

## In case you missed it: More battles lie ahead

President Trump has declared a national emergency for a border-wall, US-China trade talks have ended in Beijing with (very) little signs of progress and the Brexit impasse continues confirming our view the saga will go down to the wire. But the US Commerce Department report on car imports will be out on Sunday and is likely to dominate the agenda next week

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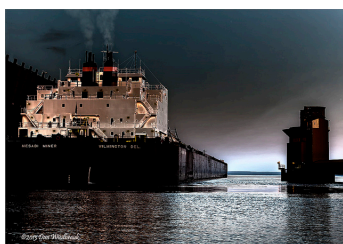


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# Higher US car tariffs would come at a bad time

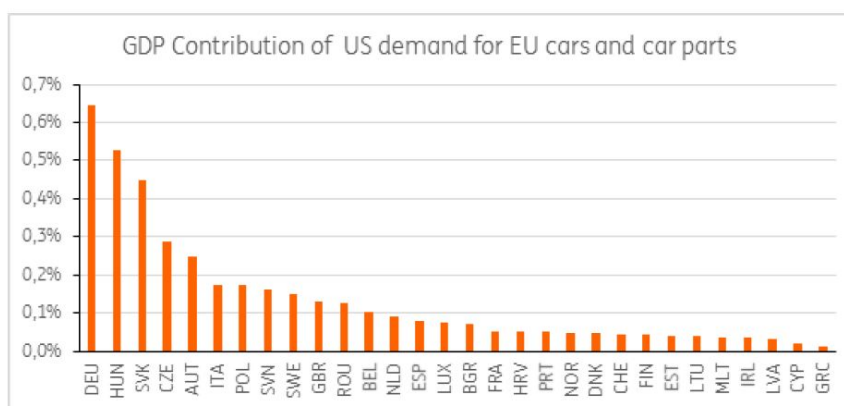
According to a report from press agency AFP, the US Department of Commerce has labelled the imports of cars a threat to national security. This gives...



Source: Shutterstock

For the EU economy, the direct effect of higher US import taxes would be limited (-0.1%GDP). But in the midst of the current slowdown and already abating economic sentiment, a tariff hike could be felt indirectly as well through negative effects on business and consumer confidence. This would at least double the negative effect on EU GDP. If the tariff precipitates a 'tit for tat' trade battle between the US and EU, economies on both sides of the ocean would be hurt significantly more.

## Limited exposure of European autos to US demand



Source: WIOD database 2017, calculations Universiteit van Groningen

The chart above shows that behind the benign average effect for the EU as a whole (-0.1%GDP), there are significant differences between EU members states. For Germany, the share of total exports of cars and car parts that end up in the US is the highest of all EU countries. But even for Germany's flagship auto industry, a rise in American import tariffs is, in itself, not the disaster many think it is.

Despite having a strong industrial base, Germany's economy is largely made up of services (71%). The car industry adds no more than 4% to German GDP and only one eighth of this depends on exports that end up in the US. Don't forget that some German car makers like Mercedes and BMW produce 30% to 50% of the cars they sell to Americans locally in the US. The equivalent of the direct damage for the EU as a whole, is a hit of -0.2% for German GDP. Significant but not shocking. Actually, the effect could be somewhat lower because German car exports include many luxury vehicles, which usually suffer a below-average fall in demand when prices rise.

Hungary, Slovakia and the Czech Republic are also strongly associated with the automobile sector. But the direct effect on the overall economy, through lost revenue in the automobile sector, is rather limited as well.

### Modest direct effect of car tariffs

If the US were to increase tariffs by 20 percentage points on imported cars and car parts from the EU, worth \$50 billion, the direct effect would be limited to little less than 0.1% of EU GDP. This effect is relatively benign because the value added of exports of cars and car parts to the US makes up only a small part of EU GDP (0.27%) and not all of those exports will be wiped out. Germany is most vulnerable to negative demand shocks from the US, followed by Hungary and Slovakia.

### Indirect and second-round effects can make things worse

While the direct effect might be surprisingly low, indirect effects are also at play. Given the current slowdown of economic growth in Germany and other EU member states, a tariff hike would come at a time when confidence is already in decline and vulnerable. We estimate that the announcement of a 20 percentage point hike in car tariffs would shave off at least another 0.1% of EU GDP through lower confidence among businesses and consumers. Including indirect effects, our

estimate of the total damage for the EU is at least 0.2% of GDP.

The EU has warned the US administration that, if the US imposes higher tariffs on car imports, it will retaliate by putting equivalent tariffs on \$23 billion of imports from the US. If this happens, the macro production loss for the EU could initially be lower. When import prices for US products rise, demand for local substitutes increases. We estimate that this will reduce the negative direct effect of lower exports on production and employment by one fifth.

But the experience in the current trade war between the US and China indicates that the mitigating effect of retaliation on production levels could be very short-lived because retaliation could well lead to further protectionist steps by the US government. President Trump sees the imposition of tariffs as necessary to restore a level playing field in trade between the US and its trade partners. In his view, retaliation simply makes trade unfair again and therefore warrants additional tariffs. This 'tit for tat' policy led to an escalation of the trade war between the US and China last year.

It should be said that a 'tit for tat' trade battle comes at the expense of consumers on both sides of the ocean. They will not only have to pay up for their cars, but for other products as well.

So, the more retaliation, the larger the negative second round effect on purchasing power will be, which in turn, will have a negative feedback into production and employment as well. It goes without saying that a broadening trade war would also be unsupportive for economic sentiment, which would have repercussions for investment and consumer spending.

If a large share of trade between the US and EU becomes subject to higher tariffs, the economic damage would be much more significant on both sides of the ocean. A mutually imposed tariff of 20% on all goods would, by the direct effect alone, cost both the EU and the US around 0.7% of GDP.

## Trump plays hard ball

Regarding the question of whether President Trump will follow up on his threat to impose higher tariffs on imported cars, various factors play a role. Some say that Trump will treat the EU with leniency because of long-standing political and economic ties. But it's wise to remember that he showed little sympathy when applying steel and aluminium tariffs to the EU and even to Canada and Mexico. Moreover, Trump has said that the EU is "as bad as China" when it comes to trading fairly with the US. Trump calls himself 'a tariff man' which he showed once again after the announcement of General Motors last November to lay off thousands of workers in the US. Trump said that would not have happened with higher import tariffs.

On the other hand, Trump's tone has softened somewhat in recent months. In the end, he wants a trade deal with the EU. That's why he entered into an agreement last summer with the president of the EU to start negotiations about a trade agreement. They agreed that during the negotiations, no car tariffs would be applied.

Nevertheless, preparatory talks have shown little progress. On the contrary, the latest demand from the US- to include agriculture in the negotiating agenda- has rather complicated the negotiations and diminished the chances that a deal can be struck.

# What will happen in the final week of Brexit?

There's a growing acceptance that the Brexit saga may go to the wire, but when push comes to shove, we suspect British MPs will be more inclined to...



Source: iStock

## Lawmakers are in no hurry to back a deal or a Brexit delay

With today's Brexit vote increasingly looking like a non-event, it's hard to escape the feeling that the Brexit saga could stretch out until days, or maybe even hours, before the UK is due to leave on 29 March. In fact, media reports now suggest things might go as late as the EU Council meeting on 21 March before some kind of deal gets struck.

With few signs of compromise on either side of the debate, it's easy to see how this could end up being the case. As we discussed in our [latest economic update](#), the EU has ruled out reopening negotiations on the main withdrawal agreement, not least because there are no guarantees any changes would make the crucial difference in gaining parliamentary support.

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*It seems unlikely that the tables will turn imminently in favour of Mrs May's deal or an alternative exit strategy. So what about an extension to the Article 50 negotiating period?*

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Equally, there are few signs that Theresa May is prepared to seek cross-party consensus on an alternative proposal. That's not to say this won't be the way things go in the end, but for now, the Conservative leader is focusing on keeping her bitterly divided party held together.

The odds of a second referendum also appear to have drifted lower. Labour leader Jeremy Corbyn remains reluctant to back one, not least because a number of Labour MPs represent leave-supporting areas.

Put all of that together, and it seems unlikely that the tables will turn imminently in favour of Mrs May's deal or an alternative exit strategy. So what about an extension to the Article 50 negotiating period?

There's little doubt now that more time will be needed to deliver Brexit – whatever happens between now and 29 March. The process of translating existing EU rules into the UK rulebook still has a long way to go, although there is talk that much of this could be rushed through at the last minute with rarely used, emergency processes. [As we noted earlier in the year](#), orchestrating alternative Brexit options (second referendum, different deal etc.) could take much longer still.

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*There's little doubt now that more time will be needed to deliver Brexit – whatever happens between now and 29 March*

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But while a delay appears increasingly inevitable, some lawmakers are reluctant to back this strategy just yet. A plan, tabled by MP Yvette Cooper and Nick Boles that laid the groundwork for an Article 50 extension, was rejected by MPs at the end of January. Two weeks on, and the plan's authors have decided to save a repeat fight until later to try and yield greater success.

One thing we do know though is that a majority of lawmakers are against the idea of 'no deal'. So when push comes to shove, and barring any accidents, MPs will ultimately have to choose between the deal and a Brexit delay (or both).

## The economy may begin to focus minds

So how will the situation look on 21 March as EU leaders meet for their final gathering before Brexit? The first thing to note is that the economic backdrop could be rapidly deteriorating. In practical terms, a lack of agreement would mean business would be planning their operations for the next week with no idea the trading terms they'll be dealing with.

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*Given there is a real risk of lorries getting stuck in the UK in the event of no-deal, there's very limited incentive for haulage firms to take UK-bound jobs in days running up to 29 March*

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One symptom of this is that it may become increasingly difficult to arrange cross-border shipments. According to the supply chain publication [Loadstar](#), 85% of the lorries that operate on



the major Dover-Calais shipping route are EU-based. Given that there is a real risk of lorries getting stuck in the UK in the event of no-deal, there's very limited incentive for these haulage firms to take UK-bound jobs in days running up to 29 March.

That's just one specific example, but more broadly firms are likely to take an increasingly cautious stance as the exit date draws nearer.

Consumers too may become increasingly wary. With one week to go, there is a clear possibility that a stockpiling mentality begins to take hold. The example of 2012, where fears of a fuel shortage saw long queues formed at petrol stations, has been cited as one scenario that may arise again.

## Who will blink first?

A growing sense of unease in the economy will place extra pressure on parliament to break the deadlock.

This may be enough to convince a few MPs to reluctantly back the deal at the last minute, although whether their numbers will be enough depends a lot on how the final deal looks after the 21 March EU Council. In reality, it's unlikely to look much different than it does now. Probably the best the UK side could hope for is a legally-binding codicil, a well-worn crisis mechanism, to give assurances that the contentious Irish backstop will not last forever.

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*The bar for MPs to get behind an extension to Article 50 is significantly lower than it is for them to back the deal*

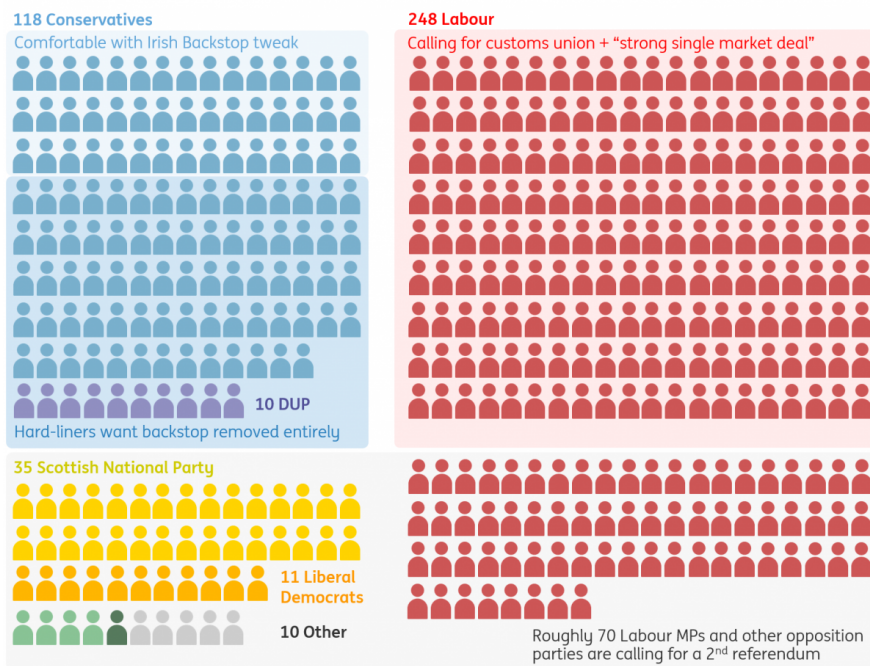
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This may be enough to change the minds of some Conservative MPs who voted down the deal in January. But many other hard-liners have indicated they will only support the agreement if the Irish backstop is removed entirely, and given that many of these MPs are more relaxed about the risk of 'no deal', it's hard to know whether they would be persuaded to back down at the last minute.

Either way, we suspect MPs would be more prepared to get behind extending Article 50 than they would be to back the deal at the last minute. After all, the original Cooper amendment, which aimed to give lawmakers a vote on extending Article 50 if the government failed to get its Brexit deal approved by the end of February, was defeated by a relatively narrow margin. At the time, it was also reported that a number of Conservative lawmakers were persuaded to reject the proposal, on the promise that they'd get another opportunity to make their feelings known on 14 February if no further progress was made.

While the MPs driving this plan have opted against pushing it again this week, they've made it clear they will try to hold a vote on extending Article 50 on 27 February. Whether or not this will yield greater success is not clear - loyal Conservative MPs and ministers may again be convinced to stand behind the Prime Minister for a little while longer. But either way, we assume that as the Brexit deadline creeps nearer, the more moderate lawmakers will begin to lose patience and there is a strong likelihood parliament will try to force the government into applying for extra time.

432 MPs voted down May's Brexit deal – but for differing reasons



Source: UK Parliament, ING

432 MPs voted down British Prime Minister Theresa May's Brexit deal - but for differing reasons

## How long might a Brexit delay last?

Nobody can really agree on how long an Article 50 extension might last. A lot depends on EU leaders, who don't forget, need to agree to any Article 50 extension unanimously.

There is a consensus now that EU leaders would be prepared to accept a delay (although if all of this happens at the last minute, there's nothing to stop certain member states trying to extract concessions out of the UK). But there is a big logistical challenge in the form of the European parliamentary elections scheduled for May, which the UK is not due to take part in.

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*The path of least resistance may be to opt for a shorter extension - perhaps up to two/three months*

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In principle, Brussels and the UK could leave themselves open to legal challenges if Britain hasn't elected new representatives. Meanwhile, the UK's seats are due to be reallocated across the bloc, so a failure to hold elections would add extra complexity (for more discussion on all of this, it's worth having a read of this [article from the Centre for European Reform](#))

It's worth remembering too that this year is a big one for Brussels, with a number of EU positions due to be filled and the next budget set to be finalised. Leaders will be reluctant to let Brexit distract from that.

With that in mind, the path of least resistance may be to opt for a shorter extension - perhaps up to two/three months. This would avoid the need to hold elections, and maybe more palatable to

the UK government. That said, a much longer extension - perhaps lasting to the end of the year - has also been mooted in the past to allow a more realistic timeframe for the situation to be resolved.

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*The risk of 'no deal' will not go away forever*

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However long a delay might last though, it doesn't remove the fact that Parliament will have to make up its mind on the deal in the end. This means that the risk of a 'no deal' will not go away forever, and as time goes on, there is a risk that Brussels begins to lose patience. However, we still think the likelihood of either the current deal or one that is adapted based on cross-party discussions, will ultimately prevail - be it before March or later on.

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# US retail sales plunge despite solid consumer backdrop

There's no doubt about it, December's US retail sales figures are off-the-charts bad. But there are a few reasons to treat these numbers with...



Source: iStockphoto

There's little doubt the December US retail sales report is grim. While the figures were always going to be dragged lower by a fall in the oil price, the broad-based nature of December's decline in sales will add to fears the US economy is entering a softer phase. The control group, which excludes a variety of volatile items, fell by 1.7% on the month, the scale of which has only been matched once before (in the aftermath of the September 2001 attacks).

**1.7%** Fall in the retail sales control group  
(MoM%)

Worse than expected

That said, there are a couple of reasons to treat these numbers with a bit of caution. Firstly, the

numbers don't tally with some other retail indicators, some of which painted a much more reassuring picture of the Christmas trading period. For instance, data from Mastercard pointed to a 5.1% increase in sales during November and December relative to the year before, while also noting shoppers picked up the pace in the run-up to Christmas.

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*We'll have to wait and see for the next few reports to see if this data was a blip, but either way, the outlook for consumers still looks decent*

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It's worth noting that the sharp fall in December sales comes after a pretty decent increase in November. This is most likely thanks to the impact of Black Friday and Cyber Monday, which make it tricky for statisticians to seasonally adjust given the constantly evolving nature of sales strategies over the past few years.

We'll have to wait and see for the next few reports to see if this data was a blip, but either way, the outlook for consumers still looks decent. The jobs market remains in very healthy shape, and wage growth continues to rise as businesses find it harder and harder to fill vacancies. At the same time, the recent plunge in gasoline prices will put extra cash in the pockets of consumers, helping to offset the waning impact of last year's fiscal stimulus.

Admittedly, the overall growth picture for the first quarter looks fairly mixed. The impact of trade uncertainty, the government shutdown, the recent polar vortex as well as financial market wobbles could pull annualised 1Q growth below 2%.

That will likely see the Fed remain on pause this quarter, but we still feel the combination of a solid economic backdrop, perhaps coupled with a gradual easing in trade tensions later this year, will see policymakers deliver one further rate hike in 2019.

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## Germany: The black eye just got blacker

The year 2018, which started off with expectations of the best growth performance since 2011, ended with a big stinker.



Source: Shutterstock

According to the first official estimate of fourth quarter GDP growth, the German economy just narrowly escaped a technical recession. GDP growth came in at zero, from -0.2% QoQ in 3Q. Year-on-year, GDP growth came in at 0.9% and 0.6% when adjusted for seasonal effects and working days. The growth composition will only be released at the end of the month but according to available monthly data and the statistical agency's press release, investments, private and public consumption were the main growth drivers, while net exports remained flat.

The weak performance of the German economy in the second half of the year is the result of (too many) one-offs, surfacing structural weaknesses and external uncertainties. Just think of cars, low water levels in main rivers, the trade conflict between the US and China, Brexit or the lack of investment in digital and traditional infrastructure, delays of railways and airlines as well as hardly any significant new structural reforms in the last ten years. What a list! However, it is still not necessarily the end of a long positive cycle.

### Not losing our optimism

Looking ahead, there are still plenty of reasons to remain optimistic. Not only were there some encouraging data signals under the surface of recent macro data, there are also fundamental reasons to remain optimistic: the labour market is strong, consumers' willingness to spend at its

highest level since April last year, order books are still richly filled and companies still report assured production close to record highs. While capacity utilisation has dropped to its lowest level since the third quarter of 2017, the lack of equipment still is a more limiting factor to production than the lack of skilled workers. In addition to this, the recent pick-up in orders in the automotive industry and favourable financing conditions in the entire economy also bode well for at least solid industrial and investment activity in 2019. Add to this the positive fiscal stimulus provided by the government and there is a good counterweight to the latest drop in sentiment.

## Don't forget politics

In the meantime, German politics is getting interesting (once again). In the very unique situation that no single party leader is actually member of the government, all parties are preparing for the upcoming European Elections and state elections in Bremen in late-May as well as for state elections in three Brandenburg, Thuringia and Saxony. Particularly, the European Elections and the Bremen elections will be crucial for the federal government as they will decide on the future of the SPD. Bremen is the last stronghold for the SPD, as it has ruled there since 1946. The upcoming elections explain the SPD's latest energetic efforts to present new policy proposals like higher pensions, an unconditional minimum pension and a further softening of previous labour market reforms illustrate an attempt to move to the political left wing. It seems obvious that these proposals will not easily find support from the CDU. However, if the SPD's attempt to move further towards the political left wing eventually receives positive feedback from the voters or at least party members, it could be the trigger to eventually exit the government towards the end of the year. For the time being, last night, the leading figures of the three coalition parties met for the first time this year. Keeping it quiet after last year's permanent quarrels apparently had the highest priority. How long this truce will last, however, is unclear. A fall of the current government coalition before the official end of its term in 2021 remains part of our German risk list.

## The black eye just got blacker

Back to today's GDP data. The German economy escaped a technical recession with the smallest margin possible. The black eye just got blacker. Still, the upside from today's data is that it can hardly get worse. Economic fundamentals remain solid and from here on, chances of a (gradual) rebound are still much higher than chances of yet another disappointment.

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## The iron ore surplus disappears

Following the tragic tailings dam accident in Brazil, we revise our iron ore price forecasts higher, with a significant reduction in the expected seaborne...



Source: Flickr

### ING iron ore price forecast

	1Q19	2Q19	3Q19	4Q19	1Q20	2Q20	3Q20	4Q20
Iron Ore 62% Fe (US\$/t)- New	82	80	80	75	75	70	70	60
Iron Ore 62% Fe (US\$/t)- Previous	67	62	58	60	60	55	55	55

Source: ING Research

### Seaborne surplus disappears

2019 was set to be a year of weakness for the iron ore market. Seaborne supply was expected to grow with the continued ramp-up of supply from a number of mines, whilst weaker steel margins, and broader concerns over the global economy suggested limited growth in iron ore demand for the year.

However, following the tragic tailings dam accident at the Corrego do Feijao mine in Minas Gerais, Brazil there is plenty of uncertainty over the global seaborne balance for the next couple of years. While the mine is relatively small, producing around 7.8mtpa, the implications from the accident

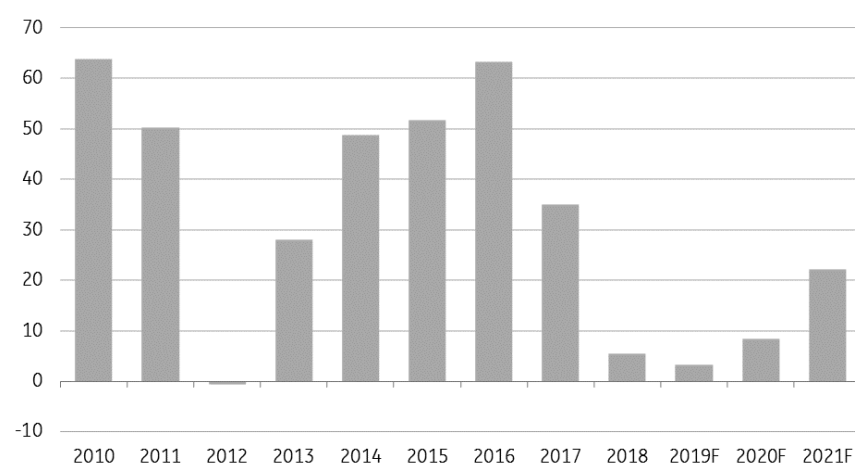


have been significant. In the aftermath of the disaster, Vale has announced that it will decommission all upstream tailings dams, resulting in a loss of around 40mtpa production. Although the miner will at least partly offset these losses with increases elsewhere.

However, Vale have had to make further cuts in order to comply with a Brazilian court order. Operations at the Brucutu mine have also been suspended, affecting an additional 30mtpa of production. Vale has in fact declared force majeure on some contracts as due to this court order. As a result of these cuts, there is the potential to see up to 70mtpa of production lost, although we think losses this extreme are unlikely. The continued ramping up of their 90mtpa S11D mine is likely to contribute significantly to offsetting losses - production at the mine over 2018 is estimated to have totalled around 55mt. Additionally, other miners will be keen to fill the gap, especially in the higher price environment.

There is still significant uncertainty over supply - potential losses range anywhere from 30mtpa to 70mtpa. In our base case scenario, we are assuming that Vale output falls by 40mt from their previous 400mt target, which leaves the global seaborne market in balance over the year. Although this does assume that we see around a 36mtpa increase in supply from other miners this year. These increases are driven by Rio Tinto, along with a recovery in Anglo's Minas Rio output this year. Any larger losses will only push the seaborne market into deficit for the remainder of the year, and prolonged shutdowns would obviously tighten the balance moving into 2020 as well. We certainly wouldn't rule out extended outages - if we use the Samarco mine as an example, a similar tailings dam accident happened in November 2015, and the mine is still waiting on approvals to restart operations. Obviously recent developments mean that this mine restart is likely to be further delayed.

## Global iron ore seaborne surplus shrinks (m tonnes)



## Downside demand risks

One of the clear themes for markets this year is concerns over a global slowdown, driven by China and the impact of the ongoing trade war between the US and China. Therefore how trade talks evolve will be key for sentiment. The current ceasefire between China and the US expires at the end of February, and assuming that there is no deal or extension to negotiations, tariffs on US\$200bn worth of Chinese goods is set to increase from 10% to 25%. The other key date is 17 February, which is the deadline for the Department of Commerce to conclude whether auto imports into the

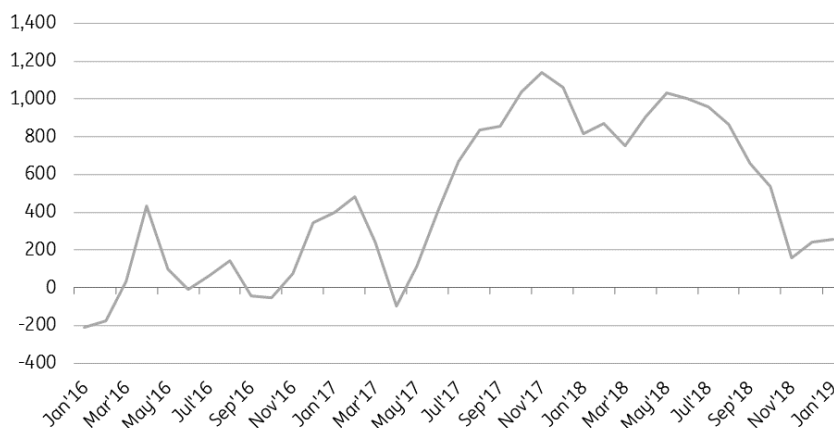
US are a national security risk. Following this President Trump has 90 days to decide what action needs to be taken if any. He has threatened in the past to impose tariffs as high as 25% on vehicles and parts. How both of these events play out will certainly have an impact on broader market sentiment, including metal markets.

Looking specifically at iron ore, imports into China did slow over 2018, with inflows totalling 1.06b tonnes, down 1% YoY. Despite this slight reduction, Chinese steel output over the year hit a record 928mt, up 6.6% YoY according to the World Steel Association. This divergence appears to reflect a combination of both increased usage of higher grades of iron ore, along with the drawdown of domestic inventories.

Moving forward, we do believe that Chinese steel output has peaked, and as a result, in our base case scenario, we are assuming that iron ore import demand over 2019 will be largely flat. Although a sustained period of weak steel mill margins may weigh further on imports, with mills turning increasingly to domestic inventories, which are largely thought to be lower quality ore.

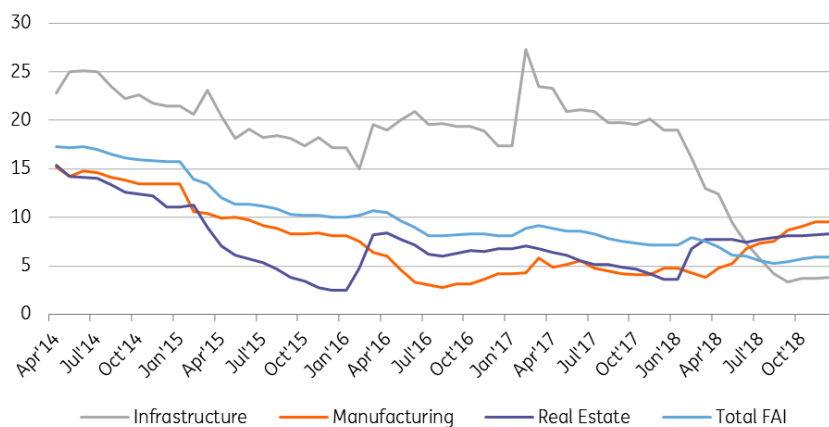
The World Steel Association in their last forecast assumed that global steel demand will grow by 1.4% over 2019, down from an estimated 3.9% in 2018. Although growth is expected to come largely from ex-China, with Chinese demand growth forecast to be flat over 2019. However, this is where the key risk is - both to the upside and downside. On the one hand, you have trade developments weighing on demand prospects, yet it is still unclear how effective stimulus programmes will be in boosting infrastructure investment. Growth rates in infrastructure appear to have bottomed out, but we are not seeing a significant rebound in these growth rates just yet.

### Chinese BOF steel margins remain weak (CNY/t)



Source: Bloomberg, ING Research

## Limited growth in Chinese Fixed Asset Investment (YoY%)



Source: NBS, Bloomberg, ING Research

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## Spain: Snap elections likely to be called

After months of trying to convince Catalan lawmakers to support the 2019 budget, Prime Minister Sanchez is likely to throw the towel in the ring and call...



Spanish Premier, Pedro Sanchez

### What happened?

As expected, the 2019 budget was voted down today in parliament. The 17 Catalan lawmakers did not vote in favour of the budget. Sanchez tried to win their support by offering an increase in money earmarked to the region, which would make Catalonia the biggest recipient of central government funding. He also wanted to start negotiations with the Catalans. But the Catalans said they only want to talk if a new independence referendum is discussed, something that Sanchez was unwilling to do.

As there is no 2019 budget, the 2018 budget rolls over. But this implies that the current PSOE-led minority government is very much limited in what it can do. The probability of snap elections has therefore increased. More specifically, Sanchez could call snap elections in April or May this Friday, after the weekly cabinet meeting. It would be the third general election in less than four years.

All this comes at a sensitive time as the Catalan independence trial started yesterday, where 12 leading politicians and activists are on trial for calling an independence referendum and declaring independence in October 2017.

## Possible scenarios in case of snap elections

Recent polls still show that the PSOE is the leading party with about 24% of the votes. The two large right-wing parties, the PP and Ciudadanos, follow with about 20% and 18%, respectively, of the votes. Podemos is fourth with about 14%. A new factor in the political equation is VOX. In recent polls, the party achieves about 10% of the votes.

The political fragmentation in Spain is therefore here to stay and forming a coalition will be necessary. What are the likely outcomes of a potential snap election?

- Right-wing government (PP and Ciudadanos, with the support of VOX): Likely

A coalition between the PP and Ciudadanos, with the support of VOX, as is already the case in Andalucía, is quite likely based on current polls. This coalition would be much harder on the Catalans. Tensions between the central government and Catalonia are likely to increase in this scenario.

- Left-wing government (PSOE and Podemos, with the support of smaller parties): Less likely

The PSOE is still the largest party in the polls and so could be in the lead to form a coalition. This support could grow further in the coming months as Sanchez was quite generous to voters. He was able to significantly increase the minimum wage, which affects 1.2 million workers. An increase of PSOE votes, however, does not mean that a left-wing government is automatically more likely. Indeed, voters could switch from Podemos to PSOE, making the sum of the two constant. Given the tensions in Catalonia, the support of regional parties is questionable, which make chances for this government setup less likely.

- Political gridlock: Likely

If the right-wing bloc does not get enough votes to form a government, then they also would need support from smaller, notably, regional parties. As this is questionable, political gridlock is also among the possible scenarios.

All in all, political uncertainty is bound to remain high in Spain, hurting investment and hiring decisions. The economy is still growing at a fast pace, although annual growth slowed from 3.1% in 2017 to about 2.5% in 2018. Given the weaker external environment, we also see the Spanish economy slowing further in 2019 to about 2% annual growth. Political gridlock could further hamper the economy, though the better state of the economy should make political tensions less dangerous than a few years ago. We don't exclude some widening in Spanish bond spreads, but this is unlikely to go very far.

Article | 11 February 2019

## Aluminium: Prices capped, for now

While the aluminium market is set to see yet another large ex-China deficit, broader macro concerns, the lifting of sanctions, falling input costs and...



Source: Shutterstock

### ING aluminium price forecast

	1Q19	2Q19	3Q19	4Q19	1Q20	2Q20	3Q20	4Q20
LME Aluminium (US\$/t)	1,925	2,050	2,150	2,250	2,325	2,300	2,250	2,250

Source: ING Research

### The Rusal effect

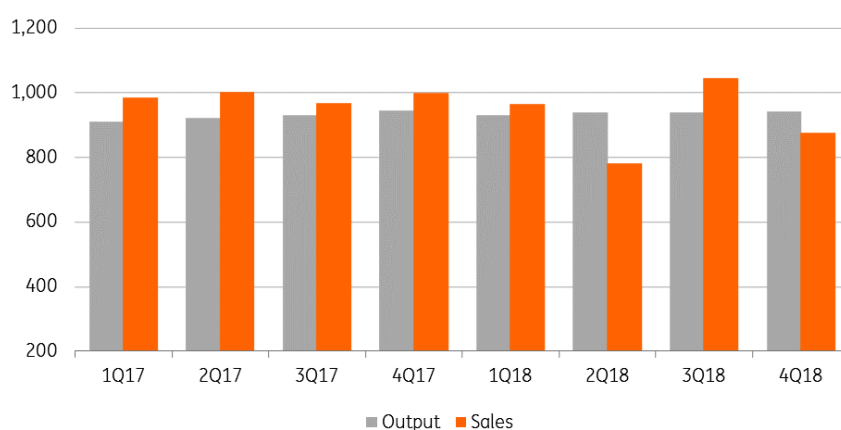
US sanctions against Russian aluminium producer, Rusal was the key driver behind increased volatility in the market over much of 2018. This was no surprise, given that the company is the largest producer outside China, making up around 13% of total ex-China supply. However as the year progressed it became clear that the US Treasury and Rusal were both keen to come to a deal which would see the lifting of Rusal sanctions. The US Treasury finally announced its intention to remove sanctions against Rusal in December, and these were successfully lifted on 27 January, despite attempts from US Democrats to block this move.

Despite it being largely expected that sanctions would be removed, confirmation of the news has put renewed pressure on LME aluminium. The concern is that unsold Rusal stock would now weigh

on the market. However when looking at Rusal production over 2018, along with sales, the build-up in inventory over the year does not appear to be significant. Rusal output totalled 3.75mt over the year, whilst sales totalled 3.67mt - leaving a stock build of 82kt. Still the concern is that, following the lifting of LME restrictions, some of this material could make its way into LME warehouses, .

The lifting of Rusal sanctions does not change our outlook for the market. We were assuming that these sanctions would be lifted, and so see little impact in terms of supply. We are still estimating that the ex-China market will see a sizeable deficit over 2019. But clearly the Rusal decision has weighed on sentiment in the short term.

## Rusal quarterly aluminium output and sales (000 tonnes)



Source: Rusal, ING Research

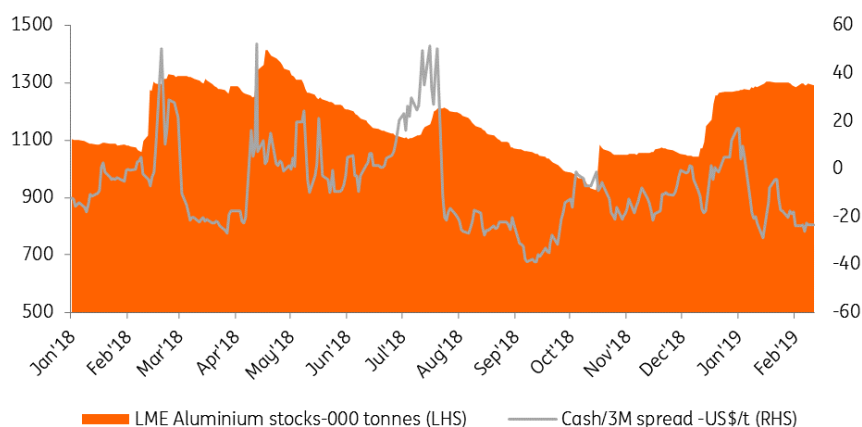
## Premium weakness

Another factor clearly weighing on sentiment is fairly weak premiums. European premiums have edged lower for several months now - US tariffs are not helping regional premiums elsewhere, whilst the threat of Rusal material is also weighing on premiums. Weaker premiums have not been supportive for the market, with this doing little to stop the inflow of material into LME warehouses. Since early December LME inventories have increased from 1.04mt to around 1.3mt.

In Asia, premiums have also been weaker, Japanese spot premiums are trading at around US\$77/t, down from over US\$90/t in October. Japanese buyers have agreed quarterly premiums for 1Q19 of US\$83-85/t, compared to US\$103/t in the previous quarter.

However, in the US the Midwest premium remains well supported. This shouldn't come as too much of a surprise given the 10% tariff that was introduced under section 232.

## LME aluminium inventories edge higher



Source: Bloomberg, ING Research

## Easing cost pressures

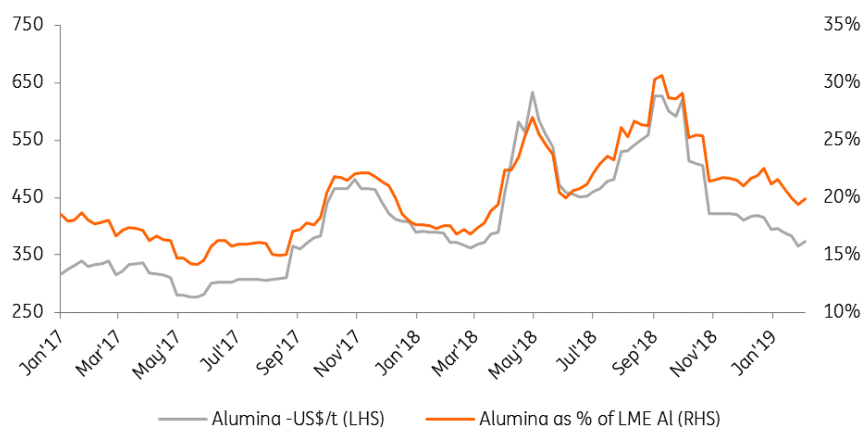
One of the key themes over much of last year, was the fact that smelter margins were getting squeezed. Producers were having to deal with rising input costs, with both energy and alumina prices strengthening over much of the year. This pressures have eased somewhat. Looking at the coal market, API2 coal prices have fallen around 25% since late October.

Meanwhile on the alumina side, the lifting of Rusal sanctions has also provided clarity over Rusal's alumina supply. Additionally over the course of 2018 China switched from a net importer of alumina to a net exporter, with attractive prices on offer in the world market. Finally the market is moving more towards the view that the Alunorte alumina refinery in Brazil will return to full operations at some stage this year, which should keep the alumina market well supplied. This has seen alumina prices falling from levels as high as US\$640/t over parts of 2018 to around US\$370/t currently. The alumina/aluminium price ratio has fallen from a peak of 31% in September 2018 to 19% currently.

However we do believe that the market may be too complacent around alumina supply, especially with the return of full operations at the Alunorte refinery in Brazil. Following the unfortunately fatal Vale dam accident, regulatory pressures are likely to grow for the metals and mining industry in Brazil. Therefore the government may be hesitant to give the final go ahead to Hydro at the moment.



## Alumina/aluminium price ratio edges lower



Source: Bloomberg, ING Research

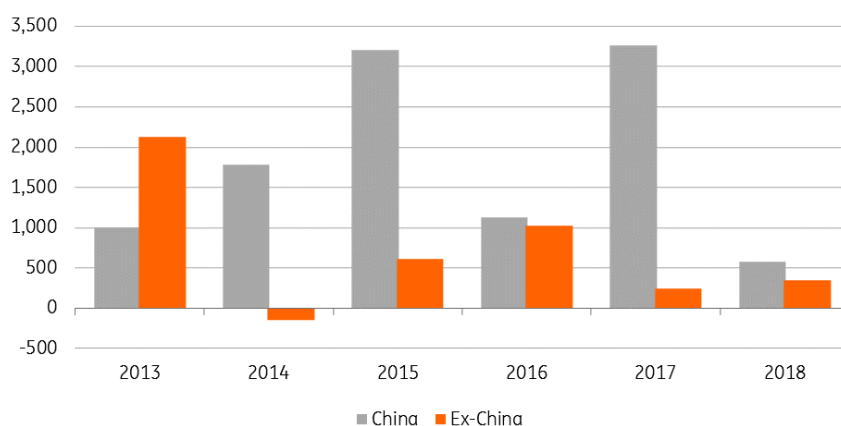
## Ex-China vs China supply

The aluminium market has a structural issue - the bulk of current supply growth is coming from China, whilst ex-China growth is still falling short of the level needed to fill the ex-China deficit.

Over 2018 Chinese primary production grew by 580kt to hit a record 36.49mt. This stronger production comes despite winter cuts, and the shutting of “illegal” capacity in the summer of 2017. Meanwhile the story of restarts and new capacity has been more an ex-China one - output over 2018 only increased by around 350kt. Outages and tighter smelter margins over 2018 did little to support the needed growth in production outside China.

Expectations are that we will once again see a large ex-China deficit - somewhere in the region of 1.8mt. Meanwhile the Chinese surplus is forecast to be in the region of 300kt, leaving a global deficit of around 1.5mt. The size of this will depend on how well demand holds up over the course of the year, especially in the current environment.

## Aluminium production growth (000 tonnes)



Source: IAI, ING Research

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## Has the Riksbank finally had enough of SEK weakness?

Limited news in today's policy announcement, but a potentially material shift in Sweden's central bank's stance on the krona



As expected, the Riksbank left the policy rate unchanged at -0.25% and also maintained the same interest rate forecast as in December indicating a hike in the second half of 2019, and two each year after that.

However, today's statement is probably a little more on the hawkish side than expected. While the Riksbank acknowledged greater uncertainty around global growth and domestic conditions, policymakers still believe 'the picture of strong economic activity remains'. And if anything, the language on the inflation outlook has grown more confident, with the Riksbank increasingly certain that inflation will stabilise around the 2% target.

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excessive SEK appreciation (which has been in the statement in one form or another for years), and the decision not to renew the mandate for FX intervention (never used, but intended as a signal to limit krona appreciation).

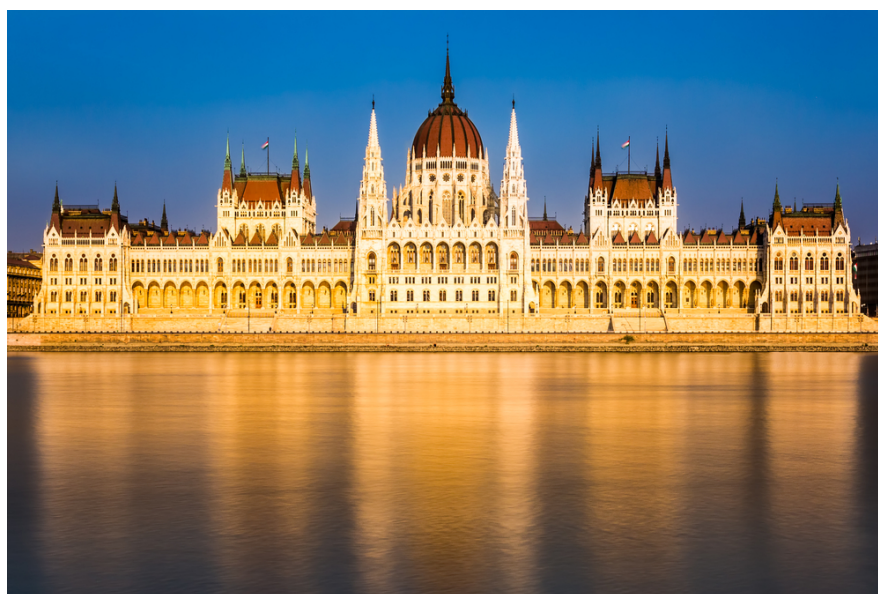
This points to a potentially significant shift in the Riksbank's stance on the krona: for several years policymakers have been concerned that krona appreciation would undermine progress on bringing inflation back to target. Over the past year or so, this concern has appeared increasingly irrelevant, as the krona has instead depreciated by around 10% since mid-2017.

So today's shift is perhaps no more than an acknowledgment that the environment has changed. But we wonder if the situation is now actually that the Riksbank is more likely to support the krona than to talk it down. Today is arguably the third time in a year (after May and September 2018) that the Riksbank has used relatively hawkish language when the krona has been weakening above 10.50 against the euro (or above 120 on the KIX index).

On balance, today's policy announcement does little to change our outlook for rates. We still see the Riksbank hiking again towards the end of the year, though risks are skewed towards a delay as our forecast for both growth and inflation is less optimistic than the Riksbank.

# Hungary: Time for a rating upgrade?

After its outstanding economic and fiscal performance in 2018, Hungary awaits an S&P rating review this Friday. An upgrade seems quite possible but...



Source: Shutterstock

**BBB-** Sovereign debt rating (S&P)  
Outlook: Positive

## The background

This Friday (15 February) S&P will be the first rating agency in 2019 to have an opportunity to deliver its sovereign rating verdict on Hungary. According to previous signals and comments from the agency, Hungary can be optimistic about a possible ratings upgrade from 'BBB-' to 'BBB', which would be its best rating since December 2010. S&P affirmed Hungary's ratings in August 2018, but signalled that it could raise these in the next 12 months if certain criteria were met.

## Arguments for

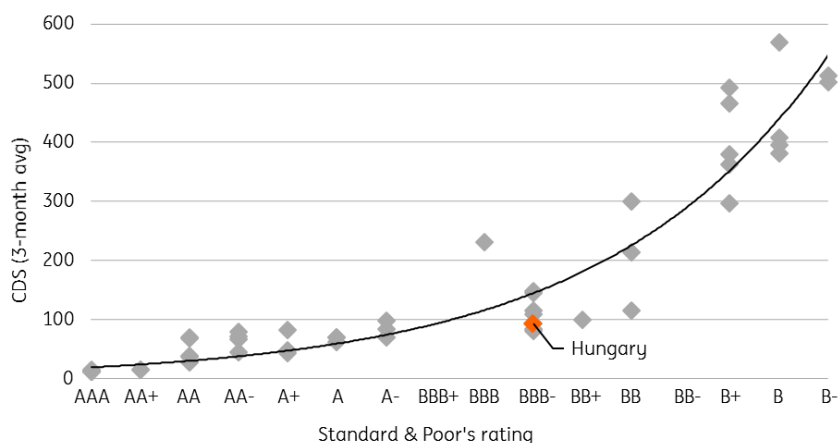
We believe that Hungary has fulfilled the requirements for an upgrade. Financial stability has further improved since the last review. The NBH's latest financial stability report (November 2018)

pointed out that “the shock-absorbing capacity of the Hungarian banking sector is strong (...), profitability is outstanding”. Lending activity is also on the rise, while non-performing ratios are shrinking across all sectors. The fiscal situation has also improved, with both public debt and the deficit to GDP lower than planned. Public debt dropped to around 71% of GDP with the FX-share now at 20%, meaning that the external vulnerability of the country has declined further. The current account balance remained in surplus (at around 1.5% of GDP) despite the strong domestic demand and a weaker external environment. Domestic factors pushed GDP growth to 4.7% YoY in 2018, a rate not seen in the past couple of decades.

## Arguments against

On the other hand, S&P could point out that the recent exceptional economic activity has been fuelled by temporary factors, while the potential for growth in Hungary is still low (at around 3%, we estimate) and the government has not made much progress in improving the country's growth rate for the long run. In its latest review, S&P highlighted that the worsening relationship between Hungary and the EU could lead to negative consequences. Since this assessment the EU has voted to trigger the Article 7 sanctions procedure, but so far this hasn't led to any apparent fiscal or economic consequences. That said, it could have an effect on the next Multiannual Financial Framework, when Hungary could face a significant fall in EU money in real net terms, especially when compared to the previous programming period. Last but not least, S&P pointed out in August it could upgrade Hungary over the next 12 months and so might take its time to further assess recent developments. This would delay the decision into August, when its second (and last) review in 2019 takes place.

## Based on market pricing, Hungary should have a better rating than 'BBB-'



Source: Bloomberg, ING

### Our expectation

All in all, we see the pros outweighing the cons and a rating upgrade to 'BBB' (Outlook: Stable) seems highly likely, but not necessarily a market mover. Given that Hungary's status as 'junk' (non-investment grade) has long gone, and based on CDS pricing which shows investors treating Hungary as a 'BBB+'-country anyway, we don't expect any major market move in the aftermath of this decision. If anything, we expect EUR/HUF to edge lower, approaching 315.

## Schedule of rating reviews in 2019

Fitch Ratings	Moody's	S&P
22 February	03 May	15 February
16 August	25 October	16 August

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