

In Case You Missed It: Testing times

It's been a tough few weeks for emerging markets but will a more orderly US rates rise help? We illustrate Mark Carney's dilemma in six charts, and ING's head of international trade explains why President Trump's strategy won't work with the EU, but he might have a point on China

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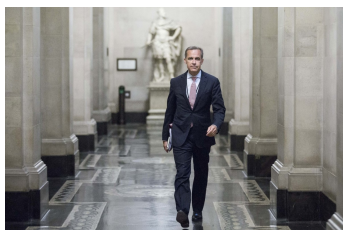


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Emerging markets: A test of nerves

Higher US interest rates and oil prices along with uncertain policy responses are weighing on the most vulnerable emerging markets right now. Investors seem to be sticking with the growth story so far, but will be looking for strong policy responses over coming weeks



Source: Shutterstock

Tough times for emerging markets

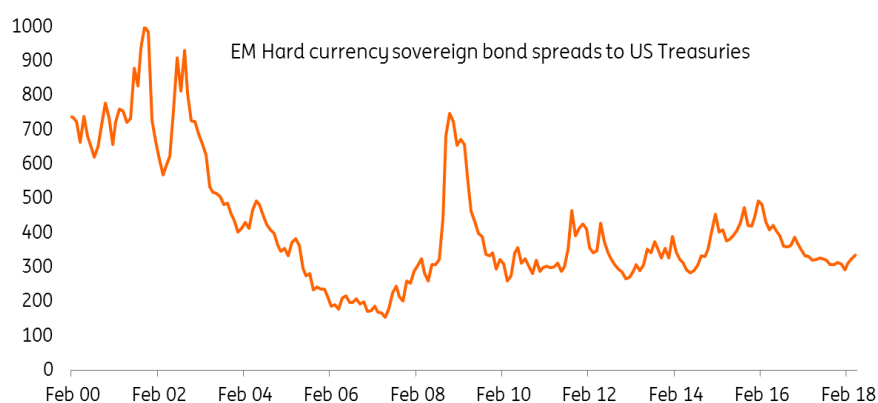
It has been a tough few weeks for emerging markets. Ever since the dollar started to surge from mid-April onwards, EM currencies and debt markets have come under pressure. Some of the most followed exchange-traded funds (ETFs) that track major EM debt indices are now down 5% year to date. And some of these funds are starting to see net outflows on the year.

For example, the iShares EMB ETF, which tracks hard currency debt issued by EM governments, has seen year-to-date outflows of US\$50mn, versus US\$1bn inflows over the last year. However, popular EM equity ETFs, such as the Vanguard FTSE EM ETF, continue to see inflows over the last week and year-to-date as well.

Emerging market currencies and debt markets might fare well if US rates rise more orderly amid a healthy global growth outlook. That said, investors will look out for strong policy responses

A firmer dollar and higher interest rates create challenges for those economies with large external deficits and also large budget deficits. Argentina scores poorly on both counts and after failing to restore confidence with aggressive rate hikes and suffering heavy losses in FX reserves, has turned to the IMF as a lender of last resort. An informal IMF meeting is scheduled for Friday this week, and expectations are that it will have to accept a fiscally tight policy in response to a multi-year programme.

Emerging markets USD denominated debt spreads



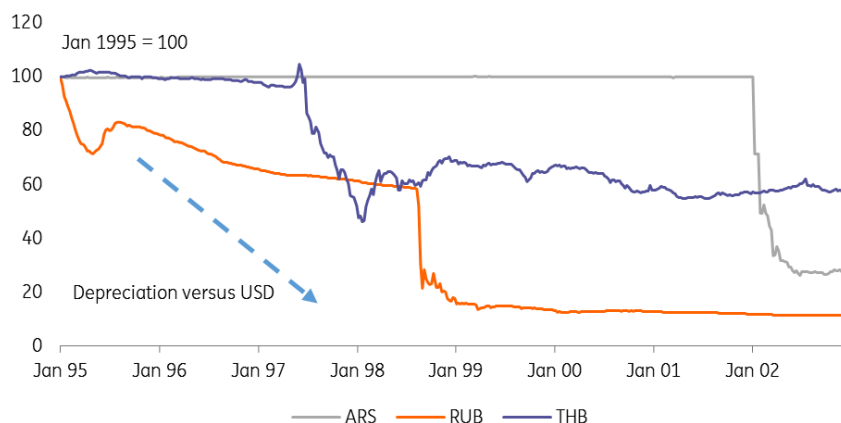
Source: Bloomberg

Putting the EM debt correction into perspective

In the bigger picture, however, the recent rise in hard currency sovereign yields does not look too severe. The popular EMBI spread, measuring an index of hard currency sovereign bond yields versus Treasuries is still a lot tighter than it was in 2016, let alone 2008 or even 2001 – when Argentina last defaulted. Venezuela defaulted last year too.

Creating a more benign outlook for emerging markets have been better policy responses. Foreign exchange rates have typically been allowed to float, avoiding some of the imbalances seen in the likes of Asia, Russia and Argentina in the late 90s and into the Argentine default of 2001. Managed FX rates contributed to the imbalances in all those cases. And frankly, we're a little surprised that anyone expected the next IMF programme for Argentina to involve any kind of FX targeting agreement.

Emerging market currencies break lower from pegs in the late 90s



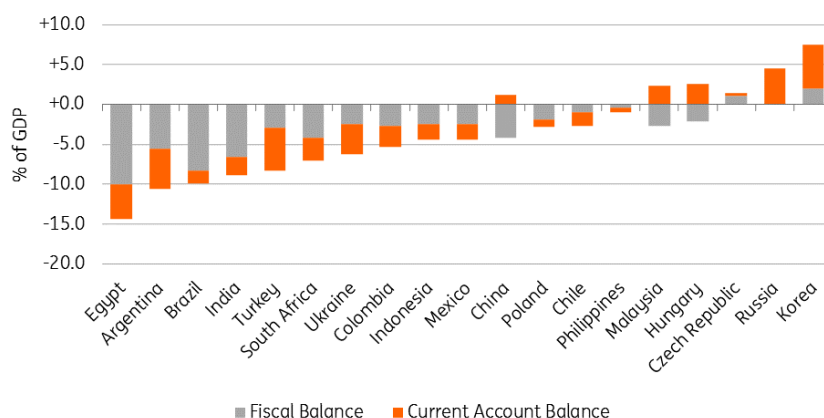
Source: Bloomberg, ING

Higher US rates keeping the pressure on

However were US rates to continue pushing higher, (seemingly now driven by oil prices), expect investors to stay wary of those economies dependent on external portfolio flows. Turkey is a concern currently where higher oil prices are driving the trade deficit wider, and investors have seen little evidence that the negative inflation-Turkish Lira spiral is soon to be broken. Newswire reports of President Erdogan wanting to have a greater say in monetary policy were not greeted well by international investors.

In addition to Argentina and Turkey, other potential candidates with high external financing needs and twin deficits that will remain on investors' radars include Egypt, South Africa and Ukraine. That said, the positive momentum in South Africa and IMF programmes in the other two have seen a more contained sell-off so far.

Emerging markets' twin deficits (current account + fiscal) very much in focus



Source: Bloomberg, ING

Strong response required

Emerging market currencies and debt markets might fare well if US rates rise more orderly amid a healthy global growth outlook. That said, investors will look out for strong policy responses among those more vulnerable to a weakening macro backdrop. Such a policy response would seem likely in the case of Argentina getting an IMF programme. Less certain is the policy mix which will emerge in Turkey before elections on June 24th.

We'd also add that crude at US\$100/barrel wouldn't help either, begging the question whether President Trump might 'encourage' friendly OPEC names to increase output quotas at their next meeting on June 22nd.

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The Bank of England's road to August in six charts

Will the UK economy emerge from the depths of the worst quarter of growth since 2012? That's the question Bank of England officials will be looking to answer between now and the August meeting



Source: Bank of England

Markets may be underestimating rate hike risks - but it all depends on the data

After the May Bank of England meeting (BoE), markets remained unconvinced we'll see a rate hike this year. [As we noted at the time](#), we think this looks like a bit of an overreaction based on what policymakers have been hinting over recent months. With wage growth on the rise, the chances of an August rate hike might be underestimated, and we still narrowly think a rate hike is more likely than not over the summer.

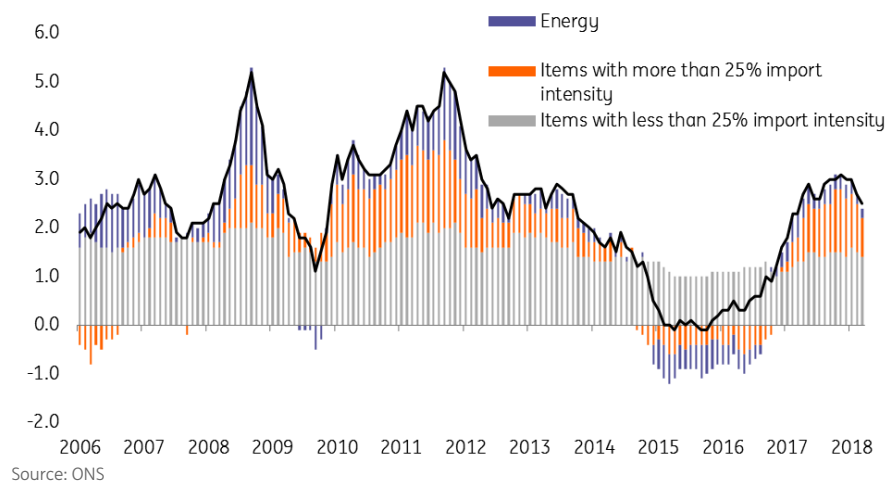
But this is certainly not a done deal. The high street is still having a particularly tough time, and contrary to the Bank's statement last week, suggests more than just snow prompted at least some of the first quarter lull.

Either way, whatever the Bank decides to do in August will depend heavily on economic data between now and then. With 78 days until the August meeting, here's a round-up of some of the numbers that policymakers will be keeping an eye on, and how we think they'll

move.

Inflation

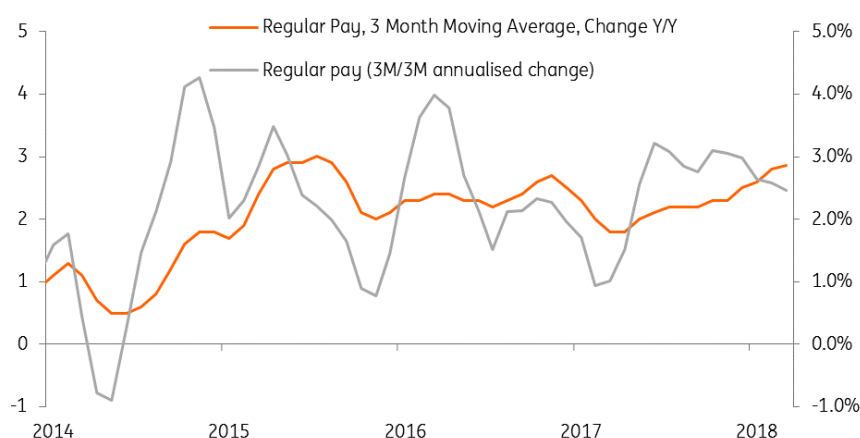
Core CPI has fallen quite sharply over the past few months, and we think it could be back at 2% in time for the Bank's August meeting. Prices have largely adjusted to the pound's post-Brexit fall, and the rate of pass-through is fading. Headline inflation will keep a touch higher by rising fuel costs, but the overall picture of easing consumer price pressure in principle takes some of the heat off policymakers in the near-term.



Wage growth

But where inflation has been more lacking, wage growth has continued to outperform. Pay is now rising at the fastest rate in over two years, and Bank Agents are suggesting that this could be the best year for pay settlements since the crisis. Admittedly it is still early days. A portion of these gains is related to the higher living wage level, while weakness in the first quarter of 2017 has been flattering the year-on-year rates of wage growth. This latter point means we've probably hit a short-term peak in wage growth with base effects set to kick in.

But even so, the momentum remains solid (albeit a little slower than three or four months ago), and we don't expect the data before August to change policymaker's minds that the overall direction is upwards. Remember that optimism on wage growth is central to the Bank's rate hike rationale.

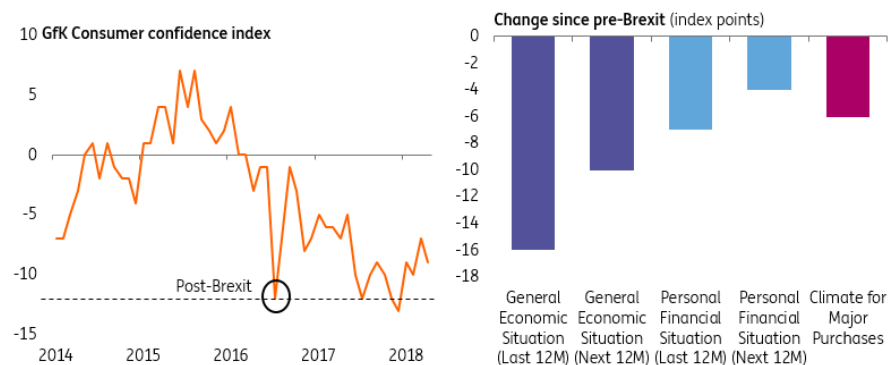


Source: Macrobond, ING

Consumer confidence

With wage growth no longer falling short of the cost of living, consumers might have been expected to up their spending plans. So far, this hasn't been the case.

Confidence has recovered off December's low but remains depressed, perhaps because real incomes are still hardly rising (even if they are no longer falling). But digging deeper into the numbers reveals that it's the economic situation, rather than personal finances, that is a great worry to households. Assuming this is related to slower growth and greater economic uncertainty – both of which look set to persist – then we think an imminent recovery in confidence is unlikely.

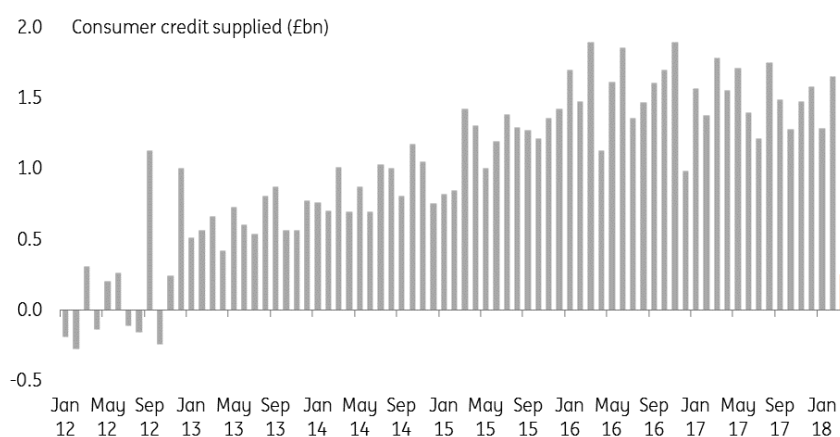


Source: GfK

Borrowing

For some Bank of England rate-setters, we suspect the dramatic fall in borrowing seen in March was a key reason for wanting to remain on hold in May. The sharp slowdown in the amount of consumer credit supplied to just £300m in March coincided with a rapid tightening in credit availability by banks. In one sense, this is a positive development for the BoE, who had been warning about the risks of unsustainable borrowing. But given that much of the consumer spending that has happened over the past couple of years has been debt-driven, a sudden drop-off in lending could see the economy suffer more heavily over coming months.

Admittedly this could all turn out to be a blip – the reasons for the sudden demise remain unclear. But we think policymakers will be paying particularly close attention to this story in the run-up to August.



Source: Macrobond

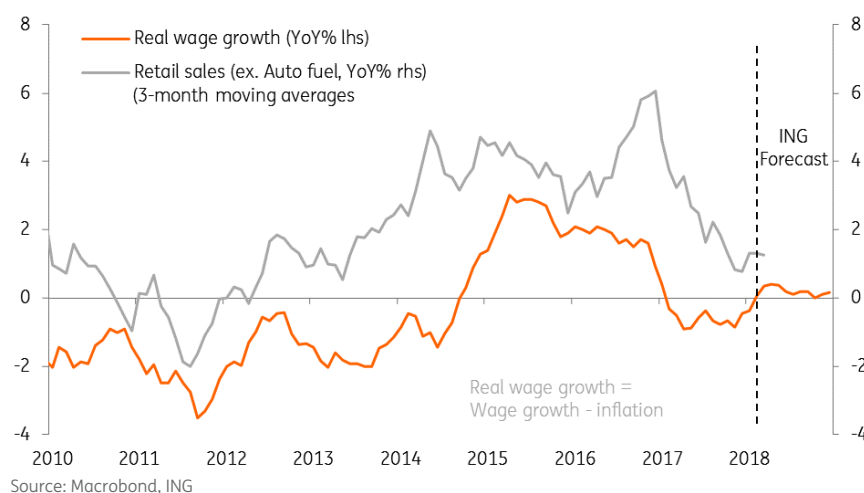
Growth and spending

Was the first quarter slowdown simply a temporary dip? This is essentially the question that prospects of a summer rate hike depend upon. The BoE's view is that the decline in growth is unlikely to last, and in fact that the particularly weak GDP figure will probably get revised upwards.

It certainly appears likely that some of the dip was down to the snow. Construction on its own knocked 0.2ppts off first-quarter growth, which is unusually large for a sector that only makes up 6% of the overall economy. Assuming the PMIs and importantly, second quarter growth bounces back, we suspect the Bank may feel comfortable enough to hike rates in August.

That said, a lot still depends on the high street. Pressured real incomes, falling borrowing and depressed confidence, have only added to retailer's woes over recent months. Shop owners have faced the 'perfect storm' of lower demand, higher minimum wage costs and rising business rates, and by some measures, the first quarter was the worst three months since the crisis.

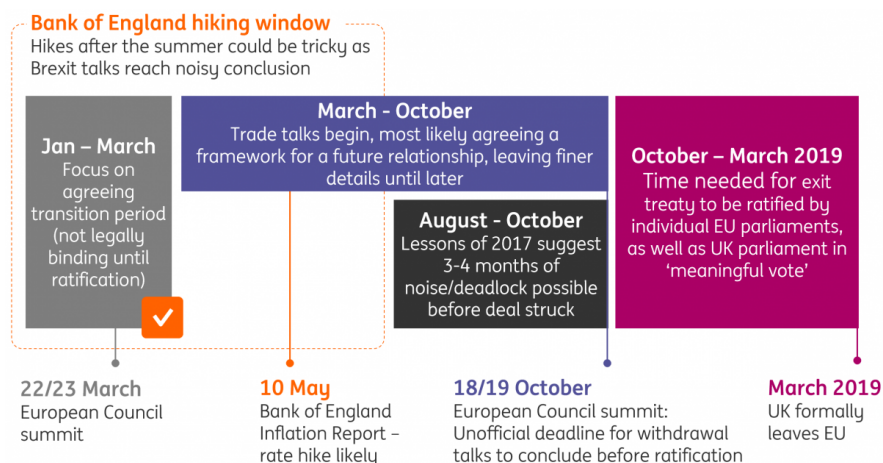
Many retailers have become highly leveraged in the post-crisis years, so if we were to see an increased number of big names entering difficulties over the next couple of months, the Bank might well judge a rate hike to be one headwind too many for the sector.



Brexit

With under six months to go until Brexit talks conclude in October (allowing time to ratify the withdrawal agreement), time is running out. Talks are currently centred on resolving the Irish border conundrum, and so far UK ministers remain divided on which customs model to pursue.

Admittedly, we doubt that the Brexit headlines over the next few weeks will make much of a difference to the odds of a summer rate rise. Having said that, policymakers will be aware that it could get increasingly challenging to hike rates later this year as Brexit noise increases before the UK formally leaves the EU in 2019. Depending on how the economy performs before August, policymakers may want to capitalise while they still can.



Source: European Commission, ING

The full timeline: What we'll be watching before August

Date	Event/data release	Date	Event/data release
23 May	April Inflation (Core CPI)	29 June	1Q F GDP (Second revision)
24 May	April Retail Sales	02 July	June Markit UK PMI Manufacturing
25 May	March Index of Services	04 July	June Markit/CIPS UK Services PMI
25 May	1Q GDP (First revision)	10 July	June BRC Retail Sales
31 May	May GfK Consumer Confidence	10 July	May Trade balance
31 May	April Consumer Credit	10 July	May Industrial Production
01 June	May Markit UK PMI Manufacturing	10 July	May Construction Output
05 June	May BRC Retail Sales	10 July	First monthly GDP estimate
05 June	May Markit/CIPS UK Services PMI	12 July	June RICS House Price Balance
11 June	April Trade balance	12 July	BoE Credit Conditions Survey
11 June	April Industrial Production	17 July	May Average weekly earnings
11 June	April Construction Output	17 July	May Employment Change (3M/3M)
12 June	April Average weekly earnings	18 July	June Inflation (Core CPI)
12 June	April Employment Change (3M/3M)	19 July	June Retail Sales
13 June	May Inflation (Core CPI)	26 July	May Index of Services
14 June	May RICS House Price Balance	26 July	2Q GDP (Initial)
14 June	May Retail Sales	30 July	June Consumer Credit
21 June	Bank of England Bank Rate	31 July	July GfK Consumer Confidence
29 June	June GfK Consumer Confidence	01 August	July Markit UK PMI Manufacturing SA
29 June	May Consumer Credit	02 August	Bank of England Bank Rate
29 June	April Index of Services		

Source: Bloomberg, ING

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TTIP 2.0: A solution to the US-EU trade conflict

President Trump is about to unleash a trade war with the European Union if the EU does not meet his demand to take unilateral measures to lower the US trade deficit with the EU. The EU says it won't comply and has instead prepared a list of retaliatory measures. Both parties would be better off if they decide to resume the TTIP negotiations



The benefits of resuming TTIP

At the end of April President Donald Trump demanded trade concessions from the EU by the first of June, at the pain of raising tariffs on EU steel and aluminium. Countries such as South Korea have already yielded to the same blackmail tactics from the US government. Canada and Mexico are also prepared to make concessions in the ongoing NAFTA re-renegotiations and even China has made some concessions.

Trump's blackmail strategy won't work with the EU

But the EU has held firm and asked the US to remove the threat of steel and aluminium tariffs before talking about changing the trade conditions. The EU is in a better position to issue this demand than other countries. South Korea, Canada, Mexico and even China are more dependent on US demand for their products than the other way round. In contrast, the US economy depends

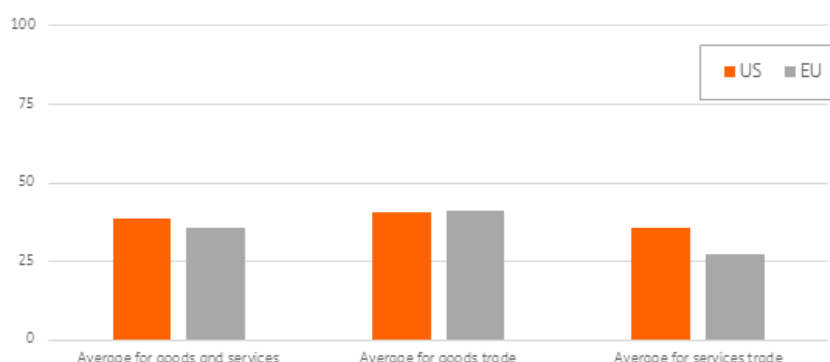
almost as much on European demand trade for its products than vice versa. A transatlantic trade war would lead to a lose-lose situation for both the US and the EU.

Resuming the TTIP (Transatlantic Trade and Investment Partnership) negotiations, on the other hand, would bring benefits to both trade giants.

A free trade agreement is not only superior to the current strategy of Trump because he has difficulties strongarming the EU, so it would avoid a mutual harmful trade war, but also because such an agreement would result in larger benefits for the US than unilateral EU- concessions. After all, if the EU would give in to the US and reduce an import tariff unilaterally, for example on cars, WTO rules dictate that it needs to offer the lower tariff to all its trade partners. So all imported cars would become cheaper – including the very competitive ones from Japan, South Korea and China. This would act as a brake on any increase in American car exports to the EU.

Doing this will require quite some resistance to be overcome. TTIP was put on ice in late 2016 after activists in Europe had undermined support for the deal. On the other side of the Atlantic too, the political support for a deal had disappeared amid the apparent popularity of Trump’s protectionist campaign messages.

Non-tariff measures US and EU (simple average)



Source: Berden et al 2009

Trade restrictiveness on a scale from 0 to 100 (survey results).

What the EU should be doing

In light of President Trump’s preoccupation with the car industry, the EU should try to lure the US to the negotiating table with an offer to reduce EU import tariffs on cars to equal the US’s 2.5%. That would enable President Trump to claim a victory at home. In return the EU could require that its standards on crash testing cars are accepted in the US, saving a second round of checks. Once at the negotiating table, the EU could be seeking to reduce the high non-tariff trade barriers on other products too, such as lipstick.

The US benefits more from a trade deal than ad hoc trade concessions

For TTIP negotiations to resume, support will need to be rebuilt in both the US the EU. To assist in

this, contentious issues such as chlorinated chicken, blue cheese and a mechanism to settle disputes between foreign investors and domestic governments, might have to be set aside. This would result in a TTIP 2.0. To build support, the tainted TTIP acronym should also be discarded.

Whatever it takes, a broad trade agreement between the US and EU is the best answer to the current trade conflict.

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Gold: How much worse before it gets better?

In our last note, we feared Gold's long-awaited breakout was going to be to the downside. Now this has happened we look to physical demand, geopolitics and inflation to provide support



Breaking below \$1300/oz

Gold prices fell 1.5% on Tuesday 15 May, breaking below \$1300 for the first time this year and ending what has been an incredible range bound for five months.

At times it seemed as if the yellow metal is prime to spring higher, but after several failed attempts to meaningfully consolidate above \$1350 and attract decent inflows this year, it was the rebounding dollar and the step up in yields that set the only remaining path: down.

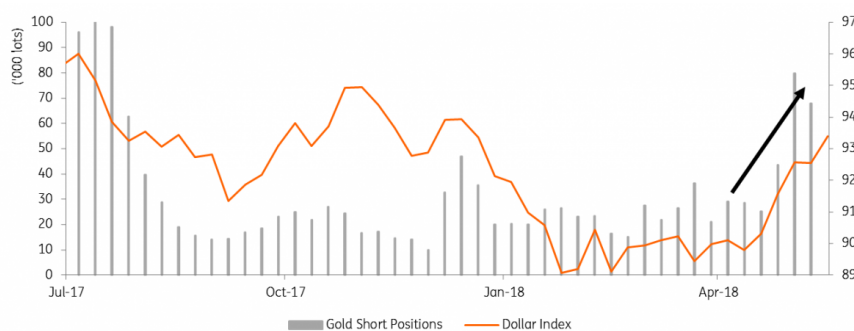
Gold's dull performance has indeed fatigued the long fund community for some time. Money manager longs were already reduced to just 109k lots by early May which is the lowest level since early 2016. We believe the USD rally from mid-April is symbiotic of a short squeeze rather than any change in fundamentals, but a surge of money managers that went short gold since the dollar turned suggests those funds saw things differently. The open interest had continued to rise after that which points to a continual short building right until the drop. Perhaps those speculative shorts were anticipating, [like our rates team predicted](#), that as that dollar rally came off the boil, the US 10yr yield was free to break above the psychologically significant 3%.

We are under no illusion that rates and currencies direct gold above everything else, but the impact of a tightening physical market will play an increasing role to cushion these lows

As the 3% yield breach occurred on Tuesday, Gold's non-yielding qualities were punished. Gold traders should expect more of the same headwinds for the next few months as ING strategists see yields on track to hit as high as 3.4%. But, with much of the fund longs already flushed out, growing inflation, geopolitical risk and a pick-up in physical demand should limit the downside. Things shouldn't get much worse, but it will take time before we see improvement.

Looking at the options, it would seem the funds have the same dwindling near-term conviction but also hold out on further optimism. The 3-month premiums for calls over puts have collapsed even as prices fell but further forward the options markets are still pricing higher upside demand.

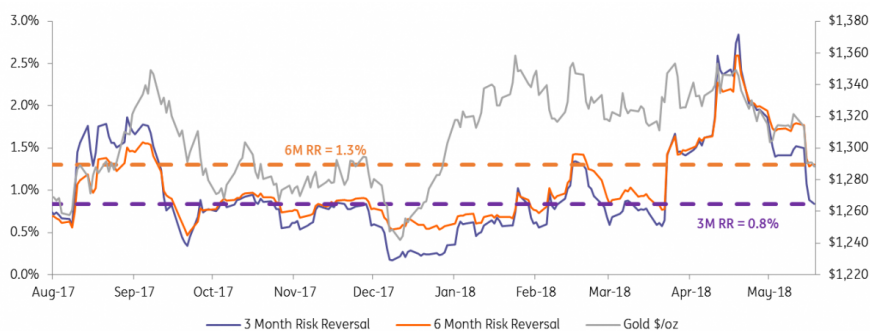
Dollar rebound spurred funds to go short gold



Source: CFTC, Bloomberg, ING Research

Options still skewed to upside further out but nearer term conviction has gone

25 Delta Risk Reversal's (RR)= 25 delta calls- 25 delta puts (i.e premiums paid for upside optionality vs downside)



Source: CME, ING Research

Fundamental case for holding Gold remains intact

We expect longer-term holders/consumers to build a floor for the yellow metal even if it remains shunned by active money managers hunting for more attractive near-term returns. Indeed, ETF holdings have increased to highs not seen since 2013, with little sign of liquidation post the sell-off. We look to the flattening yield curve and burgeoning twin trade deficits against the looming catalyst of mid-year elections or nearer term trade spats that could highlight the US policy/political uncertainties and spell a reversal for the greenback.

As the dollar eases, it will be game back on for our bullish gold view, given our expectations for inflation to pick up substantially this year. Our economists expect US core inflation of 2.8% in Q3 with potential highs above 3% as higher oil prices feed through. Oil importing countries are looking more squeezed at the same time as facing higher US borrowing costs; a collapsing Turkish Lira could be bright spot for demand since the country is already the 5th largest for gold retail investment demand (according to Metal Focus) and the sanctions on Iran are already reported to be driving a pick up in demand in what is the 4th largest country for gold jewellery consumption.

Overall, the first-quarter was awful for gold demand so even before considering the lower prices an improvement should be on the cards. The World Gold Council estimated a 7% YoY decline for Q1 demand which was a decade low and led very much by the 12% collapse in India. However, as the WGC point out, Q1 Indian demand was temporarily hit by the fewer auspicious days in the quarter (days deemed lucky for weddings). There were only seven such auspicious days in Q1 compared to 33 for the rest of the year.

The weakening Indian rupee might well prevent a stellar rebound, but rural farmers are also likely to gain jewellery purchasing power on improved crop yields and government subsidies. Chinese demand has been roaring for a while. Q1 jewellery spending was up 8% YoY but in RMB terms gold prices are now the lowest since early 2017 so we expect to see more "bargain buying" take place.

We are under no illusion that rates and currencies direct gold above everything else, but the impact of a tightening physical market will play an increasing role to cushion these lows. With North Korea negotiations looking less likely and the EU-US trade standoff going down to the wire, it is possible near-term geopolitical inflows could create support, but it is more likely to see prices lull for the next few months until US political and policy instability comes back in focus.

[Read our piece on why the USD rally has brought gold's price back to the lows of its trading range](#)

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