

# In case you missed it: Coronavirus creates chaos

The coronavirus has gone global and is no longer just a China or Asia story. Markets are expecting central banks to take the lead, as global equities suffer a battering. Things are unlikely to change next week, but we'll begin to gauge the impact of the epidemic as Chinese data begins to come in. Also, it'll be Super Tuesday and UK- EU trade talks kick-off

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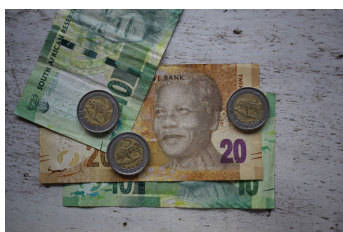


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By Padhraic Garvey, CFA

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## FX

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## Global FX: Shaken out of their low volatility torpor

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### Volatility awakens

The worldwide spread on Covid-19 has understandably taken its toll on risk assets as investors are forced to lower growth forecasts and even consider recession in some countries.

Financial assets, which had enjoyed the benign conditions of central bank money printing – have had a rude awakening. The S&P 500 is now 12% off its highs and the VIX fear index has surged back to levels not seen since the global financial crisis. Even EUR/USD volatility – written off this year – has quickly bounced back to levels last seen in 2018.

It has hard to make a call on when this equity correction will turn, especially after such a long period of low-volatility gains. However central banks will be carefully monitoring financial conditions and step in if they fear self-enforcing trends and market dislocation emerging. While credit spreads have certainly widened, we are yet to see major problems in the interbank space – e.g. a sharp widening in the TED spread (USD 3-month Libor over US T-Bills).

We would monitor that amongst other stress variables for signs that central banks could step in

with a co-ordinated rate cut, as they did in October 2008. For the time being, however, we expect financial asset prices to stay under pressure.

## FX markets react

As we outlined in [Coronavirus: Gauging the market fall-out](#), we see the risk – commodity exposure framework as the best way to assess the current vulnerabilities in the FX markets and the reaction of currencies to Covid-19 related risks. The slowdown in global growth is hitting pro-cyclical currencies and Chinese slowdown in particular further weighs on commodity FX. Mixing these two factors together, a credible vulnerability scorecard exposes those currencies that are at risk and those that can outperform.

In addition, and given the extent of the moves, the current situation has triggered a positioning squeeze and carry trade unwind (which is also evident in the emerging market bond market, where high yielding sovereign debt is underperforming low yielders - the large sell-off in the overbought RUB is a case in point)

### [Coronavirus: Gauging the market fall out](#)

## AUD, NZD and NOK to remain G10 underperformers

As Fig 1 shows, the AUD, NZD and NOK (as well as the CAD) are the most at risk given their high beta and commodity exposures (they are in the undesirable top right quadrant).

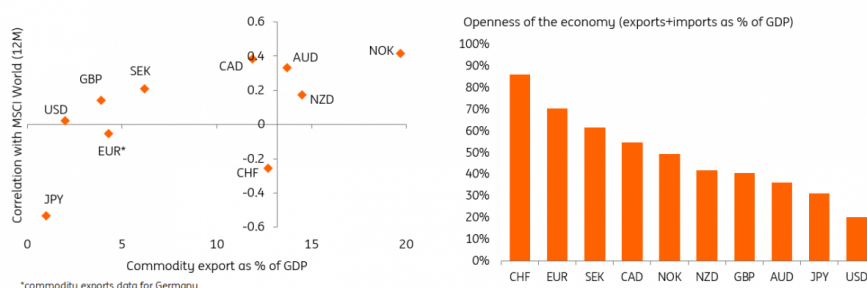
While SEK tends to weaken in the risk-off environment too, currently is an outperformer among the cyclical currencies given its lack of commodity exposure. This is in line with price action this week, whereby SEK outperformed its G10 cyclical peers.

AUD and CAD appear particularly at risk of facing additional selling pressure as the RBA and the BoC meet next week. As we have highlighted: [“Australia's central bank to stand pat, with a possible dovish tilt”](#), it will be hard for the RBA to deliver another hawkish surprise as Covid-19 risks to the Australian outlook have likely increased since the previous meeting.

Elsewhere, speculation that Canada's central bank may deliver a cut sooner than later has risen dramatically along with expectations of more Fed stimulus and we highlight a relatively high risk of a move in one of the next two meetings.

### [Australia's central bank to stand pat, with a possible dovish tilt](#)

## Fig. 1 & 2: Gauging the G10 exposure



Source: Bloomberg, ING

## JPY: Regaining the attractiveness

In contrast, JPY does well and should continue doing well (within Fig 1, it screens as the most desirable currency to hold in a risk-off scenario) given its safe-haven properties.

While two weeks ago USD/JPY was testing 112 level, this has now changed as Covid- 19 enters second-phase with the focus of market concerns no longer tied to just Asian economies but now becoming a global story (and thus being negative for economies outside of Asia). In this environment, JPY is set to flourish.

Generally the sharper the dislocation in equity markets, the higher the USD/JPY correlation with equities. A short, very sharp equity correction, therefore, leaves USD/JPY vulnerable. There is some extreme outside risk to 105 here should equity losses run unchecked – but we'd see that as the base for 2020.

### JPY: Three drivers behind the fall

## EUR benefiting from a short-squeeze, but only for now

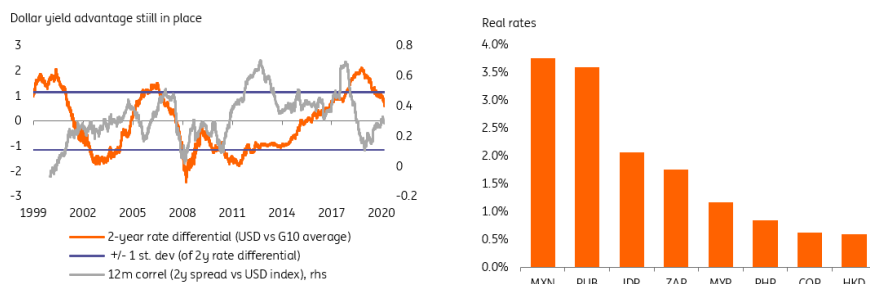
The EUR/USD spike this week is more about a euro short-squeeze (given that EUR functioned as a funding currency of choice for risk on long position in G10 cyclical currencies and EM high yielders) rather than a re-rating of the euro outlook (which in our view remains poor). The downside risk to the eurozone economy remains in place (given the very open nature of the eurozone economy and its linkage to the global supply chains which are now at risk - Fig 2).

On the dollar side, although the market's dovish repricing of the Fed rates outlook contributed to the reversal in EUR/USD higher, plenty of easing is already priced in, particularly in the context of the Federal Reserve cautious approach (which last year proved reactive rather than proactive). With the market already pricing three full Fed rates cuts this year, the dollar interest rate differential was eroded further vs the euro and its G10 peers (Fig 3), yet it still remains meaningful. This, in turn, keeps the dollar's appeal for now and EUR/USD upside should be limited.

Yet, as the dollar advantage has been eroded and the interest rate spread dropped further below the one standard deviation mark (blue line in Fig 3) this is likely to reduce dollar's appeal once the market stabilises and will increase the call for the turn in the dollar bull trend. Yet this is likely to be the case for dollar crosses against cyclical higher-yielding currencies rather than euro (as the former shows more appealing valuation than the latter), with the euro still remaining unattractive vs the dollar (both from economic and interest rate perspective) even after the dip in US rates.

But for now, we expect EUR/USD upside to be limited. EUR/USD 1.11-1.12 may be the best levels here before the markets get to assess the fresh damage done to the eurozone economy.

### Fig. 3 & 4: USD and EM rates overview



Source: Bloomberg, ING

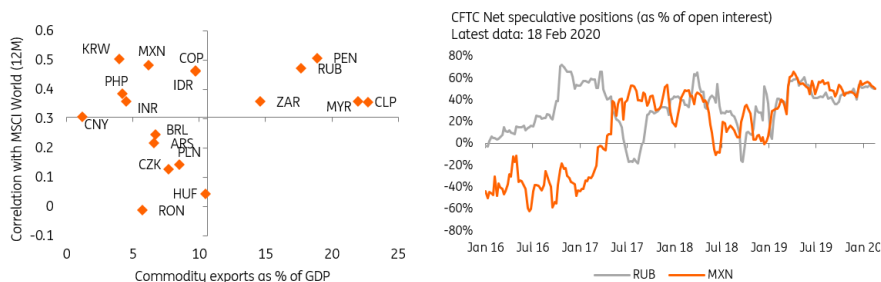
### EM FX: Running way from high yielders

The latest emerging market FX price action clearly resembles a positing unwind. Today, the four weakest emerging market currencies are RUB, IDR, MXN and ZAR. It does not come as a surprise that these are the currencies with the largest real rates in the emerging market region (Fig 4), which in calm times made them attractive.

RUB and ZAR also seem particularly exposed from the risk-commodity exposure perspective, as evident in Fig 5 (with both currencies being in the undesirable top right quadrant).

Near term, as the risk sentiment is likely to remain fragile, the high yielding currencies should remain under pressure. With MXN and RUB having been up till now seen as the darling of EM FX (as evident in meaningful speculative longs – Fig 6), these currencies are at risk of a further positioning squeeze.

### Fig. 5 & 6: EM exposure, MXN and RUB positioning in deep long territory



Source: CFTC, Bloomberg, ING

### CEE FX: Vulnerable CZK vs no longer underperforming HUF

In the low yielding CEE space, CZK should continue underperforming. As it has been the case for RUB and MXN, the koruna has also been a regional darling (in the CEE space) with long CZK positions being meaningful.

Given the indiscriminate flight to quality and liquidation of EM FX positions, the koruna is now at risk. In contrast, we reiterate our constructive view on HUF. Positioning-wise, the forint is the opposite to CZK – the Hungarian currency has been one of the most oversold in the EM FX space and with its fortunes changing (after the NBH delivered close to two 25bp implicit hikes), it should

now start outperforming CZK and PLN in the region.

The latest price action provides the case in point.

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Article | 28 February 2020

## OPEC+ meeting: Great expectations

OPEC+ are set to meet on 5 and 6 March. The market is expecting a lot from them given the demand impact from Covid-19. It is clear that OPEC+ needs to...



Source: Shutterstock

### Covid-19 & demand worries

The biggest worry for the oil market at the moment is the demand impact from the Covid-19 virus outbreak. The hit this is having on demand does mean that the expected surplus over 1H20 has grown, and therefore the need for even further action from OPEC+. As [we mentioned recently](#), we are assuming that we will see demand growth slowing by around 400Mbbls/d over the year, and so leaving demand growth at just 800Mbbls/d for 2020.

However this is an evolving number, and there clearly is further downside to demand growth as we see an increase in the number of reported cases outside of China.

[Why we have revised our price forecasts lower](#)

### OPEC+ performance

Back in December, OPEC+ agreed to additional cuts of 500Mbbls/d for 1Q20. This, along with continued over compliance from Saudi Arabia, takes effective cuts for the group to 2.1MMbbls/d over the quarter. OPEC performance with the deal over January was good, with output averaging



28.32MMbbls/d over the month, down 505Mbbls/d MoM. This fall was driven by the deeper cuts agreed, along with a plunge in supply from Libya, given the ongoing export blockade in the country. Libyan output has fallen from an average of 1.14MMbbls/d in December to around 120Mbbls/d currently.

When OPEC+ decided on deeper cuts in December, they failed to extend the deal through until the end of June, which still left a sizeable surplus in 2Q20. The group decided that it would review the market situation at the extraordinary meeting scheduled for next week, before agreeing to any action for the second quarter. However, the outbreak of Covid-19 has meant that action from OPEC+ has become more pressing.

## What do they need to agree on?

The OPEC+ joint technical committee (JTC) recommended to OPEC+ ministers to extend the current deal through until the end of this year, whilst deepening cuts by 600Mbbls/d over 2Q20. More recently, there have been media reports that Saudi Arabia is pushing for an additional 1MMbbls/d of cuts.

*We believe that deeper cuts of 600Mbbls/d over 2Q20 should be enough to keep the market largely balanced over the second quarter for now*

We believe that deeper cuts of 600Mbbls/d over 2Q20 should be enough to keep the market largely balanced over the second quarter for now. However, there is also uncertainty over when Libyan supply will return to normal. If output in the country returns to normal fairly quickly we will probably need to see cuts closer to the 1MMbbls/d that Saudi Arabia is reportedly pushing for.

As we have seen in the past, it is Russia who needs convincing when it comes to production cuts, and this time it is no different. Russia has been fairly quiet after the recommendation made by the JTC several weeks ago. However, the renewed pressure we are currently seeing on prices should be enough to send a signal to OPEC+ that they need to take action at the meeting. Failing to do so would mean only further downside to our [current price forecasts](#).

We believe the market will be disappointed with anything that falls short of the JTC recommendation.

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Article | 27 February 2020

## Sell-off pressure increases on metals as coronavirus spreads

With increasing cases of the Covid-19 outbreak reported from South Korea, Italy, Iran and Japan, base metals are now facing further sell-off pressure



Workers in Daegu, South Korea, where there's been a spike in new coronavirus infections

### Supply and demand exposure

Let's start at the metal supply and demand exposure. We've seen rising cases over the past few days from South Korea, Japan, Italy and Japan. Their collective base metals' supply and demand picture is relatively low globally and certainly when compared to China. More importantly, there are no reports of actual disruption to metals' physical operations in these areas, at least up to now.

The sell-off in the base metals complex over the last few days largely reflects the heightened risk-off sentiment or 'fear-factor' across broader riskier assets. Those fears could weigh more on the global economic outlook if Covid-19 spreads still further. We talked about those risks in Europe [here](#). However, supply chain risks may have more a far-reaching impact than their respective supply and demand figures suggest. These percentage figures are based on production and consumption in terms of primary metals; usage further downstream may not be fully captured.

## Italy

Italy consumes around 2% of global primary aluminium and is the second-largest consumer within Europe. It makes up a similar proportion of global consumption when it comes to refined copper. Both primary copper and aluminium output from the country is negligible. Looking at other base metals, Italy is a small player on the global stage. However, looking regionally, the country is a fairly sizeable market within Europe. For instance, it's the continent's largest user of lead, consuming around 260kt annually. It's the fourth biggest consumer of refined zinc with an average of 230kt per year and the second-biggest copper consumer at 550kt per year.

Europe as a whole makes up around 10-15% of both global supply and demand when it comes to base metals, of which Germany holds the largest share. On the mine side, Southern Europe's percentage is rather negligible; only Spain produces a relatively high proportion of global zinc, lead and copper concentrate. Elsewhere in the region, Northern Europe, including Sweden and Ireland, has a slightly higher proportion of mine supply for these two metals.

## Iran, South Korea and Japan

Iran's metals' industry may be facing higher risks as a result of the spread of Covid-19. This is an additional risk on top of US sanctions against their major metals products from earlier this year. However, Iran's base metals portfolio is too small to upset the global metals supply chain.

For South Korea, both refined lead and zinc production account for around 7% of the global total, and about 2.5% of refined copper. So far, the centre of the Covid-19 outbreak appears to be in Daegu. South Korea's primary Onsan smelter is located in Ulsan, around 75km away. Japan only has a slightly larger share of refined copper and aluminium supply and demand, on average, 3.5% of the global total.

## Base metals' reaction

The spread of Covid-19 outside China continues to add more uncertainty to the metals market. If the number of cases continues to rise throughout Europe or the US, there is further downside risk to prices. Still, a large focus in the market remains on China's supply and demand as it represents half the global market. A key observation is a surge in metals inventory as a result of short-term supply growth outpacing the demand recovery, which has weighed on prices.

*The spread of Covid-19 outside China continues to add more uncertainty to the metals market*

A major development in the past couple of weeks has been that local logistics and transportation appear to be recovering. Beijing has come up with a number of measures to encourage businesses to return to normal, including putting temporary waivers on tolls on all highways across the country. This could offer some relief to smelters when it comes to resolving issues with sulphuric acid storage, as well as raw material and product shipments. This could help to avoid some shutdowns or the bringing forward of maintenance work.

We tend to believe that metals with higher smelting margins and low-cost smelters have an even higher incentive to keep utilisation rates high and they're less likely to make cutbacks unless there are unexpected difficulties. Zinc smelting margins remain high mainly as a result of high Treatment Charges amid the recent mining cycle. We would therefore expect refined supply growth to remain strong. We've written about zinc turning the tide amid the coronavirus outbreak [here](#). We remain bearish in the short term as far as the zinc market is concerned unless we see meaningful cutbacks or strong inventory drawdowns by end users.

In comparison, on the overall demand side, downstream consumers are more widely dispersed and many may not be able to ramp up efficiently. These include private firms, such as semi-fabricators of copper cables, zinc galvanisers and alloy makers, and they may find it difficult to restart or are only able to work at limited capacity.

Therefore, in the short term, the imbalance between supply and demand recovery points towards stock builds and that would be difficult for the market to digest.

# Libor transition: Bank of England cranks up the pressure

The Bank of England is expediting the transition away from Libor. We review the implications for sterling rate markets and take stock of the transition



Source: Shutterstock

## Libor-linked collateral beware

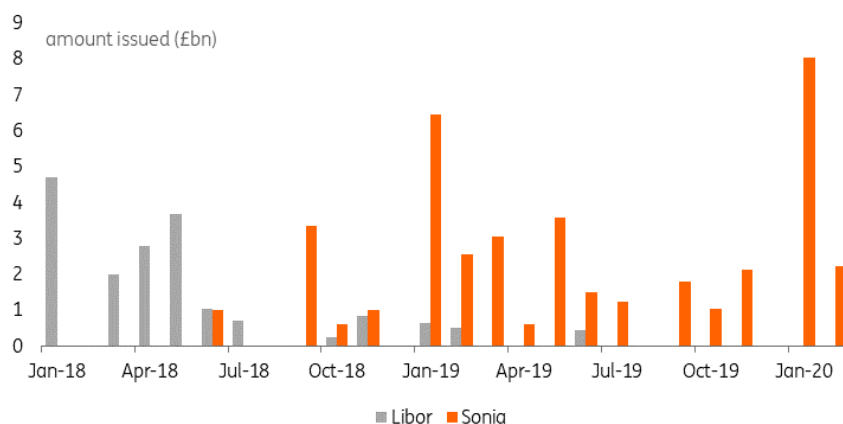
The Bank of England has taken additional steps that should ensure the transition away from Libor interest rate benchmark.

In a [market notice](#), the central bank said it will gradually increase the haircut imposed on Libor-linked collateral used in liquidity operations. This will result in counterparties pledging Libor-linked collateral, primarily loans and securities, to the central bank receiving less cash in return. The additional haircuts will come into force in October 2020 and will increase gradually all the way through to December 2021. In addition, securities referencing Libor issued after 1 October 2020 will not be eligible for these operations. Helpfully, a distinction could be made for collateral including robust fall-back language.

If the changes make sense to reflect the greater operational risk posed by Libor-linked securities after the possible discontinuation of Libor, it will also act as an additional incentive for market participants to transition away from Libor. It is also consistent with the Working Group on Sterling

Risk-Free Reference Rates' (RFRWG) aim of [ceasing issuance of cash products linked to Libor by 3Q20](#).

## Sonia-linked bonds has overtaken Libor ones...



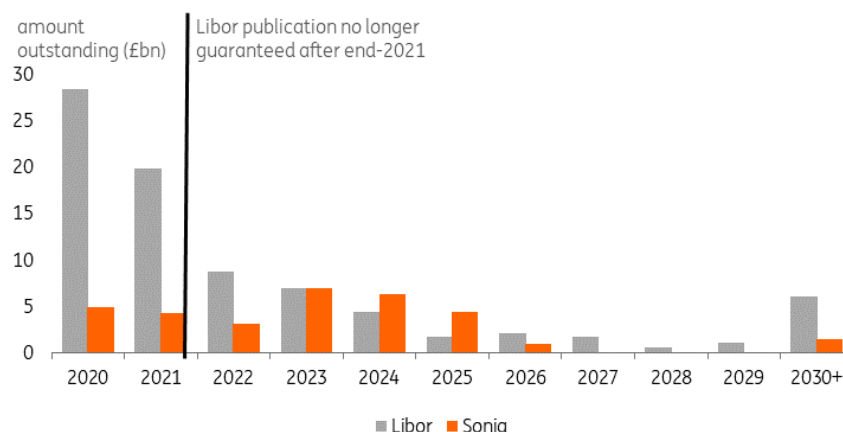
Source: Bond Radar, ING

## Progress report: Near-term deadlines

For securities, there is ground for optimism. Issuance of Sonia-linked bonds, the preferred Sterling Risk-Free Rate (RFR) replacement to Libor, has all but overtaken Libor-linked ones.

A significant amount of Libor-based bonds are still outstanding with a maturity past 2021, however, the transition for other cash products, in particular loans, is progressing albeit at a slower pace due to the sheer number of contracts to amend, and of counterparties to inform. The RFRWG thinks 90% of loans could be referencing Sonia in the future.

## But there remains Libor-linked bonds maturing post-2021

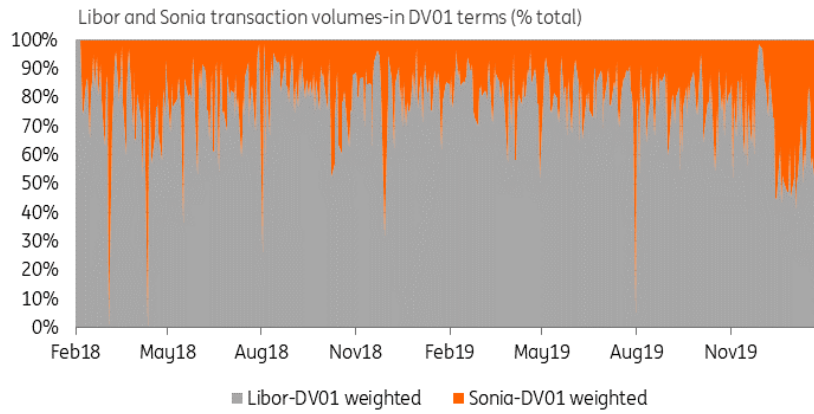


Source: Bloomberg, ING

Hedging flow around the launch of Sonia-securities and loans is also helpful in building up liquidity and familiarity with Sonia swaps ahead of the RFRWG's aim of switching the convention from Libor to Sonia on 2 March 2020.

More broadly, the fact that the reformed Sonia, rather than a new benchmark, was selected as replacement to Libor is helpful for the Sonia swap market to quickly reach critical mass.

## Sonia swaps volumes market share has increased



Source: Bloomberg, ING

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Article | 25 February 2020

## US market rates bracing for 1%

Equity markets have swapped their spectacles for bond market ones and are finally seeing some angst down the line. That has helped bond yields push...



### The Coronavirus effect

Covid-19 is the type of catalyst that both risk assets and core bond markets had been watching for, but from very different perspectives.

1. Bond markets were already trading as if there was trouble ahead (flat curve, rich 5yr valuation and rate cut discount).
2. Equity markets and risk assets generally were motoring ahead, but eyeing the blind spot for a pull-back risk.

The early reaction to Covid-19 had been a tad perverse. The US 10yr fell from 1.8% to 1.6% for starters. But equity markets saw the glass as half full - lower bond yields meant a heightened chance for a rate cut. That, plus a still benign inflation backdrop classically presents a positive underpinning for risk assets.

Fast forward, and there has clearly been a tipping point where vulnerability has been extrapolated. Risk assets have begun to look through bond market spectacles, and are now eyeing risks that are not immediately solvable through simple rate cuts. In turn we expect to see bond yields continue to significantly front run any Fed rate-cut response.



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*"Interest rate cuts will neither cure anyone's flu, nor avert close-down risks for areas that have or will become Covid-19 impacted."*

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The only logical rationale for an imminent interest rate cut is for the interests of financial market stability e.g. a case where the equity market sell-off turned into an uncontrollable rout. Beyond that, interest rate cuts will neither cure anyone's flu, nor avert close-down risks for areas that have or will become Covid-19 impacted.

Market rates, in consequence, have and will likely continue to lead any official response from the Federal Reserve. The Fed will be comforted in the fact that policy has already been eased by 75bp (in 2019), and as we turned the year into 2020 the Fed was in the process of balance sheet re-building / liquidity injecting. So no need to panic here, yet.

## **Excess demand is a central driver**

Before going into predictions for yields, there is one important (non-Covid-19) factor to consider – the excess of demand over supply for fixed income as a theme. Despite heavier USD bond supply, the demand for fixed income has been overwhelming; hence the persistent fall in yields.

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*"Despite heavier USD bond supply, the demand for fixed income has been overwhelming; hence the persistent fall in yields"*

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The demand side includes some key captive players. These include central banks (QE), private banks (regulatory liquidity buckets) and pension funds (ALM through "near-AAA" discount functions). On top of that players, like insurance companies, that have been forced out the credit curve for yield, have barbelled into core rates too.

And bigger picture impulses are in play too. European (negative) yields remain a drag for US ones, as do the likes of Japanese and Northern European ones generally. The persistent flow of funds into USD has been a coincident outcome from this, which has become a circular process, pushing yields down and USD product up.

These were all in play well before Covid-19 hit.

## **Covid-19 and final thoughts**

The Coronavirus backdrop has provided an open door for core bond markets to push through. The 5yr part of the curve has taken the lead, now at 1.15% as we head for the US close; a full 40bp through the effective Fed funds rate. The 30yr at sub-1.8% is just a smidgen above the Fed funds rate ceiling.

As nominal rates have fallen, there has also been a compression versus TIPS yields, resulting in a

big falls in implied breakeven inflation - the 10yr B/E is now only a tad above 1.5%. This is a remarkably low market discount for US inflation over the next 10 years, in turn providing fuel for calls for the Fed to step in with some rate cuts.

*"Calling the Covid-19 spread is a mugs game. But the fear factor that comes from any / every material geographical breakout is now predictable"*

Calling the Covid-19 spread is a mugs game. But the fear factor that comes from any / every material geographical breakout is now predictable, which points to material slowdown, both direct and indirect. Against this backdrop, there is likely room for yields to test lower from here, even if ultimately morphing into an overshoot to the downside.

The 1% level is a natural target, and we can envisage a scenario where the curve begins to pepper that level in the coming weeks and months, at least along the 2yr to 10yr segment. The 5yr would likely make the break below first, as the 2/5yr segment continues to invert. And the 10yr would not be too far behind as the overall curve maintains a flattening tendency (until the point where the Fed feels the need to cut).

## 1 And now for the technical bit

The US 10yr yield, now at an all-time low, does not trade through the Fed funds rate very often. When it has, it has typically been followed by significant Fed funds rate cuts.

### The 10yr breaks below the cycle low and well through fed funds

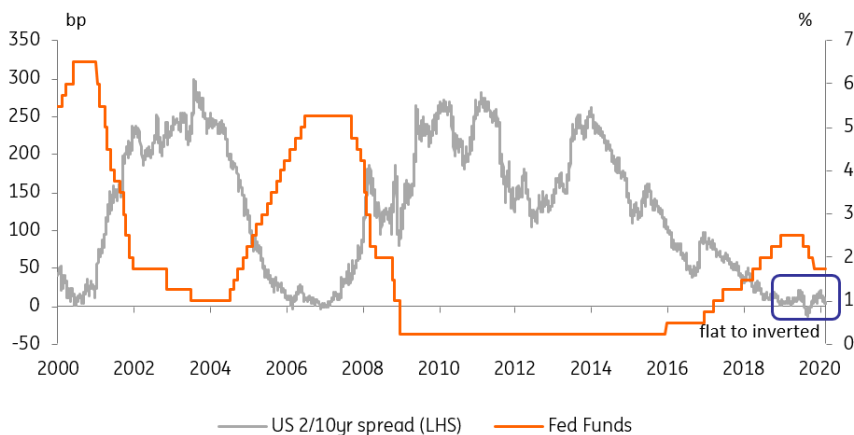


Source: Bloomberg

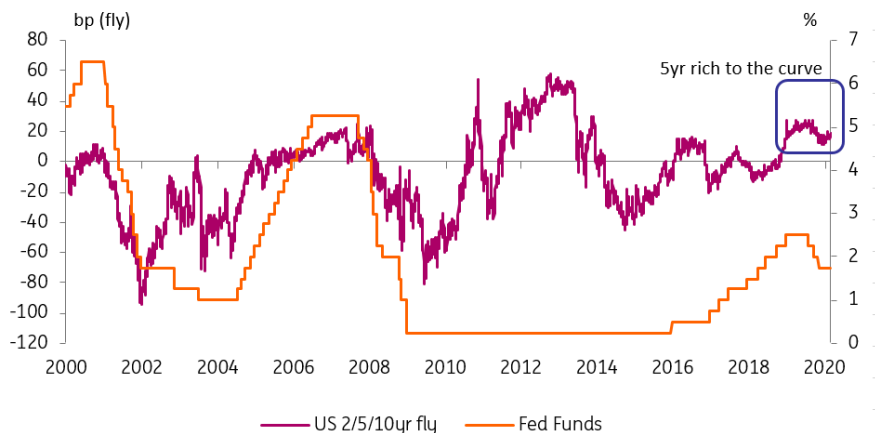
The US 2yr has been some 100bp lower than current levels, back when the funds rate was at zero-25bp. At 1.2% it is discounting at least two 25bp cuts.



History also shows that extreme curve flatness (and/or inversion) typically precedes a rate cutting process.



The inversion on the 2/5yr segment has coincided with the 5yr trading rich to the curve. A rich 5yr flags a tendency for lower rates.



Note the maintenance of richness on the 5yr segment even after the Fed had delivered 3\*25bp in rate cuts in 2019. This is unusual. Once the Fed has started a rate cutting cycle, the 5yr would typically revert to a cheaper valuation. Instead sustained 5yr richness pointed to an unfinished lower rates process, and that was before Covid-19 hit.

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# South Africa and the Rand: On the lookout for an (in)credible budget

With mounting worries about South Africa's debt pile and a Moody's downgrade on the cards, Wednesday's budget statement will be scrutinised...



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## Italy, the coronavirus and markets: a renewed flight to safety

The jump in Covid-19 cases in Italy has prompted a risk-off run in markets with equities dropping worldwide. The flight to safety could see BTP:Bund...



Some shop assistants in Milan are wearing protective face masks

### Events in Italy raise broader concern

At the end of last week, markets appeared almost settled with the idea that the risk of a broader spread of the virus looked marginal as the narrative of a Chinese regional story took hold. The movements in the FX market were a good mirror of such a stance by investors. The quintessential safe-haven JPY faced downside pressure on the back of the concerns on the economic outlook. Also, CAD and NOK - that have the highest beta to global risk in G10 - had been outperforming AUD and NZD, which are instead more exposed to China from an economic standpoint.

The developments over the weekend prompted another shift in the way markets are weighing the Covid-19 story. As stock indices in the US opened with sizeable losses following Eurostoxx's 4% drop, there's the impression this is of greater global concern, given the new coronavirus cases we've seen in Italy and Korea. In the case of Italy, here's what's worrying investors:

- Since Friday, the number of cases has risen from 20 to 229. It underlines the

- risks of contagion, with numbers that can jump in a matter of hours.
- The Italian government reported that part of the contagion came from a person showing no symptoms
  - A large number of the cases are in the Milan area, one of the most connected cities in Europe, generating fears that some may have already taken the disease outside Italian borders.
  - It's worth noting that Italy had taken preventive measures very similar to other developed countries, such as blocking flights from China.

After the Italian case, global asset markets are now under broad-based pressure, prompting the Vix or 'Fear Index' (traded US equity volatility) to rise to the highest levels since last August when trade war rhetoric was at its highest.

## Another challenge for the struggling Italian economy

The abrupt realisation that the risks related to Covid-19 were not so distant but very much local in nature has hit stock markets. Attention must now shift from the obvious channel of inbound tourism flows from China to a much broader extent where Italy may become a less attractive destination and there could also be a 'fear-effect' related to consumption and possible supply disruptions.

The area in Italy now affected by the outbreak of Covid-19, and consequently subject to particularly restrictive measures on movement and businesses, is only limited to a few municipalities affecting some 50-thousand inhabitants. That's at least for the time being. But these areas are close to economically relevant neighbours, such as the province of Milan, at the heart of the rich North. As the two affected regions, Lombardy and Veneto, account for 22% and 9% of Italian GDP respectively, the main concern will now be whether the virus can be contained without hitting neighbouring industrial and services' activities at a time when the Italian economy is already flirting with another technical recession.

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### *An impact on growth through this quarter can be expected*

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We continue to believe that the surprisingly steep 0.3% GDP contraction recorded in 4Q19 could well have been down to weather-related, temporary factors. But in this new environment, the chances of a rebound are dimming, adding to the risk of a technical recession. This will very much depend on how long the emergency measures will last, which in turn will depend on the unforeseeable evolution of the virus. However, given its nature and the emergency measures now in place, an impact on growth through this quarter can be expected.

Over the weekend, the Italian government was prompted to put in place relief measures to help out households and businesses located in those segregated areas, broadly following procedures after earthquakes. Measures will likely include beefing up the redundancy fund and the deferral of tax bills and of mortgage instalments. It's too early to say what the impact will be on public finance ratios as far as EU governance issues are concerned, but the exceptional nature of the Covid-19 along with the poor state of Italian economic activity means we can suggest that any deficit target breach will not solicit any prompt requests for a correction. That will be a first early unwelcome test for the EU Commission's stated wish to balance the excesses of pro-cyclicality.

## Italian rates: ECB is still the only game in town

The underlying assumption in Italian government bonds, as is the case in other risk markets globally, is that enough stimulus is on its way to at least keep risk premia contained. In the case of the eurozone, we see no reason for markets to question the view that the European Central Bank is, by and large, the only game in town. In an environment where sentiment is deteriorating fast, BTPs can only perform if the Lagarde-led ECB validates the market assumption that it will react the way it did under Draghi.

As for the ECB, there is an increasing risk that the Governing Council's take on the economy could be more downbeat at the March meeting than the latest round of staff projections. In terms of policy reaction, it is a trickier one as there is clearly nothing it can do to stop the virus. Given that the ECB has become more concerned about the adverse effects from its unconventional measures, it is doubtful they would easily cut rates or step up QE. Instead, we think the ECB would rather emphasise forward guidance and stress that they stand ready to act. The ECB may also much prefer to see a fiscal reaction here.

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*We think the ECB would rather emphasise forward guidance and stress that they stand ready to act*

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Central bank easing steps also have to be assessed against their economic impact. There is ground enough to doubt that both rate cuts and QE would be sufficient to get Italy, and the eurozone, out of a recession on its own. This raises two risks: Firstly, markets should question how aggressive central banks can be in using tools that have diminishing marginal benefits (if any benefit at all). Secondly, in a recession, economic underperformance and volatile political uncertainty will weigh on BTP valuations. That Italy is the current centre of Covid-19 fears in Europe is an additional worry but we would make the same argument for wider Italian spreads even if another European economy had been hit first.

Barring an aggressive change of tone from the ECB regarding QE being the last line of defence, we expect the 10Y Italy-Germany spread to drift wider to 175bp. This is not our central scenario, but if the coronavirus proves a catalyst for a more acute Italian political crisis, the combination of economic damage and political instability would propel this spread above 200bp in no time.

## FX: Safety, Liquidity and Return

Fears of a broader spread of the Covid-19 virus have triggered the sharpest one-day losses in US equities since last August, and in the FX space we see investors shifting to very cautious positioning. Relatively high interest rates no longer protect the likes of the CZK and the MXN and instead, the requirements of safety and liquidity are being given a higher priority. In absolute terms, this should favour the likes of the dollar and gold, while the JPY and CHF should outperform their regional peers.

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*The requirements of safety and liquidity are being given a higher priority*

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Conservative portfolio managers, such as global FX Reserve Managers, typically allocate their FX investments on the basis of safety, liquidity and return. The private sector, under fee pressure from the growth of ETFs and passively managed funds, are typically more driven by the need for outright return. As Covid-19 spreads, it now seems that the private sector is going to have to suspend its search for carry-driven return and temporarily increase its weightings towards safety and liquidity.

FX surveys (e.g. the BIS triennial FX survey) continue to show the dollar as by far the most liquid currency. Whatever one feels about the direction of the US sovereign balance sheet, the dollar is still additionally seen as a safe currency as well – as judged by the 5-year US sovereign CDS trading at just 17bp, only fractionally wider than that of Germany. Thus at this stage, we doubt the wholesale capitulation of global equity markets – including US equities – will turn the whole dollar bull trend.

Gold looks the cleaner story here. In a world of negative rates for two of the top three safe-haven currencies (EUR and JPY versus USD) the lack of coupon for holding gold is less of a problem. Gold also proves a good hedge should Covid-19 prompt serious financial dislocation such that the Fed is forced into emergency cuts and even the dollar starts to fall.

Within G3 FX, we would say the EUR/\$ downside still looks vulnerable (corrective rallies may well stall at 1.09), while USD/JPY looks very mixed. We discussed a few of the factors driving USD/JPY to 112 last week, but in addition would say there is a risk that, as during the Asian crisis in the late 90s, the JPY is traded weaker alongside Asian FX. We wouldn't necessarily then chase the current move lower in USD/JPY.

EUR/CHF continues to press the 1.06 area and given the threat to European activity – and Italian activity over coming months – we suspect the SNB will have to tolerate a move in EUR/CHF to the 1.05 area. Total CHF sight deposits have been nudging higher over recent weeks (suggesting modest FX intervention from the SNB), but as usual, we suspect it would only offer a temporary floor for EUR/CHF.

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# Malaysia's Mahathir's resignation comes at the worst time for the economy

Malaysia's prime minister Mahathir Mohammad's surprise resignation means politics looks set to be an added headwind for the economy already...



Malaysian Prime Minister, Mahathir Mohamad

## Surprise resignation

His move back into power was a massive surprise, and his resignation is just as surprising too.

Prime minister Mahathir Mohamad resigned today, leaving the ruling coalition, Pakatan Harapan, formed with the party of his rival-turned-successor, Anwar Ibrahim. It was all surrounding the leadership transition to Anwar, which was supposed to happen by May 2020. But Mahathir had been delaying it until the Asia-Pacific Economic Cooperation Summit in November this year and had lately even been ruling out a transition until all problems inherited from the previous government were resolved.

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*A new coalition with Mahathir at the helm may be a more likely scenario for the most experienced statesman in Malaysian*

*politics*

The political drama had been going on since Sunday when a faction of Anwar's People's Justice party reportedly collaborated with Mahathir to reconfigure the ruling Pakatan Harapan coalition and met the King in this regard, although Mahathir was absent at this meeting.

Meanwhile, Malaysian Economic Affairs Minister Mohamed Azmin Ali, who is Anwar's rival within their own party, announced his departure from the party along with 10 other members of parliament, forming an independent parliamentary bloc.

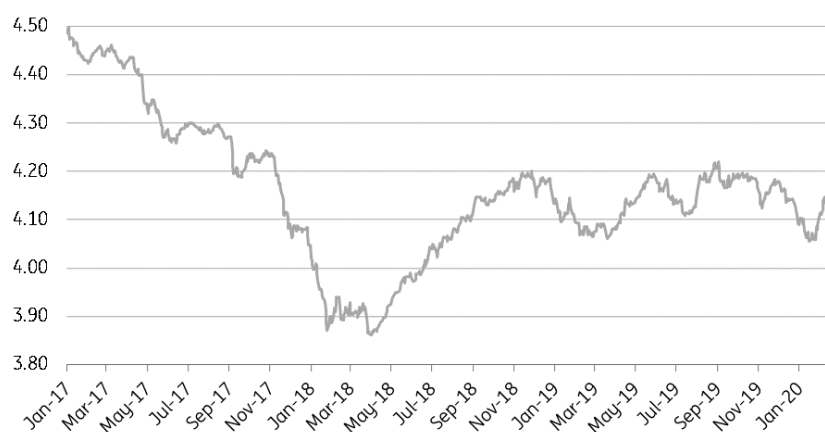
## More political uncertainty ahead

It's hard to determine what course politics will take next.

A possibility includes Mahathir forming a new coalition with other parties in the opposition. He needs 112 out of 220 seats and an alliance with the dominant party in the opposition and the one he led formerly, the United Malays National Organisation (UMNO), isn't being ruled out. Or, Anwar could end up taking that route as he was due to meet the King today.

We can't rule out the possibility of new elections if the political stalemate continues for too long. But a new coalition with Mahathir at the helm may be a more likely scenario for the most experienced statesman in Malaysian politics.

## USD/MYR - possibly on a steady weakening path ahead



Source: Bloomberg, ING

## Not great timing for the economy

The political crisis doesn't come at a great time for the economy already reeling under the impact of Covid-19. While the outbreak is taking a toll on both trade and tourism, the political risk will work to further depress investor confidence. Just recently, we slashed our growth forecast in 2020 to 3.5% from 4.5%, making it the worst year for growth since the 2009 global financial crisis.

*Prolonged political uncertainty could see the ringgit depreciating toward 4.50 over the course of the year - a level last seen three years ago*

The government was reportedly preparing a stimulus package to soften the impact of the virus but the resignation throws the economic plans into disarray, let alone the extra-budgetary stimulus. As such, the onus lies on the central bank for rate cuts to support growth as there is room for easing due to continued low inflation. We expect a rate cut at the next meeting in March.

The political turmoil has also exacerbated the weakening pressure on Malaysian assets, including the Malaysian ringgit, weakening the exchange rate past 4.20 against the USD - the level we expected for end-1Q20. Prolonged political uncertainty could see the ringgit depreciating towards 4.50 over the course of the year - a level last seen three years ago.

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