

In case you missed It: Trade tensions mount

The US stepped up its trade war with China this week, Britain's Brexit plan was rejected in Salzburg and another Nafta deadline came and went without a deal. We look at the implications for global markets. Plus, reflections on two rate decisions, musings on the Brazilian election and a special report on growing disillusion in Europe's housing market

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Trade & Tariffs - implications for the Fed

The intensifying trade war will impact both US inflation and growth. How will the Federal Reserve respond?



Trade tensions have been steadily escalating since the start of the year, culminating in the latest round of tariffs on \$200bn of imports from China. The concern is that the situation could deteriorate further with China retaliation potentially opening the door to the Trump administration implementing tariffs on all Chinese imports. This is bad news for both growth and inflation.

Downside risks for growth

In terms of economic activity, there are negative implications for both sentiment and spending with supply chain disruption, higher costs and uncertainty on the economic implications risking a slowdown in both investment and labour hiring.

US officials counter that the fact the latest round of tariffs is starting at 10% and won't be raised to 25% until next year – and that second part will only be implemented if China fails to make acceptable concessions – means that US businesses have time to make changes and bring production back to America. However, this in itself disrupts business activity while US companies will also face higher tariffs on their exports to China. Indeed, China shows no willingness to back down at this stage and instead is using domestic fiscal and monetary policy plus a weaker yuan to try and offset the protectionism impact on exports.

The key issue for US growth is that this isn't the only headwind. While the US booms for now, the outlook for 2019 and 2020 is looking more challenging with a fading fiscal stimulus, higher interest rates, a strong dollar and fears of emerging market contagion further depressing global activity. As such we expect to see US GDP growth slow from around 3% in 2018 to closer to 2% in 2019 and 2020 - just when President Trump seeks re-election.

Upside threat for inflation

As for inflation, we are already starting to see rising price pressures from tariffs. If you remember, the starting point was in January with “safeguard tariffs” of 30-50% introduced for washing machines and solar panels. This was then expanded to 25% tariffs on steel and 10% on aluminium and then on 6 July President Trump announced a 25% tariff on China imports worth \$50bn.

Looking at the price of washing machines we can clearly see the impact. Solar panel prices have also risen and we are likely to see inflation in other components rise. However, the impact on the headline rate of inflation has been small so far given that, for example, washing machines only account for 0.05 percentage points of the CPI basket of goods and services.

US CPI - laundry equipment price change (YoY%)



Source: Macrobond

A worst case scenario

So how bad could things get for inflation? Well if we do a simple back-of-the-envelope calculation and say that annualised US personal consumer expenditure in 2Q18 was \$13.87 trillion and make a broad assumption that all \$505bn of Chinese imports are consumer goods we can work out a “worst case” scenario.

This simple framework implies that Chinese imports account for 3.6% of all consumer spending and if all of these products get a 25% tariff – assuming the trade war comes to a head and President Trump declares unilateral tariffs of 25% on all Chinese imports, as he has threatened – then this would suggest the headline personal consumer expenditure deflator would be lifted by 25% x 3.6% China weight = 0.9 percentage points added to headline inflation. Stripping out food and energy it could add 1 percentage point to the core PCE deflator.

The impact on consumer price inflation (CPI) would be marginally less, simply because the weight for commodities less food and energy is 19.6% of the total CPI basket versus 21% for personal

consumer expenditure.

A reality check...

However, this overstates the upside risk to inflation. Firstly, the latest tariff on \$200bn of imports from China is set at 10%, not 25% as assumed in a worst case scenario and we haven't had confirmation that tariffs will extend to all Chinese imports. The staggering of the tariffs means that the initial impact on inflation is likely to be smaller this year, but inflation could be more persistent assuming the tariff is raised to the full 25% in 2019.

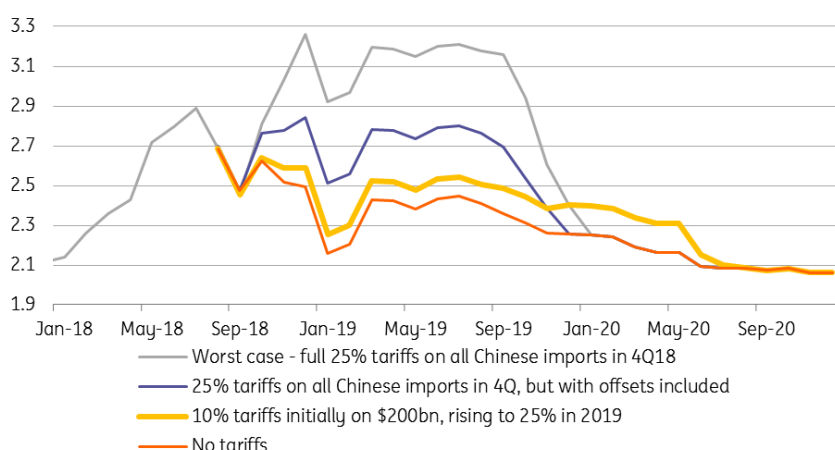
Secondly, not all Chinese imports are consumer goods – many are intermediate or investment goods so the end consumer isn't guaranteed to face the additional cost.

Thirdly, we suspect that there won't be a full 100% pass through of the tariff through to the end consumer. Instead, corporate profit margins are likely to be partially squeezed. In this regard, we also have to remember that a Chinese import has freight costs and wage costs (such as at a US retailer) attached to it before the price sticker is placed on it and it is sold in America.

Other points to consider include the possibility we see marginally lower prices from Chinese suppliers based on a desire to hold onto US market share – we assume that trade tensions will eventually de-escalate and we will return to a more normal “freer” trade environment at some point.

Then we have to consider the currency aspect. With China looking to use looser fiscal and monetary policy to support its economy and offset the negatives from trade we also expect to see the yuan weaken further. This would lower the dollar cost of exports to the US and help to partially mitigate the inflationary impact for US consumers.

Possible scenarios for US consumer price inflation due only to tariffs (YoY%)



Source: Macrobond, ING

Growth versus inflation

Historically, tariffs are interpreted as a one-off price hike that central banks tend to “look through”, much as a VAT tax rate change. The staggering of the tariffs means that it may be slightly different

this time. Taking this altogether we believe that the boost to annual US inflation is more likely to be closer to 0.2 percentage points over the next twelve months. Significant, but not enough to cause the Federal Reserve to have substantial concerns about medium-term inflation risks. We might see a similar upside risk next year if the second stage of the tariff is implemented.

If we see tariffs raised on all Chinese imports in 4Q18 we suggest headline inflation may rise by around 0.4-0.5 percentage points, before inflation converges on its previous trend in late 2019. This is more marked, but again believe the Fed will be more focused on the growth story and inflation in the medium term.

Where now for Federal Reserve policy?

The latest Federal Reserve Beige Book – an anecdotal survey of the US economy – stated that “a number of districts noted that [trade] concerns had prompted some businesses to scale back or postpone capital investment”. If this behaviour is increasingly repeated amongst US corporates, then those medium-term growth risks could intensify, which would dampen inflation pressures.

While the economy is booming right now, justifying rates hikes next week and in December, the outlook for 2019/2020 is increasingly uncertain. As such we are sticking with our view that the Fed will hike a more modest two times in total for 2019 rather than the four hikes they look set to implement this year.

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What lies beneath Asian currencies pain?

The China-US trade spat, higher oil prices, a hawkish Fed and an appreciating dollar have had almost all emerging market currencies heading for cover. But...



Source: Shutterstock

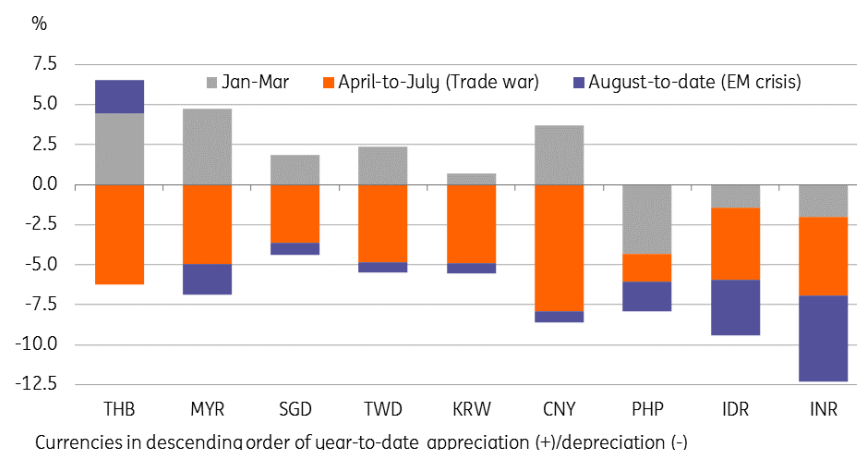
Currencies in Asia feel the heat

Emerging market currencies have been rattled in 2018 as a series of events including a hawkish Fed and appreciating dollar, the China-US trade spat and higher oil prices have had almost all regional currencies heading for cover amid increased risk-aversion and capital flight.

But some Asian currencies have been hit harder than others with the Indian rupee (INR), Indonesian rupiah (IDR) and the Philippine peso (PHP) all testing multi-year (in some cases historical) weakness in tandem with heightened USD demand from corporates.

And although the risk-off scenario has spared no one, these three currencies appear to have taken the brunt of the impact. So what is it about these three currencies that has soured investor appetite more than others?

Asia currency performance 2018



Source: Bloomberg, ING

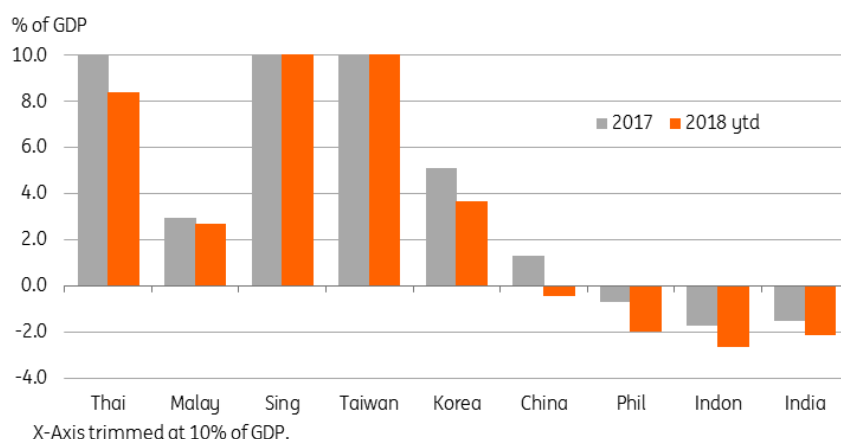
The tie that binds the peso, rupee and the rupiah

The tie that binds the rupee, the rupiah and the peso is their external deficits. All three countries run current account deficits due to the mix of aggressive infrastructure investment, strong consumer demand, and the 2018 oil price surge bloating their respective import bills.

Of the three, we believe the authorities in India are dragging their feet in terms of policy response

This is in stark contrast to countries like Thailand and Malaysia that run current account surpluses and have seen less currency pressure.

Current account balances In Asia



Source: ING

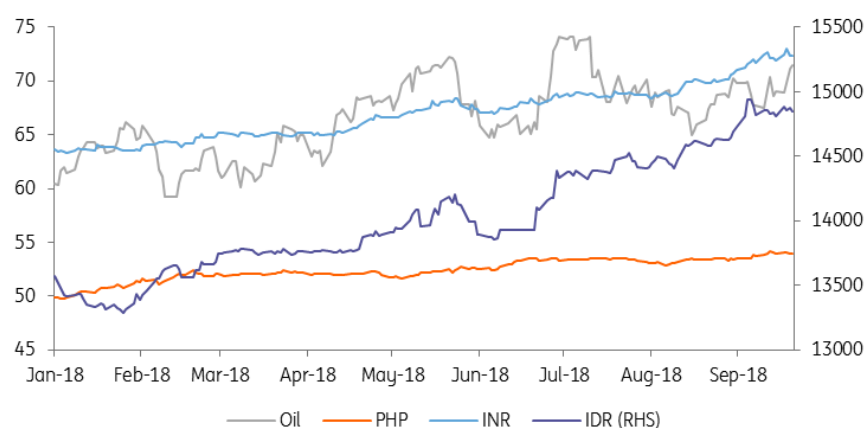
current account balances in Asia 2018 YTD vs 2017

That oil slick

Crude oil prices have all but doubled in 2018. Global demand has remained solid, and recent sanctions on Iran have weighed sharply on oil supply. The year to date 40% increase in the price of oil benchmarks has bloated the import bill of these three net energy importing countries, even as the volume of their energy imports has remained essentially flat.

The rise in the energy bill has undoubtedly exerted additional pressure on spot INR, IDR and PHP by boosting USD demand. The oil trade contributes to almost half of India's trade deficit, underpinning the rupee's abysmal performance this year.

Performance of crude oil, the peso, rupee and the rupiah



Source: Bloomberg and ING
movement of oil, inr, idr and php in 2018

More than just liquid gold

To a large extent, the widening trade deficit of these three countries is also a reflection of their strong growth. India, Indonesia and the Philippines are all posting robust growth numbers on the back of strong household consumption and the investment cycle.

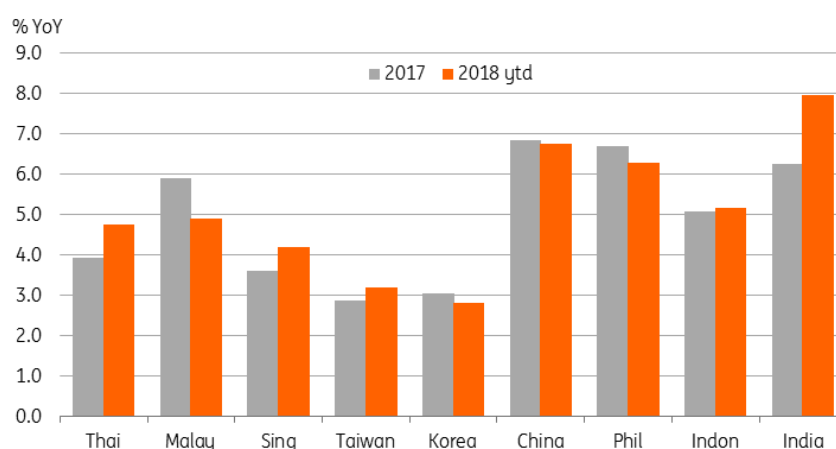
For example, the Philippines has seen a substantial build-up in capital goods imports, ostensibly linked to the accelerated pace of gross domestic capital formation in the first half of 2018.

Indonesia is also in the midst of an infrastructure drive as President Joko Widodo looks to fuel his re-election bid, although he has sought to cancel many projects in recent months, as the trade deficit widens.

India has seen its import bill increase on the back of strong consumer related imports, in particular smartphones as household incomes continue to rise, and the demand for gold (which isn't really a consumer product) - also seen as a hedge against further rupee weakness.

GDP growth in Asian economies

Annual GDP growth in selected Asian economies 2017 vs 2018 year-to-date



Source: Bloomberg and ING

GDP growth select Asian economies

Riding out the storm

With their currencies weakening, these three countries have deployed a number of offsetting measures.

The central bank of Indonesia (BI), the Reserve Bank of India (RBI), and the Bangko Sentral ng Pilipinas (BSP) have all raised policy rates to help alleviate some currency pressure. But the efforts aren't uniform, and some are using other measures in tandem with rate increases to support their currencies.

Despite their external deficits, these three currencies may find some additional support if their central banks shore up investor confidence with coherent and credible communications strategies outlining supportive economic policies along with more rate hikes

Indonesia is curtailing investments which are heavily reliant on capital imports, while the Philippines has deployed a program to help corporates hedge their USD requirements. And all three countries are looking to issue global bonds in the near-term to plug shortfalls in their financial accounts. However, because they are now doing this so from a position of weakness, they might have to accept whatever the market gives them.

Of the three, we believe the authorities in [India are dragging their feet](#) in terms of policy response. The measures announced late last week were judged inadequate by the market and the consensus is now building up for more aggressive RBI policy rate hikes, following the relatively modest 50bp hikes this year, compared to 100bp for BSP and 125bp for BI.

Despite their external deficits, these three currencies may find some additional support if their central banks shore up investor confidence with coherent and credible communications strategies outlining supportive economic policies along with more rate hikes. The resulting improvement in investor confidence will support demand for global or corporate bond offerings at lower yields and stronger exchange rates helping these three currencies ride out any future FX storm.

[Read why the Indian rupee is taking no comfort in the recent stabilisation measures](#)

Asia ex-Japan: Fiscal and monetary measures to reduce trade war impact on the economy and local currencies

Country	Govt/Fiscal measures	Monetary measures	Exchange market measures	In pipeline/expected
China	CNY 2.6tr (3.1% of GDP) fiscal stimulus, including preferential tax policy for companies with a total \$172bn (1.4% of GDP) worth of tax cuts. Increase in special bond issuance by local governments.	Liquidity boost via CNY 196bn net injection in August, driving short-term rates lower. Targeted reserve requirement cuts to direct liquidity to SME.	Resetting counter-cyclical factor in daily USD/CNY fixing mechanism.	Further increase in fiscal stimulus to CNY 5tr in 2H18 and another CNY 5tr in 1H19.
India	Increase in foreign borrowing limit to \$50 by manufacturing companies for a year compared to the current minimum of three years. Removal of withholding tax on masala (INR-denominated) bonds sold overseas.	50bp policy rate hikes in June and August	Market intervention.	Another 50bp rate hike by end-2018. Among other expected measures are topping funds from overseas indians, raising import tariffs, a swap window for all companies, and increase in the limit of foreign ownership of corporate bonds from current 20%.
Indonesia	Proposed additional 7.5% import tax on non-strategic and locally manufactured goods. Discouraging fuel and capital goods imports by removal of direct and indirect tax exemptions. Limiting ports of entry for certain imports and increased supervision of imports.	125bp policy rate hikes since May 2018. Buy-back sovereign local currency bonds from the market.	Market intervention. Tightening of rules requiring commodity exporters to convert their earnings into local currency.	More policy interest rate hikes. Sovereign borrowing from the dollar-bond market.
Philippines		100bp policy rate hikes since May		Another 75bp rate hike by end-2018. Sovereign borrowing from the dollar-bond market.

Source: Bloomberg, Internet, ING

For now, markets are taking a breather from the emerging market sell-off that dominated screens until recently. However, potential catalysts for a re-set of global risk aversion remains, possibly stemming from a more aggressive Fed tied to a pick-up in US wage inflation, a ratcheting up of the trade war, despite its waning ability to drive markets or a return to growth-centric policy responses in the three economies we have focused on here.

Sentiment appears to be stable at the moment, but a return to stormy conditions might be around the corner.

Nafta: Is a handshake imminent?

Nafta negotiations are set to resume today between the US and Canada, with the aim of striking a deal by the end of the week. Time is running out to...



Source: Shutterstock

Although there's an element of déjà vu here, Canada's Foreign Affairs Minister, Chrystia Freeland, has agreed to meet Robert Lighthizer, the US Trade Representative, today, with the aim of keeping Canada in the agreement. US Congress, which is in favour of Nafta, is pushing for Canada to be kept in the trilateral agreement, and the pressure is on for a new deal to be signed before Mexican President Enrique Pena Nieto leaves office in December. However, these congressional pressures haven't been sitting too well with President Trump, who has (quite directly) addressed Congress through tweets by saying, "Congress should not interfere w/ these negotiations or I will simply terminate Nafta entirely". Thoughts differ on whether this should be taken at face value or is merely a negotiating tactic.

What is keeping them from securing a deal?

Progress on the talks has picked up pace over the past few weeks. Although the two sides are closer than they've ever been, there are still major sticking points preventing a deal being reached. One of the key points is the dispute settlement, specifically [Nafta's Chapter 19](#), which focuses on countervailing and anti-dumping duties. In short, Washington wants to scrap this completely, whilst Canada remains adamant that this is a red line it won't cross. It will be interesting to see how both parties get around this. We think the final outcome will be somewhere between the current

situation and the deal recently struck between the US and Mexico, where Mexico agreed to soften the dispute settlement in a bid to please the Trump administration and strike a bilateral agreement.

There are signs that Canada may not back down on the dispute settlement issue; Canadian President Justin Trudeau recently stated that “we are going to make sure we are doing what is necessary to get the right deal for Canadians”, and keeping Chapter 19 appears to be one of the necessary things. One saving grace could be Canada’s dairy market. Canada has said it will offer concessions here by allowing the US limited access to the market.

Another deadline looms

A Canadian government official said a possible 'handshake deal' could come on Thursday (20 September) but Nafta deadlines have been missed in the past and there are no guarantees that an agreement will be struck by this date. That said, the White House will struggle to present the full text of the trilateral agreement to Congress by the 30 September deadline, if a deal isn't reached this week.

We see three possible outcomes from the talks:

1 A happy ever after...

A deal is reached on Thursday and Nafta remains as a three-way agreement - albeit a reworked version

2 Deal or no deal

The Thursday deadline is another false dawn and uncertainty continues to linger that Nafta could be dissolved

3 Trump vs. Congress

No deal is reached. Trump fights with Congress to withdraw from the trade deal. However, it is unclear whether the president actually has the ability to do this. Our trade team says that Trump may have the power to withdraw from trade agreements, but this is likely to be challenged in court by Congress

A waiting game

Despite the lack of clarity on Nafta, the Canadian dollar has been closely tracking the Mexican peso since early September, suggesting that a degree of optimism is being priced in. This follows President Trump's announcement of progress on a bilateral deal with Mexico in late August. Were clear signs of progress to emerge on Canada's position by 20 September, we suspect USD/CAD could trade down to the 1.27/28 region – especially given the prospect of a Bank of Canada rate hike in late October.

We do think a compromise is more likely than not; the complexity that comes with long-lasting trade agreements leaves the economies involved heavily intertwined and it's not so easy to simply 'get rid' of Nafta. In addition, Canada's high dependence on the US as an export market (the US accounted for 76% of Canadian exports in 2017) means it's probable

that Canada will acquiesce to most demands coming from the US, even if this does push their limits.

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Swiss National Bank: Extremely cautious as risks increase

The central bank kept rates on hold at its September meeting and appears to be really cautious signalling a dovish monetary policy over the coming years



Source: Shutterstock

Unchanged monetary policy

The Swiss National Bank maintained the target range for the 3-month Libor between -1.25% and -0.25% and the interest rate on sight deposits was unchanged at -0.75%. Moreover, the SNB reiterated its willingness to intervene if needed in foreign exchange markets to prevent an appreciation of the Swiss franc. The central bank still believes the franc is “highly valued”. It insisted on the appreciation of the franc over the past three months and believes the situation on the foreign exchange market is still fragile.

The SNB is in a tricky situation with some very strong growth indicators but it also has concerns about the global external environment which could impact the domestic market and CHF valuation.

Super strong growth

On the positive side, the Swiss economy grew at a fast pace in 1H18 as GDP growth reached 1% and 0.7% quarter on quarter in the first and the second quarter thanks to robust foreign demand

and favourable evolution of the Swiss franc.

The Swiss economy is on a fast track since it has been recording an above 0.7% QoQ growth rate for the fifth quarter in a row. This hadn't been the case since the beginning of 2015 when the exchange rate floor against the euro was abolished.

However, 0.2pp of this growth is somewhat artificial and due to license income generated by the marketing of major international sporting events as many international sports associations are based in Switzerland. The SNB also insisted on the improved utilisation of production capacity and the continuous decline of the unemployment rate over recent months. It believes that “economic signals for the coming months remain favourable”.

A cautious SNB

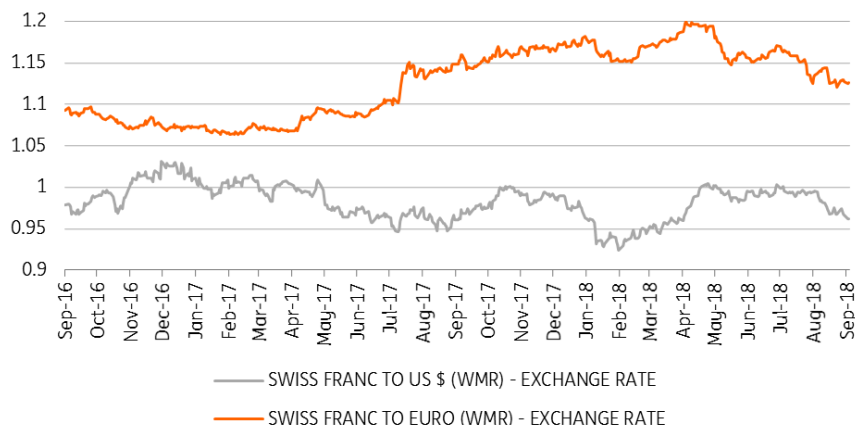
Although the situation is really favourable for the Swiss economy, the central bank remained very cautious. According to the SNB, “the risks to the positive baseline scenario are more to the downside”.

We share the central bank's view on the increased risks and we believe that such growth levels are no longer to be expected in the months ahead. The problems don't come from the domestic economy but more from the international context, which has deteriorated sharply in recent months.

Indeed, the concern around emerging markets, the Italian budget and uncertainties surrounding Brexit pushed the franc; a currency considered a safe-haven, to appreciate strongly against the euro. On average, the value of the Euro/Swiss franc rate amounted to 1.12 during the third quarter, compared to the average of 1.15 in the second quarter and 1.17 in the first. And despite the recent appreciation of the dollar against the euro, the Swiss franc also appreciated against the dollar.

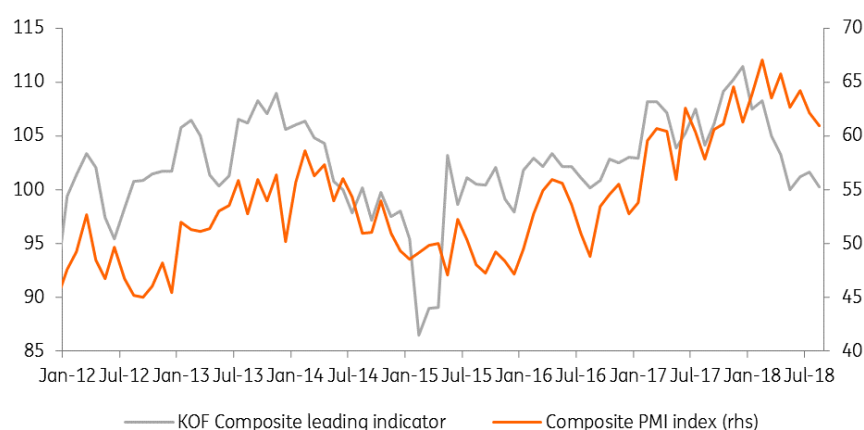
The Swiss economy is a small, open economy that relies heavily on international trade for growth and the appreciation of the franc may, therefore, reduce the growth momentum in the coming months, which is what leading surveys and indicators are already anticipating.

It seems this is what the SNB has taken into account in its monetary policy decision, i.e. “some loss of momentum is expected, due to a slight slowdown in global growth and the dampening effect of recent Swiss franc appreciation”.



Source: Thomson Reuters Datastream, ING Economic Research

Leading indicators on a downward trend



Source: Thomson Reuters Datastream, ING Economic Research

Revised SNB's inflation forecasts

The SNB has revised its conditional inflation forecast downwards (i.e., if monetary policy remains the same) for 2019 and 2020, signalling a dovish stance. For 2019, the SNB forecasts inflation at 0.8% (against 0.9% anticipated at the June meeting).

For 2020, inflation would reach 1.2% according to the SNB, against 1.6% expected in June for 2020 and 1.9% expected in March. This downward revision of forecasts signals that monetary policy will remain very accommodative in the coming years and much longer than previously expected.

Nothing is about to change

Given the importance of the value of the franc for the SNB, it's likely that the Bank will continue its very patient policy in the future.

We don't expect any hikes before the ECB starts to do the same. Given the ECB isn't expected to hike before the end of the summer of 2019, we think the SNB won't hike interest rates before December 2019.

Moreover, given the increased risks context expected for next year, it's even possible that the first rate increase will be postponed towards 2020.

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Norges Bank raises rates, but signals a more cautious stance

While the central bank hiked rates to 0.75%, as expected, an unexpected downward shift in the forecast for future interest rates suggests policy-makers...



Source: Shutterstock

The Norwegian central bank raised the policy rate to 0.75%, in line with expectations. But a reassessment of momentum in the domestic economy and concern about the effect of higher rates impacting household spending has prompted the Bank to revise down its forecast.

The new rate path is only marginally lower and still signals two more hikes by the end of 2019. But this shift in the opposite direction of market expectations - for a higher rate path signaling the potential for three hikes in 2019 - suggests the NB has become cautious.

The key reason behind the central bank's caution seems to be concern that raising rates too quickly could have a material impact on Norwegian households, which are heavily indebted and exposed to higher interest rates

The policy statement indicates the next rate hike will come in 1Q19, which most likely means March, given the NB's preference to move policy rates at meetings where they have a new forecast and a press conference.

Some of the new-found caution appears driven by global risks, in particular, the potential impact of US protectionism. The NB also notes that higher oil prices, while supportive of the Norwegian economy through increased investment in the North Sea, dampens growth elsewhere in the global economy, and that has an off-setting negative effect on Norwegian exports.

But the key reason behind the NB's caution seems to be concern that raising rates too quickly could have a material impact on Norwegian households, which are heavily indebted and exposed to higher interest rates. The NB also refers to the uncertainty surrounding the effect of the first rate hike in seven years.

The key takeaway from today's meeting is that the NB may be uncomfortable with hiking rates at a faster pace than twice per year. Given that this appears driven in large part by the high level of debt among Norwegian households – a factor that isn't going to change anytime soon – it looks like the bar for a faster pace of tightening is fairly high.

The Bank may still be open to a more aggressive stance once the initial uncertainty around the effect of higher rates passes (and if other sources of uncertainty such as the US-China trade war also fade).

If the krone doesn't strengthen as much as the central bank anticipates (EUR/NOK has risen by close to 1% since the policy announcement), that may also support the case for tighter policy. But for now, we think the most likely path for policy rates is two hikes in 2019, starting in March next year.

Brazil: The presidential race narrows

The likely outcome of the presidential election has narrowed considerably, but Brazil's post-election economic policy outlook remains highly...



Source: Shutterstock

Is it already a two-horse race?

The latest polls confirmed that the presidential election race has been substantially polarised over the past week, with PT/anti-PT sentiment contributing to exacerbate voter support towards these polar opposites, and draining support from the middle.

As a result, voter support to (right-leaning) Jair Bolsonaro has been rising towards 30% while support to (left-leaning) Fernando Haddad, the newly-anointed successor to Lula, is quickly rising towards 20%, increasing the gap from the remaining candidates. If this trend persists over the coming week, we should be able to eliminate our previous assumption that the first-round race will be hard to call until very close to the October 7 election.

In fact, it's almost as if the first-round ballot has become a test-run for a runoff (October 28) between Bolsonaro and Haddad, with both sides now aiming for a first-round victory sizeable enough (ie, larger than 50% of the valid votes) to eliminate the need for a runoff. A first-round victory remains unlikely, but it is no longer as far-fetched as it seemed just one week ago.

For now, third-runner Ciro Gomes has survived the Haddad tsunami surprisingly well, becoming a possible third-way alternative to the PT/anti-PT narrative. His main competitor is Haddad however,

and a bitter fight in the Northeast, where both compete for primacy, could end up helping Bolsonaro, if Gomes's supporters fail to support Haddad in an eventual second round, assuming that Haddad's rise is sustained.

Bolsonaro is generally considered to be a second-best option for investors, after market-favourite Geraldo Alckmin. With Alckmin's chances dropping sharply, investors are now primarily focused on assessing who would prevail in a Bolsonaro vs. Haddad runoff. Second-round simulations suggest that this is going to be a tight and polarised race, still very difficult to call.

Popular demand for “something new” gives Bolsonaro an edge

A key concern is Bolsonaro's high rejection rate, the highest among all the candidates, which makes him a relatively weak contender in runoff simulations. And his difficulties could increase if the candidate fails to make a full recovery relatively soon, which could increase the chances of a left-leaning victory in the October 28 runoff.

Lula also remains a formidable force, propelling Haddad forward, but the impressive enthusiasm demonstrated by Bolsonaro's supporters, if social media is any indication, with important grass-roots elements, suggests that he may ultimately have an edge over Haddad. The surge in that enthusiasm is due to both the rise in anti-PT sentiment, as Haddad has risen in the polls, and the persistent anti-establishment sentiment, which has been attached to Bolsonaro's candidacy from the start.

The latter (ie, the anti-establishment sentiment) is what should give Bolsonaro an edge, in our opinion. With Lula and his proxies winning every presidential race since 2002, popular support for “something new” is likely to prevail.

What does this mean for the BRL?

Near-term prospects for the BRL should follow investor assessment of the likelihood of victory by Bolsonaro (seen as BRL-positive) or Haddad (seen as BRL-negative). This suggests that the currency should remain choppy, especially if upcoming polls show improved odds for Haddad in second-round simulations, which seems likely given the fresh momentum in Haddad's candidacy.

Near-term outlook for local assets has improved, but 2019 should be another choppy year

However, we are of the view that the BRL's overall outlook has improved. This reflects two factors: 1) the risk of a Ciro Gomes victory has dropped considerably, and 2) there are now initial signs that Haddad, if elected, would immediately pivot to calm down investors, with a more pro-market rhetoric, similar to Lula's strategy in 2002. As a result, we suspect that the BRL weakness may be limited to the current range, with a much-reduced risk of a sustained surge above 4.2.

Moreover, apart from the more limited downside for local assets, we suspect that a rally right-

before or right-after the elections is much more likely now. This would reflect either a high likelihood of a Bolsonaro victory or clear signs that Haddad will pursue a fiscally responsible economic agenda, for instance by appointing a well-known and respected Finance Minister.

Given current market technicals, with anecdotal evidence suggesting of a large prevalence of short-BRL positions and/or bearish positions in local markets, which increased over the past month as much of the bullish positioning got stopped-out, we suspect that the rally in local assets could be significant. The depth of the rally would also reflect the fact that, at current levels, local asset prices may be considered quite attractive, if one assumes that the fiscal challenges will be properly addressed.

Having said that, we suspect that any local asset rally, including for the BRL, could be relatively short-lived, and characterised as opportunistic in nature. This is because we remain highly concerned about the ability of any new administration to approve the urgent fiscal consolidation initiatives needed to re-anchor Brazil's fiscal accounts. As a result, 2019 could turn out to be another choppy year for local assets, with volatility largely driven by prospects/approval of fiscal austerity initiatives in Congress.

We no longer expect the central bank to increase the SELIC rate this year

In any case, given our new assessment for the BRL trajectory in the nearer-term, we no longer expect the central bank to increase the SELIC rate this year. In yesterday's monetary policy meeting, authorities kept the policy rate on hold at 6.5% but altered the guidance from neutral to hawkish, as expected. They also clearly indicated that they are open to consider a "gradual" policy tightening program. But a rate hike remains strictly conditioned on further deterioration of the inflation outlook, which would happen, for instance, if the BRL weakens further due to the political/fiscal uncertainties.

In our opinion, if inflation dynamics remain contained, inflation expectations remain anchored, economic activity remains subdued, growing far below potential and with abundant slack in labor markets, and the BRL follows a stronger trajectory, the central bank is likely to continue to delay the policy tightening.

The chief risk to our monetary policy call would be fresh deterioration in BRL trends, in response to domestic or external drivers, or higher-than-expected inflation prints. Overall, however, we suspect that the threshold for hikes is higher than the probabilities implied in the local yield curve, which is now pricing 100bp in rate hikes during 4Q. Given the substantial ammunition to intervene in the FX market, if necessary, authorities will likely prefer to wait until a clear assessment of the fiscal outlook is possible. Fiscal policy remains the most crucial ingredient in the assessment of next-year's monetary policy path.

Disillusion mounts in Europe's housing market

Most Europeans expect house prices to increase further over the next twelve months, reducing affordability and leaving many young people feeling shut out...

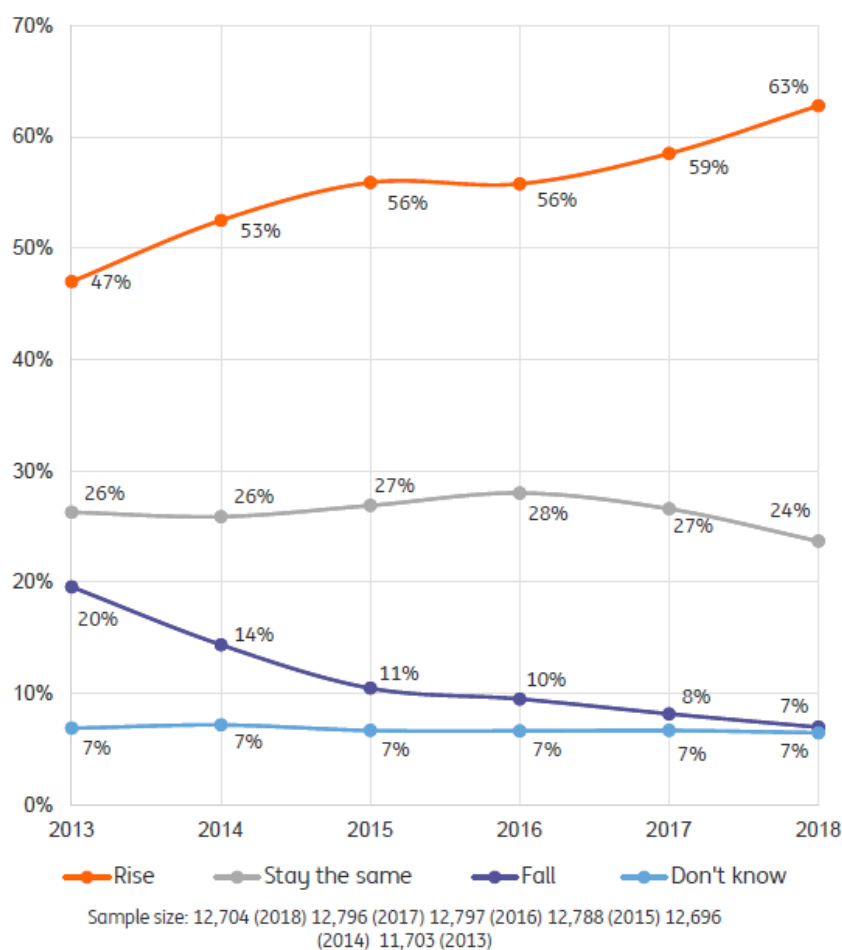


Source: Shutterstock

A majority of people in Europe believe housing in their country is on the wrong track. And the main reason is because it's expensive. This is not restricted to one country, it's a common response across Europe, Australia and the US. These are key findings from the ING International Survey Homes and Mortgages September 2018 [report titled, "Are house prices too much of a stretch?"](#) the seventh annual survey of consumer attitudes to the housing market across Europe and latterly Australia and the US.

Do you think house prices will rise or fall over the next twelve months where you live?

European consumer totals only. Answer choices were "rise sharply", "rise slightly", "stay the same", "fall slightly", "fall sharply", or "don't know".



Not measuring up

Across Europe, 53% said their country was "generally on the wrong track when it comes to housing". Only 25% responded that housing was on the "right track". The remaining 22% chose "don't know". In six of 13 countries surveyed across Europe, more than half consider housing to be on the wrong track.

"In general, do you think your country is on the right track or wrong track when it comes to housing?"

There was no country in which more than half of the respondents said housing was on the right track. In all but two European countries (Austria and Italy) the situation has worsened when we compare responses to the same question in last year's survey. For Austria and Italy there was virtually no change.

The situation is better in Australia and the US with slightly fewer considering housing to be on the wrong track this year than last. Nevertheless, only 29% in Australia and 36% in the US consider it to be on the right track.

[Click here to see our previous IIS surveys](#)

Expensive, crowded and unfair

When asked what best characterised housing in their country, the most common response by far was “expensive” (at 57% across Europe) with “unfair” (26%) and “crowded” (22%) the next most common choices from an 11 item list. The responses are similar for both owners and renters but renters are more likely to agree with negative descriptions. Unsurprisingly, owners are more likely to characterise housing as an “investment opportunity” but even so, only 22% of owners chose this option, the same percentage as owners who chose “unfair”.

These concerns seem to be having an impact on home buying expectations. Of those who don't own, 35% across Europe said they don't expect to be able to buy. Further, of those who do expect to buy, only 9% expect to do so by the time they turn 30. Conversely, 60% of those who already own property bought before they turned 30.

Feeling out of control in your home market

When it comes to housing, people typically consider conditions in their individual nation or the local area. This is what they experience and reflects much of the information from media. While understandable, concentrating on local conditions risks missing important information.

House prices globally have “shown a growing tendency to move in the same direction at the same time” according to the [International Monetary Fund](#). This is largely due to the increasing integration of financial markets, persistent low interest rates and increasing activity by institutional investors in major cities. “House prices are starting to behave more like prices of financial assets such as stocks and bonds, which are influenced by investors elsewhere in the world,” according to the IMF.

A common error when investing is known as [home bias](#). This is the tendency to have too much of your money located in your home country, reducing the opportunities of diversification. When considering housing, it appears increasingly that individual people and possibly national governments have less control of their housing markets than in the past. As much as this is a factor driving up house prices, it will feed feelings of unfairness.

Don't stop at the hard numbers – emotions matter

What people say matters. And when lots of people across 15 countries say a similar thing multiple times, it's time to recognise the importance of the message. Hard numbers such as affordability ratios are part of the equation, but responses to clear-cut questions about where the housing market is headed and where people feel they fit within it are the other part. Together they build the view that housing is very much on the wrong track and many feel like they are being swept along without an opportunity to get on the property ladder. There is more to the story than avoiding avocado on toast.

And for many wanting to get ahead in life, housing is important personally and socially. It's not just

about prices.

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