

In case you missed it: The trade war is on

Metals have been hit hard, the world's favourite safe haven currency – the yen drifts towards its lowest levels of the year, and China potentially considers 'qualitative' retaliation as the trade war escalates. Here's everything else we've been thinking about

In this bundle



FX | Japan

JPY: Why the yen's at a crossroads

We see two potentially large and opposing drivers of USD/JPY over the next six months. Further Fed tightening and US Treasury curve flattening look...

By Chris Turner



China

China: Changing the nature of retaliation on trade

It may not be until September that we'll be able to assess the extent of China's qualitative retaliation to the overnight announcement by the US...



Metals: You've got to roll with it

Metals have been hit hard by escalating trade wars and the perceived risks to global growth and demand. Amid the macro gloom, it's hard to see what...



United Kingdom

UK government in turmoil, what now for Brexit?

Having agreed a plan with her government, Theresa May has been rocked by the resignation of Brexit Secretary David Davis and now her Foreign Secretary,...

By James Knightley and James Smith



Four crucial questions for Eurozone leaders to answer

European leaders made little progress in answering profound questions about the Eurozone's future at their June summit. But ensuring economic...



FX | Switzerland

Swiss Quarterly: On the right track

Even though Switzerland's real GDP growth lost some momentum, the outlook is positive for the year ahead. Nonetheless, we've slightly revised...

By Charlotte de Montpellier

JPY: Why the yen's at a crossroads

We see two potentially large and opposing drivers of USD/JPY over the next six months. Further Fed tightening and US Treasury curve flattening look...



Bearish flattening of the US Treasury curve helping USD/JPY

Despite all the concerns of an escalating trade war, the world's favourite safe haven currency – the Japanese Yen (JPY) – is drifting towards its lowest levels of the year against the US dollar (USD). The rise in USD/JPY over 111 probably owes to firm US yields at a time when US equities are remaining bid. Here the US\$1.5trn in US tax cuts have likely delivered insulation for US equity markets.

Assuming US equities do not crash this summer, the current bias is for US yields to push higher this summer

Typically a flattening in the US Treasury curve has proved bullish for USD/JPY. Here, the typically held view is that the relative rise in short-end US rates relative to the long end makes dollar hedging costs disproportionately expensive. Japanese investors, therefore, reduce their rolling three-month dollar hedges, leading to dollar demand. For reference, it currently costs Japanese

investors 2.6% annualised to hedge their USD exposure back into the JPY using three month forward contracts. That nearly wipes out all of the yield pick-ups of investing in US Treasuries. Assuming US equities do not crash this summer, the current bias is for US yields to push higher this summer as US price pressures stay firm and the balance of risks favour USD/JPY towards 114/115 at this stage.

Flatter US Treasury curve usually helps USD/JPY



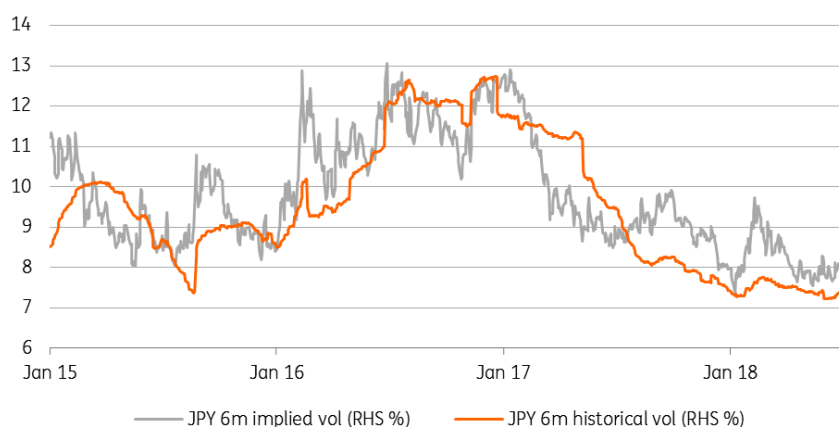
Source: Bloomberg, ING

Trade war escalation extends into the US Treasury market?

However, those positioning for higher USD/JPY will have to be nimble. As our Chinese economist [Iris Pang highlights today](#), China could start considering alternative routes to retaliate against US trade sanctions, simply because America has more imports on which to place tariffs than China. One of these qualitative threats from Chinese authorities is that of diversifying away from its large (US\$1 trillion+) worth of US Treasury holdings (probably towards European debt markets).

Clearly, it would take much provocation for the Chinese to undertake this act of economic self-harm – since the result would be to devalue both the asset and the currency which comprise the largest share of its foreign exchange reserves. [Viraj Patel addressed this issue](#) earlier in the year. Any early signs of the Chinese losing interest in US Treasuries could emerge from their participation at US Treasury auctions. Typically foreign central banks hold US Treasuries with a maturity of five years or less. Were the indirect bid (a key metric of foreign participation at US Treasury auctions) to fall dramatically at the next five-year auction (July 25th), the market could take fright.

Historical versus traded JPY volatility



Source: Bloomberg, ING

Volatility looks too low

A Chinese threat to sell Treasuries is not in our base case but were it to emerge it would prove a major negative for USD/JPY and create the kind of divergence between the dollar and US yields that was briefly seen in February this year and we discussed in Dollar Regime Change.

A Chinese threat to sell Treasuries is not in our base case

So a directional call on USD/JPY is not without its risks! But what seems more clear to us is that volatility looks too low given the risks over the next six months. Six months implied volatility – or the traded price of volatility – is at 7.50%, the lowest since summer 2014 and well before Republican primaries. Six-month historical volatility – or how much spot prices actually rise and fall – are also very low. Notably implied volatility rarely trades below historical volatility at these relatively low absolute levels. The FX options market's pricing of USD/JPY in a 106-116 range over the next six months looks too conservative in our opinion.

Author

Chris Turner

Global Head of Markets and Regional Head of Research for UK & CEE

chris.turner@ing.com

China: Changing the nature of retaliation on trade

It may not be until September that we'll be able to assess the extent of China's qualitative retaliation to the overnight announcement by the US...



Qualitative retaliation, but how?

China's imports from the US reached only \$168 billion in 2017. So, after tariffs on \$34 billion worth of goods, with an additional \$16 billion in the pipeline, the overnight announcement (11 July) of a 10% tariff on a further \$200 billion of goods means that China will likely retaliate "qualitatively", as previously indicated by the Chinese authorities.

Here are some measures we believe are possible (definitely not an exhaustive list). The uncertainty surrounding such qualitative retaliation could be a cause of concern for markets.

1. We believe that the most likely "qualitative" retaliation is a version of the "Lotte Department store model" (a Korean store forced to shut down by the Chinese government after missiles were installed on land the company sold to the South Korean government). As they are opening up their market to the rest of the world, China should tread cautiously in making life difficult for US companies operating in China. But, they could, if they feel they need to, make US business operations on the mainland more cumbersome, making it clear that this is only a retaliation to US tariffs and specific to US companies. It is likely that European and

- domestic brands would emerge as winners.
2. China can also limit tourists visiting the US, bringing business worth \$115 billion in 2017 [according to Xinhuanet](#). China will probably not limit students going to the US for study because these students are a source of future talent for the country.
 3. The final weapon is not the currency, but US treasuries. Even reshuffling the foreign exchange reserve portfolio slightly by selling some US treasuries and investing more in other sovereign bonds could push up US borrowing rates.

Quantitative retaliation is on the cards

Apart from qualitative measures, China could continue its retaliation quantitatively.

China could impose a higher tariff rate on US goods. They could also impose import quotas on US goods though this would probably violate WTO rules, and as China wants to maintain its strong reputation in the WTO, this would not be ideal.

China is more likely to win the trade war

When the US started the trade war, it turned away from a free-market model to a more planned economy. China had previously operated as a planned economy for many years.

China has already announced that the tariffs collected from US would be given back to Chinese companies affected by the trade war. China can also provide tax relief for affected exporters and provide incentives for exporters to sell their goods, either in the domestic market or through exploring possibilities in non-US foreign markets.

All these measures could come into effect more quickly in China than in the US, which has a more complicated administrative process.

This is not just a trade war – but rivalry for global economic leadership

China has started to pour money into technology R&D. But it will take some time for this to bear results. Meanwhile, we expect that the US administration will continue to put pressure on Chinese technology companies operating in the US.

USDCNY forecast now at 7.0 by the end of 2018

[Our revised USDCNY forecast at 7.0 by the end of 2018](#) seems more likely than before, especially after [foreign reserves rose in June](#). We believe that the yuan is going to depreciate against the dollar in the middle of this trade war. A [7.0 may look weak but compared to other Asian currencies, it is not the weakest](#).

Article | 11 July 2018

Metals: You've got to roll with it

Metals have been hit hard by escalating trade wars and the perceived risks to global growth and demand. Amid the macro gloom, it's hard to see what...

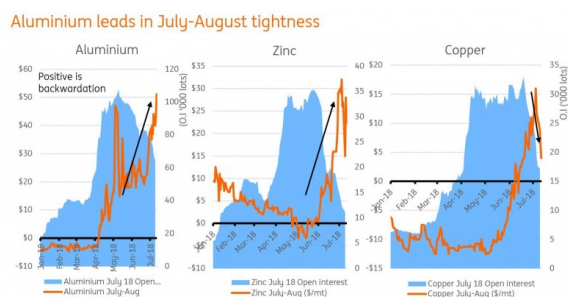


Impending tightness between July-August

Aluminium and zinc are fast approaching sharp rolls between the July-August prompts on the LME that will be costly for any near-term short positions to roll. Traders should be on the look-out for how this impending tightness could drive outright prices higher by causing shorts to exit. From thereon, however, to entice a return of long allocations will depend on the global trade-war sentiment. ING economists think that at least the direct impacts on growth/metal demand are limited and that a deal is probably going to be sought after the US mid-terms, but it's increasingly becoming the indirect effects to business sentiment that are most risky.

In LME metals, spreads between the futures dates have the proven ability to direct prices and especially as key expiries approach. It is important to remember that in a backwardation rolling a short position forward position is costly (buying the nearby is higher than selling the further out). Many commentators focus on the Cash-3 month (Cash-3M) LME spread. This is the price difference between historically the most defined closing prices but it actually tells us little about the real cost for traders to roll long/short positions in the market. In actual fact, most positions (over 2/3rds of open interest) sit on the LME's regular monthly contracts (3rd Wednesdays) and so most positions are rolled between those dates.

With the July month contract soon to expire (18th July with the last full day of trading on Monday 16th), those still short the contract will be facing costs to roll the short position forward. If they choose to instead just square out their position (buy nearby without also selling further out) that is likely to bring some much needed positive momentum to these markets. The 288 kt equivalent shorts of July Zinc, 428kt of July copper are actually fairly in line at this stage ahead of the expiry, but the 1.6Mt of Aluminium July shorts, that are going down to the wire before rolling, are looking very high making it the most tense of rolls with the most short-squeezing potential.



Source: LME, ING Research

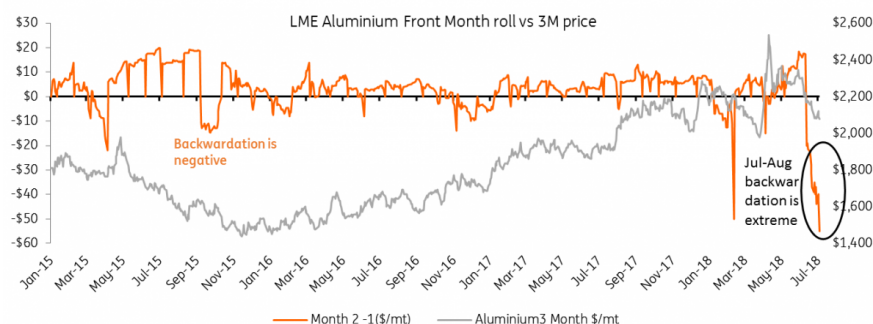
Aluminium: Immense tightness looms

It's been our conviction for a while that in a world of lower LME stocks (vs off-warrant levels) sharp monthly rolls in Aluminium are becoming more commonplace and are actually responsible for a good deal of the rally since 2015. (Read: [It's not all about China](#)).

The situation escalated as premiums get higher and provide the opposite incentive for metal to be bought and sold into the physical market rather than delivered on the LME. US premiums are now at 20c/lb effectively walling off any customs cleared material from being profitably delivered into the exchange. Other regional premiums, such as in Europe, have corrected (\$84/mt down from \$158/mt peak) and even where the forward curve on CME expects a decrease (assuming Rusal sanctions get lifted) premiums are still likely to remain higher than incentives offered by warehouses for metal to be delivered. These incentives have dropped considerably since queues at the LME warehouse were resolved and so we think its the new normal for the market to trend towards deep pockets of backwardations in an attempt to attract deliveries to the exchange.

For whatever the structural drivers of the sharp rolls, the July-August backwardation is particularly immense: \$50b (b=backwardation) and counting. It's now even surpassed the sharp spasm that occurred through February-March. Short holders who have stocks may well find this situation compelling to unwind any stocks in financing and deliver (even against high premiums) into the exchange, but likely we are also due for a substantial amount of shorts to simply buy out their position and exit the market. Given the high amount of July LME Aluminium positions outstanding (1.6 million tonnes= 62k lots) aluminium may well get the most upward support from the roll as shorts feel the squeeze.

Aluminium's erratic rolls hit new extremes for July-August backwardation



Source: LME, ING Research

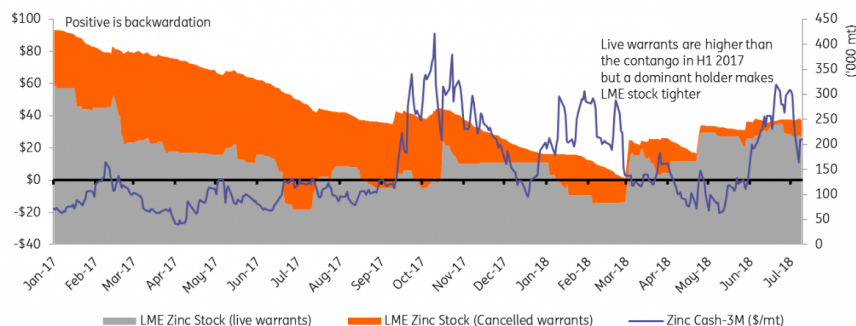
Zinc: Spreads eased but still in backwardation

We warned of a [short-term bear trap](#) from zinc spreads when the Cash-3M surged in June but it hasn't deterred the huge sell-off since: (-20% since the G7 summit). Shorts may well have increased confidence as this spread eased from a high of \$55b to a low of \$11b on Monday 9th. The more significant July-August still remains at a substantial \$22.25b, however, which would pose a big sting to the front month shorts still waiting to roll.

We think much of zinc's downfall this year has been the sheer availability of stocks on the LME. Not just have the stock levels increased but the very high proportion of those stocks on live warrants (only 14% are cancelled) has reflected a situation of high stock churn and associated spread lenders. That eased-zinc tightness certainly prevented what many saw [as a last squeeze higher](#) above \$3k. Through June though, long positions have expired into stock holdings and a single party now holds 50-79% of the LME stocks, LME data shows. The LME Lending Rules prevent a squeeze at the shortest term rolls (tom/next: 1-day rolls) but the influence to the other monthly dates can certainly be felt. Since June the July contract zinc price is down 0.5% less than the 3-month price as near-term supplies/stocks become centralised.

Zinc open interest is up 7% since June, reflecting a wave of new short positions that are being added to ride the sell-off. Whilst these positions are being made out further than the July-August tightness it is still likely that if the dominant stockholder remains in place this tightness will continue and could eventually catch those positions. Whilst we respect that zinc concentrate supply is easing significantly this year, the refined zinc metal market remains in deficit (ILZSG expect a 263kt shortage). Given this, we see no reason why a sizeable cancellation of LME stock to fill the shortfall could not occur and, in turn, maintain the backwardation. Zinc's bull run from a shortage of mine supply is surely ending but shorts need to be cautious to navigate around this squeeze.

LME Zinc stocks have been highly available, but it can quickly change



Source: LME, ING Research

Copper: A short lived backwardation

We don't think Copper's run to \$7,300 was fundamentally justified and put that move down to a technical backwardation in the spreads (read: [Copper goes back to a back](#)). Prices had peaked alongside the Cash-3M which hit a backwardation of \$12/mt before retreating and has now flipped back to a contango.

Once again looking at the monthly rolls tells us more about the strain on the shorts. June-July had peaked at a sizeable \$10.50b and it was as June expired the curve flipped back to contango. It was the roll past June that seemed to set the Cash-3m to flip back to contango. July-August did get as tight as \$16b at the beginning of July but that has retreated considerably since.

Like zinc, in copper we focus on the dominant stockholder to explain. This we believe drove the spreads to tighten through July. The dominant holdings have now retreated from 50-79% of LME (un-cancelled) stock in mid-June to the 40-49% banding currently.

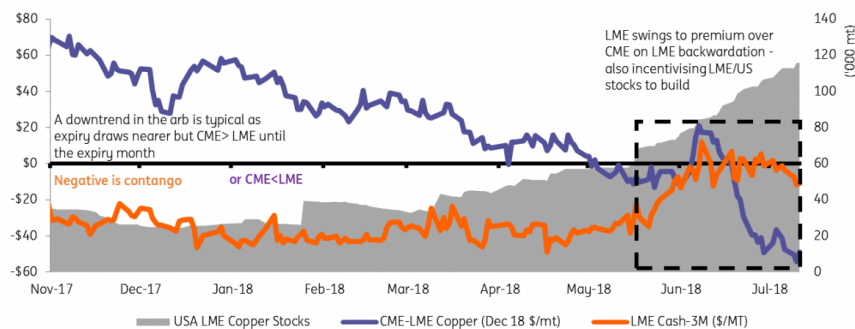
Also amid a considerably lower premium environment than the likes of aluminium (especially as Asian premiums drop) copper spreads need not be so tight to incentivise delivery into the exchange. The spreads haven't yet materialised into any big deliveries in Asia where the premiums are weakest but there has been some previously cancelled stock being put back on warrant. The ratio of cancelled-to-warranted LME Copper stock in Asia has gone from a 9 month high of 0.77:1 at the end of June to 0.43:1 currently.

In fact, the only place the backwardation is visibly drawing stocks into the LME is in the US. Reinforcing our view that the LME's backwardation has been temporary and technical (vs. fundamental), the CME has actually remained in a wide contango (along with SHFE). The divergent curve structure and the squeeze on the LME shorts have seen LME prices recently outperform CME. The CME copper price for December 18 was at a slight premium to the LME until May when the LME backwardation began to surface. Since the 2nd half of June, however, the LME has gone to having around a \$40 premium compared to CME. That LME premium to CME would only normally happen in the expiry month (December).

Some traders have therefore profited from the CME discount by delivering copper into the LME. Comex stocks have only drawn slightly though since most are fairly isolated in Utah and freight costs around the US remain very high. It's those same freight costs that are also supporting US

copper premiums and, in turn, provides competition for the copper to be sold physical material vs. the exchange.

LME Copper backwardation drove premium to CME and incentivised US stock build



Source: CME, LME, ING Research

UK government in turmoil, what now for Brexit?

Having agreed a plan with her government, Theresa May has been rocked by the resignation of Brexit Secretary David Davis and now her Foreign Secretary,...



Source: Shutterstock

UK Prime Minister, Theresa May, addresses her cabinet, including David Davis (left, looking down)

PM May's new plan

After all the build-up, last Friday UK Prime Minister Theresa May managed to persuade ministers to rally around a new plan for Brexit. Crucially, the agreement means that the UK will abide by a "common rulebook for all goods" - in other words, the single market for goods/agriculture. The government will also press for a "facilitated customs arrangement". Here the UK could apply different tariffs to the EU, in theory enabling it to pursue trade deals outside of the EU. Where tariff rates differ, the UK would collect fees on the EU's behalf.

But there's still a big question of whether the EU will accept this. Here are our thoughts on what could happen next:

1 Will the EU accept the UK's vision presented on Friday?

Not in its current form - There are three reasons why the EU is likely to reject the UK's proposal.

Firstly, on the "facilitated customs arrangement", the EU will likely view this as unworkable (practical issues of UK collecting potentially higher EU tariffs), legally-challenging (there are concerns it could encourage smuggling) and politically unacceptable (the thought of a third country collecting EU tariffs is reportedly unpopular in Brussels).

The second reason is the UK's proposal to remain in the single market for goods and agricultural still fundamentally amounts to 'cherry-picking'. The EU is worried that other countries could seek similar concessions should the UK be handed a deal that allows it to flourish. While some on the UK side point to the Swiss deal as a clear example of a country being in the single market for goods only, it's said the EU views that Swiss agreement as a mistake.

Finally, the EU is unlikely to accept that the UK has given enough ground on "the price" of single market access - that's budget contributions, freedom of movement and ECJ oversight. The UK plan officially says that all of these would "end".

Admittedly on the ECJ point, it looks like the UK may be more open to a fudge. This could potentially take the form of the EFTA court (involving EU, UK and third country judges agreeing on rulings), which is similar to what is employed in the EEA. But aside from saying a new "mobility framework" will be set-up to facilitate work/study visas, there was little talk on the other two points.

So the EU will almost certainly say no, but Brussels may seek to strike a balance when communicating this. A UK government breakdown is not in the EU's interest, so it will be wary not to completely destroy the fragile cabinet truce and risk May's position as PM, just as she is pushing in a "softer" direction.

2 Will there be a Conservative leadership challenge?

In the aftermath of Friday's meeting, Brexit Secretary David Davis has resigned, raising some uncertainty over how long that Cabinet truce on the agreement can survive. However, according to press reports, this has been in the offing for quite a while. As he implied in his resignation letter, Davis has not been happy with Number 10's strategy and has been increasingly sidelined by Theresa May's Europe Advisor, Olly Robbins.

Another key Brexiteer, the Foreign Secretary Boris Johnson also quit this Monday in another big setback for the Prime Minister's authority. But keep in mind that there is a sense that his support among governing Conservative MPs has been waning, particularly after derogatory comments about British business were made public. While damaging, this might not be a fatal blow for Theresa May.

However, we need to watch Jacob Rees Mogg and his fellow pro-Brexit MP colleagues who according to some reports are threatening to gather enough signatures to trigger a vote of no confidence and a leadership challenge. 48 signatures are required, and the press have been reporting for a while that around 40 are already secured. This morning Rees-Mogg retweeted a snap poll of Conservative Party members suggesting 60% think the Chequers plan is "a bad deal". He subsequently tweeted "no deal is better than a bad deal".

If a Tory leadership challenge is initiated, it's not guaranteed that May would lose. David Davis said this morning that Theresa May is a "good PM" and will stay – a leadership contest is "the wrong thing to do... I won't throw my hat in the ring". Many other senior MPs will be rallying around her. But if she was to lose, bookmakers suggest that Michael Gove (a key Brexit supporter) is the favourite to come out the winner. Betting company PaddyPower have odds of 4/1 that he will be the next Prime Minister with current Home Secretary Sajid Javid at 6/1 versus Jacob Rees Mogg at 7/1.

If a Tory leadership challenge is initiated, it's not guaranteed that May would lose

Gove's stance on Brexit seems to be very similar to that of May. On BBC television yesterday he issued a rallying cry for MPs to unite behind May's plan, and it looks like he is trying to be the bridge between the two Brexit factions. Javid has said very little on his Brexit vision, while Rees-Moggs would be that of a short sharp Brexit with no vestiges of EU control over the UK.

If Theresa May goes, a second election looks unlikely. Two-thirds of MPs would need to vote in favour of it, but while the Conservative party rebels may be willing to vote against the government in parliament, they aren't prepared to vote for a new election. A Survation poll in today's Daily Mail has Labour on 40%, the Conservatives on 38% and if repeated at the election then a very different Brexit could emerge to what Tory Brexiteers want.

A second referendum on Brexit also still seems unlikely – not least because there's no obvious "leader" or a united party looking for this. At PaddyPower the odds of another referendum before April 2019 are 5/1. In terms of support for Brexit, the UK is becoming more divided by age. Support for Brexit is rising in the over 65s (Survation suggested it is now at 65% for the over 65s versus 60% at the time of the referendum). Conversely, those under 45 are increasingly anti-Brexit. You Gov suggests that nationally there has been a slight shift towards remain, but not enough to clearly say the UK would likely change its mind.

5/1 Odds of a second referendum
(PaddyPower)

3 So assuming the EU says "no", what happens next?

Assuming May clings on, then the big question is how the UK's position will evolve.

We suspect it is probably only a matter of time before the UK accepts that it will stay in a customs union in full after Brexit (the "facilitated customs arrangement" agreed on Friday is halfway there). The UK may also ultimately water down its red lines on budget payments, the ECJ and migration. The EU knows these issues are politically troublesome in the UK, so it may perhaps be willing to help the government in the communication/spin – for instance, one suggestion we've heard is that the UK could make payments under the guise of aid/development funds.

So if the UK was proposing a customs union, the single market for goods, and some ground on these other issues, then it will be very interesting to see how the EU reacts. So far in the Brexit process, the EU has been very united. However, this would arguably represent the UK's first serious and workable option put on the table. Some EU countries, particularly those that trade heavily in goods with the UK, may be more tempted to go for it – although Germany and France would still likely be resistant.

4 If it's still a "no" from the EU, "no deal" risk would rise

If the EU were to reject a revised UK proposal on the single market for goods and customs union membership, then we think there are two very different directions.

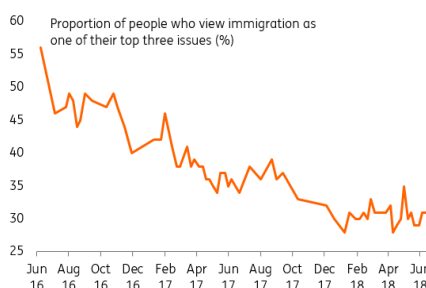
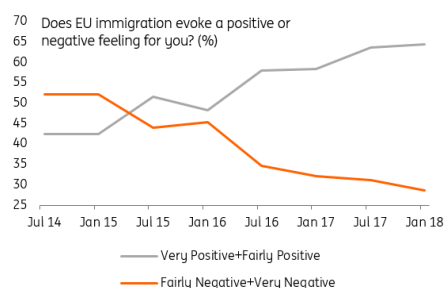
The first and probably more likely scenario is that the UK inches closer to the Norway-model (at least for a long transitional period), possibly by accepting full single market access. However, the obvious issue is that this would most likely require freedom of movement - perhaps the reddest of red lines for the UK government. Admittedly public opinion has softened on immigration since the Brexit vote two years ago - only around 30% of people put it in their top three issues, versus over 50% at the time of the referendum. But even so, this is unlikely to make this option any more politically palatable for the Conservative party.

If the government can't agree on a way forward, then a second scenario could arise where negotiations grind to a halt and talk of "no deal" rises.

The EU reportedly believes that the UK government isn't serious about a "no deal", given that no new customs staff have been hired and no obvious preparations have been made for the event of exiting without an agreement. Certainly, it could be damaging economically. The British Freight Transport Association has said that there could be up to 29-mile queues back from Dover if additional border checks were to take just four minutes (in reality it could take much longer). There would likely be similar congestion at major EU ports.

Given these concerns, we suspect it's unlikely the UK government will ultimately walk away from talks. That said, if no obvious progress were to be made as we move into the winter, then the perceived risk of a "no deal" could rise, creating sharply higher uncertainty for companies and markets.

UK voters are less negative on immigration than around the referendum



Source: DG COMM, YouGov

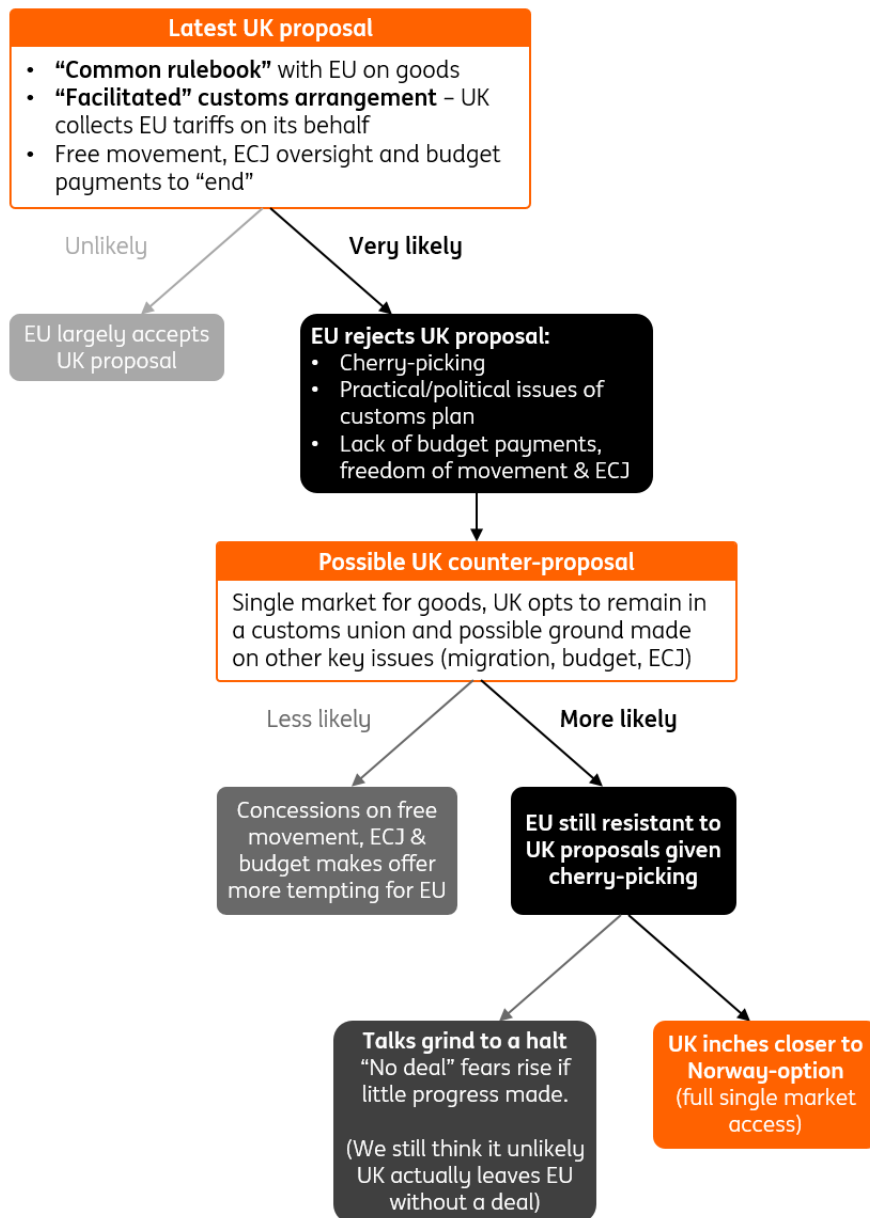
The October deadline could easily slip

Officially, the EU and UK are still working towards securing the withdrawal agreement and a political declaration on the aims of future trade talks by October. But this looks increasingly likely to slip until December, which would mean a much reduced period of time for parliament and EU governments to ratify what has been agreed. A last-minute “fudge” to enable the transition period to begin cannot be fully ruled out.

This scenario is looking increasingly likely to us given growing concern across Europe that anti-EU parties could perform very strongly at the May 2019 European parliamentary elections. It is not inconceivable that the biggest voting block in the EU parliament turns out to be anti-EU. As such we consider it doubtful that the EU will shift significantly from its current position ahead of those elections. Offering something to the UK government that could be construed as a “win” may be perceived as providing a boost to anti-EU parties elsewhere. However, once the elections are out of the way progress on Brexit could pick-up momentum.

This article was updated on Monday afternoon following the resignation of Boris Johnson.

Possible scenarios for Brexit talks over coming months



Source: ING

Authors

James Knightley

Chief International Economist, US

james.knightley@ing.com

James Smith

Developed Markets Economist, UK

james.smith@ing.com

Article | 11 July 2018

Four crucial questions for Eurozone leaders to answer

European leaders made little progress in answering profound questions about the Eurozone's future at their June summit. But ensuring economic...



Source: Shutterstock

German Chancellor Angela Merkel, left, and French President Emmanuel Macron, right, welcome the President of the European Commission Jean-Claude Juncker. June 2018

The future of Europe

Although some progress has been made over the years, we're potentially only one recession away from the fragmentation of the Eurozone. Building up Europe's resilience to future economic setbacks should be at the top of the agenda for Europe's leaders. Prompted by a recent ING-sponsored [Future Europe conference](#), where politicians and policy-makers tackled some of the pressing issues, here are four questions that Eurozone leaders should be giving answers to.

1 Is some form of fiscal capacity necessary to preserve the Economic and Monetary Union?

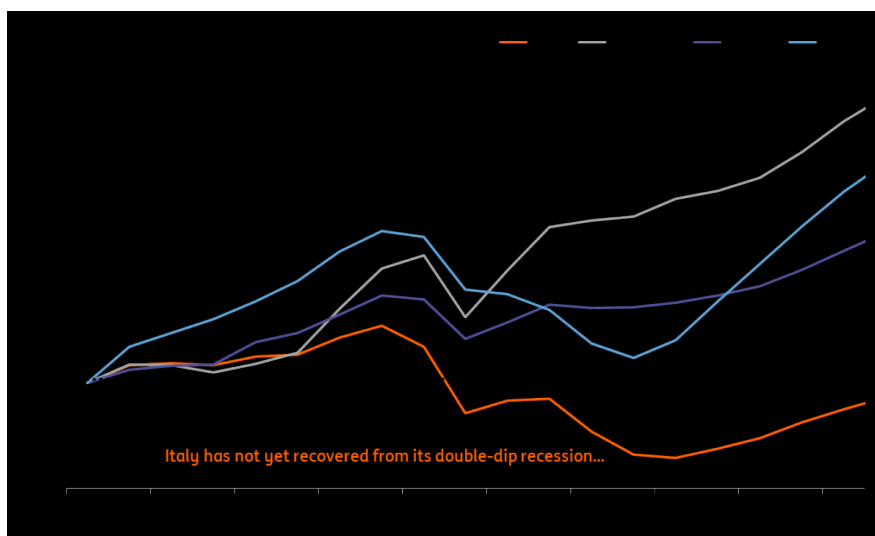
Greater fiscal capacity – an expanded budget – is not essential but it would be very helpful. Since reform, and therefore structural flexibility could take years to have a big enough effect, developing

a substantial countercyclical fiscal capacity would be timely. Governments would have greater room to fight downturns by temporarily relaxing fiscal policy. Agreement on this would also have a powerful signalling effect. By increasing the confidence in the sustainability of European Economic and Monetary Union (EMU), it might increase investment and reduce the risk of speculative attacks on it.

But size matters: the precise *form* of the fiscal capacity is less important than the strength and scale of the political commitment to it. This is important to give investors' confidence in the sustainability of the Eurozone. As to what type of fiscal capacity is envisaged, there are a number of ideas that are being considered:

1. Prioritising investment is a good idea in principle, but the efficiency in implementation in the past has been questionable.
2. An unemployment insurance fund is another worthwhile idea because it has a redistributive quality that is both economically and politically appealing.
3. A euro-wide safe asset would not only spread risk but also *reduce* risk by making it less likely that self-fulfilling market panics about debt sustainability break out in the first place.

Divergence in real incomes remains an issue



Source: ING, IMF WEO data

2 How can we balance the Eurozone's need for both financial discipline and risk-sharing?

One way is to make the fiscal rules need to be smarter. A key aspect is to make them more countercyclical. The original rules and the conditionality of the European Stability Mechanism (ESM) have forced members in trouble to tighten fiscal policy in the midst of a severe downturn. This procyclicality has been both destructive and divisive. The rules need to more clearly

Smarter and fairer rules would be easier to enforce

and consistently differentiate between current and investment spending, and headline and cyclically-adjusted deficits. Another way is to make the rules more symmetrical; surpluses can be excessive too. 'Beggars thy neighbour' policies, such as big and persistent current account surpluses, make it harder for other members to grow and reduce their deficits. Rules that are acknowledged as both smarter and fairer would be easier to enforce.



Mark Cliffe leads the New Horizons Hub

3 Is a lack of trust, given current political gridlock, a core problem?

Trust is a big part of the problem. Without it, unity is undermined. Lack of trust then leads people to rely more heavily on rules, but also lose confidence that others will obey them. It also helps to explain why there is little appetite for a **'transfer union'**, involving large-scale fiscal transfers between member states.

Lack of trust also undermines trade and investment

This reflects both a lack of trust: that transfers will be spent wisely, and a lack of solidarity: that the rich are reluctant to support the poor. Over the past decade, in the wake of the financial crisis, the likelihood of transfer union has fallen further. This has fuelled, and been fuelled by rising populism and nationalism. In economic terms, lack of trust also undermines trade and investment.

But it's not just about trust: there also has to be a common understanding of the problem. There is a clear divide between those who believe the Eurozone's problems lie more in the supply-side and institutional framework, with those who point to the lack of activism in demand management and burden sharing. Moreover, widening income divides across the Eurozone have made the EU and EMU convenient scapegoats for domestic politicians.

4 Has the goal of real economic convergence been dropped?

Formally, the EU is still committed to promoting real economic growth and convergence. Last

year's Rome Declaration by EU leaders stated:

"We...pledge to work towards...a Union promoting sustained and sustainable growth, through investment, structural reforms and working towards completing the Economic and Monetary Union; a Union where economies converge."

However, while the formal commitment to convergence remains, in practice, we have the following:

1. Politicians have failed to deliver, most critically in the case of Italy. Over the last 18 years, real incomes per head in Italy have fallen by 28% compared with Germany.
2. Post-crisis antagonisms and the rise of populism have undermined the strength of this commitment. In this atmosphere, moves to increase convergence will be harder to deliver.
3. It is hard to discern a concerted effort to deliver it in the future, whether through domestic economic reforms or larger scale fiscal transfers.

At the Future Europe conference, there was a general consensus that given the current relatively benign economic conditions, now would be a good time to act to speed up efforts to build the Eurozone's resilience to future economic downturns. But as we've seen many times before, politicians' ability to delay addressing fundamental questions about reform to ensure future economic stability is well-known. If they're not very careful, that could be their and the Eurozone's, undoing.

Swiss Quarterly: On the right track

Even though Switzerland's real GDP growth lost some momentum, the outlook is positive for the year ahead. Nonetheless, we've slightly revised...



Source: Pexels

Internal demand supports growth in 1Q18

In 1Q18, real Swiss GDP increased by 0.56% quarter on quarter, which is slightly less than the second half of 2017 (0.73% for 3Q17 and 0.62% in 4Q17), but still above its average. Moreover, compared to the first quarter of 2017, GDP grew by 2.4% which is the strongest performance in three years.

This performance is mainly due to the service sector with trade and business-related sector recovering (+0.8% and +0.5% QoQ), while financial services (+1.0% QoQ), transport and communications (+1.3%) and healthcare (+1.2%) continued to gather pace. On the contrary, the manufacturing industry experienced a low growth situation (+0.2% QoQ) and the construction sector a stagnation.

Contrary to previous periods where growth was supported by exports, the good performance of the first quarter was due to strong internal demand. Household consumption was strong (+0.4% QoQ), investment recovered strongly (+2% QoQ, the highest quarterly growth in three years) and all of this translated into above average imports growth (+2.2% QoQ).

World Cup to post a strong calendar effect

Swiss GDP is influenced by the value-added creation of Switzerland-based international sports associations such as the International Federation of Association Football (FIFA), the Union of European Football Associations (UEFA) and the International Olympic Committee (IOC).

We believe the franc could depreciate further this year and in 2019 which would boost export growth, however, risks have definitely increased given the safe-asset nature of the currency

License income generated by the marketing of major international sporting events contributes to Swiss GDP in the same way as licenses and patents in other sectors, such as the pharmaceutical industry. This isn't particularly a problem, but from a business cycle perspective, the fluctuations caused by major sporting events cause short-term movement as they don't take place every year. This is a type of calendar effect, increasing GDP during years of sports events and decreasing after that.

The Swiss administration recently started to publish GDP data adjusted for major sporting events like the World Cup or the Olympics Games, and it appears that the effect is quite significant. Adjusted for sporting events, the Swiss economy grew by 0.4% QoQ in 1Q18 compared to 0.6% QoQ without the adjustment.

0.2
pp

Effect of major sport events on Swiss GDP growth in 1Q18 due to licence income of Switzerland-based international associations

Positive outlook for investment

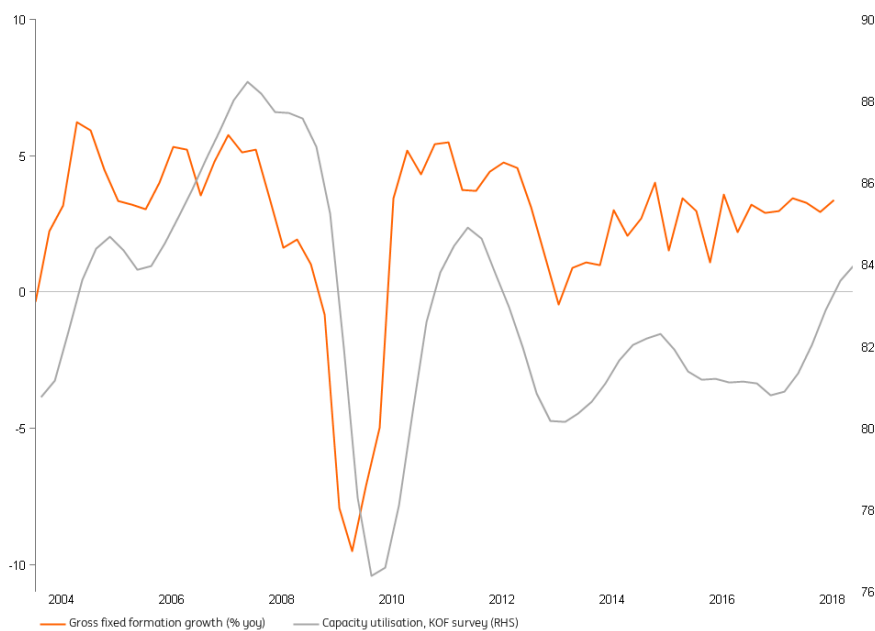
The upward trend in business investment is set to continue during this year and 2019, and as a result of the cyclical recovery, the use of production capacity has increased in strength.

According to the KOF industry survey, it is now again above the long-term average for the first time since the end of 2011. The increasing use of production capacity is likely to encourage companies to invest in their expansion. Moreover, the KOF industry survey indicates that industrial companies' order books seem to be well filled and the indicator has strongly increased since January from -4.71 to 1.04 in June. It is now above its long-term average, which has never been the case in the last ten years.

The KOF survey highlights industrial production has increased again in June after the small decrease experienced during the last three months. Expected production indicators are still at their

highest point since 2011., which is why we believe business investment should grow at a fast pace in 2018 (3.8%) and 2019 (3.1%).

Increasing use of production capacity would boost investment



Source: Thomson Reuters Datastream, ING Economic Research

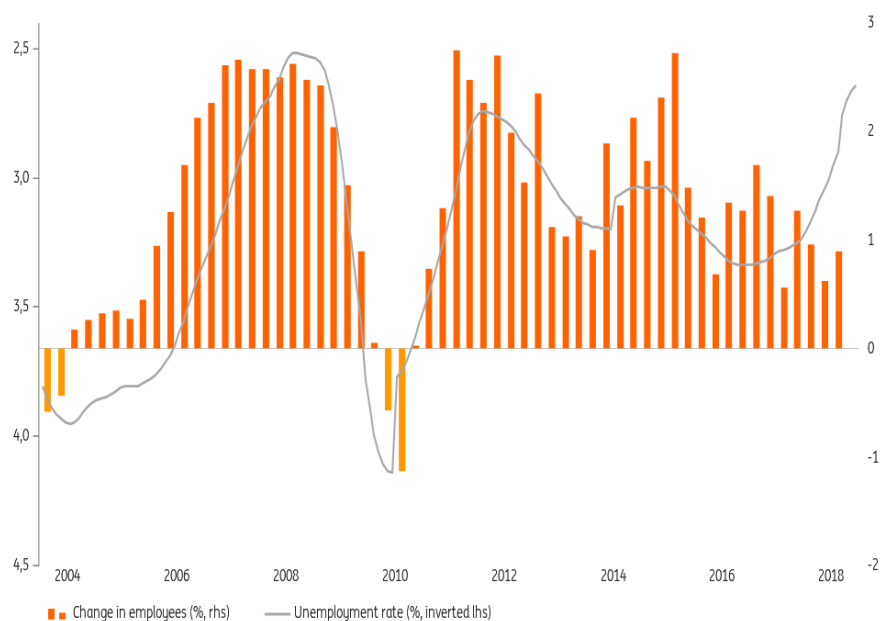
A strong labour market

In 2017, growth in consumer spending amounted to + 1.2%. The pace has therefore slowed significantly compared to the previous two years (1.8% in 2015 and 1.5% in 2016). Even though consumer confidence was high compared to 2015 and 2016, modest nominal wage developments, higher prices reducing the real purchasing power of households and sluggish job creations weakened the dynamics of consumption in 2017.

For 2018, consumption has taken the path of a better trajectory with a 0.4% QoQ in 1Q18. For the rest of the year, we expect consumption to continue rising. Indeed, leading indicators on the labour market suggest that the situation is improving again, which would push wages up and increase consumption. The unemployment rate is on a downward trend for one year, and the vacancy rate is rising. However, since inflation is set to increase a bit more in 2018, we don't expect to see much of an increase in real wages in the short term.

We believe that consumption will grow by 1.4% in 2018 and that the pace of growth would then consolidate further to 1.5% in 2019.

Unemployment rate is low



Source: Thomson Reuters Datastream, ING Economic Research

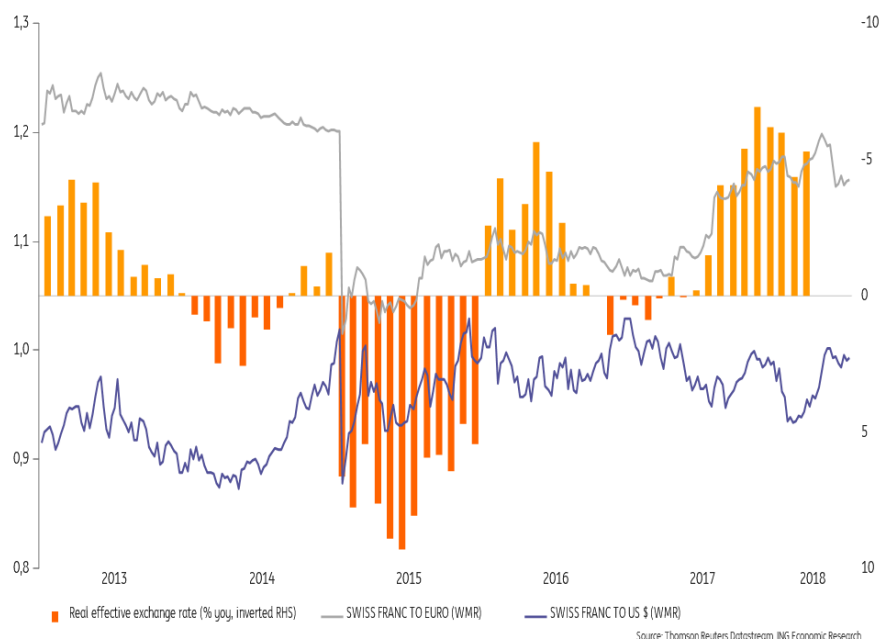
Exports would boost growth, but risks have increased

Give the strength of the US and the eurozone economies and the real depreciation of the Swiss Franc since mid-2017, foreign demand for Swiss intermediate and final products has strengthened. Consequently, exports contributed positively to growth in 1Q18. (0.96 pp).

The Swiss franc depreciated considerably at the beginning of 2018 and EUR/CHF reached 1.20 (the former floor) in April 2018, but since May, the exchange rate started to appreciate again as a consequence of political situations in Italy and Germany as well as the heightened risk of a global trade war.

We believe the Swiss franc could depreciate even more this year and 2019 which would boost export growth, however, risks have definitely increased given the safe-asset nature of the Swiss franc. A global trade war including the US administration's threat of new tariffs on the automotive sector, political tensions in the eurozone and difficulties with Brexit negotiations could lead to an appreciation of the franc and dampen Swiss companies' competitiveness.

CHF volatility



Source: Thomson Reuters Datastream, ING Economic Research

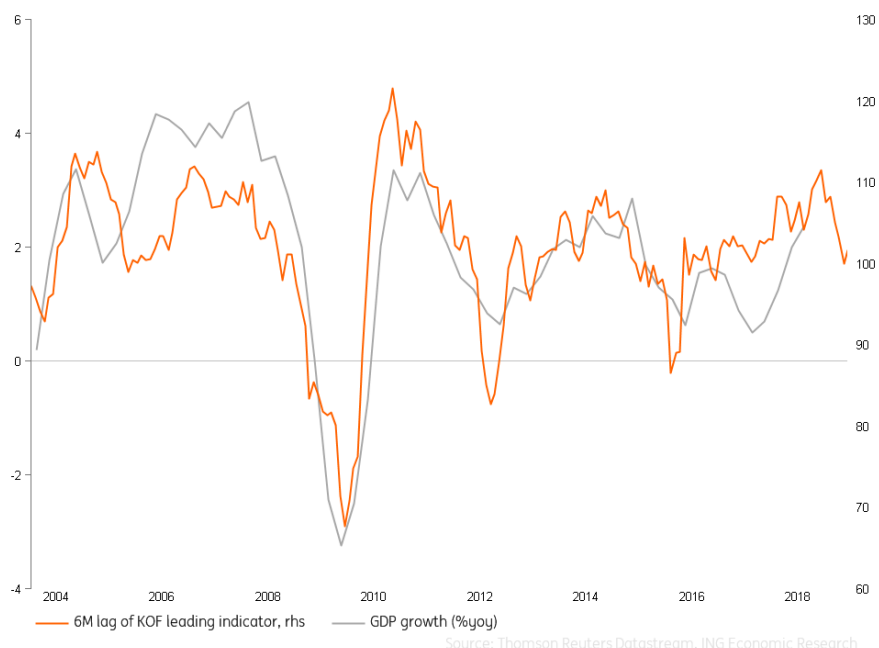
Strong GDP growth expected

Risks have increased during the last few months, especially because of political uncertainties in the EU and protectionists policies. Moreover, turbulence in financial markets remains a risk for Switzerland as it could create further upward pressure on the Swiss franc, a traditional safe haven.

Internally, the real estate sector could still be a risk given the number of new constructions is still increasing, while the vacancy rate continues to grow. However, the decline in rents is expected to accelerate indicating the risk of a housing bubble is declining.

Switzerland's leading indicator, the KOF economic barometer, fell from 108.3 in February to 100, its long-term average, in May. In June, it started to increase again to 101.6. Consequently, we have slightly revised our GDP forecast downwards for 2018 to 2.2% (from 2.3% previously) and we expect it to stabilise at 2.0% in 2019.

GDP growth on the right track



Source: Thomson Reuters Datastream, ING Economic Research

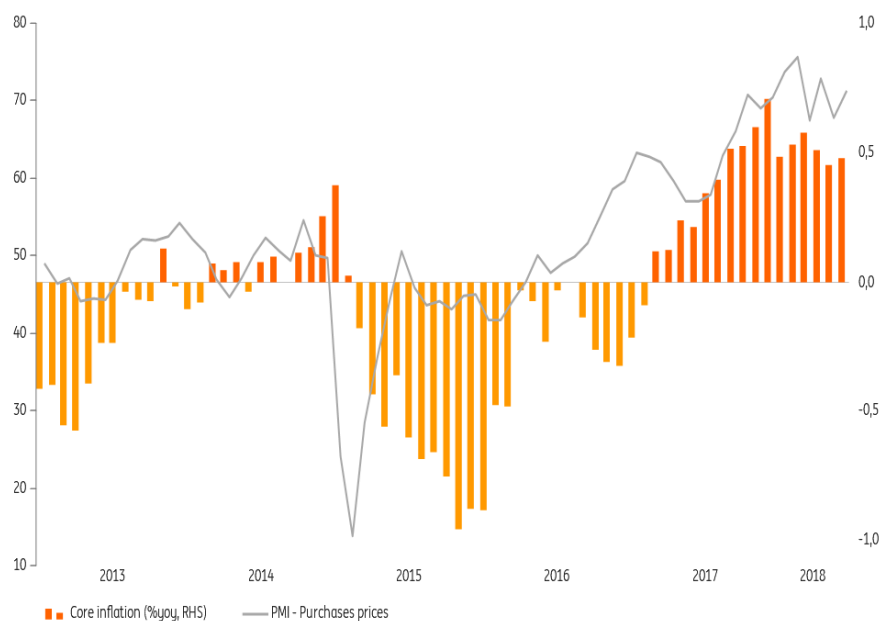
A temporary higher inflation

After a long deflationary period, inflation has been in positive territory since January 2017, thanks to higher energy prices and the CHF depreciation, which made imported goods more expensive. From 0.6% YoY in February 2018, inflation has gradually increased and reached 1.1% in June.

While a lower VAT rate, adjusted medical service prices and diminishing rents could put downward pressure on inflation in 2018, rising oil prices and higher American and European tariffs on global imported goods would push up import prices which are expected to further contribute to inflation.

Also, given the favourable economic situation, domestic price pressure should gradually increase as well because companies will gain pricing power because of stronger domestic demand. After having reached a level of 0.5% in 2017, CPI inflation is expected to climb to a modest 0.9% in 2018 and reach 1% in 2019.

Positive outlook for core inflation



Source: Thomson Reuters Datastream, ING Research

Source: Thomson Reuters Datastream, ING Economic Research

Caution remains the code word for the Swiss central bank

At its June meeting, the Swiss National Bank (SNB) left its main policy rate unchanged: the target range for the 3-month Libor was maintained between -1.25% and -0.25% and the interest rate on sight deposits remained set at -0.75%. Moreover, the central bank reiterated its willingness to intervene as needed in the foreign exchange markets to prevent an appreciation of the franc.

Given that the ECB is not expecting to hike before the end of the summer of 2019, we think the SNB won't raise rates before December 2019

The SNB still believes the franc is “highly valued” and that it is still considered a safe-haven asset. According to them, political factors in the eurozone are the main culprits for the recent appreciation of the currency. Even though it still considers the global economy will continue to grow above its potential, the assessment of the global growth outlook by the SNB was more cautious than in March. It considered trade tensions and political developments in some European countries as risks for the Swiss economy.

Given that inflation was higher than expected during the first few months of 2018, the SNB revised its conditional inflation forecast upwards, i.e. based on the assumption of no change in monetary policy for 2018 to 0.9% from 0.6% estimated in March. However, it didn't revise its forecast for 2019 (0.9%), recognising that higher inflation is due to temporary factors. Moreover, it revised its inflation forecast downwards for 2020 from 1.9% to 1.6%, which signals a rather dovish monetary policy over the next years.

We believe the central bank won't change its policy anytime soon. Given the SNB's worst nightmare is a strong appreciation of the franc, we believe it will wait until the ECB raises rates. The ECB's announcement that it would stop bond buying in December isn't enough on its own to make the SNB change its policy and given that the ECB is not expecting to hike before the end of the summer of 2019, we think the SNB won't raise rates before December 2019.

Author

Charlotte de Montpellier

Senior Economist, France and Switzerland

charlotte.de.montpellier@ing.com

Disclaimer

This publication has been prepared by the Economic and Financial Analysis Division of ING Bank N.V. ("ING") solely for information purposes without regard to any particular user's investment objectives, financial situation, or means. *ING forms part of ING Group (being for this purpose ING Group N.V. and its subsidiary and affiliated companies)*. The information in the publication is not an investment recommendation and it is not investment, legal or tax advice or an offer or solicitation to purchase or sell any financial instrument. Reasonable care has been taken to ensure that this publication is not untrue or misleading when published, but ING does not represent that it is accurate or complete. ING does not accept any liability for any direct, indirect or consequential loss arising from any use of this publication. Unless otherwise stated, any views, forecasts, or estimates are solely those of the author(s), as of the date of the publication and are subject to change without notice.

The distribution of this publication may be restricted by law or regulation in different jurisdictions and persons into whose possession this publication comes should inform themselves about, and observe, such restrictions.

Copyright and database rights protection exists in this report and it may not be reproduced, distributed or published by any person for any purpose without the prior express consent of ING. All rights are reserved. ING Bank N.V. is authorised by the Dutch Central Bank and supervised by the European Central Bank (ECB), the Dutch Central Bank (DNB) and the Dutch Authority for the Financial Markets (AFM). ING Bank N.V. is incorporated in the Netherlands (Trade Register no. 33031431 Amsterdam). In the United Kingdom this information is approved and/or communicated by ING Bank N.V., London Branch. ING Bank N.V., London Branch is authorised by the Prudential Regulation Authority and is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. ING Bank N.V., London branch is registered in England (Registration number BR000341) at 8-10 Moorgate, London EC2 6DA. For US Investors: Any person wishing to discuss this report or effect transactions in any security discussed herein should contact ING Financial Markets LLC, which is a member of the NYSE, FINRA and SIPC and part of ING, and which has accepted responsibility for the distribution of this report in the United States under applicable requirements.

Additional information is available on request. For more information about ING Group, please visit <http://www.ing.com>.