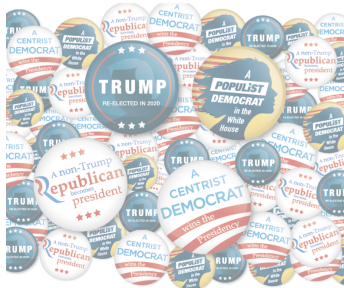


In case you missed it: Trump, Draghi and Johnson

Second-quarter GDP in the US, a chance for some early action from the ECB, and a new British Prime Minister; it's happening next week. Disinflationary trends should bring rate cuts in both Russia and Turkey following the footsteps of Korea, Indonesia, South Africa and Ukraine. And what's that we hear, is the ECB tinkering with the goalposts?

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China's GDP growth has slumped to its slowest pace in almost three decades, as trade tensions weigh on sentiment and activity. While retail sales...



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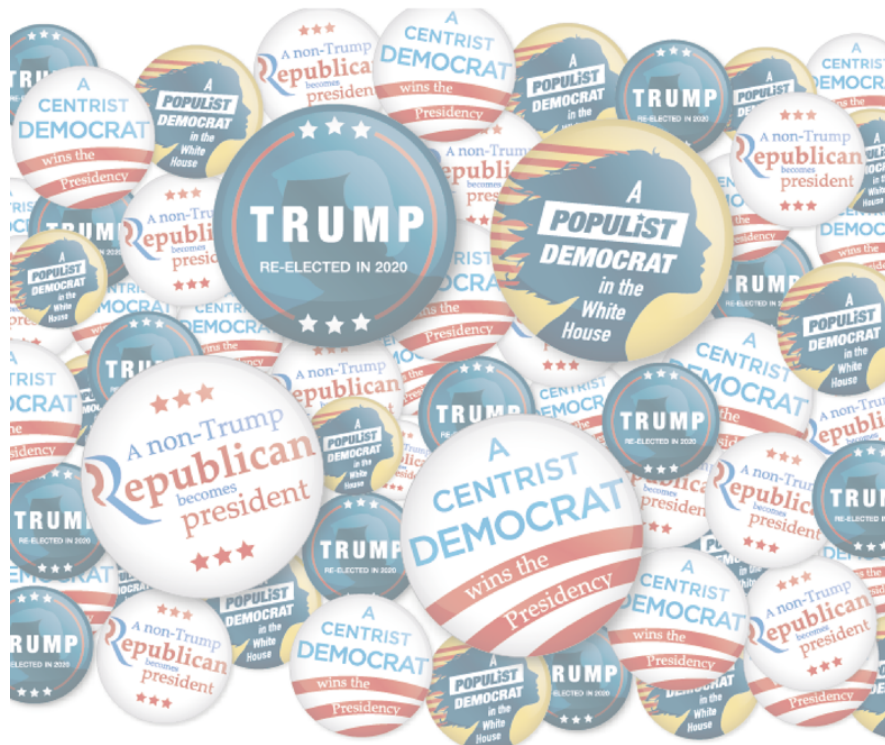
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We expect a 200bp cut on 25 July, though given increasing concerns about credibility, with the appointment of the new Governor, risks are to the downside....

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Trump leads while Democratic front runners emerge

President Trump's re-election odds are strengthening but a second term is far from certain. In the first of a series of updates to our in-depth report, US Politics Watch: Four Scenarios for 2020 and Beyond, we have collaborated once again with Oxford Analytica to look at how the race is shaping up



United States of Trump



Trump re-elected

Increased likelihood

A Republican phoenix



Non-Trump Republican elected

Decreased likelihood

Consensus builders emerge



Centrist Democrat elected

Increased likelihood

A New New Deal



Populist Democrat elected

No overall change





Source: ING, Oxford Analytica

Where things stand

Former Vice President Joe Biden remains the early front runner in the Democratic Party primary, though his lead has significantly narrowed following the first Democratic Party debates, where both Elizabeth Warren and Kamala Harris were seen as performing well. Both have since improved in the polls, and are now competing with Bernie Sanders for second position. With only nine candidates polling at 2% or more in national polls during June, a failure by smaller candidates to increase their support in July may see the number of candidates reduced.

The US economy has continued to perform well despite increased trade tensions, with the stock market up around 4% since early April, increasing President Trump's odds of re-election. The Federal Reserve is indicating it will be cutting interest rates, but this is characterised as an "insurance policy" to cushion against possible future shocks. Officials continue to talk of "solid" activity, which was underlined by June's rebound in job creation. After officially launching his re-election campaign, President Trump appears set to be the Republican party nominee, as the risk of impeachment or a serious primary challenge has significantly diminished.

Impacts on each scenario

<p>United States of Trump</p>  <p>Trump re-elected</p> <p>Increased likelihood</p> <p>President Trump's approval rating has remained relatively stable around 42%, with a majority of Americans now expecting him to be re-elected in 2020. This view, along with the continuation of relatively positive economic conditions, has strengthened his chances for re-election.</p> <p>Although the continuation of trade tensions with China and the sharp increase in risk of a military conflict with Iran remain concerns, the potential for some form of agreement to be reached still exists, further assisting this scenario.</p>	<p>A Republican phoenix</p>  <p>Non-Trump Republican elected</p> <p>Decreased likelihood</p> <p>As outlined in the April report, this scenario is reliant on President Trump not running for re-election, a prospect that has significantly diminished.</p> <p>Following the release of the Mueller report, which did not make a judgement on obstruction of justice, President Trump launched his re-election campaign in Florida in June. Given the poor performance of former Massachusetts governor Bill Weld, and no other declared candidates, it is increasingly unlikely that President Trump will not be the Republican nominee for President.</p>
<p>Consensus builders emerge</p>  <p>Centrist Democrat elected</p> <p>Increased likelihood</p> <p>The emergence of Joe Biden as the frontrunner in the Democratic primary, the strong performance of Kamala Harris and the increased likelihood of President Trump standing as the Republican nominee have strengthened the odds of this scenario.</p> <p>While positive economic figures mean the likelihood of this scenario has increased less than that for Trump re-elected, the continued focus of the electorate on Trump as the key issue indicates that this scenario is more likely than either <i>A Republican Phoenix</i> or <i>A New New Deal</i>.</p>	<p>A New New Deal</p>  <p>Populist Democrat elected</p> <p>No overall change</p> <p>Three candidates which can be considered Populist (Sanders, Warren and Buttigieg) are polling within the top 5 of Democratic presidential nominees, giving this wing of the party momentum and press attention to make the campaign issues focused and on widespread change.</p> <p>However, the positive performance of the US economy continues to be a mitigant, leading to its classification of no change since the assessment in April. As its primary drivers have not been activated.</p>

Source: ING, Oxford Analytica

Scenario drivers



Source: ING, Oxford Analytica

Economic performance – A less positive backdrop for Trump

After posting robust growth of 3.1% annualized in the first quarter, the US outlook is now looking less positive. Recent data suggests the economy is more vulnerable to the negative US-China trade headlines than it was in the second half of 2018. Manufacturing is bearing the brunt, although

there has been some softening in recent service sector surveys too. The Federal Reserve kept interest rates steady at its June meeting, but is now clearly signalling a precautionary "insurance" 25bp interest rate cut on 31 July even though officials retain a positive outlook on the economy outlook.

Trade tensions are the key risk for the economy. Prolonged uncertainty regarding trade policy runs the risk that firms sit on their hands, which implies a slowdown in investment and hiring that could lead to lower consumer spending and broader economic weakness. The Trump-Xi meeting on the sidelines of the G20 summit has led to a restarting of talks although neither side seems willing to offer major concessions at this stage. As such, we could see a re-escalation of tensions with additional tit-for-tat tariff hikes. We suspect that only after both sides experience the increasingly negative effect of the trade war will they be prepared to make concessions and finally strike a deal. As discussed in the April release, such a deal would be an undoubted boost to Trump and to global trade.

This suggests that the economic backdrop may start to become less supportive for President Trump's re-election. Indeed in three key swing states, Ohio, Michigan and Pennsylvania, the unemployment rate remains above the national average, indicating weaker economies in areas critical to a Trump re-election bid. Given the US economic position is currently one of a growth slowdown rather than a full blown recession, this appears more supportive of a centrist Democrat rather than triggering the Populist Democrat scenario, which is reliant on a more negative economic outlook.

However, President Trump will be well aware that pushing too hard for too long on trade risks a weaker economy and plunging asset markets, which would undoubtedly hurt his re-election chances. As such we would expect him to strike a "deal" around the turn of the year even if it doesn't meet all of his demands. Such an outcome would be cheered by markets and provide a positive boost for economic sentiment with Trump likely claiming it as a personal victory that supports his case for the Presidency.

Salient issue – Trade, Trump and foreign policy at center stage

Foreign trade and President Trump's handling of foreign disputes, particularly vis-à-vis Iran, are the current salient political issues, strengthening primarily the Trump re-elected and Centrist Democrat scenarios, as both Trump himself, and his foreign policy receive constant coverage. The ongoing trade conflict with China continues to impact the market and US businesses and has become the flagship foreign policy of Trump's administration. While a deal is not currently within sight, the use of Huawei as leverage to gain concessions from Beijing later in 2019 would strengthen the likelihood of a Trump re-election scenario.

Prior to a deal being agreed, the trade conflict with China is likely to remain in its current pattern of sporadic escalation. It is likely to thus slightly fall out of view over the coming weeks, as the shock of the most recent escalation wears off, allowing another issue, potentially the handling of migration into the United States, to become a more poignant issue, weakening both Democratic scenarios.

Conversely, the ongoing dispute with Iran, which originated from attacks on international oil tankers in the Strait of Hormuz and escalated to the downing of an unmanned American drone, has ignited criticism of Trump's handling of foreign policy and made his temperament a key talking point. Anything but a swift and peaceful de-escalation of that conflict in the coming weeks is likely

to strengthen both the Centrist and Populist Democrat scenarios due to increased concerns over Trump’s response and his seemingly unpredictable foreign policy.

The new batch of US sanctions against Iran however, which directly target senior individuals including Supreme Leader Ayatollah Ali Khamenei, has likely ended the possibility of a diplomatic de-escalation of hostilities. Tensions with Iran are thus set to remain high over the coming months, and will continue to be a focal point of critiques of the Trump administration.

Identity politics – Illegal immigration and race based divides

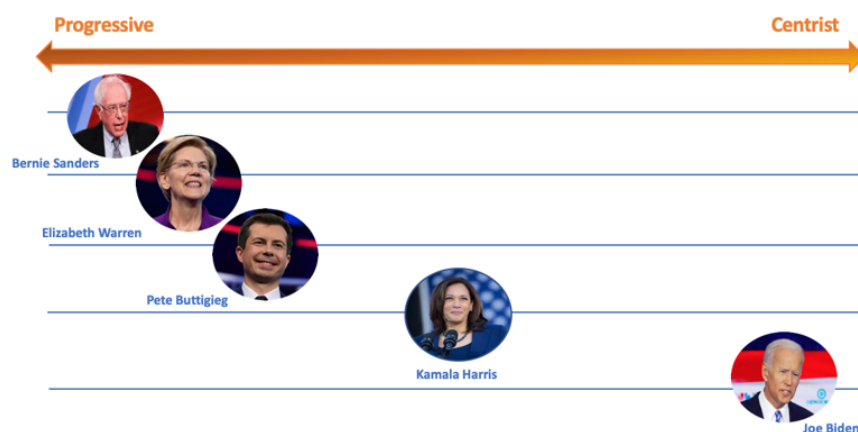
Discussions around identity politics remain based around racial issues, such as illegal immigration, strengthening the odds of the Trump re-elected scenario. The declaration of an emergency on the US border with Mexico, and the threat to impose tariffs on Mexico if it did not improve border security, has kept immigration -- and with it racial based politics -- a more prominent issue than socio-economic divides. Race has also begun to impact the Democratic presidential primary where comments made by former Vice President Joe Biden on his ability to work across the aisle in Congress with noted segregationists in the 1970s drew criticism from his fellow candidates, helping to shed further light on liberal issues such as reparations.

With the economy set to continue on its positive trend in the medium term, socio-economic divides will continue to be of secondary importance as a driver of identity politics, while race based issues, in particular illegal immigration, will likely remain the primary fault line. The uncertainty surrounding the competing border appropriations bills in Congress and the threat of a Presidential veto will continue to heighten the importance of this issue in July and potentially into the fall if only a temporary funding solution is reached.

The Democratic front runners

While it is still early days in the Democratic primary, and plenty of time remains for another candidate to have a breakout moment, a group of competitive candidates has started to emerge.

Top 5 Democratic Party nominees

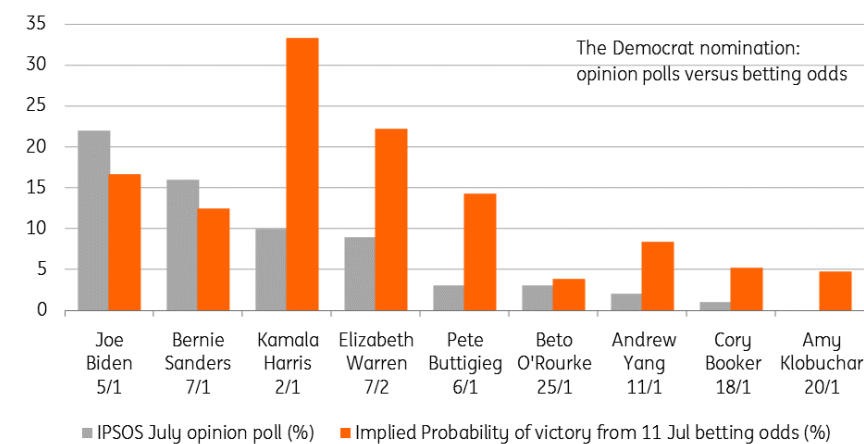


Source: ING, Oxford Analytica

Former Vice President Joe Biden continues to lead nationally, but this has dwindled following the first Democratic debates, where both Senators Elizabeth Warren and Kamala Harris performed

well, and have seen subsequent boosts to their poll numbers. For now, Senator Bernie Sanders remains in second place in national polls, though he has failed to grow his support. Meanwhile, South Bend Indiana mayor Pete Buttigieg has managed to raise his profile and substantial financial sums, with his 24.8 million dollars the most of any candidate.

Joe Biden ahead in the polls, but the money is on Kamala Harris



Signature policies

Biden

Former Vice President Joe Biden currently lacks a signature policy position, and instead has focused on two broader themes: foreign policy and a return to bipartisanship. Biden aims to use his experience in working across the aisle to govern, and his traditional view on foreign affairs to create the appearance of a safe pair of hands.

Harris

Harris, similar to Biden, is not strongly associated with many unique policies and has struck out a position generally in favor of some more modest progressive proposals. The most notable exception is in the area of equal pay, whereby Harris has promised to undertake an executive action to fine companies for the continuation of a wage gap between male and female employees and raising teacher salaries, a popular and important constituency.

Buttigieg

Along with Warren and Sanders, Buttigieg is a supporter of many progressive policies including agendas such as the Green New Deal. His signature policy is a national service program for young adults, in order to foster greater social cohesion within American society, and ideas to remake the Supreme Court.

Warren

Warren has been the most active candidate in outlining policy positions, with her campaign already detailing plans on universal child care, defense procurement, reproductive rights protection and antitrust against technology firms. Her signature position however is her plan to introduce a

wealth tax against Americans earning more than 50 million dollars per year.

Sanders

Sanders' campaign is highly progressive, with key issues promoting many long held liberal policy objectives. While not alone in championing Medicare for All, Sanders has been one of its most vocal supporters. Abolishing college tuition fees and a significant increase in the estate tax to encourage greater income distribution are also among his primary issues.

Vulnerabilities in an election against Trump

Biden

- _ Previous voting record in Congress which is out of line with current progressive policies
- _ Lack of clear policy proposals, return to the past, and his advanced age
- _ Apathy from liberal wing of the Democratic party may hamper grassroots efforts

Harris

- _ A career trajectory, mirroring that of Barack Obama, could be used to convince voters of her inexperience
- _ Positions taken while a prosecutor are unpopular with some liberal voters
- _ Lack of major legislative achievements
- _ Will face obstacles as African-American and a woman

Buttigieg

- _ Will be treated dismissively due to young age and no national political experience
- _ Poor performance of South Bend, Indiana, in particular on issues of social equality and police brutality
- _ May struggle to attract socially conservative Democratic voters

Warren

- _ Overly left for the national electorate in a positive economy
- _ Increased attention on her personal background and identity scandal may tarnish her image and reputation
- _ May be portrayed as similar to Hillary Clinton and elitist, given her Harvard background

Sanders

- _ Painted as too far left for the electorate
- _ Advanced age could hurt him appealing to middle-aged voters. Polls poorly within his own age

group

_ Lack of large donors could negatively impact funding in a long election cycle

What next

President Trump is set to remain in the strongest position over the coming months, as the economy looks likely to continue posting positive results during the summer. While a trade agreement with China, or a significant international agreement with Iran or North Korea remains a long way off, the continued focus on trade and foreign policy will only serve to strengthen his chances of re-election. The likelihood of another Republican running for President will continue to fall, with the Republican Phoenix scenario significantly handicapped.

For the Democratic candidates, the initial fracturing between tiers of candidates will continue and solidify. With the rules to make the debate stage for the third Democratic debates in mid-September more stringent than those for the first two in June and July, the field of Democratic candidates is expected to narrow towards the end of the summer, as more struggle to get national coverage. This will further escalate the grouping of the field into Tier-1 and Tier-2 candidates, allowing policy divisions between those in the top tier to grow in importance. By the autumn, differences on key policy issues will be far clearer for the main group of candidates.

This update follows our in-depth report [US Politics Watch: Four Scenarios for 2020 and Beyond](#) published in April 2019, examining the potential electoral outcomes and the political, economic and market implications of each scenario.

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Snap | 18 July 2019

ECB preview: One final talk before walking the walk

It's a very close call but we expect the European Central Bank to change its forward guidance next week and effectively pre-announce a package of new measures at the September meeting



ECB President Mario Draghi delivers a speech at the European Parliament in Strasbourg back in January

A dovish press conference after the June meeting, an even more dovish speech by Mario Draghi in Sintra and very little evidence that the economic outlook is about to improve any time soon.

Against this backdrop it will be very hard for the European Central Bank to send a sufficiently dovish message without actually delivering at next week's meeting. In our view, the discussion within the ECB's Governing Council will be an exciting and heated one.

Dovish, more dovish, most dovish or simply action?

In fact, Draghi's Sintra speech has made clear that the question regarding the short-term outlook for the ECB is no longer "what negative surprise is needed for the ECB to cut rates" but rather "what positive surprise could actually prevent the ECB from cutting rates". This is how we read Draghi's comments that - absent economic improvements - more stimulus will be needed.

Economic data out of the eurozone, as well as the Fed's de facto announcement of a July rate cut,

have clearly pushed the ECB closer towards July action, rather than waiting until September. After some tentative signs of stabilisation at the end of the first quarter, the eurozone economy seems to have slipped once again. What is also worrying is that there are signs the solid domestic part of the economy may be faltering as well. In particular, German data is worrisome with an increase in short-term work schemes, fading momentum in the labour market and falling retail sales.

Consequently, for next week's meeting, the main question is whether the ECB can afford to wait six more weeks before delivering new monetary stimulus or whether it should surprise financial markets by frontloading new measures. In fact, traditional ECB watching argues in favour of compiling more data, waiting for the release of 2Q GDP in mid-August and the next ECB staff projections and only then taking a decision at the September meeting. Draghi's track record of over-delivering and trying to be ahead of the curve, however, could bring new ECB action at the ECB's July meeting. It's a very close call, which will only be decided during the meeting next week.

What we expect the ECB to do next week

To keep a somewhat friendly balance between the doves and hawks, a typical European way out would be to step up the dovishness once again. And to be frank, it will be the very last time the ECB can talk the talk without walking the walk. In this regard, the only way out is to change the forward guidance to say that interest rates will "remain at their present or lower levels...". A pre-announcement of a rate cut in September and a clear hint that the bank is once again considering quantitative easing.

This approach would allow the ECB to collect more data and, in case macro data continues to disappoint, cut the deposit rate by 20 basis points in September, introduce a tiering system for the deposit facility and (possibly) even restart QE.

While in the past, we often believed that the ECB preferred to deliver new stimulus in small steps and in sequences, this view has changed. In Philip Lane's first encompassing speech on monetary policy as ECB chief economist, he clearly pointed to a package of measures rather than a sequencing of smaller individual steps. This means that instead of incremental moves, the ECB appears to be shifting towards bolder, bundled action.

If we are wrong and the ECB wants to frontload new monetary stimulus, next week's meeting could bring rate cuts and a clear indication that QE could restart in September.

One final talk before walking the walk

In our view, the latest disappointing macro data, tentative signs that the resilience of the domestic economy is faltering, a potential rate cut by the Fed and continued dovish communication from ECB officials since Sintra, have all pushed the ECB to the point of no return. In fact, the ECB and Mario Draghi have taken the genie of more monetary action out of the bottle and it will be hard to get it back in. The only question is whether words alone, as dovish as they might be, will be enough. It seems as if the ECB will try to talk a very final talk before walking the walk in September. However, the risk to this call remains that Mario Draghi will try to surprise financial markets. It would not be the first time.

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Article | 19 July 2019

Rates: The asymmetry in the ECB's symmetrical inflation target

As our economics team expects the European Central Bank to ease at either next week's meeting or the one in September, we look at the implications for Rates markets of a potential change in its inflation target



Source: iStock

5Y5Y inflation swaps

Rates markets are not pricing in higher inflation despite imminent ECB easing



Source: Bloomberg, ING

Rethink on inflation

Yesterday, [Bloomberg news quoted ECB sources as saying](#) the central bank is looking into altering its inflation target of 'below but close to 2%'. The news should not come as a surprise. President Draghi has repeatedly voiced his preference for a symmetrical inflation target which would allow the ECB to 'look through' episodes of higher inflation. Nor is this happening in a vacuum; the Federal Reserve is also undergoing a review of its tools and strategy and the ECB's own difficulties in maintaining inflation at target have prompted calls for a rethink.

Impact on Rates

A change in the inflation target would be significant for Rates markets nonetheless, were it to come to pass. For instance, investors would infer this reduces the risk of a premature withdrawal of stimulus when inflation shows signs of edging back to target. It would also dampen market reaction in cases of hawkish dissent to easing decisions.

The implications for Rates markets are twofold. The first and most obvious conclusion is that it would contribute to the further anchoring of expectations of 'lower for longer' interest rates. The second implication pertains to the credibility of the ECB's inflation-boosting effort. Given the persistent undershoot of its target, the ECB would be more likely to influence markets' inflation expectations by introducing new tools.

Steeper or flatter curve?

And here would lie the asymmetry in the ECB's symmetrical inflation target: without new tools, investors might conclude that the central bank has simply decided to push harder on the same string. This would thus imply little need for longer-dated Rates to offer compensation for anticipated inflation and result in a lower and flatter yield curve.

If, on the other hand, a new inflation target precipitates a debate on what tools are at the ECB's disposal, then curve dynamics may well shift to steepening. This is a more distant prospect however, with most current policy tools fraught with difficulties. Rates investors may well wait and

see how this debate evolves before pricing more inflation down the line.

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GBP: The pressure is building

Sterling continues its descent as concerns about the Brexit outlook intensify. While there is already a 3% risk premium in EUR/GBP, this is still below the 4% level seen in 3Q18 after Chequers, making it consistent with our 3Q19 forecast of 0.92 for EUR/GBP. The likely election of Boris Johnson as the next Conservative leader will add pressure to GBP



Source: Shutterstock

More negative news ahead

In the month ahead, we expect headline news to continue to negatively impact sterling. First, the likely confirmation of Boris Johnson as the next Conservative leader and thus prime minister next Tuesday won't be helpful for GBP. The Conservative party conference in late September will also add pressure to GBP, with peak pressure building in October ahead of the 31 October Article 50 extension deadline.

While the outlook for GBP does not look great, sterling has already moved considerably. Below we look at the technicals such as risk premium, positioning and the option market and conclude that despite the bad news already being reflected in sterling, there is still scope for further GBP decline. This is consistent with our forecast of EUR/GBP 0.92 and GBP/USD 1.22 this summer. Risks to our GBP forecasts remain on the downside, stemming from both risks of a hard Brexit or early elections.

If elections are called early, we see EUR/GBP approaching the 0.95 level.

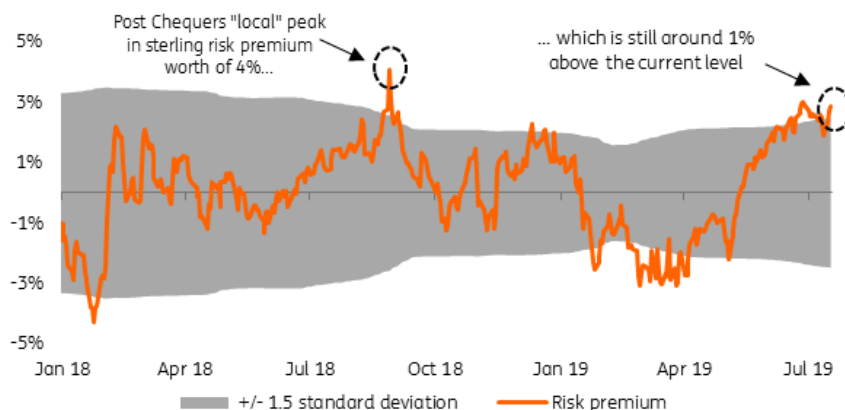
Risk premium

Following the recent sterling decline, a fair degree of risk premium is priced into sterling. Based on our short term financial fair value model, we estimate the risk premium is currently worth around 3%, which is elevated and outside of the usual 1.5 standard deviation band – as the figure above shows. However, the same chart shows, this is still below the GBP risk premium highs observed in 3Q18 after the Chequers cabinet meeting, which was followed by the resignation of Boris Johnson. At that time the risk premium was worth 4%, suggesting another 1% decline in GBP could be still on cards and consistent with our forecast of 0.92 this summer.

In the case of early elections (a meaningfully rising probability), we can see EUR/GBP at 0.95 as the prospects of a potential Labour government or a hard Brexit are unlikely to go down well with global investors.

GBP risk premium on the rise

The estimate of EUR/GBP risk premium. A residual between EUR/GBP fair value and spot.

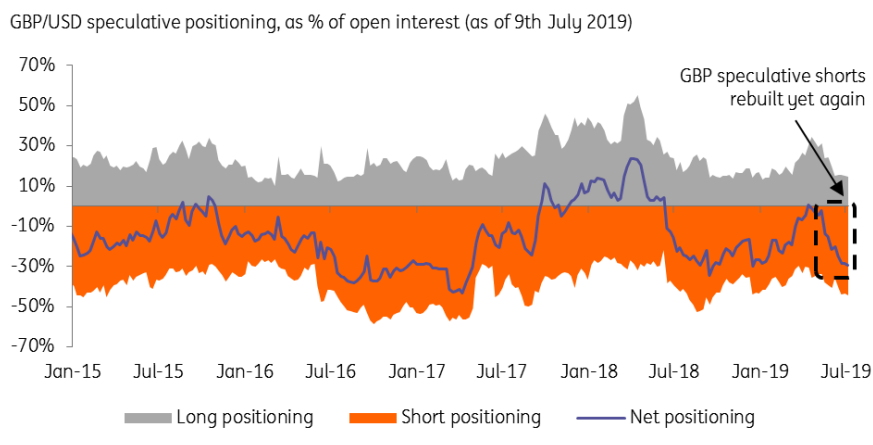


Source: ING

Speculative positioning

Market concerns about the Eurosceptic prime minister have led to a meaningful build-up / re-building of speculative sterling shorts, 30% of open interest currently, as the figure above shows. This exceeds the level of speculative shorts in January this year and has been only surpassed by the level of speculative shorts in the post Chequer's period (around 35% of open interest at the time). As the figure below shows, only rarely have GBP/USD speculative shorts exceeded the 35%-40% level (in terms of open interest). This means that while there is still some scope for a build-up of short GBP positions, the pace of the increase in GBP shorts should slow versus the aggressive build-up over the past months. This also suggests EUR/GBP trades to 0.92 this summer unless we see meaningful news (i.e., sharply rising probability of hard Brexit or early elections).

GBP speculative shorts on the rise

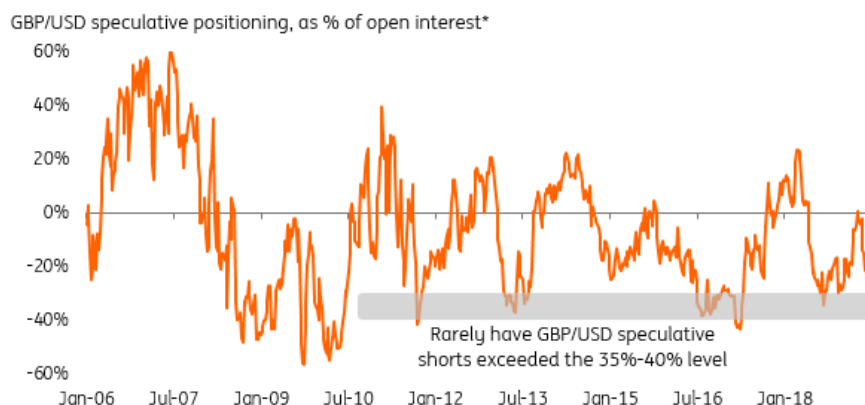


Source: ING

Option market / volatility

The rising perceived probability of a disorderly Brexit after the 31 October deadline (in response to the comments from Boris Johnson, the leading Conservative leadership candidate) is reflected in the option market, with the sterling implied volatility curve heavily kinked around the deadline date (that is the 3-4 months tenors) versus the close-to-normally upward sloping shape of the curve 2-3 months ago. This is evident in the figure below. Sterling risk reversals also surged, but are still below the March highs, suggesting a further increase over coming months

Rarely have GBP/USD speculative shorts exceeded the 35%-40% level

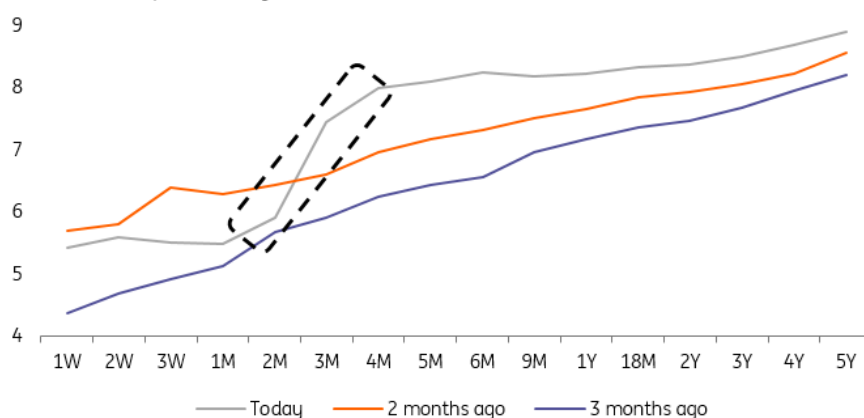


* As of 9th July 2019 (data are reported with a lag)

Source: CFTC, ING

Sterling volatility curve heavily kinked around the deadline date

EUR/GBP ATM implied volatility term structure



Source: ING, Bloomberg

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China: GDP growth slumps; Retail sales show warning signs

China's GDP growth has slumped to its slowest pace in almost three decades, as trade tensions weigh on sentiment and activity. While retail sales appear to be holding up so far, we see signs that the tech war is starting to affect job security and expected wage growth



Source: Shutterstock

Donald Trump, Xi Jinping. President Donald Trump, right, with China's President Xi Jinping, left

Infrastructure stimulates economy

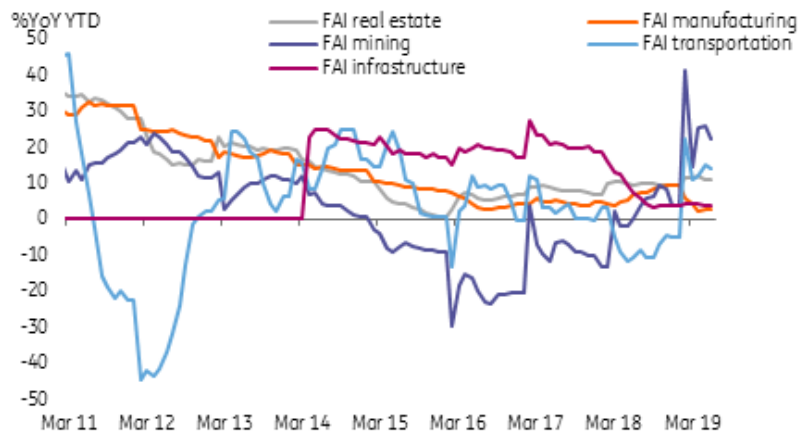
GDP grew by 6.2% year-on-year in 2Q19 as was widely expected. The detailed activity data show that infrastructure investment, which grew by 5.8% YoY in June from 5.6% a month ago, was at the core of economic growth.

Mining and railway investment grew by 22.3% YoY and 14.1%, respectively, helping to drive overall infrastructure investment and, in turn, the entire investment environment in China. [Loan data paints a similar picture.](#)

Industrial production also reflects this trend. Ferrous and non-ferrous metal processing grew 10.3% and 10.4% YoY, respectively, while railway-related manufacturing grew 10.6% YoY.

[The export environment has been gloomy due to an escalating technology war with the US.](#) From January to June 2019, mechanical and electronic products made up around 55% to 60% of China's exports, which means the tech war will hurt China's exports significantly. This may not change in the remainder of the year.

Transport infrastructure projects, especially metro lines, have driven GDP growth



Source: ING, Bloomberg

It is infrastructure, not exports, that have been helping manufacturers



Source: ING, Bloomberg

Retail sales boom, but for the wrong reasons

With exports no longer the engine of the economy and infrastructure now in the driving seat, we're likely to see some changes in the job market. So how does that affect consumption? Consumers are in fact spending more than usual. But don't get too excited.

Retail sales boomed by 9.8% YoY in June from 8.6% YoY. This number looks encouraging. But the details tell a different story.

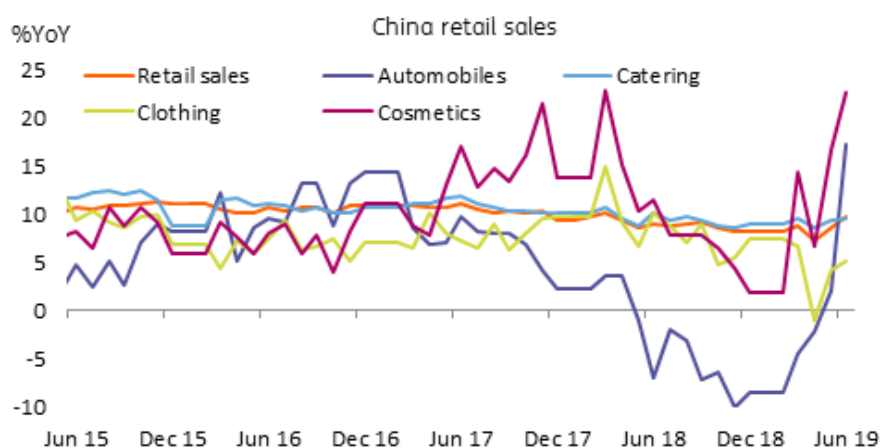
1. There are signs that Chinese consumers have become more cautious about spending on leisure trips, signalling that consumers are potentially concerned about their job security and wage growth. Consumer items typically bought on overseas' leisure trips have been bought domestically. For example, cosmetics, usually bought in duty free shop in airports, grew 22.5% YoY in China compared to 13.2% YoY YTD. The current account shows that outbound tourism spending fell 8.7% year-on-year in 1Q19. Another example is that in

Hong Kong, retail sales fell 1.3% YoY in May and have shrunk for four months in a row. We expect retail sales in China will continue to grow at a good rate even that growth is coming for all the wrong reasons.

- Another reason for the jump in retail sales in June was that China's car dealers cut prices, which boosted car sales 17.2% YoY after sales growth of just 1.2% YoY YTD. But the price cutting promotion can't last for more than a quarter. And together with shrinking production (by 16.8%YoY in June), corporate earnings of car dealers and car producers will suffer.

"There are signs that Chinese consumers have become more cautious about spending on leisure trips, signalling that consumers are potentially concerned about their job security and wage growth "

Consumption booms as spenders limit leisure trips



Source: ING, Bloomberg

China's future depends on 5G

From industrial production, we know that smart devices fell 6.9% YoY YTD, integrated circuits also fell by 2.5% YoY YTD. This trend will not change unless there is a significant improvement in value add in new smart devices. We strongly believe that will arrive when 5G is ready for commercial use and then for the general public.

However, China faces hurdles in buying technology from its businesses partners and may have to invent the technology itself, be it the nanochips, the operating system or the apps. This is bad news for China although if Chinese technology companies are forced to develop new technologies themselves, investment and production will likely grow.

It is then up to the Chinese consumers to choose which brand to buy. If China's 5G is at the forefront of the world, it should be an easy decision for them.

Before 5G arrives, the economy will continue to be stimulus driven

We will continue to keep an eye on the retail sales data, and the development of 5G to see if we need to fine tune our forecasts later.

Until then, the Chinese economy will need to be driven by stimulus. We expect that infrastructure stimulus will double from 2 trillion yuan to 4 trillion yuan to fill the gap of lost exports and related supply chain disruption. Infrastructure stimulus will keep the economy growing at 6.3% in 2H19.

The People's Bank of China must make targeted cuts to Reserve Requirement Ratios and cut the 7-day interest rate to limit the upward pressure on interest rates brought about by the additional loan demand from infrastructure projects.

We maintain our forecasts that the PBoC will make a targeted RRR cut of 0.5 percentage points with the 7-day rate cut by 5bp in 3Q and 4Q, respectively.

USD/CNY will be fairly stable around the 6.90-6.95 level. Depreciating the yuan can do no good for exporters who may lose the whole export orders if there is a 25% tariffs or they simply can't do businesses with US companies.

Author

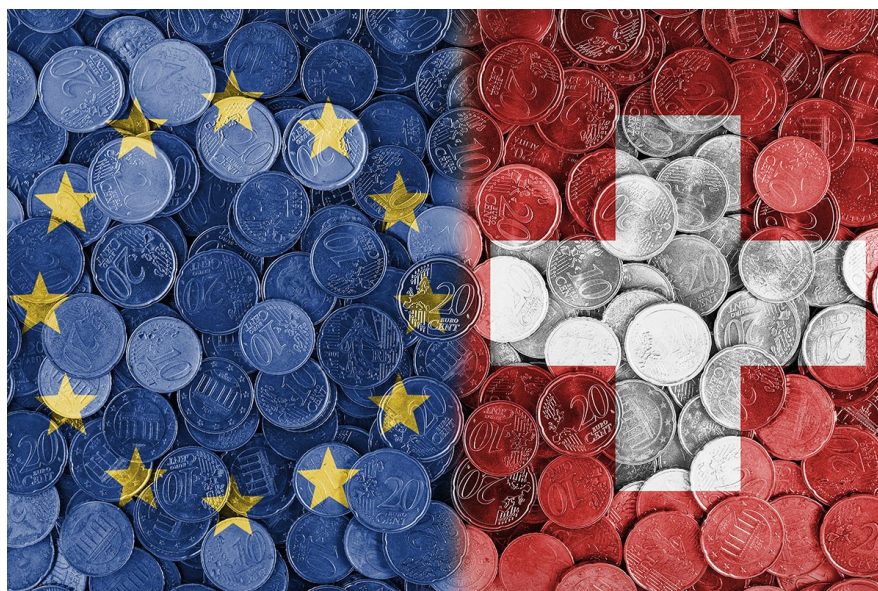
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EUR/CHF: It's beginning to look a lot like 1.05

EUR/CHF is trading close to the lows of the year and it's not hard to see why. Expect the market to now question the Swiss national bank's ability to match ECB rate cuts and undertake large scale FX intervention. We can see the inflation-adjusted CHF trade-weighted index moving back to 2015 highs, which should mean EUR/CHF at 1.05



Source: Shutterstock

Rewind back five years

The ECB has turned dovish again and at the June meeting, President Mario Draghi confirmed that a fresh round of asset purchases is under discussion. Certainly, European debt markets have responded to the suggestion of ECB asset purchases, where sovereign spreads have narrowed and eligible corporate debt markets have done very well.

In the FX market, the EUR trade-weighted index has been relatively flat since June. However, this is a function of some weakness in the CNY, USD and GBP, all of which have large representation (19%, 14% and 10%) in the trade-weighted EUR.

However, we have seen EUR/CHF soften to the lows of the year – and this isn't really a surprise. Spreads in short term interbank rates have narrowed to the lowest levels since 2015. And for many in the market, memories are still fresh (and painful) of how Switzerland's central bank abandoned

the 1.20 minimum exchange rate for EUR/CHF on January 15th, 2015 – one week before the ECB announced the start of a new €60bn per month asset purchase plan.

As 2H19 progresses, and more clarity emerges on ECB rate cuts and its plans for quantitative easing, expect Switzerland's central bank policy to come under greater scrutiny

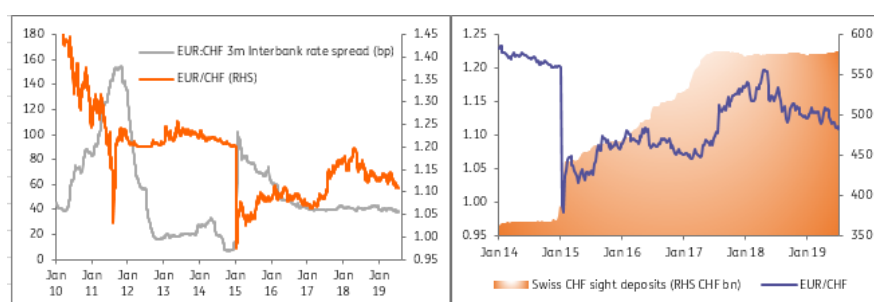
At the time and in subsequent comments the SNB admitted that the massive intervention to support the 1.20 floor was 'no longer sustainable and would require ever-larger foreign currency purchases to enforce it'. This in the face of the forthcoming tsunami of euros from the ECB.

Fast forward five years to 2019 and the ECB is now considering fresh rate cuts and another round of asset purchases. [Our macro team feels that next week's ECB rate meeting](#) maybe a little too early for a deposit rate cut (but acknowledge that President Draghi tends to over-deliver). More asset purchases may be held back as ammunition in case of a disorderly Brexit – but are now squarely back on the market's radar.

Currently, there is no acute pressure on EUR/CHF. For example, CHF sight deposits have only risen CHF1bn since early June, suggesting little or no FX intervention from the SNB to limit CHF strength. Yet as 2H19 progresses and more clarity emerges on ECB rate cuts and its plans for quantitative easing, expect SNB policy to come under greater scrutiny.

In other words, to prevent the CHF becoming even more 'highly valued', can the SNB take negative rates (now -0.75%) even deeper into negative territory and could it undertake a fresh round of large-scale FX intervention?

Soft rate spreads weigh on EUR/CHF, but it doesn't seem like the SNB is intervening



Source: ING, Bloomberg

Deeper negative rates?

[As our team points out](#), the SNB would probably try first to intervene in FX markets to hold EUR/CHF above 1.10, but failure to do so could prompt another small rate cut from the SNB. Certainly, the SNB says they haven't run out of room to take the policy rate further deeper into negative territory. However, like many central banks, negative rates are impacting banks profitability, given that retail deposit rates have not been taken below zero and margins are under pressure.

If the Swiss central bank were to match the near 20bp of ECB cuts priced by the end of 2019, the policy rate would be very close to -1.00%

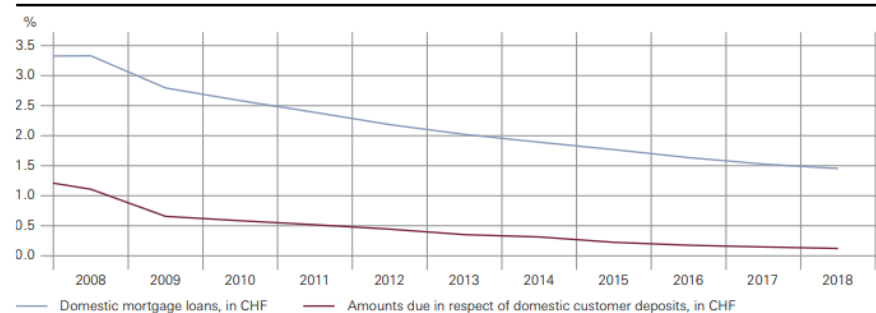
For reference, the average interest rates on customers deposits amongst Swiss banks in 2018 was 0.12%, while for large banks it was just 0.06%. No wonder the SNB would have to expand the current (generous) exemptions for negative rates on CHF sight deposits – were they to cut rates further. This would be especially necessary given the Swiss aversion to negative savings rates – [as discussed by our colleagues in the results of our consumer finance poll last year](#). A separate poll of over 1000 Swiss savers showed 25% keeping cash at home if savings rates turned negative.

If the SNB is to match the near 20bp of ECB cuts priced by the end of 2019, the policy rate would be very close to -1.00% - and to match fresh ECB QE we assume the SNB's balance sheet and FX intervention would come into play.

[Read ING's survey on why sub-zero deposit rates might not boost consumer spending](#)

Swiss mortgage and deposit rates compress

AVERAGE RATE OF INTEREST ON SELECTED BALANCE SHEET ITEMS



Source: SNB
Source: SNB

Limits to FX intervention?

In theory, the SNB can increase FX reserves and its balance sheet ad infinitum. In practice, there are two key limits. If FX reserves grow too large relative to GDP, huge profit and loss swings on the back of reserve revaluation can damage central bank credibility and if the central bank's FX intervention exceeds 2% of GDP over a 12 month period, it would trigger one of the US Treasury's three criteria on currency manipulation.

In theory, the SNB can increase FX reserves and its balance sheet ad infinitum. In practice, there are two key limits

On the former, being forced out of the 1.20 floor cost the SNB CHF20bn in terms of FX losses in

2015 and wiped out 60% of its provisions and equity capital. The SNB's balance sheet is 50% larger today than it was in late 2014, while its provisions and equity capital are 80% larger (end May 2019 figures). While the SNB may feel it has unlimited room for FX intervention and to grow FX reserves, the sheer size of reserves, now over 100% of GDP may make the SNB a little queasy.

Perhaps a greater constraint for the SNB is the US Treasury's increased surveillance on currency markets – in an effort to reduce the US trade deficit. Recall Washington has three criteria to determine whether a trading partner is manipulating its currency for trade gains. 1) A bilateral goods trade surplus with the US in excess of US\$20bn over the last 12 months. 2) A current account surplus larger than 2% of GDP and 3) FX intervention (buying FX) greater than 2% of GDP, again over the prior twelve-month period.

A greater constraint for the SNB is the US Treasury's increased surveillance on currency markets

In the last Treasury FX report, published on 19 May, Switzerland just about escaped the first criteria with a US\$19bn bilateral surplus, blew away the second condition with a 10% current account surplus and on 3 was identified as having intervened to the tune of 0.3% of GDP in FX markets.

CHF 14
bn

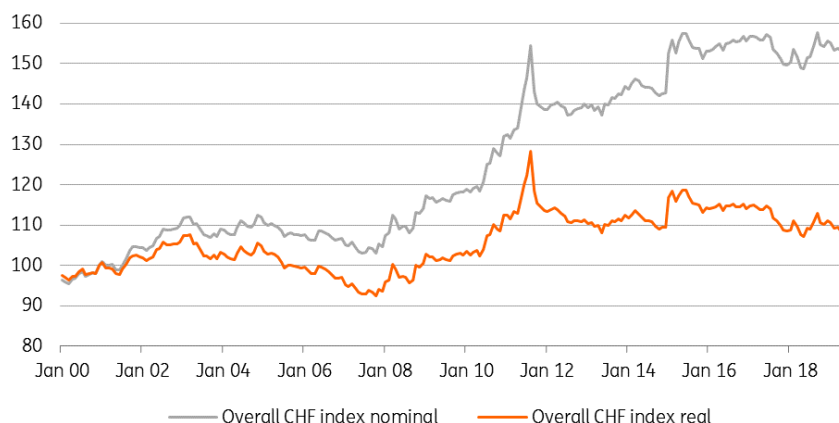
Potential ceiling on SNB FX
intervention

Over the next 12 months

The third criteria could be a challenge for the SNB this year. 2% of Swiss GDP is around CHF 14bn – that is not a lot at all given Swiss FX reserves grew CHF300bn during the ECB's 2015-2018 QE campaign. Of course, there is no suggestion that the ECB will repeat a three year, EUR 2.5trn asset purchase programme, but even a programme worth one-tenth of that suggests SNB FX intervention could fall foul of the US Treasury rules.

Were Switzerland to be named a currency manipulator, it could ultimately result in tariffs – or there is [even a new idea emerging that the US should undertake countervailing currency intervention](#), which in this case would see the US Treasury instructing the Fed to buy CHF!

Swiss franc trade weighted: Nominal TWI is on its highs, real TWI is not



Source: SNB

1.05 seems quite conservative

If we believe that conviction levels of ECB easing grow this summer, we should expect EUR/CHF to stay pressured. While the SNB's nominal trade-weighted CHF index is on its highs, the inflation-adjusted 'real' index is not.

This latter measure of the CHF is some 5% off the highs seen in summer 2015 (largely due to low inflation in Switzerland relative to trading partners) and a retest of that 2015 high would equate to EUR/CHF hitting the 1.05 area. That seems quite a conservative target for EUR/CHF this summer.

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Article | 18 July 2019

CAD: Markets turning more bullish

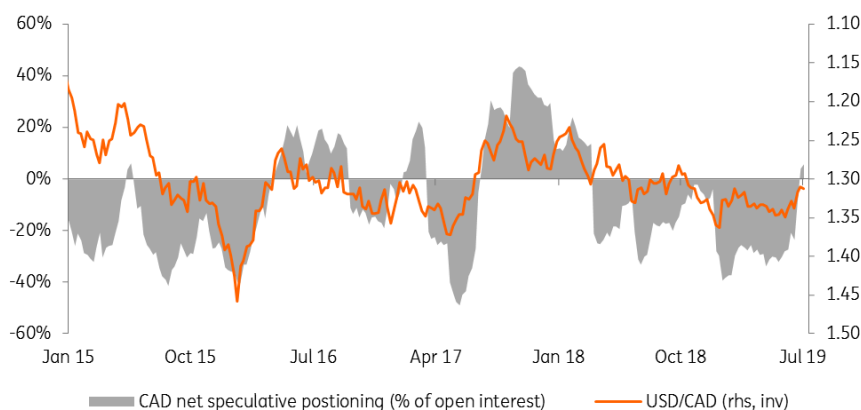
Net positioning in the Canadian dollar has jumped into long territory in July. We expect markets to be reticent to enter additional long-CAD positions for now, although we maintain a long-term bearish bias on USD/CAD



Source: iStock

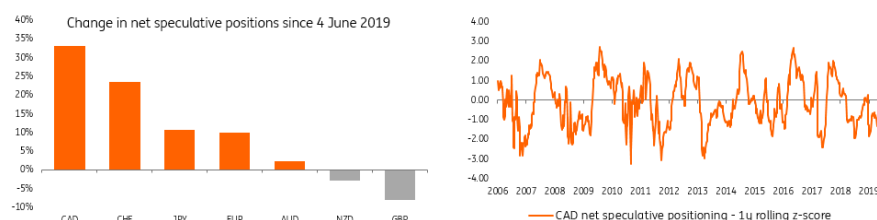
Markets have turned increasingly optimistic on CAD

CFTC commitment of traders data showed how in July – for the first time since 1Q18 – long combined speculative positions on CAD have outnumbered the shorts (Fig. 1). This comes as investors have gradually abandoned their bearish views on CAD and slashed short positions in the past month. On 4 June, market shorts on CAD were 27% of open interest, whereas the latest numbers show net longs amounting to 6% of open interest. No other currency in the G10 space has displayed such a marked upside move in net speculative positions in the same period (Fig. 2).



Source: CFTC, Bloomberg, ING

Market sentiment on the loonie has been diverging compared to other commodity currencies such as the Australian and New Zealand dollars. This is likely due to the divergence in monetary policy. The Reserve Bank of Australia delivered back-to-back rate cuts in June and July while the Reserve Bank of New Zealand has maintained an easing bias after cutting in May. In contrast, the BoC has maintained a neutral policy stance. When normalising the data through rolling 1y z-scores (Fig. 2), the magnitude of CAD short-covering in recent weeks appears even sharper. This could suggest that a deeper move into net long territory is not imminent. In particular, we suspect that as long as the threat of another escalation in US-China trade tensions lingers - and given the already meaningful move in CAD in the past few weeks - investors may refrain from entering heavily bullish positions on CAD. If anything, positioning might suffer from a light downward correction in the short-term.



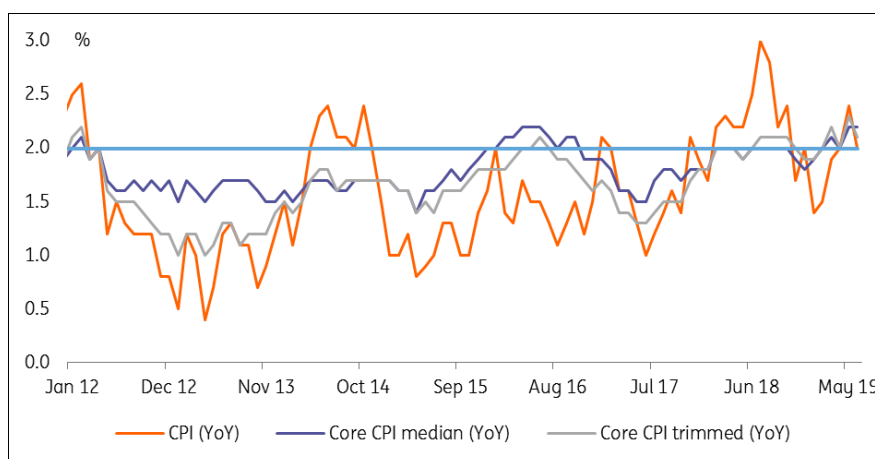
Source: CFTC, Bloomberg, ING

What lies ahead for the loonie?

Yesterday's CPI numbers confirmed that robust price growth remains a strong point in favour of a neutral BoC stance on monetary policy. Headline inflation decreased from 2.4% to 2.0% in June (as widely expected), but all core measures have remained above the 2% BoC target mid-point. We believe the Bank of Canada will not decrease policy rates at least for the next 18 months, particularly when considering that:

- The BoC did not raise rates as fiercely as the Fed in the past few years and can therefore take its time before following any Fed easing
- The labour market remains tight: June's decrease in jobs was all due to the part-time segment, while wage growth peaked
- The outlook for oil remains constructive after the OPEC+ output cuts
- The USMCA deal should soon be ratified, with reservations from US Democrat gradually

fading



Source: Bloomberg, ING

A possible re-escalation in trade tensions between the US and China indeed has the potential to dampen appetite for risk-sensitive currencies such as CAD, but we expect the mix of factors mentioned above to provide some support to the currency, keeping any upside in USD/CAD limited. We forecast that the recent downward pressure on the currency pair will resume in 4Q19, when we expect trade tensions to abate, crude prices to peak and US-Canada policy divergence to linger. Accordingly, we do not exclude another upward move in the CAD positioning indicator towards the end of the year, when USD/CAD should start to test the sub-1.300 area.

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Article | 18 July 2019

Big shipping concerns as sulphur fuel cap deadline approaches

We're in the final stretch of the long-awaited International Maritime Organization shipping regulation, which will see the global shipping fleet having to move to a fuel with a maximum sulphur content of 0.5% from 2020 from the current limit of 3.5%



Refuelling at sea - A small oil products ship fuels a large bulk carrier

The options for the shipping industry

With less than six months to implementation, the shipping industry would have largely decided on the best way to tackle this new sulphur cap. As we have mentioned in previous notes, the options are: burn a compliant fuel, install scrubbers which will allow vessels to continue using high sulphur fuel oil (HSFO), retrofit with LNG engines or not comply with the new regulation.

Compliant fuel

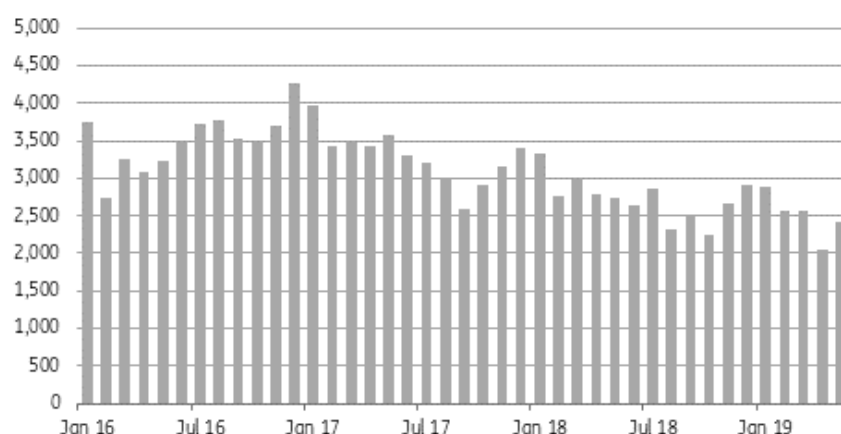
Suppliers have spent some time coming up with compliant 0.5% sulphur fuel oil or very low sulphur fuel oil (VLSFO), and we do think that a general industry move towards a compliant fuel remains the most likely outcome. However, this comes with its own challenges. Firstly moving to a compliant fuel is going to be costly, and the extent of this depends on whether shipowners go the route of a VLSFO or a marine gasoil (MGO), with the latter being more expensive. The key concern with VLSFO is the issue of commingling- while two fuels may be compliant and stable, they may be

incompatible, leading to the potential for sediment formation. Secondly is the issue of fuel availability, with compliant fuel potentially not available at smaller bunkering ports.

A general industry move towards a compliant fuel remains the most likely outcome

Fuel availability may not be too much of an issue as we move into 2020, as stocks of compliant fuel would have been built up, ensuring enough supply at least initially. The concern may be further down the road, once stocks are reduced and the shipping industry is reliant on refinery output. But again this shouldn't be a long-running issue, as refineries around the world make the necessary investments. Look at Russia, where years of upgrades have seen refineries there yielding larger volumes of top and middle of the barrel products, whilst residual fuel oil yields have declined. Russian fuel oil exports over the last couple of years confirm this; fuel oil exports over the first five months of this year averaged 2.5mt a month, down from an average of 3.58mt in the same time period of 2017.

Russia fuel oil exports (k tonnes)



Source: CDU TEK, Bloomberg, ING Research

The scrubber route

If shippers are concerned about a more expensive fuel, the other option for them is to install a scrubber, which removes the sulphur, so allowing them to use HSFO. There are issues though going this route, and regulatory risks are also growing. The spread between gasoil-HSFO clearly does give the price incentive for shipowners to go the scrubber route; the spot spread is trading at around \$226/t, and when you look at the forward curve, the March 2020 spread is as wide as \$300/t.

There's clearly still an attractive incentive for ships to install scrubbers

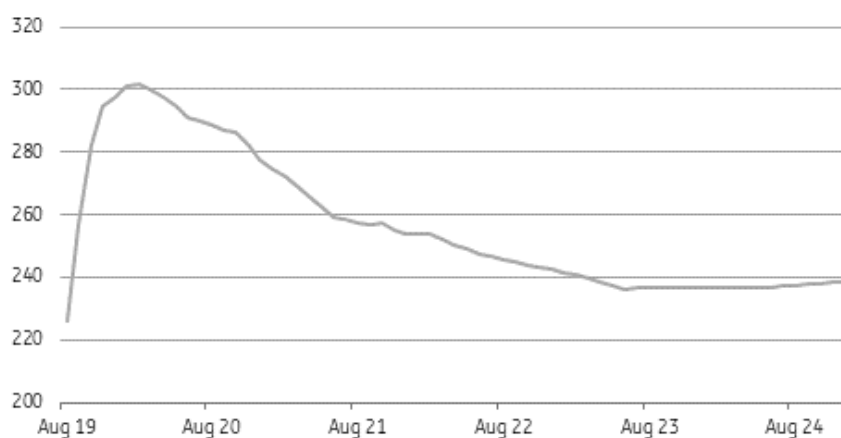
Admittedly over the last year, these spreads have been even wider, but there's clearly still an attractive incentive for ships to install scrubbers. Taking into consideration the cost of a scrubber and a spread of \$300/t, the payback period for the scrubber is around one year. If the spread were to fall to around \$100/t, this would see the payback period increase to around three years.

There are a number of issues with scrubbers though. Firstly with the regulation less than six months away, it is unlikely that a significant portion of the global vessel fleet will have scrubbers installed, there's just not enough time. The general consensus is that by 1 January 2020, we could see in the region of 3,000-4,000 ships with scrubbers, so only scratching the surface of the global fleet.

Secondly, there is the issue of increased yard time to install a scrubber, which means lost revenues for a shipowner, along with the fact the a scrubber will also reduce the load that a ship can carry.

Finally, and probably most importantly, is the growing concern that scrubbers create their own environmental issues, with wastewater from the scrubber pumped back into the oceans. A number of ports have already banned the open-loop scrubber system, and more will likely follow. Singapore, Fujairah and China are some which have already introduced a ban on the open-loop system, which will be a concern for those who have made this particular investment. However, there are other scrubber options: ships could use the closed-loop system or a hybrid system, but admittedly this would be more expensive, and so increasing the payback period.

Gasoil - HSFO spread forward curve (US\$/t)



Source: Bloomberg, ING Research

LNG switch limited

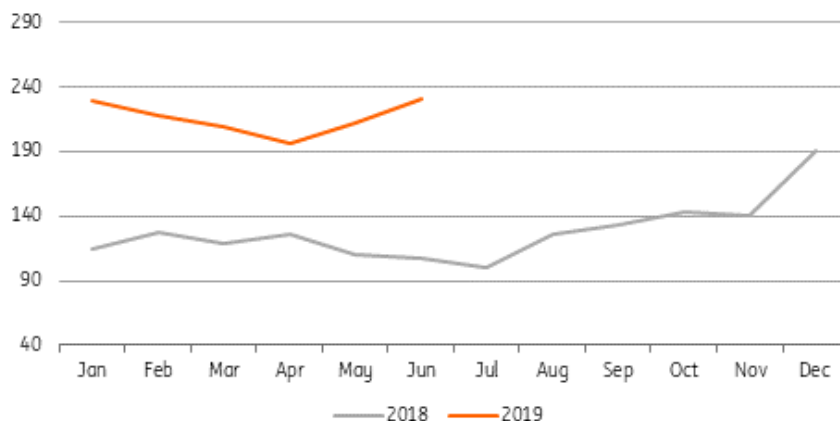
The other option is to turn to Liquefied Natural Gas. However, for now, we do not believe it is a viable option; the additional expense of retrofitting a vessel with an LNG engine is too burdensome, while the lack of LNG bunkering infrastructure is another obstacle. Longer term, the case for LNG had been largely bullish. However, with the focus shifting to carbon emissions after the low sulphur cap, the industry will probably have to look at even lower carbon alternatives.

Strong compliance expected

The final choice for the shipping industry is not to comply with the regulation. This non-compliance may be intentional, while there may be a segment which has tried to unsuccessfully procure a

compliant fuel, in which case they receive a waiver. We do think that compliance will be strong, with ship owners not wanting to risk fines from flag states. Furthermore, breaching the regulation would class the vessel as unseaworthy and therefore, uninsurable.

Singapore light sulphur marine gasoil bunker sales (k tonnes)



Source: MPA, ING Research

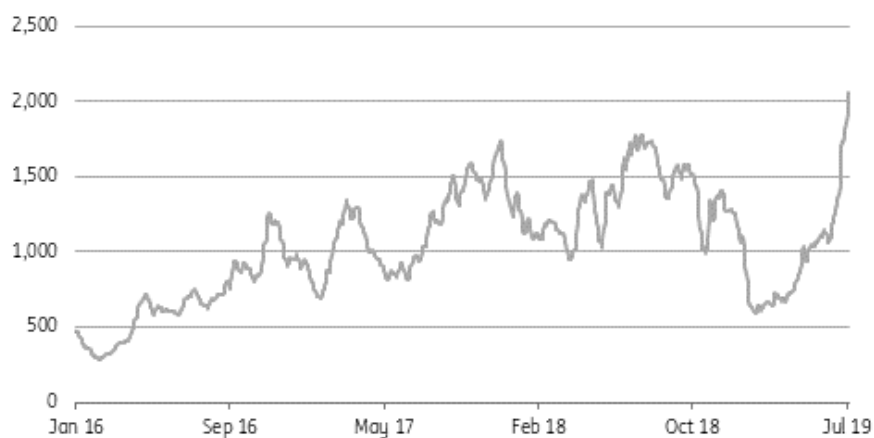
When will the impact of IMO be felt?

We already see signs that the fast-approaching IMO regulation is having an effect. If we look at bunker sales in Singapore (the largest bunkering port in the world), while total bunker sales over the first six months of the year are down 6.5% YoY, sales of low sulphur marine gasoil have increased by almost 84% YoY over the same time period. Although these sales are still a fraction of the higher sulphur fuel sales, it still suggests that the industry has started to prepare to ensure compliant fuel. We believe that vessels will start to transition towards a compliant fuel over the course of the 4Q19. From a cost point of view, shipowners would want to burn HSFO through until the 31st December. However, from a practical point of view, this is very unlikely.

Strangely the regulatory change is not reflected in current forward curves as strongly as it was over the last year. We saw the spot gasoil-HSFO price spread in north-western Europe trade out to over \$293/t in 2018, however it is currently trading at around \$226/t. Furthermore, if we look at middle distillate cracks, they have come off from the highs of 2018, when the NW Europe spot gasoil crack broke above \$20/bbl. If one expects there is going to be a significant shift from HSFO to gasoil as a result of IMO, one would expect these cracks to only strengthen further from the \$14/bbl they are currently trading at. We expect these cracks will pick up over Q4, as demand picks up, sending a signal to refiners that they should maximise middle distillate yields. While HSFO cracks should start to weaken as demand falls away, for now spot HSFO cracks are well supported.

In terms of freight, we are already starting to see rates picking up; the Baltic Dry Index has rallied by a staggering 237% since February- the highest levels seen since early 2014. While a large part of this strength is attributed to a pickup in iron ore shipping activity, the other element is reportedly lower vessel availability due to ongoing scrubber installations.

Baltic Dry Index rallies



Source: Bloomberg, ING Research

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UK: A diminishing war chest

With prime ministerial candidates promising tax cuts and a spending splurge the latest fiscal numbers offer something of a reality check to their plans

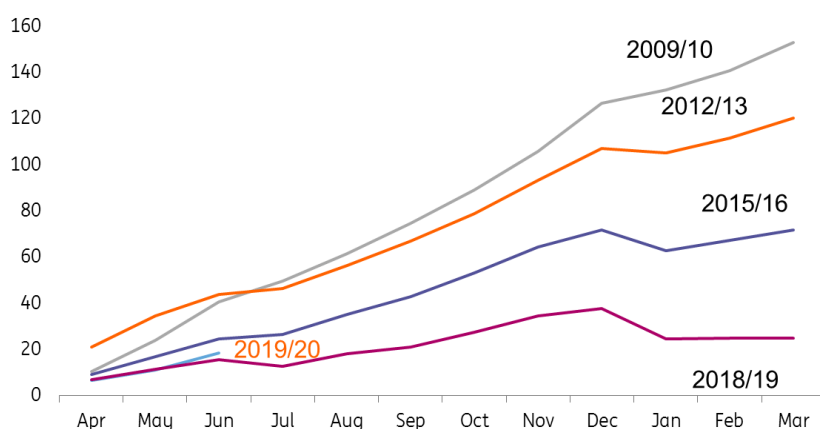


Source: Shutterstock

UK government borrowing increased more than expected in June thanks to both higher spending and weaker tax revenues. In fact, this is the largest June budget deficit for four years and is nearly twice as big as what economists expected. Excluding banking groups, public sector net borrowing came in at £7.2bn and although the May deficit was revised down, cumulative borrowing for fiscal year 2019/2020 is £17.9bn - tracking nearly one third, or £4.5bn above the same period for fiscal year 2018/19.

Cumulative UK government borrowing by fiscal year

Cumulative monthly public sector monthly borrowing (ex banks) by fiscal year (£bn)



Source: Bloomberg, ING

The details show spending was up 7.2% year on year due to more outlays, but also higher borrowing costs. Rising retail price inflation has meant the interest paid on index-linked gilts has risen. Unfortunately, receipts rose just 1.5% YoY with corporation tax revenues actually falling, which underlines the rather weak state of the UK economy right now.

The [Office for Budget Responsibility reported yesterday](#) that under a “no-deal” Brexit on 31 October, government borrowing could jump £30bn a year in 2020/21. Given that context, today’s poor borrowing figures underlines the point that the tax and spending proposals from Boris Johnson and Jeremy Hunt will be difficult to achieve under the current fiscal framework.

[Read the OBR's report here](#)

That said, neither candidate has pledged to keep the structural budget deficit below the 2% GDP level targeted by current Chancellor Philip Hammond. Even if a “no-deal” Brexit is avoided in October, the prolonged uncertainty will likely keep the economy growing weaker than trend and tax revenues, therefore, underperforming budgeted predictions.

With Philip Hammond likely to be out of his job next week, his fiscal rule will be quietly dropped. Government borrowing looks set to climb irrespective of who becomes the next UK prime minister.

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LATAM FX Talking: The Brazil vs Mexico divergence gains steam

The external risk environment has turned slightly more benign with US-China trade tensions stabilizing and market relief provided by expected rate cuts in the US and Europe. The Brazilian BRL continues to stand out, even though we have recently moderated our appreciation trajectory for the Real. There is a weakening bias for the Mexican peso



Source: Shutterstock

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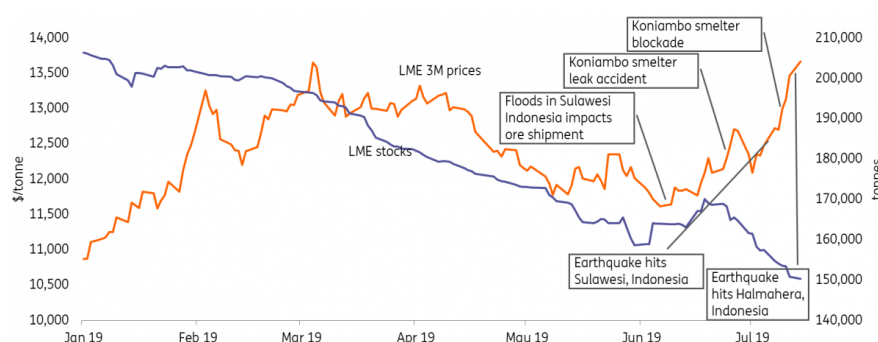
Article | 16 July 2019

Nickel: Is the rally sustainable?

LME nickel has gained momentum from a rising number of supply disruption threats and exchange reported stocks continuously drawing down. However, we think the recent rally doesn't have a strong rational from underlying fundamentals and as such, we only see a moderate rally towards the end of this year and it will be a bumpy ride



Nickel's poor performance in 2023 has been driven by a supply surge from Indonesia



Source: Bloomberg, ING

Recent disruptions to supply

There have been quite a few threats to production in recent weeks. Glencore's partly-owned

Koniambo nickel smelter experienced a leak in June, which was followed by a brief blockade by protestors last week. Indonesia, the world's most important nickel ore supplier and a hub to growing NPI (nickel pig iron) and stainless production, has also been a source of concern. Some areas of the country have experienced heavy rain caused by floods and landslides in June and two deadly earthquakes in July at Sulawesi and Halmahera, respectively. Both areas are important to nickel operations. Meanwhile, fears have also resurfaced in the market over whether Indonesia will resume its ore exports ban in 2022.

Mixed signals over different parts of the market

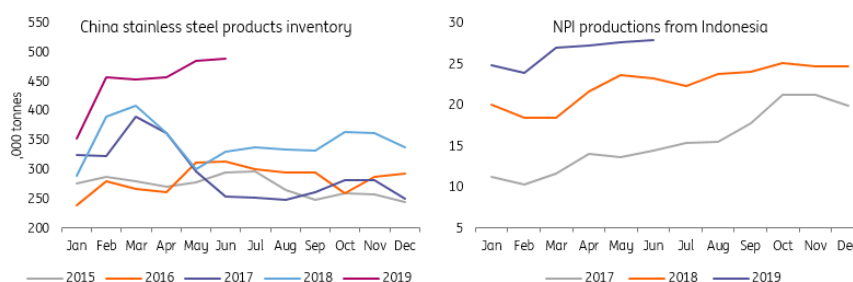
Looking at the recent performance of nickel on the LME and ShFE, we see mixed signals. LME inventory has trended down to its lowest level in more than six years although the time spreads don't seem to be implying an acute supply crunch. Moreover, off-exchange inventory remains opaque. The cash/3M has been caught in a range of \$40-70 contango over the last couple of days. Still, ShFE inventory has surged to a 17-month high. In the physical market, there hasn't been much improvement in the fundamentals out of China, although the global macro environment has been generally supportive over the past month.

The problem has not been resolved

The nickel market has long suffered from structural problems, being segregated into interlinked areas. The NPI, the preferred nickel input for stainless steel making, has been booming. Production has been growing quickly after some new projects were commissioned in both Indonesia and China. It also serves as a cheaper alternative to refined nickel. In the exchange-traded contracts, refined nickel has been punished by the bearish sentiment tied to supply pressures in NPI.

So far, there have been few reasons to be optimistic, although there is stainless steel capacity in the pipeline, which is expected to help nickel and NPI demand this year. There is also a wider expectation that downstream demand will pick up due to China's economic stimulus measures.

In the very short term, one cannot ignore the fact that LME stocks are running lower and in the background, there are threats to supply, which remain a bullish sign for nickel. However, we remain cautious because if prices continue to climb, it could potentially incentivise some off-exchange inventories to be switched on. And looking at China's market, we'll need to see clear signs of a recovery, including stainless destocking and NPI supply pressures to ease, which would give a stronger rationale to become more bullish.



Source: Bloomberg, ING

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Turkey: Is deeper easing on the way?

We expect a 200bp cut on 25 July, though given increasing concerns about credibility, with the appointment of the new Governor, risks are to the downside. Remarks on economic activity and inflation, along with an emphasis on a reasonable rate of real return, the CBT is signalling deeper cuts until the year-end



CBT to begin easing in July

At the rate setting meeting on 25 July, we expect the Central Bank of Turkey to start an easing cycle and to come up with a 200bp rate cut given improvements in inflation and new Governor, Murat Uysal's remarks on 15 July. This is aligned with a Reuters survey (vs around 400bp priced in the market according to the swap curve), up from 100bp before the change in the CBT management.

"Room to manoeuvre" with improving inflation

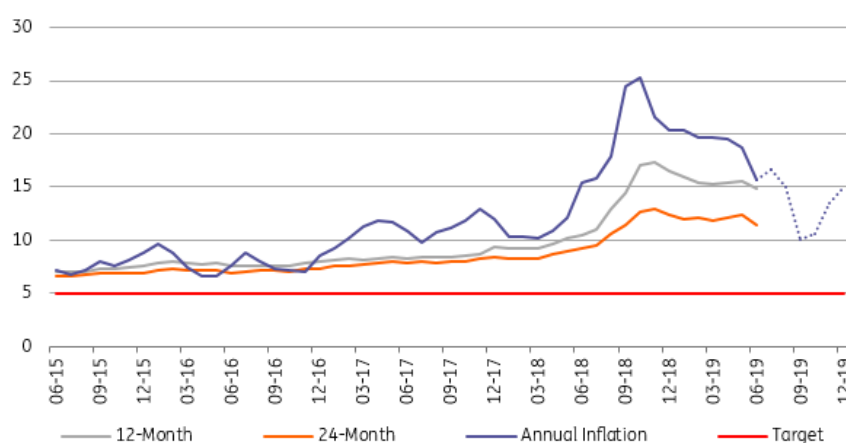
In an interview, Governor Uysal supports this view as he sees "room for manoeuvre in monetary policy" on the back of:

1. The downtrend in inflation: In fact, the most recent inflation data hints at improving price pressures with a downside surprise in recent months, reflecting the weakness in domestic demand and the CBT's tight policy, despite the volatile course of the exchange rate and still high services inflation

2. Improving inflation expectations: The ongoing disinflation has also contributed to a recovery in inflation expectations given that according to the CBT's latest survey, 12M and 24M expectations have maintained a downtrend due to the backward-looking nature of expectations formation with the former down to 14.8% (from the highest since late 2003 at 17.4% in Nov-18) and latter to 11.5% (from 13%, an all-time high since the start of data collection in Mar-06).

So, in tandem with the expected fall in annual inflation, inflation expectations should recover further in the period ahead.

Inflation Expectations (%)



Source: TurkStat, ING Bank

The CBT to maintain "a reasonable rate of return"

The Governor also provides some further guidance regarding policy making that can be seen as evidence of a deeper than expected easing until the end of the year. In this regard he states that:

1) "The design of monetary policy will be based on a data-focused approach that takes into account all macroeconomic indicators, primarily inflation and economic activity."

The Turkish economy remained on a rebalancing track in 1Q, with ongoing weakness in domestic demand despite strong public consumption and contributions from exports. The recent early indicators give encouraging signals in June with improving consumer and business confidence indices, rising PMI to the highest level in a year, higher capacity utilisation rate etc.

However, the recovery will be gradual and take time as the expanding budget deficit this year suggests that public consumption growth cannot be sustained, while loan growth has already lost some momentum. Given the focus on the activity along with a likely tightening in fiscal policy, the easing cycle in monetary policy may be larger to support the growth outlook.

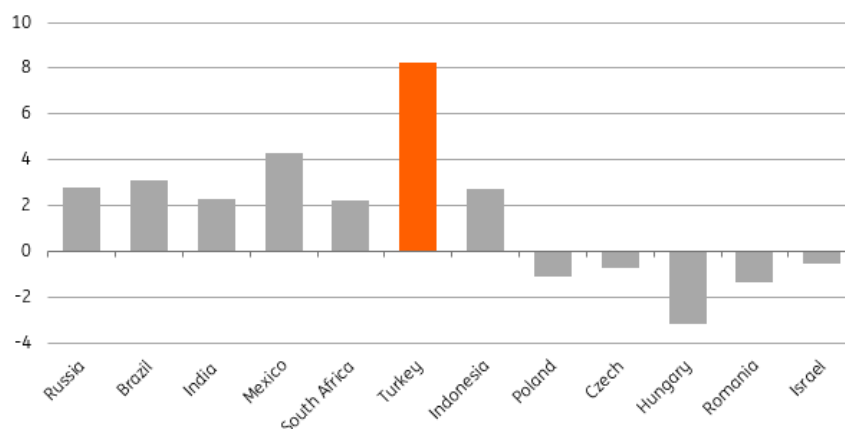
2) "...(the CBT) will develop a framework that is built upon both expectations and our own projections and maintains a reasonable rate of real return."

The ex-post real policy rate that had been low or sometimes even negative since the global crisis currently stands more than 800bp, above that of many emerging market peers. Sensitivity to shifts

in global risk appetite, the still high-risk attitude towards Turkey due to geopolitical factors and lower credit ratings call for high real rates. Given the average ex-post policy rate for EM peers of around 300-400bp, and year-end inflation forecast below 15.0%, there is room for the CBT to come up with deeper cuts if geopolitical risks are managed and prudent policies are introduced in the aftermath of local elections.

Current real policy rates in EMs (%)

(we use 3m Bubor as a policy rate for Hungary)



Source: Bloomberg, ING

Markets are pricing a large easing until year-end

So, we now see a cumulative 500bp in cuts by the end of this year, while markets are already pricing larger easing. On the flip side, reviving currency volatility impacting the disinflation trend would remain a key variable for the CBT in the policy implementation as stated by the Governor that “to achieve an ever-improving inflation outlook it is crucial to maintain a cautious monetary policy”.

Following a significant underperformance, TRY has been strengthening recently, though the recovery seems to be quite fragile. So, sensitivity of the TRY to geopolitical news flows and domestic issues keeps the CBT cautious and requires a well-calibrated monetary policy to avoid currency volatility.

Overall, the CBT Governor’s remarks suggest that the CBT was encouraged by the down-side surprises in the recent inflation data, while the pace of disinflation provides confidence for the timing of the policy easing in July.

So, a better than expected inflation outlook, more accommodative policy signals from global central banks, TRY strengthening and the contribution of declining geopolitical risk anticipation are all likely to encourage the CBT to start the easing cycle this month. We expect a 200bp cut on 25 July, though given the market’s increasing concerns about credibility with the appointment of the new Governor, risks are to the downside. Also, remarks on economic activity and inflation along with an emphasis on “a reasonable rate of real return”, the bank is signalling deeper cuts until the end of the year.

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