

## In case you missed it: The 'Powell put'

Rate cuts from Washington seem to be universally expected, we're now forecasting two this year. The Chinese government seems set to pull out all the stops to maintain stability but despite their best efforts, the trade situation will probably get worse before it gets better. In Europe, the musical chairs for top jobs in the EU and the UK goes on

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Article | 14 June 2019

## Two US rate cuts this year - we've changed our view

Trade worries are not abating and the economy is starting to feel the strain. The Federal Reserve is preparing for a change of course and we now look for...



Source: Shutterstock

### Plotting a new course

Over the past month, the debate surrounding the outlook for Federal Reserve interest rate policy has swung from “if” they will cut to “when” they will cut rates. Trade tensions look set to persist and recent data suggests the economy is more vulnerable to the fallout than it was in the second half of 2018. With senior policymakers opening the door to action, we now expect the implementation of the “Fed put” with pre-cautionary September and December rate cuts.

### Economy feeling the strain from trade tensions

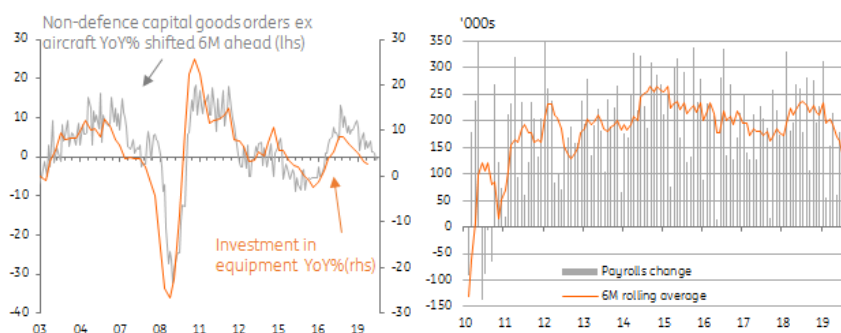
The combination of the US administration’s more belligerent position on trade with China and the willingness to use the threat of tariffs as a means of achieving non-related political “wins” (such as with Mexico and immigration) has only intensified concerns about the prospects for the US

economy. There is a growing risk that the uncertainty surrounding global trade leads to a sense of paralysis in corporate America that prompts a broader economic slowdown.

Do firms go through the expensive process of on-shoring production back to the US or looking for non-Chinese suppliers only to find that President Trump has changed his position again? Or do they instead carry on with business as usual and risk higher tariffs that put up costs and hurt profit margins? Faced with such uncertainty many firms may simply sit on their hands and do nothing. This implies a slowdown in investment and hiring – and not just in the US – which in turn leads to lower consumer spending and the rising threat of recession.

The narrative surrounding the attritional nature of prolonged trade tensions received support from the latest jobs report, showing a significant slowdown in hiring in May – 75,000 versus the consensus forecast of 175,000, while there was a further 75,000 downward adjustment in employment numbers for the previous two months. Weakness can also clearly be seen in the manufacturing sector, with the ISM report at its lowest level since October 2016 as high inventory levels led to softer new orders. Currently, the Atlanta Fed GDPNow indicator is running at a rate consistent with 2Q GDP growth of just 1.4%, which would be the weakest outcome since 4Q15.

## Signs of a slowdown...



## The Fed's shift

At the same time, Fed officials appear to be laying the groundwork for another shift in stance. Having signalled a willingness to be “patient” on assessing whether a change in interest rate policy was going to be required, Fed Chair Jerome Powell stated last week that the Fed was now “closely monitoring” the implications of the protracted trade negotiations for the economy.

St Louis Fed President James Bullard (an FOMC voting member) was more direct, arguing that a rate cut “may be warranted soon” to provide some insurance in case of a sharper than expected slowdown”. Other Fed officials, such as Charles Evans, President of the Chicago Fed, continue to talk about the US’ “solid” fundamentals, but he too acknowledged that they can adjust policy “if that’s necessary”.

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*Equities like what they hear*

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The trade, macro, Fed talk and subdued inflation backdrop has led markets to price-in up to 100bp of rate cuts over the next twelve months. This coincidentally matches the demands of President Trump, which would, in his view, allow the US to lift off like “a rocket ship”. Equities like what they hear and we are left with the bizarre situation whereby “good” economic data is ignored and “bad” economic data is seen as increasing the likelihood of a rate cut so both bonds and equities rally.

## Trade remains key

There is the possibility that rate cuts will not be required, but for this we would need to see a prolonged period of expectations-beating data and a swift positive conclusion to trade talks. In this regard, President Trump’s decision to pull back from ramping up tariffs on Mexico has renewed hope that he and the Chinese president could strike a deal at the G20 summit later this month (assuming the latter turns up). However, we think this is doubtful.

China will not want to be seen as having been successfully bullied into agreeing to US demands while President Trump’s view that tariffs are boosting US Treasury coffers and that the “strong” US economy can withstand near-term pain suggests he is not going to back down soon.

This could go in one of two directions. On the negative extreme, China refuses to do a deal with the US and uses domestic stimulus to offset to pain from trade. Donald Trump doesn’t back down, the US economy slows markedly and even aggressive rate cuts fail to stimulate the economy enough to get President Trump re-elected. China then gets to negotiate with a new Democrat President who may be less confrontational and with whom they can get a “better” deal.

On the positive extreme President Trump’s hardline stance intensifies and the Fed delivers the aggressive rate cuts he has been demanding. He then swiftly ends the trade war (irrespective of whether he has won a “great” deal) and tariffs are slashed to zero. We then get a positive wave of sentiment with equities surging and the economy bouncing back right ahead of the election.

## Rate cuts are coming

Either way, the trade situation will get worse before it gets better and is likely to spread to Europe and Japan. Given the language shift from Fed officials we believe that they will use the June FOMC to signal an easing bias. This would perhaps be through repeating Chair Jerome’s Powell use of the “closely monitoring” phrase and downward revisions to their economic projections and their “dot” diagram of rate expectations, which currently has a rate hike in for 2020.

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*The trade situation will get worse before it gets better and is likely to spread to Europe and Japan*

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Some in the market believe that this could be a catalyst for a July rate cut given Powell has said all meetings are “live”, not just the ones where there are press conferences. However, outside of manufacturing, the US numbers don’t look too bad. The ISM non-manufacturing index moved higher this month, consumer confidence is holding at strong levels and labour surveys suggest the slowdown in employment growth remains primarily because of a lack of suitable workers rather than a downturn in hiring. After all, the National Federation of Independent Businesses reported that a net 21% of its members are looking to hire (highest since last December) while 38% of

businesses can't fill the vacancies they currently have. These readings are not consistent with an imminent threat of recession.

Cutting rates in such an environment could be negative for corporate and household sentiment if it is interpreted as signalling the economy may be in worse shape than believed. It would also leave the Fed open to criticism of caving into political pressure. Instead, we suspect the Fed will favour waiting until September and follow up with another 25bp move in December.

## Trump needs a deal

This is a shift from our previous view that the Fed would keep policy on hold through 2019 and 2020, but we remain less aggressive than the market. Our more upbeat assessment centres on the strong US fundamentals, the tightness in the labour market and our view that President Trump will want deals to be done. Bond markets will be impatient for more so a temporary 2-10-year yield curve inversion is probable before a trade agreement is signed.

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*We remain less aggressive than the market*

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The often-repeated suggestion that equity markets are a better barometer of his success than opinion polls means that President Trump will need to be wary that pushing too far for too long runs the risk of weakening his re-election campaign. After all, lower interest rates can only do so much to support the equity market if the core problem – trade – is not dealt with and global growth is deteriorating. A weakening economy and plunging equity markets is an easy attack line for a Democratic challenger.

The hawks in Trump's team who are more focused on restraining China's global political ambitions will also be wary because if Trump loses the election they will be out of the Administration and will not be able to influence the debate to anywhere near the same extent. As such, we think President Trump will make compromises to get a deal done, but with Europe and Japan also in the firing line our trade team believe it may be 1Q20 before there is a clear resolution.

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# Stability, not growth, is China's domestic focus amid the trade war

Weak Chinese exports are hitting the country's supply chains. With no deal in sight in the trade war, we're expecting the Chinese government to...



China's President, Xi Jinping with US President, Donald Trump in Beijing, 2017

## No trade deal in sight

Even if President Xi and President Trump do meet on the sidelines of the G20 Osaka meeting later this month, a trade deal looks almost impossible in its current form. China is not going to capitulate under US pressure to change its laws (it's a matter of sovereignty) and the US will not accept this resistance. A meeting could take place, but we expect it will not undo the current deadlock. A good outcome would be a commitment to resume talks and result in no changes in tariffs. A bad outcome would be an immediate 25% increase in tariffs on China's remaining (some USD300bn) of goods.

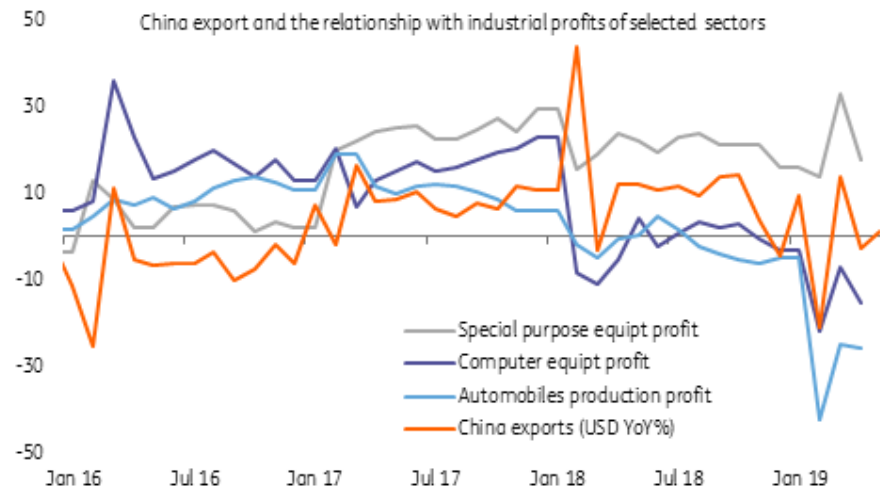
## How exports are hurting China's supply chain

Recent data releases highlight the deterioration in Chinese economic activity stemming from damage to export supply chains. This isn't just the effect of US tariffs but also reflects the technology war.



China exports are directly related to the profit growth of computer and special purpose equipment as these are industries highly related to export sales. It's a similar story for automobile production because of the logistic demand and also because exports affect the income of many industries that in turn affect consumption and, of course, vehicular demand itself.

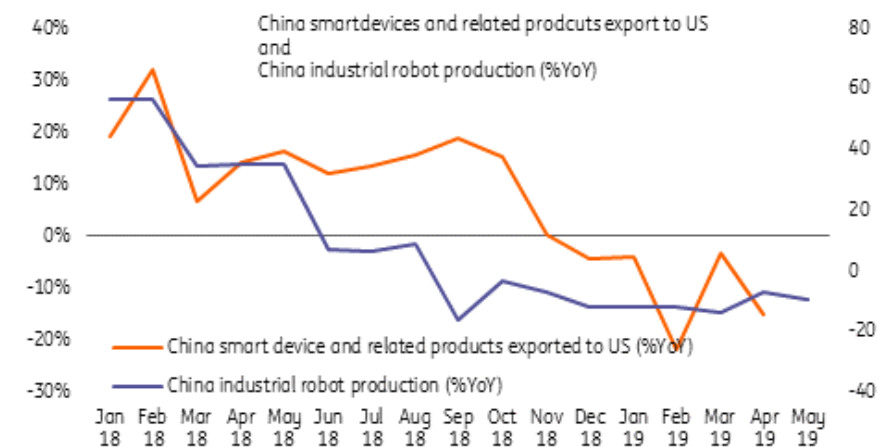
## China exports and the relationship with selected industries' profit



Source: ING, Bloomberg

Moreover, China's exports of smart devices and related products to the US is highly correlated to its domestic production of industrial robots. If China faces an intensifying technology war that continues to ban the use of Chinese made smart devices and 5G equipment, other industries in the supply chain, such as industrial robot manufacturing, in China will also be affected.

## A strong relationship: Chinese exports of smart devices to the US and its production of industrial robots



Source: ING, Bloomberg, CEIC

Expectations for a quick end to either of these conflicts has all but evaporated, and this is weighing

on investment intentions, not only in China but around the world. One of the consequences of globalisation is that companies are more interlinked, so problems with China's value chains can cause problems in companies in other countries.

## Activity data in May shows a weakening economy

Industrial production and fixed asset investments grew slower than expected in May. Retail sales came in as expected, but that's not necessarily a good sign either.

Manufacturing activities, as reflected by industrial production, grew 5.0%YoY in May from 5.4% a month ago. In some ways, this looks bad as it's even lower to the growth lows we saw in the global financial crisis in 2009-2009. But, perhaps, it looks more reasonable when you consider that exporters have expected fewer orders from exports in the coming months due to tariffs imposed on Chinese goods and the ban on using Chinese technology equipment in some countries. Industrial robot production shrank by 9.3%YoY in May after a 7.3% contraction in April.

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*The leverage effect on the economy from fiscal and monetary stimulus should be adequate to keep GDP growth at 6.3% in 2019*

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Retail sales grew 8.1%YoY YTD in May from 8.0% in April. Consumption during the long holiday supported sales. But this could be a sign that Chinese spenders stayed at home during the long holiday instead of taking leisure trips to spend in other economies. Consumers are cautious when spending. We keep monitoring items that are more volatile than others during bad times. Spending on automobiles and clothing continued to be very weak at -2.0%YoY YTD and 2.6%YoY YTD. Vehicular sales have been particularly weak due to structural changes in the market caused by technology disruption and this intensifies the current weak economic cycle. Weakening exports and a slowing manufacturing sector could derail jobs and wage growth which could well be reflected in softer retail sales data.

Investment growth was slow at 5.6%YoY YTD from 6.1%. Infrastructure related investments continued to be the sole engine of investment growth, which is the result of fiscal stimulus. Mining investment and transportation investment grew 26.1% YoY YTD and 15.4% YoY YTD in May from 25.7% and 12.3% a month ago, respectively.

## Mining and transportation investments



Source: ING, Bloomberg

## RRR and interest rate cuts expected to support a doubling of fiscal stimulus

China is likely to take pre-emptive action that will help shield the economy from the threat of further tariffs currently being made by US President Trump. We expect fiscal stimulus, mainly through infrastructure investments, to increase from CNY2 trillion to CNY4 trillion in 2019.

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*Our estimate on the size of the fiscal stimulus is more conservative than some other financial houses*

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Our estimate on the size of the fiscal stimulus is more conservative than some other financial houses. One prominent pundit sees a stimulus as large as CNY7.2 trillion. We think that's overdone as we believe that although China wants to maintain a growth rate of 6.0% to 6.5%, it does not want to create another wave of over-supply production problems, similar to those after the 2009 crisis. We anticipate that the Chinese government will step up fiscal stimulus more aggressively only if and when the economy is battered seriously by the trade and technology war. That isn't happening yet. It could do, and if it does, then they can expand stimulus further. But it is too early to make such call.

During this trade and technology war, the Chinese government indeed looks for quality growth as much as quantitative growth.

- One indicator to support this view is that shadow banking activities have shrunk since the beginning of the year. Trust loans, entrusted loans and undiscounted bills fell 6.7%YoY YTD, 10.4%YoY YTD and 14%YoY YTD in May, respectively. This is the result of small private companies being able to borrow from banks so they don't need to get loans from the shadow banking sector. Though banks take on more risks it is better than having those risks piling into such a non-transparent part of the economy.
- Another indicator of quality growth is that infrastructure investments nowadays are funded by local government special bonds. Each bond funds one investment project. This makes the

use of fiscal money more visible than back in 2009 when fiscal money could get into speculation property easily and hence created ghost towns that did not have any residents.

If infrastructure investment spending is going to be doubled, the economy needs extra liquidity. We expect the PBoC to increase liquidity by cutting the targeted reserve required ratio (RRR) 0.5 percentage points in 3Q and 4Q respectively. If extra liquidity is needed, the targeted RRR cuts could become broad based. We also believe the PBoC will cut the 7D policy interest rate, currently at 2.55%, by 5 basis points in 3Q and 4Q respectively to 2.45% to drive interest rate lower. This combination of monetary easing policies should keep 7D repo around 2.5%.

The leverage effect on the economy from fiscal and monetary stimulus should be sufficient to keep GDP growth at 6.3% in 2019, which is in the middle of the official target range of 6.0% to 6.5%.

## What about the currency?

First of all, monetary easing in China has no correlation with the currency. As such we don't expect yuan depreciation from further monetary easing.

However, though we agree that USDCNY at 7.0 is just a “round number”, it is too late for the PBoC to change market concerns that USDCNY crossing 7 will create chaos. At the end of 2016 and in October 2018, the USD/CNY didn't cross the 7 handle. The perception in the market that USDCNY 7.0 is a big deal has been consolidated by the PBoC.

Currently the Chinese economy is facing headwinds from the trade and technology war. It is even more difficult for the PBoC to allow the USDCNY to cross 7.

It is equally difficult for the yuan to appreciate as that will create an impression that the PBoC is appeasing the US administration.

We therefore forecast USDCNY at 6.90, 6.95 and 6.90 by the end of 2Q, 3Q and 4Q19.

## USDCNY: We're close to 7, but unlikely to pass it



Source: ING, Bloomberg

As of 14th June 2019

China	2018	1Q19	2Q19F	3Q19F	4Q19F	2019F	2020F
Real GDP (%YoY)	6.6	6.4	6.2	6.3	6.3	<b>6.3</b>	<b>6.2</b>
CPI (%YoY)	2.1	1.8	2.5	2.6	2.6	<b>2.4</b>	<b>2.5</b>
PBoC 7D reverse repo rate (% eop)	2.55	2.55	2.55	2.50	2.45	<b>2.45</b>	<b>2.40</b>
10Y govt. bond yield (% eop)	3.30	3.07	3.20	3.00	2.95	<b>2.95</b>	<b>2.85</b>
CNY per USD (eop)	6.88	6.71	6.90	6.95	6.90	<b>6.90</b>	<b>6.75</b>

Source: ING

# Three scenarios for Brexit under Boris Johnson

A new eurosceptic UK prime minister will face stiff opposition from Parliament if they push for a 'no deal' Brexit. That might lead to another...

## Five scenarios for Brexit under a new leader

	ING probability	How scenario could materialise	Article 50 extension?	Market reaction
Parliament forces a general election	35%	Parliament stops 'no deal' by passing no confidence motion. General election takes place in late Nov/early Dec	✓ At least 3 months	EUR/GBP: 0.95 GBP/USD: 1.18
Revamped deal	25%	To avoid election at all costs, pro-Brexit MPs reluctantly back tweaked deal given there's a Brexiteer in place for next stage of trade talks	✓ Possibly (for legislation)	EUR/GBP: 0.85 GBP/USD: 1.34
Second referendum	15%	Parliament may struggle to force a 'People's vote'. But can't fully rule out PM triggering one as "least worst" option versus an election	✓ At least 6 months	EUR/GBP: 0.82 GBP/USD: 1.40
No deal	20%	If EU rejects further A50 extension, or a new leader pushes for a hard Brexit, Parliament may lack the legislative tools to stop it	✗	EUR/GBP: 1.00 GBP/USD: 1.10
Revoke Article 50	5%	Parliament may prefer this over a 'no deal' exit, but like a 2 <sup>nd</sup> ref, MPs could lack a legislative tool to force the new PM's hand.	✗	EUR/GBP: 0.78 GBP/USD: 1.47

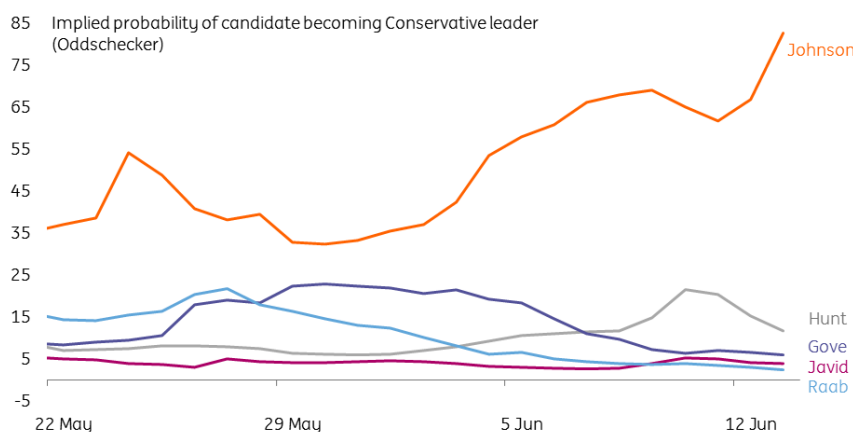
Source: ING

## What would a 'Boris Brexit' really look like?

Former UK foreign secretary Boris Johnson is now odds-on to replace Theresa May as Conservative leader. But what would a 'Boris Brexit' really look like?

Markets, at least, have become warier that it could result in a 'no deal' Brexit. In the first instance though, we assume that the first act of any new leader will be to return to Brussels and at least attempt to renegotiate the current deal.

## Johnson is easily the favourite to become leader



Source: Bloomberg, Oddschecker

Some candidates have gone one step further by saying they would try to seek a Parliamentary majority for an adapted deal upfront – e.g. one that adds a time-limit on the Irish backstop – to try and demonstrate to the EU that they have the necessary support to get their vision ratified at home.

In reality, it's very unlikely that a new leader will be able to achieve something Theresa May could not. The EU has been extremely clear that is not prepared to reopen negotiations on the withdrawal agreement, which includes the controversial Irish backstop.

But what would happen then? Taken at face value, recent comments from Johnson and other Eurosceptic candidates suggest they want the UK to leave in October, whether a deal is in place or not.

If a new PM did push for 'no-deal', Parliament would likely do all it can to stop it from happening. But unlike in earlier in the year, there may be few legislative mechanisms available to do so (for more, see this [Institute for Government](#) report). That's partly why we think the probability of MPs stepping in and revoking Article 50 is still only around 5%.

Having said that, we think the risk of 'no deal' is still relatively low (20% probability) and we think there are three main alternative scenarios that could prevail instead.

[Read the Institute of Government report here](#)

### 1 Scenario 1: Parliament forces an election through no confidence vote (35%)

While the legislative options may be limited, there is one obvious way that Parliament could block 'no deal', and that's to try and force a general election. The leader of the opposition, Jeremy Corbyn, could put forward a motion of 'no confidence', and it wouldn't take many Conservative MPs to back it. Several moderate Conservative lawmakers have hinted they would be prepared to collapse their own government if that was the only way of stopping 'no deal'.

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*A no-confidence motion is unlikely to be successful unless 'no deal' is truly imminent*

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This poses two questions: when could an election happen, and what would be the result? On the former, the minimum time between a successful no-confidence vote to election day is seven weeks. The first opportunity for a confidence vote would be at the start of September when MPs return after the summer, which could allow just enough time to hold an election before the end of October.

In reality though, a no-confidence motion is unlikely to be successful unless 'no deal' is truly imminent. That suggests that if an election happens, it's unlikely to be triggered until mid/late October, and therefore wouldn't take place until late November/December at the earliest. Another Article 50 extension would be needed, although it's unlikely the EU would try to block it in this scenario.

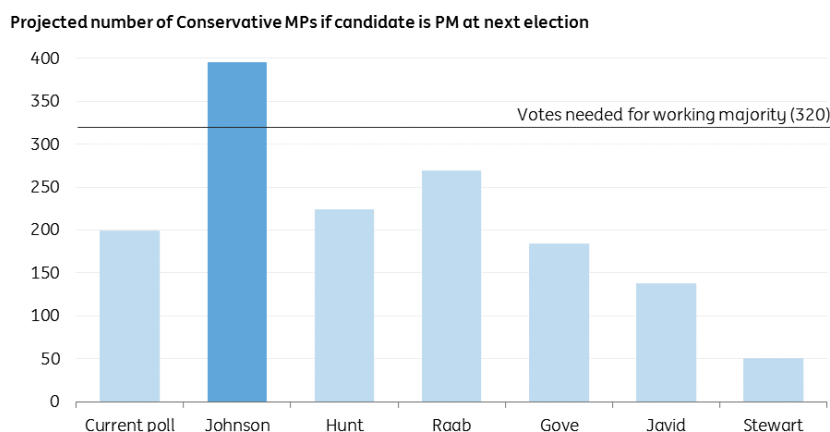
Calling the winner of a late-2019 election is much trickier. A simple mapping of recent polling onto the UK's electoral system suggests Boris Johnson could hypothetically secure an absolute majority for the party at the next election (Figure 2 ). But that prediction comes with several caveats (electoral calculators can be relatively crude), and an election forced upon him by Parliament could prove very tricky for the Conservatives. A failure to live up to his promise of achieving Brexit by October would undoubtedly give leverage to the Brexit Party.

A lot would also depend on Labour's Brexit position - so far leader Jeremy Corbyn has been reluctant to back a second referendum. But polls suggest that if he is to become prime minister, he would need to join forces with several other political parties - almost all of which would set a second referendum as their price for a coalition/confidence and supply arrangement with Labour.

It's not impossible therefore that Labour opts to campaign for a second referendum from the start, to try to limit losses to other remain-supporting parties.



## Polls suggest Johnson would be the best candidate for the Conservatives at an election – but that could change...



Source: Telegraph, ComRes, Electoral Calculus

Electoral calculus have translated recent polling into projected seats under the first past the post system – although there are various caveats with this method

### 2 Scenario 2: 'Revamped deal' receives Parliament's backing (25%)

The upshot is that there is a clear risk that a new leader could be knocked out of power if they try to push for 'no deal'. This begs the question: would Boris Johnson (or an alternative Eurosceptic candidate) be more pragmatic in office than current rhetoric suggests?

On the face of it, this sounds unlikely. Mr Johnson said at his campaign launch that "we must do better than the current withdrawal agreement", but as we noted above, meaningful changes are unlikely to be forthcoming.

But assuming Boris Johnson and other leading Brexiteers believe the election threat to be credible, it's not impossible that they'll be more open to approving May's deal (with cosmetic tweaks) than it currently seems. Don't forget that in the third meaningful vote back in March, a number of leading pro-Brexit Conservatives actually voted for May's deal – something that was unthinkable just weeks before – on the basis that they would have a 'true Brexiteer' in Number 10 for the next phase of trade talks.

That's not to say it will be easy to get a stable majority for the deal. There are a handful of MPs who want nothing short of 'no deal', while concern within the more moderate factions of the party could increase. It also seems unlikely that the DUP would sign up to a deal with the backstop. We, therefore, think this scenario is relatively unlikely, and if Boris fails to get Parliament fully on-board, he could quickly revert back to pushing for a 'no deal' exit.

### 3 Scenario 3: The wildcard - Johnson backs a second referendum (15%)

Ultimately, a new leader may well conclude that the current deal is just as unpalatable as the risk of a 'general election'. So what about a second referendum?

On the face of it, it sounds unthinkable that a Brexiteer prime minister could decide to initiate a second referendum. However, according to the [Eurasia Group](#), Johnson may be more open to this option than he admits publically.

This would undoubtedly be a high-risk strategy. While Boris Johnson would presumably push for a remain vs. no deal vote to try and maximise the leave share of the vote and gain a mandate for a harder vision of Brexit, Parliament could force a different choice of referendum question into the legislation, or even block it all together – perhaps culminating in an election after all. A botched referendum attempt, where either it took too long to arrange, or where ‘Remain’ won, would spell disaster for the Conservatives at the ballot box.

We, therefore, think it’s unlikely a Eurosceptic prime minister would go down this route – and as we mentioned earlier, we think the legislative options for Parliament to force a second referendum upon the government are fairly limited. We currently put a 15% probability on one being triggered before October.

### Lesser of two evils: Losing power vs losing a hard Brexit

The bottom line is that a new prime minister could easily find themselves boxed in by the same hurdles as Theresa May. Ironically, this means there is also a fairly good chance that a new leader will try and kick the can down the road for another six months, to allow more time to break the deadlock. There are [question marks over whether the EU](#) would grant more time without justification (France, in particular, is reluctant to allow further extensions), but even if they did, the leader will still arrive back at the same scenarios further down the road.

*A new prime minister could easily find themselves boxed in by the same hurdles as Theresa May*

In the end, it will come down to whether the new prime minister is prepared to risk losing a ‘no deal’ Brexit, in order to retain power and control of the next stage of negotiations. Taking recent comments from the leadership contenders at face value, we think there is a reasonable chance that a new Eurosceptic leader will attempt to push for a ‘no deal’ Brexit if they are unable to rework the deal before the end of October. That leaves a general election as the most likely scenario out of the ones we’ve considered, but a more pragmatic approach certainly shouldn’t be ruled out either.

For the time being, the uncertainty surrounding the process will continue to restrict economic growth. As a result, we do not think the Bank of England will hike interest rates this year, particularly given the broader risks to global growth.

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Opinion | 13 June 2019

## ECB: About bazookas and water pistols

At last week's meeting in Vilnius, ECB president Mario Draghi sent a strong signal that the ECB was only one small economic slip away from new...



Source: Shutterstock

It was not so much the announced actions – new forward guidance and TLTRO pricing – which surprised financial markets last week but Draghi's comments during the Q&A session, stressing the ECB's readiness to act "if adverse contingencies were to materialise" (see our review of the ECB meeting [here](#)). The surprise moment was when Draghi actually reported that the ECB had discussed options such as rate cuts and restarting quantitative easing in such a scenario. According to Draghi, no one should have doubts about the ECB's policy space.

### What could the ECB still do?

Since last week, many market participants are scratching their heads, wondering what the ECB actually still could do if it felt the need to act. Here are some thoughts:

- **Another cut of the deposit rate – the safe bet.** As long as the ECB believes that negative interest rates actually stimulate the economy and do not have significant negative effects (as suggested by a recent [ECB working paper](#) bank profitability is not affected by negative deposit rates) another rate cut looks like the easiest first option. Even without a tiering system. Combined with a tiering system, the ECB would shift away from the bank lending channel towards the fx channel, possibly bringing the Eurozone back on the US radar screen

- as a potential currency manipulator.
- **Restart QE – possible but only with some tweaks.** Another relatively easy-to-do option for the ECB. However, a valid question is how much “headroom”, as Draghi put it, the ECB really has to purchase bonds. According to [ECB estimates](#), the current reinvestments still absorb close to 30% of the planned new issuances in Germany in 2019 and 2020 but less than 15% in France, Spain and Italy. Don't forget that the 33% issuer limit was one of the main arguments used by the European Court of Justice in its ruling that QE was not monetary financing. As a result, headroom to significantly restart the sovereign bond purchases is rather limited, unless the ECB would be willing to deviate from the capital key. Instead, the ECB could either increase the issuer limit for EU supranationals (from currently 50% up to 100%) or step up its corporate bonds purchasing programme.
  - **Buying stocks – the bold option.** So far only a theoretical or rather hypothetical option but if the ECB really wanted to make a difference, buying equity – or going Japanese – would be the ultimate answer. Obviously, with many strings attached but just think of purchasing stocks, funds or baskets aimed at supporting investments into green technologies or linked to “green” ratings.

## Bazooka or water pistols?

All in all, while further rate cuts and restarting QE look like the most likely policy options for the ECB in case it really feels the need to act, none of these options is a magic bullet. In fact, technical, legal or economic limitations to these two types of policy instruments bring back previous euro-crisis memories of wanna-be bazookas, which actually are rather water pistols.

Eventually, the entire discussion of whether monetary policy still can kick-start a stagnating economy in a zero-rate environment will get more attention. If bazookas turn out to be water pistols, the only resort left is fiscal policy. Probably, the only thing that could really work to fight a recession or a protracted stagnation would be fiscal stimulus backed by monetary policy. However, this would require either a Eurozone budget or loosening the fiscal rules. None looks likely in the short run.

Over the last few years, the ECB under Mario Draghi has frequently proven that no one should ever underestimate its willingness to act or simply do “whatever it takes”. At least as long as Mario Draghi is in office, there is nothing worse for the ECB than admitting it has run out of ammunition. The ECB will do everything it can to avoid such a confession. Secretly, most ECB officials will keep their fingers crossed that the ECB's determination to act will not be tested and that the Eurozone economy can avoid new slippages. If not, the next months will quickly show whether Draghi can once again overachieve or whether he has lost his magic touch.

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## Swiss National bank: Doves remain silent

The Swiss central bank decided today to keep its monetary policy unchanged and leave the main policy rate at -0.75%. It has reiterated its willingness to...



Source: Shutterstock

Swiss National Bank's Chairman of the Governing Board Thomas Jordan

### No change in monetary policy

The monetary policy assessment was not fundamentally different from that of March. In its text, the central bank was not really more "dovish" than the last meeting, unlike other big central banks like the Federal Reserve and the European Central bank. It still considers that the Swiss franc is "highly valued" and has not really changed its analysis of the macroeconomic situation. The Swiss central bank considers that downside risks are greater than at the March meeting but it did not change its forecast for GDP growth. It has slightly changed its inflation forecast for 2020 (upwards) and for 2021 (downward), but not enough to signal a change of course.

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*We will probably have to wait for the next economic cycle to see the Swiss central bank raising rates, which means not before 2023*

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The only change in monetary policy is more a technical change: the SNB has changed the reference rate for its monetary policy. If it was basing itself on the 3-month Libor, it stopped that because the future of the 3-month Libor is not guaranteed after 2021. So it set a new benchmark rate, called "the SNB policy rate". The SNB is still aiming to keep short-term interest rates on the money market pledged in francs at a level close to that of its key rate. The short-term interest rate of the most representative money market for short-term loans in francs is currently SARON, which it now uses as a reference when assessing the actual conditions in the money market. SARON being a day-to-day money rate, the SNB announces there will be no fluctuation band anymore. At the moment, the three-month Libor and the SARON are at the same level, which means that monetary policy has not been changed.

## Base scenario: Rates unchanged for a very long time

Given today's decision, we think the SNB will keep rates at their current level for a long time. We will probably have to wait for the next economic cycle to see the Swiss central bank raise rates, which means not before 2023.

### Will the SNB follow the "dovish" movement?

Given the global context and the probable monetary easing by other major central banks, the most interesting question now is what the SNB will do if the Fed or the ECB reduced their key interest rate. The SNB was reluctant to answer this question at the press conference.

*We believe the first thing the SNB will do if the Fed and the ECB cut rates is to intervene in the foreign exchange market in order to offset the appreciation of the Swiss franc*

We believe the first thing the SNB will do if the Fed and the ECB cut rates is to intervene in the foreign exchange market in order to offset the appreciation of the Swiss franc. If it's not enough and we were to see a big effect on the EUR/CHF exchange rate and a strong appreciation of the Swiss franc, the SNB would then consider loosening monetary policy further.

After all, members of the SNB's governing board have said many times that there is still some room to cut rates further. In that case, it could increase the exemption threshold from the negative interest applied to sight deposits in order to lower the burden on banks. However, this would not solve the side effects linked to negative interest rates on the mortgage sector (bubble risk) and that's why we think they'll first try to avoid cutting rates.

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# Europe's crucial choice: Who'll be the next ECB president?

The next president of the European Central Bank should be decided at a crucial European summit on June 20th. ING's Carsten Brzeski looks at who's...



## Carsten Brzeski on the next ECB president

Carsten Brzeski, Chief Economist for ING Germany, looks at who's in the running for the top job at the European Central Bank.

[Watch video](#)

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Article | 13 June 2019

## Brazil: No room for rate cuts just yet

Central bankers seem reluctant to ease monetary policy, despite the poor activity prints seen lately. With passage of fiscal legislation still uncertain,...



Source: Shutterstock

### Uncertainty regarding the fiscal consolidation agenda continues to call for caution

Recent statements by central bank officials show a strong resistance to considering rate cuts at this stage. This shows up primarily in their diagnosis of the poor GDP growth prints seen recently, which are justified by several factors, particularly the persistent uncertainty regarding Brazil's fiscal outlook. But the central argument that officials seem to be making is that rate cuts would not be effective to stimulate growth right now.

With the fiscal consolidation effort critically dependent on the still-uncertain passage of the social security reform in Congress, rate cuts would be premature, hurt the central bank's hard-won credibility and, ultimately, fail to stimulate the economy.

As a result, we expect the central bank to keep the SELIC rate unchanged, at 6.5%, at next Wednesday's monetary policy meeting.

The post-meeting statement could be tweaked slightly, in acknowledgement of the frustration with the economic activity, but we are afraid that **investors expecting a decisive dovish shift may be disappointed.**

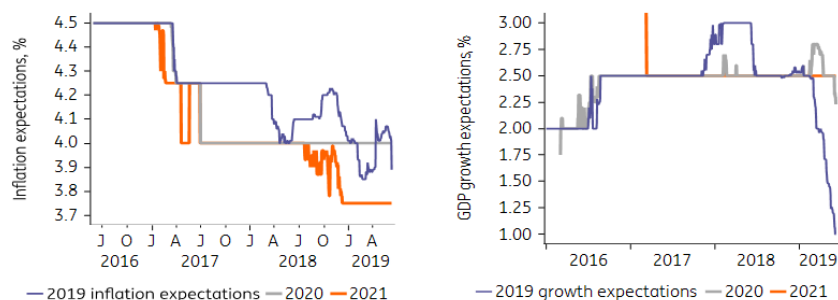
For now, we expect bank officials to maintain the current “neutral” guidance largely unchanged, characterizing the balance of risks to the inflation outlook as “symmetrical”. This should give bank officials maximum optionality to implement policy changes once the outlook for the social security reform is altered, in the coming weeks.

## A more aggressive dovish shift is possible, after next week’s meeting

Once fiscal uncertainties are addressed, with the passage of the social security reform, possibly by mid-July, Brazil’s inflation outlook should undergo a large-enough improvement, we suspect, to prompt central bank officials to launch a new easing cycle. This vote should be the biggest catalyst for price action in the coming months.

With inflation likely to drop to less than 3.5% YoY next month, thanks to a specially favourable base-effect in June and lower energy prices, fully-anchored inflation expectations and improved inflation forecasts, largely on the back of the expected appreciation of the BRL, monetary authorities would have strong arguments to re-launch the easing cycle as early as the July 31 meeting, if the reform has been approved by then.

## Central bank surveys reinforce prospects for fully-anchored inflation and a delayed recovery



Source: Macrobond

Our base-case is that the reform will be approved late in August/early September, therefore the first rate cut would take place only in the September 18 meeting, but the risk of an earlier approval of the reform, and an earlier cut, has increased.

Given the heavy long-USD positioning by local investors, who have used the USD as a hedge for their overweight positioning in other local assets (equity/bonds), if a confidence-boosting social security reform is approved, the BRL could undergo a particularly strong rally, possibly overshooting towards the 3.3-3.4 range in a relatively short period of time.

The persistently wide output gap, with large spare capacity seen in both industrial activity and labour market, and with prospects for considerable fiscal tightening in the foreseeable future, the SELIC rate can be cut by at least 100bp further, without risking turning the policy mix excessively loose.

In fact, the approval of a strong social security reform, a strong BRL and dovish action by global

central banks suggests that BACEN could follow its Chilean counterparts and opt for a frontloaded adjustment. As such, **two 50bp rate cuts could be an appropriate course of action**, when compared to alternatives of 25bp and 100bp.

## Social security reform debate reaches its most critical stage

The social security reform debate is now reaching its final stage in the Brazilian Lower House. The Lower House Special Committee presented today the amended draft proposal, which incorporates a relatively moderate dilution in the expected fiscal savings, when compared to the ambitious initial proposal by the Bolsonaro administration. The new proposal matches the BRL1.1tr 10-year adjustment included in the original proposal, but part of that adjustment now comes from higher taxes.

A firm voting schedule has not been agreed upon yet, but the committee could vote on this new proposal by next week. This could pave the way for the all-important first-round vote by the entire Lower House to take place during 1H July, i.e. before the 1-month mid-year recess that starts mid-July.

Our base-case scenario though is still that this vote will place after the mid-year break, in the second half of August. In this case, the reform could reach the Senate by mid-September and be fully concluded by November.

The political momentum has improved, with support for the reform broadening, but pressure by special-interest groups suggests that much can still change until the reform becomes law, with the risk of erosion in the projected savings from the reform staying elevated in the coming weeks.

# European builders frontrunners in robotics

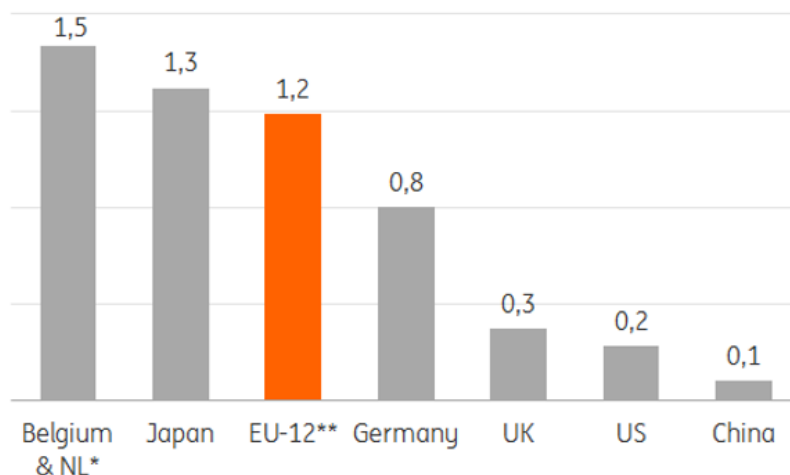
The global construction sector is not known for innovation. But in Europe, that's changing



For all the talk of a robot revolution, change has been slow to come to the global construction sector. With high investment costs and variable work locations, innovation has proven challenging and automation has lagged behind other industries, such as manufacturing. But as new technologies threaten to disrupt the industry and push traditional businesses out of the supply chain, many firms are taking action- and Europe has been leading the way.

### EU-12 has relatively high number of robots in construction

Number of robots per 10,000 workers, 2017



Source: World Robotics, National Bureau of Statistics of China, Oxford Economics. \*Data for Netherlands, Belgium only available for two together. \*\*Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain

## The EU-12 is doing well relative to other regions

European construction companies may still have a long way to go. But relative to their peers in the US and China, they're significantly more advanced in the area of robotics. Builders in the EU-12 have, on average, 1.2 robots per 10,000 workers compared to 0.2 in the US and 0.1 in China.

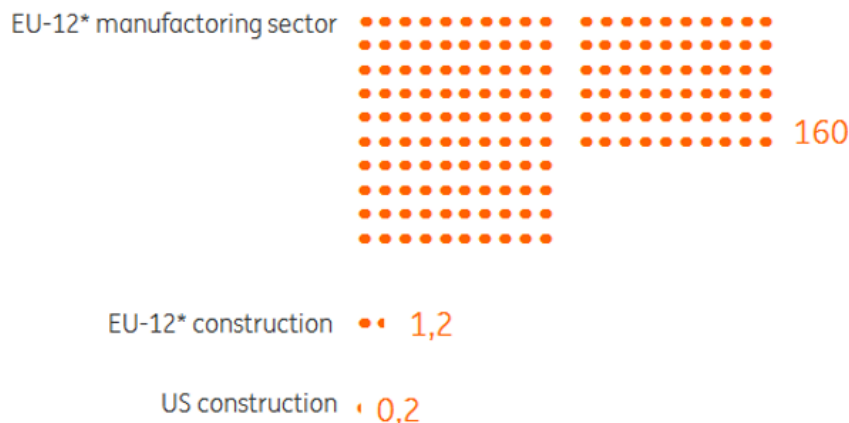
Within Europe, however, there are sizeable differences:

- The German sector has 0.8 robots per 10,000 workers
- The UK has 0.3 robots per 10,000 workers
- The Netherlands and Belgium have 1.5 robots per 10,000 workers

The high score in the Netherlands and Belgium is perhaps not too surprising given the relatively high wage costs there, which make robotics more financially attractive. For the Netherlands specifically, the relatively high percentage of series-based construction (such as terraced houses) ensures that work can also be robotised relatively more easily. In addition, building production has grown faster there in recent years than in most other countries, suggesting more room for new investment (in new robots, for instance).

### Robots in the EU-12 construction sector: fewer than in manufacturing, more than in the US

Number of robots per 10,000 employees (2017)



Source: World Robotics, National Bureau of Statistics of China & Oxford Economics, processed by the ING Economics Department. \*Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain.

## Construction lags behind in industrialisation

In Europe, each employee in the construction sector has access to almost €10,000 worth of machinery. While that might sound like a lot, it's less than a fifth of the amount available to those working in manufacturing.

Construction companies require a very high degree of flexibility, which industrialisation does not offer. Builders have to build something different each time at a different location, and expensive machinery is not easy to move from place to place. Construction companies are also dealing with a volatile market, with periods of peak activity alternating with periods of no activity – conditions that demand quick scaling up and down. This is not a good combination for a business with high capital intensity.

### European construction worker has little machinery

Value of machinery per worker



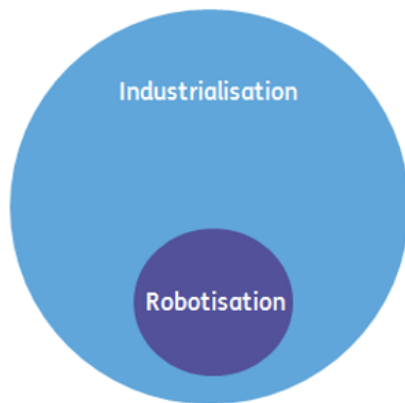
Source: Eurostat & ING Economics Department

## Robots suitable for parts of the construction process

To some extent, new robotics technology, along with prefabs, provide a solution for further industrialisation. After all, robots do offer more flexibility than 'traditional' machinery that can often only do one thing. There are various activities in the construction sector (such as bricklaying) that lend themselves to robotisation. Unlike a machine, a robot can also perform various programmable tasks, which is very important in construction, where every project can be different.

The rise of prefabs provides a boost because it's easier to have robots operating in a factory than outside at the construction site, where weather conditions can be changeable.

### Robotisation is a part of industrialisation



**Industrialisation:** One aspect of industrialisation is the mechanisation of production processes, as part of which manual actions are performed by machines.

**Robotisation** involves having actions performed by advanced machines (robots) that:

- are reprogrammable;
- are operated automatically;
- have three or more axes;
- can be either fixed at one spot or mobile; and
- offer flexibility because they can be used for multiple purposes.

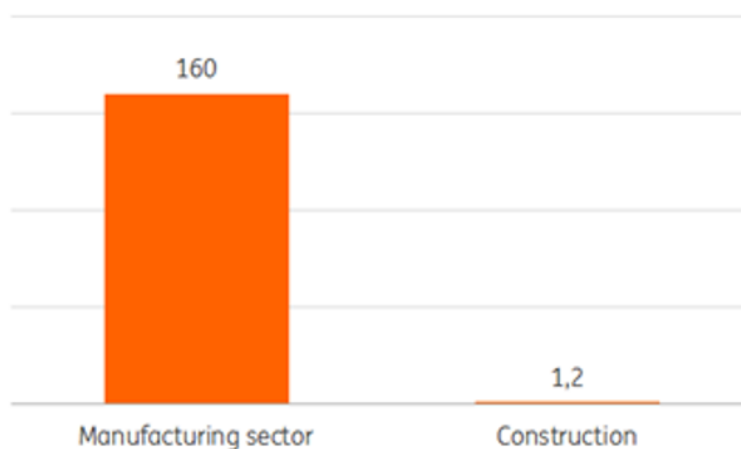
Source: ING Economics Department

## Construction lags manufacturing

Compared with the European manufacturing sector, there is still a significant difference in terms of the use of robots. As mentioned above, there are 1.2 robots per 10,000 workers in the construction sector, compared with approximately 160 (per 10,000 workers) in the European manufacturing sector. Robots may be able to perform various activities in construction but the high investment costs are often a problem for companies because they don't know whether they will be able to recoup the investment if the economy turns down. In addition, not all construction activities can be carried out in a factory, which means that the transportation of robots from one construction site to another, along with possible adverse weather conditions, remains an issue.

### Very few robots in construction compared with manufacturing sector

Number of robots per 10,000 workers in EU-12\*, 2017



Source: World Robotics, Eurostat & Oxford Economics & ING Economics Department. \*Austria, Belgium, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain



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Report | 14 June 2019

## June economic update: Monetary policy to the rescue

Financial markets are clamouring for policy stimulus as trade tensions and worries about global growth mount. Optimism that China and the US will settle...



### Monetary policy to the rescue

Financial markets are clamouring for policy stimulus as trade tensions and worries about global growth mount. Optimism that China and the US will settle their issues this month is fading fast, and it looks increasingly likely that central bankers will bow to both political and market pressure for rate cuts. However, we expect any easing to stop short of current market expectations. This may result in further equity market weakness and a renewed inversion in the yield curve before a trade agreement is eventually signed.

Recent US data suggests the economy is becoming less resilient to the negative trade headlines and the Federal Reserve is signalling moving in the direction of policy easing. This is fuelling market

expectations of aggressive stimulus – in line with President Trump’s demands for 100 basis point of rate cuts. We think precautionary 50bp rate cuts from the Fed are likely.

Neither China nor the US seem willing to back down right now and it looks as though trade tensions will escalate further. But in the end, we believe President Trump wants to get re-elected and a deal will be done. After all, lower interest rates can only do so much to support the equity market (and Trump’s perceived re-election chances) if the core problem – trade – isn’t dealt with and global growth deteriorates further.

In China, we think the authorities will increase fiscal stimulus, as well as cut interest rates and the reserve requirement ratio (RRR) to support growth, in what is a difficult environment for Chinese companies in the trade and technology sectors.

Some of the green shoots we observed last month in the eurozone might be nipped in the bud if the trade war continues to escalate. The initial figures for the second quarter are mixed, though it’s too soon to pencil in a stalling of the recovery. While the European elections were basically a non-event, the political risk in Italy is rising again. Slowing growth and declining inflation expectations have forced the European Central Bank to introduce an easing bias in its communication. The path forward now looks open for a rate cut in the coming months.

Boris Johnson is odds-on to become the next UK prime minister, prompting concern that he could push for a ‘no-deal’ Brexit. But a new leader will face the same hurdles as Theresa May, and parliament would likely trigger an election if a ‘no-deal’ is imminent. In the meantime, the uncertainty will continue to keep a lid on economic growth.

Japan’s 1Q19 GDP was an impressive 2.2%, but the details behind that growth are far less impressive, and growth in 2Q and beyond could struggle. With the Fed looking more dovish, the Bank of Japan will be looking anxiously at the USD/JPY rate, and wishing it had some effective tools left in its monetary arsenal. Unfortunately, it has none.

The drop in US interest rates has undermined the dollar. If this is the start of the long-awaited dollar decline, we expect it will be USD/JPY that leads the charge. Macro-political challenges in Europe mean that EUR/USD will struggle to better the 1.15 level.

On market rates, one of the nuances that we identify is the likelihood that the Fed under-delivers on the market rate cut expectations. This could force long rates lower as the disappointment on the extent of the delivery of cuts prompts investors to switch out of risk assets into Treasuries, which still offer a positive yielding risk free rate.

# ING Global Forecasts

	2017					2018F					2019F					2020F				
	1Q	2Q	3Q	4Q	FY	1Q	2Q	3Q	4Q	FY	1Q	2Q	3Q	4Q	FY	1Q	2Q	3Q	4Q	FY
<b>United States</b>																				
GDP (% QoQ, ann)	1.8	3.0	2.8	2.3	2.2	2.2	4.2	3.4	2.2	2.9	3.1	1.7	1.6	1.8	2.5	1.6	1.8	1.9	1.9	1.8
CPI headline (% YoY)	2.6	1.9	2.0	2.1	2.1	2.7	2.7	2.6	2.2	2.4	1.6	2.0	1.9	2.1	1.9	2.5	2.1	2.2	2.2	2.2
Federal funds rate (% eop) <sup>1</sup>	0.75	1.00	1.00	1.25	1.25	1.50	1.75	2.00	2.25	2.25	2.25	2.25	2.00	1.75	1.75	1.75	1.75	1.75	1.75	1.75
3-month interest rate (% eop)	1.15	1.30	1.35	1.55	1.55	2.30	2.35	2.45	2.65	2.65	2.60	2.45	2.20	2.05	2.05	2.05	2.05	2.05	2.05	2.05
10-year interest rate (% eop)	2.40	2.30	2.30	2.40	2.40	3.00	3.00	3.00	2.80	2.80	2.30	2.00	1.80	1.60	1.60	1.70	1.90	1.90	1.90	1.90
Fiscal balance (% of GDP)					-3.5					-4.0					-4.6					-4.7
Fiscal thrust (% of GDP)					0.0					1.1					0.4					0.0
Debt held by public (% of GDP)					76.1					76.7					78.8					81.2
<b>Eurozone</b>																				
GDP (% QoQ, ann)	2.7	2.7	2.7	2.7	2.5	2.8	1.6	0.5	1.0	1.9	1.6	0.4	0.9	1.1	1.0	0.9	1.2	1.0	1.0	1.0
CPI headline (% YoY)	1.5	1.3	1.5	1.4	1.4	1.3	1.7	2.0	2.0	1.8	1.4	1.3	1.0	1.1	1.2	1.3	1.3	1.4	1.4	1.4
Refi minimum bid rate (% eop)	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
3-month interest rate (% eop)	-0.33	-0.33	-0.33	-0.33	-0.33	-0.33	-0.33	-0.33	-0.33	-0.33	-0.32	-0.32	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40
10-year interest rate (% eop)	0.45	0.40	0.45	0.42	0.42	0.50	0.30	0.40	0.24	0.24	-0.07	-0.20	-0.20	0.00	0.00	0.10	0.10	0.10	0.10	0.10
Fiscal balance (% of GDP)					-0.9					-0.5					-0.9					-0.8
Fiscal thrust (% of GDP)					0.2					-0.2					0.3					-0.1
Gross public debt/GDP (%)					89.2					87.8					86.5					85.3
<b>Japan</b>																				
GDP (% QoQ, ann)	1.9	2.3	1.6	1.3	1.9	-0.3	2.2	-2.5	1.6	0.8	2.1	0.5	0.7	0.5	0.9	0.5	0.6	0.8	0.8	0.6
CPI headline (% YoY)	0.2	0.4	0.6	0.6	0.5	1.3	0.6	1.1	0.9	1.0	0.3	1.0	0.6	0.3	0.6	0.8	0.6	0.8	1.0	0.8
Excess reserve rate (%)	-0.1	-0.1	-0.1	-0.1	0.0	-0.1	-0.1	-0.1	-0.1	0.0	-0.1	-0.1	-0.2	-0.2	0.0	-0.2	-0.2	-0.2	-0.2	0.0
3-month interest rate (% eop)	0.00	0.00	0.00	0.00	0.00	0.00	0.00	-0.05	-0.05	-0.05	0.05	0.05	0.00	0.00	0.00	0.00	0.10	0.10	0.10	0.10
10-year interest rate (% eop)	0.10	0.10	0.10	0.10	0.10	0.10	0.00	0.10	0.00	0.00	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10
Fiscal balance (% of GDP)					-3.0					-3.0					-2.8					-2.5
Gross public debt/GDP (%)					233.0					235.0					233.0					232.0
<b>China</b>																				
GDP (% YoY)	6.9	6.9	6.8	6.8	6.9	6.8	6.7	6.5	6.3	6.6	6.4	6.2	6.3	6.3	6.3	6.3	6.2	6.2	6.2	6.2
CPI headline (% YoY)	1.4	1.4	1.6	1.8	1.6	2.2	1.8	2.3	2.5	2.2	1.8	2.5	2.6	2.6	2.4	2.6	2.6	2.5	2.4	2.5
PBOC 7-day reverse repo rate (% eop)	2.45	2.45	2.45	2.50	2.50	2.55	2.55	2.55	2.55	2.55	2.55	2.55	2.50	2.45	2.45	2.40	2.40	2.40	2.40	2.40
10-year T-bond yield (% eop)	3.30	3.55	3.60	3.90	3.90	3.75	3.50	3.65	3.30	3.30	3.05	3.20	3.00	2.95	2.95	2.95	2.90	2.90	2.85	2.85
Fiscal balance (% of GDP)					-3.7					-2.6					-4.5					-4.0
Public debt, inc local govt (% GDP)					50.0					88.0					102					103
<b>UK</b>																				
GDP (% QoQ, ann)	1.3	1.0	1.9	1.6	1.5	0.2	1.6	2.8	0.9	1.4	2.0	0.9	1.2	1.8	1.5	1.5	1.7	1.2	1.1	1.5
CPI headline (% YoY)	2.1	2.7	2.8	3.0	2.7	2.7	2.4	2.5	2.3	2.5	1.9	2.1	1.9	2.0	2.0	2.4	2.1	2.1	2.0	2.2
BoE official bank rate (% eop)	0.25	0.25	0.25	0.50	0.50	0.50	0.50	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	1.00	1.00	1.25	1.25	1.25
BoE Quantitative Easing (Ebn)	445	445	445	445	445	445	445	445	445	445	445	445	445	445	445	445	445	445	445	445
3-month interest rate (% eop)	0.35	0.35	0.35	0.50	0.50	0.60	0.80	0.80	0.80	0.80	0.85	0.85	0.85	0.85	0.85	1.05	1.10	1.30	1.35	1.35
10-year interest rate (% eop)	1.15	1.10	1.35	1.20	1.20	1.45	1.48	1.57	1.30	1.30	1.00	0.80	0.70	0.80	0.82	1.00	1.20	1.20	1.20	1.20
Fiscal balance (% of GDP)					-2.5					-1.4					-1.5					-1.5
Fiscal thrust (% of GDP)					-0.5					-0.4					-0.4					-0.3
Gross public debt/GDP (%)					87.0					84.0					83.0					81.5
<b>EUR/USD (eop)</b>																				
EUR/USD (eop)	1.08	1.12	1.20	1.20	1.20	1.20	1.17	1.15	1.12	1.12	1.12	1.12	1.12	1.15	1.15	1.16	1.17	1.18	1.20	1.20
USD/JPY (eop)	112	115	110	113	113	107	110	114	113	113	112	108	105	103	103	102	100	100	100	100
USD/CNY (eop)	6.89	6.78	6.65	6.51	6.51	6.28	6.67	6.87	6.88	6.88	6.74	6.90	6.95	6.90	6.90	6.90	6.85	6.80	6.75	6.75
EUR/GBP (eop)	0.87	0.88	0.94	0.89	0.89	0.88	0.88	0.89	0.90	0.90	0.85	0.90	0.92	0.92	0.92	0.90	0.88	0.85	0.85	0.85
<b>Brent Crude (US\$/bbl, avg)</b>																				
Brent Crude (US\$/bbl, avg)	55	51	52	61	55	67	75	76	69	72	64	68	69	73	69	70	74	76	74	74

<sup>1</sup>Lower level of 25bp range; 3-month interest rate forecast based on interbank rates

Source: ING

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