

# In case you missed it: De-throning the king

President Trump's tariff wars have produced an unintended consequence: a stronger US dollar. Is there anything he can do to stop the rally and is 'fair' trade even the answer to the US's burgeoning trade deficit? Meanwhile, as Nafta talks show signs of progress, Trump finds a new bugbear in South Africa. Here's how we think it'll all shake out

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# Dethroning the King: Five ways Trump could weaken the dollar

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## Key messages: Time to consider how Trump could weaken the dollar

- President Trump's [ramped up verbal jawboning in recent weeks](#) suggests that current USD strength may be the upper bound of the White House's tolerance level
- We identify five policies that the White House could employ to weaken the dollar: (1) US FX intervention and building out US FX reserves; (2) Changing the rules of the game for the Fed; (3) Ongoing jawboning and talking down the dollar; (4) Pressuring major trading partners to strengthen their currencies; (5) Creating a US sovereign wealth fund.
- We don't think any small-scale unilateral intervention by US authorities will have a sustained impact on weakening the dollar. The best historical precedent – the Bush FX interventions in 1989-1990 – shows that this approach had a limited impact in driving the USD materially lower.
- Given that the current loose fiscal, tight monetary US policy mix is inconsistent with a weaker USD, we think that the US administration may find greater success by addressing one of the root causes of recent USD strength – higher US rates. Constant Fed criticism may keep a downside skew in US rates markets when it comes to pricing in Fed policy tightening – and on the margin, help to keep USD strength at bay.
- In a normal market environment, we think Trump jawboning could weigh on the dollar via a clearout of speculative long USD positions, weakening the power of interest rate differentials in influencing USD crosses and reducing the incentive for overseas investors to take on unhedged USD exposure. If the short-term fundamental USD factors were to wane as well, then we think a clearout of long USD positioning could be worth a 5-7% decline in the trade-weighted USD index.
- Alternative ways in which the Trump administration could weaken the US dollar – pressuring major trading partners to strengthen their currencies or even the creation of a US sovereign wealth fund – would be more slow-burning and medium-term in nature.
- Overall, more active steps from the White House to weaken the dollar could serve to knock the top off of an emerging dollar bull trend. Indeed, such active steps send a strong signal about the White House's current dollar policy. We think the US administration's implicit desire for a weaker USD that is consistent with its

mercantilist US trade policy will inevitably be self-fulfilling over the medium-term – and is one of the reasons why we remain strategically bearish on the US dollar.

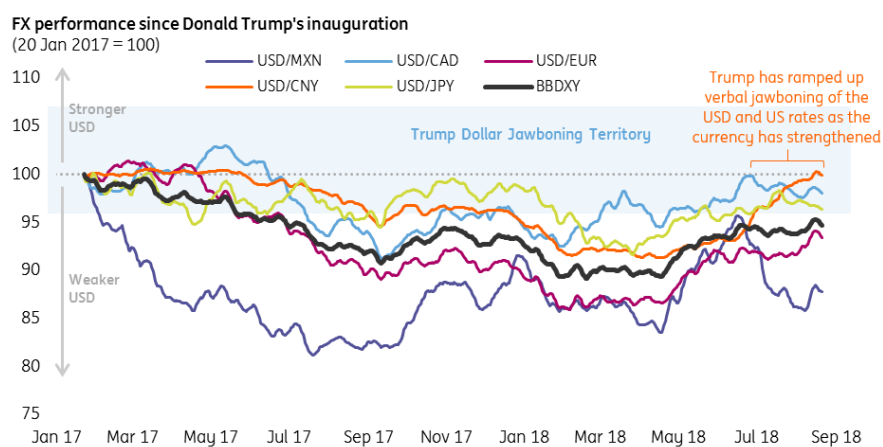
## White House needs a weak dollar for US trade policy consistency

While the first sentence of the above Larry Summers quote is certainly true, the second sentence is up for major debate. It may be difficult for investors to reconcile (i) a White House adamant in narrowing its trade deficit by boosting US competitiveness and (ii) broad-based USD strength. In theory, the two cannot coincide simultaneously.

*The exchange rate is the purview of the Treasury. The United States is in favour of a strong dollar - Former US Treasury Secretary Larry Summers (2011)*

Yet, whilst the White House has enforced sizeable tariffs on major trading partners in 2018, the dollar has broadly strengthened since April – with fundamental flows outweighing the uncertainty factor over Trump's dollar policy (see our note [USD: Trade War Trap](#)). We suspect the USD's recent strength – in particular against the Chinese yuan (CNY) – will have grabbed the US administration's attention, not least as it is incompatible with their current mercantilist policy agenda (see chart showing FX performance since Trump's inauguration). As we have seen in recent weeks, the President has ramped up verbal jawboning over a strong dollar and higher US rates as the currency has strengthened – suggesting that current USD strength may be at the upper bound of the White House's tolerance level.

## Dollar strength starting to move into White House jawboning territory



Source: ING, Bloomberg. Note: Performance indexed 20 Jan 2017 = 100.

## Dethroning the King: President Trump's toolkit to weaken dollar

Given Washington's desire to address the US trade deficit and boost domestic competitiveness, we think it now makes sense to consider the tools that President Trump has at his disposal to keep a lid on dollar strength. We identify five policies that the White House could employ to weaken the dollar:

1. US FX intervention and building out US FX reserves
2. Changing the rules of the game for the Fed
3. Ongoing jawboning and talking down of the dollar
4. Pressuring major trading partners to strengthen the currency
5. Creating a US Sovereign Wealth Fund

### 1 US Treasury FX Intervention | Likelihood: Very Low | Impact: Limited

The most direct way in which the Trump administration could seek to weaken the dollar would be to order the US Treasury (via the New York Fed) to conduct FX interventions. This would involve selling dollars and buying foreign currency most likely via the Exchange Stabilization Fund (ESF) – which permits the Treasury Secretary, with the approval of the President, to "deal in gold, foreign exchange, and other instruments of credit and securities" (see Footnote 1). So in theory, the ESF gives the Trump administration the power to buy and sell foreign currencies – without needing any prior approval from Congress.

Would it be this easy for President Trump to intervene in FX markets? Unilateral FX intervention by US authorities would be politically contentious – not only at home but also abroad. US FX interventions have been sparse since the early 1990s (see Figure 1 below) – with the last two occasions in 1998 and 2000 having been coordinated interventions with major central banks to support relatively weaker foreign currencies in disorderly markets (see Footnote 2). The last time US officials unilaterally intervened to weaken the dollar was in the early 1990s.

**The main obstacle to effective US FX intervention via this channel is the size and the mechanics of the ESF.** For ESF interventions that involve buying FX assets – which have historically largely been in EUR and JPY – USD assets on the ESF balance sheet need to be sold. As of 31 July 2018, there are just over \$22.27 billion dollar-denominated assets held on the [ESF balance sheet](#) (all in US government debt). Even if the Treasury Secretary instructed all of these to be used to purchase FX assets, the direct impact on a USD market that has a \$4 trillion daily turnover would be fairly muted.

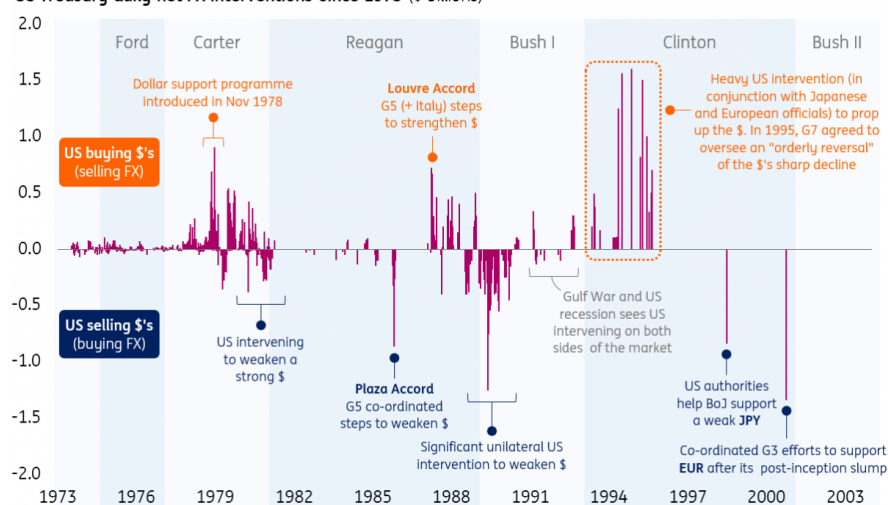
While we will save the technicalities of US FX intervention for a later note, it is worth noting that there are some out-of-the-box ways for the US administration to bypass the ESF technical constraints – as well as any FOMC approval – to increase the pool of funds available to buy FX assets:

- While the Treasury can instruct the Fed to intervene on behalf of the ESF, it is unable to force the central bank to intervene under the Fed's own account (SOMA). One exception would be if FX intervention was deemed a national emergency. While in the current environment this would seem absurd, it is not something we can completely rule out given that the current US administration is seeking to enforce tariffs on the grounds of national security.

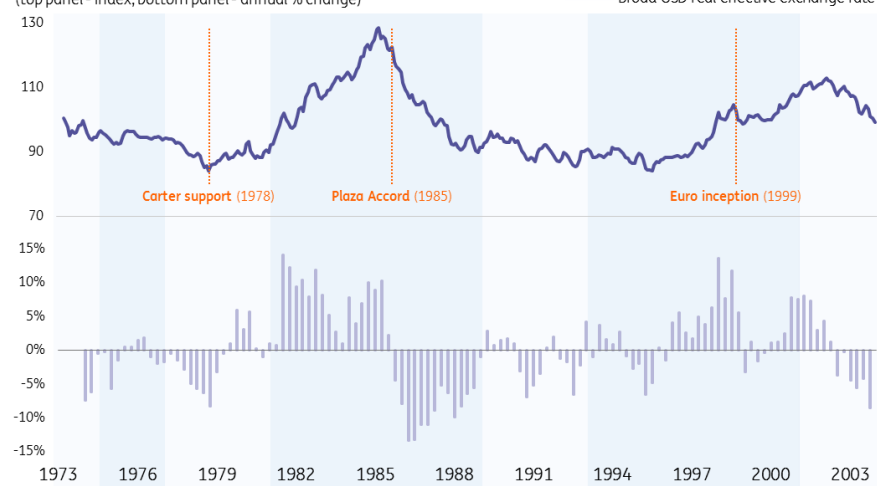
- The other way would be for the administration to officially adopt a policy that seeks to build up US FX reserves buffers. While this makes little sense in the current environment – with the USD a reserve currency and the US running a trade deficit, the White House may see the need for a bigger US FX reserves buffer under its strategic plan to boost the US's role as an exporting nation. While again this sounds absurd, the Trump administration may be able to 'sell it' to Congress by simply pointing to other major trading partners which have bigger reserves buffers – and justifying a similar US policy on the grounds of national security.

## Prior US Treasury FX interventions have marked distinct shifts in dollar policy

US Treasury daily net FX interventions since 1973 (\$ billions)



US dollar effective exchange rate index (top panel - index; bottom panel - annual % change)



Source: ING, FRED, US Treasury Department, Bloomberg

### Would unilateral US FX intervention be effective?

Even if we engage in this thought exercise, we don't think any small-scale unilateral intervention by US authorities will have a sustained impact on weakening the dollar. Over time, economic fundamentals will prevail – and the administration will find it difficult to fight these forces.

And right now, US officials have an incoherent policy mix to achieve a weaker USD – loose fiscal and tight monetary policy is typically fundamentally positive for any currency in the short-term. Add on top of this the White House's own trade policy that has seen the imposition of tariffs on major trading partners and fuelled flight-to-safety flows into USD-assets – and one could easily argue that any 'leaning against the wind' US FX intervention to weaken the dollar would be futile.

Therefore, in the current US policy environment, we think unilateral FX intervention by the Treasury would at best keep a lid on USD strength. Indeed, the best historical precedent – the Bush FX interventions in 1989-1990 – shows that this approach had a limited impact in driving the USD materially lower (with the trade-weighted USD flat over this period).

## 2 Altering the Fed's mandate | Likelihood: Very Low | Impact: High

Given that the current loose fiscal, tight monetary US policy mix is inconsistent with a weaker USD, we think that the US administration may find greater success by addressing one of the root causes of recent USD strength – higher US rates. Indeed, a more effective way to weaken the USD in the current environment would be to alter the rules of the game for the Fed in a way that would force them to adopt a slower tightening path.

This again provides legislative hurdles; it's difficult to see Congress passing any change in the Fed's mandate that would effectively force the central bank to adopt a higher inflation target (note that it is the FOMC that holds the mandate to set the explicit level for the inflation target). However, further criticism from the White House over the Fed's tightening approach – as we have seen in recent months – could have two indirect consequences: (1) it could in the short-term force the Fed to more likely than not err on the side of caution whenever the decision to raise interest rates is close and (2) it may get the FOMC re-thinking its long-run monetary framework ([a debate that is taking place behind the scenes in the academic world](#)).

The first factor could keep a downside skew in US rates markets over Fed policy tightening – and on the margin, keep USD strength at bay. But in the absence of forcibly changing the rules of the game for the Fed, interest rate differentials will be one of the main drivers for the USD – and like we've seen in recent months, can be quite a powerful positive driver for the currency.

## 3 White House dollar jawboning | Likelihood: High | Impact: Negligible

Given the legislative difficulties in enforcing an active policy to weaken the USD, the most likely thing that we will see from President Trump is ongoing talking down of the dollar and US interest rates. The effectiveness of this has been mixed (see the timeline of Trump dollar talk table below) – and we think the prevailing market conditions matter for whether the impact is sustained. For example, in a fully-fledged risk-off market, negative Trump comments on the USD would have a negligible – and potentially non-existent – short-term impact.

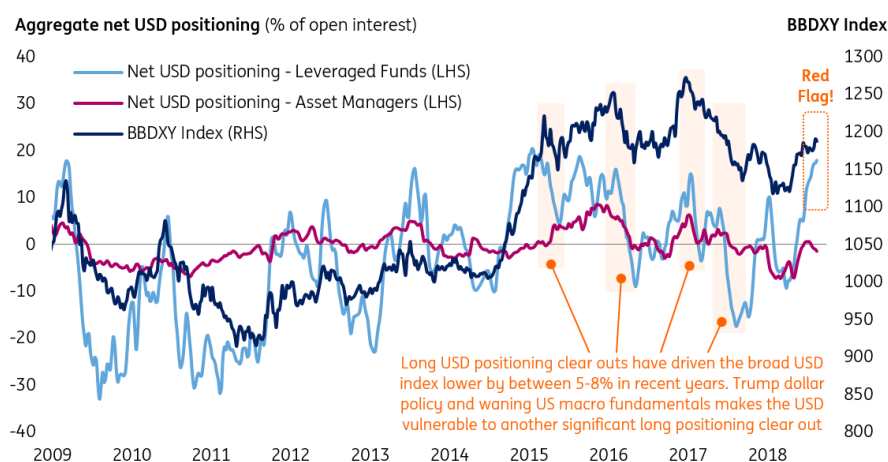
In a normal market environment, we identify the following channels through which any Trump jawboning could weigh on the dollar:

- A clear out of speculative long USD positions
- Reduced power of interest rate differentials in influencing USD crosses

- Less incentive for overseas investors to take on unhedged USD exposure
- A small uncertainty premium over White House dollar policy

However, these channels would only have a sustained impact if the short-term fundamental factors were also pointing to a weaker US dollar. If US leading activity indicators continue to come off the boil as they have been in recent weeks (we've seen a sharp drop in the ISM, Philly Fed index and Michigan consumer confidence) – then we think the USD could be vulnerable to a sharp positioning adjustment fuelled by weaker cyclical macro dynamics and Trump jawboning. Indeed, similar long USD positioning clearouts in 1H16 and 2H17 have been worth around a 5-7% decline in the trade-weighted USD (BBDXY) index.

## Extreme long spec positioning makes USD vulnerable to Trump jawboning



White House jawboning would be more potent and effective in the short-term if President Trump – via Treasury Secretary Steven Mnuchin – were to formally end the long-standing 'strong dollar' policy. We see the risks of this as being low ahead of the US midterm elections given that it could cause some backlash within Congress and the Republican party. However, the White House officially ending the 'strong dollar' policy could mark a distinct shift in USD dynamics – that could have medium-term repercussions, marginally reducing the incentive of real-money investors (central bank reserve managers) to hold excess USD reserves.



## A timeline of Trump administration dollar talk

A timeline of Trump administration 'dollar talk'

Date	Source	Person	Quote / Statement	BBDXY Index (%)	US 10Y yield (bp)	S&P 500 Index (%)
17 Jan 2017	WSJ	Donald Trump	"Our dollar is too strong"	-1.3%	-7.1	-0.3%
31 Jan 2017	FT	Peter Navarro	The Euro is an "implicit Deutsche Mark that is grossly undervalued"	-0.7%	-3.5	-0.1%
	Transcript	Donald Trump	China and Japan "play the devaluation market and we sit there like a bunch of dummies."			
23 Feb 2017	Reuters	Donald Trump	"I think they're [China] grand champions at manipulation of currency"	-0.3%	-4.1	+0.0%
12 Apr 2017	WSJ	Donald Trump	"I think our dollar is getting too strong, and partially that's my fault because people have confidence in me."	-0.5%	-5.7	-0.4%
24 Jan 2018	Davos	Steven Mnuchin	"A weaker dollar is good for us as it relates to trade and opportunities"	-1.0%	+3.3	-0.1%
25 Jan 2018	CNBC	Donald Trump	"The dollar is going to get stronger and stronger and ultimately I want to see a strong dollar"	+0.1%	-3.0	+0.1%
14 Mar 2018	CNBC	Larry Kudlow	"I have no reason to believe [President Trump] doesn't favor a sound and strong and steady dollar."	-0.1%	-2.6	-0.6%
16 Apr 2018	Twitter	Donald Trump	"Russia and China are playing the Currency devaluation game as the U.S. keeps raising interest rates. Not acceptable!"	-0.3%	-0.9	+0.8%
19 Jul 2018	CNBC	Donald Trump	"In China their currency is dropping like a rock and our currency is going up, and I have to tell you it puts us at a disadvantage"	+0.3%	-3.1	-0.4%
20 Jul 2018	Twitter	Donald Trump	"China, the European Union and others have been manipulating their currencies and interest rates lower, while the U.S. is raising rates while the dollars gets stronger and stronger with each passing day - taking away our big competitive edge."	-0.8%	+5.5	-0.1%
	16 Aug 2018	Twitter	Donald Trump	"Money is pouring into our cherished DOLLAR like rarely before"	-0.2%	+0.9
	CNBC	Larry Kudlow	"The king dollar. The strong dollar. It's a steady dollar. It's a sign of confidence."			
21 Aug 2018	Reuters	Donald Trump	"I'm not thrilled with his [Fed Chair Powell] raising of interest rates... I think China's manipulating their currency, absolutely. And I think the euro is being manipulated also."	-0.2%	+2.0	+0.2%

Source: Source: ING FX Strategy, Bloomberg. Note on colour coding: Orange = dollar jawboning; Purple = talking the dollar up

### 4 Pressure major trading partners to strengthen their currencies | Likelihood: High | Impact: Medium

A simple, yet effective, policy approach that the Trump administration could take to weaken the dollar is by actively encouraging major trading partners to strengthen their domestic currencies. We have already seen the White House tie currency clauses to any new trade deals – with the updated US-South Korea trade agreement (KORUS) a [good example](#).

Indeed, this may also be a tactic that President Trump is currently employing with China on any forthcoming trade deal – with headlines crossing the newswires last Friday that Washington will put pressure on Beijing to "lift" the yuan as part of upcoming talks. The effectiveness here shouldn't be underestimated; [as we've argued](#), a more stable – and even higher – CNY would be transmitted across other closely-linked currencies.

### 5 A US Sovereign Wealth Fund | Likelihood: Very Low | Impact: Medium

One final and very left-field idea to weaken the dollar – or at least put a lid on dollar strength – would be for President Trump to establish the United States' very own Sovereign Wealth Fund (SWF). Critics could argue that China was only able to establish its own SWF in 2007 – the China Investment Corporation (CIC) – with an undervalued renminbi and proceeds from its burgeoning FX reserves during that period. The CIC was capitalised with \$200 billion of China's FX reserves in 2007 and now has close to \$1 trillion in assets under management.

Typically SWFs have been created by those nations running huge current account surpluses – largely on the back of natural resource exports – and have chosen to save those export proceeds for future generations. Thus the likes of Norway and the Middle East have some of the largest SWFs in the world and conduct regular FX buying operations to prevent those export proceeds driving the domestic currency a lot higher.

Its typical position of a net debtor on the current account would not make the US a conventional candidate for an SWF. But these are unconventional times and were President Trump to instruct the US Treasury to build up FX reserves for the purpose of capitalising an SWF at some future date, the move could serve to knock the top off of an emerging dollar bull trend.

## Bottom line: Weak dollar policy will be self-fulfilling

Overall, more active steps from the White House to weaken the dollar could serve to knock the top off of an emerging dollar bull trend. Indeed, such active steps send a strong signal about the White House's current dollar policy. We think the US administration's implicit desire for a weaker USD that is consistent with its mercantilist US trade policy will inevitably be self-fulfilling over the medium-term – and is one of the reasons why we remain strategically bearish on the US dollar.

### Footnotes

1. Strictly speaking, the 1976 amendment to the Gold Reserve Act – which forms the legislative basis for the ESF – states that it must be used in a manner that is "consistent with the obligations of the Government in the International Monetary Fund". The IMF would be unambiguously opposed to any unilateral FX intervention by the US for competitive devaluation purposes – given that this would be a violation of international exchange rate commitments.
2. The Fed's coordinated intervention with the Bank of Japan in 2002-2003 to weaken the yen was not recorded as US intervention given that US officials were selling yen (and buying dollars) on the behalf of Japanese authorities (MoF/BoJ). Therefore no 'money' of US authorities was involved. [The New York Fed's website has more on how it acts as an agent for foreign central banks.](#)

### Author

#### Chris Turner

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

[chris.turner@ing.com](mailto:chris.turner@ing.com)

# Making trade 'fair' won't do the trick for Trump

Tariff wars don't address the real drivers of the US trade deficit, and US policy is on track to increase, rather than decrease the US trade...



Donald Trump speaks on trade in Illinois, July 2018

## Deficit drivers

The US trade deficit is sometimes used as proof by President Trump that the US is treated unfairly by its trade partners. This is a popular – perhaps even election-winning – position. Presidential approval ratings on the economy have improved in 2018 alongside the escalating trade war. In practice, the US is not more open than [other advanced economies](#). Around half of the US trade deficit, which was 3% of GDP in the latest [data](#), is accounted for by trade with China. Germany, Japan and Mexico make up a further quarter. But these surplus countries don't fit a particular profile in terms of openness. China is less open than the US, in terms of tariffs and non-tariff [barriers](#). Mexico is in a free trade agreement with the US, meaning there is no difference between the tariffs of the two countries. Germany and Japan have similar tariffs to the US, and are more open in their treatment of foreign [suppliers](#).

The US's official [position](#) on trade imbalances covers a broader set of factors than fit in a tweet, but also basically lays the blame for the US's trade deficit at the feet of other countries. Along with trade and investment barriers, it highlights major trading partners' slower domestic demand growth, and undervalued currencies. Separately, it has been suggested that relatively high barriers

to trade in services have made it more difficult for countries which have specialised in services – such as the US – to export [them](#). New IMF [research](#) shows reductions in the costs of exporting are associated with improvements in current account balances (made up of the trade balance and net income and transfers from abroad). However, the fundamental driver of the US current account deficit is the level of saving and investment in the US economy. Over many years, foreign capital has been readily available to fund investment at a level that could not have been sustained by US domestic savings. The dollar's role as a global reserve currency plays a part in attracting these inflows, as does the level of savings in other countries.

In its 2018 [assessment](#) of external imbalances, the IMF highlights that fiscal easing in the US is leading to a stronger US dollar and increase in the current account deficit in the coming years. We would add that the effects of the dollar's appreciation during 2014-17 are still likely to be passing through to the current account, and the government and households both seem unlikely to increase [savings](#). The IMF and the Trump administration agree on one thing: that the US should reduce its current account deficit. But the IMF's policy [prescription](#) of fiscal consolidation, encouraging household saving, and resolving trade disagreements without raising tariffs and non-tariff barriers, is the opposite of what the US is doing. (The IMF also highlights the role of co-operation between countries to address global imbalances, with an onus on surplus countries to loosen fiscal policy).

## Tariff limits

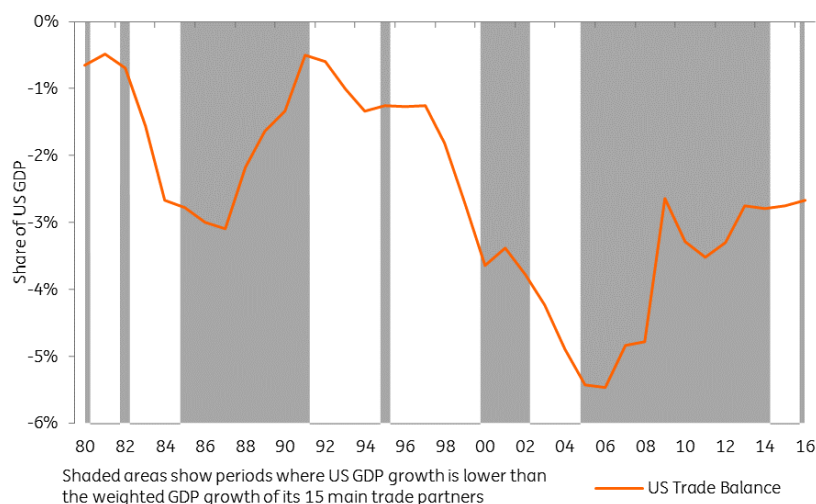
Increasing tariffs raises the price of foreign goods and thereby reduces demand for imports. Similarly, another country reducing its tariffs reduces the prices of goods it imports, i.e. exports from other countries. What the US has been trying to do with its trade policy is to create both effects, reducing its imports and increasing its exports. On the imports side, the US has raised tariffs on products worth around 4% of its total imports. However, other countries have challenged the tariff increases at the WTO, and US companies have applied for tens of thousands of the affected products to be exempt from the tariffs.

On the exports side, things have not gone entirely to plan for the US either. While some trade partners have offered concessions, many have raised tariffs in retaliation against the US measures. Aside from retaliatory measures making US exports more expensive, the US's tariffs harm the competitiveness of its own exports. US firms which make use of imported goods as inputs may be able to switch to domestically-produced alternatives, but at higher prices. Some of these firms are exporters, whose prices will rise, reducing demand for US [exports](#). This has been the case for Whirlpool, the US-based manufacturer of home appliances, which has seen margins squeezed by US import tariffs on steel, and falling sales abroad, even as it has benefited from US import tariffs on washing machines, which have increased the costs of its main competitors in the US market.

While the effects of the tariffs themselves may be limited, the tariffs are serving another purpose for the US in bringing countries to the negotiating table. In President Trump's words, "Either a country negotiates a fair deal, or it gets hit with tariffs." In bilateral negotiations, the US has been asking countries to offer up ways of increasing their imports from the US. South Korea earned an exemption from US steel tariffs by agreeing to quotas for its exports of those products and further opening its market to imports of US cars. The EU earned a reprieve from the potential US tariffs on cars by promising to buy more US soybeans and liquefied natural gas. But in the end, in market economies the decision to import from a given country is made by businesses on the basis of relative prices.

During the last four decades there have been only two periods when the US trade deficit shrank significantly: 1987-1991, and 2006-2009. These periods saw US economic growth being outstripped by growth in the countries where it sent most of its exports (**Chart 1**) and followed declines in the dollar's value. These conditions are not likely to be repeated in the near term. We expect the dollar to weaken against the euro and yen over 2018-2020, but not to the extent that it offsets the effects of higher US growth on the trade deficit.

## When US growth has been lower than trade partners', the deficit has narrowed



Source: UNCTAD and ING calculations

## What about jobs?

The official reason for tariff increases on steel and aluminium is to protect US national [security](#). This involves a contested idea of national security that other countries are challenging at the WTO, but the international trade system is built on the recognition that trade poses a potential threat to domestic industries, even as it brings lower prices and variety to consumers, and productivity growth through innovation and competition. In the US's case, the firms and industries most exposed to competition from Chinese imports have shed jobs over the past two decades. In turn, this has led to job losses in other industries through lower [demand](#). The labour market has not been flexible enough for those workers to take up new jobs, leaving unemployment persistently high in parts of the US and giving the trade deficit its political charge.

Could this have been avoided with a smaller trade deficit? Less trade over this period would have meant fewer people in employment overall, thanks to jobs [created](#) in US exporting industries and those serving the resulting rise in demand. It would have also meant US consumers paying higher prices for goods and services. Less trade would not have guaranteed continued high employment in manufacturing, thanks to productivity gains in manufacturing and the long-term trend in the US towards services production. Trade is only one of many sources of disruption, and protectionism a costly and ineffective response to the disruption it brings. Policies to help labour markets and industries adjust would have been, and still are, a better [response](#).

It seems that reducing the US trade deficit has become an end in itself for the President.

However, his chosen means of achieving this – through raising tariffs, and extracting promises from other countries to import more from the US – won't deliver the desired result. Demand for imports within the US is likely to continue rising, in spite of the tariffs. And other influences on the demand for US exports are not expected to deliver much growth. It's not clear that US voters would thank President Trump for reducing the US trade deficit, even if the IMF would. This would involve fiscal consolidation and lower household consumption, in favour of saving. In common with other countries, the US has seen winners and losers within its population from globalisation. To address these, President Trump would be better off leaving tariffs alone in favour of policies that support the competitiveness of its industry and flexibility of its workforce.

## Trade war: China retaliates but with a punchier list

China's decision to include automobiles in the retaliatory tariffs list is a more aggressive move than we expected, but for now the real concern is...



Source: Shutterstock

As the US imposes 25% tariff on \$16 billion of imported goods from China, China retaliated with the same amount but with a revised list of goods that contains automobiles, which we see as a more aggressive retaliatory measure.

*Qualitative retaliations could include placing administrative measures on US companies operating in China or following the US lead and leveraging 'national security' to prevent American companies operating in the country*

The \$16 billion revised tariff list from China includes medical equipment and automobiles when the US administration would like to help American automobiles fare better in the international market. We see this list as more punchy than the previous one even the amount involved stays the same

at \$16 billion.

The dollar index has reacted in strengthening trend and the yuan weakened against the dollar.

## What will the 'qualitative retaliations' be?

The uncertainty now lies in how China would retaliate qualitatively and this the main concern for markets rather than today's tariffs implementation.

If the trade talks between China and the US do not yield positive results this week, the US is set to impose another 25% tariffs on \$200 billion of imported goods from China. The amount would be around half of the goods US imports from China, but China will only retaliate with tariffs on \$60 billion because the US doesn't export as much. But China has repeatedly stated that it can retaliate qualitatively.

Qualitative retaliations could include placing administrative measures on US companies operating in China or following the US lead and leveraging 'national security' to prevent some American companies operating in the country. Given that, 'national security' examination has recently been added as a clause in foreigners' investment policies in China, this seems like a possibility.

## Will there be any beneficiaries?

We are aware there could be some substitution effect.

Some economies may benefit by providing goods that are produced in China or the US. For example, Brazil soybean is a substitute for US soybeans, and similarly, some Asian manufacturers may now be in a better position to compete in export orders to the US. But these substitution effects won't be huge as there isn't enough time to rapidly expand product lines in such a short time.

But overall, both American and Chinese manufacturers are likely to face slower growth in manufacturing and trade-related activities or even record a fall. And this fall isn't just limited to the two countries; the global supply chain will face similar prospects.



# South Africa: Trump's unwelcome attention

President Trump's foreign policy tirade has turned in a surprising new direction: South Africa. His concerns over threatened land expropriations...



## Trump tweet hits the rand

The ZAR briefly sold off Thursday on news that Donald Trump had tasked Mike Pompeo, the US Secretary of State, to 'closely study' the issue of land expropriation from farmers in South Africa. With US foreign and economic policy merging into one this year, investors have naturally started to worry about whether Washington could look at the economic sanctions tool to effect change.

For reference, South Africa's ruling ANC party is currently examining ways to amend the constitution to potentially expropriate farmland without compensation. A parliamentary review committee will come back with an opinion on this issue by the end of August.

## Where could this lead and how could the rand react?

It seems unlikely that the Trump administration would attack this issue with as much gusto as it has done against China (unfair trade and superpower threat), Russia (election meddling) or Turkey (holding a US evangelical pastor). Yet the situation is certainly worth monitoring.

Were Washington to decide that action needed to be taken, the world would naturally look at

South Africa's trade exposure to the US. Here [7% of South Africa's exports go to the US and South Africa runs about a \\$2 billion annual goods surplus – largely in precious metals, stone and vehicles.](#)

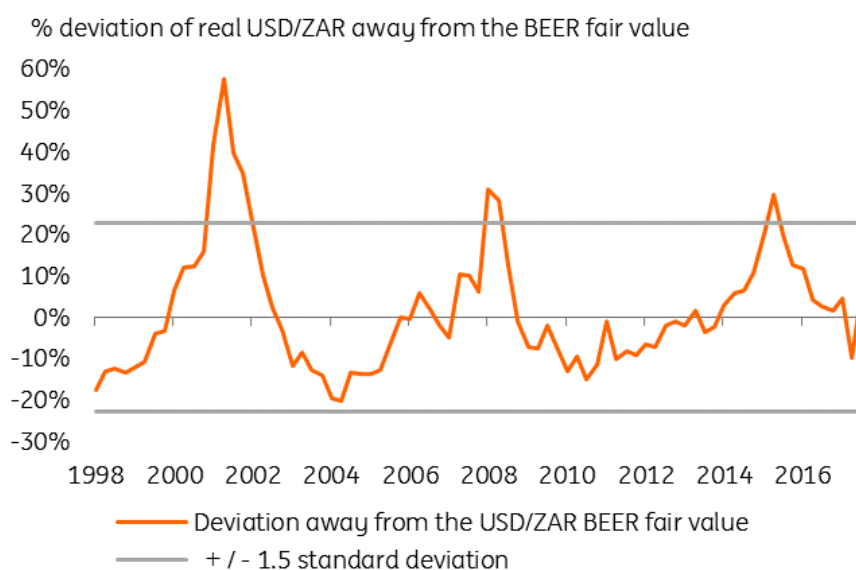
A particular focus may be South Africa's eligibility for the [African Growth and Opportunity Act](#), a Bill Clinton initiative providing duty-free status for US imports from eligible African countries.

In what would seem the unlikely event of Washington dialling up the sanctions threat on South Africa (actually South Africa was already caught by US steel and aluminium tariffs earlier this year), how would the rand respond?

The rand is typically a high beta currency to risk sentiment given its relatively liquid equity and debt market and prominent position in emerging market benchmark indices. It typically trades as a high volatility currency and currently shows, against the dollar, one-month realised volatility of 27%. This is high compared to the Russian rouble (15%), Polish zloty (11%) and Mexican peso (14%).

Our medium-term fair value model (the BEER) currently shows USD/ZAR some 8% above its fair value – but that can easily extend into the 20-25% overvaluation area, or 16-17 in USD/ZAR, during times of extreme concern.

## USD/ZAR: A little overvalued but could rally further



Source: ING

## South Africa's external debt burden is manageable

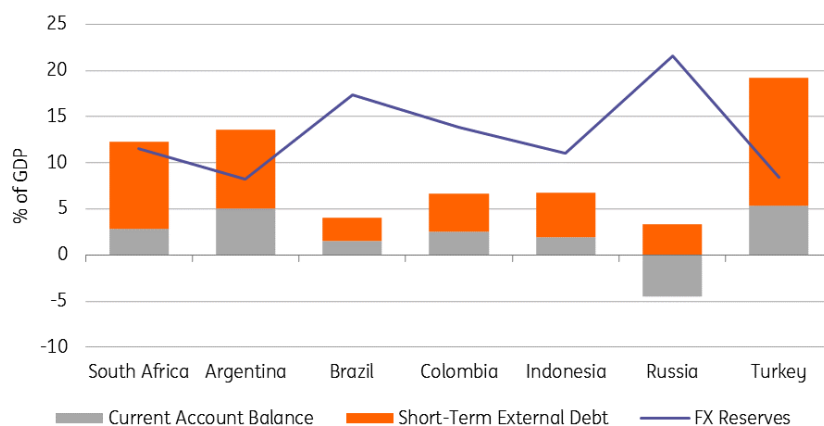
At first glance then, South Africa appears to be vulnerable given its high external debt (50% of GDP) and short-term refinancing needs (3% current account deficit and 9% short-term external debt as a percentage of GDP), with FX reserves just sufficient to cover the latter.

Yet, South Africa stands out for its high share of local currency debt (53% of total external debt) which substantially eases the pressure from a depreciation of the rand on fiscal and corporate balance sheets.

In comparison to idiosyncratic stories such as Argentina or Turkey, we also believe that South

Africa will be able to prevent substantial outflows: Institutional independence and credibility of the National Treasury and the Reserve Bank (SARB) are key strengths. Reassuringly, inflation stood at 5.1% year-on-year in July, which is still within the South African Reserve Bank's target band of 3-6%.

## EM Refinancing needs and FX Reserves (% of GDP)



Source: IMF, World Bank, ING calculations – negative value indicates current account surplus

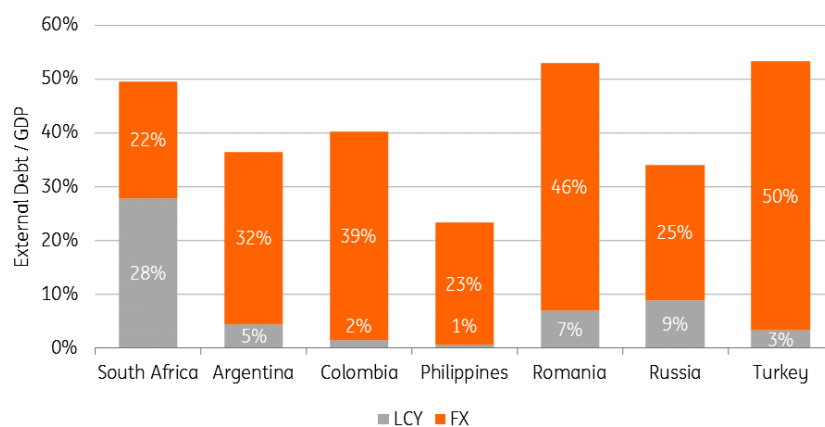
## Tough times for the rand

Trump's tweet merely adds to the headwinds facing the rand. These headwinds are blowing out of Washington, where: i) a Fed shifting monetary policy to neutral if not tight and ii) US economic sanctions are starting to weigh on South Africa's biggest trade partner, China.

Were the US in late September to go ahead with 25% sanctions on the next \$200 billion of Chinese imports, we could see the emerging market FX complex, especially the commodity exporters like South Africa, taking another leg lower. So even though the rand looks to be cheap and has an implied yield of 7% per annum through the three month forwards, we're more worried that USD/ZAR has to trade to the 15.50 area first.

Currency depreciation would also raise questions for the South Africa Reserve Bank (SARB). The market is toying with the idea of a 25 basis point rate hike from South Africa over the next six months, but more aggressive tightening could easily be priced in were the rand to come under heavy pressure over coming months.

## EM Local Currency and FX External Debt (% of GDP)



Source: World Bank, ING calculations

### Author

**Chris Turner**

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

[chris.turner@ing.com](mailto:chris.turner@ing.com)

## Nafta talks progress but sticking points remain

A 'handshake' deal between the US and Mexico is reportedly within touching distance, raising the possibility that Canada could rejoin talks. But...



Source: Shutterstock

### A handshake is all it takes

With the [possibility that a 'handshake' deal](#) between the US and Mexico could come as soon as today, the likelihood that Canada will rejoin the negotiations soon is rising.

After five weeks of discussions, the US and Mexico have reportedly come close to an informal deal on some of their main issues - namely automotive rules, and in particular how much of a car must be sourced in North America to qualify for reduced Nafta tariffs. Industry expectations are that North American car content may rise to 70%, up from 62.5% to make the tariff cut, and reports suggest that somewhere around 40% of this value must come from a source paying at least \$16 per hour - which isn't bad news for Canada.

[Read the Politico article here in full](#)

### A deal is far from complete, but small steps take us closer

The idea of reshaping Nafta is far from complete, as certain [US demands](#) remain unresolved - in particular, the 'sunset clause', that could see the Nafta agreement expire every five years. This will

have to include discussions from all three parties and has proven to be a particularly tricky issue to resolve, as Canada and Mexico both see this preventing long-term investment.

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*The progress made in bilateral discussions between the US and Mexico is positive news for Nafta prospects*

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Talks have been on hold for some time following the recent elections in Mexico, but progress in bilateral discussions between the US and Mexico is positive news for Nafta's prospects and is an important step towards securing a trilateral agreement.

Mexico is keen to wrap up a deal which allows President Enrique Pena Nieto enough time to sign it off before he leaves office in December. Although nothing has yet been confirmed on Canada's return to discussions, the door appears to be open for them to get back involved.

## **Trump talk is still a threat**

But President Trump is adamant that if he can't have what he wants (i.e. a deal which will contribute to shrinking the US trade deficit), the threat of scrapping Nafta altogether still exists.

The President's approval ratings have also been improving in recent months, and this appears to have encouraged him to push forward with his trade policies. With polls suggesting Democrats could regain control of Congress, it's unlikely we'll see a full de-escalation in trade tensions before the US mid-term elections in November.

Trump will sense he needs to get the core Republican vote out, and tough talk on trade can help him do that.

### **Author**

#### **James Smith**

Developed Markets Economist, UK

[james.smith@ing.com](mailto:james.smith@ing.com)

# Sweden: How long can the good times last?

The Swedish economy has held up surprisingly well in the first half of 2018. We still think a slowdown is coming though

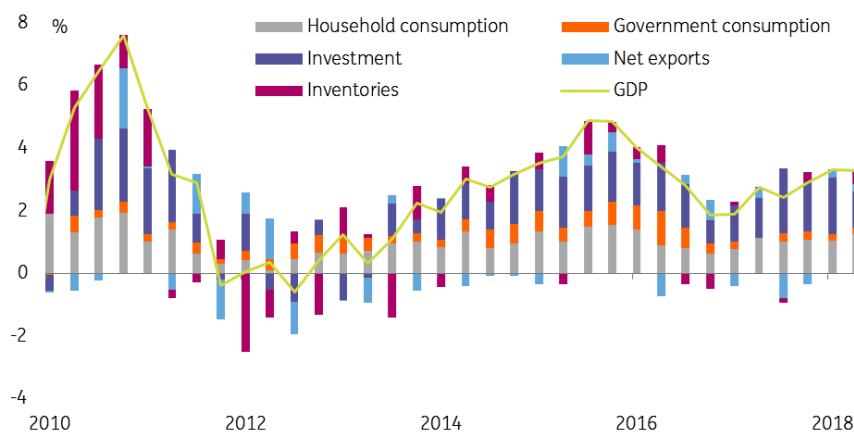


## Growth has remained strong

For some time now, we and most other forecasters have been expecting the Swedish economy to slow down. After several years of strong growth, driven in large part by a booming housing market and strong consumer demand, the Swedish economy seems unlikely to sustain 3%+ annual growth in output. Long-term potential growth is more like 2% per year.

But so far this year, expectations for a slowdown have proven unfounded. GDP grew strongly in both 1Q and 2Q, with output up 3.3% compared to the middle of 2017. The housing slowdown has yet to make a major impact on growth figures. While new housing construction slowed markedly in 2Q, an increase in other investments offset this. And consumer spending, which is typically sensitive to house prices, has held up despite the sharp fall in house prices at the end of 2017.

## Swedish GDP growth by component, YoY

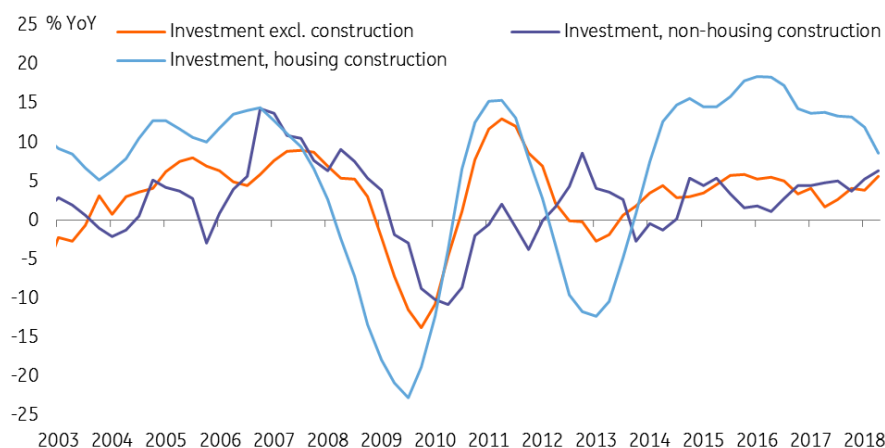


Source: Macrobond and ING calculations

Still, the second half of 2018 is likely to see softening growth momentum. First off, the 2Q growth figure was flattered by a build-up of inventories and strong net exports, which is likely to be partly reversed in 3Q. Household consumption may also have been flattered by changes to the taxation of new cars from the start of July, which created an incentive to bring purchases forward. Again, this may push down on the 3Q and 4Q growth figures.

High-frequency survey data also suggest momentum is faltering, with consumer confidence weakening, in particular. Housing construction will slow further, and it is not clear that investment in other sectors will continue to make up the shortfall. So growth in the second half of the year is unlikely to match the first half pace.

## Housing investment is slowing down



Source: Macrobond and ING calculations

## But the housing market is still a concern

House prices have been broadly flat in 2018, stabilising after the sharp fall last autumn. The market is down around 5% nationally and around 10% in Stockholm. So far, the spillover to the rest of the



economy appears limited, with household consumption holding up well in the first half of the year.

The key question now is how the market develops over the rest of the year. The signals are mixed. On the positive side, sentiment on housing seems to be turning more positive again. But at the same time, sales volumes have been extremely low over the summer, and there remains a large overhang of newly built properties coming on to the market in Stockholm and other major cities.

In our view, a further leg down in prices over the autumn, perhaps another 5-10%, is a plausible scenario. This would likely further depress new construction, and would likely start to dampen consumption to some extent as well.

## **And the global outlook also looks cloudy**

While the deal between the US and EU to take auto tariffs off the table has reduced the immediate threat from the US administration's aggressive tariff policies, continued tensions between the US and China are bad news for the export-dependent Swedish economy. If the global economy slows down, Sweden will slow with it. At a time when domestic momentum is already waning, this would be a double-whammy for Swedish growth.

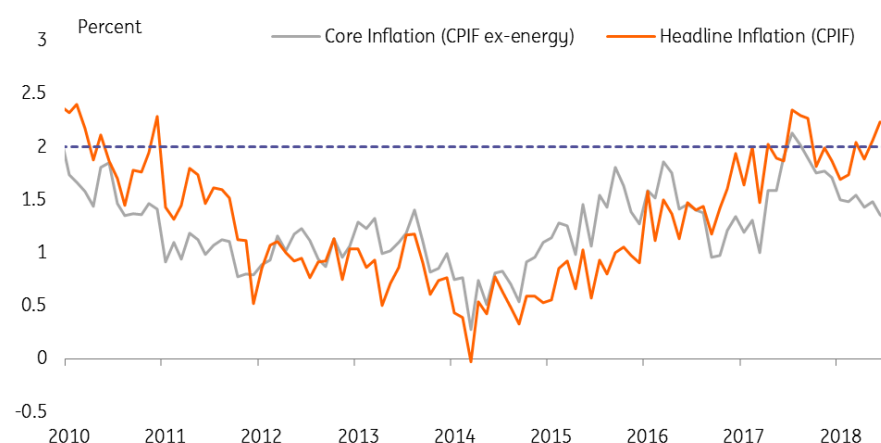
The recent turmoil in Turkey that's spread to other emerging markets, as well as the underlying tension between the EU and Italy's new government around the country's fiscal plans, also poses risks to the global outlook, and particularly the European economy.

## **Energy prices have risen, but underlying inflation continues to disappoint**

Over the summer, the headline inflation rate has risen above 2%. But this is entirely down to high energy prices: the rise in oil prices earlier this year is feeding through to consumers, and the extremely hot summer causing electricity prices to spike (the dry weather meant Sweden's hydropower plants had to reduce output). As the energy effects start to fade, inflation is likely to fall back, unless domestic inflation starts to pick up.

But underlying, domestically-generated inflation remains weak, with core inflation at 1.3% in July and services inflation at 1.2%. And there are few signs of domestic prices picking up materially. The Riksbank's core inflation forecast has proved too optimistic six out of seven months this year, despite a 10% depreciation of the krona since last autumn (which should be pushing up in core inflation by now).

## Headline inflation rises on energy prices, but core lags behind



Source: Macrobond

## The Riksbank's dilemma remains the same

For the Swedish central bank, the situation is dreadfully familiar. Swedish growth is strong, but risks are clearly skewed to the downside both at home and abroad. Underlying inflation remains stubbornly low, with no clear upward trend. And ECB continues to keep policy setting loose – no interest rate change is likely until the autumn of 2019.

This puts the Riksbank in a tough spot. There's no doubt the committee would like to start raising rates, and a 10 basis point hike in December, consistent with the Riksbank's current interest forecast, cannot be excluded. But given how adamant policymakers (at least the majority of the MPC led by Governor Stefan Ingves) have been that inflation needs to return sustainably to target before monetary stimulus is withdrawn, the likelihood is that the continued weakness in underlying inflation will cause them to delay the first rate hike into 2019.

We expect a move in that direction at the 6 September policy meeting, though divisions on the committee make it difficult to judge how the communication will play out.

## Elections in September

Sweden holds elections on 9 September. Polls suggest the likely outcome is a hung parliament, where record support for the far-right, anti-EU Sweden Democrats means neither of the traditional centre-left and centre-right blocks are even close to a majority. That means messy and potential lengthy negotiations to form a new government lie ahead, which could lead to at least a short-term political risk premium being priced into the krona.

# Swedish elections: Muddy waters

Swedes go to the polls on 9 September. The election result looks likely to be messy. While Sweden's economic fundamentals and institutions are...



## A stable foundation

Swedish elections are usually fairly staid affairs and historically, have not been all that interesting from a market perspective. When it comes to economic policy, the differences between the mainstream centre-left and centre-right political blocks in Sweden are arguably not all that significant. The centre-left tends to favour welfare spending when in power while the centre-right is more likely to pursue tax-cuts, but both are committed to a sound budget underpinned by a fiscal rule.

Fiscal policy is constrained by a requirement to run a structural surplus of 0.33% of GDP over the economic cycle and keep government debt anchored around 35% of GDP. In practice, this means there is limited scope for any government to pursue radically different fiscal policies. And key long-term decisions (e.g. pension reform) have historically been agreed by consensus among the major parties.

## But an unfamiliar situation

This election is unusual though, for two reasons. First, the rise of the far-right Swedish Democrat party has disrupted the traditional left vs right dynamic in Swedish politics, and is likely to make it difficult for anyone to form a stable government after the elections.

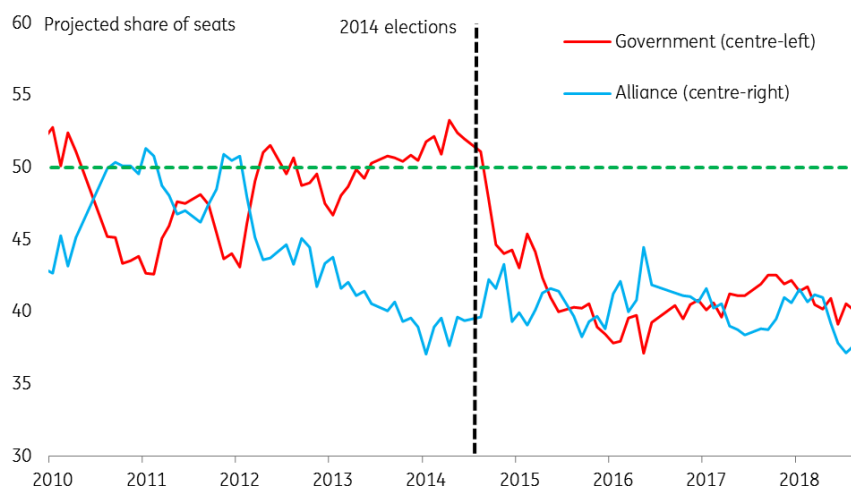
Second, this year the Swedish krona (SEK) has become a bellwether for global risk sentiment, depreciating at signs of escalating trade tensions or emerging market stress. The wobbly housing market, a peaking economy, and the ultra-dovish Riksbank have also undermined SEK.

The trade-weighted krona index has depreciated 10% since last autumn. We think that in this environment, domestic political uncertainty could easily become another factor driving SEK volatility.

## No one is going to win a majority

Polls have been pretty clear for some time that neither the current centre-left government nor the centre-right opposition alliance is likely to win a majority in September. Both blocks are polling below 40%, and the leading parties on both sides (the Social Democrats and the Conservatives (Moderaterna) are headed for historically poor showings.

## Neither government nor opposition looks likely to gain a majority

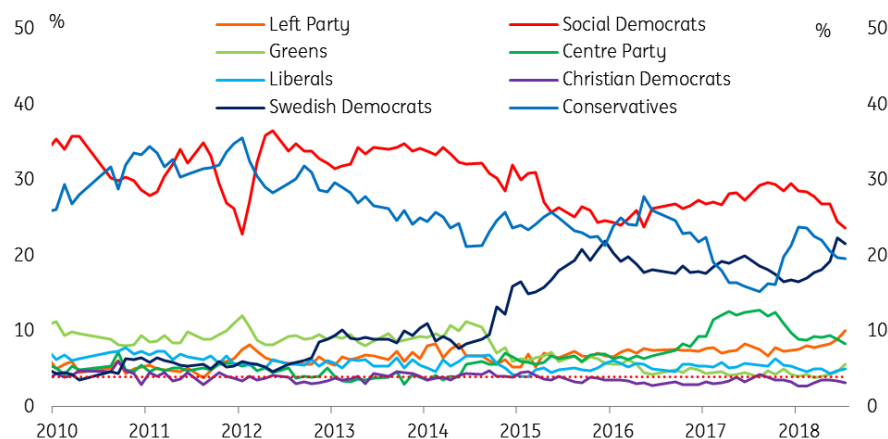


Source: Macrobond and ING calculations

In contrast, the populist far-right Sweden Democrats have gone from strength to strength, and are polling around 20% (having only entered parliament in 2010). Some polls even show they could become the largest party, though there is a discrepancy between polls that use self-selecting online panels (which show the far-right winning the largest share) and the standard polls (which have the Social Democrats in first place).

Among the smaller parties, the Greens, the Liberals, and the Christian Democrats are all at risk of missing the 4% threshold for entering parliament. The Christian Democrats, in particular, look to be struggling, though this is a familiar pattern for them and in previous elections they've always managed to squeak past the 4% barrier. If one of the smaller parties drops out of parliament it would alter the balance between the two mainstream blocks, but would not leave either much closer to a majority.

## Polls by party



Source: Macrobond

## Post-election confusion likely

It is hard to say how the post-election negotiations will go. The positions of the main parties during the campaign imply a deadlock: none of the mainstream parties want to work with the Swedish Democrats, the centre-right parties will not govern with the Social Democrats and the Social Democrats will not allow a centre-right government. If the result reflects current polls, these positions imply an impasse.

In 2014 and 2010, neither of the two main blocks had a majority either, but the mainstream parties agreed that the block with the larger vote-share would form a minority government – in effect ignoring the far-right vote.

That is one plausible outcome this time around as well and would result in either a continuation of the current government or a return to the previous centre-right coalition. But there appears to be less willingness on both sides to compromise in this way, and a realisation that ignoring the far-right has only served to strengthen its position.

So two other options are on the table. The Conservatives could choose to govern with support from the far-right. While they have consistently excluded this option, the temptation may become too great post-election (especially if the Conservatives, Christian Democrats and Swedish Democrats win a majority in Parliament).

The other alternative is a centrist coalition led by the Social Democrats with support from the Liberals, Centre Party, and the Greens (and probably implicit support from the Left). A grand coalition between the Social Democrats and the Conservatives is a more remote possibility, given the two parties have always defined themselves in opposition to the other.

In short, the weeks after the election are likely to be very messy. Forming a new government and passing a budget for 2019 could easily take up the rest of the year. New elections, if the deadlock cannot be resolved, are a clear possibility (this almost happened in 2014, and the current situation looks more difficult). That would prolong the period of uncertainty into the first half of 2019.

## Economic policy implications

The Swedish economy is doing well. After several years of strong growth, government finances are in good shape (net government debt is below 30% of GDP). Though we see a slowdown ahead, and the potential for a rather nasty downturn if weakness in the domestic economy were to coincide with a global downturn, the immediate situation facing the new government is fairly benign.

Given the fiscal rule, regardless of what shape the next government comes in, fiscal policy will not change materially. Major reforms (a comprehensive tax reform and a new housing policy have been mooted) would likely be undertaken through cross-party consensus, which will be a slow-moving process and likely a story for 2019 or later.

Deliberate disruption (the Swedish Democrats have called for a referendum on EU membership, while the Liberals want Sweden to join the euro) looks unlikely. Neither is a realistic political proposition: polls suggest Swedes are content with the status quo – less than a quarter would support leaving the EU, and less than 20% want to join the euro.

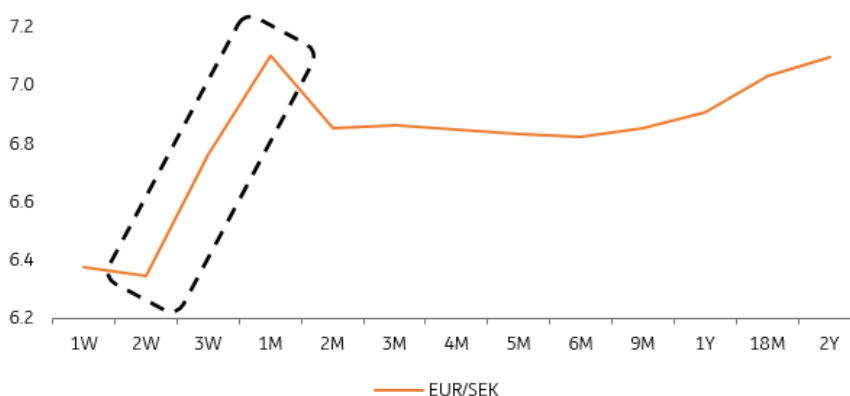
Looking a bit further ahead, a weak minority government could lead to difficulties in some scenarios. If there was a sharp slowdown (for example, due to the housing market taking a turn for the worse, or the global trade war worsening) and difficult decisions had to be taken, a minority government may struggle to take decisive action.

## Currency market implications

The election risk premium is already apparent in the option market, with EUR/SEK volatility term structure showing a meaningful kink over the one-month time horizon which covers both (a) the election on 9 September and (b) the likely immediate uncertainty thereafter (note the one-month tenor also covers the September Riksbank meeting). This contrasts with the rather smooth-term structure of other European currencies, in turn pointing to the specific SEK risk premium

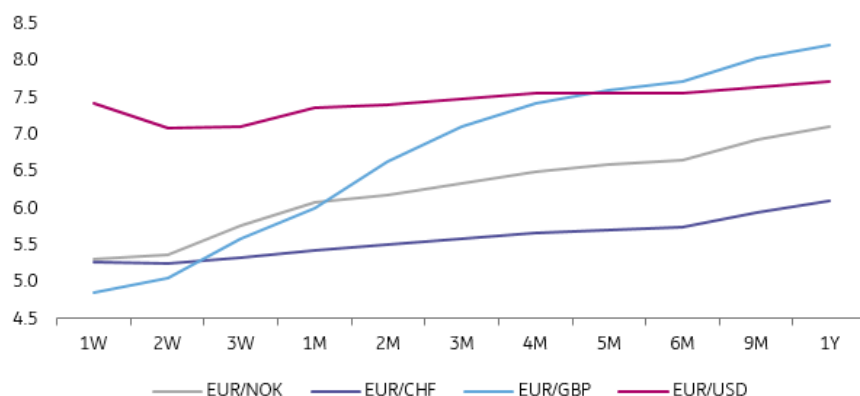
### EURSEK term structure

Implied volatility term structure for At The Money options



## EU FX term structure

Implied volatility term structure for At The Money options

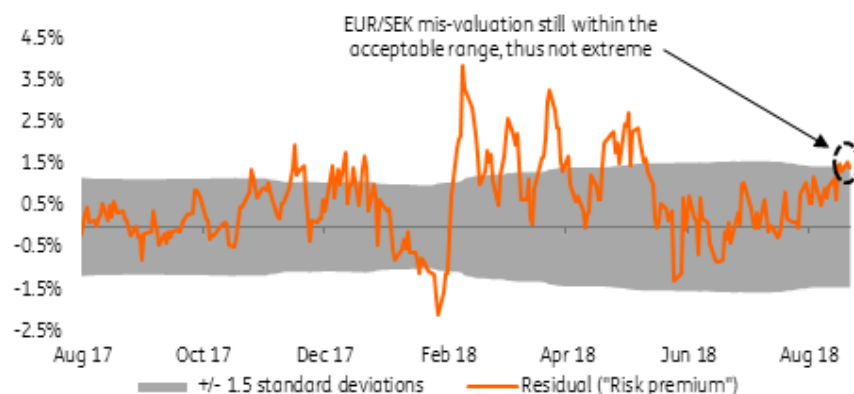


Source: Bloomberg and ING calculations

While EUR/SEK has also been showing a degree of risk premium, it is not extreme (i.e. the misvaluation is still within the 1.5 standard deviation band) and well below the February to May 2018 highs. The lack of an extreme risk premium present in the SEK spot suggests that the krona may experience more weakness in response to the likely hung parliament result and the accompanying uncertainty.

## EURSEK Risk premium

% residual (a gauge for risk premium) between EUR/SEK fair value and spot.



We retain our bearish SEK view and target the EUR/SEK 11.00 level by the year-end. The likely political uncertainty following the hung parliament result, the dovish Riksbank, slowing economy, the deteriorating Swedish current account and cheap funding costs should all keep SEK under pressure for the remainder of the year. Needless to say, with Sweden being a small open economy, the spectre of trade wars is a clear negative for SEK.

Although short-term SEK negative, we don't expect the outcome of the Swedish election to be a structural and persistent negative for SEK (as per above). Rather, its negative effect on SEK should be a matter of months (during the initial phase of uncertainty) rather than quarters. Coupled with cheap medium-term undervaluation, we expect the SEK weakness to trough this year (around

EUR/SEK 11.00) and to embark on a very gentle recovery trend next year.

In the relative value space, we continue to favour long NOK/SEK positions as (a) elections will weigh on SEK and (b) Norges Bank rate hike in September will support NOK. NOK/SEK to break above the 1.10 level next month.



## Expect more voter volatility ahead of Brazil's presidential election

Latest opinion polls suggest Brazilian voter intentions have been remarkably steady in recent months. That could change given the high level of undecided...



Source: Shutterstock

Former Brazilian president 'Lula' da Silva

### Alckmin has secured his position as a competitive candidate

The biggest change in local market sentiment towards the Brazilian election over the past month has been a more constructive assessment regarding the ability of the establishment candidate, Geraldo Alckmin, to win the race, following the consolidation of a broad party alliance network.

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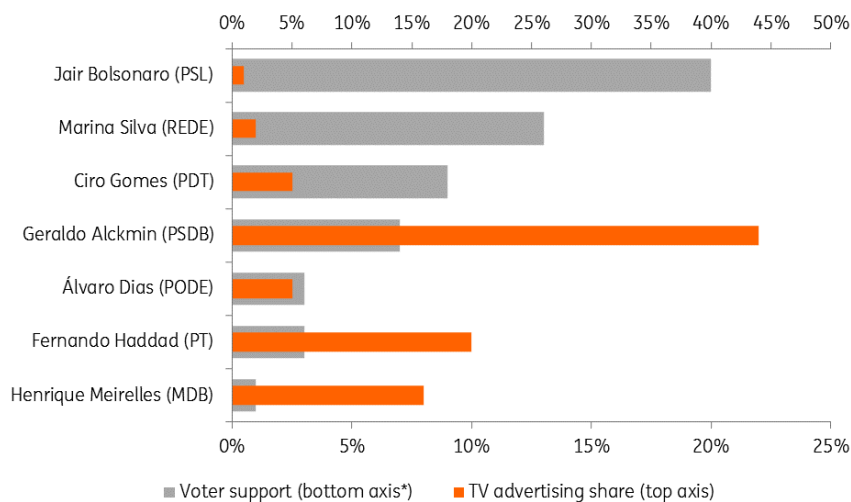
*Alckmin was indeed the biggest winner of the party negotiations*

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Alckmin was indeed the biggest winner of the party negotiations, followed by the jailed former president, Luiz Inácio 'Lula' da Silva's PT party, which was able to unify part of the left with the withdrawal of Manuela D'Ávila's candidacy. Ciro Gomes was the biggest loser, as the candidate failed to seal any significant alliances, despite intense negotiations with both the left, which he lost to the PT, and the centre, which he lost to Alckmin. Marina Silva and Jair Bolsonaro seem more

comfortable with their isolation, actively deploying it to solidify their status as outsider/anti-establishment candidates.

As a result of the negotiated party alliances, Alckmin’s campaign will amass 44% of the total airtime for presidential candidates in the state-sponsored TV/radio campaign that starts on August 31. The PT candidate will receive about 20% of the dedicated airtime, followed by Henrique Meirelles (15%) while the remaining candidates all get 5% or less, as we show in the chart below



Source: ING (\*poll-of-polls, without Lula)

Party alliances accentuated the asymmetry of campaign resource distribution. In particular, as the chart above demonstrates, the fact that leading contenders are the ones with the fewest resources increases the likelihood of bigger changes in voter support after August 31, greatly complicating the assessment of the electoral outlook.

Investors will be expecting Alckmin materially to improve his poll numbers throughout September. TV is still the most important way to reach the electorate in Brazil, despite the rise of social media. We agree that the greater exposure gives Alckmin a much-improved chance to move on to the second round but, in our opinion, this won't be enough to catapult him to certain victory.

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### *A strong anti-establishment sentiment*

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The candidate’s association with the political establishment, which deepened with the alliances that closely mirror President Temer’s support base, suggests that Alckmin is vulnerable to deeply felt voter dissatisfaction with the political class and strong anti-establishment sentiment. His troubling performance in his home state where, despite his good reputation and name-recognition, Bolsonaro appears to maintain a narrow lead also raises questions about his viability in this electoral cycle.

As seen in Colombia and Mexico this year, anti-establishment sentiment was a much more potent driver for election results than traditional resource advantages, which perhaps also lost their effectiveness due to the rise of social media.

## PT insists on Lula, but gets ready for Haddad

Another important development over the past month was the confirmation that the PT party will insist on Lula's candidacy, which should help maximize the party's media exposure. The local consensus is that there's a negligible chance the courts will allow the jailed former-President to run. A decision by the courts is expected at some time between the end of the month and the September 17 deadline.

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### *Voter support for Lula remains quite high*

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In that case, the PT is expected to replace Lula with Fernando Haddad, the current VP candidate in the ticket. Manuela D'Ávila (PC do B) would be added to the ticket as VP candidate.

Voter support for Lula remains quite high, at about 35%, while support for Haddad is quite low (2-4% range). As a result, the PT's main goal should be securing a high level of transfer of voter support from Lula to Haddad. This may not necessarily be a trivial task because Haddad is little known, and Lula is unlikely to be able to record videos or give interviews in support of Haddad, while the use of his image in Haddad's campaign may also be restricted.

The uncertainties surrounding this transfer, which presumably would happen very late in the campaign cycle, throughout the second half of September (Election Day is October 7), is another critical source of uncertainty vis-à-vis the outcome of the elections.

## Fractured electoral landscape suggests low bar for a first-round win

As the polls released this week indicated, the campaign still lacks an undisputed leader, with no candidate (other than Lula) with more than 20% support, while a large part of the electorate (more than a third) remains undecided about their vote. The fragmentation of voter support is perhaps the chief characteristic of the current electoral process.

That fragmentation should rise ahead, further complicating the assessment of the electoral outlook. Three factors should contribute to that:

1. as mentioned above, the leading contenders in the race are the ones with the least resources, and presumably, with more room to fall
2. the PT's expected attempt to transfer voter support from Lula to Haddad
3. the profile of the undecided voters, with a larger proportion of centrist/liberal women, appears to be more aligned with Alckmin and Marina, to the detriment of Bolsonaro and the PT

These three factors suggest that September should be marked by greater swings in the polls. In particular, even though local political analysts remain deeply divided in their assessments about the final electoral results, it is widely expected that:

- greater exposure should increase Alckmin's support levels materially
- greater exposure and the confirmation of his candidacy should trigger a more dramatic rise

- in Haddad's voter support,
- on the left, Haddad's rise may come to the detriment of Marina Silva and Ciro Gomes, both of whom could lose support among Lula-loyalists
  - in the centre, Alckmin's rise may come to the detriment of Álvaro Dias

There's much less clarity, in our opinion, about how these dynamics will affect Jair Bolsonaro, who should be able to offset his campaign resource disadvantages with the savvy use of social media, and the greater enthusiasm and loyalty typically associated with his supporters.

These developments suggest that the gap between the leading candidates should narrow during September, with four candidates (at least) likely remaining competitive until Election Day. As a result, the voter support needed to move to the second round is likely to be unusually small and the risk is that the election will be decided by razor-thin margins, severely complicating the assessment of who will be the next President.

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### *The gap between leading candidates should narrow*

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We also question the popular view that the first-round will be won by a candidate from the left (Marina, Haddad or Gomes) and a candidate from the centre/right (Alckmin or Bolsonaro). Unlike previous electoral cycles that were dominated by a typical polarisation between the left and right, any combination of the five leading contenders seems plausible under certain circumstances.

Low conviction prevails and the odds remain very difficult to call but, for now, the local consensus is that the three candidates that appear to have the strongest chances of moving on to the second round are: Alckmin (due to the greater TV exposure), Haddad (due to Lula's support) and Bolsonaro. Following yesterday's poll results (to be confirmed by a Datafolha poll expected to be released on Wednesday) the prevailing view is perhaps that Haddad and Bolsonaro have an edge over Alckmin.

Silva and Gomes also have potential but are seen as less likely to make the cut. Silva could surprise, however, by attracting a bigger share of undecided voters given her broad-range appeal, especially if Haddad's candidacy fails to gain traction. Gomes' situation is more precarious, given that he has been so weakened by party negotiations that the growing consensus is that his chances of moving to the second round have already been fatally compromised.

### **Near-term political catalysts for the BRL**

Polls are likely to be the main domestic drivers for local assets going forward. The chief market assumption is that Alckmin will rise in polls once the TV/radio ads start airing on August 31. But the longer it takes for the candidate to rise, the more anxious investors are likely to become.

As discussed above, we agree that Alckmin's voter support should increase but we still find it unlikely that investor conviction about his victory will solidify. Our base-case assumption is that at least four candidates should remain competitive until October 7, keeping uncertainty elevated until the end.

Lack of clarity that an investor-friendly candidate will win should weigh on local assets,

intensify demand for FX hedge and trigger a BRL selloff towards the 4-4.20 range during September/October.

The central bank still has much ammunition (at least about US\$50bn) to intervene in FX markets and alter the BRL's trajectory. After record-levels of intervention in June (when the CB sold US\$37bn in FX swaps), the bank took advantage of the improved market environment in July and did not intervene, effectively saving some ammunition for later. As a result of intervention uncertainty, a more precise FX trajectory remains hard to predict.

Post-October 7 and before the second-round on October 28, local assets will react to the election result and second-round poll simulations. Any scenario in which Alckmin fails to move to the second round is bound to weigh on local assets. Bolsonaro's economic agenda is pro-market, but the candidate is also seen as more vulnerable in second-round simulations while lingering questions about his conviction on his economic programme and his ability to execute it suggest greater caution.

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