

In case you missed it: Self-fulfilling prophecy?

It's been a rollercoaster week, but parliament has yet again rejected Theresa May's deal on the day the UK was meant to leave the EU. In Europe, it seems the ECB is prepping for the new reality of lower interest rates for longer. And the US yield curve inversion has raised fresh concerns about recession risks, but beware of the self-fulfilling prophecy

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What next after PM May's third Brexit defeat

Out of all the options, we think parliament is most likely to rally behind the customs union option in the second round of 'indicative votes' on Monday. But is a general election around the corner?

Our latest Brexit probabilities with market impact

Scenario	Probability (Rough estimates)	Market reaction
Short technical Article 50 extension required for legislation		
May's deal passes before 12 April	15% PM might pit her deal against 'indicative vote' winner – although still hard to see it winning	EUR/GBP: 0.84 GBP/USD: 1.35
Longer Article 50 extension required		
General election	15% No confidence vote could happen again. Some Conservative/DUP MPs must back it	EUR/GBP: 0.94 GBP/USD: 1.20
Different deal (e.g customs union)	25% Indicative votes could ultimately force the government to tweak the deal in Brussels	EUR/GBP: 0.81 GBP/USD: 1.40
Second referendum	20% Gaining traction, although many Labour MPs still object to it, so option still lacks a majority	EUR/GBP: 0.80 GBP/USD: 1.42
No deal on 12 April	20% EU stance is hardening, could happen if Parliament fails to reach agreement on a deal	EUR/GBP: 1.00 GBP/USD: 1.13
Revoke Article 50	5% Could happen if saga goes to the wire. MPs could decide to stop the clock to have rethink	EUR/GBP: 0.75 GBP/USD: 1.50

Source: ING

Theresa May's Brexit deal defeated - yet again!

After a rollercoaster couple of days, UK prime minister Theresa May has failed to convince lawmakers to back her Brexit deal. She did, however, succeed in narrowing the scale of her loss, with a number of Conservative switchers taking the margin of defeat to 58 from 149 a few weeks ago.

Nonetheless, it's hard to escape the conclusion that as things stand, the prime minister's deal in its current form looks finished - although this might not be the last we hear of it.

For now, though, attention is shifting to Monday, where backbench lawmakers will continue the process of 'indicative votes' to try and settle on an alternative Brexit plan.

A customs union is most likely to win Monday's indicative votes

On Monday, lawmakers will get an opportunity to choose between the most popular alternative Brexit proposals that emerged from the first round of 'indicative votes' on Wednesday. There still seems to be a bit of a debate about the exact process, although, by the sounds of it, MPs will again be given a piece of paper with the short-listed options, where they will be able to vote "yes" or "no".

The prime minister's deal in its current form looks finished

In theory, a permanent customs union still seems most likely to command majority support. That's because it represents a 'softer' Brexit, but one where freedom of movement doesn't happen. That said, a second referendum did perform surprisingly well in the first round, although if these two options are pitted against one another, we suspect the more pro-Brexit Labour MPs (or rather those who represent Leave-supporting regions) would be more inclined to back the former.

Of course, everybody loves an 'underdog' too, and the so-called 'common market 2.0' option may be just that

Of course, everybody loves an 'underdog' too, and the so-called 'common market 2.0' option may be just that. This proposal - which amounts to joining the single market and customs union after Brexit - saw a high number of abstentions in Wednesday's votes, including by the Democratic Unionist Party (DUP). If these abstainers were to turn into "yes" votes, it could see the option gain traction against the other popular rivals on Monday.

But can any option gain a 'stable majority'?

This is absolutely crucial because unless lawmakers convincingly rally around a particular option, the subsequent approval stages could become harder. The majority will need to survive a meaningful vote on the revised deal, assuming the prime minister returns to Brussels and gets what parliament asks for. Lawmakers will also need to approve all the follow-up legislation before the UK can formally leave the EU.

This is absolutely crucial because unless lawmakers convincingly rally around a particular option, the subsequent approval stages could become harder

The first round of indicative votes failed to generate a majority at all, let alone any that could be classed as stable. However once the options are narrowed down, that could change if lawmakers are prepared to compromise on their first-choice proposals. There is also some talk that MPs may

try to combine the two most popular options, by requesting a customs union tweak, that is then put to the people in a second referendum. The hope is that this could command a sizeable majority, even if the two options cannot do so individually.

Will this just all end in a general election?

Whatever wins, the latest reports suggest the prime minister may attempt to hold a vote which puts her deal against the winner of indicative votes. But if this doesn't happen, or if the government loses this vote to parliament's favoured Brexit alternative, many people are questioning whether a general election would become inevitable. There are two ways we see this coming about.

Firstly, if parliament requests a customs union and Theresa May begrudgingly accepts, eurosceptic Conservative MPs could decide 'enough is enough' and support a vote of no confidence in the government.

Alternatively, PM May could decide an election is preferable to whatever parliament asks her to do - particularly if MPs request a second referendum. For example, this could happen if the prime minister were to face the threat of mass resignations from her cabinet, although don't forget a snap election would require two-thirds of parliament to agree.

It's not clear an election is in anybody's interest at this stage

Both paths are undoubtedly growing more likely, although neither are straightforward. It's also not clear what any of the major parties have to gain from an imminent election. The Conservatives will be reluctant to go to the polls before a new leader is in place, and a leadership contest could take a few months. Labour risks a backlash at the polls from both ends of the party - 'remainers' may be angered if a second referendum isn't in the manifesto, while 'leavers' may be inclined to vote for a party that is perceived to deliver a swifter or harder Brexit.

The Democratic Unionist party, who would be pivotal in a vote of no confidence, could risk losing their seat at the table if either of the big political parties were to win a majority at an election. The newly founded Change UK party, formally known as the Independent Group will take time to develop their election machine.

Throw all that together, and it's not clear an election is in anybody's interest at this stage - and even if it does happen, it's not clear from the polls that a snap election would generate a substantially different result to the current parliamentary formation.

Long extension to Article 50 remains our base case

[While the mood-music in Brussels appears to be turning more hardline](#) when it comes to offering an extension, we suspect parliament will do all it can to avoid a 'no deal'.

To cut a long story short, the most likely scenario in our opinion is, MPs back a softer version of Brexit. If they do, and it is clear there is a stable majority for such an option, then this would likely tick the box for EU to grant a longer extension to the Article 50 period beyond

12 April.

That said, the past few weeks of Brexit have taught us to expect the unexpected, and the next two weeks look set to be anything but plain sailing.

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US: Heading for recession?

The US bond market is seemingly worried about a slowdown. While not our base case, a prolonged inversion of the yield curve runs the risk of becoming a self-fulfilling prophecy through constraining credit



Source: Shutterstock

Markets are spooked

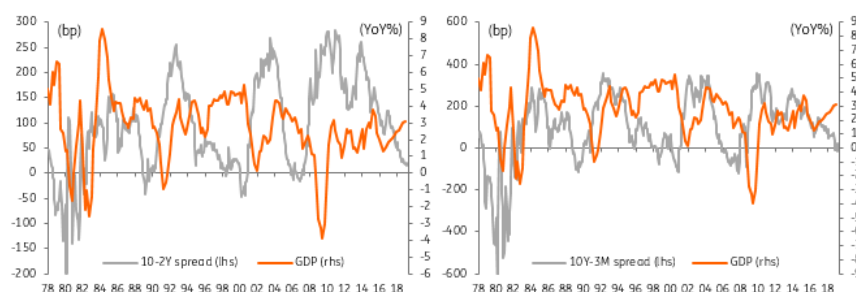
We have regularly written about the headwinds facing the US economy this year, namely the lagged effects of higher interest rates and the stronger dollar, the fading support from the fiscal stimulus, signs of weakness in Europe and Asia and the uncertainty generated by ongoing trade tensions with the rest of the world. Nonetheless, we feel there are still positives that can keep the economy expanding at a decent pace both this year and next.

Longer-dated yields have fallen too with the yield curve having inverted – 3M interest rates are now higher than 10-year bond yields

However, an increasingly dovish sounding Federal Reserve, which last week dropped the two rate hikes its officials had been pencilling in for this year, has contributed to a growing belief their next move will be an interest rate cut. The perception that inflation is not a threat and that a slowdown is coming has prompted futures markets to price more than an 80% chance of a 25 basis point rate cut before the end of 2019 with two full cuts priced by the end of 2020. Longer-dated yields have fallen too with the yield curve having inverted – 3-month interest rates are now higher than 10-

year bond yields. As such, the market appears to be signalling deep concern about the economic outlook.

10Y-3M inversion, but 10-2Y still positive



Source: Macrobond, ING

How worried should we be?

An inverted yield curve has preceded all last nine recessions, so such an event is typically cited as an indicator of impending doom. Indeed, the New York Federal Reserve has a recession indicator based on the 3M-10Y spread, and even before the current inversion the probability of recession was pegged at 24.6%. However, it's important to remember that it has given false signals before and we have to acknowledge the distorting influence of the Federal Reserve's large QE driven balance sheet, which has helped to keep longer-dated Treasury yields low.

There has been some concern about activity in 1Q caused by disruption relating to the government shutdown and trade tensions, but the Atlanta Fed NowGDP model is currently running at 1.2% for 1Q GDP growth versus just 0.2% a couple of weeks ago. As more data comes in, we look for a 1.5-2% outcome for 1Q GDP annualised growth, which wouldn't be too bad given the tendency in recent years for 1Q GDP to disappoint.

We continue to look for US GDP growth more than 2% this year with 2020 growth currently pegged at 1.8%. Such outcomes are likely to be consistent with a re-steepening of the yield curve.

Indeed the current US economic position looks fairly decent. The strong jobs market is resulting in rising worker pay and means consumer confidence is back close to cycle highs. There have also been better retail sales and durable goods orders numbers of late while the ISM reports continue to point to healthy growth rates. Meanwhile, a 60 basis point plunge in the interest rate on a 30-year fixed rate mortgage offers support to the real estate market.

If progress can be made on US-China and US-EU trade talks that can lift some of the gloom surrounding the global economy, we may see markets gradually re-appraise the growth outlook and prospects for inflation. We continue to look for US GDP growth more than 2% this year with 2020 growth currently pegged at 1.8%, broadly in line with the consensus forecast. Such outcomes would likely be consistent with a re-steepening of the yield curve.

ISM indices still point to growth



ISM surveys ask major US companies what they are seeing in terms of output, order, employment, inventories, supplier delivery times and comes up with an aggregate index of performance. #>50 = expansion #<50 = contraction

Source: Macrobond

But beware of the self-fulfilling prophecy...

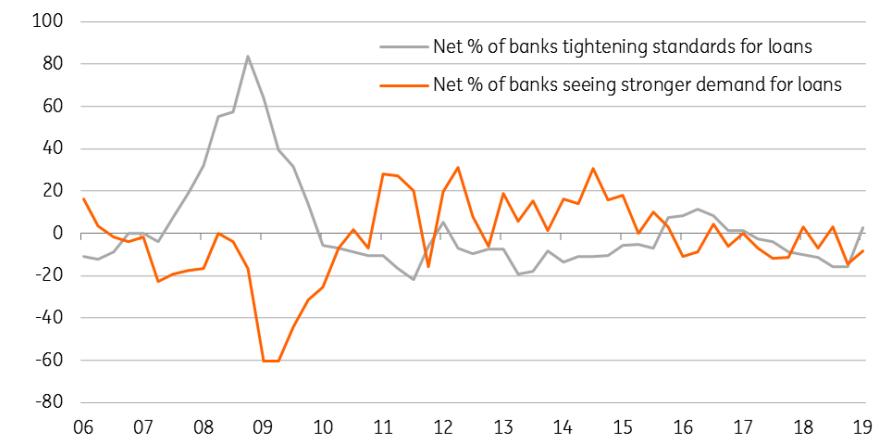
That said, we have to be wary that an inverted yield curve driven by recession fears can potentially be self-fulfilling. Banks typically borrow short term and lend longer term so when the yield curve is inverted, the interest rate received on assets is typically going to be lower than what they pay on their liabilities.

A scenario of much tighter credit conditions would clearly add to the headwinds facing the US economy and heighten the chances of a downturn. It's difficult to see the Fed not eventually bowing to the markets' will and cutting rates in such an environment

This will likely hit profitability and could decrease risk tolerance, which implies tighter lending standards. Indeed, when asking banks about this for the Federal Reserve's Senior Loan Officers report, the write up concluded an inverted yield curve would be interpreted as 'signalling a less favourable or more uncertain economic outlook and likely to be followed by a deterioration in the quality of existing loan portfolio.'

So far there is little evidence that the flattening and subsequent inversion of the yield curve is feeding through into reduced credit availability, but that could change if the inversion persists, and this still isn't our base case given underlying healthy economic fundamentals. A scenario of much tighter credit conditions would clearly add to the headwinds facing the US economy and heighten the chances of a downturn. It's difficult to see the Fed not eventually bowing to the markets' will and cutting rates in such an environment.

Senior Loan Officers survey still suggest widespread credit availability



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China: How opening up the financial sector could affect the yuan

China's Central Bank Governor Yi Gang says there's further room to open up the country's financial sector. But we don't think that includes the capital account, at least not yet. And that has implications for the yuan



Source: Shutterstock

Opening up the financial sector during an economic downturn is rare

At the China Development Forum on Sunday, the governor of the central bank commented that [China's financial sector has room to open further](#).

The content of the speech is rare because China is currently facing a weakening economy. And the central bank or regulators as a whole in China usually adopt a more cautious approach on opening or liberalisation reforms when there is an economic downturn.

Which area of the financial sector does China want to open up?

In fact, areas of the financial sector such as payment platforms and private equity funds have been increasingly open for foreign investments since the 2018 Boao Forum, and we think there will be continuous progress.

Removing red-tape and equalising licensing requirements for domestic and foreign investments in the financial sector are good practices. But as domestic players have dominated the market, it is difficult for foreign companies as a whole to get a meaningful share of the market.

This makes us believe that opening up the financial industry to foreign investment is not really what Yi Gang was referring to.

Reform on the yuan mechanism

The governor touched on the yuan exchange rate mechanism and claimed that the currency has been more flexible.

We agree that the USD/CNY has followed the movements of the dollar index in general, and has sometimes been more volatile than the dollar index.

""The People's Bank has largely phased out regular interventions in the foreign exchange market, and the RMB has become more flexible. Market participants are able to adapt to this increased flexibility.""

Yi Gang, PBoC governor

Capital account in focus

Our view is that allowing the USD/CNY to follow the dollar index is the first stage of exchange rate reform.

The second stage will be opening up the capital account, which will allow capital to flow in and out of China with few restrictions so that the yuan exchange rate can be a genuine free floating currency.

To prepare for the second stage, and with a more liberalised interest rate policy, the governor rightly pointed out that China needs to have more hedging tools to mitigate market risks.

We believe we will indeed see more hedging products for interest rates, exchange rates, equities and bonds, but not necessarily this year. Markets take time to develop meaningful trading depth.

China won't open up capital account while economy is weakening

It is rare for Chinese regulators to talk about market liberalisation during an economic downturn. As such, we believe that the opening up of the capital account, in terms of outflow channels, will not happen this year.

We may see more capital inflows into China via passive funds that follow the MSCI and Bloomberg bond indices but we doubt there will be a further opening up of capital outflows channels, as this would create extra risk to the weakening economy. So the yuan will likely continue to follow the

dollar index but won't be a truly free floating currency until China really opens up its capital account.

This means we may see the yuan appreciate more frequently in 2019, rather than depreciate.

As such, we maintain our forecast of USD/CNY and USD/CNH at 6.75 by end of 2019 from 6.88 at the end of 2018.

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ECB: Never a dull moment

The latest comments from members of the European Central Bank have suddenly given rise to rate cut fantasies. Don't get carried away



Source: Shutterstock

Comments from ECB President Mario Draghi at yesterday's ECB watchers conference have given rise to speculation about further easing, and were followed by further drops in bond yields. In his speech, Draghi said that *"we will continue monitoring how banks can maintain healthy earning conditions while net interest margins are compressed. And, if necessary, we need to reflect on possible measures that can preserve the favourable implications of negative rates for the economy, while mitigating the side effects"*. At the same time, Draghi also added that *"low bank profitability is not an inevitable consequence of negative rates"*. These comments were also echoed by ECB Chief Economist Peter Praet and ECB Vice-President Luis de Guindos and got even more [support from a Reuters story](#), quoting ECB sources that the ECB was investigating several options, including a so-called tiered deposit rate.

To bring or not to bring relief - the long discussion

Let's try to put all these comments and rumours into perspective. The discussion on adverse side-effects on banks from the negative deposit rate is not new but has actually been ongoing for a long while. However, up to now, the ECB has been hesitant to present a clear-cut view or analysis. Press conferences since October last year have seen a kind of back-and-forth on this issue. Up to now, the overwhelming view has always been that negative interest rates have been good for the economy, with hardly any negative effects on banks. The latter part of this view has now started to

shift, even though one should not forget that all targeted longer-term refinancing operations (TLTRO) up to now have been instruments to mitigate adverse side-effects on banks due to the built-in incentives. The discussion on whether there could be more to mitigate had already started in the run up to the March meeting, with speculation on combining new TLTROs with some relief, e.g. through hike(s) of the deposit rate or tiering systems.

This morning, in a recorded interview on Bloomberg TV, Peter Praet hinted that the ECB was indeed looking into possible options to mitigate the side-effects from negative interest rates but that there had to be a monetary policy case to justify any tiering. In our view, this is correct. There are currently much bigger challenges for banks' profitability than the negative deposit rate, and a tiering system will not make an unprofitable bank suddenly profitable. Therefore, the ECB will have to investigate whether the negative deposit rate actually leads to a smaller (or more expensive) supply of loans than a zero deposit rate or a tiering system.

A tiering system? Some thoughts

There are at least four risks, in our view, to introducing a tiering system:

1. It could be perceived as a sign that the ECB is preparing for a “low for much longer” period
2. It could actually complicate the pass-through of monetary policy to the real economy; depending on the technical details of such a system
3. Rapid introduction of a tiering system could be perceived as yet another “free lunch” for the banking sector
4. While a tiering system would open the door to further rate cuts, these cuts would mainly be seen as exchange rate manipulation rather than supporting the bank lending channel

All in all, despite all the market excitement, all of these latest comments should be seen as an attempt by the ECB to demonstrate that it is not running out of ammunition. The most likely next step is still the announcement of the detailed conditions for the third batch of TLTROs (at the June meeting). Introducing a tiering system will be investigated but probably only announced in case the economy has not started to rebound by June. In fact, there is a balancing act between the details of the next TLTROs and a tiering system. The more favourable the conditions of the next TLTROs, the less urgent the need for mitigating measures. Consequently, we expect the ECB to remain rather cautious and not act hastily. Still, one thing is for sure: low interest rates for longer are the new reality.

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Indonesia: Reforms needed for lift-off

Indonesia has seen growth plateau at the 5% range since 2016. After targeting 7% since taking office in 2014, President Jokowi looks to secure a fresh term with the current administration forecasting the fastest pace of growth in the next two years



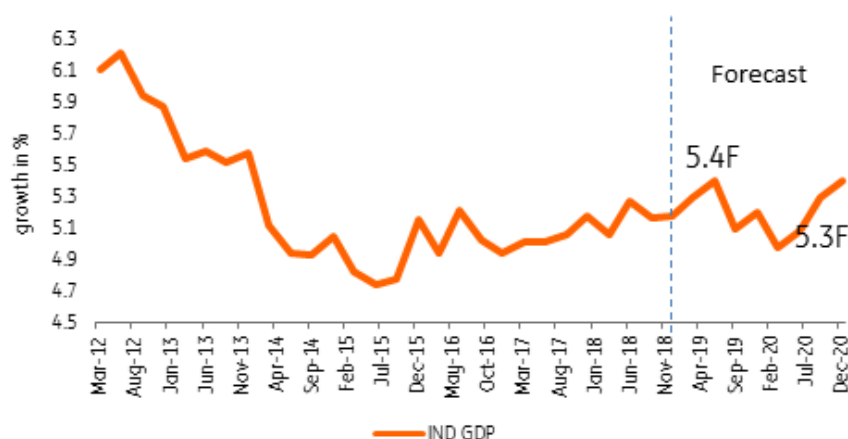
Source: Shutterstock

Recent Growth and outlook: On cruise control with elections ahead

Growth in Indonesia has hovered about the 5% level in recent quarters and given the nation's solid fundamentals will likely keep to this range in the near term. The administration however is now forecasting economic growth to average 5.3% in 2019 and at 5.3-5.5% in 2020 against a backdrop of benign inflation. The elections in April are expected to boost economic growth on the consumption side but more investment and reforms will be needed to achieve lift-off and break free from the 5% level.

Inevitably the growth trajectory will depend largely on the elections, with incumbent Joko Widodo (Jokowi) vowing to continue his infrastructure and investment push while challenger Prabowo Subianto (Prabowo) has pledged to ban imports of agricultural products, lower the reliance on imported oil and reinstate fuel subsidies cut by Jokowi.

Indonesia GDP growth (2010 base year) actual and forecast values



2010 base year

Inflation and outlook: well-behaved and on course to stay within target

Price pressures have been subdued with the basic food component pushing headline inflation closer to the lower-end of the 2.5-4.5% inflation target. Meanwhile, prepared food, beverages, tobacco and utilities were the main contributors to the latest 2.57% inflation reading for February. Meanwhile, core inflation, which strips out some food items as well as government influenced transport and utilities was also well-behaved, settling at 3.06% for the month of February.

One factor that has helped inflation settle at the lower-end of the 2.5-4.5% target has been the ability of Indonesia to import important grains which has ensured adequate supply domestically, something that Prabowo has vowed to cancel should he take power.

On the other hand, Prabowo has also campaigned on a promise to reinstate fuel subsidies and lowering reliance on imported fuel via higher biofuel content, something that would also affect the inflation dynamic should he wrest the presidency from Jokowi. For the time being, inflation is forecast to remain within the lower end of the inflation target with Bank Indonesia (BI) shifting focus to financial market stability over price stability.

Indonesia inflation (in %) actual and forecast values



Source: Bloomberg and ING

Monetary policy and interest rates: BI on hold for now but rate cut now on table

In 2018, Bank Indonesia (BI) unleashed a flurry of rate hikes at the height of the emerging market currency rout, citing the need to establish financial market stability as they looked to steady the Indonesian Rupiah's fall. Governor Warjiyo hiked a total of 6 times in 2018, beginning in May, to bring BI's 7-day reverse repurchase rate to 6.0% by November with the last rate hike catching some market players by surprise. BI had maintained that raising rates aggressively and acting in a "pre-emptive" manner was done in order to maintain the stability of the economy and financial system by keeping financial assets attractive to foreign funds. The ability to keep the IDR stable is in line with the overall government move to keep the current account from ballooning.

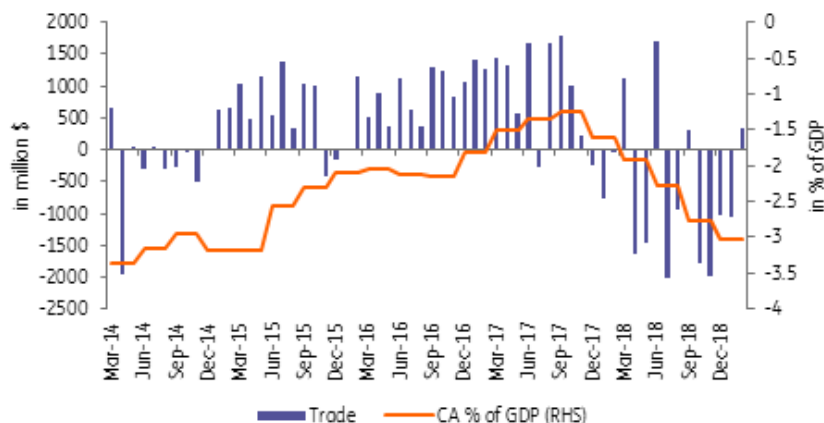
The widening of the trade and current account deficits had been flagged as a major concern for foreign investors and one of the main reasons cited for the flight of capital at the height of the EM rout in 2018. In the coming months, the central bank will remain vigilant to ensure IDR stability, although the Fed's recent reversal in outlook coupled with Governor Warjiyo's comments indicating that he felt rates may be "close to peak" hint at the possibility for a policy reversal in the coming months. Should the IDR remain stable, with an appreciation bias and global market conditions remaining favourable to emerging markets, we believe Warjiyo will be afforded a window to dial back 2018's rate hike salvo to help boost economic growth in an environment of slowing global growth.

Country specific highlight: Narrowing the current account

The twin threats of 2018 - a trade war between the United States and China moving in tandem with a hawkish Federal Reserve - buffeted currencies across emerging markets. The three currencies that had been hit the most were those whose economies ran substantial current account deficits, with the IDR joining the INR and PHP at the back of the line. For the year, Indonesia recorded a current account deficit of 2.98% of GDP, the widest since 2014 as the deficit swelled to \$31.1bn. With the trade gap ballooning to \$8.496bn, Indonesia rolled out several reforms to help boost exports, with incentives and tax perks doled out to exporters while some infrastructure projects requiring substantial imports were postponed in order to achieve import compression.

Indonesia is now targeting a current account deficit of 2.5% of GDP which should alleviate some pressure on the IDR, especially with the turn in risk sentiment in the first quarter of the year. In 2019, market players will continue to monitor whether Indonesia can continue to whittle down the current account deficit, with early 2019 trade data showing a surplus recorded, but at the expense of a large contraction in imports.

Indonesia trade balance and current account % to GDP

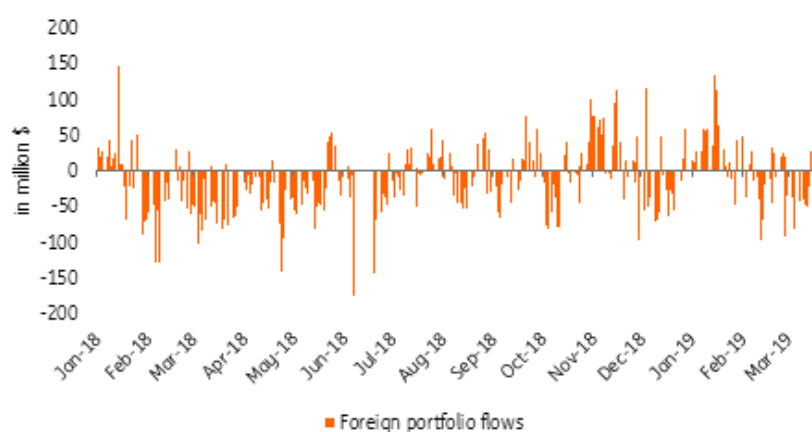


Source: Bloomberg

Currency movement: IDR depreciates then steadies as foreign flows return

The IDR was one of the worst performing currencies in 2018 with stark risk-on sentiment forcing foreign investors to head for the exits, noting the outlook for the Fed and the US-China trade war. At the height of the emerging market currency rout, the Rupiah had lost 12.72% from its level at the start of the year on renewed concerns about Indonesia’s current account position. Bank Indonesia was called into action, actively participating in the foreign exchange market, setting up a domestic non-deliverable forward market and revising rules on export revenue repatriation to limit outflows. 2019 brings a more favourable environment with the Fed taking a more dovish tack while US and China appear amenable to some form of agreement, hopefully in the near term. The IDR has managed to appreciate for the most part in 2019 as portfolio flows have returned as a result of the improved sentiment. With the currency stable and growth expected to receive a boost from the elections, Bank Indonesia has held off on adjusting monetary policy while vowing to help boost liquidity to offset the ill effects of its recent aggressive tightening cycle. If risk sentiment continues to favour emerging markets, we could see the IDR appreciating further as Governor Warjiyo still views the currency as “undervalued” with the possibility of a policy reversal from the central bank now gaining some steam.

Indonesia foreign portfolio equity flows



Source: Bloomberg

Summary: on cruise control but reforms needed for lift-off

Growth prospects for Indonesia remain favourable, given still robust domestic consumption which will be aided further by benign inflation dynamics. Elevated borrowing costs, raised last year to ensure IDR stability, however may limit capital formation to some extent but government spending is expected to continue to provide a lift. Reforms and investment may be needed in order for the economy to break out of the 5% trend, something that incumbent Jokowi has pledged to do with improvements in infrastructure seen as a priority. Meanwhile, Indonesia will need to secure other more stable sources of foreign currency, given the economy's susceptibility to foreign outflows and its reliance on low value added exports for foreign currency. A shift to higher value added export products would help address two concerns at once by securing a stable source of foreign flows and at the same time offering an alternative outlet for the young labour force in the manufacturing sector. Regardless of the outcome of the election, Indonesia's growth trajectory will lean heavily on the next president's ability to boost investment in order to improve productivity and increase efficiencies. Growth of 5% is highly achievable but reforms to push a shift to higher value added production will be key to not only secure Indonesia's external position but also provide another stable source of growth via higher value added manufacturing.

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US growth: take a step back

US 4Q GDP was revised down to 2.2% and 1Q19 growth is likely to be even lower. This will fuel talk of Fed rate cuts, but we still think there are reasons for optimism.

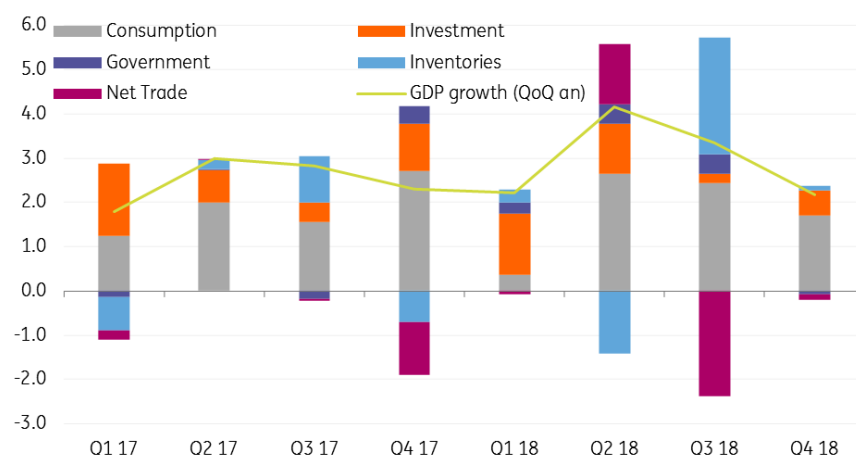


4Q GDP revised down

4Q US GDP has been revised down to 2.2% QoQ annualised from the 2.6% figure initially reported. This is the weakest reading since 1Q18 and in the febrile world of markets it will do little to dispel talk of an intensifying US economic slowdown. Yet we have to remember that this still equates to growth of 3%YoY, something that virtually any other developed market would desperately love to have.

The details show consumer spending growth now at 2.5% versus 2.8% originally while non-residential investment was revised to 5.4% from 6.2% and residential investment is now -4.7% versus the -3.5% figure initially reported. Government spending was revised to -0.4% from +0.4%, but the contribution to growth from net trade was revised up to -0.08 percentage points from -0.22 percentage points. Inventories were largely left unchanged.

Contributions to US GDP growth



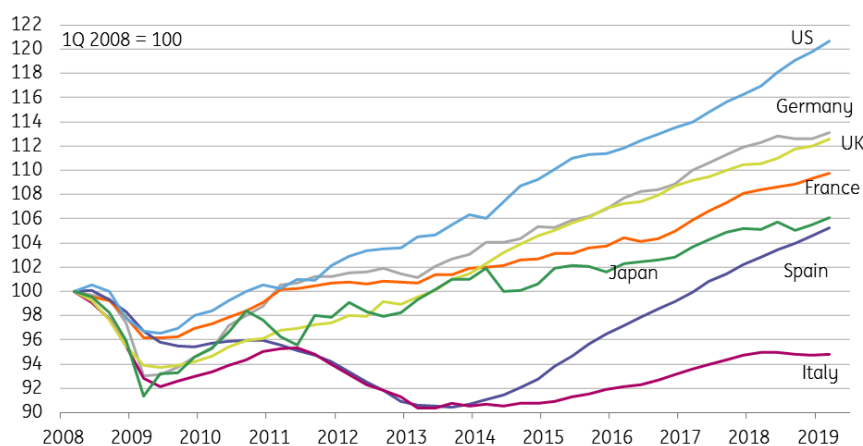
Source: Macrobond, ING

US remains the outperformer

Taking a step back it is clear that the US economy continues to perform very well both in absolute terms and relative to key developed market economies. Output is now 20% above its 2008 pre-crisis peak with the economy having grown 24% since its 2009 trough, whereas the UK and Germany are eight percentage points behind and Italy is in a completely different race.

It is remarkable that a country that was the primary source of the financial crisis was in the end the least impacted and has performed the best – amongst key developed markets - since. We suggest this is down to a swift recapitalisation of the banking sector, an early and aggressive response from the Federal Reserve (whereas the ECB actually raised rates in 2011) and a fiscal policy response as far removed from Europe’s position as you can possibly imagine.

GDP levels - US versus other developed markets



Source: Macrobond, ING

What about 1Q19?

The Atlanta Fed GDPNow indicator is frequently cited as an important gauge of how the economy is performing at a specific point in time. However, it is important to remember it is simply a

“Nowcast” for a quarterly GDP figure based on the numbers already released – it is not an actual forecast. It had been running below 0.5% annualised growth through the first half of March, but after yesterday’s trade figures it is up to 1.5%. We continue to look for a 1Q GDP growth outturn of 1.5-2%, which we believe would be very respectable given the government shutdown for much of January and late December and the tendency in recent years for 1Q GDP to disappoint.

We think 2Q GDP will be better given the firm labour market and rising pay and if we can see progress being made in US-China and US-EU trade talks this would remove a dark cloud that hangs over the global economy. Moreover, there are tentative signs that China’s stimulus programme may be getting a little bit of traction and the rise in the German Ifo index may also be a positive signal.

And interest rates?

But in the wake of softer global activity data and the Federal Reserve’s dovish shift, financial markets are increasingly of the view that the next policy move will be an interest rate cut. Futures markets are now pricing in around 30bp of interest rate cuts this year. Our view is that policy will remain on hold this year and that is down to the underlying resilience of the US economy.

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Dutch exporters, already feeling the Brexit pinch

Since the Brexit referendum, the growth of Dutch exports of goods to the UK has virtually come to a standstill while exports of goods to other countries grew by 17%. According to our analysis, the fall of Sterling reduced the value of Dutch exports to the UK by nearly €11 billion in 2018



Source: Shutterstock

Growth in output value under pressure, thanks to Brexit

The economic pain of Brexit is evident, even before the UK leaves the EU and this is particularly noticeable in exports. Since the referendum in 2016, the growth of Dutch goods exports to the UK has virtually come to a standstill.

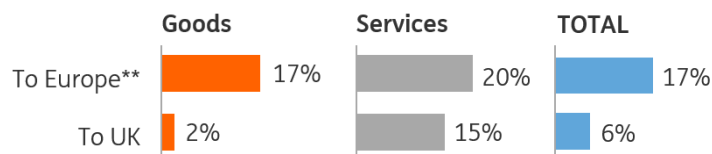
This is due to two factors: the fall of the pound against the euro, i.e., the 'currency effect' and the cooling of demand among British consumers and producers. The fall in the value of the pound has made products from outside the UK relatively more expensive, and as a result, the position of Dutch suppliers has deteriorated compared with British competitors.

It's estimated that in 2018 alone, the currency effect reduced the export value of goods and services by nearly €11 billion *, but simultaneously, in the last three years, total exports to other European countries have increased sharply, so this positive trend has so far alleviated Brexit pain

for Dutch businesses.

Growth of Dutch goods exports to the UK is lagging

Trend in turnover of Dutch exports, 2018 compared to 2016



Source: Statistics Netherlands (CBS), *estimate ING Economics Department ** excluding UK

Agriculture, industry, transport and wholesale are feeling the pain

The currency effect and the drop in demand have brought negative consequences for Dutch companies that do a lot of business with the UK, as they're experiencing pressure on their margins and/or volumes alongside a greater need to focus on alternative markets.

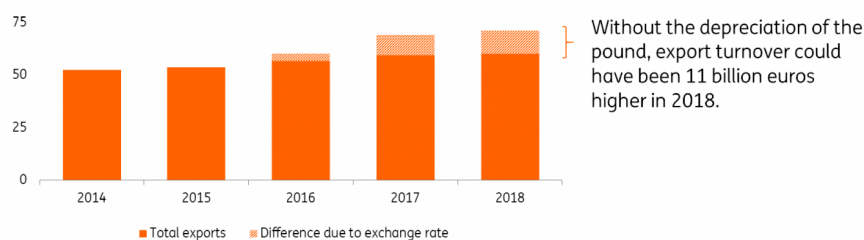
In particular, companies in agriculture and fisheries, industry, trade, and transport indicate that Brexit affects their business. The proportion of entrepreneurs who expect Britain leaving the EU will affect their business operations in the coming months has increased to 25% at the beginning of 2019.

*We calculated the impact of the currency effect on the export value as follows:

1. The starting point is the long-term development of Dutch exports to the UK, and the euro/pound exchange rate.
2. Using a regression model, we estimated the elasticity of the euro/pound on the Dutch export flow to the UK. The export flow from the Netherlands to the rest of Europe was used to monitor third-party effects.
3. Both goods (monthly data) and services (quarterly data) showed that there was a connection.
4. The elasticity has been used to adjust the export flow for exchange rate changes after January 2016.

Brexit has already had a substantial effect on export turnover

Turnover of direct exports of goods and services from the Netherlands to the UK, billion EUR



Source: Statistics Netherlands (CBS), ING Economics Department

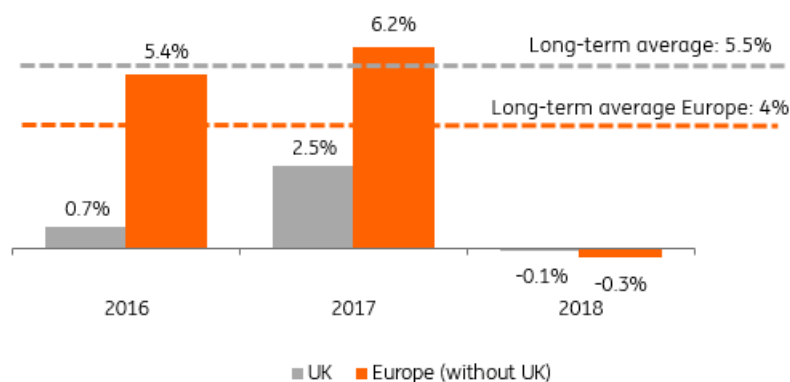
Agrifood

- The export value of Dutch agrifood* products to the UK was almost €6 billion in 2018. But since 2016, development of these exports has been significantly worse than in previous years.
- The export value decreased slightly in 2018. For the three most important product groups (fruit and vegetables, meat, and flowers and plants) the development is even more negative.
- Traders say they are hardly affected by lower sales volumes, but lower prices are playing a role. Companies in the agrifood chain also respond creatively to market developments. Traders often find new markets for their fresh products fairly quickly if necessary or adjust their product range. In British supermarkets, this sometimes results in shrinkflation. For example, to keep prices at the same level, a bouquet is sold containing one less flower.

*agricultural raw materials, foodstuffs, drinks, flowers, and plants

Export growth agrifood to UK well below long-term average

Growth in the export value of the agrifood sector, year-on-year. Long-term average based on developments between 1996 -2015



Source: Statistics Netherlands (CBS), processing by ING Economics Department

2 High-tech industry

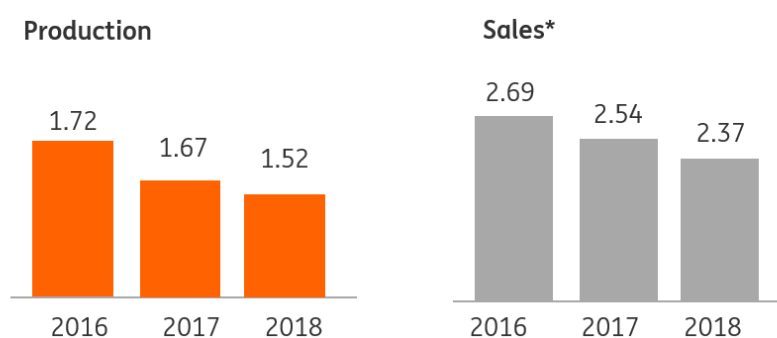
- The UK accounts for 8.5% of the total export value of the Dutch high-tech industry. Exports to the UK were down in 2017. The figures for 2018 indicate a slight growth due to an increase in re-exports, but exports of goods produced in the Netherlands continue to decline.
- Within the high-tech sector, manufacturers of machines and trucks, among others, are being hit by British companies postponing or cancelling replacement and expansion investments.
- More than 40% of entrepreneurs in the industry expect Brexit will influence their business operations in the next three months. Only in agriculture is this share higher, according to the statistical office of the Netherlands and Consumer Survey in early 2019.

3 Automotive industry

- The negative effects of Brexit are noticeable in the automotive industry. The low level of British consumer confidence is causing a decline in car sales. In addition, car production in the UK is also declining. This is not only because of lower domestic demand, but also because manufacturers choose to produce in other countries.
- The market conditions for Dutch dealers and suppliers to the automotive industry are therefore more challenging. Despite this, companies in the Netherlands managed to maintain the export value and re-export value of cars and car parts to the United Kingdom in 2017 and 2018.
- Indirectly, Dutch suppliers may face declining orders from other countries due to a drop in demand in the UK. For example, German manufacturers have a strong market share in the British market. If the British demand for cars falls, this could also lead to lower production volume at German factories.

Decline in car production and sales in the UK

Production and sales of passenger cars in the UK, number x 1 million



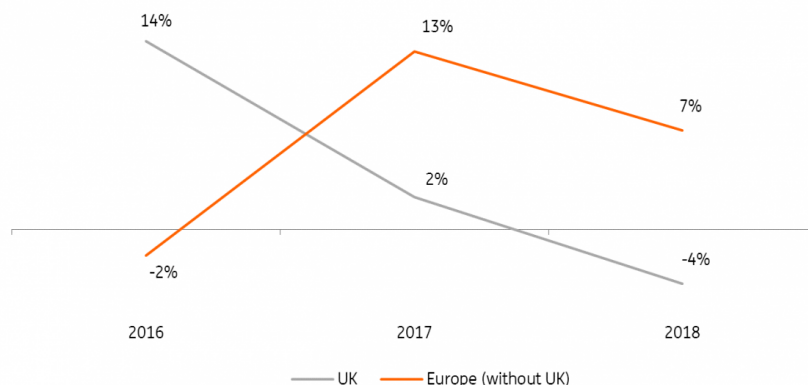
Source: SMMT, *concerns registrations of new passenger cars

4 Chemical industry

- The UK is an important country for chemical products from the Netherlands. Around 90% of Dutch chemical production is exported and the UK is the third largest export destination, with around €6.5 billion and 7% market share.
- Exports of chemical products (raw materials and semi-finished products) to the UK were clearly lagging behind in 2017 and contracted in 2018, despite higher oil prices and higher output prices.
- Supplies to manufacturers of medicine and personal care products account for nearly €2 billion export sales. In this market, the export value declined as a result of lower sales of British cosmetics producers.

Decline in exports of chemical products to the UK

Development of export value of chemical products



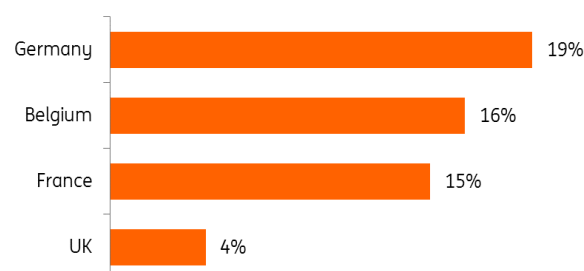
Source: Statistics Netherlands (CBS)

5 Wholesale sector

- According to Statistics Netherlands, off all sectors, the wholesale sector earns the most from exports to the UK, and this was €3.8 billion in 2017.
- The top five categories of exports to the UK include ICT equipment, petroleum and petroleum products, fruit and vegetables, medicines, and cars. Therefore, wholesalers active in these segments will be relatively harder hit by Brexit. A large proportion of these export products are re-exports.
- Especially many smaller wholesalers are purely re-export companies. Re-exports are becoming increasingly important for the Dutch economy. For example, the volume growth of re-exports has been stronger over the past ten years than for exports of products made in the Netherlands: 60% versus 40%.
- Half of the export value to the UK consists of re-exports of goods, which is in line with the European average. However, the development of re-exports in 2018 compared to 2016 lags well behind the three other top four exporting countries.

Growth in re-exports to the UK lags well behind

Re-export value development of the four main export partners of the Netherlands, 2018 compared to 2016



Source: Statistics Netherlands (CBS), processing by ING Economics Department

6 Transport and logistics

- Because of its favourable location, by sea, the Netherlands is the most important trading partner for the UK. In addition to the export of Dutch products, there is also a great deal of intercontinental freight transport from the rest of the world via the ports of Rotterdam (including Hoek van Holland) and, to a lesser extent, Vlissingen and Amsterdam to the British Isles.
- Because of the many small and medium-sized British seaports, ferries are typical for transport to the UK. Between 2013 and 2015, annual growth in freight transport per ferry ('roll on/roll off') was almost 7%. This has more than halved since 2016, despite the favourable economic climate in Europe. Logistics service providers note that export growth to the UK is lagging, although this is disguised by the ongoing stockpiling at the beginning of 2019.
- From the Netherlands, Stena Line, DFDS, and Cobelfret provide intensive services to the UK. In 2018, 16.5 million tonnes of goods were transported by ferry, mainly to Harwich/Felixstowe and Immingham.

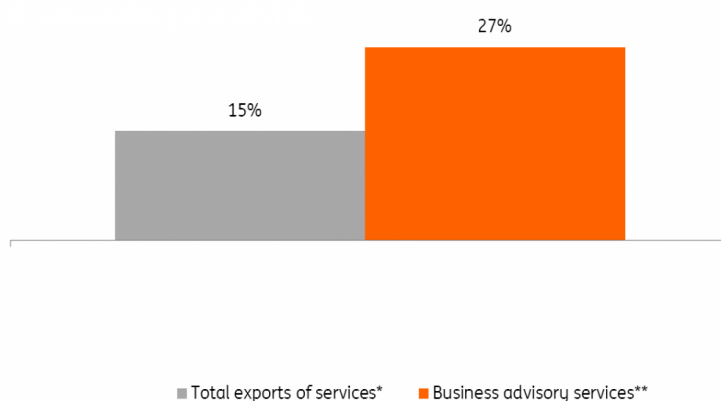
7 Business services

- Dutch export of services to the UK amounted to more than €20 billion in 2018. The total growth of the export of services over the past three years has been reasonably in line with European trends.
- A large part of the export of services to the UK consists of business services. Among other things, British demand for business advisory services, including legal advice and accountancy, rose sharply. Therefore, Dutch service providers appear to benefit from Brexit preparations made by British companies, especially those that tend to have activities on the European continent.
- In general, the export of services is less price-sensitive than export of goods. The impact of a weaker pound on the export of business services appears limited, at least for the time being.

Usually, when hiring specialists, country knowledge and skills of the hired foreign service provider are more important than an increase in prices.

Strong increase in export of business advisory services* to the UK

Development of Dutch export value to the UK, 2018 compared to 2016



Source: CBS, 2018 based on forecast ING Economics Department, *exports excluding royalties and licence fees, ** including legal services, accountancy and management advice

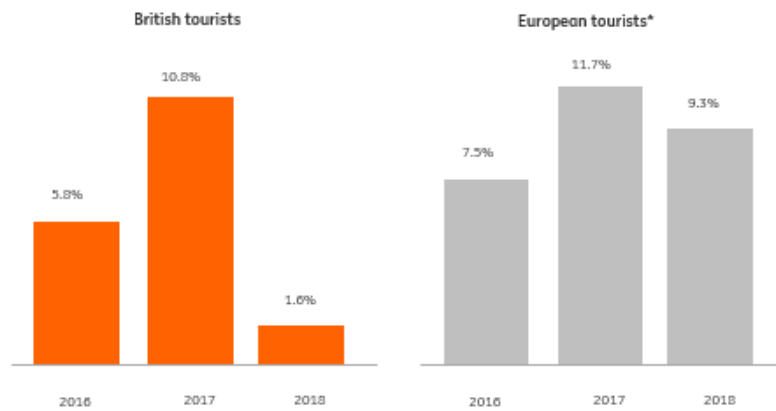
8

Tourism

- Britons are the third largest group of foreign tourists in the Netherlands, after Germans and Belgians.
- The number of foreign tourists in the Netherlands breaks record after record, but since 2016, the number of British people staying in the Netherlands has grown less rapidly than the number of guests from other European countries.
- This was particularly the case in 2018. Low UK consumer confidence and the unfavourable exchange rate are two reasons for consumers to reign in spending.
- We estimate that without Brexit the growth of British tourism would have been more in line with the European trend. This could have resulted in approximately 275,000 extra (hotel) overnight stays.
- British travellers spend an average of €240 per day during a trip to the Netherlands, mainly on travel and accommodation. 275,000 extra overnight stays are equivalent to a turnover of €65 million. This is about 4% of the annual tourist expenditure of Britons in the Netherlands, which is around €1.5 billion.

Not as many Brits going to Netherlands now

Percentage change in the number of room nights in Dutch hotels, hostels, and bed & breakfasts



Source: Statistics Netherlands (CBS), *Europe excluding UK

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India: Rising odds of another rate cut

We expect a 25 basis point rate cut next week from the Reserve Bank of India (RBI), in line with the consensus. However, we aren't convinced that the economy needs a lot more easing, with inflation on the rise



Source: Shutterstock

Consensus is for further RBI easing

The RBI's Monetary Policy Committee conducts its bi-monthly policy review next week. The policy decision is expected around noon local time on Thursday, 4 April.

As of this writing, there is no fresh consensus available for the upcoming meeting. In the last Bloomberg survey in late February, the majority of analysts forecast a 25 basis point cut in the second quarter of 2019, suggesting the central bank could cut rates either at the April or June policy meeting. However, under pressure from the government to ease, the central bank may well opt to move in April rather than June.

6.25%

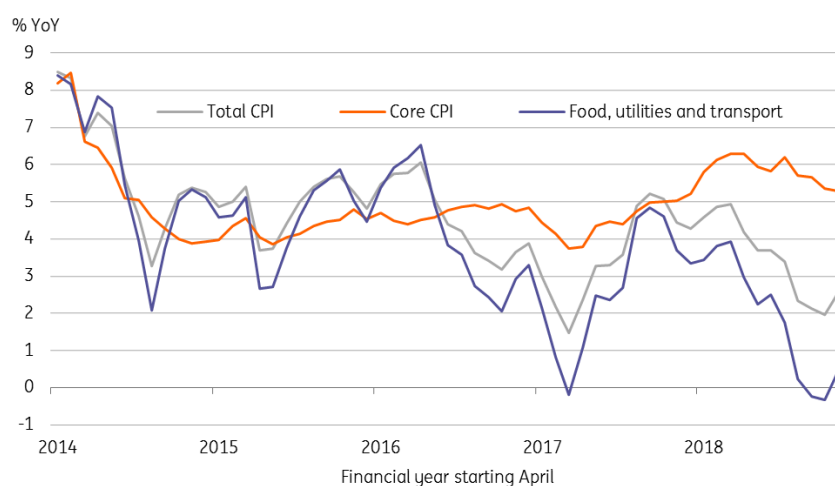
RBI repurchase rate
The policy rate

Neutral bias doesn't always mean a stable policy

At the last meeting in early February, the RBI shifted its policy stance from a 'calibrated tightening' to 'neutral'. Yet it also cut rates by 25 basis points, catching the markets- which had overwhelmingly expected no change- off guard.

The only supportive factor for the last rate cut was the falling current rate of inflation (CPI). But inflation expectations were still high and remained supported by loose fiscal policy and a weak currency (INR) - which were strong arguments against a rate cut. The rupee's (INR) 1.9% depreciation in January was the worst in Asia.

Inflation has bottomed



Source: Bloomberg, ING

Growth-inflation outlook isn't that bad

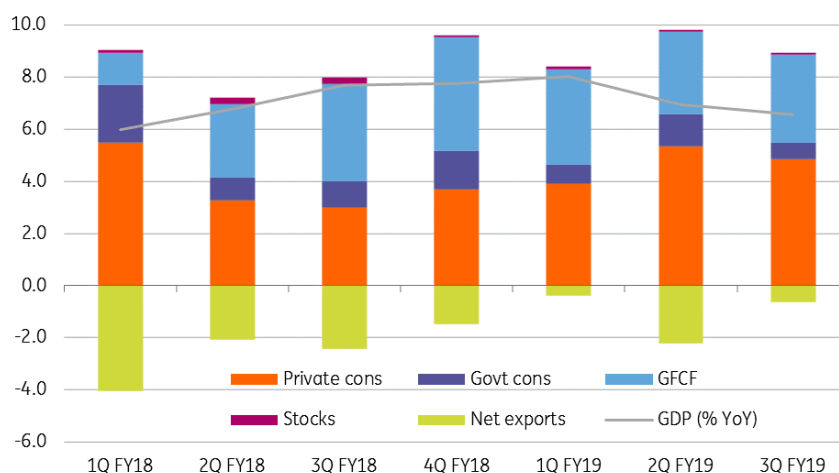
Subsequent economic data has shown that inflation, in fact, bottomed at 2.0% year-on-year in January. Its spike to 2.6% in February probably marked the beginning of an uptrend on the back of firmer food and fuel prices and an election-related boost to consumer spending. Meanwhile, GDP growth continued to grind lower. It slowed in line with our forecast to 6.6% in 3Q FY2019 (Oct-Dec 2018) from 7.1% in the previous quarter. Judging from a sustained slowdown in exports and manufacturing, it could dip further to about 6% in the current quarter.

The INR gained some ground in February in line with its emerging market peers, which benefited from a dovish turn in Fed policy. In fact, the rupee was Asia's best performing currency in March despite all the prevailing woes - a lack of policy support, increased geopolitical tensions (border issues with Pakistan), domestic political risks before the general election and a persistent twin-deficit (trade and fiscal) problem. Adding to the negative outlook was the news of President Trump

stripping India off the GSP preferential trade status, signalling a possible shift in the US trade battle from China to India.

The economy enjoys strong domestic demand

Expenditure-side sources of GDP growth



Bars may not stack up to total GDP growth due to statistical discrepancy.

Source: CEIC, ING

Balance of risk is tipped toward easing

Prevailing market conditions reduce our confidence in the view that the RBI will leave monetary policy unchanged for the rest of this year. The RBI could use the ongoing INR strength to deliver a rate cut next week. However, we don't think the currency is completely out of woods just yet. Elections are just around the corner (voting takes place from 11 April to 19 May, results expected on 23 May) and investors might prefer to wait on the sidelines until this political uncertainty lifts.

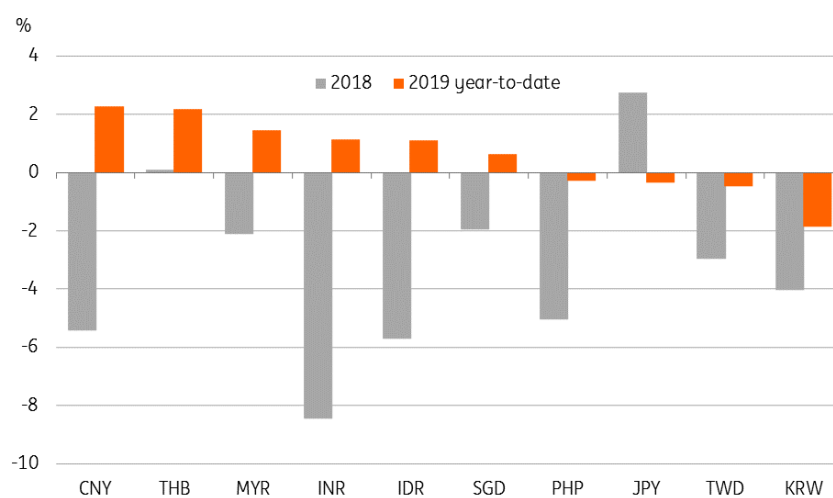
While the growth argument for RBI easing may have gained some ground, the inflation argument remains less persuasive. Although inflation may not be an issue through the first half of FY2020 (Apr-Sep 2019), staying in the lower half of the 2-6% RBI policy target, it's likely to be a problem thereafter, as the low base effect complicates demand-pull pressure from loose economic policies. Shouldn't the RBI stave off future inflation by keeping rates steady now?

On the growth side, the RBI's forecast of 7.2% full-year FY2019 growth remains at downside risk while its 7.4% projection for FY2020 will likely be far off the mark. It will be difficult for the economy to perform well amid a global slowdown although it is currently benefiting from strong domestic demand.

We think loose fiscal policy obviates the need for monetary accommodation. Political pressure from the government to ease remains intact, though we are sceptical that a monetary boost will really help the government to win an edge over its rivals in the coming elections.

Despite all of these conflicting arguments, we think the balance of policy risks is tipped towards easing and another 25bp RBI rate cut looks to be a done deal for next week's meeting.

Indian rupee - from Asia underperformer to outperformer



Note: In descending order of 2019 performance.

Source: Bloomberg, ING

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