

## In case you missed it: Rocky road ahead

OPEC and Russia agree to cut oil production, US firms are beginning to feel the pinch, Belgium's government is on the edge and after a decade of negotiations the Swiss snub the EU risking financial sanctions. Plus, we bring you some of the best-and-worst-case scenarios for the global economy next year

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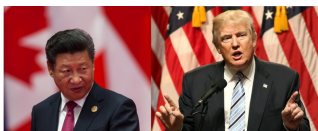
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Article | 6 December 2018

# 2019: The best of times, the worst of times

As we look ahead to 2019, we're hoping for the best and preparing for the worst. Our base case calls for a slowdown in economic growth. But with so much being driven by political posturing, we'll admit, anything is possible. So here's a look at some of the best- and worst-case scenarios for the global economy next year



In this list, we look at some possible outcomes-- both positive and negative-- for the most important themes of the year, including Brexit, the US expansion, global trade problems and the eurozone economy. While we don't consider these to be the most likely outcomes, they're not farfetched either and we can't afford to ignore them. P.S. if this isn't bleak enough for you, we also did a piece with [some pitch-black scenarios just for the eurozone](#).

## 📌 UK: A 'no deal Brexit'

Fears are growing that the UK could crash out of Europe on WTO terms – and it's not hard to see why. With 29 March enshrined in UK law as the Brexit date, 'no deal' is the default position unless a majority can be found for an alternative in Parliament, be that an election/second referendum

(which would require the exit date to be pushed back), or some kind of tweaked deal. If no alternative can be found, the UK will abruptly leave the EU's single market and customs arrangements, and **a UK recession would be highly likely**. Lengthy queues would likely form at major ports, with or without fresh checks being implemented at European ports, given the British logistics industry is already operating at full capacity. Given that the UK imports 40% of its food, the worst case scenario could see shortages of produce. Britain won't quite starve but in this 'no deal' scenario, the Bank of England has indicated that policy rates could go either way – although the likely sharp hit to confidence makes a cut (or more QE) in our view, much more likely than a hike.

## ↑ UK: Changes its mind after all

With no majority for any kind of Brexit in Parliament, calls for a second referendum are growing, although it will inevitably face challenges. Firstly, the bulk of Conservative MPs are unlikely to vote in favour of one, and there's no guarantee many opposition Labour MPs would either. But if enough support is found for a second vote, then the legislative process means it could take several months to arrange (the [LSE estimates](#) at least five to six months, if everything goes smoothly). This would almost certainly require the two-year Article 50 period to be extended. There is also a lot of debate about what the question would be – would it be May's deal vs. No deal, or May's deal vs Remain, or a combination of all three? That debate could take some time, and either way, it's worth noting that the polls are still fairly neck-and-neck, with Remain slightly out in front.

## ↓ US: Debt doomsday

Higher US interest rates are already starting to bite with housing activity slowing. There are also worries about the investment backdrop while intensifying trade worries could hurt sentiment even further. Should US-China relations worsen markedly there is the possibility that China could use the US's deteriorating fiscal position and the fact the Federal Reserve is running down its balance sheet as a way of fighting back against the Trump administration. China holds 20% of US Treasuries and while it won't sell those Treasuries, it could choose not to turn up at future Treasury auctions. Given that China is typically such a huge buyer, this could mean a failed auction. The result could be a spike in yields, which would have ramifications for US equities and by extension, the US economy. Escalating geopolitical tensions would be bad news for everyone, and safe havens such as gold, the Swiss Franc and the US dollar would be sought after.

## ↑ US: The long boom

The US economy has had a fantastic 2018 and while there are clearly headwinds from tighter monetary conditions and protectionism, there is still a fair chance the US can maintain its momentum. The upside would most likely come from an acceleration in wage increases. Surveys suggest firms are struggling to recruit staff with the right skill sets and compensation is consequently rising. Average hourly earnings are already running above 3% year-on-year and are set to rise further. With more money in their pockets, consumers would continue spending and if President Trump succeeds with a bi-partisan push on infrastructure investment spending, growth could confound expectations. In addition, any thawing of trade tensions would be a major boon. This would support equity markets and keep the Federal Reserve hiking interest rates for longer, meaning additional gains for the dollar.

## **Global trade: End of the ceasefire**

Following the G20 meetings, China has joined the EU in negotiating with the US to try to avoid further tariff increases. In China's case, the deadline for reaching results in the talks is 1 March. By then, negotiators are tasked with finding some common ground on issues which have remained some of the most intractable in international trade, including technology transfer. If the negotiations fail, tariffs will increase by a further 15 percentage points on the \$200 billion package of Chinese goods that has already seen 10 percentage point increases. The remainder of US-China trade will then also become subject to tariffs. At the same time, trade negotiations between the US and EU officially begin in January, after the EU Council has given its formal agreement. Alongside negotiations on tariffs, the talks aim to enhance regulatory co-operation in selected industries and reduce trade barriers more generally. The talks, however, are overshadowed by a Section 232 investigation report finding that imports of cars and parts present a threat to US national security. This would clear the way for tariff increases on these products, ramping up the pressure on the EU-US talks.

## **Global trade: Agreements and access**

The threat of trade barriers has prompted firms to re-assess their supply chains during 2018. Both the US and the EU are pressing for better market access for their firms in China in different ways. In contrast to the looming deadline in the US-China talks, negotiations on an EU China investment agreement have been ongoing since 2014, and this year, they dealt with the crucial issue of market access for the first time. Reaching an agreement in 2019 will be challenging, but should be possible given the political will to signal both parties' commitment to openness, as well as the increased appeal of investing outside the US. Physical and digital infrastructure facilitating trade between the EU and China is also being improved under the Belt and Road Initiative. Firms in the EU can engage more confidently with the BRI now that the EU has finalised its own complementary strategy for connecting Europe and Asia.

## **Eurozone: European elections cause a new vacuum**

The European Elections in May could bring bigger gains for the anti-EU parties than expected. If 2019 marks more losses for parties in the political centre, this would reduce the appetite for further integration or reforms.

Investors were relieved in 2017 after the election of French President Emmanuel Macron, with a long lull in the markets with regards to euro-risk. But with Macron's popularity now at rock-bottom levels, German Chancellor Angela Merkel stepping down and the Italian government continuing its collision course with the European Commission, the entire eurozone could get caught in a new wave of uncertainty. It is not unimaginable that concerns about the strength of the monetary union return with a vengeance and weigh on investment and consumption as the economy slows more significantly than already thought.

## **Eurozone: A second wind**

While all the focus is on limiting the impact from downside risks, it could well be that none of these actually materialise. If the Withdrawal Agreement for Brexit is signed, a transition period will follow in which trade is not impacted. A fudge over the Italian budget could be found, with Italy reducing spending and the Commission therefore not starting an excessive deficit procedure. The truce between the EU and US on trade could continue, which would make for a much sunnier scenario

that boosts confidence. This would then result in higher investment, given that capacity utilisation is still high and new hires are hard to get. The eurozone economy could then see growth rates of above 2% again as some delayed investment and spending boosts growth materially. As a consequence, wage growth would accelerate in the first half of 2019, pushing core inflation closer to 2% and forcing the ECB to hike the deposit and refi rate in September and the refi rate once again in December. With possibly a more hawkish ECB president in place – dare we say Germany's Jens Weidmann? – this would result in a swift shift towards monetary policy normalisation, causing 10-year yields to rise above 1.5% before year-end.

The list does not end here, there are many global factors likely to have a decisive impact on 2019 global growth. A slowing growth path seems logical given that many major economies are now late cycle, but it does not require an extraordinary scenario for growth to slow much more severely, as can be seen above. Equally, as many of the 2019 risks have not yet materialised, matters could well be resolved, with upside potential for global growth. With our crystal ball hazier than usual this year, it's best to be prepared for all scenarios.

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## US payrolls: Firms feeling the pinch

November payrolls were soft, but this was partly driven by the lack of available workers to hire. Wage pressures are building and will keep core inflation moving higher and the Federal Reserve hiking rates



Source: iStockphoto

US non-farm payrolls rose 155,000 in November versus the 198,000 consensus forecast, and there were a net 12,000 downward revisions to the past two months' data. Manufacturing employment was good, rising 27,000, but services saw slower gains than hoped.

However, markets shouldn't be too disappointed as the fact that there aren't enough workers was almost certainly a major factor. Indeed, the National Federation of Independent Businesses continues to report that the proportion of firms that can't fill the vacancies remains at an all-time high. The rate of jobs growth has accelerated in 2018 to average 206,000 per month versus 182,000 in 2017, but it will slow next year, partly for this very reason.

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*Decent economic momentum means there is little reason to expect a significant drop-off in demand for workers anytime soon but the key question is whether companies can actually find workers. Given the scarcity of available labour, this suggests further upside for wages*

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Conversely, wage pressure will continue to build because of worker shortages. Wage growth rose 0.2% month on month leaving the annual rate of wage growth at 3.1%. Firms are also increasingly having to compete on non-wage benefits with this week's Fed's Beige Book stating that "most Districts noted examples of firms enhancing non-wage benefits, including health benefits, profit-sharing, bonuses, and paid vacation days".

If we round out the numbers, the unemployment rate remains at a 49-year low of 3.7% with underemployment at 7.6%.

In terms of the outlook, decent economic momentum means there is little reason to expect a significant drop-off in demand for workers anytime soon. The key question is whether companies can actually find workers. Given the scarcity of available labour, this suggests further upside for wages.

This will add to inflationary pressures in the US economy and ensure a December interest rate hike from the Fed. There will be more headwinds for growth in 2019, such as the fading fiscal support, strong dollar and protectionism fears, but for now, we continue to predict three further 25bp interest rate increases next year.

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# Eurozone: It's the end of QE as we know it...

...and we will be fine as the European Central Bank is gradually shelving the controversial bond-buying programme



ECB headquarters, Frankfurt

The ECB meeting next week will not only be the last meeting of the year but will also be a historic meeting. It should mark an important step in returning monetary policy to normality. Only, hardly anyone seems to be interested. Thanks to changes in the communication back in June, market participants and ECB watchers have been well prepared for the gradual end of the ECB's net asset purchases. Anything else than the announcement to bring these purchases down to zero by year-end at Thursday's meeting would be a great surprise.

## New macro projections: how low will they go?

The biggest unknown at next week's meeting should be the ECB's latest staff projections and the Governing Council's assessment of the economic situation. Up to now, ECB senior officials have maintained their relatively upbeat take on the eurozone economy, despite a recent and more subtle shift towards putting more emphasis on downside risks. Back in September, the ECB saw GDP growth at 2.0% this year, 1.8% in 2019 and 1.7% in 2020. Headline inflation was expected to come in at 1.7% in all three years. In the meantime, the market consensus has clearly shifted to

the downside.

When analysing the ECB's projections, keep in mind that compared with the September projections, the external assumptions have changed significantly. In particular, the sharp drop in oil prices, in terms of both spot and forward prices, should have boosted GDP growth and lowered the headline inflation forecasts. While the trade-weighted exchange rate has remained broadly stable, long-term interest rates have come down, also inserting some stimulus to GDP growth. Taken together, all changes in the external assumptions could add some 10 basis points to GDP growth and shave off 10 basis points from headline inflation. As regards growth, however, this should be too little to offset the impact from a weak 3Q on 2018 and 2019 growth. Any downward revisions to below 1.6% for 2019 and beyond would, in our view, signal a clear shift towards more pessimism. Finally, the forecast horizon will be extended to 2021. Keep a close eye on the inflation projections for 2021.

## Details on reinvestments and liquidity

During the press conference, ECB President Mario Draghi will probably also be asked questions about details of the reinvestment programme and possible new liquidity injections. The changes to the capital key do not necessarily have to affect the reinvestment programme. As regards new targeted long-term refinancing operations, the discussion within the ECB has already started with an aim to avoid any liquidity shortages. A new TLTRO in the summer of 2019 with a variable interest rate could be a way out but currently comes too early, as it could be perceived as direct support to Italian banks.

## One done but not a lot more to come

With the end of the net asset purchases, at least one unconventional measure should be shelved now. Expectations that the end of QE would lead to surges in bond yields have – so far – been proven wrong. However, let's not forget that there is still a reinvestment programme in place. The ECB's balance sheet will hardly shrink in the coming months. As successful as the transition has been, there will be little time for the ECB to relax. As of next week, all eyes will be on what is coming next.

For the time being, the ECB should keep all its cards close to its chest and stick to the current forward guidance on rates and the reinvestment horizon of at least one year. This keeps all options open for further normalisation and a first rate hike at the end of next year but also for keeping rates at their current level for much longer. However, if things really get nasty, next year's discussions on the timing of the first rate hike could easily morph into discussions on whether the second unconventional measure (negative deposit rates) should be shelved or whether to hike rates at all.

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## 2019 FX Outlook: Peak Dollar

The big question for 2019 is when will global asset markets be released from the stranglehold of high US interest rates and the strong dollar? We think it's too early to be positioning for a turnaround just yet, however, the dollar is significantly overvalued against most currencies, suggesting any new highs are likely to be marginal



Source: Shutterstock

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## Political storm brewing in Belgium

A political crisis has developed in Belgium over its position on the UN migration pact. Will this crisis cause the government to fall? The answer is complex, especially as the next general election is scheduled for next May. We think the election campaign has already begun



Source: Shutterstock

### Will the Prime Minister go to Marrakech?

A UN pact on migration is in negotiations at the UN, and each country must present its position next Monday on 10 December in Marrakech, Morocco.

In September, Prime Minister Charles Michel pledged Belgium would support and sign the pact, and this didn't seem to be a problem for the different parties of the majority back then. But in the last few days, the Flemish nationalist party, who are also his coalition partners have become strongly opposed to signing the pact and believe the Prime Minister can't go to the conference as he doesn't have the support of his government.

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*After this afternoon's vote, we can't rule out that ministers from the NV-A party won't resign, but that is not our base case*

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But the Prime Minister has confirmed he will attend the meeting to defend the position of the Belgian Parliament, which will vote over a motion in favour of the pact this afternoon alongside an interpretative document clarifying the supremacy of the national legislation over the Pact itself - as other countries have also done.

Without the NV-A, the government won't have a majority to adopt the motion at parliament, but other parties, currently in the opposition, are ready to support the motion which means PM Michel could have a majority but not the one he currently has in government, hence the political crisis.

## First deadline: 10 December in Marrakech

After this afternoon's vote, we can't rule out that ministers from the NV-A party won't resign, but that is not our base case.

Even if we don't get a unanimous vote, given the Marrakech meeting is informal, by attending the Prime Minister doesn't commit the Belgian government to the Pact. He can simply go there to defend the parliament's position, which at this stage seems the best compromise. The most likely scenario is that no minister resigns by Monday.

## Second deadline: 19 December in New York

But the pact needs to be approved at the UN session in New York, and the Prime Minister cannot commit without the unanimous agreement of his government. If the N-VA categorically refuses to approve the pact, a few different scenarios arise:

- (i) An internal solution is found, and the pact can be approved while keeping the government in place. Although difficult, given the intransigence of the N-VA, we can't completely rule out this solution. The business community in Flanders has already warned of the negative impact if the government falls. Various reforms launched by the current government have yet to be implemented (changing the profile of unemployment benefits, pension reform, etc.). This could make the N-VA modify its position.
- (ii) If no solution is found, it is likely that the ministers of the NV-A resign. The government could stay in power, but then it will not have a majority in parliament. This situation is rather rare in Belgium but exists in other European countries. It would then be necessary for the government to find one or more alternative majorities to vote on bills. It won't be easy, and the minority government would be paralysed until the general election in May.
- (iii) It is also likely that the entire government resigns and remains in place as a caretaker government until the elections, which limits its ability to do very much.
- (iv) If, in addition to the resignation of the government, the parliament acts its dissolution or if the government falls on motion of mistrust, another majority at the parliament has to be proposed within three days. If not, elections are inevitable and will take place in the 40 next days. The scenario of a new majority seems unlikely and with the next general election taking place in May, it would not have the time to launch new projects.

Similarly, early elections are possible, but there is a low probability. The election campaign would be very short, and it would create a time gap between the federal and regional and European elections (which will be held in May). Also, the last session of parliament is devoted to deciding which articles of the Constitution can be revised by the legislature. However, in the case of

premature dissolution of parliament, no article of the constitution would be revised, which will probably not suit some political parties and in particular the N-VA.

## Bottom line

At this point, we think the government will manage to stick around until 19 December. But after that, either the N-VA will find a solution, driven in particular by the need to complete the reform package launched so far and by the willingness to launch another State reform over the next legislature. If no solution is found, a minority government would set up, with little room for manoeuvre but early elections are still unlikely at this stage.

For now, we don't expect any major impact on economic growth, given that the next elections are scheduled for May 2019, it was unlikely that the government would embark on new initiatives.

**Note: Given the constant evolution of the political positions of parties, this analysis is subject to updates.**

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## Soybeans: How much is “substantial”?

The soybean market was eagerly awaiting the outcome of trade talks between China and the US at the G20 summit, and discussions were constructive with the two nations suspending any new trade tariffs. However, until China lifts tariffs on US soybeans, upside to CBOT prices should be limited



### What was agreed?

Trade talks between China and the US appeared to go better than many in the market were expecting, evident in the strength that we have seen across the commodities complex today. According to a White House statement, both nations will refrain from implementing any additional tariffs for a 90-day period, while they try to come to a deal. Failing to do so would mean that US tariffs on Chinese goods would increase from 10% to 25%, an increase that was planned to come into force on 1 January 2019.

Specifically for the soybeans market, the White House statement does say that China agreed to buy a “substantial” amount of US agricultural products from US farmers immediately. However there was no mention of what “substantial” means, whilst the Chinese statement does not specify what specific goods they agreed to purchase, and under what timeframe.

### Chinese tariffs remain on US soybeans

While trade talks were constructive, it is important to remember that Chinese tariffs on US

soybeans still remain in place. The tariff remains at 25%, which means at the moment, particularly after the rally in CBOT soybeans, that Brazil still remains a more cost-effective origin for buyers. The import arbitrage for Brazilian soybeans is still open, whilst for US soybeans it remains shut.

Furthermore, sentiment following developments over the weekend may weigh on Brazilian cash values, whilst propping up US cash values, and if this is the case it should further support the view that Chinese buyers will continue to favour Brazilian soybeans from a landed cost point of view.

We believe that China will only return as a “substantial” buyer of US soybeans if and when the 25% import tariff is removed, up until then we would expect the US to be a marginal supplier of beans to China.

The other alternative is that the government puts pressure on state enterprises to start increasing purchases of US soybeans.

## Brazilian cash values could come under further pressure with a US/China deal (USc/bu)

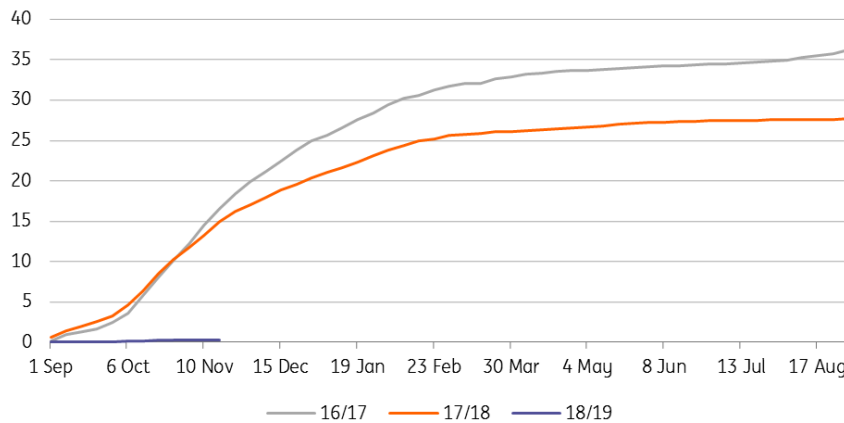


Source: Commodity3, Bloomberg, ING Research

## Don't forget about seasonality

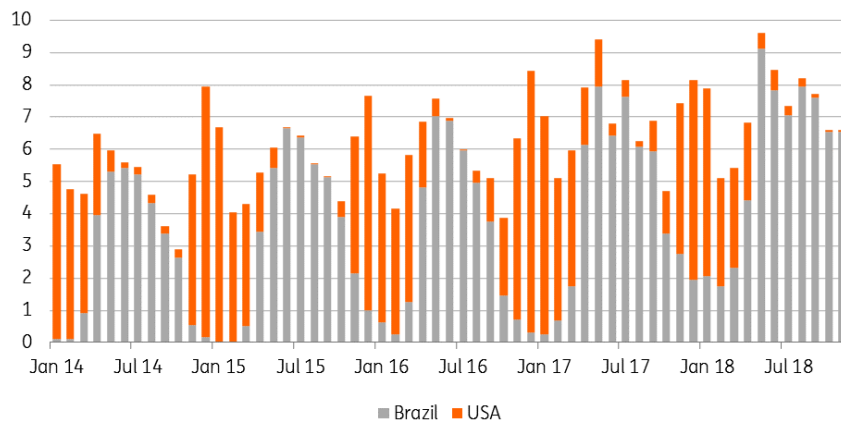
In the coming weeks and months the market will be watching closely US export volumes to China, to see what exactly “substantial” means. We would suggest to largely ignore any WoW or MoM comparisons, given that we are in the peak of US supply, and the low point of Brazilian supply, and so naturally US export volumes should pick up. The key is to focus on the YoY changes, and in our view given the closed import arb for US soybeans, Chinese buyers will continue to minimise US purchases as much as possible. In the 2017/18 marketing year, at this stage, China had imported 14.98mt of US soybeans, which was down from 16.61mt in the 2016/17 marketing year. However so far in the 2018/19 marketing year (starting 1 September), cumulative exports over the same time period total just 339kt.

## Cumulative US soybean export sales to China (m tonnes)



Source: USDA, ING Research

## Chinese imports of soybeans from Brazil and the US (m tonnes)



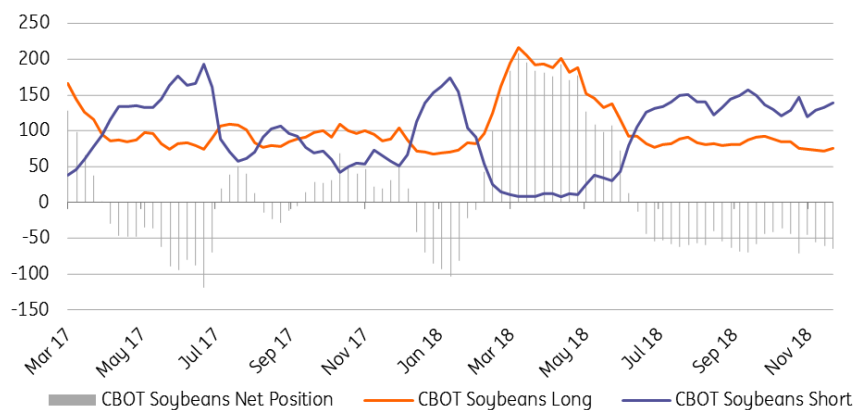
Source: China Customs, Bloomberg, ING Research

## Will spec longs return?

We are likely to see some short covering from the headlines over the weekend, while the fact that China and the US have agreed to suspend further action is positive for sentiment. However, fundamentally for the soybean market, as things stand, nothing has changed. Therefore, any significant speculative buying will likely be short-lived.

As of 27 November, speculators hold a net short of 63,862 lots in CBOT soybeans, and have in fact held a net short of around this level since early July. There is a significant gross short in the market, with shorts totalling 139,235 lots, and therefore this does leave the market vulnerable to an aggressive short covering rally. This is obviously dependent on an appropriate catalyst, such as the removal of tariffs on US soybeans.

## Speculators still hold a sizeable gross short in CBOT soybeans (000 lots)



Source: CFTC, Bloomberg, ING Research

## African swine fever outbreak in China

The other issue for the market is whether there will be strong consumer demand for soybean products moving forward. China is currently going through an outbreak of African Swine Fever, which has seen around 600k hogs culled according to government data. However these numbers are several weeks old, and so the actual number is likely to be quite a bit higher. While this seems like a significant amount, it represents only 0.2% of the total Chinese hog count. Therefore as things stand, it is unlikely that the outbreak will have a significant impact on soybean demand.

The bigger downside risk, is if we do start to see protein content falling in animal feed. The government lower required content levels previously as a result of trade tensions between the US and China.

## What does this all mean for US plantings in 2019?

US farmers still lack the clarity to make proper planting decisions for 2019. Given the loss of China as a key buyer, inventories have been building up in the US this season. Farmers are set to harvest a record 125mt crop, yet cumulative export sales come in at 11.92mt, down 44% YoY. This clearly sent the signal that farmers should reduce soybean area when it comes to 2019 plantings, and this is what the market is largely expecting. However if trade talks between China and the US are progressing in the right direction could this change?

We don't believe farmers will risk it, they will already be in the early stages of making planting decisions, and would not want to see a repeat of this season- where there is a significant crop, yet China is not there to purchase the beans. Therefore we would still expect to see farmers increasing corn acreage at the expense of soybeans. A quick resolution though may mean the switch is not as aggressive as initially anticipated.

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## Eurozone: Filibuster on Eurozone reforms continues

Another red-eye meeting of Eurozone finance ministers shows how difficult it is to agree on further Eurozone reforms. Only another existential crisis would speed up the reform efforts - something even the most Europhile experts should not really hope for



Source: Shutterstock

For euro crisis veterans, it was almost a déjà-vu: a red-eye meeting of Eurozone finance ministers with several breaks ending early in the morning with a hard-fought written conclusion.

However, contrary to the heydays of the euro crisis, there was no market opening or debt payment which had increased the urgency to act to a maximum. Instead, the urgency is more of a longer-term nature. Currently, apparently not enough for Eurozone finance ministers to decide on additional bold institutional reforms of the monetary union.

To put last night's Eurogroup meeting into perspective: the latest attempt to revive the discussion of further Eurozone reforms started more than a year ago, was than postponed last December due to a political deadlock in Germany and picked up by the Eurozone government leaders in June this year. Already back then, Eurozone government leaders had agreed to: i) start work on a "roadmap for beginning political negotiations on the European Deposit Insurance Scheme"; ii) the ESM providing "the common backstop to the Single Resolution Fund" and further strengthening of the

ESM; and iii) to discuss “possible instruments for convergence and stabilization in EMU”. Eurozone finance ministers were asked to present their results at next week’s Euro Summit.

## What did they decide last night?

Last night’s meeting yielded the following outcomes:

- **ESM as a financial backstop for bank resolutions, the Single Resolution Fund.**  
Here, finance ministers agreed on the main operational details and an earlier introduction than previously anticipated in case of sufficient progress in risk reductions in the banking sector.
- **The ESM toolkit was strengthened and made more explicit.**  
Here, finance ministers agreed on a more transparent eligibility process for precautionary credit lines (with a strong emphasis to comply with benchmarks of the fiscal rules). Also, ministers intend to introduce collective action clauses by 2022 and stressed the need for a debt sustainability assessment. The idea of possible ex-ante debt restructurings has not disappeared but was kept vague.
- **On banking union,** the Eurogroup announced to start a new high-level working group to work on next steps regarding a European Deposit Insurance Scheme, which in plain English simply means the idea has not been shelved, but it remains a long, complicated process ever to get there.
- **On a Eurozone budget,** the discussion seems to have been the most controversial. Here, the only thing that is clear is that nothing is clear or decided. Instead, finance ministers decided first to escalate it to the level of government leaders to make their minds if to continue or stop the discussions.

## Eurozone reform train keeps on moving

It’s easy to label this morning’s Eurogroup decision as ‘too little, too late’, ‘lacking ambitions’, ‘baby steps’ or the famous ‘kicking the can down the road’ as the result of more than another year of endless and cumbersome negotiations is a meagre shadow of original ambitions, voiced by numberless reports of many presidents, experts and also French President Emmanuel Macron.

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*In our view, to make the Eurozone fully-sustainable, there should be a fully-functioning and integrated Eurozone capital and financial market, which would require a European bank deposit insurance scheme and better instruments for macro stabilisation*

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The list of “unfinished business” is clearly longer than the list of achievements. Nevertheless, let’s not forget that compared with ten years ago, the Eurozone’s institutional set-up is now much more crisis-resistant. Who, back then, could have imagined a Eurozone bailout fund, a single European Bank Supervisor, a Single Bank Resolution Fund with a financial backstop, the ECB as a lender of last resort and somewhat closer policy coordination and stricter control by the European Commission? Against this background, last night’s decisions were indeed again a small step into the right direction.

Nevertheless, the current set-up remains suboptimal as it does not entirely eliminate a subliminal break-up risk and therefore does not exploit the full economic benefits of a monetary union.

In our view, to make the Eurozone fully-sustainable, there should be a fully-functioning and integrated Eurozone capital and financial market, which indeed would require a European bank deposit insurance scheme and better instruments for macro stabilisation. As regards the latter, one can think of a Eurozone budget or more flexible fiscal rules but also of common tax or social security systems. In short, more economic risk sharing without necessarily creating new permanent transfers.

To sum up, the Eurozone reform train keeps on moving. Admittedly, rather at a snail's pace than at high speed, but it is moving. The reform project is highly technical and politically hard to sell as it will probably not win a single vote at elections, which explains widely-spread filibustering.

Probably only another existential crisis of the Eurozone would speed up the reform efforts. Something even the most Europhile experts should not really hope for.

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## G20: Don't cry victory yet

The ceasefire between the world's largest trading nations is positive because the signals coming from the preceding negotiations were rather pessimistic. The ceasefire means that the planned elevation of import tariffs by the US are off for the next three months. But there is a long way to go before there is a real deal



Source: Shutterstock

### Little time for a deal

Although the deal between China and the US is mainly a question of buying time, China has committed itself to import more industrial, agricultural products and energy from the US.

If President Trump is consistent in his demands, the reduction of the bilateral trade deficit has to be more than China's offer of US\$70bn last spring, which was not good enough for Trump. Trump has demanded a halving of the deficit, which means a reduction of US\$190bn. It is not clear how far China is prepared to go.

Another reason to wait before cheering the end of the trade war is that 90 days to work out a broad agreement is very short. Especially because the agreement should also encompass a deal on more sensitive issues like the theft of intellectual property and forced technology transfers in joint ventures. Most wide-ranging bilateral trade agreements take years to negotiate.

A positive is that both parties did not say that China's 'Made in China 2025'- strategy will be part of the coming negotiations. This could mean that Trump has accepted that this is a 'no go' for China.

### Uncertainty continues for WTO

On the WTO there is just a commitment to talk about reforms. No steps made on the content side, so it is too early to say whether a deal is possible. Trump will keep the WTO under high pressure by blocking the appointment of judges for the appellate body as long as his demands for reforms

are not met. If there are no new judges before 1 December 2019, it will paralyse the WTO.

This approach fits the strategy that we have seen in all the trade battles that President Trump has started thus far. And it means that the closer we get to the December deadline, the larger the pressure will become on the other countries that are more attached to the survival of the WTO, to give in to Trump's demands.

In six months world leaders will discuss the progress of reforming the WTO at their next G20 meeting. Developed nations want China and other large emerging economies to give up their status as 'developing nation' within the WTO and the benefits that come along with it. China is thus far not prepared to give in. Once again, China faces a difficult choice in the months to come: does it want to call President Trump's bluff and risk that the US paralyse the WTO? Or will China compromise to save the international guard dog of trade, an institution that watches over a framework that helped China, like many other countries, to increase living standards of its people

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## Russia 2019: Risk-averse mode

With persistent external uncertainties, we expect Russian consumers and corporates to remain risk-averse in 2019. Any monetary stimulus is unlikely given the mounting inflationary risks, while the budget could be used as a tool to support growth. We remain constructive on the rouble and rates while acknowledging there are external risks to this view



# 1.0%

2019 GDP growth - ING Forecast

Versus the 1.6% forecast for 2018

### Little confidence in income growth puts pressure on consumption

We see GDP growth slowing from our already modest forecast of 1.6% in 2018 to 1.0% for 2019, primarily due to weakening household consumption. The income fundamentals are still rather strong, with unemployment close to the lows of 4.5 - 5.0% and real wage growth still in the mid-single digit range.

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*The current slowdown in household consumption growth doesn't reflect declining income, but a somewhat higher preference for savings*

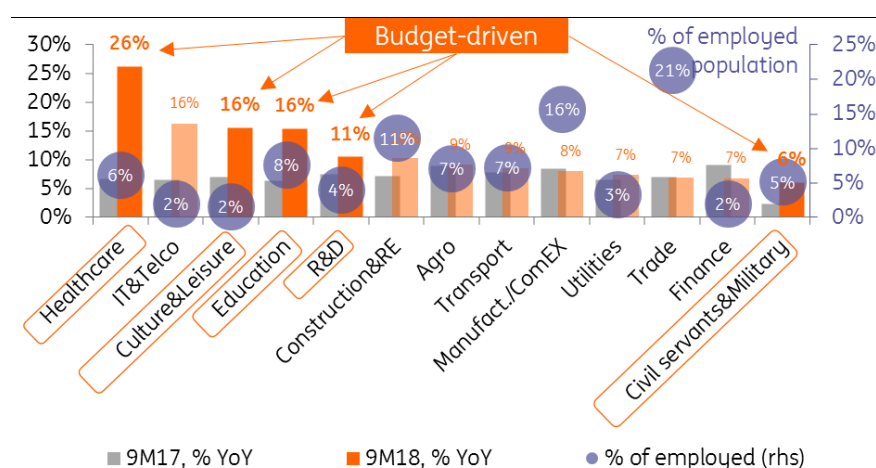
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However, this doesn't translate into higher consumer confidence because only 25% out of Russia's

73 million employees see an acceleration in the salary growth, which is mostly budget-driven. The increase in consumer confidence is limited as the electoral cycle is over too. The remaining 75% of employees (except IT and telecommunications, which account for 2% of Russia's employees) don't see faster salary growth and are instead focused on accelerating inflation, upcoming VAT rate hike and increase in the retirement age.

The silver lining in this reality is that the current slowdown in household consumption growth from 2.5% in 2018F to 1.0% in 2019F doesn't reflect declining income, but a somewhat higher preference for savings - making future improvements in the consumption trend a matter of confidence.

## Nominal salary growth by sector



Source: State Statistics Service, ING

## Investment demand doesn't appear broad-based

We see investment growth also slowing down from 3.0% in 2018F to 1.5% in 2019F as large investment projects related to the World Cup are completed. The pipeline of government-sponsored investment projects for the next six years totals around RUB six trillion including three trillion financed from the budget directly, which means less than 1% of GDP per year.

Demand for borrowed funds, which is driven by non-state sectors, seems to be limited. In 2017-18, the rise in the corporates' debt burden made up RUB 1.3 - 1.5 trillion per year against RUB 3 - 6 trillion in 2011-13. Some acceleration in the local corporate loan growth to around 6% YoY seen in 2018 reflects substitution of the foreign debt.

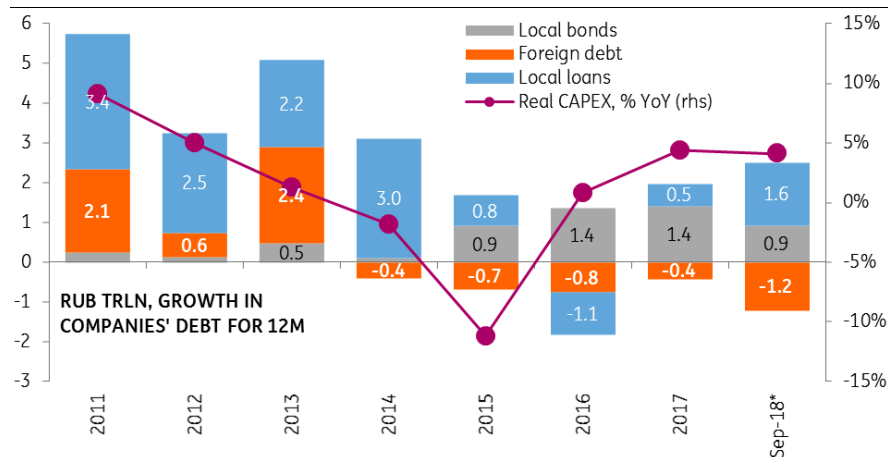
*We see investment growth also slowing down as large investment projects related to the World Cup are completed*

The quality of corporate loan growth is raising questions, as with the exception for transport and telcos (7% of portfolio), pick up in local corporate lending is driven by sectors with high NPL/leverage (construction, trade, agriculture - 24% of portfolio) or is unidentifiable (other, 21% of portfolio). Sectors with the highest quality (industrials, 41% of portfolio) are either deleveraging (oil

exporters) or showing merely stable demand for local loans.

## Companies' debt burden and fixed investment

\* Last data point (September 2018) reflects 12-month trailing debt burden growth and 9M18 fixed investments growth



Source: State Statistics Service, Bank of Russia, ING

63-66

USD/RUB range for 2019

Based on BoP fundamentals

## Balance of payments favors stronger rouble at year end

Although limited investment demand and persisting sanctions predetermine continued corporate foreign debt redemption, under the house view of Urals crude oil at around \$65/bbl, we see current account surplus as sizeable enough to finance \$10-12 billion in quarterly FX interventions and \$8-11 billion in the expected quarterly net capital outflow.

*Overall, we see the rouble less vulnerable to oil price developments than to emerging market portfolio flows*

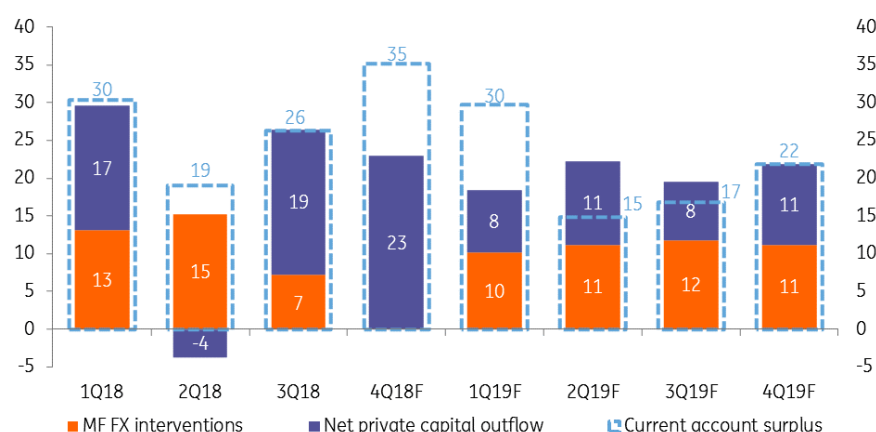
In that respect, the recent indication by the central bank that FX purchases might resume in January 2019 shouldn't prevent rouble appreciation from the current levels, especially given that the current account surplus in 4Q18F and 1Q19F is \$30-35 billion, providing an extra FX cushion. Combined with the moderately positive mood in the emerging market space, supported by doubts in aggressive Fed tightening and a ceasefire in the US-China trade conflict, this sets the stage for a stronger rouble at least in the coming months. Overall, we see the rouble less vulnerable to oil price developments than to emerging market portfolio flows.

That said, the possible deterioration in the portfolio flows due to tightening in Ukraine-related

sanctions or escalation in the US-China trade conflict not yet priced in by the market poses an obvious downside risk to our view.

Non-residents are holding USD 27 billion worth of local state bonds (OFZ). In the case of new sanctions, they can reduce their positions by up to 30% as it happened in 2014. Each USD 5 billion of extra capital outflows correspond to the weaker fair value of the rouble by 1USD/RUB, but the short-term market reaction can be sharper. The \$9 billion portfolio outflow from OFZ in April-October, which was driven by general emerging market risk-off, has resulted in almost RUB9/USD depreciation and around 150 basis points increase in benchmark long-term bond yields.

## Quartely balance of payments (2019F Urals at \$64-67/bbl)



Source: Bank of Russia, Finance Ministry, ING

7.50%

2019 year-end key rate

Subject to risk of upward revision

## Mounting CPI risks make monetary easing unlikely

With 14% year-to-date rouble depreciation, the recent spike in local gasoline prices and the upcoming VAT hike from 18% to 20%, inflation is accelerating from a low base. We see inflation reaching 4.0% by the end of the year and 5.7% YoY by mid-2019 before returning to the 4.5-5.0% YoY range by the end of 2019Y.

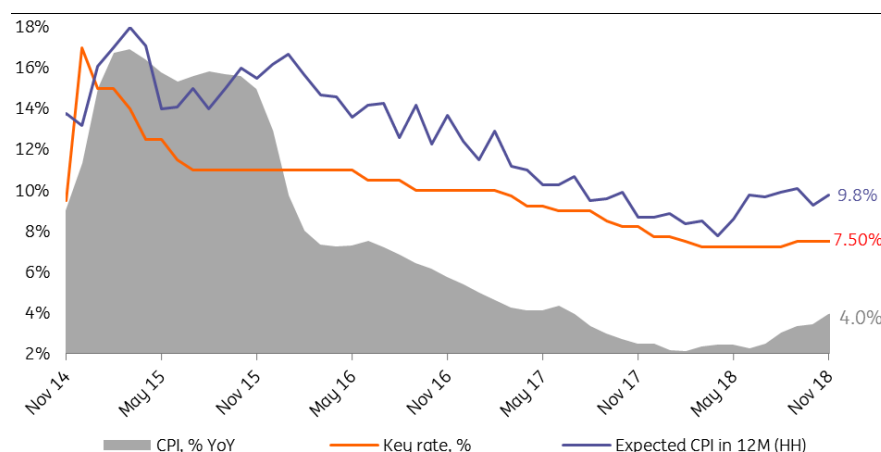
The upcoming spike in the CPI is already accounted for by the central bank and technically doesn't require an additional increase in the key rate, currently at 7.5%. Additional arguments against further hikes in the short term include stabilisation of households' inflationary expectations, freeze in gasoline prices, Russia's comparatively high real rates in the emerging market universe and weakening of the local GDP trend.

At the same time, any easing in monetary policy is definitely out of the question, and the risks to our CPI and key rate views are skewed upwards.

First, if the weekly CPI stays at 0.15 week on week level seen in the last three weeks, then our near-

term inflation forecast will be exceeded, and the YE19 level may hit 4.2%, which is the upper bound of the central target range - a potential trigger for a hike. Second, the sustainability of the gasoline price freeze remains under question, unless some amendments to the fiscal parameters to the oil sector are made. Third, in case of further risk-off towards Russia (USA-China and/or USA-Russia tensions), the rouble can depreciate further, and each 10% rouble depreciation adds up to 0.5-1.0 pp to the CPI trend and could require extra key rate hike.

## CPI, households' expectations, and key rate



Source: State Statistics Service, Bank of Russia, ING

## But the budget does have some scope

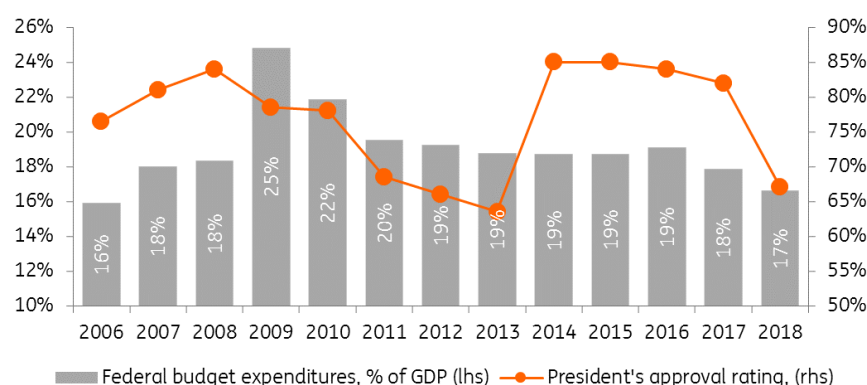
Unlike the monetary policy, the budget policy could potentially be used as a tool to support growth or offset the deterioration of the external environment if it takes place.

Currently, even with the state investment and social projects included, the 2019-2021F budget is drafted very tightly, assuming a 1-2% GDP surplus with the VAT tax hike, higher dividend collection from state companies and a reduction of expenditures to 17% of GDP, a 10-year low, and breakeven Urals has fallen to US\$50/bbl.

Unless the government is successful in reigniting full-scale investment growth (which would be a positive surprise to our outlook), this tight budget policy framework may prove unsustainable, especially if a decline in popular support for the political leadership continues.

A combination of higher than expected spending and some fiscal easing for the oil sector to enable a sustainable freeze in the gasoline prices is possible in 2019. This could lead to pressure to ease the budget rule leading to a halt in accumulation or even net spending of the National Welfare Fund depending on the scale. The effect of any easing on growth is likely to be modest and unlikely to be seen before 2020.

## Federal budget spending and popular support



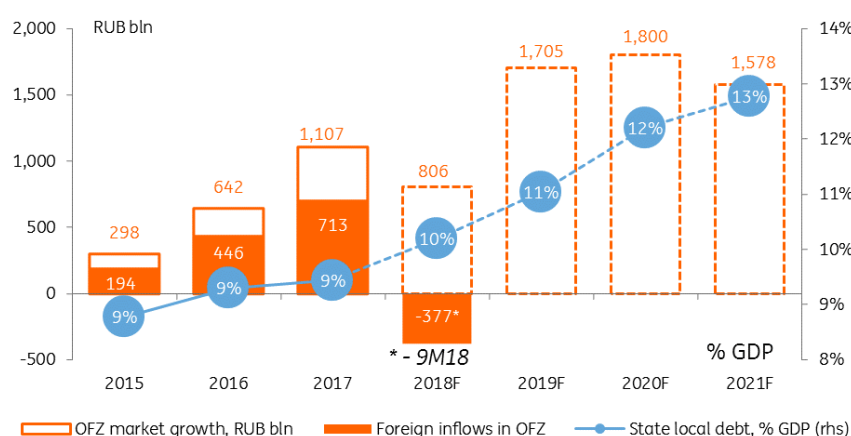
Source: Finance Ministry, Levada Centre, ING

## The local debt placement program can be reduced

The persisting uncertainty regarding sanctions and emerging market risk sentiment creates risks for the local bond market, as foreign capital accounted for two-thirds of the growth in the rouble state bond (OFZ) market in 2015-17. This process was supported by Russia's macro stability combined with expectations of the rouble's recovery and monetary policy easing amid favourable global sentiment towards EM risk. This trend broke in 2018, casting a shadow on the Ministry of Finance's significant RUB 1.6-1.8 per annum net OFZ placement programme for 2019-21F.

We believe local banks, holding RUB 3 trillion of liquidity, could partially offset the outgoing non-residents. Also, the programme could be reduced if USD/RUB is weaker than the drafted 64 (by RUB1.2-1.3tr for every RUB10/USD) or if the budget rule is eased (by RUB1.5-1.8tr for every US\$10/bbl increase in cut-off Urals price).

## Local state debt market growth (MinFin's plan) and foreign participation



Source: Finance Ministry, Bank of Russia, ING

[Please find the full overview of our Russia 2019 outlook here](#)

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