

## In case you missed it: Peak uncertainty

After a week of high drama in the UK and low growth in the eurozone, levels of uncertainty appear to be reaching a crescendo. It's all very far from ideal. The question is, will the situation get worse and could it even lead us into recession?

### In this bundle



United Kingdom

#### Brexodus heaps pressure on May

A slew of ministerial resignations and the probability that enough of her MPs will look to trigger a no-confidence vote leave PM

Theresa May's...

By James Knightley



FX | United Kingdom

#### GBP: Rocked by Brexit resignations, sterling could fall another 3 to 4%

The resignation of the British Brexit Secretary, Dominic Raab, has increased the chances of a leadership challenge to Theresa May and a 'no-deal'...

By Chris Turner

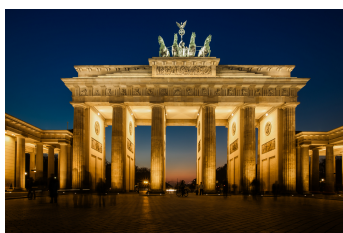


Germany

#### The Eurozone economy: Between optimism and pessimism

There is currently a lot of speculation about the future path of the global economy. Is the best behind us and are fears about an imminent and protracted...

By Carsten Brzeski and Bert Colijn



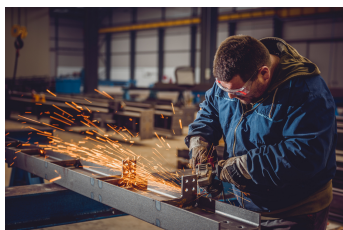
Germany

### Germany: Wake-up call

First it was politics, now it is the economy. The worst economic performance since 1Q 2013 is another wake-up call for the eurozone's largest...

By Carsten Brzeski

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### Eurozone: a dismal third quarter confirmed

GDP growth in the Eurozone was confirmed at just 0.2% in Q3. Industrial production saw a decline in September. While a small recovery of GDP is expected...

By Bert Colijn

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Germany

### ECB: Auto pilot with a slight dovish bias

In one of his rare public speeches, ECB president Mario Draghi just confirmed the bank's determination to end quantitative easing, but opened the door...

By Carsten Brzeski

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### Br-Asia

Brexit feels a long way from Asia, but are there any implications of a no-deal exit for our region? In short, yes.

By Robert Carnell

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### Forecasting is fallible, yet necessary

Economic forecasters are caught out by shocks so often that one might reasonably ask why they bother. The short answer is that they have no choice, writes...

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## Brexodus heaps pressure on May

A slew of ministerial resignations and the probability that enough of her MPs will look to trigger a no-confidence vote leave PM Theresa May's Brexit plan in tatters. The biggest loser is the UK economy



PM May's proposed EU exit deal was never likely to please everyone and in the end, it pleased no-one. Ministers queued up to hand in their resignation and Conservative Brexit hardliners vocally rallied to the cause of ousting Theresa May as Prime Minister. They have since been joined by some remainers who have lost faith in the Prime Minister's leadership. As such it looks increasingly likely that the threshold of 48 MPs (15% of total Conservative MPs) writing letters of no-confidence in the PM will be achieved today. This then will trigger a full no-confidence vote in a secret ballot of all Conservative MPs.

## The process of no-confidence

Such a vote is likely to be early next week given that many MPs will already be back in their constituencies. If a majority backs her, then she cannot face another leadership challenge for 12 months. That is why this is such a gamble for the Brexit hardliners. They want someone in charge that can deliver a "true" Brexit, but risk being stuck with the status quo if they cannot convince 158 of the 314 Conservative MPs to do the same. If she loses the vote then she is forced out and there is a leadership election in which she cannot contest.

Under this scenario, a contender has to be nominated by two MPs. If there is only one name put forward then that person will become leader of the party and Prime Minister. If two candidates are put forward then this goes to a ballot of Conservative party members who decide which of the two becomes leader and prime minister. If three or more are nominated then a vote is held amongst MPs and the one with the least votes withdraws. If there are more than three nominations then this process is repeated until only two candidates remain to put before the broader party membership.

## What might happen?

Political analysts suggest that Theresa May (at this stage) is likely to win. As former Chancellor and pro-remain MP Kenneth Clarke stated yesterday, she is likely "doomed to carry on leading us through this mess because there isn't anybody else." However, bookmakers are not so sure. Indeed, the pressure is likely to continue building and if her leadership looks doomed this could see momentum build for a change. This could accelerate if the DUP withdraw their "confidence and supply" deal with the Conservatives – headlines this morning suggest they "could review it".

PM May has been resolute and determined and lasted much longer than most analysts might have expected, but even if she wins a confidence vote, this latest twist may have been a step too far. Her mandate may be too heavily damaged and there is clearly a risk she eventually steps down. Indeed, if she puts her EU withdrawal plan before a vote in parliament it seems certain to fail. The EU shows no sign of being willing to rework the plan and it would be difficult to see where she could make progress from here.

## So who could take over?

If Theresa May is forced out then according to bookmakers the favourite to take over is Dominic Raab, the former Brexit Secretary who resigned yesterday, triggering the chaos. He is then followed by former Foreign Secretary Boris Johnson, current Home Secretary Sajid Javid and the (for now) Environment Secretary Michael Gove, who reportedly turned down the Brexit Secretary role yesterday. But again, we come back to the point – what can they achieve that Theresa May couldn't?



The EU's prerogative is to look after itself and its members and to protect the integrity of the single market. If a new UK leader was to be installed they are unlikely to achieve any meaningful concessions. At best, we make get a slightly looser wording, but that is it.

Despite growing calls for a second referendum, Theresa May is adamant it won't happen if she remains leader and given that all the other contenders are to varying degrees pro-Brexit, it is unlikely to happen under them before March 29. Article 50 could be extended in theory, but the process is not easy, nor guaranteed. If Micahel Gove wins through though there could be a possibility that the UK slips seamlessly into the European Economic Area, but again there would be resistance from the hardline Brexiters as this is not "true" Brexit.

## Where next?

Our view, as it has been for a long time, is that this is going to go down to the wire – British MPs feel that there are several months before the “hard” deadline in March 2019 and as such there is no impending pressure to get a deal done right now. However, there is no majority in the House of Commons for a “no-deal” Brexit and that is why the most likely route of success is to put a simple choice of the UK leaving without a deal or the UK progressing into a smooth transitional arrangement as late as possible to help focus minds. This is obviously at odds with the EU timetable and will anger EU leaders, but it is difficult to see much of an alternative at this stage.

This will be economically damaging for everyone due to the uncertainty and worry it causes for businesses and individuals, but it will be the UK that is hit hardest. Some notable manufacturers in the UK are already warning of plant shutdowns over the Brexit period and others are likely to follow suit. After all, there is a very real fear that components could be trapped on motorways as ports grind to a halt under the burden of customs and regulatory checks at a time when there aren't enough qualified staff available to deal with it.

There are also warnings of food and medicine shortages. The UK only produces 60% of the food it consumes and there are major questions over what will happen in supermarkets. Hungry voters tend to be quite angry voters and MPs will not want to risk the wrath of the electorate. As such, we keep coming back to the point that the most likely scenario remains we get an 11th hour deal to allow the UK to go into a transitional arrangement that effectively keeps things as they are until December 2020.

## What about the future arrangements?

Where we go from there remains even more uncertain. It has taken 29 months to get to the current juncture following the June 2016 referendum. I simply cannot see how an all-encompassing deal on the UK's future arrangement with the EU and non-EU countries can be agreed in the 20 months the transitional arrangement currently allows. As a benchmark, it took Canada seven years to agree a trade deal with the EU.

On the positive side, the UK would be starting negotiations from a point of full regulatory alignment, which may make things a little easier. But on the other hand, we assume that the eventual deal should be deeper and broader than the Canada deal given the massive amount of trade in goods and services.

Brexiters disagree and suggest that only a Canada plus style deal will allow the UK to “break free” from the EU and enable the UK to fully develop trade deals with other non-EU countries. However,

in an environment of global trade protectionism, there are serious questions about the type of trade deals the UK may eventually win. Hammering out what the UK actually wants could well eat up most of the transitional period in itself.

As such, the transitional arrangement probably won't be long enough and there is already talk that it may be extended by 12 months. Even this may not be long enough. The technology required to allow rapid assessment on the customs and regulatory standards that could generate "frictionless" trade at UK ports is not something that can be bought off the shelf. We could be talking years of implementation and testing in the knowledge that UK governments don't have a great track record on huge procurement contracts.

## Economic pain to continue

This all means that we will not have clarity on the UK's economic situation for a protracted period of time. When asked about the economic impact of Brexit so far, I use the rough rule of thumb that UK growth should be half-way and three-quarters of the way between eurozone and US growth. After all, the UK has a labour market, tax system and enterprise culture tilted more towards the US than Europe. If we have a eurozone economy growing 2% in 2018 and a US economy growing at 3%, I would have thought the UK should be growing around 2.5-2.7%. Instead, we are looking at 1.3% growth this year.

With sterling's sharp post-referendum fall still pushing up inflation and squeezing spending power, consumption has been hit while the uncertainty from Brexit has led to a much weaker path for business investment. At the same time, the fact is that the UK has a relatively small manufacturing base these days so it has not seen a meaningful bounce in economic activity caused by the competitiveness boost from a weaker currency.

Obviously, we are in a significant state of flux right now and with a lack of clarity, the situation is likely to get worse before it gets better. UK asset prices will remain under pressure in the near term – our FX team sees the risk of a 3-4% decline in sterling from here. Moreover, the latest Brexit developments suggest the risks to growth are increasingly skewed to the downside. Confidence will be hit and with sterling set to fall further, the upside risk for inflation and the squeeze on spending power look set to continue. Indeed, the prospect of a Bank of England rate rise in May is looking less likely, with markets now barely pricing in two rate rises over the next three years.

### Could Britain change its mind?

This remains the most frequently asked question we get. It remains possible, but at this stage, the political mantra from the two major parties remains "we must respect the will of the people". Moreover, opinion polls suggest support for Brexit remains strong, so if there was another referendum held before 29 March there is no guarantee we would get a different outcome.

However, opinion polls such as those done by Survation suggest that Britain is becoming more polarised by age with the under 45s looking increasingly in favour of "remain" and the over 65s even more certain that Brexit is the best course of action. There also appears to be growing support for a referendum on the "final" deal, which could open the door to a reversal of the decision in time. This won't happen soon though. The most likely scenario for a change in opinion polling and a reversal of Brexit involves a prolonged transitional period with the UK economy underperforming key trading partners, which is not particularly

palatable for the economy, or jobs either. It is also highly doubtful that Theresa May would be in power to deliver such an outcome.

## Author

**James Knightley**

Chief International Economist, US

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

## GBP: Rocked by Brexit resignations, sterling could fall another 3 to 4%

The resignation of the British Brexit Secretary, Dominic Raab, has increased the chances of a leadership challenge to Theresa May and a 'no-deal' Brexit. Investors can demand greater risk premia of UK assets, which could mean another 3 to 4% fall for sterling



British Prime Minister, Theresa May

### Raab rocks GBP

After rallying on a brief period of optimism on the scope for a soft Brexit, GBP has today been hit hard by the resignation of Dominic Raab, the Brexit secretary. His resignation letter referenced two key concerns of the Withdrawal Agreement recently negotiated between London and Brussels, namely: i) the threat to the integrity of the UK posed by the proposed regulatory regime for N.Ireland and ii) the EU holding a veto over the UK's ability to exit the back-stop of a customs union.

For the Brexiteers, the withdrawal deal offers too many concessions to Brussels. For the Remainers, they reject the proposition that it is a question of this (bad) deal or no deal at all. They would prefer another referendum or at least a delay in Article 50 to allow more time to negotiate a better deal.



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## *Investors must weigh up two key challenges*

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International investors now have to weigh up the chances of a leadership challenge against the Prime Minister, Theresa May, in addition to the (seemingly declining) chances of the withdrawal deal being approved by UK parliament in December. On the former, the news cycle will be focusing on whether sufficient names are backing a no-confidence vote in May, which could potentially take place in the next few days.

For reference, our Chief International Economist, James Knightley and our UK economist, James Smith, both think that we won't see a leadership challenge, arguing that one would merely delay negotiations and make an Article 50 extension and a Brexit delay more likely. So let's see what happens within Conservative ranks over the next few days.

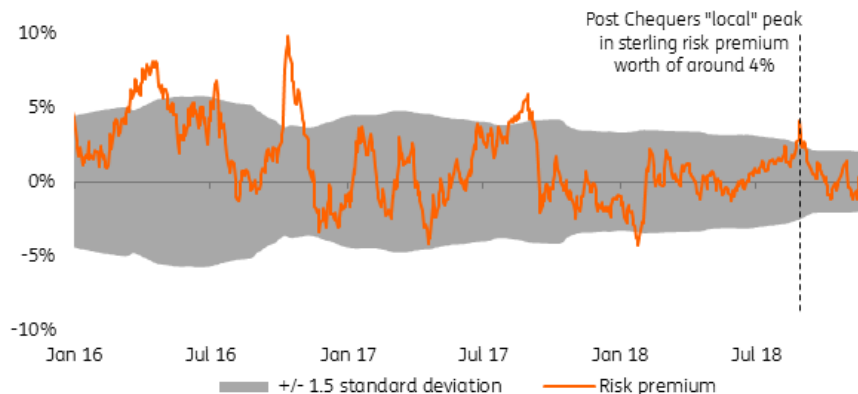
### **Not enough risk priced into GBP**

For GBP, the question is how much risk premium should be priced in? Is enough priced in already? We would say not. Until there is some clarity on a leadership challenge, there is a risk that we end up with a more Brexit-leaning leader. Such an outcome would increase the chances of a No Deal, on the assumption that a new leader would be unlikely to secure any further concessions from Brussels. That is up for debate but would suggest a change in Conservative leadership - a scenario not in our baseline, nor likely in investors' baselines either.

In determining how much risk premium is priced into GBP, we use a Financial Fair Value model (FFV) (see the chart below), which looks at which financial variables have done a good job of explaining where EUR/GBP should be trading. This morning we calculated that the risk premium was around zero - i.e. EUR/GBP was trading in line with short-term financial variables. But as recently as August, GBP traded with a 3-4% risk premium on the uncertainty around the Chequers deal and the Brexit supporting former Foreign Secretary Boris Johnson's resignation. In other words, were the market to price in a more credible leadership challenge, GBP could potentially fall another 3-4% - sending EUR/GBP back towards the 0.91 region and GBP/\$ towards new lows for the year near 1.23/24. That's the risk.

## EUR/GBP Financial Fair Value model suggests current risk premium is very modest

The estimate of short-term EUR/GBP risk premium. A residual between short term EUR/GBP financial fair value and spot.



Source: ING FX Strategy

## Investors are underweight UK, but can add to shorts

Perhaps one of the few supports to UK assets right now could be positioning. Is the market 'limit short' GBP such that there is no one left to sell? Well, speculative positioning data from the Chicago futures market (see chart below) suggests that while the market is undoubtedly short GBP against the dollar, it is not quite as short as it was in early 2017.

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*One of the few supports to UK assets could be positioning*

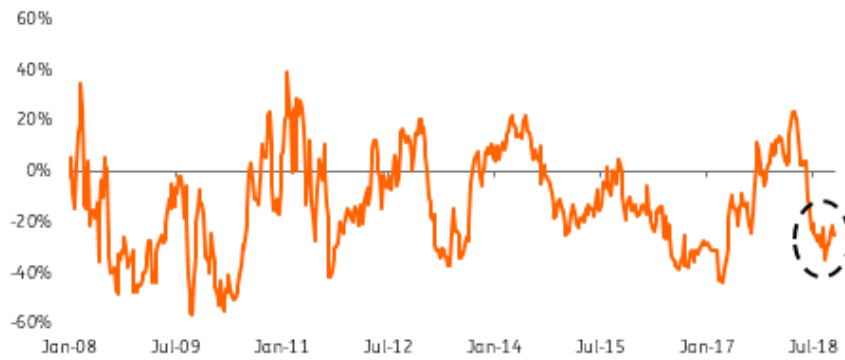
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In terms of equities, global equity investors remain substantially underweight as they have been since the Scottish referendum in 2014, but buy-side surveys suggest they are not as underweight now as they were in late 2017/early 2018.

Even though it is very hard to make baseline forecasts on GBP right now, we would say that GBP could fall another 3-4% unless the threat of a leadership challenge is quashed or there are clearer signs that the withdrawal agreement can garner more support in parliament.

## Speculative positioning in GBP/USD

GBP/USD speculative positioning, as % of open interest\*



\* As of 11th November 2018 (data are reported with a lag)

Source: ING

### Author

**Chris Turner**

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

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

## The Eurozone economy: Between optimism and pessimism

There is currently a lot of speculation about the future path of the global economy. Is the best behind us and are fears about an imminent and protracted slowdown justified? For the Eurozone, an old saying by Ben Bernanke rings a bell: recoveries don't die of old age. However, they can definitely lose momentum



Source: Shutterstock

The discussion between optimists and pessimists is getting fiercer. Recent developments have sparked uncertainty about the length of the expansion in the Eurozone as confidence among businesses and consumers has been hit by concerns about a trade war, Brexit, higher oil prices and emerging market turmoil.

This does not necessarily mean that the economy is set for a severe decline. The investment environment remains favourable with low borrowing rates, eased credit standards and high levels of capacity utilisation. Consumption continues to profit from lower levels of unemployment and cautious increases in wage growth.

*Business cycles show Eurozone recoveries don't die of old age - instead, they always need a special trigger. This can either be the central bank hitting the interest rates brakes*

*too early and too strongly or an external event, like an oil crisis or a financial one*

Still, with lower confidence, capacity constraints and slowing demand from outside of the Eurozone curbing growth at the moment, the economic cycle does seem to have peaked in 2017. According to our latest forecasts, growth will slow markedly this year, dropping from 2.4% in 2017 to 2.0% this year. As output gaps have closed faster than initially expected by the IMF, it looks like the Eurozone economy is currently set for a loss of momentum and not for an upcoming recession.

Empirical evidence of previous business cycles shows that recoveries in the Eurozone indeed don't die of old age. Instead, it always needs a special trigger. This can either be the central bank hitting the interest rates brake too early and too strongly or an external event, like an oil crisis or a financial one.

At the current juncture, it looks highly unlikely that the European Central Bank could do anything that would harm the economic expansion. However, a slowing of the US and Chinese economies, additional weakness in emerging markets, trade tensions or a new existential crisis of the Eurozone could obviously trigger a new recession. Or at least lead to a severe slowdown.

*Our base case is that the Eurozone expansion is losing some momentum but not on its last legs yet. However, it would be naïve to exclude the possibility of a recession in the short-run*

If one or more of the ample downside risks were to materialise, the policy response would likely be very weak. At every recent ECB press conference, President Mario Draghi has called for more structural reform and fiscal responsibility of the Eurozone economies and a comprehensive capital markets and banking union.

But looking at Draghi's call from the perspective of a next possible recession reveals that the ECB may not be able to fight the next crisis all by itself again.

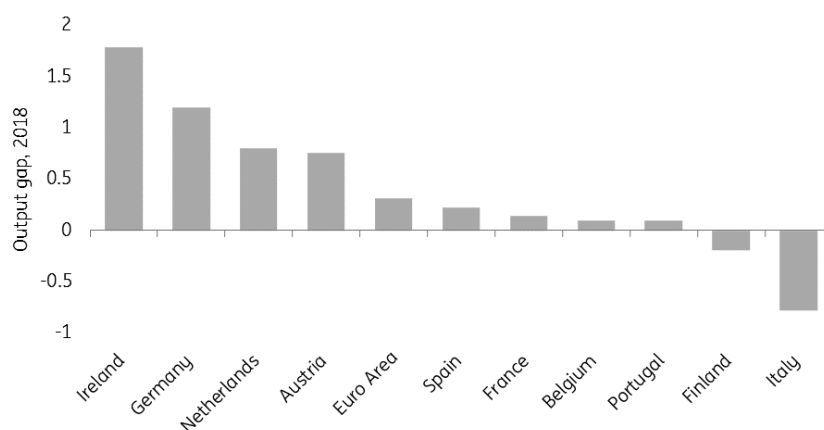
## The expansion has slowed significantly, is this the end of the cycle?

This year, the Eurozone economy is about to end the fifth consecutive year of economic growth. However, in recent quarters, growth has started to slow down, and the combination of weaker data since the summer and increased external risks has fed the debate on whether or not the Eurozone is already heading towards a new recession.



Let's forget about external factors for a moment and just look at the domestic dynamics of the Eurozone recovery. Currently, only Germany is in a late stage of the cycle, at least compared with previous cycles. The rest of the Eurozone still has ample room for economic expansions. Even positive output gaps in some countries are no reason for concerns. The estimated output gap according to the IMF of 0.3% for the Eurozone is still significantly off the levels seen at the end of previous cycles.

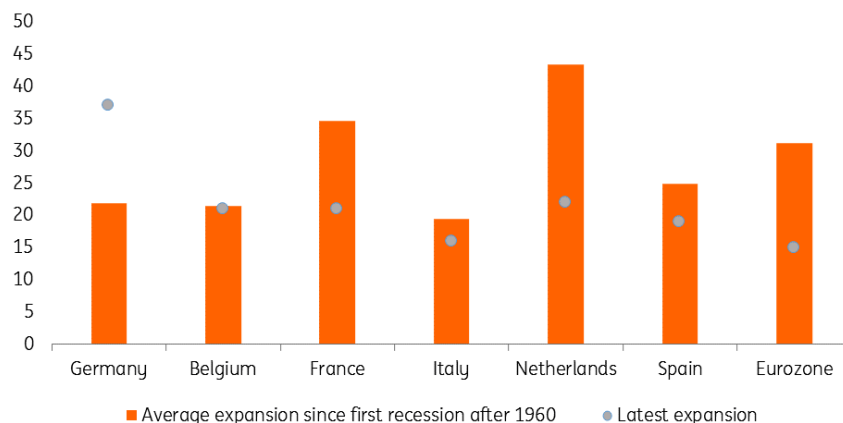
## Output gaps have been closed quicker than expected



Source: IMF

The simple length of the current expansion in the Eurozone warns against too much pessimism and brings back memories of Ben Bernanke's statement that recoveries don't die of old age. To follow this analogy, the current expansion should be in its midlife crisis. Also, the recent experience of the German economy suggests that a mix of favourable external and internal factors can easily extend a cycle beyond its historical length.

## This expansion is still relatively short for most Eurozone economies



Source: Eurostat, EABCN, OECD, ING Research

## So what do Eurozone recoveries die of?

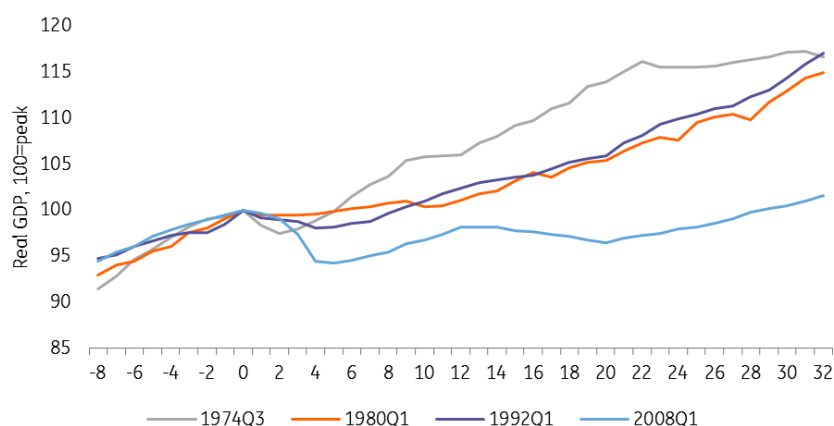
Let's take a step back and investigate what has actually triggered recessions in the Eurozone in the past.

Since the second world war, Eurozone-wide recessions have been related to oil crises and the subsequent reaction of central banks, financial crises and existential problems (the euro crisis between 2010-2012). The Center for Economic Policy Research (CEPR) defines official Eurozone recessions in its Business Cycle Dating Committee since 1970.

The first oil crisis caused the first recession that started in 1974, the second started in 1980 and was related to stagflation after the second oil crisis and the subsequent reaction of central banks. The recession in 1992 was caused by deteriorating global conditions thanks to the savings and loan crisis in the US, the end of reunification stimulus in Germany and was prolonged by the currency crisis related to the European Monetary System (EMS).

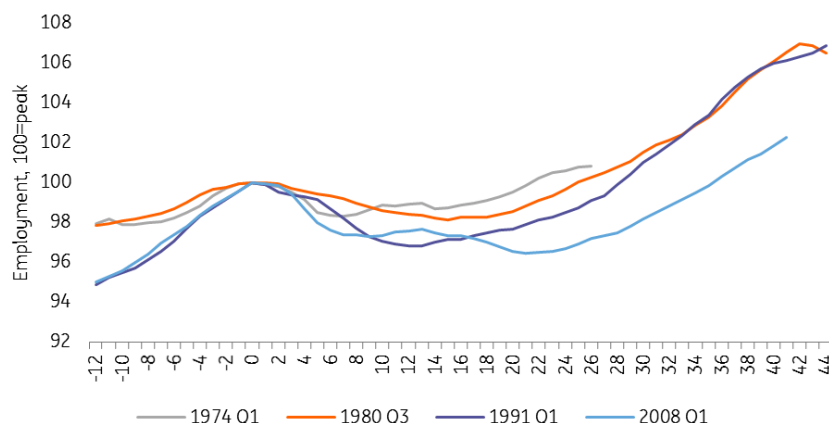
The 2008 crisis initially started in the US subprime market but spread out quickly throughout the financial system, and the Greek problems started the 2011 recession. There have been many recessions with different causes, plenty of which stemmed from outside the monetary union.

## The most recent crisis was very deep and long, with a very slow recovery



Source: EABCN, Eurostat, ING Research

## Employment has therefore taken much longer than usual to return to its previous peak



Source: EABCN, Eurostat, ING Research

Applying previous experiences to the current situation and assuming the ECB will definitely not raise rates too quickly means that downside risks would have to materialise for a possible recession in the Eurozone. While the trigger for a next crisis is often missed, a few downside risks that have the potential to be the next trigger for a recession could include contagion from a possible US slowdown, a fully-fledged trade war and another existential crisis in the Eurozone.

As regards contagion from a possible US slowdown, the old rule of thumb that the Eurozone lags behind the US cycle by six to 12 months currently only holds for Germany. Interestingly enough, the German and the US cycle share many characteristics in terms of length and labour market performance.

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However, due to the euro crisis, the Eurozone as a whole has fallen behind in terms of the cycle. Therefore, the question is whether a new dip in the US would hit the Eurozone with the current lag of around three years or with the old traditional lag of six to 12 months. In our view, only strong domestic demand and increasing trade ties with the rest of the world could shield the Eurozone economy against the usual contagion.

Regarding the adverse impact from a fully-fledged trade war, all has been said. It is not our base-case scenario but a fully-fledged trade war with a further escalation between China and the US and elevated tariffs on EU goods could obviously and easily push the Eurozone economy towards the brink of a recession.

The current conflict between the European Commission, the European Council and Italy on the Italian fiscal plans shows that the risk of another existential crisis further down the line can never be ruled out.

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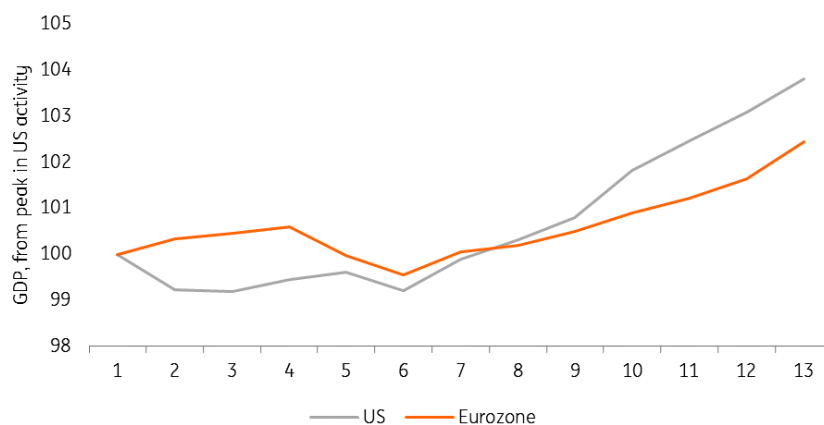
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In our view, the driver will not so much be short-term tensions between Italy and the rest of the Eurozone, but rather the fundamental and still unresolved issue of what is the right policy prescription in the Eurozone. The swelling conflict between austerity measures and structural reforms on the one hand and US-style fiscal stimulus, on the other hand, will always have the potential for another existential crisis, be it through financial market reactions, electorate swings or the banking system.

All of the above three scenarios clearly have the potential to push the Eurozone into a recession, at any time in the next couple of years. They are not our base- case scenarios but we would be naïve to completely rule them out.

## The Eurozone usually lags the US by a year in the cycle



Source: EABCN, Eurostat, ING Research

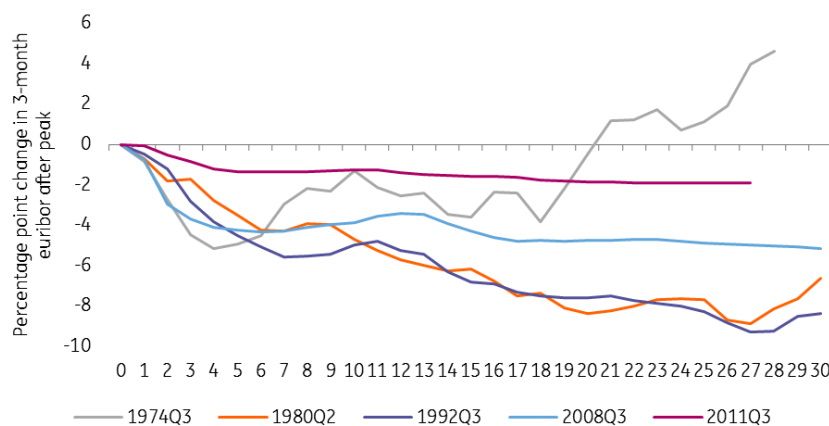
## Thinking the unthinkable

Imagining that the unthinkable would happen and the Eurozone would enter a recession or a protracted period of significantly-below-potential growth rates any time between now and 2020. What could a policy response look like?

First of all, such a situation would hit the Eurozone and the ECB at a time at which interest rates have hardly – if at all – increased, giving very limited leeway for the central bank. In fact, at least when it comes to policy rates, the monetary response to the euro crisis was already the weakest so far. At the same time, it is doubtful whether the ECB, then under a new president would again

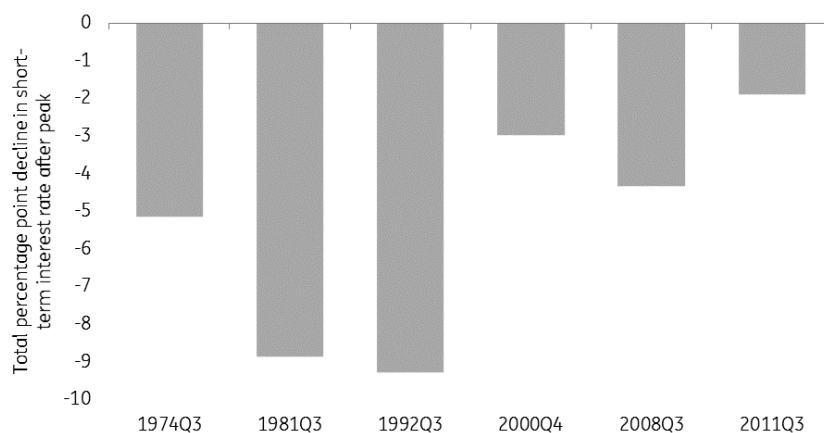
engage in a large-sized quantitative easing programme when the balance sheet of the ECB has hardly shrunk.

## The recent ECB response has had a very weak impact on short-term rates



Source: EABCN, Eurostat, ING Research

## And with short-term rates still negative now, a weaker response to a next recession is likely



Source: EABCN, Eurostat, ING Research

With monetary policy probably being hampered, a recession in the coming years would put enormous pressure on fiscal policies. In fact, it could very well be that the current discussion on the Italian fiscal plans would then apply to a wide array of Eurozone member states. Contrary to the current Italian case, the Eurozone's fiscal rules allow for fiscal stimulus in special circumstances.

However, a Eurozone-wide fiscal stimulus to tackle a recession could easily re-spark animosities between the core and peripheral countries.



## Author

### **Carsten Brzeski**

Global Head of Macro

[carsten.brzeski@ing.de](mailto:carsten.brzeski@ing.de)

### **Bert Colijn**

Chief Economist, Netherlands

[bert.colijn@ing.com](mailto:bert.colijn@ing.com)

## Germany: Wake-up call

First it was politics, now it is the economy. The worst economic performance since 1Q 2013 is another wake-up call for the eurozone's largest economy to take action



Source: Shutterstock

**-0.2%** 3Q German growth rate (QoQ)  
First drop since 1Q15

The swan songs and obituaries on the golden decade of the German economy were already waiting in the wings (and devastating headlines had already been prepared). Monthly data over the last few months was simply too bad not to expect a disappointing 3Q performance of the German economy. The just-released first estimate of 3Q GDP confirms the negative gut feeling.

According to the first release of the statistical agency, the German economy had its worst performance in 3Q since the first quarter of 2013, shrinking by 0.2 % quarter-on-quarter. The first quarterly drop since the 1Q 2015. On the year, the economy still grew by 1.1%. The GDP components will only be released at the end of the month but available monthly data suggests that net exports were the main drag on growth, while investments and the construction sector were growth-supportive. Private consumption declined.

## A mix of one-offs and more worrying structural factors

The disappointing performance of the German economy in the third quarter can be explained by several one-off factors but also some more worrying structural developments. Problems with the emission norms created severe production problems in the automotive industry, higher energy prices completely erased previous wage increases and also don't underestimate the negative confidence effect from the World Cup. We don't dare to predict the performance of the national football team but at least the automotive sector should rebound in the coming months and somewhat lower energy prices should revamp private consumption. However, the poor export performance, despite a weak euro exchange rate, suggests that trade tensions and weaknesses in emerging markets could continue to weigh on Germany's growth performance.

## Wake-up call

Looking ahead, the late-cycle economy is likely to fluctuate between hopeful and worrying news and developments. Low interest rates, a weak euro and some fiscal stimulus, as well as the reversal of adverse one-off factors, are strong arguments in favour of a growth rebound in the coming quarters. At the same time, however, dropping capacity utilisation and increasing external risks put a lid on any upside potential.

In sum, the outlook for the German economy is still positive and swan songs will have a short shelf-life but the reputation of the invincible strong man (or woman) of Europe has received some scratches. After the latest political developments, today's disappointing growth data is yet another wake-up call that political stability and strong growth are by no means a given.

### Author

**Carsten Brzeski**

Global Head of Macro

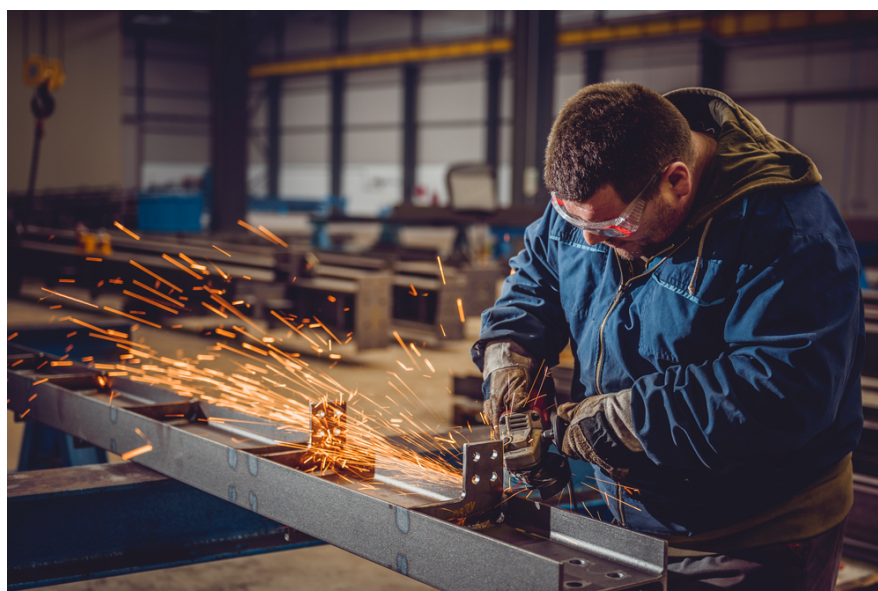
[carsten.brzeski@ing.de](mailto:carsten.brzeski@ing.de)

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Snap | 14 November 2018

## Eurozone: a dismal third quarter confirmed

GDP growth in the Eurozone was confirmed at just 0.2% in Q3. Industrial production saw a decline in September. While a small recovery of GDP is expected for Q4, growth momentum has clearly been lost in 2018



The second estimate, GDP growth was confirmed at just 0.2% QoQ and 1.7% YoY. The main culprit was Germany, the Eurozone's stronghold throughout the 2010s, which saw its economy shrink by -0.2% in Q3. Disruptions in the car industry were an important driver of the first negative quarter since 2015 and the slow quarter in the Eurozone, but it seems that the worries about growth are broader than that.

Exports are weaker thanks to global problems related to trade wars and emerging markets, and consumption was dampened by the higher oil prices seen in Q3. The stagnation in Italy's economy adds to worries around the Italian budget. The confrontation with Brussels has not been resolved as the ball now returns to the European Commission's court that now has to decide whether to put Italy in an excessive deficit procedure.

Industrial production in the Eurozone posted a very small decline in Q3, adding to the slow growth performance. Production in September dropped by -0.3% MoM. On the year, growth is just 0.9% for industry and production is still well below the November peak. 2018, therefore, seems to have

become the year of one-off excuses for a severe weakening of growth. The question is whether this explains the whole picture or whether these are excuses along the lines of “the dog ate my GDP” and something more structural is happening. While a small recovery of growth in Q4 is in the making, it seems evident that the growth cycle for the Eurozone already peaked last year.

## Author

**Bert Colijn**

Chief Economist, Netherlands

[bert.colijn@ing.com](mailto:bert.colijn@ing.com)



## ECB: Auto pilot with a slight dovish bias

In one of his rare public speeches, ECB president Mario Draghi just confirmed the bank's determination to end quantitative easing, but opened the door for a long period of low interest rates



Source: Andrej Klizan

When ECB President Maro Draghi gives a speech four weeks ahead of a crucial policy meeting, it is always worthwhile listening closely. In his speech at the Frankfurt European Banking Congress, Draghi gave his view on the current discussion on whether the eurozone economy was in a soft patch or already at the start of a new downswing. Not surprisingly, he confirmed the ECB's previous take, arguing in favour of a soft patch and pointing to several one-off factors. At the same time, however, Draghi stressed that some temporary factors could become long-lasting, ie trade tensions and external uncertainty. In sum, Draghi is still betting on domestic demand, the strong labour market and investment, to support the eurozone recovery in the coming months.

Turning to inflation, Draghi pointed to satisfying wage growth but emphasised that the pass-through from higher wages to higher inflation was still hardly visible and that uncertainties surrounding the medium-term outlook had increased.

Against all of the above, Draghi slightly changed the well-known ECB communication. While there is still a strong determination to end the net-QE purchases by the end of the year, Draghi opened the door for changes to the forward guidance in the course of 2019. This is the key paragraph from the speech: **“The nature of this forward guidance is contingent on economic developments and therefore acts as an automatic stabiliser. If financial or liquidity conditions should tighten**

**unduly or if the inflation outlook should deteriorate, our reaction function is well defined. This should, in turn, be reflected in an adjustment in the expected path of future interest rates.”**

It is too early to read any real changes in the ECB's anticipated path for monetary policy beyond the end of the net-QE purchases. However, Draghi at least just sent a clear signal of the ECB's willingness to err on the side of caution when it comes to the first rate hike. The risk that Draghi could go down in European history books as the first ECB president who never hikes rate is increasing.

## Author

**Carsten Brzeski**

Global Head of Macro

[carsten.brzeski@ing.de](mailto:carsten.brzeski@ing.de)

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Opinion | 12 November 2018

## Br-Asia

Brexit feels a long way from Asia, but are there any implications of a no-deal exit for our region? In short, yes.



### Countdown to chaos?

According to some media sources, one way or another, we should get a good idea by tomorrow whether the EU and UK negotiators have come up with a Brexit deal. If so, markets will briefly rejoice. But before the sound of champagne (or sparkling Kent wine) corks popping dies away, the hard question of "will it pass parliament?" needs to be answered and this highlights a huge problem that has been there from the very start of these negotiations.

Whatever deal the EU agrees to allow the UK to have (don't kid yourself that the UK has much say in this), has to be sufficiently bad that no one else in the EU would want to take it. If so, then won't it be insufficiently "good" for parliament to accept? You would think so, wouldn't you? Which raises the possibility of either a no deal exit, or, as some are beginning to suggest, a second-round referendum. Because no matter what the politicians say, no one specified the sort of Brexit that is likely to emerge, deal or no deal.

For more detail on how the Brexit saga is progressing (or rather, not progressing) take a look at [James Smith's Brexit Blog](#). But what of Asia? Who here (apart from me) even cares what happens to the UK?

## There's more to Brexit than a potential UK disaster

To listen to some commentators, you would think that Brexit involved only one country, the UK. The reality is, it involves at least 27 other countries (the other EU nations) and a bad Brexit will hurt trade, economic growth and employment to varying degrees across the whole region. Ireland is most exposed in terms of trade, but Belgium and the Netherlands are also well in the frame, and judging by the noises out of Munich, Germany's car-makers are none too happy with the prospect of a bad Brexit deal either.

The UK's nearest neighbours across the Channel will probably be content to see their rival in a thousand year love-hate relationship humbled by a bad exit. But with thousands of French jobs reliant on Briton's love of French food, climate and countryside, that schadenfreude may not last long.

One thing does seem evident, a bad Brexit is not good for the euro - so by definition, is positive for the dollar.

## Stronger USD means weaker Asian FX

A hefty boost to the US dollar is not in the interests of much of Asia. For one thing, it will tend to reduce Asian FX strength, raising the prices of imports and inflation, and putting central banks back on watch to tighten policy - just as they were earlier in the year. Tighter policy rates most likely mean weaker domestic economic growth. And as we move into 2019, with elections in the Philippines, India, and Indonesia, some of our region's more vulnerable economies to economic and market volatility could see spillover from economic weakness with upsets at the ballot boxes that could spillover into financial markets.

Nor should we relax just because the UK is only a small percentage of any of our region's export destinations. Sure - if we only focus on the UK, the threat seems small. But the EU as a whole is a similar economic size to the US. [EU data for 2017](#) showed the region accounted for 32% of all Asian exports, just behind the US (34.5%). EU growth already looks rather tepid by comparison with the beginning of the year. Couple a further EU slowdown with the US fiscal stimulus turning to a drag, and you have a fairly downbeat global growth backdrop - add in some lagged inflation effects from earlier capacity overshoots, and you have in addition a toxic environment for risk assets too, with not much room for central banks outside the US to respond.

These are not base case forecasts, merely downside scenarios. And some of these downbeat outcomes could emerge even if the UK and EU do cement a workable exit deal over the next few days. But a bad exit will push the balance of probabilities in the direction of a nastier global economic outcome, and I for one would rather be stacking the chips the other way if possible.

### Author

#### Robert Carnell

Regional Head of Research, Asia-Pacific

[robert.carnell@asia.ing.com](mailto:robert.carnell@asia.ing.com)

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Article | 12 November 2018

## Forecasting is fallible, yet necessary

Economic forecasters are caught out by shocks so often that one might reasonably ask why they bother. The short answer is that they have no choice, writes ING chief economist Mark Cliffe for Project Syndicate



ING Chief Economist, Mark Cliffe

In a complex and uncertain world, making predictions is a fraught business, not least for economists, whose forecasts are notoriously inaccurate. Even worse, economic forecasts tend to let you down just when you need them most. The Nobel laureate economist Paul Samuelson [once quipped](#) that “the stock market has called nine of the last five recessions,” which seems forgivable when compared with economic forecasters who rarely predict any.

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*People simply cannot live without predictions*

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Given that economic forecasters are so often caught out by shocks, one might ask why they bother. The short answer is that they have no choice. Even when they are well aware of the fallibility of their analyses. People simply cannot live without predictions. Because all decisions – in business, politics, or even one’s personal life – are based on some idea of what the future holds, demand for forecasts is insatiable. People want to be able to justify decisions that they would have



made anyway for other reasons. And when things go wrong, they can always blame the “experts.”

## The problem of overconfidence

Forecasts – and the stories behind them – can comfort us, but they can also lead us astray by creating an illusion of control. This is why investment projects are often late or over budget. Similarly, official forecasts published by government agencies and central banks tend to be overly optimistic. This not just because they are based on assumptions of a policy's future success, but because they are designed to change people's expectations and behaviour.

When conjuring such self-fulfilling prophecies, forecasters often ignore the sage advice that 'it's better to be vaguely right rather than exactly wrong'. Having constructed elaborate models to predict the future, they tend to forget that they are offering only approximations.

Of course, it doesn't help that the most confident and provocative forecasters are the ones who make headlines. As [Philip E. Tetlock](#) of the University of Pennsylvania has shown, the most direct and simple narratives are often [way off the mark](#). Yet, rather than “weed out bad ideas,” the media often [favour](#) them, “especially when the truth is too messy to be packaged neatly.”

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*We should always be wary of forecasts based on a single factor*

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Indeed, the devil is in the detail, so we should always be wary of forecasts based on a single factor. At the same time, we should remain open to forecasters who are honest about their degree of confidence (or lack thereof). Far from signalling weakness, such self-awareness indicates that they have based their prediction on a realistic interpretation of the data, rather than speculation and unjustified assumptions.

We all have implicit biases, and forecasters are no exception. More recent and shocking news events tend to command more of our attention than episodes in the distant past. And yet the latest news might be misleading, especially when it comes to newly published statistics that may be subject to large revisions in the future.

Moreover, forecasters, like everyone else, have a natural tendency to indulge in elegant, after-the-fact rationalisations. Yet hindsight, though a wonderful thing, poses dangers of its own. All too often, forecasters succumb to selective memory, cherishing their successes while forgetting their failures. To the extent that they fail to acknowledge and learn from their mistakes, they are prone to repeat them.

## Art, Not Science

Forecasters have an incentive to make more predictions because doing so raises their chances of getting something right. But, on a more practical level, it also offers more chances to learn, assuming that forecasters are prepared to revise their views in light of new information.

Here, it is important to remember that forecasters are not playing the same game as financial market traders and investors. Because the latter are judged mainly by the profits they make, they are happy to get things right for the wrong reasons. By contrast, forecasting is not primarily

concerned with accuracy *per se*. Nobody should expect forecasters to get it right all of the time. As long as they specify their confidence and avoid catastrophic errors, what they are really offering is a mode of thinking.

The most meaningful forecasts, then, are the ones that provide useful explanations and a cogent framework for understanding current conditions and future events. What matters is not so much the amount of information a forecaster marshals, but rather the depth of the wisdom underlying the analysis. Those who focus solely on information are liable to equate correlation with causation. Wisdom comes from a deeper understanding of *why* things happen.

Forecasters' models are necessarily based on past causal relationships. People's spending, for example, will typically reflect their incomes. But while these variables do reliably follow steady trends or cyclical patterns, history does not repeat itself or even necessarily rhyme. Just because a variable followed a certain trend in the past does not mean that it will do so in the future. "Normal" can be a moving target – models live in the past and die in the future.

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### *Economists make a crucial distinction between risk and uncertainty*

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Accepting that it takes just one unprecedented shock to wreck a forecasting model, economists make a crucial distinction between risk and uncertainty. With risk, you at least know the odds, such as when playing roulette; with uncertainty, you don't – indeed, can't – really know anything. "Unknown unknowns," to use former US Secretary of Defense Donald Rumsfeld's term, could change the rules of the game at any moment. That is why forecasting will always be more an art than a science.

The further out you look, the less reliable your forecast will be, which is why economic pundits on TV prefer to appear smart by focusing only on the short term. In fact, some forecasts of monthly indicators, which are released with roughly a month's delay, are more like "backcasts," because anecdotal information helps to "predict" last month's outcome.

Beyond the time dimension, some forecasting variables are more prone to extreme swings than others; for example, commodity and share prices are far more volatile than consumer prices. It is important to understand these dynamics because the price point or circumstances that inform the starting point of a forecast are often critical to the outcome.

Economies, like climactic or biological systems, can be acutely sensitive to initial conditions. The phenomenon of one thing leading to another – like the proverbial butterfly causing a hurricane by flapping its wings – can make forecasting especially difficult when such path dependencies aren't understood at the outset.

In wrestling with the sheer complexity of the economy, the forecaster's job is helped by the fact that some things matter more than others, and therefore deserve more attention.

Sometimes this is obvious: the prospective price of oil is a critical determinant of the profitability of an oil rig, whereas many other variables are not.

Still, many other crucial risks can evade forecasters, particularly when they are tied to deeply held assumptions that lead us to take things for granted. An obvious example of this is the 2008 global financial crisis, which owed much to the widespread complacent belief that US house prices never fall.

## The Role of Stories

One way to deal with myriad possible futures is to construct scenarios. Rather than betting the farm on a single forecast, one can buy into a larger story that has been constructed around certain key drivers in terms of probability and impact. Such stories offer benchmarks for assessing what kind of a world we are in. We know that people tend to make bad decisions when under stress, so it is helpful to know if some potentially disruptive event might be in the offing. We can plan for such contingencies and aim for “grace under fire.”

That said, when thinking about alternative scenarios, it is important not to overlook the possibility of “unknown unknowns”. Ultimately, however, having too many stories will lead to confusion, so one must eventually make a choice. The goal should be to develop a “no regrets” strategy that accommodates a variety of scenarios; admittedly, this is easier said than done.

Stories are all the more important for grappling with issues that don't lend themselves to measurement. Economists often ignore non-economic factors that are hard to include in their models, which can result in missing the elephant(s) in the room. In particular, politics and institutions matter. They can be critical in determining whether countries ultimately succeed or fail. And even in the short term, recent US experience shows that a divisive election can be far more important than a forensic analysis of the latest economic data when formulating a forecast.

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### *Having more data isn't always better*

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Indeed, having more data isn't always better. To be sure, data are necessary for testing theories in the real world; but the numbers rarely speak for themselves. Nonetheless, with economic forecasters having been thoroughly embarrassed by the financial crisis, they are in danger of being overshadowed by the new breed of “data scientists.” There is no denying that big data and machine learning are opening up new forecasting opportunities by applying massive computing power to pattern recognition and automated trial and error. But such powerful new tools can be dangerous weapons in the wrong hands.

For example, far from being a silver bullet, “predictive analytics” is really appropriate only in microeconomic forecasting. Though adding more data and variables can help identify more correlations, the proportion that are spurious and dangerously misleading rises even faster. As Nassim Nicholas Taleb [puts it](#), big data elevates “cherry-picking to an industrial level.”

This brings us back to the distinction between wisdom and information. Failing to put data into context, check its quality, or understand the questions that one is trying to answer will result in noise, not signal. Forecasts will not be improved unless we are identifying why things are happening.

Likewise, more data in an uncertain world may create the impression that we are dealing with

calculable risks when we actually are dealing with unknowns. In such situations, simple rules of thumb – or heuristics – might well outperform complex forecasting techniques.

After all, we don't even need precise, quantitative forecasts for some purposes. Sometimes the direction is enough, such as in situations that have binary outcomes. Elections (or wars) are either won or lost. We are far more concerned with who wins than with the margin of victory.

Similarly, non-linear relationships can create major problems for forecasters, because they are difficult to model and harder still to forecast. This is particularly troubling in view of the explosive growth of many of the emerging digital technologies. Even minor initial errors in one's forecasting model can quickly lead to huge ones.

In this environment, Taleb argues in his 2012 book "[Antifragile: Things That Gain from Disorder](#)" that we should give up on forecasting altogether, and instead focus on non-predictive forms of decision-making. That means looking for choices that would confer benefits in the event of unexpected extreme changes. But, again, this is easier said than done, especially now that many businesses appear to be paralysed by uncertainty, rather than energised by techno-phoria. That said, technological progress is not entirely unpredictable. Moore's Law, which stipulates that computer processing power doubles every two years, has proven to be remarkably durable.

## The certainty of uncertainty

Surveys of forecasts typically reveal that there are only a few mavericks willing to stick their necks out; most forecasters prefer to stay close to the consensus of their peers. They seek safety in numbers, reckoning that it is better to get it wrong in a crowd. This is just as well when it comes to the financial markets, where forecasters are typically wrong, often by large margins.

Financial markets are not like other markets, because the prices are themselves forecasts. They reflect expectations of returns and risk. According to the "efficient market hypothesis," one cannot beat the wisdom of the crowd, because its collective intelligence already incorporates all available information. But while markets do incorporate incoming information rapidly, the hypothesis does not stand up to scrutiny. After all, the "wisdom" of the crowd is often revealed to be madness.

This makes sense when one accepts that investor beliefs about the future are loosely held, and prone to rapid swings from optimism to pessimism, resulting in booms and busts that leave consensus-minded forecasters trailing in their wake. And for their part, forecasters are prone to hedge their forecasts by saying that "times are unusually uncertain." It is surprising how rarely this cliché gets challenged.

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### *The world is beset by potential volatility*

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It is easy to forget that all eras have their own uncertainties. Today, the world is beset by potential volatility from digital technologies, political and social turmoil, unconventional monetary policies, financial fragilities, and regulatory change. But hindsight makes it easy to forget past sources of uncertainty, not least the existential threat of "mutually assured destruction" during the Cold War.

Because forecasters' hand-wringing about "unusual uncertainty" has the practical effect of

detering risk-taking, it leads to a pessimistic outlook. Yet we should not forget that the darkest hour comes before the dawn. Positive surprises *do* happen.

*This article by ING's Mark Cliffe was commissioned by [Project Syndicate](#).*

## Author

### **Alissa Lefebre**

Economist

[alissa.lefebvre@ing.com](mailto:alissa.lefebvre@ing.com)

### **Deepali Bhargava**

Regional Head of Research, Asia-Pacific

[Deepali.Bhargava@ing.com](mailto:Deepali.Bhargava@ing.com)

### **Ruben Dewitte**

Economist

+32495364780

[ruben.dewitte@ing.com](mailto:ruben.dewitte@ing.com)

### **Kinga Havasi**

Economic research trainee

[kinga.havasi@ing.com](mailto:kinga.havasi@ing.com)

### **Marten van Garderen**

Consumer Economist, Netherlands

[marten.van.garderen@ing.com](mailto:marten.van.garderen@ing.com)

### **David Havrlant**

Chief Economist, Czech Republic

420 770 321 486

[david.havrlant@ing.com](mailto:david.havrlant@ing.com)

### **Sander Burgers**

Senior Economist, Dutch Housing

[sander.burgers@ing.com](mailto:sander.burgers@ing.com)

### **Lynn Song**

Chief Economist, Greater China

[lynn.song@asia.ing.com](mailto:lynn.song@asia.ing.com)

### **Michiel Tukker**

Senior European Rates Strategist

[michiel.tukker@ing.com](mailto:michiel.tukker@ing.com)

### **Michal Rubaszek**

Senior Economist, Poland

[michal.rubaszek@ing.pl](mailto:michal.rubaszek@ing.pl)

**This is a test author**

**Stefan Posea**

Economist, Romania

[tiberiu-stefan.posea@ing.com](mailto:tiberiu-stefan.posea@ing.com)

**Marine Leleux**

Sector Strategist, Financials

[marine.leleux2@ing.com](mailto:marine.leleux2@ing.com)

**Jesse Norcross**

Senior Sector Strategist, Real Estate

[jesse.norcross@ing.com](mailto:jesse.norcross@ing.com)

**Teise Stellema**

Research Assistant, Energy Transition

[teise.stellema@ing.com](mailto:teise.stellema@ing.com)

**Diederik Stadig**

Sector Economist, TMT & Healthcare

[diederik.stadig@ing.com](mailto:diederik.stadig@ing.com)

**Diogo Gouveia**

Sector Economist

[diogo.duarte.vieira.de.gouveia@ing.com](mailto:diogo.duarte.vieira.de.gouveia@ing.com)

**Marine Leleux**

Sector Strategist, Financials

[marine.leleux2@ing.com](mailto:marine.leleux2@ing.com)

**Ewa Manthey**

Commodities Strategist

[ewa.manthey@ing.com](mailto:ewa.manthey@ing.com)

**ING Analysts**

**James Wilson**

EM Sovereign Strategist

[James.wilson@ing.com](mailto:James.wilson@ing.com)

**Sophie Smith**

Digital Editor

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

**Frantisek Taborsky**

EMEA FX & FI Strategist

[frantisek.taborsky@ing.com](mailto:frantisek.taborsky@ing.com)

**Adam Antoniak**

Senior Economist, Poland

[adam.antoniak@ing.pl](mailto:adam.antoniak@ing.pl)

**Min Joo Kang**

Senior Economist, South Korea and Japan

[min.joo.kang@asia.ing.com](mailto:min.joo.kang@asia.ing.com)

**Coco Zhang**

ESG Research

[coco.zhang@ing.com](mailto:coco.zhang@ing.com)

**Jan Frederik Slijkerman**

Senior Sector Strategist, TMT

[jan.frederik.slijkerman@ing.com](mailto:jan.frederik.slijkerman@ing.com)

**Katinka Jongkind**

Senior Economist, Services and Leisure

[Katinka.Jongkind@ing.com](mailto:Katinka.Jongkind@ing.com)

**Marina Le Blanc**

Sector Strategist, Financials

[Marina.Le.Blanc@ing.com](mailto:Marina.Le.Blanc@ing.com)

**Samuel Abettan**

Junior Economist

[samuel.abettan@ing.com](mailto:samuel.abettan@ing.com)

**Franziska Biehl**

Economist, Germany

[Franziska.Marie.Biehl@ing.de](mailto:Franziska.Marie.Biehl@ing.de)

**Rebecca Byrne**

Senior Editor and Supervisory Analyst

[rebecca.byrne@ing.com](mailto:rebecca.byrne@ing.com)

**Mirjam Bani**

Sector Economist, Commercial Real Estate & Public Sector (Netherlands)

[mirjam.bani@ing.com](mailto:mirjam.bani@ing.com)

**Timothy Rahill**

Credit Strategist

[timothy.rahill@ing.com](mailto:timothy.rahill@ing.com)

**Leszek Kasek**

Senior Economist, Poland



[leszek.kasek@ing.pl](mailto:leszek.kasek@ing.pl)

**Oleksiy Soroka, CFA**

Senior High Yield Credit Strategist

[oleksiy.soroka@ing.com](mailto:oleksiy.soroka@ing.com)

**Antoine Bouvet**

Head of European Rates Strategy

[antoine.bouvet@ing.com](mailto:antoine.bouvet@ing.com)

**Jeroen van den Broek**

Global Head of Sector Research

[jeroen.van.den.broek@ing.com](mailto:jeroen.van.den.broek@ing.com)

**Edse Dantuma**

Senior Sector Economist, Industry and Healthcare

[edse.dantuma@ing.com](mailto:edse.dantuma@ing.com)

**Francesco Pesole**

FX Strategist

[francesco.pesole@ing.com](mailto:francesco.pesole@ing.com)

**Rico Luman**

Senior Sector Economist, Transport and Logistics

[Rico.Luman@ing.com](mailto:Rico.Luman@ing.com)

**Jurjen Witteveen**

Sector Economist

[jurjen.witteveen@ing.com](mailto:jurjen.witteveen@ing.com)

**Dmitry Dolgin**

Chief Economist, CIS

[dmitry.dolgin@ing.de](mailto:dmitry.dolgin@ing.de)

**Nicholas Mapa**

Senior Economist, Philippines

[nicholas.antonio.mapa@asia.ing.com](mailto:nicholas.antonio.mapa@asia.ing.com)

**Egor Fedorov**

Senior Credit Analyst

[egor.fedorov@ing.com](mailto:egor.fedorov@ing.com)

**Sebastian Franke**

Consumer Economist

[sebastian.franke@ing.de](mailto:sebastian.franke@ing.de)

**Gerben Hieminga**

Senior Sector Economist, Energy

[gerben.hieminga@ing.com](mailto:gerben.hieminga@ing.com)

**Nadège Tillier**

Head of Corporates Sector Strategy

[nadege.tillier@ing.com](mailto:nadege.tillier@ing.com)

**Charlotte de Montpellier**

Senior Economist, France and Switzerland

[charlotte.de.montpellier@ing.com](mailto:charlotte.de.montpellier@ing.com)

**Laura Straeter**

Behavioural Scientist

+31(0)611172684

[laura.Straeter@ing.com](mailto:laura.Straeter@ing.com)

**Valentin Tataru**

Chief Economist, Romania

[valentin.tataru@ing.com](mailto:valentin.tataru@ing.com)

**James Smith**

Developed Markets Economist, UK

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

**Suvi Platerink Kosonen**

Senior Sector Strategist, Financials

[suvi.platerink-kosonen@ing.com](mailto:suvi.platerink-kosonen@ing.com)

**Thijs Geijer**

Senior Sector Economist, Food & Agri

[thijs.geijer@ing.com](mailto:thijs.geijer@ing.com)

**Maurice van Sante**

Senior Economist Construction & Team Lead Sectors

[maurice.van.sante@ing.com](mailto:maurice.van.sante@ing.com)

**Marcel Klokk**

Senior Economist, Netherlands

[marcel.klokk@ing.com](mailto:marcel.klokk@ing.com)

**Piotr Poplawski**

Senior Economist, Poland

[piotr.poplawski@ing.pl](mailto:piotr.poplawski@ing.pl)

**Paolo Pizzoli**

Senior Economist, Italy, Greece

[paolo.pizzoli@ing.com](mailto:paolo.pizzoli@ing.com)

**Marieke Blom**

Chief Economist and Global Head of Research

[marieke.blom@ing.com](mailto:marieke.blom@ing.com)

**Raoul Leering**

Senior Macro Economist

[raoul.leering@ing.com](mailto:raoul.leering@ing.com)

**Maarten Leen**

Head of Global IFRS9 ME Scenarios

[maarten.leen@ing.com](mailto:maarten.leen@ing.com)

**Maureen Schuller**

Head of Financials Sector Strategy

[Maureen.Schuller@ing.com](mailto:Maureen.Schuller@ing.com)

**Warren Patterson**

Head of Commodities Strategy

[Warren.Patterson@asia.ing.com](mailto:Warren.Patterson@asia.ing.com)

**Rafal Benecki**

Chief Economist, Poland

[rafal.benecki@ing.pl](mailto:rafal.benecki@ing.pl)

**Philippe Ledent**

Senior Economist, Belgium, Luxembourg

[philippe.ledent@ing.com](mailto:philippe.ledent@ing.com)

**Peter Virovacz**

Senior Economist, Hungary

[peter.virovacz@ing.com](mailto:peter.virovacz@ing.com)

**Inga Fechner**

Senior Economist, Germany, Global Trade

[inga.fechner@ing.de](mailto:inga.fechner@ing.de)

**Dimitry Fleming**

Senior Data Analyst, Netherlands

[Dimitry.Fleming@ing.com](mailto:Dimitry.Fleming@ing.com)

**Ciprian Dascalu**

Chief Economist, Romania

+40 31 406 8990

[ciprian.dascalu@ing.com](mailto:ciprian.dascalu@ing.com)

**Muhammet Mercan**

Chief Economist, Turkey

[muhammet.mercan@ingbank.com.tr](mailto:muhammet.mercan@ingbank.com.tr)

**Iris Pang**

Chief Economist, Greater China

[iris.pang@asia.ing.com](mailto:iris.pang@asia.ing.com)

**Sophie Freeman**

Writer, Group Research

+44 20 7767 6209

[Sophie.Freeman@uk.ing.com](mailto:Sophie.Freeman@uk.ing.com)

**Padhraic Garvey, CFA**

Regional Head of Research, Americas

[padhraic.garvey@ing.com](mailto:padhraic.garvey@ing.com)

**James Knightley**

Chief International Economist, US

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

**Tim Condon**

Asia Chief Economist

+65 6232-6020

**Martin van Vliet**

Senior Interest Rate Strategist

+31 20 563 8801

[martin.van.vliet@ing.com](mailto:martin.van.vliet@ing.com)

**Robert Carnell**

Regional Head of Research, Asia-Pacific

[robert.carnell@asia.ing.com](mailto:robert.carnell@asia.ing.com)

**Karol Pogorzelski**

Senior Economist, Poland

[Karol.Pogorzelski@ing.pl](mailto:Karol.Pogorzelski@ing.pl)

**Carsten Brzeski**

Global Head of Macro

[carsten.brzeski@ing.de](mailto:carsten.brzeski@ing.de)

**Viraj Patel**

Foreign Exchange Strategist

+44 20 7767 6405

[viraj.patel@ing.com](mailto:viraj.patel@ing.com)

**Owen Thomas**

Global Head of Editorial Content

+44 (0) 207 767 5331

[owen.thomas@ing.com](mailto:owen.thomas@ing.com)

**Bert Colijn**

Chief Economist, Netherlands

[bert.colijn@ing.com](mailto:bert.colijn@ing.com)

**Peter Vanden Houte**

Chief Economist, Belgium, Luxembourg, Eurozone

[peter.vandenhoute@ing.com](mailto:peter.vandenhoute@ing.com)

**Benjamin Schroeder**

Senior Rates Strategist

[benjamin.schroeder@ing.com](mailto:benjamin.schroeder@ing.com)

**Chris Turner**

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

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

**Gustavo Rangel**

Chief Economist, LATAM

+1 646 424 6464

[gustavo.rangel@ing.com](mailto:gustavo.rangel@ing.com)

**Carlo Cocuzzo**

Economist, Digital Finance

+44 20 7767 5306

[carlo.cocuzzo@ing.com](mailto:carlo.cocuzzo@ing.com)

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