

# July Economic Update: From yesterday to tomorrow

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Report | 2 July 2020

# July Economic Update: From yesterday to tomorrow

The reopenings have led to a sharp rebound in activity, but new localised Covid-19 outbreaks have cast a renewed cloud over the global economic outlook for the second half of the year. Discover the latest views and ideas from ING's economists and strategists in our July update



Source: Shutterstock

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### US: The wrong direction

- Covid-19 infections and hospitalisations are on the rise in many states, leading to fears that the recovery could falter in response to renewed restrictions and consumer caution. In the absence of a vaccine, the Federal government will need to provide more support to keep the economy on the recovery track

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the cards

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### **Asia: India and Indonesia riding up the Covid-19 curve**

- First China, now India and Indonesia – two more of Asia's largest economies face their worst recession in decades, thanks to Covid-19. But the divide in the market's perception is reflected best by the performance of their respective currencies. The rupiah is one of the best performers in the EM space while the rupee hasn't been appreciating very much since the rally started

### **Latin America: Recession deepens fiscal challenges**

- Covid-19 continues to spread across Latin America but, given the mounting economic costs of stay-at-home orders, governments are easing social isolation guidelines. Robust economic policy responses should help lessen the recession but will leave behind severe fiscal challenges that should alter intra-region relative performance post-pandemic

### **FX: Markets leave lockdowns behind them**

- This month, we've been tasked with looking at the effects of lockdown exits on FX markets. The truth is there that does not seem to be a strong relationship there. Instead, FX markets are being driven by the abundant liquidity story. As summer progresses, however, we expect US elections to make their mark. Both themes are dollar negative, in our opinion

### **Rates: Warning signs that equities might have it all wrong**

- Most financial instruments are present values of a discounted stream of future income. For equities that is earnings. For core bonds, it is coupons, plus principal payback. For high yield, a spread is added to compensate for the non-systemic risk. The equity discount is upbeat. The rates discount is ominous. The HY one is in between. Something must give

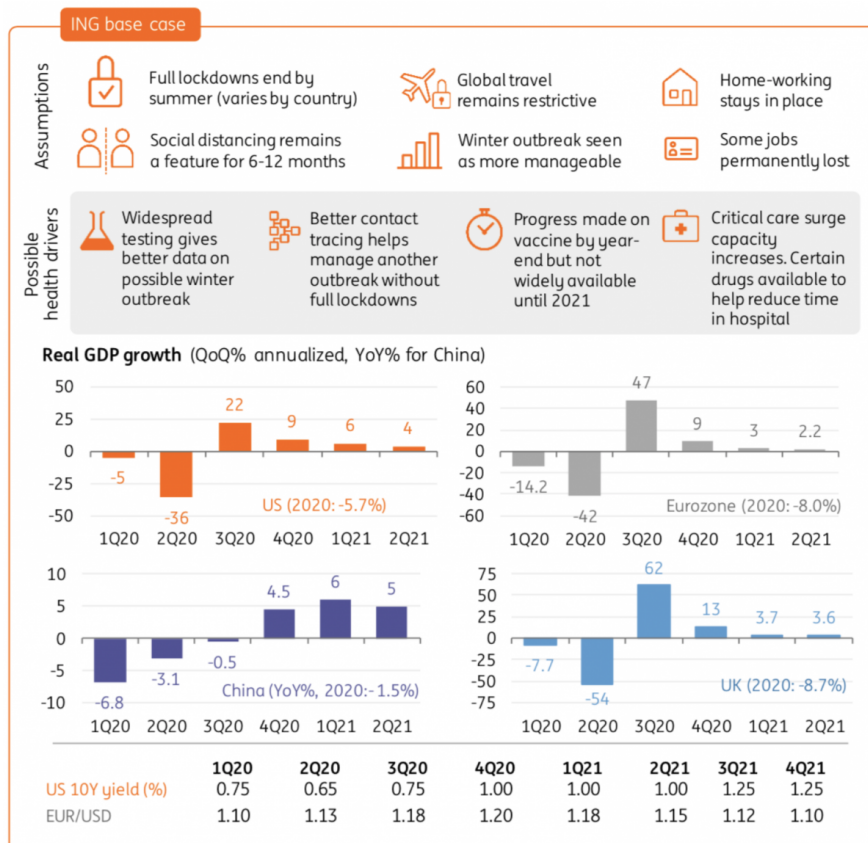
### **US Politics: Troubling times for Mr President**

- President Trump is languishing in the polls both nationally and in the swing states that are key to winning the electoral college and re-election. Democrat rival Joe Biden is keen to keep this a referendum on Donald Trump, but the President has other ideas and is going on the offensive

### **CEE: Gradual recovery but no deflation**

- It seems that Central and Eastern European economies are through the worst and a gradual recovery lies ahead. Despite the sharp fall in growth, there aren't any deflationary pressures as these economies were running hot prior to the Covid-19 crisis. All this is likely to translate into limited monetary easing ahead, but Poland remains very dovish

## ING's base case



Source: ING

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## US: The wrong direction

Covid-19 infections and hospitalisations are on the rise in many states, leading to fears that the recovery could falter in response to renewed restrictions and consumer caution. In the absence of a vaccine the Federal government will need to provide more support to keep the economy on the recovery track



Source: Shutterstock

Federal Reserve Chair Jerome Powell and U.S. Secretary of the Treasury Steven Mnuchin greet each other after testifying before the House Financial Services Committee

### Consumer sector offers encouragement

After hitting rock bottom in April, economic activity in the US bounced as the re-opening process gathered momentum in May and June.

Google Covid-19 mobility data focusing on movement around retail and recreation venues suggests states like Montana and Idaho are experiencing above “normal” activity. However, in more populous states, such as Illinois and Michigan, activity remains about 15-20% down while in California and New York the mobility data suggests activity is still around 30% lower versus pre-Covid-19 levels.

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*Is the US is experiencing self-sustaining growth or is this merely*



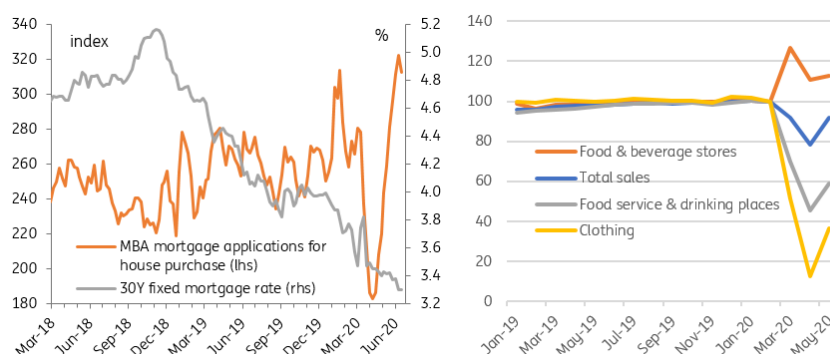
*pent-up demand fuelled by the novelty of being able to visit a shop or a restaurant?*

Overall though, consumer activity has performed well with the housing market and car sales obvious areas of strength. Mortgage borrowing costs are at record lows while auto manufacturers are offering interest-free financing for up to five years, making it an attractive time to buy. Moreover, the typical home and car buyer is around late forties to early fifties and will have been less exposed to the job losses in retail and hospitality (which are usually filled by younger workers) and is more financially secure with better credit rating.

Broader retail activity has also rebounded, albeit to a lesser extent, with aggressive Federal government action deserving of credit. Extended unemployment benefits have broadened the number of recipients to include the self-employed and independent contractors while the extra \$600 per week payment means many claimants are receiving higher incomes than they did when they were actually working<sup>[1]</sup>.

[Working paper: US unemployment insurance replacement rates during the pandemic](#)

### Mortgage applications surge as retail starts to recover



Source: Macrobond, ING

### Self-sustaining growth or pent-up demand?

The key question is whether the US is experiencing self-sustaining growth? Or is it merely pent-up demand fuelled by the novelty of being able to visit a shop or a restaurant that will fade away as harsh economic realities bite?

There are three key areas to focus on. Firstly, and most importantly, it's the virus itself. The number of cases has risen sharply over the past few weeks, particularly in southern and western states that opted for an early, aggressive re-opening schedule. This is starting to put a strain on hospitals. In response, some state governors are reinstating restrictions such as closing bars, a limited number of customer numbers on premises and better policing of face mask requirements. Other states will likely follow while states that are further behind in the re-opening process may become more hesitant to push on with their phased programs.

Just as important is how consumers respond to the situation. Will fear of catching the virus see

people choose to stay at home, thus further damaging the prospects for recovery?

## The jobs story may be losing momentum

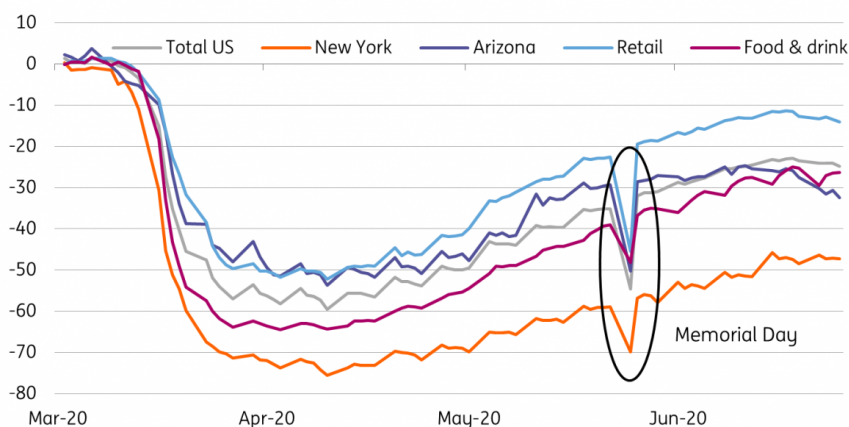
Secondly, the jobs market. The shock increase in employment in May boosted hopes that the US economy was well on the road to recovery. Unfortunately, the news since then has been less rosy.

Initial jobless claims remain elevated at just under 1.5 million – more than double the worst weekly reading of any period during the financial crisis – while continuing jobless claims remain at around 20 million. Add in all the people who are claiming some form of unemployment benefit and it equates to 20% of the workforce well above the 13.3% “official” unemployment rate published by the Bureau for Labour Statistics.

More worryingly, daily data from Homebase, which is an employee scheduling and time tracking tool used by many small businesses, suggests that employment is falling once again. One possible explanation is that many small businesses that took advantage of the loan forgiveness aspect of the Paycheck Protection Program have exhausted the money.

In this regard, the National Federation of Independent Businesses reported 14% of members that took advantage of the scheme are expecting to fire staff in coming weeks given demand has not returned to pre-Covid levels. If renewed containment measures make it unviable for businesses to operate then it will only add to the problems in the jobs market.

## Homebase: Hourly employees that day vs. the median for that day of the week for the period Jan 4, 2020 – Jan 31, 2020 (% difference)



Source: Bloomberg, ING

## More Federal support will be needed

The third factor is fiscal and monetary support. The Federal Reserve continues to state that a full recovery is unlikely until “people are confident that it is safe to re-engage with a broad range of activity”. Given the lack of progress on a vaccine, this could be a prolonged period so they will continue to ensure market functioning in an environment of ultra-low interest rates for the next couple of years.

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*House Democrats have approved a \$3 trillion stimulus, but this won't get through the Republican-controlled Senate. In the end, we suspect a \$1-1.5 trillion package will eventually get approved this summer*

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However, we suspect that the Federal government will need to do more to keep the US economy on the recovery path. July sees the ending of the \$600 per week boost to unemployment benefit and with around 30 million people still claiming, if there isn't some form of extension household incomes will fall sharply. Failure to take action would severely dent the chances of a rapid recovery.

Additionally, individual states are struggling financially due to higher Covid-related costs and lower tax revenues. They will need more Federal support otherwise we could see tens of thousands of state and local government workers laid-off. House Democrats have already approved a \$3 trillion stimulus, but this won't get through the Republican-controlled Senate. In the end, we suspect a \$1-1.5 trillion package will eventually get approved this summer, but it is unlikely to be plain sailing.

### **A long road to a full recovery**

Bringing it all together, the recent data suggests that the 2Q GDP contraction will not be as large as we had been fearing – perhaps -35% annualised rather than -40%.

*We think 2Q GDP contraction will not be as large as we had been fearing – perhaps -35%*

Unfortunately, the pick-up in Covid-19 cases and the more troubling newsflow from the jobs market is adding to the uncertainty surrounding the outlook for the recovery in the second half of the year. We doubt there will be a return to full lockdowns, but even temporary restrictions will hurt growth prospects and further dampen inflation pressures.

We doubt the economy will regain all the lost output until the second half of 2022. While supply Treasury supply may put some upward pressure on bond yields, we don't expect there will be a meaningful break above 1% for the US 10-year anytime soon given the economic backdrop and absence of inflation.

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## Eurozone: A deceptive ‘V’

Recent indicators point to a V-shaped recovery, but that won't last very long. With the European Central Bank trying to appease the German Constitutional Court further rate cuts look unlikely, though an increase in the Pandemic Emergency Purchase Programme is still in the cards

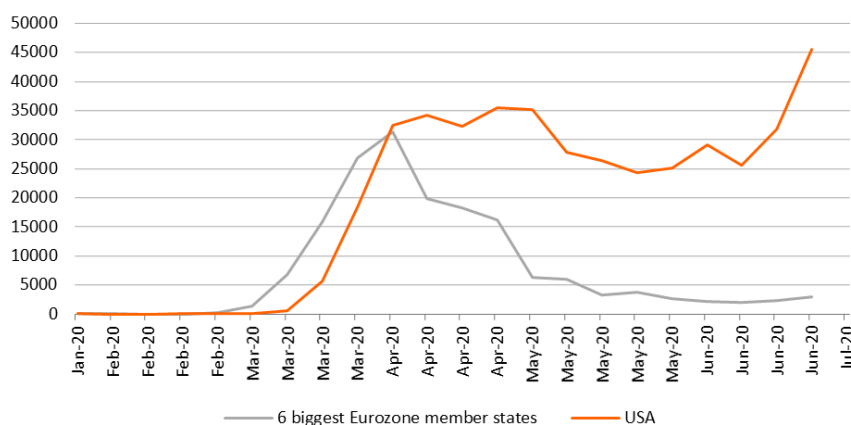


Source: Shutterstock

### Living in hope

We now have increasing evidence that the trough of the recession is behind us. That said, let's not get carried away with data that signals a V-shaped recovery. The flash IHS Markit Eurozone Composite PMI rose from an all-time low of 13.6 in April to 31.9 in May, increasing further to 47.5 in June. Pretty V-shaped, but bear in mind that the gradual lifting of lockdown measures had to have some impact on sentiment. That said, orders remained quite weak while on balance, jobs were cut for the fourth consecutive month. Same story with the Ifo-indicator in Germany. The healthy increase in June was largely attributable to the jump in the expectations component, while the present conditions component showed only a marginal improvement and remains far below the normal level. The eurocoin indicator, a proxy for the underlying growth pace in the eurozone, actually continued to fall in June.

## Number of daily new Covid-19 infections

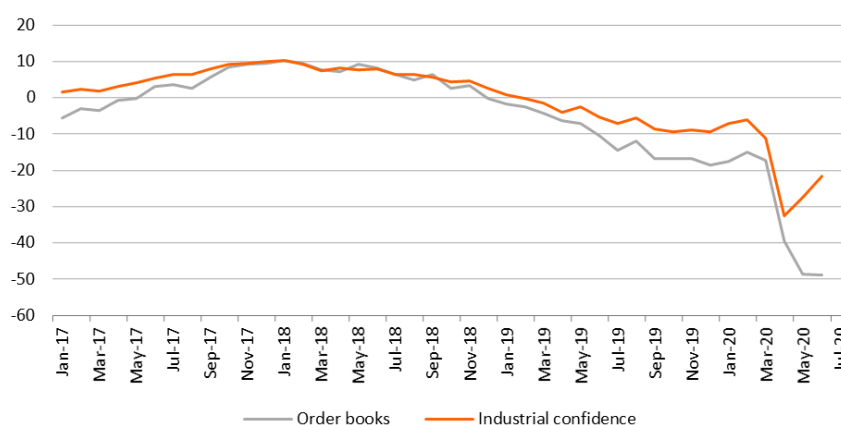


Source: Refinitiv Datastream

## Covid-19 is still there

Meanwhile the pandemic is still not under control, with worldwide new infections continuing to rise. While Europe is doing better than the US on that count, new infections are not falling anymore and one could expect a flare up after the holiday season. Fortunately, authorities have now developed tools to take more targeted measures without having to lock down the whole economy. But still, as long as there is no effective vaccine, it will be difficult to return to normal. To be sure, the massive monetary and fiscal stimulus will have some effect (both in France and Spain, temporary unemployment schemes have been lengthened recently). But after a very strong third quarter and a good fourth quarter, we expect the growth pace to level off quite rapidly. We stand with our -8.0% GDP growth for this year (with risks skewed to the downside) and +4.5% for 2021, meaning that it will take until the end of 2023 before the economy returns to the pre-corona level. Would you call that a V-shaped recovery?

## Not everything goes up



Source: Refinitiv Datastream

## Strong money growth

Inflation remains low and the German VAT cut will contribute to a further decline in core inflation in

the second half of this year. Even if the pass-through to consumer prices is only partial, it could still shave off close to 0.5 percentage points from core inflation in the coming quarters. Since the VAT cut is temporary, this effect will be reversed in the course of 2021. Meanwhile, inflation hawks are getting excited by the strong increase in money growth. Indeed, M3 rose 8.9% year-on-year in May, with credit growth equally strong. However, much of this increase reflects liquidity hoarding by companies drawing on their credit lines, while precautionary household savings in more liquid assets also contributed to the strong increase in M3. But make no mistake, this is a sign of distress and no harbinger of significantly higher inflation.

## Constitutional truce

The conflict between the German Constitutional Court has been gradually defused. The Bundesbank has decided to give quarterly briefings to the German parliament, while the ECB went out its way in its communication to demonstrate that it's taking the proportionality of its decisions very seriously. Significantly, Isabel Schnabel demonstrated in a speech in Frankfurt that the ECB had decided to put in place the PEPP because in order to obtain a similar inflation effect, it would have to cut the deposit rate to -1.7%, something that would adversely impact European (read German) savers. That is basically the reason that we don't think the ECB will lower the deposit rate any further. That said, we continue to believe that the bank will announce a further extension of the PEPP of approximately €400 billion in the second half of the year. However, as a complaint against the PEPP is now also being prepared in Germany, the ECB might feel a bit more constrained in the coming years. But that is not a near term worry, for sure.

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## China: Covid-19 adds pressure to exports

Domestically-driven growth has been faster than foreign-driven exports and manufacturing. It seems that occasional Covid-19 clusters have not disrupted domestic demand too much. As such, we have revised our PBoC policy forecast to no more rate cuts for the rest of 2020



Source: Shutterstock

### Covid-19 creates hot and cold of the Chinese economy

The Chinese economy shows domestically-driven growth, but an external demand drag.

Domestically, the government has continued to promote more research and development on advanced technology so that it can achieve self-reliance in the most advanced semiconductor chips in the coming years. Most of the growth we see is around this sector.

Some stimulus money has flowed into the real estate market as shown by the increase in land sales fees. Though this is not ideal, it shows that there are still people in good financial shape. They are willing to invest and spend, which at least provides some short-term support for the economy. In the longer-run, this means that Covid-19 has widened the wealth gap in China. As not all the stimulus money has found its way into infrastructure projects, we see little support from infrastructure to economic growth.



*The pain point of the Chinese economy are small manufacturers, and they usually produce for small exporters*

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Although there are still some occasional Covid-19 clusters in China, they have quickly been brought under control by semi-lockdown practices. As such, those cluster cases have not disrupted the economy. We see that recovery in consumption continues albeit slowly.

But when it comes to foreign demand-related industries, the economic picture is different. Covid-19 cases have increased overseas, and export orders continued to shrink on a monthly basis in June as shown by the PMI index. This means that China's exports and export-related manufacturing and service activities (e.g port-services) will continue to be under pressure.

The pain point of the economy are small manufacturers, and they usually produce for small exporters. These two groups are expected to face an increased chance of a shutdown. Even though the People's Bank of China set up an innovative re-lending programme for SMEs, they might not be willing to borrow if they can't see orders coming.

## **What we expect from fiscal and monetary policy in 2H20**

The central government will continue to put a lot of focus on stimulating the technology industry in the second half of the year. This is good for long-term growth.

But technology advancement takes time, so this is not a strategy for short-term growth. We expect that infrastructure projects will be increasingly important in supporting the economy in the second half.

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*We are sceptical on further broad-based monetary easing. There is a chance that the central bank believes that liquidity is ample as the front-end of the interest rate curve is already low.*

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We are sceptical on further broad-based monetary easing. The government has stated that a cut in the required reserve ratio (RRR) could help the economic recovery. But there has been no action from the central bank since the government made that statement. There is a chance that the central bank believes that liquidity is ample, as the front-end of the interest rate curve is already low. The PBoC has cut re-lending rates by 25bp for small firms and the agricultural sector, and made a similar cut in the rediscount rate. These actions are not expected to move the overall interest curve. And therefore further cuts should only be for a targeted purpose.

3M SHIBOR has fallen to around 2% at the end of June (even though liquidity is usually tight at half-year end, the interest rate has not jumped a lot) from 3% at the end of 2019. And it is well known that the PBoC does not like ultra-low interest rates.

As such, we have revised our PBoC policy forecast to no more rate cuts for the rest of 2020. This may change if there is a large outbreak of Covid-19 in China or a sustained outbreak in

the rest of the world that hurts the economy - similar to the situation back in February/March this year.

Our GDP growth forecast remains unchanged at -1.5% for 2020.

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## Asia: India and Indonesia riding up the Covid-19 curve

First China, now India and Indonesia – two more of Asia's largest economies face their worst recession in decades. But the divide in the market's perception is reflected best by the performance of their respective currencies. The rupiah is one of the best performers in the EM space while the rupee hasn't been appreciating very much since the rally started



Source: Shutterstock

Factory workers in India queue at Kapashera border after local police stopped them from crossing amid the lockdown on May 18, 2020 in Gurugram, India.

# 567k

## Covid-19 cases in India

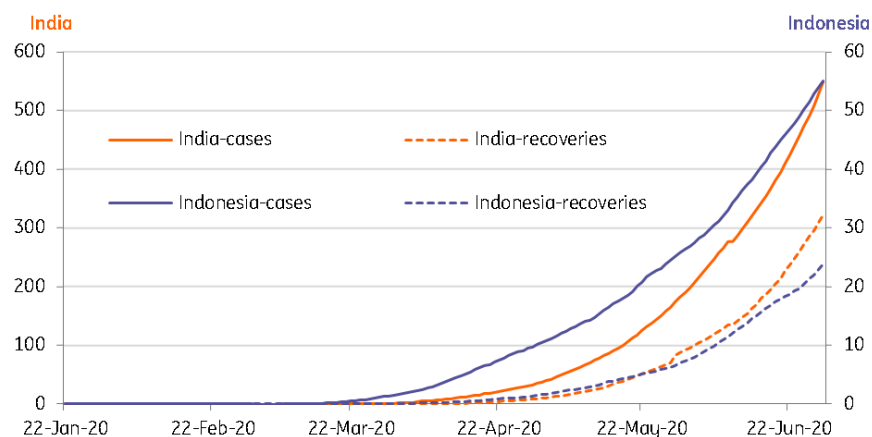
As of 29 June

### Riding the Covid-19 curve

More than three months since they reported their first confirmed cases, India and Indonesia, the world's second and fourth most-populous countries, show no signs that their respective Covid-19 outbreaks are subsiding.

India is now the **fourth worst-affected** country in the world with 567k infections. Indonesia, with 55k officially recorded cases, sits well behind in 29th position but is among the worst affected in Asia. It took less than a month for cases in both countries to double to their present count. Large population size, poor healthcare infrastructure, weak testing and isolation efforts, and ineffective policies have all helped the spread of the virus in both countries.

## Covid-19: Rapid infections, tepid recovery ('000)



Source: Worldometers

Note: Data as on 29 June.

## Wasted lockdowns

India was among the first countries in Asia to begin a nationwide lockdown on 25 March when officially recorded cases touched 500. But lockdown implementation was chaotic; announced just hours before it started, and dragging on with four extensions from the initial three-week phase until end-June.

Despite reportedly being one of the strictest in the world, India's lockdown has failed to break the Covid-19 chain. Undermining it was the migrant crisis – workers from largely unorganised sectors in big cities moving back to their native states, many of whom reportedly died during the journey, whilst survivors carried the disease back to their home towns and villages. Large slum dwellings in cities like Mumbai turned out to be fresh breeding grounds for the virus. This, combined with the country's strained healthcare system, leaves the true number of infections, recoveries, and deaths in India in question.

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*A weak economy will be the authorities' argument against renewed lockdowns in both India and Indonesia*

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Indonesia may not appear as bad as India, but the true extent of the outbreak is also debatable, and even the official spread of the virus remains fast (see figure).

Indonesia started its movement restrictions late. The government pushed back on strict lockdown measures, and instead opted for partial restrictions on mobility which were relaxed by June for

most regions given the urgency of mitigating the negative economic impact.

With Indonesia's recovery rate a little over 40%, there is no end in sight for the first wave of their outbreak. And in India, with the seven-day average of daily new infections running at 17k, it is probably only a matter of time before they move up into third place globally for total officially recorded cases, ahead of Russia. That said, we think a weak economy will be the authorities' argument against renewed lockdowns in these countries.

## 2020 – a write off year

Nearly a whole quarter of economic inactivity in 2Q20 is paving the way for the steepest GDP falls in decades. We expect close to -8% year-on-year falls in India and -5% for Indonesia.

It's looking so bad, that the Indian statistics authority recently had to suspend releases of some economic indicators like the CPI and industrial production on the grounds of distortion from the lockdowns. However, a record low in the manufacturing PMI (30.8 in May) and crashing exports (-37% year-on-year in May after -60% in April) hint at the damage. So too does an estimate by a local think tank which put the unemployment rate at more than 20%.

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*We have cut our forecast of India's GDP growth in the current fiscal year to -5.2% from -2.1%.*

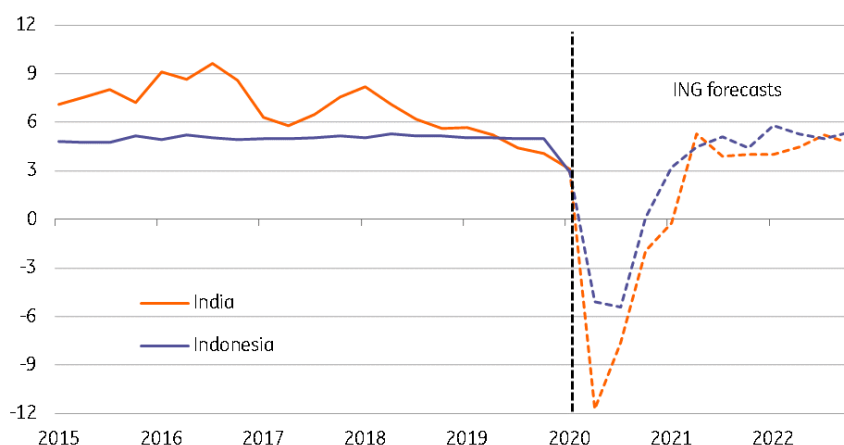
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The five most affected Indian states (Maharashtra, Delhi, Tamil Nadu, Gujarat and Uttar Pradesh) make up 43% of India's GDP. Recovery here will hinge on the return of a large number of migrant workers, though not all of them are likely to be reabsorbed back into disrupted supply chains, while weak demand continues to hinder activity.

Meanwhile, resurgent food inflation resulting from supply disruptions and panic buying, and high fuel prices due to recent hikes in excise duty are pressuring CPI inflation. We have cut our forecast for India's GDP growth in the current fiscal year to -5.2% from -2.1%, but maintain our inflation forecast at 4.3%.

In Indonesia, data also points to a broad-based economic slowdown, with retail sales falling sharply, by 11.8% in April, and the manufacturing PMI down to 28.6 in May, prompting further cuts to the government's still probably optimistic expectation for GDP this year to between -0.4% and 1.0%. We forecast a contraction of -1.9%.

## Crashing GDP (% year-on-year, quarterly data)



Source: CEIC, ING

Note: Dotted parts are ING forecasts.

### Policy constraints

Tight public finances limit the availability of fiscal support. India's big-bang 10% (GDP equivalent) stimulus was heavy on structural reforms. That's helpful over the longer-term but doesn't provide much immediate help for the economy. The real fiscal thrust comes to just 2.6% of GDP. It's a little better in Indonesia, with a roughly 3.5% real GDP thrust in a 4.2% total package.

Central banks in both countries have been responding to the urgency of accommodation though. In addition to liquidity boosting measures, the Reserve Bank of India has cut the policy rate by a total of 115 basis points so far this year while Bank Indonesia has cut its rates by 75bp. The doors are open for further easing.

The divide in the markets' perception of post-Covid-19 prospects for the two economies is probably best reflected by the performance of their respective currencies -- the Indonesian rupiah is one of the best performers in the emerging markets space, while the Indian rupee has been one of the currencies appreciating the least since the emerging market rally started in April.

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# Latin America: Recession deepens fiscal challenges

Covid-19 continues to spread across Latin America but, given the mounting economic costs of stay-at-home orders, governments are easing social isolation guidelines. Robust economic policy responses should help soften the recession but will leave behind severe fiscal challenges that should alter intra-region relative performance post-pandemic



Source: Shutterstock

Health worker instructs the people waiting outside the medical center on how to get tested for COVID-9, at the Central de Abasto market of Mexico City

## Deep uncertainties and uneven recovery paths

Latin American countries continue to struggle to control the spread of Covid-19, exacerbating uncertainty about the future of stay-at-home measures and complicating any assessment of the depth of the recession that regional economies will suffer this year.

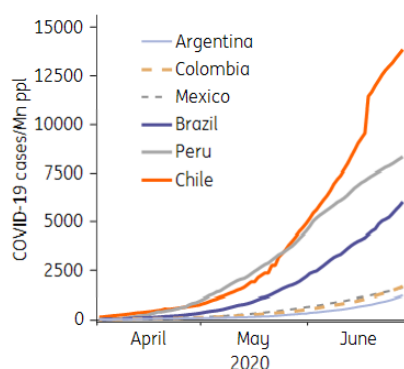
The health crisis is unlikely to abate soon given the inherent difficulties in combating the spread of Covid-19 in less developed countries. Dense living arrangements together with widespread labour informality complicates the region's ability to enforce mandatory social-isolation procedures.

*Dense living arrangements, widespread labour informality along with the prevalence of weaker health-system infrastructures across the region, help explain the emergence of regional hotspots in Lima, Santiago, Guayas and Manaus*

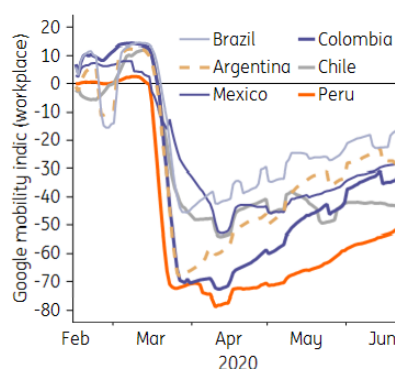
Moreover, unless governments have the ability and logistical capacity to transfer vast amounts of resources to businesses and households, which is not the case for most of Latin America, returning to work becomes imperative sooner or later. These vulnerabilities, together with the prevalence of weaker health-system infrastructures across the region, help explain the emergence of regional hotspots such as Lima, Santiago, Guayas and Manaus.

As the graphs below suggests, even though confirmed Covid-19 cases continue to rise across the region, workplace mobility is also gradually rising. Chile and Peru are notable exceptions, as the greater severity of the virus spread have resulted in a delayed return to work.

## Continued rise in Covid-19 has not prevented gradual return to work



Source: Macrobond, ING



Source: Macrobond, ING

This gradual return to normalisation suggests that, perhaps with the exception of Chile, April likely marked the bottom for economic activity. The collapse in activity varied materially across countries, with Peru's massive 40% year-on-year drop standing as a clear outlier when compared to the smaller drops seen in Brazil and Chile, of 15%, Colombia and Mexico, 20%, and Argentina's 26%.

The recovery should also be uneven, with the path likely influenced by the trajectory of the health crisis, the pace of the reopening and by the economic policy decisions taken place over the past few months.

## Recession and fiscal stimulus raise questions about fiscal sustainability

Policymakers have, with the notable exception of Mexico, responded with vigour to the crisis. Aggressive monetary policy easing was adopted throughout the region, with the policy rate now



set at, or very near, their “technical lower bound” in most places. This likely means near 2% in Brazil and Colombia, and at 0.25-0.5% in Peru and Chile.

Aggressive rate-cutting cycles, together with the rise in risk aversion, resulted in widespread FX weakness across the region. Brazil's FX weakness stands out but appears consistent with the fact that Brazil also saw the greatest reference-rate drop when compared to historical averages. Overall, however, FX weakness may have increased business uncertainty, but it is not a binding constraint to monetary policy right now, given that inflation is low throughout the region.

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*Policymakers have, with the notable exception of Mexico, responded with vigour to the crisis*

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Fiscal policy was also adjusted, to help mitigate the collapse in household and business income resulting from the interruption in economic activities. The amounts involved appear commensurate with the dimension of the health crisis seen in each country, with Chile and Peru leading with the most generous fiscal packages, followed by Brazil, and Colombia.

Mexico, once again, stood out for its unusually modest counter-cyclical policy effort, which contrasts with the fact that Mexico's GDP is likely to face one of the deepest slumps in Latin America this year.

The different policy choices adopted in each country should result in different challenges and recovery paths over the coming months. Despite the ample policy stimulus adopted in Peru and Chile, it's hard to be optimistic about faster recovery prospects given the severity of the health crisis still faced by these two countries.

The economic paths adopted by Brazil, Colombia and Mexico should provide especially interesting comparison opportunities, however. The larger stimulus adopted by Brazil, followed by Colombia (medium), and Mexico (small) should help provide important contrasts about the policy choices adopted.

In contrast to Mexico, Brazil's (and Colombia's) more generous fiscal package should help expedite the recovery but create severe fiscal challenges in the future. But we also worry that Mexico's “fiscal prudence” may exacerbate the risk of greater permanent damage to the economy, delay the eventual recovery and, ultimately, create more lasting damage to its fiscal trajectory, while keeping the risk of credit-rating downgrades elevated.

Overall, it's still too soon to state with great conviction which policy path will prove most effective in the current context. And this should provide much room for performance differentiation in the coming quarters, especially as each country will have to make difficult fiscal policy choices ahead.

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## FX markets leave lockdown behind them

This month, we've been tasked with looking at the effects of lockdown exits on FX markets. The truth is that there does not seem to be a strong relationship. Instead, FX markets are being driven by the abundant liquidity story. As summer progresses, however, we expect US elections to make their mark. Both themes are dollar negative, in our opinion



Source: Shutterstock

### Leaving lockdown

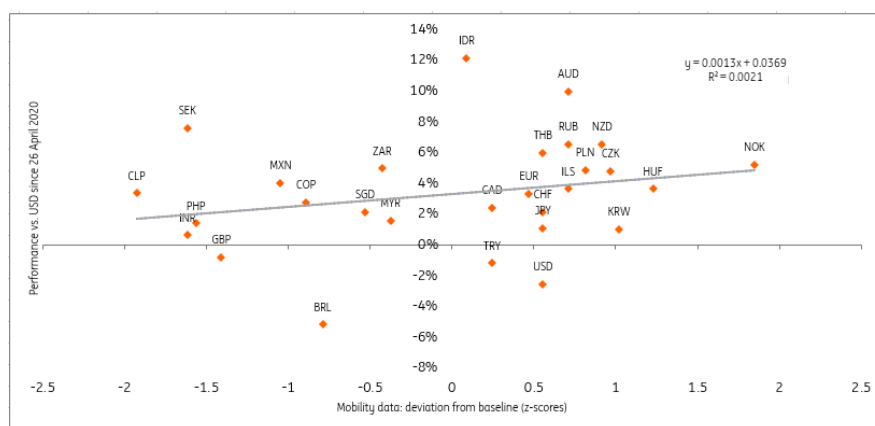
It has been nearly two months since some of the lockdown exit measures were announced in continental Europe and Google mobility data shows the gentle upturn in European activity from early May.

Below we look at a snapshot of FX performance against Google mobility data since 26 April (when

the end of lockdowns was announced in both Italy and Spain). Has a greater degree of recovery in that mobility data-driven FX performance? The short answer is no.

At a stretch, one could argue that sterling and Norway's krone do reside in sensible places on the scatter chart – although Downing Street’s intransigent position on Europe and the recovery in oil might also have a say here. For the rest, there does not seem much of a relationship and for the US dollar (we look at the Bloomberg BBDXY index here), we argue that abundant liquidity has been a bigger driver of performance.

## FX performance versus change in Google mobility data since late April



Source: ING, Google

## Risk On, Dollar Off... for now

In terms of broad drivers of the FX market, we still believe the Federal Reserve's printing presses have set the overall FX tone.

Recall that back in September the Fed discovered the point at which low excess reserves held at the Fed would trigger some tightening of financial conditions – especially in USD repo markets. That level was US\$1.25 trillion. Excess reserves now held at the Fed are over US\$3 trillion and the many Fed measures to restore confidence in the financial system since March have breathed air into the lungs of global risk markets. After nearly 14 weeks of outflows from late February, emerging markets have now enjoyed five consecutive weeks of portfolio inflows.

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*After nearly 14 weeks of outflows from late February, emerging markets have now enjoyed five consecutive weeks of portfolio inflows*

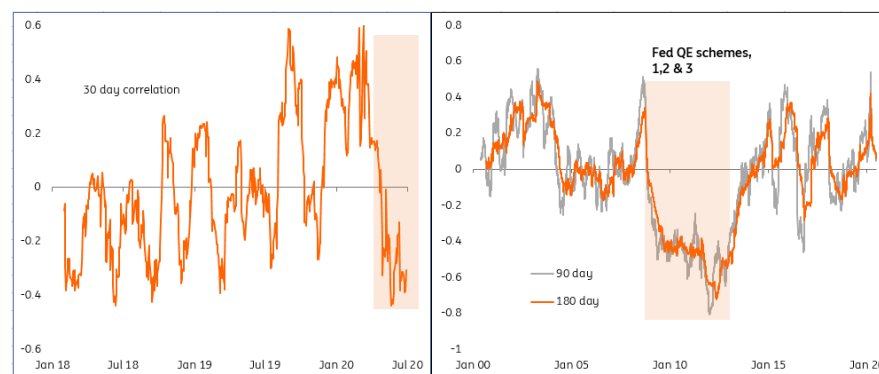
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Fed money printing has now secured what seems to be a stable negative correlation between risk assets (we look at the US S&P 500 index) and the dollar (DXY). We show how the correlation has shifted over the last couple of months. This recent turn is consistent with the relationship seen in the 2009-2012 period when the Fed was forced to initiate quantitative easing programmes one,

two, and three. Tapering of the Fed's balance sheet was only discussed in June 2013 and implemented in December 2013, when the correlation really started to reverse.

As long as the Fed is still buying assets and prepared to do more, we expect this negative correlation, Risk On, Dollar Off, to dominate financial markets over the coming quarters. Economies slowly getting back on their feet should mean a backdrop of a benign dollar bear trend in the second half of the year.

## DXY versus S&P 500 correlations, now (2020) and then (2009-2012)



Source: ING, Bloomberg

## The elephant .. or is it donkey? in the room

Probably the biggest threat to the above FX regime is US elections.

Typically, we would expect these to start moving markets from late August/early September onwards. We do not think Joe Biden's lead in the polls has played a role in FX pricing just yet – but this will undoubtedly be a theme for 3Q20.

Below we take a look at how the DXY has performed in presidential election years when the White House has changed hands. We would discount the strong dollar gains in both 1992 and 2008 when the Exchange Rate Mechanism crisis in Europe and the global financial crisis were dominant themes. But it seems fair to say that the dollar did not embark on a big rally ahead of the early November result.

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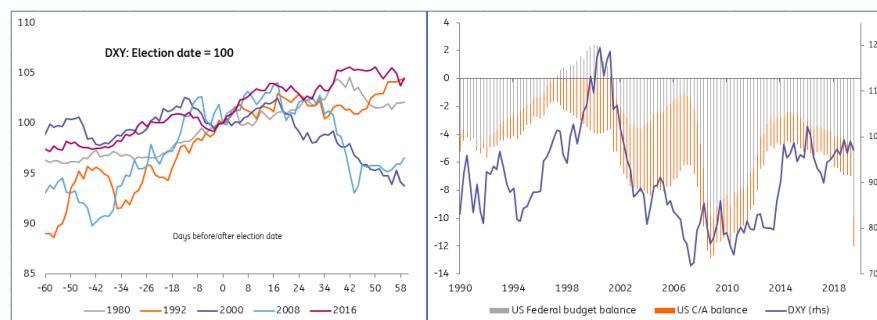
[At the same time, the press is starting to further explore the idea of a dollar crash.](#) At the heart of that story is the sharply widening twin deficit (driven by the fiscal side). And mapped against the dollar it certainly makes an impressive chart.

While wider deficits alone do not make a story for a weaker dollar – after all, which government

can boast of a narrower fiscal deficit now – they do make the point that the US is increasingly relying on the kindness of strangers to fund its balance of payments. And if uncertainty arises as to what the US growth package constitutes – an uncertain election outcome will not help here – the dollar should become more vulnerable as 3Q progresses.

For this reason, we are still comfortable with EUR/USD rising to 1.18 by end 3Q20 and finishing the year at 1.20. DXY should fall around 6-7% during this period.

## DXY in election year, DXY versus US twin deficits



Source: ING, Bloomberg

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Article | 2 July 2020

## Rates: Warning signs that equities might have it all wrong

Most financial instruments are present values of a discounted stream of future income. For equities that is earnings, for core bonds it is coupons, plus principal payback. For high yield, a spread is added to compensate for the non-systemic risk. The equity discount is upbeat, the rates discount is ominous, high yield one is in between. Something must give



Source: Shutterstock  
Federal Reserve

### Relative optimism in equities - should we buy into it?

The rates (or bond) market has a better record than most at discounting the future. For example, as the great financial crisis unfolded, bond yields fell for months before equities finally got the message that things were looking a bit ropery. And there are many other examples. Not that the bond market is perfect, but it has typically done a much better job than equity markets.

Equity market valuations are a function of forward earnings, typically heavily influenced by the immediate year ahead, through corporate guidance. Beyond that, things get quite fuzzy. And even with prospects for 2020/21 far from certain, equity markets are looking into that fuzziness and are tending to see more positive than negative shadows.

## What is the Rates market discounting? Not a pretty picture

The bond market discount is quite different.

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*Typically when the 5yr is rich, it signals an imminent fall in yields. It does not signal a bear market for bonds. This is a rates market that discounts maintenance of low rates*

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This is being partly driven by a Federal Reserve that has been unwaveringly apprehensive on the future. That has anchored the 2yr rate at sub-20bp, literally for months now. And the prognosis is for it to remain there. The 10yr did manage to jump to 90bp a few weeks back as the risk-on mood became almost persuasive, but it has since drifted back to the magnet of 60-65bp.

The talk now is of a potential test of the all-time low at 54bp hit in early March as the crisis really took hold.

Either way, one thing is for sure. This bond market does not look anything remotely like a bear market. We assert that not purely based on the level of yields, but more on the structure of the curve. Specifically, we note the richness attached to the 5yr area (a combination of the 2yr and 10yr returns a higher yield than the 5yr outright). This is an important signal. The 5yr area is not as slavish to the fed funds rate futures as the 2yr is, and tends to have a better nose for what is coming down the line than the 10yr does (its nose, is too long).

Typically when the 5yr is rich, it signals an imminent fall in yields. It does not signal a bear market for bonds. This is a rates market that discounts maintenance of low rates.

## What is the credit market telling us exactly? Stresses lie ahead

Very often credit spreads correlate with equity markets. As equity markets bottomed in late March, credit spreads peaked, just as the VIX did.

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*Here we find that the current theoretical default rate is in the area of 8% for one year. How does this compare with the great financial crisis? Well through 2008/2009 cumulative defaults were in the region of 15%.*

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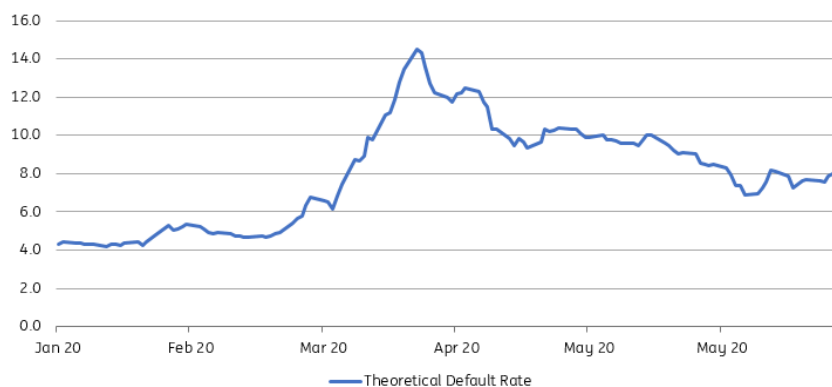
The USD high yield CDS hit almost 900bp at the extreme, before falling back to a low in the area of 425bp. That is still above the pre-Covid levels in the sub-300bp area, but well below the explosive highs. That said, in the past month the spread has drifted wider by some 100bp, to the 530bp area.

So what does a 530bp spread tell us?



Well the spread itself is a repercussion for being in a default-prone asset class. It provides compensation for taking business risk above and beyond the systemic risk-free rate. By the same token it can be used to back out a default rate expectation, and in fact as the spread changes over time, so too does the implied future default rate.

## The default rates as backed out from USD high yield CDS



Source: Bloomberg, ING estimates

We find that the current theoretical default rate is in the area of 8%. The low was 7%, but it is in any case well down from the 14% default rate that was being predicted when spreads approached 900bp.

How does this compare with the great financial crisis? Well through 2008/2009, cumulative defaults were in the region of 15% (over two years). Typically default rates are quoted over a 12-month period. Here it was 5.5% in 2008 and 9.4% in 2009. The cumulative measure overstates when compared with a one year measure, but provides a deeper impression, and helps to fully contextualise the current implied default expectation.

[A more detailed discussion on corporate default rates, credit rating agency estimates, and views from our credit team see here.](#)

## Something must give - and bonds have the far better predictive pedigree, unfortunately

We've been impressed with the fact that the Nasdaq is up some 10% year-to-date. But we should also remember that the rally seen in equity markets since end-March still leaves most bourses well down year-to-date. The Dow Jones is now down some 10% and the likes of Spain's IBEX is down over 20%.

So, while equity markets have turned in a remarkable improvement since end-March, absolute valuations are still stressed. The fact that rates markets have not bought into the relative optimism remains an underlying drag.

### An uncomfortable path ahead

While equity markets have toed and froed, and credit markets have done a bit of the same,

there is one constant here - the unwavering discount coming from the core bond market. The low level of rates plus bond bullish curve structures that impute maintenance of low rates paint a picture of more negative shadows than positive ones as we gaze into the fuzzy future.

It's a world of negative real core rates, and minimal pull coming from inflation expectations. Reverse engineer that into a real economy prognosis and an uncomfortable picture of the path ahead gets sketched.

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Article | 2 July 2020

## US Politics: Troubling times for Mr President

President Trump is languishing in the polls both nationally and in the swing states that are key to winning the electoral college and re-election. Democrat rival Joe Biden is keen to keep this a referendum on Donald Trump, but the President has other ideas and is going on the offensive



Source: Shutterstock

Former Vice President Joe Biden, left, and President Donald Trump

### Biden - from also ran to race leader

Four months ago the implied probability of Democrat challenger Joe Biden winning the presidency was just 10%. However, a big win in the South Carolina Democrat primary breathed new life into his campaign. As party rivals dropped out of the race, a quick consolidation of the centrist vote gave Biden the momentum to overcome his populist rival, Bernie Sanders, to secure the Democrat nomination.

The coronavirus pandemic has since turned the race on its head. President Donald Trump, who has long portrayed the strength of the economy and stock market as his signature success, is now challenged by an unprecedented economic downturn. The highly polarised criticism of his handling of the crisis has since been given a dramatic twist by his response to the protests over the police

killing of George Floyd in Minneapolis.

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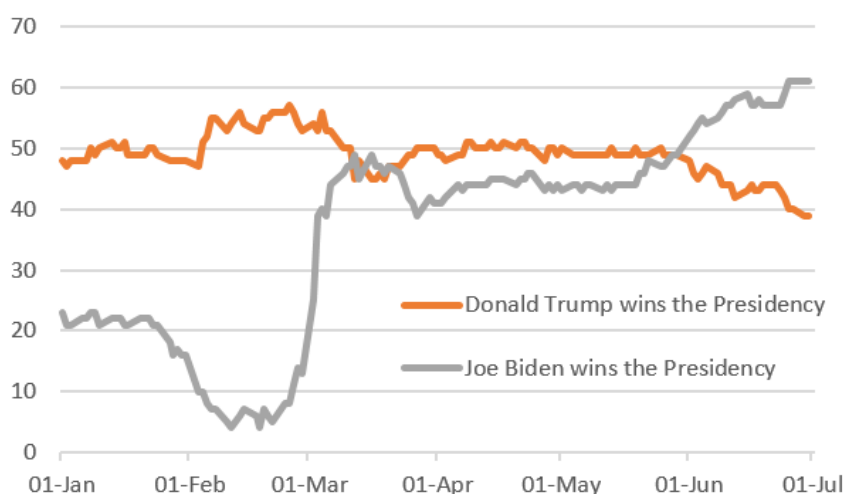
*In several national polls, Biden now has a double-digit lead, so as a result, betting odds are implying a 62% chance of a Biden presidential victory*

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In several national polls, Biden now has a double-digit lead while in the five key swing states that will likely determine the election outcome, (Arizona, Florida, Wisconsin, Michigan and Pennsylvania), Biden has opened up a 4-8 point lead. As a result, betting odds are implying a 62% chance of a Biden presidential victory.

But the election isn't today, it's in four months and as we have seen, a lot can change in that time. Opinion polls offer just a snapshot and a mistake here or some out of the blue news there can quickly change things - exactly what President Trump needs.

## Implied probability of presidential victory based on betting quotes available on the PredictIt website



Source: Bloomberg, ING

## President Trump will make it personal

President Trump's support amongst rural voters and white evangelicals remains solid, but his handling of healthcare and Covid-19 has seen support waver amongst older voters. The onus is therefore on the president to shake things up and we are already seeing some of this happen with actions such as restricting visas for foreign workers and proposals to put new tariffs on European imports. Rhetoric towards China remains tough and could get tougher as we head towards election day.

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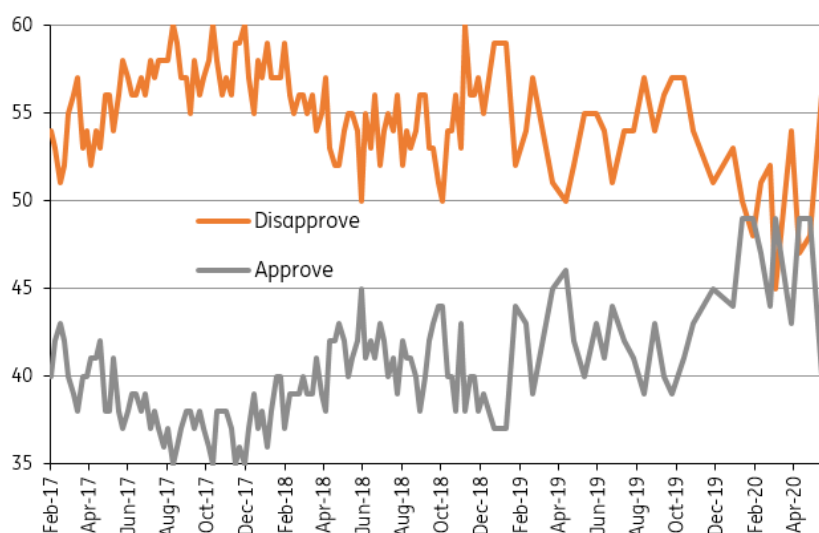
*This election is also likely to be even more personal, aggressive*

## *and nasty than the 2016 Trump-Clinton battle*

This election is also likely to be even more personal, aggressive and nasty than the 2016 Trump-Clinton battle. The social media campaigns, the name-calling and the personal attacks suggest President Trump wants to paint Joe Biden as unreliable and unfit for the presidency. Biden's campaign also risks being blown off course given sexual harassment claims from former staffer Tara Reade and the growing momentum behind getting Joe Biden's son, Hunter, to be more fully investigated regarding his business dealings. Televised debates could influence the outcome and will put immense pressure on Biden with his responses closely scrutinised for missteps.

Another problem for Biden is that he doesn't have the unflinching support of highly active and vocal campaigners of former rival Bernie Sanders. He also doesn't ignite audiences to anywhere near the same extent. However, he arguably can win a broader range of support across the nation by being the middle of the road candidate. His supporters push his "nice guy" image and he is viewed as the person who, by not being Donald Trump, can bring a return to presidential "normality".

### President Trump's approval rating



Source: Gallup

### The economy will be the swing factor

The Covid-19 pandemic has limited the opportunities for Biden to be heard and seen, but the strategy so far appears to make the 2020 vote a referendum on President Trump. Although Biden has a large lead at this point, the dislocations and disruptions from the coronavirus make him far from a guaranteed winner.

In that regard, we believe the economy will be the key swing factor. Should renewed lockdowns and consumer caution lead to a faltering of the recovery and millions of people remain out of work on election day, we will likely see a change of president. But if the recovery gains significant traction, it'll become more difficult for Biden to beat Trump.

## What a Biden presidency could mean

As for what a Biden presidency may bring, he has already promised that his administration will be “Rooseveltian”.

This implies a major stimulus package and a series of reforms from across the party including new regulations on the financial sector and the tech sector plus a greater focus on climate change and green infrastructure. It would also likely bring higher taxes, particularly on corporates and the wealthy with an investigation into the merits of universal basic income.

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*Joe Biden has already promised that his administration will be “Rooseveltian”*

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Such policies may not be favoured by the equity market and could contribute to further dollar weakness, but a greater willingness from Biden to work with international partners may offer some mitigation through the reduced threat to global trade.

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## Central and Eastern Europe: Gradual recovery but no deflation

It seems that Central and Eastern European economies are through the worst and a gradual recovery lies ahead. Despite the sharp fall in growth, there aren't any deflationary pressures as these economies were running hot prior to the Covid-19 crisis. All this is likely to translate into limited monetary easing ahead, but Poland remains very dovish



Source: Shutterstock

Romanian seasonal workers wait for check-in at the Avram Iancu international airport, in central Romania.

### Economic growth to gradually recover

Despite the high degree of uncertainty, the worst seems to be behind the CEE region. Significantly downward revisions to growth have been made vs pre-Covid-19 (Figure 1), but 2Q looks to be the bottom and the second half of the year should offer a gradual recovery. Still, local economies are unlikely to reach pre-Covid-19 levels until late 2021 or 2022.

*2021 growth should range around 4% for the Czech Republic,*

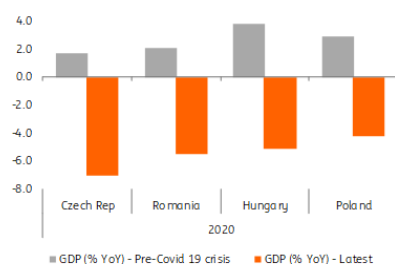
## Poland and Hungary, while around 7% in Romania

The Czech economy is set to see the most negative growth in the region this year (-7.0%) though in terms of the scale of the outlook downgrades vs pre-Covid-19 situation, the almost 9% downward revision to Czech growth (+1.7% pre-crisis vs -7.0% now) is equal to the one in Hungary and larger than in Poland and Romania. This partly reflects the mix of the large openness of these two CEE economies (as very evident in Figure 3 ) as well as their exposure to the cyclical auto industry (particularly when compared to Poland).

The CEE growth recovery should stem from a mix of improving foreign demand and stabilising domestic demand, both underscored by the low base, generating solid YoY figures. The 2021 growth should range around 4% for the Czech Republic, Poland and Hungary, while around 7% in Romania.

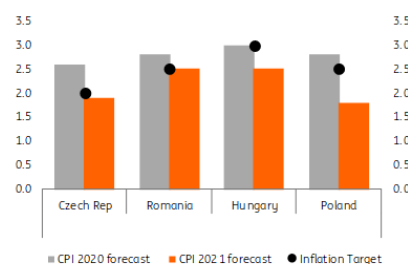
[See the full version of the CEE Economic Update for details and in-depth analysis of individual CEE country outlook](#)

Fig 1 Large drop in the GDP outlook due to Covid-19



Source: ING

Fig 2 No urgent CEE deflation risks on the horizon



Source: ING

## Declining CPI from above target levels means no deflation risks

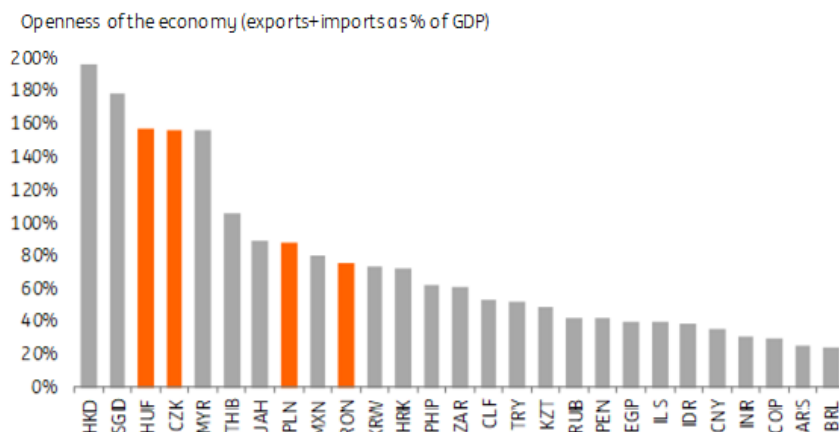
As for the inflation outlook, the trend into the year-end is largely similar across the region. That is declining CPI (with the exception of stable inflation in Romania) from the rather high, well above the inflation target level starting points. The decline is to be mainly driven by lacklustre demand.

But any talk of deflation is premature and the regional inflation outlook for next year points to either at-target CPI (Czech and Romania) or modestly below the target CPI (Hungary and Poland) – Figure 2 .

As pre-Covid starting point for CEE inflation numbers was rather high vs the rest of Europe (due to most CEE economies running above their potential, solid labour market and high wage growth), the subsequent decline is not strong enough to cause deflation concerns.



**Fig 3 Czech and Hungarian economies particularly opened**



Source: OECD

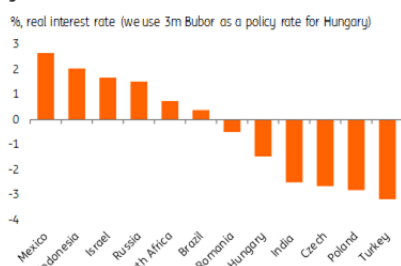
## Limited easing ahead

As the worst seems to be over, there is a gradual recovery ahead and no imminent deflation pressures, this also means the bulk of the across-the-board aggressive monetary policy easing is behind us.

Note that Poland's central bank delivered one of the largest QE programmes globally while the cumulative 200bp worth of Czech national bank rate cuts was one of the largest conventional easings. We see both the CNB and the NBR as largely done.

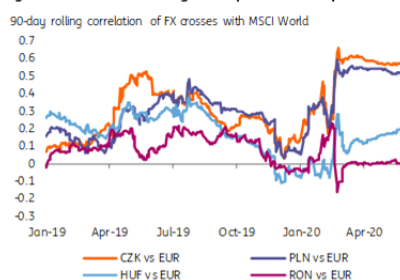
In Hungary, the central bank started the process of reversing the previous FX stabilising hikes, but additional easing should be only modest (one last 15bp cut and we don't see 3m Bubor below 0.60% this year) while the central bank has paused its QE programme. In this respect, the NBP should be the leader on the policy loosening front and we expect QE in Poland to be extended into 2021.

**Fig 4 PLN suffers from one of the lowest real rates**



Source: Bloomberg, ING

**Fig 5 HUF risk sensitivity decoupled from its peers**



Source: Bloomberg, ING

## FX: CZK to outperform, PLN to underperform

In terms of allocation and preferences, we would argue that overweight CZK, neutral HUF and RON and underweight PLN makes sense.

CZK is our preferred CEE currency given limited scope for further Czech central bank easing, the solid fiscal position and the low odds of the central bank leaning against CZK strength (due to the low risk of deflation – vs the clear deflation risks in 2013 ahead of the start of FX interventions). We

see EUR/CZK at 26.00 by the year-end.

In contrast, the dovish bias of Poland's central bank should translate into the PLN underperformance as the NBP is likely to extend QE beyond this year. With inflation still high and rates at the zero lower bound, PLN currently suffers from one of the most negative real rates in the emerging market space (Figure 4 ).

While HUF weakened noticeably in recent days (following the surprising June National bank of Hungary cut), we don't see this as long-lasting. Not only was the 15bp cut modest, but the latest guidance suggests that only one additional 15bp cut will be delivered and the base rate is to stay at 0.60% - which is higher than in the Czech Republic and Poland.

We expect EUR/HUF to range trade around the 355 level in coming months

[See the full version of the CEE Economic Update: Gradual recovery, no deflation report for details and in-depth analysis of the individual CEE country outlook](#)

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