

## In case you missed it: Race to the monetary bottom

With the yuan 'cracking seven', it's becoming clear China is going to fight this trade war hard. Meanwhile, the President has been cranking up pressure on the Fed and with three Asian central banks making pre-emptive moves, we think it's just a matter of time till the Fed succumbs. In other news, Saudi comes to rescue oil prices and it's all kicking off in Italy

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## US FX intervention: What are the chances?

A further tirade from President Trump over the strong dollar begs the question whether he's prepared to weaken it through FX intervention? We would still only assign a 25% probability to such an outcome, but the chances are rising



Donald Trump nominates Jerome Powell as Fed Chair, November 2017

### The dollar is increasingly on the White House's radar

This week's move above 7.00 in USD/CNY and widespread monetary easing across Asia has provided further fuel to the President's criticism that the Fed has kept US interest rates too high and the dollar too strong.

The term 'currency wars' has also made a strong come-back – a term last used as countries were softening their currencies to compete for diminishing external demand after the Global Financial Crisis. We agree with most that China has not devalued its currency this week, but has instead allowed market forces to play a greater role in setting its value.

In fact, the [US Treasury's statement](#) supporting the designation of 'currency manipulator' against China reads something like 'if you claim you're so good at controlling your currency, why couldn't you keep \$/CNY below 7?'

## Intervention: Is it a strong dollar or weak renminbi problem?

There are two schools of thought on FX intervention:

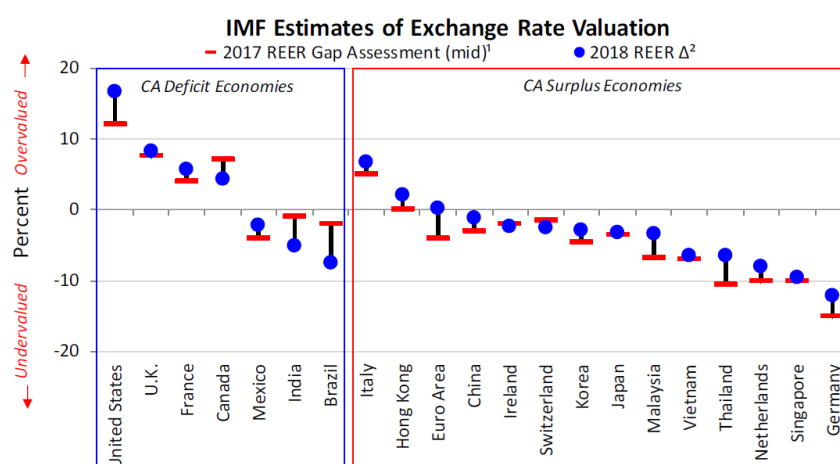
1. Is Washington's key focus an over-valued dollar that is hurting the US manufacturing sector?
2. Is the main concern that China is manipulating its currency lower for trade gain and to offset tariffs?

The answer to these questions will require different policy responses.

Listening to the President yesterday, the former certainly seems to be the case. The response required from the White House to this is largely to pressurise the Fed into more aggressive easing and, in exceptional circumstances, to get the US Treasury to instruct the Fed to sell dollars against the EUR and JPY (the two currencies already in the Exchange Stabilisation Fund (ESF). Washington's sense that the dollar is too strong could be backed up by the IMF's own calculations of FX valuations, where the dollar stands out as over-valued (see below).

The latter issue would see US FX intervention entertained against USD/CNY. After the admission of the Renminbi to the SDR in 2016, China has been welcoming public sector investments into its onshore bond markets. In theory then, the Fed should be able to buy the onshore CNY, with the proceeds parked in onshore CNY government bonds, just as fellow FX reserve managers do.

## IMF estimates of FX valuation: over-valued dollar stands out



Sources: IMF 2018 External Sector Report, IMF 2018 Article IV Consultation Staff Reports for Vietnam and Ireland, BIS REER Indices, JP Morgan, and FRB.

1/The IMF's estimate of real effective exchange rate (REER) gap (expressed as a range) compares the country's average REER in 2017 to the level consistent with the country's medium-term economic fundamentals and desired policies. The midpoint of the gap range is depicted above.

2/Change through December 2018 versus 2017 average.

Note: The IMF does not provide an estimate of Taiwan's REER gap.

Source: IMF

## What are the chances of intervention?

There is no perfect way to judge the market's view here, but a rough gauge is to look at FX options and see what probability the market attaches to certain outcomes. If we assume that unilateral US FX intervention (near unprecedented) would knock the dollar, say, 3% lower, what probability is attached to that for USD/JPY, EUR/USD and USD/CNY? Looking at One Touch option prices, the probability of the dollar falling 3% over the next month against the JPY, EUR and CNY is 23%, 13%

and 9% respectively. The USD/JPY is more volatile than the EUR/USD and USD/CNY, so the probability of a 3% move is naturally higher – but the exercise does provide some idea of what's priced.

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### *We see the probability of intervention around 25%*

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We see the probability of intervention around 25%, largely because of the risk of failure. How would the White House react to headlines of 'failed intervention' if after selling USD/CNY at 7.05, the spot rate trades above that level over later days and weeks as the Fed fails to re-appear with a sustained bout of USD/CNY selling?

We've written about the US Treasury's [available fire-power here](#), but after further discussion and assuming that neither: i) Congress approves a massive increase in ESF resources for intervention, raising US debt levels in the process or ii) the Fed decides to print money and support the US Treasury in unsterilized intervention, most seem to think the US Treasury's resources for FX intervention is around the US\$100bn mark. Not much by international standards.

Indeed, there is much academic literature on the failure of sterilised FX intervention (i.e. the monetary base doesn't change). And the chances of getting another 1985 Plaza Accord to weaken the dollar, involving co-ordinated FX intervention and co-ordinated monetary policy, look virtually zero.

What would be a significant game-changer here would be if the Fed were to give greater weight to the drag from the international environment, including the strong dollar. The Fed might not wish to risk its credibility in getting sucked into a currency war, but FX intervention backed up by more aggressive Fed easing would be a more compelling proposition for the FX market.

## **Dollar forecasts**

Based on a slowing US economy and the Fed being drawn [into deeper easing](#), we maintain a view that USD/JPY will head down to the 102/103 area later this year. This will be exacerbated by broadening trade tensions over the coming months.

For EUR/USD, we see a risk that the recent narrowing in EUR:USD short rated differentials actually accelerates as US rates fall further, while EUR rates get stuck on the view that the ECB can't cut the deposit rate below the -0.70/80% threshold.

Narrowing rate differentials – and perhaps a re-think over Washington's dollar policy – have prevented EUR/USD breaking down to the 1.08 area. We continue to favour a 1.10-1.15 range for the remainder of the year, but will carefully watch the trade-off between US and Eurozone policymakers within a global slow-down.

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## President Trump and the Fed - we've changed our view

President Trump is ratcheting up the pressure on the Fed to support his efforts on extracting concessions from China on trade. Policymakers appear reluctant, but market moves and other central bank actions look set to give them a nudge. This is why we think it looks increasingly likely that the Fed will step in with two 25bp cuts in September and December



Source: Shutterstock

US President Donald Trump and Federal Reserve Chairman Jerome Powell

### President piles on the pressure

President Trump has been active again on Twitter this morning, saying that the Fed must make “bigger and faster” interest rate cuts and that it as an institution is “too proud to admit their mistake” of - in the President’s view - raising interest rates too aggressively over the past couple of years.

The latest blast follows the sharp sell-off in equities, but the President is also likely to have been irked by the fact that other central banks around the world are easing by more than expected. Today, we saw surprisingly aggressive moves from India, New Zealand and Thailand’s central

banks. At the same time, the European Central Bank appears to be gearing up for more aggressive stimulus in response to weak growth and low inflation. Meanwhile, in the Federal Reserve, President Trump has a central bank that seems far more reticent to offer the kind of support he feels is necessary as he battles China over trade practices.

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*In the Fed, President Trump has a central bank that seems far more reticent to offer the kind of support he feels is necessary as he battles China over trade practices*

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Yesterday, St Louis Fed President James Bullard, arguably the most dovish voting member of the FOMC, pushed back against the market pricing four further 25bp rate cuts over the next 18 months. He admitted that in June he was one of the eight FOMC members to have pencilled in 50bp of policy easing this year to the Fed “dot plot” and said his view has not changed dramatically since then. After all, the US is “not in recession mode here” and that “monetary policy cannot reasonably react to the day to day give and take of trade negotiations”.

Today, Charles Evans from the Chicago Fed talked similarly. He acknowledged the risks have “gone up”, which can justify “more accommodation”, and acknowledged the other central bank moves, commenting that “once a substantial number of central banks consider repositioning their monetary policy, it's natural that other central banks might be thinking that too”.

## Trade proving tricky

For now the US economy is in far better shape than other developed markets. Unemployment is low, growth remains “solid” and wages are rising. It was this contrasting story that had emboldened President Trump to push hard on trade with the narrative that trade partners would be desperate to cut a deal.

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*We simply don't have the visibility on the outlook for trade policy to give us much confidence in our forecasts when President Trump appears to over-rule his trade negotiation team on a whim*

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It hasn't worked out that way with China offering domestic monetary and fiscal stimulus whilst also allowing the yuan to weaken against the dollar. Moreover, there is growing evidence that the US activity story is softening, with particular concerns over investment spending. Certainly, escalating trade tensions through higher tariffs and restricted access to markets is hurting sentiment, increasing costs, damaging supply chains and weakening corporate profitability. And the knock-on effect is that this deters companies from putting money to work, such as delaying investment decisions and hiring fewer workers – or even raising the prospect of lay-offs in key impacted sectors such as export manufacturing. This then feeds through into consumer sentiment and spending more broadly in the economy with recession risks mounting.

It is important to point out that this is in the realms of the “worst-case scenario”. We simply do not



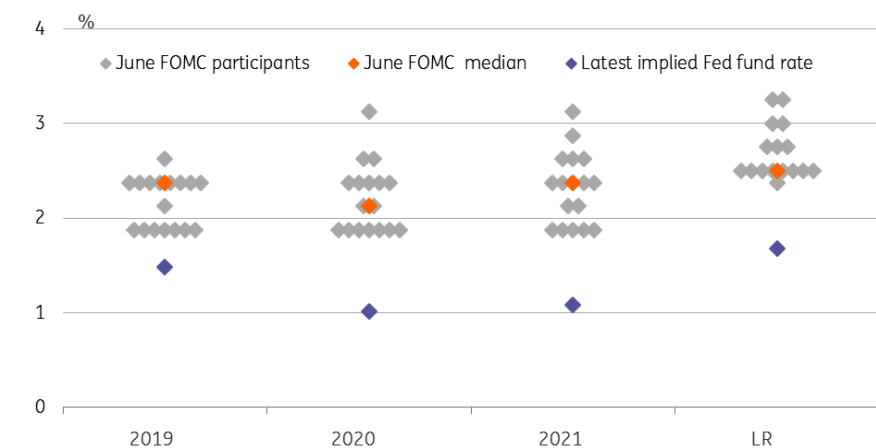
have the visibility on the outlook for trade policy to give us much confidence in our forecasts when President Trump appears to over-rule his trade negotiation team on a whim. It may well be that in the next couple of weeks he rows back on the prospect of additional tariffs. Alternatively, he could go harder.

## Things set to get worse before they get better

Our assumption is that the tensions will escalate over the next couple of months, which will add to economic headwinds and result in weaker growth. China talks of the need for “respectful” negotiations, which it doesn’t feel it is getting when President Trump takes unilateral decisions, so there is little incentive to offer anything meaningful until there is.

This runs the risk of the US ramping up the pressure on China and further weakening global sentiment and economic activity. With commodity prices falling broadly, particularly oil which is in a bear market, and with the dollar remaining in the ascendancy there are more downside risks for headline inflation too.

## Markets are priced for the worst



Source: Macrobond

## The market is ramping up the pressure for action

The ever flattening yield curve is also adding to a sense of nervousness. All nine recessions since 1955 were preceded by an inverted yield curve and we are there already on the 3M-10Y and only 8bp away on the 2-10Y. However, there have been false signals before and this time we have to recognise there are factors in play that are depressing longer US dated yields and thereby perhaps overhyping the threat of a recession.

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*What worries us more about a flat/inverted US yield curve is that it hurts banks and can disrupt and deter the process of credit creation*

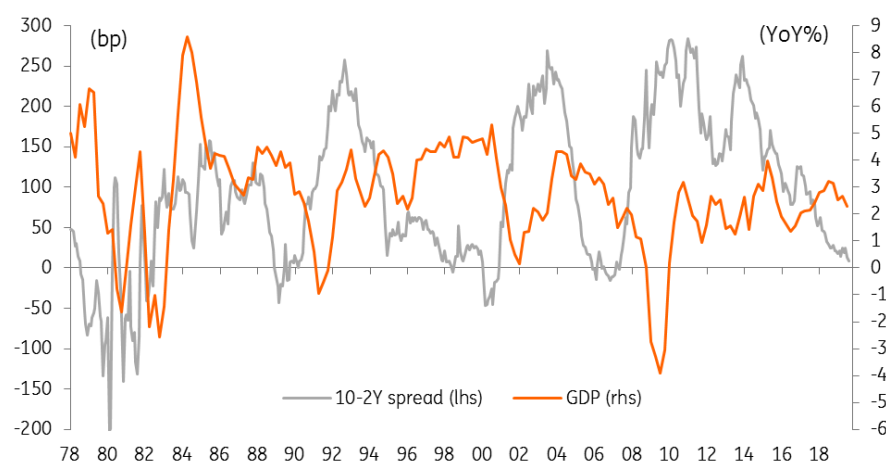
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The lagged effects of the Fed's quantitative easing programme is making the curve flatter than it

otherwise would be (relative to previous cycles) while negative yields in Europe are also contributing to the demand for US Treasuries given the US safe-haven status and the fact investors at least get a positive return and the dollar remains strong.

What worries us more about a flat/inverted US yield curve is that it hurts banks and can disrupt and deter the process of credit creation since banks typically receive long term and payout short-term. This means weaker profitability while setting off warning signals about future credit quality in risk models. Less willingness to lend can, therefore, contribute to making the bond market's downturn expectations self-fulfilling.

## Yield curve recession warning



## Fed set to cut rates further, but not as much as the market wants

All of this suggests to us that our current forecast of just one further Fed rate cut in September is looking too cautious. Growth risks and inflation risks are looking increasingly to the downside in the wake of the latest trade escalation. With other central banks easing aggressively, this risks exacerbating upside pressure on the US dollar, which could further dampen growth and inflation and add to the pressure on the Fed to ease policy.

*It looks increasingly likely that the Fed will step in with more easing – with two 25bp cuts in either September and October or September and December (our preference)*

As such it looks increasingly likely that the Fed will step in with more easing – with two 25bp cuts in either September and October or September and December (our preference). In this regard, the Jackson Hole symposium 22 -24 August will see a lot of Fed discussion on this topic with Fed Chair Jerome Powell's favourite phrase of late that an "ounce of prevention is worth a pound of cure" likely to crop up again.

Though, we continue to doubt that the market will get the four additional rate cuts they are discounting. After all, we think that President Trump wants to be re-elected next year and recognises that a robust economy with rising asset prices is critical for that to happen. We continue to look for a “deal” even if not all of President Trump’s demands are met later this year.

Relief in business and markets that trade uncertainty has been lifted and with interest rates globally offering a decent stimulus, may well give President Trump what he needs.

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## Revising yuan forecast

We are revising our USD/CNY forecast following the Chinese government's decision to allow the yuan to cross the 7 handle



### We were right and wrong

We didn't think China's authorities would allow USD/CNY to pass the 7.0 handle because of the disruption such a move would cause in asset markets, not just in China but around the world.

We were partly right; the People's Bank of China let the currency pair pass this key level on 5 August, whereupon global markets experienced a sharp fall. China's CSI300 index fell 1.91%, the Hang Seng Index fell 2.85% and the Dow Jones Industrial Average index tumbled 2.90% on the day.

We thought China would refrain from using the yuan as a 'weapon' in the trade war because triggering a currency war would not be helpful to China's economy. But Chinese leaders appear to have concluded that the currency can be used as a tool to provoke Trump and inflict political damage.

### Near term: What's next after 7?

We think it unlikely that USD/CNY will fall below 7 unless upcoming trade talks go particularly well, which is not our base case. Both sides are to blame for escalating this situation. The US raised tariffs on \$300bn goods to 10%, China stopped buying US agricultural products and let the yuan pass through 7.0, and the US immediately labelled China a currency manipulator. On

Wednesday, the US imposed a ban on federal purchases of equipment and services from five Chinese companies, including Huawei. We expect further retaliation.

In the near term, we think the yuan will trade in a range of 7.00 to 7.10. Further weakness would send a signal that China wants to start a currency war, which we strongly believe is not the case because this would do little to benefit the Chinese economy as other Asian currencies would just weaken along with the yuan.

The market is currently trying to work out how much the yuan will deviate from the fixing price. As such, the difference between the fixing and closing prices of USD/CNY is still quite large (more than 250 pips). We believe that as the market gets used to the yuan's new level, the daily fixing of the USD/CNY will be closer to the closing price.

## Medium term: Progress of the trade war is now key for yuan

USD/CNY passing 7.0 shows that China is going to fight this trade war hard, at least while President Trump is in office.

There is a chance, in the medium term, that the yuan could weaken past 7.10 if:

1. The trade war escalates even further and the Chinese government uses the yuan to create market volatility. This could be a tool to frustrate Trump's 2020 re-election campaign.
2. The Chinese government has a plan to compensate for the loss of economic activity caused by the trade war. Asset market turmoil, led by a far weaker yuan, may not hurt China so much as it hurts the US.

We think the chances of this happening are very small but we don't rule out the possibility.

## Forecast of USD/CNY and USD/CNH

We forecast the USD/CNY will reach 7.05 (previous 6.95) by the end of 3Q19 and 7.10 by end 4Q19 (previous 6.90). The USD/CNH should be 150 pips higher than USD/CNY.

We think USD/CNY will fall to 7.05 by the end of 1H20 (previous 6.85) and to 7.00 by the end of the year (previous 6.75), as we expect positive progress in the trade war after the US presidential election in November 2020.

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## Three political scenarios for Italy with FX and rates implications

The collapse of Italy's ruling coalition opens the way for three possible scenarios: new elections, an extension of the current coalition or a new technocratic government. Timing will be crucial, given the proximity to the budget season. Rising political uncertainty is likely to prompt a widening in the 10Y BTP-Bund spread and to weigh on the euro



Italian Deputy Prime Minister, Matteo Salvini, presented a vote of no-confidence in his coalition partners

### Three scenarios ahead of the government crisis

Italy is facing another political crisis after the leader of the country's Lega's party, Matteo Salvini, told the prime minister and the Five Star Movement coalition partner that he wants fresh elections and that the government is now technically dead. It comes after Five Star failed to block the construction of a high-speed train link between Lyon and Turin, something strongly supported by Salvini. Polls suggest that Lega could be close to winning the 40% of votes needed to govern either alone or through a coalition, probably with the ultra-conservative Brothers of Italy (currently at 7%).

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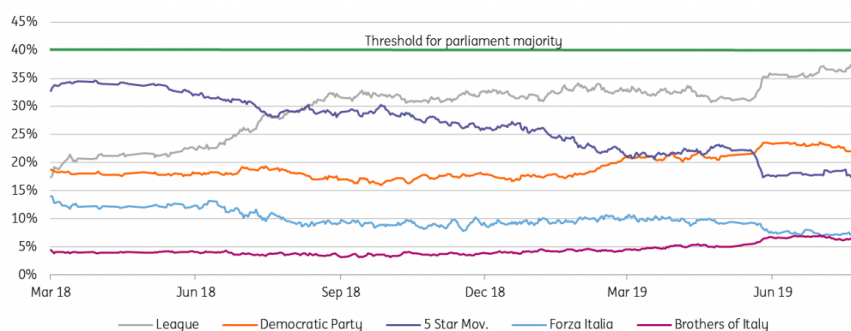
*This crisis comes at a critical juncture*

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This crisis comes at a critical juncture. Only last month the prime minister, Giuseppe Conte, managed to get an agreement with the European Commission to avoid an EU disciplinary procedure over its growing debt. But the 2020 budget looks set to become even more challenging and the absence of a working government in October will complicate matters even further.

Timing is the key variable to consider when analysing the possible scenarios for Italian politics. First, it will be crucial to see when Prime Minister Conte will decide to officially resign. That allows the President of the Republic, Sergio Mattarella, to start a period of consultation with the leaders of the main parties whilst weighing the different options. How long these consultations last is relevant: there is not a fixed deadline and it is mostly up to the discretion of the President. The more the decision is delayed, the more complicated it will be for a new government to deal with the busy schedule of budget-related obligations starting in October. At the moment, PM Conte appears reluctant to loosen his grip just yet and he called for a formal no-confidence vote in the parliament. The current situation suggests three possible scenarios ahead.

## Opinion polls suggest Salvini is close to a majority



Source: Politico, ING

### 1 New elections

Salvini has explicitly called for new elections as he pulled the plug on the governing coalition. General elections in Italy can take place no earlier than 45 days after the President dissolves the parliament and announces snap elections. In practice, at least 60 days are probably going to be needed to set up the electoral procedures. Should President Mattarella decide to rush things and dissolves parliament next week, then we would be realistically looking at either the 13th, 20th or 27th of October as the earliest possible dates for an election.

This would inevitably collide with the deadline set by the EU to submit the 2020 budget draft (October 15th), although the Commission may well grant an extension given the extraordinary situation. Waiting much longer to announce snap elections can be very risky: the new government may not have enough time to receive parliamentary approval of the budget before the December 31st deadline. This would increase the possibility that the “provisional system” would automatically come into force. That's a system provided for in the Italian constitution that forces the government to spend only a limited amount of resources each month, thereby blocking any long-term investment previously included in the budget. All parties (and the President) would likely want to avoid this situation given the possible dampening effects on the already-battered Italian economy.

## Extension of the current government

With those concerns about the budget deadlines in mind, President Mattarella may decide to try to convince Salvini and his co-deputy prime minister, Five Star's Luigi Di Maio to extend the current coalition at least until the end of the year. He would likely require a commitment by the two parties to deliver on the budget. Such an agreement may include demands for a cabinet reshuffle, with a bigger presence of League representatives in some key roles. This would likely lead to elections at the beginning of 2020.

### 3 A new technocratic government

Similar to the second option, the President may try to ensure a “calm” budget season, but this time by calling for an external figure to lead an interim government with the specific task of having the budget approved (by the EU and the parliament). The President would inevitably need to ensure there would be a majority backing the technocratic government, which may turn out to be a anything but a simple task. Also in this scenario there would likely be snap elections in early 2020. There's also some speculation of a possible agreement between the 5-stars and the Democratic Party to form a new government, but no official negotiations have started and the parties' political views are, for now, very far apart.

## Rates: 10Y BTP-Bund spread to widen

From now until we know the date of the election, we're going to see further volatility in Italian markets. And that prospect is enough to flush out positions established with a view to benefiting from carry over the summer months, in our opinion. This justifies our short-term call for a widening of the 10Y Germany Italy spread to 250bp. The range of possible outcomes discussed above, and market reactions discussed below, also justifies a greater risk premia baked into this spread in the near term.

For investors, the interplay between the election and budget dates will be crucial. The failure to pass a 2020 budget before the election would expose holders of Italian bonds to a period of uncertainty until it becomes apparent whether an Excessive Deficit Procedure (EDP) will be reopened against Italy or not. It could also raise doubts in investors' minds as to whether the ECB would restart PSPP (the Public Sector Purchase Programme) and risk being seen supporting a government breaching EU fiscal rules.

On balance, we think the political turmoil is unlikely to prevent a restart of purchases, given that easing is required by conditions within the eurozone's economy as a whole. The tone of the League's campaign on fiscal issues will also be important, not least because prominent party members have expressed reservations about Italy's euro-membership in the past. More broadly, the prospect of a more assertive, and more powerful, Salvini raises the prospect of protracted tensions with the EU.



## Different reactions from the 10Y BTP-Bund spread



Source: Bloomberg, ING

If we get elections in October (scenario 1 above) then the period of uncertainty is likely to be short but intense. League election rhetoric will gain in importance given its implication for the 2020 budget. There is a possibility that the League's economic agenda might ultimately be perceived positively by investors, but the near-term risks surrounding the election should dominate price action, especially as the build-up to the Italian election would coincide with the build-up to Brexit. If we get that, we see the 10Y Italy-Germany spread testing 300bp to the upside during the campaign.

In the event that the current coalition survives the crisis (scenario 2) until after the 2020 budget process, we think the likelihood of a clash between the government in the autumn is high but manageable given the proximity of ECB easing. This was the closest outcome to what markets were pricing prior to this week. We doubt a retracement of the 10Y spread below 200bp is likely in this event, however, because Salvini's strengthened position will give him more leeway to push for his fiscal demands. We see the spread staying around 250bp in this scenario.

If President Mattarella manages to muster a technocratic government (scenario 3) with the main aim to pass a 2020 budget giving no ground for the EC to restart the EDP against Italy, then we expect the 10Y Italy-Germany spread to recover from today's widening, and BTP correlation to other EGB markets to return to positive territory. This outcome would dispel any lingering doubt about the ECB's willingness to include government bonds, and thus BTPs, in its purchases. In this scenario, we see the 10Y spread retracing inside to 200bp into the restart of PSPP.

## FX: Another negative added to the EUR outlook

About a year ago, the freshly-formed Lega-5 Star government spread uncertainty in the markets as they announced a 2.4% deficit target to be included in the draft budget. In the following weeks, Italian political uncertainty was a constant dragging factor on the euro. The main takeaway from our scenario analysis is that the breakup of Italy's ruling coalition is probably the first step towards a period of extended uncertainty stemming from the country.

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*An escalation in political risk is likely going to add more negatives*

## to the euro outlook

This may add more negatives to an already clouded outlook for the common currency. Our economists are expecting the ECB to deliver a heavy package of monetary easing in September: a rate cut and the announcement of a new round of quantitative easing. In addition, the global environment continues to bode quite badly for the already-concerning European economic outlook: trade wars may soon hit the EU directly, with President Trump possibly aiming to levy tariffs on autos, The lingering Brexit-related uncertainty also continues to weigh on forward-looking indicators.

An escalation in political risk stemming from Italy is likely going to add more negatives to the euro outlook. In particular, we expect such potential escalation to have a magnified effect on EUR/CHF among other crosses. The pair proved to be highly correlated to the dynamics of the 10Y BTP-Bund spread during the troubled 2018 budget season. On the opposite side, EUR/USD may face more resistance in entering an extended downward trajectory, given that simultaneously-escalating trade tensions may join recent pressure from the White House to suggest more easing by the Federal Reserve, thereby weighing on the US dollar.

Despite the upcoming easing moves by the ECB, the outlook for the EUR-USD rate differential appears more likely to move in favour of the euro. Negative rates in the eurozone may only have limited space for a further drop, whereas an easing cycle by the Fed may keep pressuring the relatively-higher US rates. In the table below, we outline the potential reaction of EUR/USD and EUR/CHF to the three different scenarios discussed in this article.

| Scenario                           | Timeline   | Impact on 10Y BTP-Bund spread | Impact on EUR                      |
|------------------------------------|--|-------------------------------|------------------------------------|
| New elections in October           | Parliament dissolved in the next few days. Salvini becomes new PM in late October and negotiates the new budget with the EU.                 | 300 bp<br>(+65 bp)            | EUR/USD<br>1.10<br>EUR/CHF<br>1.07 |
| Continuation of current government | The current coalition remains in place at least until year-end for the budget season (possibly with a cabinet reshuffle). Elections in 2020. | 250 bp<br>(+15 bp)            | EUR/USD<br>1.11<br>EUR/CHF<br>1.08 |
| Technocratic government            | The President appoints an external personality to lead the government and have a "thin" budget approved. Elections in 2020.                  | 200 bp<br>(-35 bp)            | EUR/USD<br>1.12<br>EUR/CHF<br>1.10 |

Source: ING

One thing's for sure, the collapse of the Italian government is paving the way for more uncertainty, and not just as far as politics are concerned. The spill-over effect will likely depend on the number of implications about the future Italy-EU relationships and the

stability of the battered Italian economy. We believe that the balance of risks for Italian sovereign bonds is tilted to the downside, with the 10Y BTP-Bund spread that may well edge back to the 300bp area in case of new elections in October. Similarly, this scenario would probably add selling pressure to the EUR, with the CHF likely to come up as the main beneficiary: EUR/USD may explore the 1.10 area while EUR/CHF could touch 1.07.

Given the early stages of the government crisis and the lingering uncertainty about the upcoming developments, we're not putting probabilities to the scenarios, although we acknowledge a significant increase in downside risk for eurozone sentiment.

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# Watch: Two key market implications of the US-China FX war

USD/CNY has been allowed to trade above 7 for the first time since the Global Financial Crisis. ING's Chris Turner says there are two key market implications to watch for now



## Why the US-China currency war matters

[Watch video](#)

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## Norway: Rates and Saudis hold the key for the krone

The Norwegian krone has been battered by tumbling oil prices and rising risk aversion. Saudi's intervention in the oil markets and a possible hawkish signal from the Norges Bank next week will be needed to avert another leg lower in the currency



### A toxic combination for NOK

The Norwegian krone has been the major underperformer in the G10 space in the past few weeks. We identify two main factors for this NOK weakness and discuss how they are likely to play out in the short and medium term.

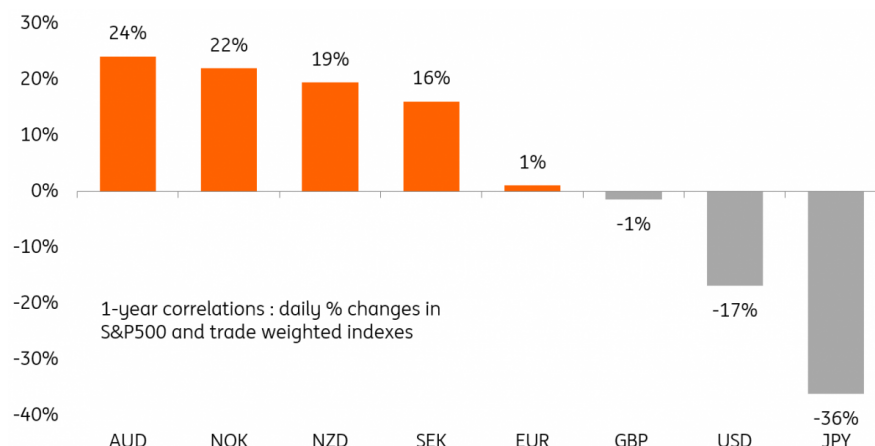
#### 1 Trade tensions: things will get worse before getting better

The imposition of new US tariffs on China and the sharp depreciation of the Chinese yuan have dampened market risk appetite, pressuring global risk assets. In the currency space, the spillover effect has not been limited to the Australian and New Zealand dollars but has also hit the krone and Sweden's krona. The krone's sensitivity to swings in global sentiment is evident by its high correlation with moves in the equity markets (Fig. 1)

Looking ahead, our view is that US-China trade relations are likely to get worse before they get any better. First, it will be key to see how the Chinese government retaliates against the freshly-

imposed tariffs and whether the yuan will be allowed to depreciate further. At the same time, the US has not run out of trade “weapons” yet and may still hike current tariffs on the remaining \$300 billion of Chinese goods from 10% to 25%. In turn, we expect trade tensions and the consequent weakening in risk appetite to continue weighing on the risk-sensitive NOK in the short term. In the longer-term, our trade team remains confident that trade tensions will abate towards the end of the year as the US and China move closer to a deal. Should this be the case, we expect NOK, along with other risk-sensitive assets, to stage a rebound, given its high beta to market sentiment.

**Fig. 1 - NOK shows relatively high correlation with the S&P500**



Source: BIS, Bloomberg, ING

## 2 Oil market: Saudis may come to the rescue

The oil and gas sector accounts for 22% of Norwegian GDP and 67% of the country's exports to the world. It is therefore little surprise that the currency has historically been closely tied to the energy market. Crude oil prices have declined by nearly 12% since the start of August, which has inevitably triggered an extended selloff in NOK. This weakness in oil prices is related to trade tensions, given the potential negative implications for global demand.

Our commodities team has recently updated its [forecasts for crude oil prices](#) (Fig. 2). We remain of the view that there is room for a recovery in prices in the short-term as strong overall compliance to OPEC+ production cuts has reduced supply. But we acknowledge that concerns about weak demand will persist in light of recent trade developments. A key factor that oil bulls will likely hold onto will be the reported activism of Saudi Arabia in preventing further slips in oil prices. The Saudis will likely start by ensuring that all members are complying with the output cuts (Iraq and Nigeria have actually increased production), before proposing further supply tightening. Overall, oil prices remain a big question mark on the krone's outlook in the short-term, and much will likely depend on the impact of Saudi activism on oil prices. In the longer term, we expect oil prices to keep rising in 4Q19 and fuel a recovery in the currency.

**Fig. 2 - ING crude oil forecasts**

|                      | 2019 |     | 2020 |     |     |     |
|----------------------|------|-----|------|-----|-----|-----|
|                      | 3QF  | 4QF | 1QF  | 2QF | 3QF | 4QF |
| ICE Brent (US\$/bbl) | 65   | 68  | 63   | 61  | 65  | 70  |
| NYMEX WTI (US\$/bbl) | 57   | 60  | 56   | 54  | 58  | 63  |

Source: ING

## Norges Bank to keep going against the easing tide?

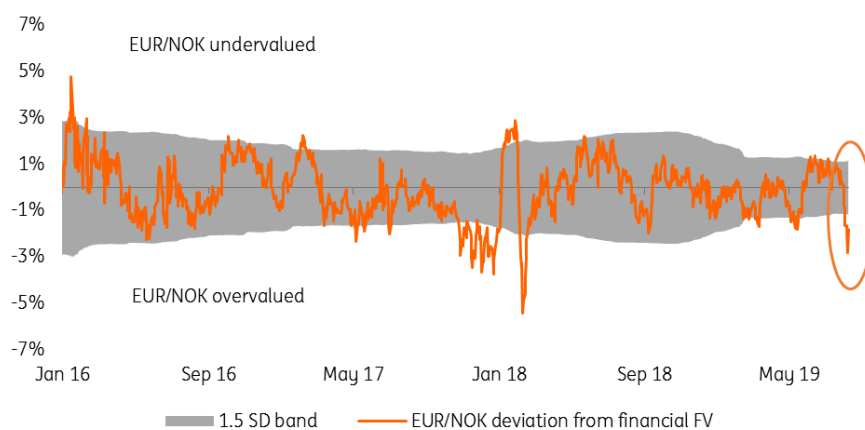
Despite the deteriorating global growth backdrop, the Norwegian central bank has hiked interest rates twice since the start of the year. And while there's a clear risk that trade tensions intensify further, the strong domestic story suggests Norges Bank could hike rates again in the second half of this year.

Despite a decline in oil prices since the June meeting, 2019 oil investment is projected to be the highest since 2015. According to the central bank, cost-cutting measures taken over recent years mean that break-even production costs are substantially below current market prices – ranging between \$10-35 bbl – and this is incentivising firms to lift capital spending. This is contributing to tight conditions in the jobs market, and is translating into higher wage growth.

So it's really a question of "when" rather than "if" when it comes to another Norges Bank rate hike. We have been pencilling in December for the next move, although it looks increasingly likely that it could occur as soon as September. It's worth remembering that while trade tensions have been escalating, this is not exactly a new phenomenon, and has not proven to be a major hurdle to the Norges Bank tightening at previous meetings.

The central bank has a habit of explicitly flagging rate hikes at the meeting prior to the move, so we'll be watching next week's statement for a clearer signal – although given that a lot could still change on trade between now and September, policymakers may choose to keep their options open.

### Fig. 3 - Our financial fair value model shows EUR/NOK overvaluation



Source: ING

We are reluctant to bet on the end of the NOK downturn just yet. The high beta to swings in risk sentiment still suggests downside risk if trade tensions ramp up further (as we are inclined to believe). In addition, uncertainty about the oil outlook in the short-term is unlikely to revive appetite for the krone just yet, with most hopes currently resting on Saudi's reported pledge to halt the decline in prices. This suggests that it will be mostly up to the Norges Bank and its determination to stick to its hawkish stance to put a solid floor under NOK.

All in all, we expect EUR/NOK to have limited downside potential in the short-term and we definitely don't exclude the pair advancing further in the 10.00 area, possibly exploring the 10.20/10.30 region. Nonetheless, our financial fair value model suggests that EUR/NOK has moved into deep overvaluation territory (Fig. 3), currently displaying almost 2% of risk premium that was last seen at the beginning of 2018. This may hint at a quick downward correction in the pair as soon as the twin negatives of trade and oil dissipate. The possibility of the European Central Bank delivering a substantial easing package in September should further assist such correction. In the meantime, we see NOK holding its ground relatively better against other risk-sensitive currencies such as SEK, AUD and NZD. In the longer-term, we remain of the view that a rebound in risk sentiment and supported oil prices towards the end of the year will pave the way for a steady recovery in the krone across the board.

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# China: Exports better than expected with unusual jump in some items

China's exports were better than expected in July, even seeing positive growth. But we found some unusual export activity, which may have distorted the headline number



Source: Shutterstock

## China's export turnaround is puzzling

China's exports jumped 3.3% year-on-year in July from -1.3% a month ago. But the devil is in the detail.

Unusual items appeared to be very supportive to exports. China exported more coal (64% month-on-month), which could be due to a surplus in coal mining, as well as more fertiliser (42% MoM). It even exported more crude oil (56% MoM), which is very unusual because China's crude exports had fallen 61.8% YoY year-to-date.

It is possible that these exports are going to the Belt and Road economies which, if true, could be the start of a new trend for China's exports.

The more typical export items put in a fairly average performance. Handsets grew 9% MoM but were down 15.8% YoY YTD and auto-process computers fell 8.0% MoM. Combining the two, we don't hold a very positive view of China's exports because these two items usually comprise much of the growth.

## August number could be good due to front-running tariffs, again

As there will be 10% tariffs on \$300 billion of Chinese exports to the US effective on 1 September, there will be some front-running export activities in August to avoid the tariffs.

But this factor is a one-off, so for the rest of the year, we expect China's export volume to shrink due to the escalation of the trade war.

## Weaker yuan won't create currency war

Though the People's Bank of China has allowed the USD/CNY to cross the 7.0 handle, this is not the beginning of a currency war. Other Asian export economies' currencies will weaken, together with the yuan. The relative change in the exchange rate among Asian currencies should be very small, in our view.

## Small scale depreciation of the yuan won't help export

As we have argued, if Chinese exporters lose orders due to tariffs rising from 10% to 25%, it is difficult to see how they could benefit from a weaker yuan.

We suspect that more exporters will move away from the US market to Europe and the domestic market to avoid the tariffs.

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Opinion | 8 August 2019

## 3 Central banks cut 110bp yesterday - who's next?

It's all kicking off in Central Bank space with three cuts yesterday from the Bank of Thailand, Reserve Bank of India and the Reserve Bank of New Zealand. Pressure must be building on BSP Governor, Diokno, to deliver more than 25bp today, and the ECB too after dreadful German production figures raise spectre of recession. The Fed won't be far behind...



### But is this actually good news?

Yesterday could hardly be described as "yet another day in the office".

We started off being surprised by the RBNZ move. I think it is fair to say that no-one saw 50bp of

easing coming. We were even thinking of chopping our rate cut call altogether - [here is our longer view](#). We then moved on to disappointment, [that the RBI did not pause, mixed with bemusement at the 35bp easing](#). I love the tweet from Lorcan Roche Kelly (see below) which offers an excellent if tongue in cheek answer as to why this odd number.

We switched to elation later on, as [the Bank of Thailand finally delivered 25bp of easing](#), and was probably the only move of the day that was fully justified. I might add, it would not have upset us to see 50bp of easing from the BoT, nothing from the RBI and only 25bp from the RBNZ - that is, if our job was to forecast what central banks "should" do (we do stray into that territory from time to time), not what they will do.

## BSP today - 25 or 50bp?

Yesterday's CB action puts pressure on Philippine Central Bank Governor Diokno to deliver more than the 25bp of easing priced in by markets. He has already suggested that there will be 50bp of easing before the year-end. but that view may have lengthened after yesterday.

The main thing that may dissuade him would be the PHP, which has been in the vanguard of EM currencies hit by recent market turmoil kicked off by China's relinquishing of the USDCNY 7 level. So 25bp is the more likely outcome, but let's not rule anything out. [See Nicholas Mapa's thoughts following recent Philippine inflation figures](#). GDP data out this morning may add to the debate if they come in on the weaker side.

## Will the Fed get in on the action?

It seems that all this rate-cutting is making President Trump jealous he does not have such an acquiescent central bank. Well, we think he does, he just needs to be a bit more patient. James Knightley has just added another cut from the Fed to our house forecast - that's on top of the September cut we had in before. Just for the record, they have already finished quantitative "tightening" though the term is a horrible misnomer. No time for a rant on that today - and it's only a few days since I last let rip on this subject too.

## I told you commodities were looking miserable

While I am peppering today's note with tweets, I might as well add one from our Head of Commodity Strategy, Warren Patterson, who more eloquently summed up my clumsy observations on commodities in yesterday's note with this simple tweet...

## Back to the matter in hand

This has rather taken me off track from whether any of this is good news or not. Equities have bounced a bit overnight, though in Asia the futures markets look a bit mixed. Good, I think that for once, this is an appropriate response. Yes the prospect of further easing does help the discounted cash flow calculations for equity valuation purposes, but it only makes sense to rally every time a central bank hikes if you don't change your earnings outlook, and that is the point that Warren's commodity chart is screaming loud and clear - the global demand backdrop is clearly slowing.

As for whether it makes sense to front-run or over-deliver on monetary easing - there are many conflicting arguments here, and the answer is partly dependent on what you think the demand outlook really is, the prevailing very low level of interest rates and bond yields, and the absence of

much fiscal support. We could spend all day on this, which really means - it isn't obvious.

## ECB?

It won't surprise anyone that we are looking for a return to incremental easing from the ECB in September. Yesterday saw some squalid production figures from Germany that suggest GDP growth may have now turned negative. This may not be the time for half-hearted measures.

But with all this monetary easing going on, the principle currency pair - EURUSD, seems relatively stable at about 1.12. If this was a tug-of-war between the ECB and Fed, they both seem fairly evenly matched right now. Currency wars really are a zero-sum game.

## Asia today

Two other main events to watch today - both of them China-related:

1. Yesterday's CNY fix at 6.9996 indicates that we should expect a 7 - something fix today. That would be the first in a very long time, so watch out for the market reaction to that. Hopefully quite modest.
2. Chinese Trade data - Exports figures could look quite soft, and of course, this is pre-new tariffs, so whatever we see today, might not mark the low point.

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