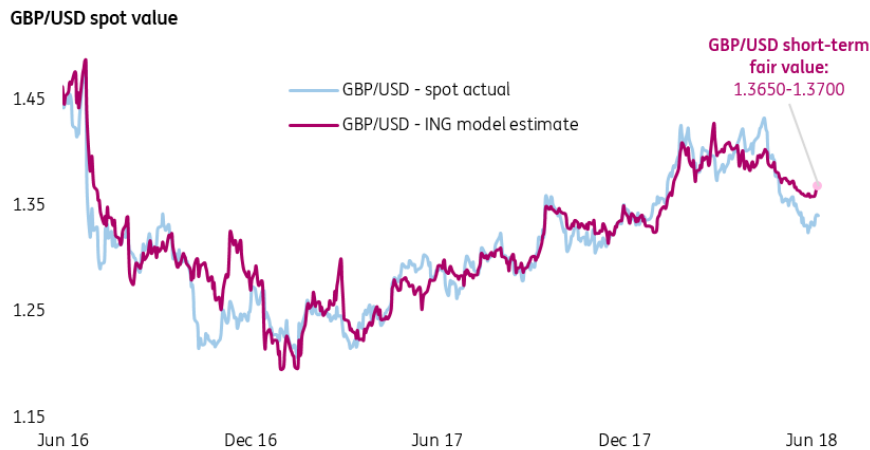
However, GBP's currently depressed value suggests that a lot of 'bad' Brexit news is already in the price. For a more sustained downturn, we'd need to see the probability of a 'hard' Brexit pick-up substantially. This week's events in the House of Commons are unlikely to shift one's assessment materially (in either direction).

### Bottom line: A lot of bad news priced in... but hard to find a positive Brexit catalyst

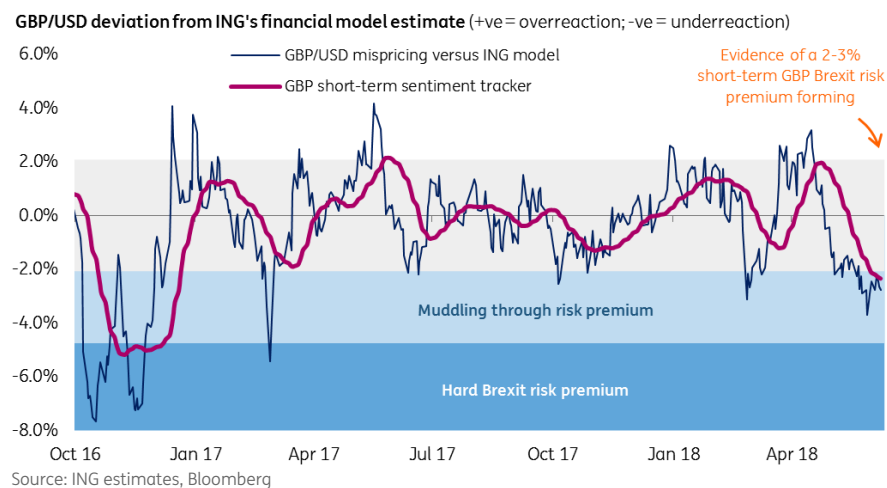
While a tricky summer of Brexit politics lies ahead, with May facing an impossible Brexit trinity, the pound still remains a good long-term value play. Our current forecasts continue to look for sterling to navigate towards levels consistent with a 'neutral' Brexit later this year (**GBP/USD: 1.43** and **EUR/GBP: 0.86**)\* – with the near-term balance of risks tilted towards GBP/USD moving back towards 1.36 (200-day moving average).

\*These remain under review – and we will address GBP's longer-term direction in a note later this summer.

## GBP/USD trading with a 2-3% short-term Brexit uncertainty premium



## Current GBP price action indicative of a 'muddling through' Brexit risk premium



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# China: We're cutting our GDP forecast as deleveraging bites

China's credit tightening is hitting economic activity and we are cutting our 2Q GDP forecast as a result. But don't panic. We don't think this weakness will last very long and we're not expecting a credit crunch



Source: Shutterstock

## Revising GDP growth downward to 6.7% YoY from 6.8% in 2Q18

We are revising our China GDP growth forecast to 6.7% YoY from 6.8% YoY in 2Q18 but maintain our forecasts for 3Q18 and 4Q18 at 6.7% YoY. The revised GDP forecast for 2018 is 6.70% from 6.75%.

## Weaker economic activity could be a result of credit tightening

Economic activity was slower than expected in May.

- Industrial production fell to 6.8% year on year in May from 7.0% YoY in April
- Retail sales grew 8.5% YoY from 9.4% in April
- Fixed asset investments have fallen to 6.1% YoY year to date from 7.0%

We have found that credit tightening has had a big impact on economic growth.

## Slower retail sales growth as consumers wait for tariff cut to be reflected in prices

Slower growth in retail sales has been broad-based, with the exception of telecommunication items and petroleum and related products. Even automobile sales posted a negative 1% YoY growth rate. The slower growth has been caused by:

1. A high base, as retail sales growth has been strong for many years.
2. Tariff cuts, which have encouraged consumers to wait for prices of imported goods to come down. This applies to automobile sales and daily consumer products. Sellers of goods imported before the tariff cuts may need to lower their prices to attract consumers, so we may see a revival of retail sales in June.

## Fixed asset investment shows only in manufacturing

A slowdown in fixed-asset investment growth has also been broad-based but in varying degrees for different industries.

Investment in transportation fell 2.3% YoY YTD, of which investment in rail transport was down 11.4%. This is a direct result of financial deleveraging reform that has tightened issuance of wealth management products, of which the underlying assets are usually local government-supported infrastructure projects.

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*High-tech investments and manufacturing should be able to pick up. Fiscal and monetary support for high-tech and SMEs will offset the loss of economic growth from credit tightening.*

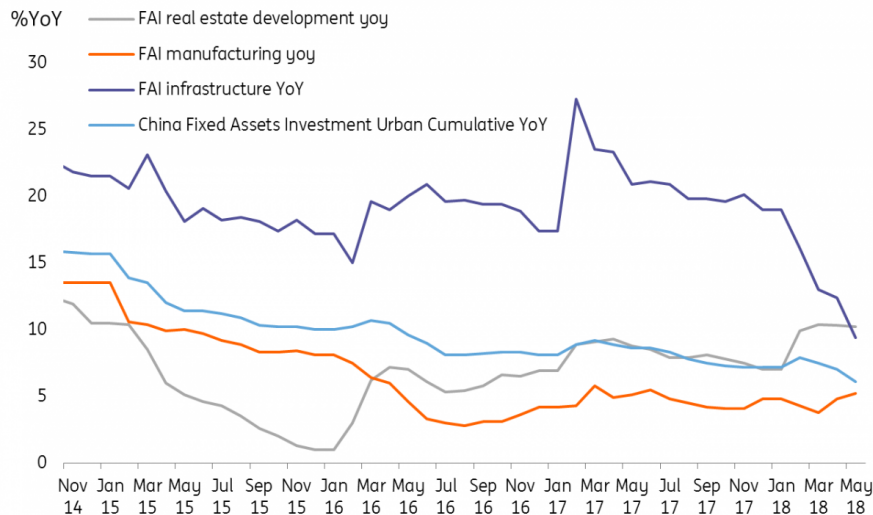
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Still, investment in computer telecommunications manufacturing still held up well at 14.6% YoY YTD. This allows us to retain our bullish stance for 2H18, as we expect more fiscal support in this area.

In addition, real estate development didn't slow as quickly as the headline number. Real estate development grew 10.2% YoY YTD, down just slightly from 10.3% YoY YTD. The central government's gradual approach to deflating the property bubble has indirectly cushioned overall investments.

Trade tensions have had some impact on investment, reflected by a fall in spending by Hong Kong-owned and foreign-owned enterprises. These enterprises focus more on export markets and could delay investment decisions as trade tensions escalate around the world.





Source: ING, Bloomberg

## Industrial production still has high-tech support

Unlike retail sales, slower growth in industrial production was not broad-based.

Most of the high-tech items continued to grow at a solid rate. For example, industrial robots grew at 35.1% YoY in May up from 33.7% in April, and integrated circuits grew 17.2% YoY compared to previous month's 14.6%.

It seems to us that industrial production in areas related to Made in China 2025 is still holding up well. This implies the current credit tightening from financial deleveraging reform has not hit the high-tech sector.

## Financial deleveraging reform will continue to pressure the economy

Credit tightening has led to a rising number of defaults in China and has resulted in weaker economic activity. But growth momentum is not going to return simply by the central bank [halting a five basis point rate hike](#). We think there will be more fiscal support to boost investment in high-tech sectors, as well as monetary support for SMEs ( more on [PBoC's monetary policy here](#)) and we don't expect the weakness in May to last long.

With financial deleveraging reform continuing throughout 2018, we don't expect there will be a sudden return of high growth in fixed asset investments in sectors related to transport infrastructure, and that is the reason behind our revised 2Q18 GDP forecast.

## But we don't see China facing a credit crunch

We are not expecting a credit or liquidity crisis as a result of tighter credit because:

- Credit measures and liquidity are controlled by the central bank. The central government and the central bank can be flexible in crafting policies to avoid the economy weakening continuously.
- The impact of financial deleveraging on wealth management products (and therefore the

underlying assets) should be reflected in around three months' time. The new measures were announced at the end of April, so most of the impact should be seen from May to July.

As financial deleveraging reduces the unnecessary financing of projects, it should also reduce the number of projects by local governments. This would keep investment growth in transport infrastructure at a low level.

In the meantime, high-tech investment and manufacturing pick up.

As a result, we are still optimistic on growth in the second half of this year and expect fiscal and monetary support to offset the loss of economic growth from credit tightening.

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Snap | 15 June 2018

# US tariffs on Chinese imports invite retaliation

The US is already seeing retaliation from its major trade partners after it raised steel and aluminium tariffs. Now it has escalated its dispute with China



Source: Shutterstock

The US has [confirmed](#) the list of approximately \$50 billion worth of Chinese products to be targeted with higher import tariffs. The tariffs- which target the key sectors in China's "Made in China 2025" industrial strategy including chemicals, pharmaceutical products and industrial machinery- form part of the US's dispute with China over intellectual property and technology transfer. The tariffs will come into effect in stages, with the first set coming into effect on 6 July and the remaining set after further public consultation. China is likely to retaliate by raising tariffs on imports of US products, including soybeans.

The US is trading blows with its other main trade partners too. Canada, Mexico and the EU have responded to US tariffs on steel and aluminium by announcing their own tariffs on imports from the US, in addition to challenging the national security basis for the US tariffs at the WTO. Canada's decision to retaliate was the apparent cause of the spectacular implosion of the affirmation of commitments to free trade made at last week's G7 [meeting](#). The EU will raise tariffs from the beginning of July on imports of American jeans, bourbon, and motorbikes.

Cars look likely to be the next front in the developing trade war, as the US Department of

Commerce has started investigating whether car imports represent a threat to US national security. With the EU, Mexico and Canada challenging the US's use of national security as a cover for the steel and aluminium tariff increases, and the car industry at the centre of the Nafta negotiations, higher tariffs are likely to spark retaliation by the US's trade partners.

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## Crunch time for OPEC

OPEC members descend on Vienna next week for the official semi-annual meeting on 22 June. Will members of the OPEC+ deal decide to ease production cuts? While some members appear to be against the idea, we believe that we will see a gradual lifting of cuts

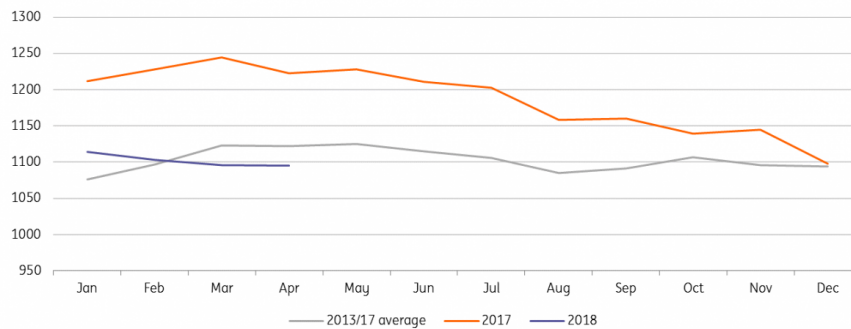


### Why are some calling for an increase in output?

As we wrote in our previous note, [OPEC oil cuts: To continue or not to continue, that is the question](#), we were of the view that OPEC would look to implement an exit strategy at its June meeting. This was due to the fact that the group has achieved its goal of bringing OECD crude oil inventories back to the five-year average. We also felt that implementing an exit strategy at a time when there is downside risk to Venezuelan and Iranian supply would be appropriate. Let's also not forget the growing pressure from a number of key importers about higher oil prices.



## OECD crude oil inventories (MMbbls)



Source: IEA, ING Research

## What increase could we see?

At the moment, the potential range of increases is rather large, with many expecting somewhere between a 300M-1MMbbls/d production increase. There have been media reports that the US government asked OPEC to increase output by 1MMbbls/d, while more recently Bloomberg reported that Russia is planning to suggest that members scrap the cuts altogether, and take production back to October 2016 levels. This would suggest a 1.8MMbbls/d increase in supply. We believe that we will see a gradual increase of between 800M-1MMbbls/d over the course of the year.

## Will the Russians and Saudis get what they want?

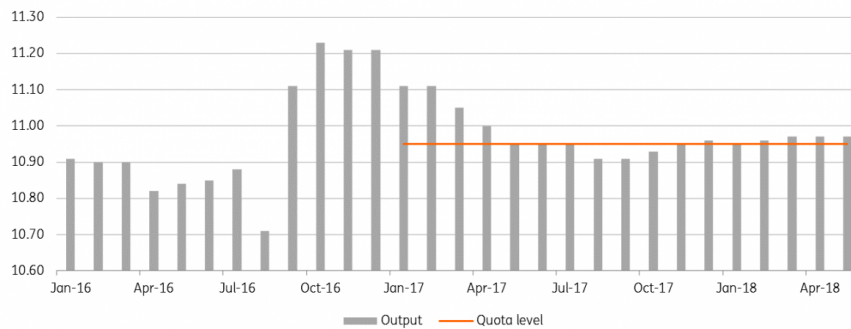
It is pretty clear that the one member of the OPEC+ deal that believes it is time to ease production cuts is Russia. Heading into the last official OPEC meeting, they were reluctant to extend the deal, and this time around that reluctance has certainly grown. As part of the initial deal, Russia agreed to cut production by 300Mbbbls/d to 10.95MMbbls/d. However, since February, the country has produced more than this and, in fact, according to Interfax, Russia's oil output in the first week of June increased to 11.1MMbbls/d.

We would not rule out a scenario where Russia decides to exit the deal altogether. They believe that the intervention carried out has achieved its target. If Russia were to break away from the broader OPEC deal, we believe they could increase supply by around 300Mbbbls/d from their current quota level.

Saudi Arabia is the other main proponent of increasing output. It seems that concerns over possible demand destruction and calls from importing countries have distracted the Saudis from pursuing higher oil prices in the run-up to the Saudi Aramco IPO.

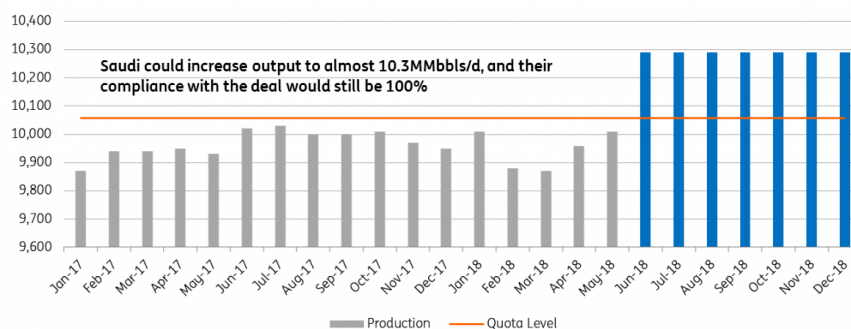
The Saudis up until now have done a great job with compliance; they have cut more than they should, with compliance averaging 120% since the start of the deal. This strong compliance does give the Kingdom a rather large buffer. They can increase production by almost 300Mbbbls/d by the end of this year, and they will still be 100% compliant with the deal. The Saudis have appeared to make their intentions clear, with May production exceeding 10MMbbls/d for the first time since August 2017, although this could be nothing more than the usual seasonal increase we see in production, with a pick up in domestic demand over the summer.

## Russian monthly oil production (MMbbls/d)



Source: CDU TEK, Bloomberg, ING Research

## Saudi Arabia could still pump much more and remain compliant with the deal (Mbbbls/d)



Source: OPEC, Bloomberg, ING Research

## Who are those against increasing output?

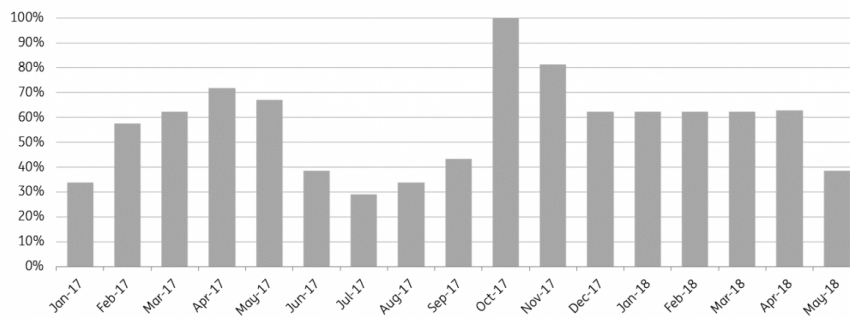
A short answer to this question would be anyone who does not have the capability to increase output. The bulk of other OPEC members do not have much in the way of spare capacity, and so would be worse off if the likes of Russia and Saudi Arabia increase output.

It is in Venezuela's interest to continue with the current framework of the production cut deal. The oil industry continues to suffer as a result of a lack of investment, and production has been in steady decline since early 2016. Looking at the latest Baker Hughes rig data for the country, the number of active rigs stands at just 28, down from more than 70 in early 2016, and the lowest number since 2003. As a result, there appears to be no reversal in this trend, with production expected to continue declining towards 1.2MMbbls/d by the end of this year. In order to help offset these declines, stronger oil prices are needed.

As for Iran, it would also be keen for the deal to stay as is, as the country could be forced to reduce supply if buyers take a step back from Iranian crude as a result of US sanctions.

Finally, plenty of noise has come from the Iraqis in recent days, calling for the deal to remain intact. However, Iraq is at the bottom of the leaderboard when it comes to compliance amongst OPEC nations. The country's compliance has averaged just 57% over the course of the deal and, in fact, compliance hit just 39% in May.

## Iraq fails to meet compliance with the deal



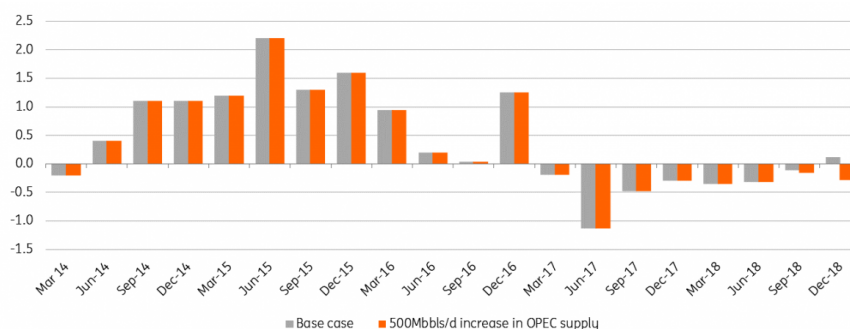
Source: OPEC, Bloomberg, ING Research

## The global balance

Under our base case scenario, we are assuming that we will see 500Mbbbls/d of Iranian oil supply lost by the end of this year, along with Venezuelan production falling towards 1.2MMbbbls/d. In order to offset these losses, we are assuming that we see the remaining members of the OPEC+ deal increase output gradually by a little over 900Mbbbls/d by the end of this year. Unsurprisingly, the bulk of this increase is driven by Saudi Arabia and Russia. Under this scenario, we do see a smaller deficit over 3Q18, and in fact a small surplus in 4Q18.

However if we were to assume only 500Mbbbls/d of additional supply, and assume similar losses for Iran and Venezuela, the global market will remain in deficit through the end of 2018. The more extreme scenario, which would lead us to revisit our current price forecasts, is if we were to see Iranian supply fall by more than 500Mbbbls/d by year-end, or if OPEC decides to leave the current deal intact.

## Quarterly global oil balance (MMbbbls/d)



Source: IEA, EIA, ING Research

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