Bundle | 8 June 2018

In case you missed it: Big week ahead

The Swiss vote on 'Vollgeld', Theresa May faces her biggest challenge yet, the Fed and the ECB meet - one might hike while the other will be talking QE, but first, all eyes on the G7 summit and whether Trump can be talked out of his protectionist agenda?

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By Carsten Brzeski

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The start of labour negotiations at the world's largest copper mine, Escondida, have restored volatility to the copper market. We are keeping a...

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Vollgeld: Our response to Martin Wolf

This week, Financial Times commentator Martin Wolf argued that the Swiss should vote in favour of Vollgeld- a plan to fundamentally change the way money...

Open to ideas

We have discussed some pros and cons of Vollgeld elsewhere and Wolf raises some very valid questions. In discussing some of them, we should first emphasise that we are not against alternative setups of the monetary system per se. There are many developments, tech-related and otherwise, which prompt financials and banks, in particular, to fundamentally rethink their business models and balance sheets. Why not add monetary reform to the mix? In fact, when designing the system from scratch with today's technology and knowledge, one would probably exclude physical cash (way too easy to counterfeit and abuse) and include a form of central bank digital cash. After all, the idea that the public should have access to money at its source, and not only via an intermediary like a bank, is fundamentally appealing.

But money creation is not the source of the problem

Yet Vollgeld goes a few steps beyond introducing central bank digital cash. It strips banks of their money creation ability. This is often justified by pointing to repeated banking crises. Yet most, if not all of those crises, started with *credit*. That means they affected the *asset* side of banks' balance sheets. Crises tend to be called 'credit crises' and not 'money (creation) crises' for a reason. Money, on the other hand, is a bank *liability* and is at best a by-product, not the source, of the problem. It should also be noted that credit necessarily involves two parties: a lender and a borrower. Credit cycles are not only supply-driven but also reflect mood swings among borrowers.

Shadow banking would get a boost under Vollgeld

Wolf is well aware of all of this, of course, but notes that in a crisis (whatever its source), a bank will be rescued to protect its liabilities, in particular, deposit holders. By disconnecting deposits from bank assets, banks no longer need to be rescued. This sounds like a logical solution. However, depositor protection is just one reason for the elaborate system of bank oversight that has been erected. Credit crises show that a sudden stop in credit supply is detrimental to an economy. As depositors, we may be glad our money is safe, but if we then lose our jobs because of a deep recession, we are hardly better off.

Moreover, the most recent and severe crisis began with lending by *non-bank* entities in the US. 'Parallel banking' or 'shadow banking' is a channel starting with originate-to-distribute lenders and ending with money market funds. This channel performs functions that are normally done by banks: transforming non-liquid, long-duration and risky assets into highly liquid, short-term and (perceived) low-risk liabilities. We all know where US shadow banking ended in 2008. The point here is, Vollgeld, or any other monetary reform aimed at money and money creation, does not address the issue of the parallel banking channel mimicking banks. In fact, this parallel banking channel receives a boost under Vollgeld as traditional bank lending is curtailed and made less competitive by the inability to create money.

Strict regulation still needed

Wolf rightly states that investors will bear the risk. But is that sustainable? In a Vollgeld system, lenders will compete for funds by offering attractive terms. Yield swings may contribute to booms and busts, just as they do in bank-based lending. In addition, parallel banks will try to shape their liabilities into something that resembles money and traditional deposits as closely as possible, in terms of liquidity and perceived risk – as US money market funds started to do back in the 1970s. Investors will be lulled into believing these “near monies” are like money, also in terms of safety. A belief that will hold until the next crisis – when investors will call for bailouts (which were duly established e.g. in 2008).

So in order to avoid the proliferation of such 'near monies' and the inflation of the next credit bubble outside the regulated banking system, lenders, both bank and non-bank, will need to be tightly regulated from the start, which annuls one of the touted advantages of Vollgeld-like systems, namely less regulation.

But if we need to maintain strict regulation anyway, regardless of where money is held, why make the switch to an untested alternative setup with uncertain benefits? A system too, where the central bank has the difficult task to make crucial judgements about the pace of growth in both money and credit?

Lack of detail

As Wolf acknowledges, regulation and supervision have changed a lot over the past ten years, giving supervisors a host of new tools to prevent crises and if needed, wind down banks while imposing losses on holders of equity and debt. At the same time, Vollgeld and sister proposals at this time are lacking in detail. Do the Swiss really want to subject their large financial sector to such an unprecedented experiment? Better to first work it out in more detail, and start experiments on a more limited scale.

Article | 6 June 2018 China

G7 Summit: Trump needs to back off to secure his wins

So far President Trump's 'maximum pressure' strategy has worked, but the results are now at risk because China has threatened to take back...

Source: ING

Smart tactics

President Trump has said trade wars are good and easy to win. Economists have been keen to point out that trade wars are not good and everyone loses out. Who is right? To answer this, we need to understand what a trade war is.

When economists refer to a trade war, they are referring to countries slapping tariffs on each other. It's easy to explain why everybody loses out in such a situation because the benefits for the domestic industries that are protected by higher tariffs are countered by losses of exports that face higher tariffs as well when retaliation kicks in. Add to this, the loss of purchasing power, because tariffs lead to higher prices and there you go: the net effect on welfare for the two countries is negative. Essentially, a lose-lose situation.

But the trade conflict that President Trump has started is not a real war yet, because retaliation has been limited, at least until last week. Trump has so far practised a 'maximum pressure' strategy that has been quite successful. In March, Trump imposed higher import tariffs on steel and aluminium for all countries and said exemptions would be granted in return for better US trade conditions.

In the past, Donald Trump is the one who has said that deals work best when each side gets something it wants from the other.

Countries like South Korea, Brazil, and Argentina, gave in and 'voluntarily' restrained their exports to the US, accompanied by other concessions too. To avoid tariffs on 1333 of their export goods, China has also promised to lower their import tariffs on cars and loosen restrictions on foreign investments in the financial sector, automotive, transport, and the energy sector. The US has given nothing in return, except an exemption for the sanctions on the Chinese company ZTE that was about to be punished for doing business with North Korea and Iran (and even that isn't a sure thing).

Once the concessions of the trade partners kick in, these bargaining results will not only lead to more domestic sales for US steel and aluminium companies (substitution of imports) but also more exports of US companies in industries like automotive, agriculture and energy. This pushes up US national income and stimulates employment. The welfare loss for the US buyers of steel and aluminium due to the higher price they have to pay has to be taken into account as well, but this will be partly offset by the tariff income for the US government. A precise calculation, using various empirical findings on price sensitivities of demand for imported products, is warranted to derive the effect on US economy as a whole. But the effect will at least be positive for the steel and aluminium industry at the expense of the welfare in the countries that have granted Trump these favours.

More important for the President than the net benefit for the US economy as a whole is the fact that with these bargaining results he lives up to the promises he made to specific industries and their workers.

Pushing it too much

But recent events put these results for Trump at risk.

Last week, the EU, Canada and Mexico announced they would retaliate against higher tariffs for steel and aluminium. And over the weekend, China threatened to take back their commitment to lower tariffs on cars and loosen the restrictions on foreign direct investments if the US doesn't return to its earlier position that imposing tariffs on 1333 Chinese products is no longer an option in the short run.

Mexico and Canada are hugely dependent on American demand for their products, which is why over the last few months they've shown willingness to grant the US more favourable conditions within the North America Free Trade Area (Nafta). Word has it that they were willing to lower the threshold that allows cars to be labelled as Nafta-vehicles so they can qualify for tariff-free trade. They did not go along with the size of the increase that the US originally wanted but still have come a long way.

President Trump might lose it all if he keeps pushing

But other demands from Trump- like a sunset clause that makes a renegotiation of Nafta possible every five years (creating fundamental uncertainty that would make foreign investors wary of investing in the offshore paradise Mexico) have inhibited the closing of a Nafta deal.

China has shown too that it is willing to make sacrifices to save free trade, but not enough in the eyes of President Trump who has demanded an unrealistic reduction of the trade deficit with China by $200 bn in two and a half years. This ambition explains why Trump recalled the recent decision to take away the threat of imposing a 25% tariff on a package of 1333 goods that the US imports from China.

Count your blessings

Many times, President Trump has made clear that for him life is about winning and losing and that he always keeps on fighting to get what he wants. So it's no surprise that the President has already warned the EU that retaliation will lead to another round of tariff elevation, this time for European cars.

This would just be the next logical step in his strategy of using threats to get concessions, but such a step could well lead to further escalation because the US is almost as dependent on the EU as the other way around. This means that Trump does not have the upper hand in negotiations with the EU which makes it easier for the EU to play tough as well.

But in the past, Donald Trump is the one who has said that deals work best when each side gets something it wants from the other.

Let’s hope that he keeps this in mind when he goes to Canada for the G7 summit on Friday, rather than just fighting to win. If he lets go of a few of his most extreme demands he can secure better terms of trade that important trade partners like China, Canada and Mexico have offered him.

Together with the favours that South Korea, Brazil and Argentina have done him already, he can then claim to be the winner. If not, broad-scale retaliation will close in. That would hurt US exports and would turn him into one of the losers of the current trade conflict.

Article | 8 June 2018 United States

Federal Reserve preview: Stepping on the gas

A rebound in US growth and rising inflation pressures mean the Fed will concentrate on domestic issues rather than be distracted by emerging market woes...

Source: Shutterstock

Emerging markets favour policy restraint...

Brazil, Turkey, India and Argentina have all been in the spotlight as authorities try to stem volatility in FX markets. Domestic imbalances - widening fiscal and current account deficits - together with political uncertainty have been compounded by higher dollar borrowing costs and a stronger greenback. Consequently, there have been calls from some quarters for the Federal Reserve to consider the implications for the broader global economy when it sets interest rate policy on Wednesday. This was what happened under Alan Greenspan 20 years ago following the Russia/LTCM crisis and more recently in 2014 and 2016 in response to market volatility.

But it's America First at the Fed

However, the Federal Reserve today is a different beast and as with its political leaders, the focus is very much America first and foremost. Fed Chair Jay Powell said last month that “there is good reason to think that the normalisation of monetary policies in advanced economies should continue to prove manageable for emerging-market economies... The role of U.S. monetary policy is often exaggerated." Indeed, a less aggressive Fed will do nothing to resolve the fundamental challenges facing these economies. As such, we have to look at what is going on domestically in the US and in that regard, it all points in the direction of higher rates.

Growth is great

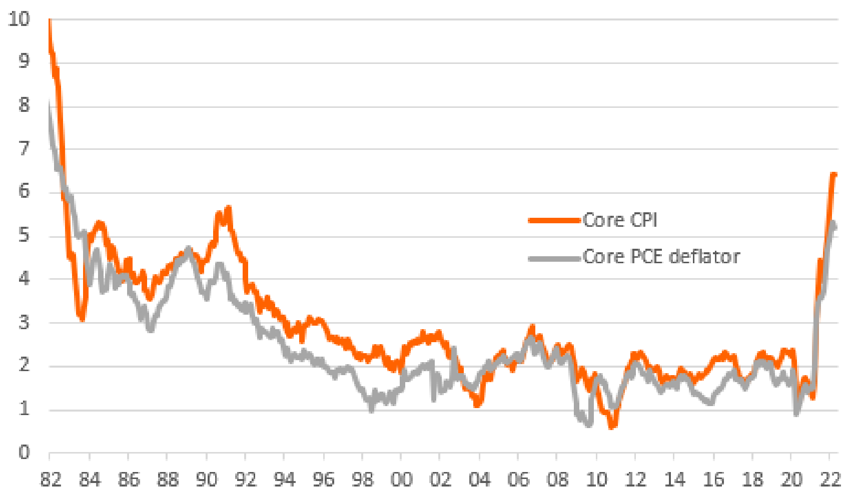
After experiencing its "typical" soft patch in 1Q18, growth looks set to rebound sharply in 2Q with the Atlanta Fed Nowcast model based on data already published suggesting we could see growth as high as 4.8%. We think this is probably too optimistic, but believe something around the 3.5% mark is looking probable. At the same time, the jobs market is going from strength to strength with unemployment at a 49-year low and payrolls growth accelerating from an average monthly increase of 182,000 in 2017 to 207,000 per month so far in 2018.

There is also growing evidence of wage pressures, with the National Federation of Independent Businesses reporting that a net 35% of businesses are raising worker compensation – the highest since records began 32 years ago. Admittedly, average hourly earnings growth is still fairly soft at 2.7%, but the employment cost index is showing faster growth. Add in the effects of the $1.5 trillion of tax cuts, equivalent to around $900 per household, and we find real disposable incomes are increasing 2% YoY. As such, households have plenty of cash in their pockets to go and spend.

With rising inflation pushing the Fed to hike

Inflation is also pushing higher with only the core personal consumer expenditure deflator below 2% out of all the major inflation measures the Fed watches. Rising wages should keep the upward momentum going. So with the economy set to expand 3% this year, we look for the Fed to hike rates again on 13 June with two further rate rises in the second half of the year.

US inflation measures on the rise



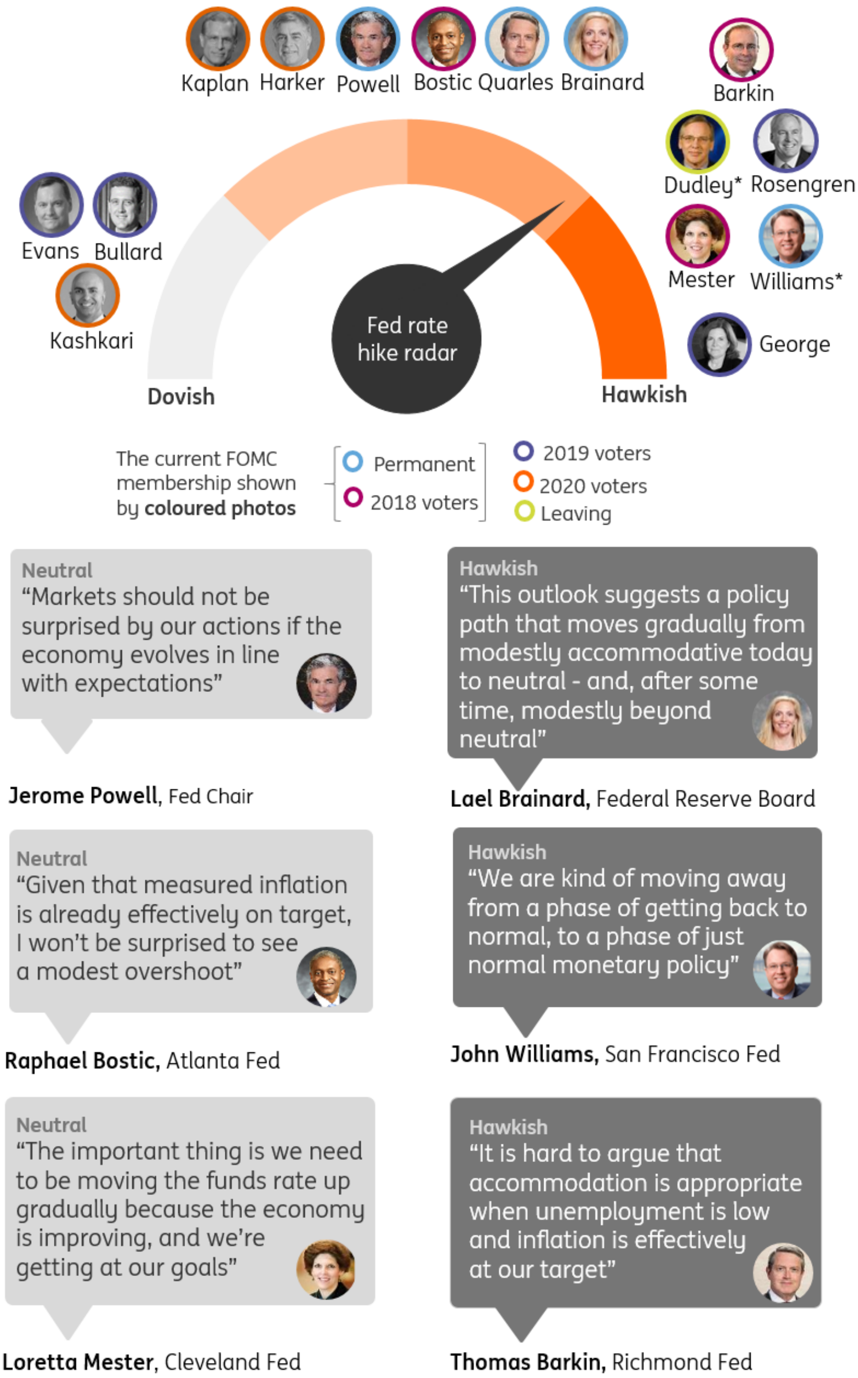
Fed "dots" to move higher

Also look out for the median Fed "dot diagram" of individual policy rate expectations creeping higher – potentially signalling that a majority of Fed officials favour two further rate hikes this year rather than the current even split between one and two in 2H18. It will also be interesting to see if the 2020 forecasts push higher, too, given comments from both John Williams and Lael Brainard that the outlook suggests "a policy path that moves gradually from modestly accommodative to neutral – and, after some time, modestly beyond neutral." Consequently, there is scope for the language in the statement to become a little more robust, which could push longer-dated Treasury yields higher as well.

Trade could yet play a part...

Nonetheless, trade fears could yet influence Fed policy. Should protectionism escalate this could weaken sentiment, investment and hiring amongst businesses, while also putting up costs. Fed officials have made it clear they are more concerned about potential negatives for growth rather than upside risks for inflation resulting from tariffs, implying that it could result in slower policy tightening from the central bank. For now though, consumers and businesses are brushing aside the concerns of financial markets and we think the Fed will too.

Fed commentary becoming more hawkish



*NY Fed Chair Dudley is to leave the committee after June's meeting. Current SF Fed Chair Williams is set to take over.

Source: ING

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Article | 8 June 2018 United Kingdom

Brexit update: Theresa May's biggest test yet?

The UK Prime Minister faces a series of challenging parliamentary votes on her plan to leave the customs union and single market after Brexit

Source: Shutterstock

The biggest test yet?

Almost exactly one year on from the her big election upset, Prime Minister Theresa May faces another mammoth challenge.

On Tuesday, the EU Withdrawal Bill – which would see all current EU rules enshrined into UK law in March 2019 - will return to the House of Commons. As part of this, parliament will debate and vote upon a series of controversial amendments that were passed by the House of Lords a few weeks ago. These votes will put pressure on the government to reconsider access to the customs union and EEA, as well as giving more clarity on parliament's so-called 'meaningful vote'.

A loss on one or many of these amendments would come as a major – albeit perhaps not fatal – blow to PM May's government.

? Where's all of this come from?

Leaving the customs union, along with the single market, has long been a central plank of the UK government's Brexit vision.

In the single market, the UK would have no control over immigration. It would also be bound by EU rules, whilst having only a limited say in defining them. And while a member of a customs union – which would require accepting a common external tariff on goods - ministers have argued that the UK would not be able to negotiate its own trade deals with the rest of the world.

International Trade Secretary Liam Fox once said that the country would effectively "have one hand tied behind its back" – in reference to being unable to offer concessions on goods trade, in exchange for potentially more lucrative market access for UK services.

But many members of parliament are less convinced. Amongst other reasons, many are concerned that a hard border with Ireland cannot be avoided unless customs union membership (and perhaps even single market access for goods) is retained.

The opposition Labour Party has recently made staying in a customs union its official policy, and a number of Conservative MPs appear to agree. For this reason, the government has repeatedly pushed back a vote in the House of Commons for as long as possible. But come Tuesday, and MPs will have a chance to have their say.

Given the government only has a tight majority, there's a reasonable chance they'll lose this particular vote.

The Brexit options compared

	UK Red Lines/Priorities				EU Red Lines	
	No Free Movement	Negotiate trade deals	Access for services	No ECJ jurisdiction	No "hard" Irish border	No cherry-picking
EEA (Norway option)	X	X	✓	X	✓	✓
Customs Union	✓	X	X	✓	✓	✓
Managed Divergence/ Three baskets	✓	✓	✓	?	X	X
Canada-style FTA (No "plus")	✓	✓	X	✓	X	✓

Source: ING

? Could this spell the end of Theresa May as leader?

If the government does lose the vote on the customs union, it would come as a major defeat on its flagship policy. But while Theresa May would no doubt be weakened by the results, it might not prove fatal.

This is partly because the wording of the amendment means that the government wouldn't be legally obliged to join a customs union, instead only required to report on its efforts to negotiate customs union access – so in theory a "we tried, but..." answer would suffice.

Even so, a heavy defeat would undoubtedly lead to calls for a fresh snap election, although we still think the chances of this materialising remain relatively low. Two-thirds of MPs would need to vote in favour of an early vote, and while numerous Conservative lawmakers on both sides of the Brexit divide are clearly frustrated with the government's Brexit approach, it's not clear they'd actively trigger a fresh election. Bookmakers suggest that 2022 is still the most likely date for the next national vote.

Labour may have fallen back in the polls over recent weeks, but the same was true in the run-up to last year's bruising snap election. As the old saying goes, 'Turkeys don't vote for Christmas'.

That said, PM May could still face a leadership contest. This would require 48 Conservative MPs signing a motion of no confidence, and press reports over recent months suggest this is feasible – although again we think this may not be so likely. For one thing, it's not clear that any other senior Conservatives would be keen to take the job - although as the last couple of years have proven, you never really know what's around the corner in UK politics!

? Is a customs union a good enough deal for the UK?

A customs union would undoubtedly go some way to reducing the amount of paperwork and checks required for goods trade after Brexit. Tariffs between the UK and EU would be removed, and firms would not become embroiled in complex 'rule of origin' regulations.

But that doesn't necessarily mean trade would flow as seamlessly as it does today. Unless the UK adheres to EU standards on goods (in other words, the single market rulebook), then there would presumably need to be some checks at the border. Likewise, unless an agreement were reached on VAT, this would need to be paid on entry at UK/EU ports. And without a deal on transport, there have been suggestions that lorry drivers (and their vehicles) may not be legally allowed to make deliveries overseas. With an acute shortage of drivers already occurring in the UK, this latter issue could result in major delays at UK ports.

However, even if these problems are overcome (which is likely, over time), we have to remember that the UK is predominantly a service-sector economy. A frictionless customs arrangement would do little to help here.

? Could the UK stay in the single market after all?

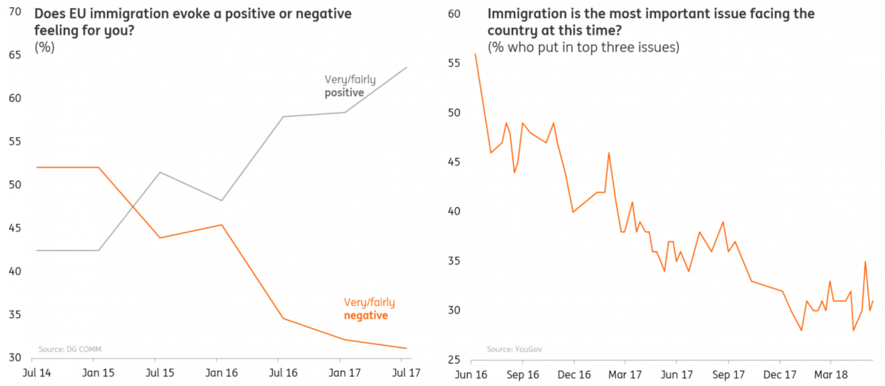
Given these issues, the possibility of joining the entire single market is coming a little more into focus.

Membership of the European Economic Area (EEA) – or the 'Norway option' as it is more typically branded – had long been written off as an unviable post-Brexit option. Critics say that staying in the single market, whilst having little say on the rules, would be unacceptable for an economy as large as the UK's. But of course the far bigger issue is that of free movement of people – perhaps the 'reddest' of red lines of the Brexit debate.

Interestingly though, this appears to be less of a public concern than it once was. A recent survey by YouGov, which asked people what their biggest issues are, found that only 30% of people put immigration in their top three. Compare that to 55% back around the time of the referendum. A separate European Commission survey has identified a similar trend.

Admittedly none of this is likely to affect the outcome of next week's votes. Like the customs union, there is also an amendment pushing EEA membership after Brexit, as well as Labour's own proposal that would retain "full access" to the "internal market". Neither are likely to be passed at this stage, although as the public's attitude appears to lighten, it will be interesting to see whether parliamentary support shifts as the negotiations go on.

Immigration – less of a public red line after all?



Source: YouGov, DG COMM

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Article | 8 June 2018

ECB preview: Praet's pivot pirouette

Despite growing uncertainties around the strength of the eurozone recovery, little underlying inflationary pressure and possible further market turmoil,...

Source: European Central Bank, Flickr

Until recently, the ECB had remained tight-lipped about its next steps for monetary policy, particularly quantitative easing (QE) beyond September this year.

Remember after the April meeting, when the ECB president Mario Draghi went as far as saying the ECB had not discussed next steps for monetary policy at all. This approach seems to have changed. The latest speech by the ECB chief economist Peter Praet suggested the discussion on an end to quantitative easing (QE) could gain lots of traction at next week's meeting. Even ECB doves seem to be fine with a gradual end to QE this year.

> *Whether the ECB is getting cold feet and wants to unwind QE before it gets too late or whether it simply wants to prove that it is entirely focused on macro facts is still unclear*

In his speech, Peter Praet signalled the ECB's criteria for assessing whether there is a sustained adjustment in the path of inflation towards target: convergence, confidence, and resilience - were almost fulfilled. Contrary to earlier statements by many ECB officials and even the minutes of recent ECB meetings, Praet no longer mentioned doubts about inflation really picking up. Praet also stressed the underlying strength of the eurozone economy, suggesting the ECB considers the recent weakness in the eurozone data transitory.

Praet speech

Praet's assessment will hardly change in the coming days and therefore be similar at next week's ECB meeting.

In addition, a fresh round of ECB staff projections will be available at the meeting. In our view, the discussion will first of all focus on the right assessment of the outlook for growth and inflation and in this regards, there seem to be three main challenges for the ECB:

1 Soft patch vs downswing

At face value, the growth slowdown in the first quarter was mild enough to be filed away as a "soft patch" instead of a "downswing". Economic fundamentals have also not changed over the last few months. However, soft indicators have not yet recovered, available hard data has been rather disappointing, the fading eu(ro)phoria could dent further optimism, and the external environment has become a risk rather than an opportunity.

Even though Peter Praet sounded optimistic, there is still too little information for the ECB to take a clear position in the soft patch versus downswing discussion. Consequently, we expect the ECB to stick to its positive take on the Eurozone recovery, but at the same time stressing increased uncertainty and the need for more evidence.

2 The double-edged sword called oil

The surge in oil prices since the beginning of the year is probably the single biggest problem for the ECB. Since February, oil prices have increased by more than 20%. Add the effect of the weaker euro exchange rate, oil prices denominated in euro have increased by almost 30%. As so often in the past, higher oil prices are a double-edged sword for the ECB.

On the one hand, higher oil prices could dent the recovery (according to our back-of-the-envelope estimates, higher oil prices could allow one-third of the wage increases in Germany evaporate in thin air). On the other hand, they should push up the ECB's inflation projections. The ECB uses future prices as a technical assumption. If oil (and their respective future) prices were to stay at their current levels, headline inflation could come to 0.4 percentage points higher in 2019, from 1.4% in the March projections. At the same time, GDP growth forecast could be revised downwards by some 0.2 percentage points. All of this means that only due to changes in the technical assumptions, a benign outlook for headline inflation could quickly become a close-to-target forecast.

Normally, the ECB tends to look through energy-driven volatility in headline inflation and instead focus on core inflation measures as higher oil prices have a disinflationary impact on the recovery. This is why we expect the ECB to stress the reflation process will only be over once inflation has sustainably converged towards a target and that it would only react to possible second-round effects. Still, an upward revision in headline inflation could make a few hawks at the ECB and some market participants slightly uncomfortable.

3 Italian politics

Obviously, Italian politics is the new kid on the block when it comes to challenges for the ECB. We don't expect ECB president Mario Draghi to comment on this. The ECB will rather focus on developments in the eurozone as a whole.

Nevertheless, in the back of some ECB officials' minds, Italian politics and possibly returning market volatility could still affect the timing of the ECB's next steps.

Mutual agreement to end QE but no end-date

As observed already earlier, there is a growing majority within the ECB's governing council favouring an end to QE by the end of the year. Maybe an ironic outcome of the Italian market tensions is that the weaker euro is making it even easier to engage in QE tapering. After the Praet speech, it looks as if the discussion at the June meeting will be more heated than we previously thought. It is the famous devil who will be in the detail, and the controversial topics will be:

- **When to communicate?**
  Should the ECB present an explicit roadmap for the next QE steps at the 14 June meeting or should it wait until the end of July to get more and better information on the state of the eurozone recovery?
- **An explicit end date?**
  Should the future path for QE be communicated with an upfront end-date or should it remain open for as long as possible, thereby creating more flexibility?
- **From thirty to zero?**
  Should the period beyond September 2018 be a tapering period, reducing the monthly purchases gradually from €30 billion to zero or should there be another transitory period of a reduced pace?

What to expect from next week's meeting

We still don't think the ECB will easily give away flexibility and room for manoeuvre on QE in a situation where downside risks to the economic outlook have increased and political risks (be it from Italy or later this year from Brexit) could easily reemerge.

Against this background, it looks very unlikely the ECB will announce an end date for QE any time soon. Keeping in mind that Peter Praet will put a policy proposal on the table, we expect the ECB to announce another recalibration of QE already next week, i.e. an extension of QE at a reduced pace of 10bn euro per month at least until December 2018. This would follow the pattern of the first recalibration of QE from 80bn euro to 60bn euro, which was announced three months in advance. Whether the ECB is getting cold feet and wants to unwind QE before it gets too late or whether it simply wants to prove that it is entirely focused on macro facts is still unclear.

However, Peter Praet's remarkable turn promises a very exciting meeting in Riga on 14 June.

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Article | 5 June 2018 Credit | China

China: Why the central bank won't cut reserve requirements

China's central bank is supporting the onshore bond market by expanding collateral for the medium-term lending facility (MLF). This will reduce...

Source: istock

Central bank expands collateral of medium-term lending facility

Since 1 June, the central bank (PBoC) has expanded the collateral of its medium-term lending facility (MLF), which is a lending facility for banks.

MLF collateral expands to:

1. AA-rated bonds issued by financial institutions for small and micro enterprises, green financing and agricultural financing.
2. AA+, AA-rated corporate bonds (priority to accept bonds involving small and micro enterprises, green economy).
3. High-quality micro-enterprise loans and green loans.

Before this expansion, the central bank only accepted sovereign bonds, central bank notes, China Development Bank and other policy bank bonds, local government bonds and AAA corporate bonds as collaterals for MLF. The interest rate on MLF is now at 3.3%.

Limiting contagion risks

By doing so, China's central bank is comforting the onshore bond market.

In the past, bonds issued in China were rolled over without any issue. However, as the central bank tightens liquidity to accomplish financial deleveraging reform, maturing bonds have become increasingly difficult to roll over, especially for companies that have weak financial backgrounds.

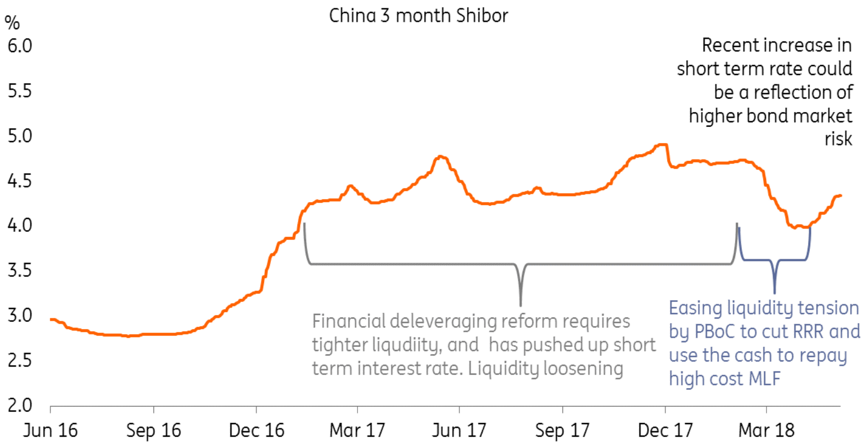
> *Collateral expansion for MLF would reduce contagion risks and calm the market, however, we still expect standalone default cases, especially for companies with weak financials as financial deleveraging reform continues.*

As of 1 June 2018, some 22 bonds had defaulted involving seven issuers, totalling CNY20.2 billion according to Securities Daily. Though the number of issuers and default amount look small, default risk is rising in the onshore bond market.

According to ChinaBond, on 1 June, the three-year yield spread between AAA-rated and AA-rated credits widened to 76 basis points, much higher than around 30 basis points at the beginning of the year.

Collateral expansion for MLF would reduce contagion risks and calm the market, however, we still expect standalone default cases, especially for companies with weak financials as financial deleveraging reform continues.

Short rate reflects tightness of liquidity



Source: ING, Bloomberg

Market expects PBoC to cut RRR and let banks repay MLF in June

For the whole of June, there are CNY920 billion of reverse repos and CNY259.5 billion MLF maturing, in addition, June marks the half-year point. It looks as though liquidity will be extra tight in June.

The market expects the central bank to cut its reserve requirements ratio (RRR) to replace the higher-cost MLF borrowed by banks, a repeat of April's monetary policy after MLF collateral expanded.

Here's why we don't agree with the market

We believe that it is unlikely for the central bank to repeat its April action in June.

- First, expanding MLF collateral implies that the central bank is going to extend more MLF to banks, and banks would get extra liquidity.
- Second, expanding MLF collateral should have an immediate impact on the bond market. It should be easier to roll over maturing bonds as there will be extra liquidity, and this should improve sentiment in the bond market. So there is no imminent need for the central bank to cut the RRR, which may send the wrong signal to the economy that the central bank's monetary policy favours easing over deleveraging.
- Third, expanding MLF collateral and at the same time cutting RRR to repay the MLF complicates the monetary transmission mechanism. Put simply, the actions would induce the market to put up lower-rated corporate bonds as collateral to borrow more from the central banks, and then repay higher-cost borrowing (at 3.3%) with low-return RRR money (at 1.62%). This would distort the efficiency of credit in the whole economy.

Our forecasts on monetary policy in June

We believe that a better way to smooth out seasonal liquidity tightness is to rely on daily open market operations with different tenors, so that liquidity would increase directly and would only be short term to cross the half-year end. At the same time, the market would get a consistent message that liquidity will remain tight as financial deleveraging continues.

As mentioned, expanding MLF collateral would probably induce more MLF lending. This should replace the maturing CNY259.5 billion MLF.

These two actions should be enough to smooth out liquidity tightness created by seasonality and negative bond market sentiment.

We also expect the central bank to follow the Federal Reserve in hiking rates in June to maintain the interest rate spread between China and US. But given that liquidity is already tight, PBoC's rate hike would be a modest five basis points.

A repeat of April's central bank action would be more likely in the second half, as officials need more time to see the impact of its MLF collateral expansion on bond market liquidity.

Article | 5 June 2018

United States

US housing: Still going strong but for how long?

A mixed month for US housing data, but the overall direction remains upwards. The question is, how long will this trend continue?

Source: Shutterstock

Sales are down

Several key data for the US housing market pointed downwards in April. Sales of both new and existing homes fell relative to March, and by somewhat more than consensus expectations. New home sales in previous months were also revised down. Pending homes sales also fell by 1.3% month on month, again well below consensus, indicating sales are likely to slip further over the next couple of months.

One key reason for slowing sales is the dearth of houses on the market. The supply of homes for sale relative to the current pace of sales keeps falling and with less than four months of supply available is now at the lowest level since the 1990s. That makes it difficult for buyers to find a home they want to buy. Rising mortgage rates also make it harder for buyers, and to some extent could discourage potential sellers from moving house if it means they may end up with a more expensive mortgage.

Though construction is powering ahead

At least the construction of new homes is increasing at a brisk pace. In April, new starts and new building permits fell slightly compared to March. But that was largely due to upwards revisions to the March data, as actually the data release was positive news. Compared to a year ago, new construction is increasing by nearly 10%. That means supply should eventually start to catch up with demand.

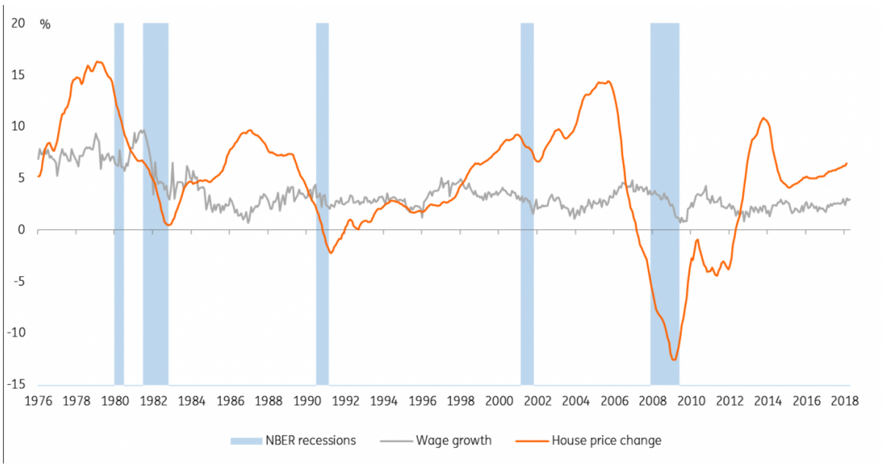
The current lack of supply coupled with robust economic growth and wage growth is also pushing up prices. The latest price data from March shows a year on year increase of 6.5% in the S&P/Case-Shiller national house price index. That's well above the pace of average wage growth. With mortgage rates continuing to rise, affordability is getting steadily worse. US tax cuts have boosted disposable income, but reductions to the tax benefits on mortgage payments make the effect on housing affordability ambiguous.

But how long can it last?

Taking a step back, the obvious question is how long these trends can persist. After all, we know from history that house prices can't keep rising faster than wages indefinitely. And when house price growth slows, it is often an indication that the economy will slow down as well.

So how far are we from an inflection point? As ever, predictions are difficult.

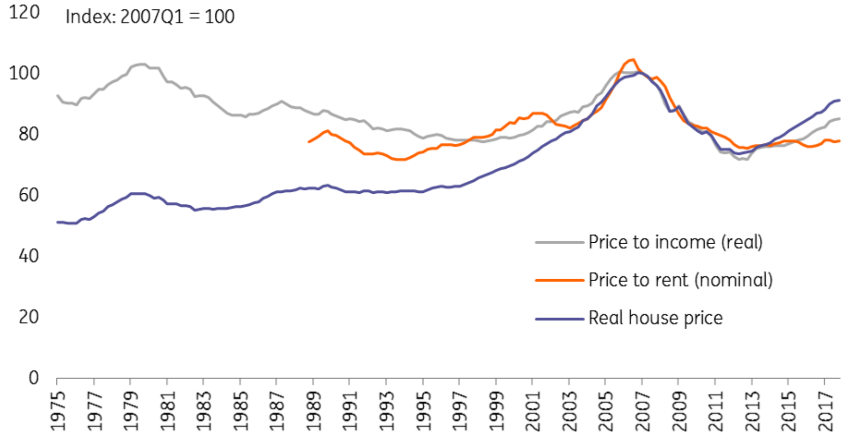
House price increases and wage growth



Source: Macrobond

The current pace of house price increases is actually fairly modest compared to previous peaks in price growth, which suggests the turning point could be some way off. Other measures of house price valuation, such as real house prices (discounted for inflation) or house prices relative to rent or income, are currently also well below their previous peak in 2006. But that was at the top of a massive bubble. We shouldn't really expect to see these indicators return to those elevated levels again before the next downturn. Indeed, it would be very worrying if they did.

US Housing valuation measures compared to 2017

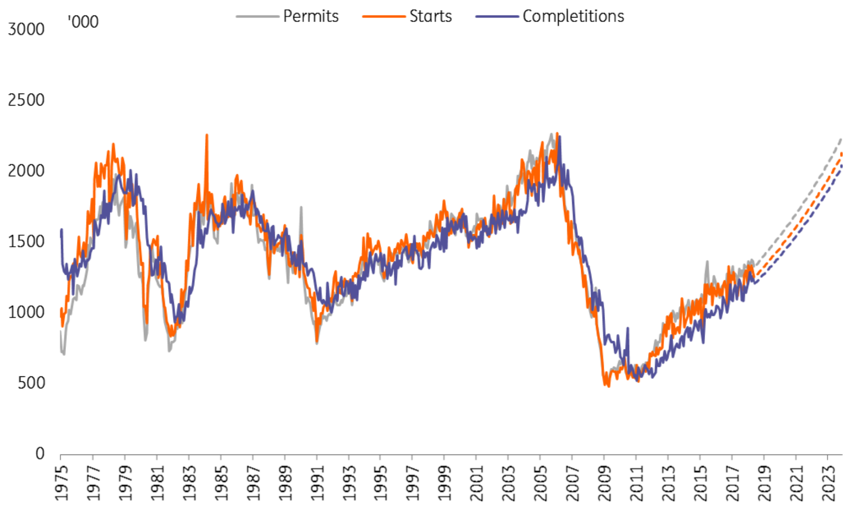


Source: Macrobond

The other key piece of the puzzle is supply. For house prices to decline meaningfully, there needs to be an excess of houses for sale relative to buyers willing and able to pay for them. Despite the healthy pace of housing construction and deteriorating affordability, such a situation looks like it is some way off. That said, there is anecdotal evidence in some markets, such as New York City, that there may be an excess of high-end new-built apartments coming onto the market.

Even if construction continued to increase at a very robust 10% YoY rate (which is improbable), new construction wouldn't match the 2006 peak until mid-2023. Again, it's unlikely that construction will actually reach pre-crisis levels again, not least as the growth in new households has slowed considerably since last decade. But the current lack of supply is unlikely to turn into a glut in the near term.

US housing construction, actual and projected assuming 10% growth



Source: Macrobond and ING calculations

Well, probably a while yet

On balance, we don't think the US housing market is about to turn south just yet. The most plausible scenario is that house prices continue to rise at a decent clip while construction grows fairly rapidly for at least another year or two. Of course, a sudden slowdown in the economy, for example, if the Trump administration triggers an all-out trade war, could bring that rosy outlook to an abrupt end.

But as a baseline forecast, a broad-based downturn in the US housing market looks more likely to be a story for the second half of 2019 or 2020. By coincidence, that is also a probable time frame for the US yield curve to invert, another powerful signal of a coming recession.

Article | 6 June 2018

Copper back above $7k as the curve flirts with backwardation

The start of labour negotiations at the world's largest copper mine, Escondida, have restored volatility to the copper market. We are keeping a...

Source: Shutterstock

Labour negotiations back to the fore

At the beginning of 2018, we cautioned bulls were likely pricing in a high amount of mine disruptions too early which only risked disappointment. With the retreat of prices, open interest and money manager positions through Q1, this seemed to play out as we expected.

2018 is indeed an extreme year for the number of labour negotiations in Chile and Peru, but until now all talks have gone without any hit to supply. Only two mines including Los Pelambres and Chiquicamata/Radimoro Tomic saw negotiations go down to the wire.

Now labour is back in focus as talks have now begun at the world's largest mine Escondida. A record 44-day strike here cost c.200kt of supply in 2017, and the rebound (+ concentrator expansion) is expected to add c.300kt this year making it the largest contribution to supply growth.

As we stressed in our 2018 copper outlook, counting on a higher supply disruption rate than usual for 2018 was a tough sell because fewer greenfield mines are ramping up and prone to delays. Given the smooth start to the labour negotiations in the first five months, it would take a very prolonged strike at Escondida to now surpass the 5% disruption allowance in our models and swing the market into a price driving, curve flipping, refined deficit. At the historical disruption rate, copper concentrate looks set for a shortfall of around 100kt, but the refined market looks effectively balanced.

Our base case doesn't see prices break much higher than $7k

However, never say never. Both sides appear to be far apart since early mediations broke down and the union is demanding the largest one-time bonus ever for Chilean mining. More worryingly, the union has said they have the cash to potentially sustain a strike for up to a year. Those possibilities have sent the speculators bidding up copper prices, but we would still urge caution. Last year's lengthy strike was extreme and if not the workers, then certainly BHP, would have little appetite to withstand such a lengthy outage.

In short, supply disruptions are expected and will happen this year, but only a very extreme Escondida strike can swing the balance. But Escondida will not be the last strike either. The year has started smoothly, but plenty of labour negotiations remain (c.4.4Mt of annualised production). Some look less risky because they concern supervisors, but many of these mines have also had strike action in just the last few years.

Read Copper: What happened to the funds?

Copper mine labor negotiations until now go without a hitch (ktpa)

	Country	Company	Operation	Union	Deal Status	Total capacity (ktpa)	In Conc.	Refined inc. SX/EW
January	Chile	Glencore	Lomas Bayas	Labor Union	Resolved – No strike	70		70
	Canada	Hudbay	Manitoba	Labor Union	Resolved – No strike	30		
	Peru	Hudbay	Constancia	Labor Union	Resolved – No strike	105		
	Chile	Codelco	Andina	Labor Union	Resolved – No strike	215		
	Chile	Codelco	Ventanas (Smelter)	Labor Union	Resolved – No strike	400		400
February	Chile	Antofagasta	Los Pelambres	Labor Union	Resolved – Strike narrowly avoided	350	350	
March	Chile	Codelco	Chuquicamata	Supervisors Union	Resolved late (April)	430	390	40
	Chile	Codelco	Radomiro Tomic	Labor Union	Resolved late (April via/mediation) – no strike	200		200
	Chile	Codelco	Ministro Hales	Supervisors Union	Resolved – No strike	190	190	
April	Chile	Lumina	Caserones	Plant union	Resolved – No strike	133	110	23
May	Chile	Centinela	Centinela	Labor Union Sulufro Mina	Resolved early	260	190	70
June	Chile	Codelco	Andina	Labor Union	Resolved early	205	205	
	Chile	Antofagasta	Centinela	Labor Union Sulufro Planta	Resolved early	260	190	70
	Chile	Antofagasta	Los Pelambres	Plant union	Resolved	350	350	
	Chile	BHP	Spence	Staff		200		200
	Chile	**BHP**	**Escondida**	**Labor Union**	**Talks currently (early mediations failed)**	**1250**	**1000**	**250**
July	Chile	Lumina	Caserones	Mine Union		133	110	23
	Peru	Antamina	Antamina	Labor Union		420	420	
	Chile	Codelco	Andina	Supervisors Union	Resolved early	205	205	
	Chile	Codelco	Salvador	Labor Union		60	45	15
August	Peru	Freeport	Cerro Verde	Labor Union		500	470	30
	Chile	BHP	Cerro Colorado	Labor Union		70	70	
	Peru	Southern Copper	Toquepala	Labor Union		180	160	20
September	Chile	Codelco	El Teniente	Labor Union		400	398	2
	Chile	Codelco	Salvador	Labor Union		60	45	15
October	Chile	Antofagasta	Centinela	Labor Union Oxida Planta	Resolved early	260	190	70
	Chile	Antofagasta	Centinela	Labor Union Oxido Mina	Resolved early	260	190	70
	Chile	Anglo	Collahuasi	Supervisors Union		505	505	
	Chile	Codelco	El Teniente	Supervisors Union		400	398	2
	Chile	Codelco	Vice presidency of projects	Supervisors Union				
November	Chile	BHP	Spence	Labor Union		200		200
	Chile	Codelco	Ministro Hales	Labor Union	Resolved early	190	190	
	Chile	Codelco	Gaby	Supervisors Union		115		
December	Chile	Lumina	Caserones	Supervisors Union		133	110	23

Total	6428	4741	1337
Outstanding	4423	3766	542
Of Which Supervisors (only)	1300	1298	2

Source: MB, Teck, Bloomberg, ING Research

Physical is firm but unchanged

Since February, we've been forecasting copper's return to $7,000 for Q3.

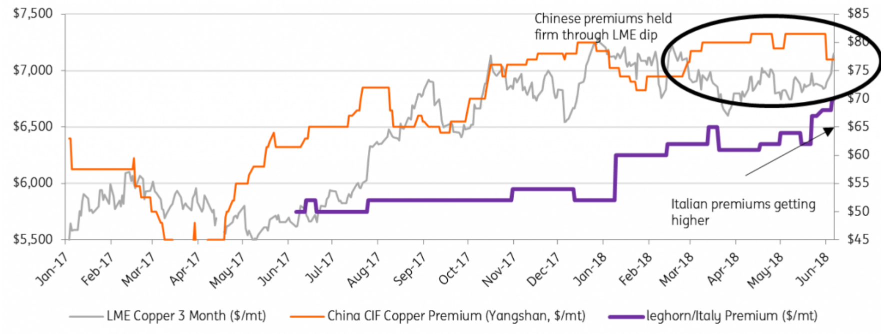
As we saw it, copper prices were bullied lower through March/April by both a temporary blip in Chinese demand (extended new year/NPC slowdown) and concerns over trade wars. But the fund length has now been essentially washed out limiting any further downside. With Q2 and Q3 being seasonal deficits for copper, the tightening backdrop seems suitable setting for copper to regain some of the aggressive liquidation.

Meanwhile, the physical premiums have actually been holding up firm. The Chinese premium has mostly been around $80 (a slight nudge down recently), and the European premiums have been picking up considerably in Italy after tightness draws the LME European stocks down 40kt since March. While total visible stocks are moving in the right direction (down 100kt since March), the LME stocks in Asia have been so volatile that they are almost ignored by the market. The draw in Europe (and Comex in late May) however, is a first and could prove more meaningful.

However, our base case doesn't see prices break much higher than $7k. To really back this rally we would need to see physical conditions tighten: a prolonged Escondida strike needs to happen or Chinese premiums to edge up. Or, the curve needs to go to a sustained backwardation (next section).

The slightly softer Chinese premium has been disappointing given the now permanent closure of Vedanta's Sterlite smelter (400ktpa with India exporting 340ktpa to China) and the month-long blockade on US scrap trade to China. It seems this could be a now or never moment for the premium to edge closer to those $90's levels that historically coincide with a bull rally, but instead, it's moving the wrong way. The Chinese refined market actually seems well supplied: SHFE stocks are drawing very slowly after the new year (they are up 43% YoY), the SHFE market is in contango, and the import arb remains in loss-making territory.

Physical premiums had held firm through LME weakness ($/mt)



Source: SMM, Fastmarkets, ING Research

Spreads and dominant stock holders in focus

The copper cash-3M was stuck in a wide contango for most of 2017-18 and the lengthy costs for funds to roll longs likely contributed to the liquidation and sliding prices between January to March. Since May 15th, however, the spreads have tightened significantly flirting ever closer to a backwardation. Nothing drives metal markets like a backwardation and if so we could expect a volatile up-shoot but is unlikely to hold its ground unless the physical market genuinely tightens.

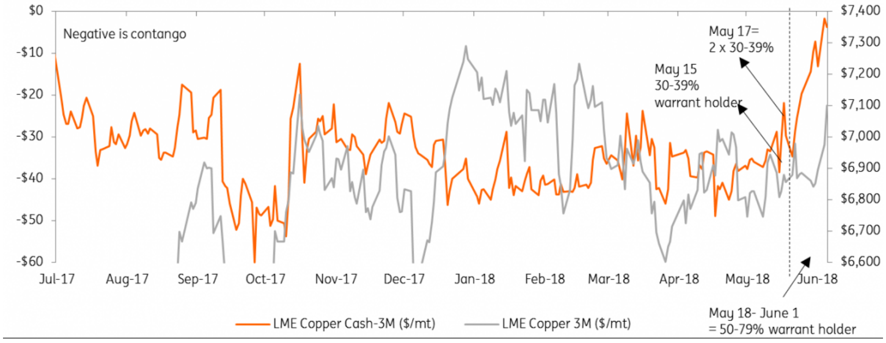
In particular, we are concerned if LME stocks become more freely distrusted/free floating then spreads might return to a wider contango. LME data shows much of the tightness in the spreads has coincided with a building dominant LME stockholder(s) position.

On May 15th, the LME warrant holdings report showed the largest stockholder held 30-39% of warranted LME copper stock. On the 16th, the one day spread (tom-next) hit the highest backwardation since 2012 ($35b) as another party also held 30-39% (60-78% in total).

With one holder presumably selling their position into the backwardation the other party went on to hold 50-79% of the warrants. The availability rather than the total amount of stock is what most directs the spreads and while a large stockholder is obligated to lend the very nearby tom/next spreads (via the LME lending rules) the influence further along the curve can surely be felt. As of the most recent June, 4th warrant holdings report the dominant stockholder had retreated to the 40-49% banding.

Read Copper: What's it going to take to flip the curve?

Copper flirts with backwardation amid dominant LME stock holder



Source: LME, ING Research

Bottom Line

As far as the copper curve seems to be running ahead of current tightness in physical markets, both spreads and outright prices seem pegged to the outcome of Escondida negotiations.

For a strike to surpass our disruption allowance and bring the refined market to a curve flipping deficit, it needs to be extreme. We reiterate our $7,000/mt Q318 forecast and $6,900 for Q4 unless the situation changes.