Bundles | 9 April 2021

Just can't get enough

Whether it's computer chips, vaccinations or organic milk, we just can't get enough given shipping's dire straits, the cure for Europe's coronavirus woes, or the farm ambitions of the European Union. So just what's going on in the world? You'll find answers here, including the market implications of next year's tight French presidential race

In this bundle

FX | France

Macron v Le Pen: How markets could react to a far tighter election in 2022

The 2022 French presidential election campaign has many similarities to 2017, but also some notable differences. Rates markets' reaction should be...

By Charlotte de Montpellier

Funky SOFR, or a plug-and-play? You choose

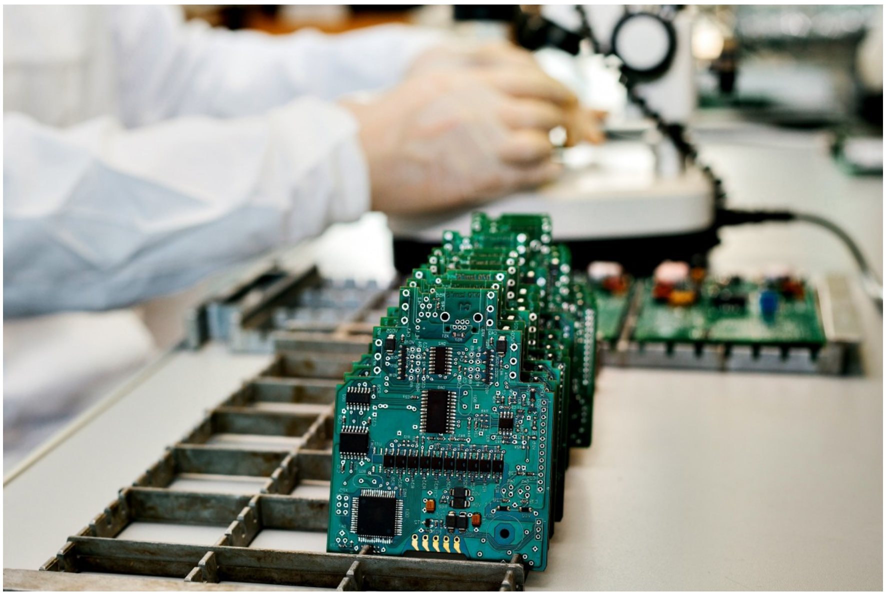
Some segments of the US market have been pining for two characteristics of Libor that are not present in SOFR. The first one will never be present in SOFR...

By Padhraic Garvey, CFA

Article | 8 April 2021 **Transport & Logistics | Corporate Sector Coverage | TMT**

Why semiconductors are as scarce as gold

A shortage of semiconductors is a continuing and major issue. The squeezed market is forcing manufacturers to slow down, weighing on recovery. And ongoing strong demand keeps the pressure on. A ramp-up of capital investment to boost production capacity helps, but it's going to take time before demand and supply are structurally in sync again



Demand and supply shocks squeeze chip markets

Computer chips are in short supply due to a sudden spike in demand linked to Covid-19. This demand shock is primarily caused by consumers who can't splash the cash on services such as restaurants and travel and who are now spending more on consumer electronics. The strong demand for home office equipment and faster than expected recovery from other sectors are also not helping.

The roll-out of 5G networks isn't helping

On top of that, 5G cellular networks are rolling out and there's a subsequent rise in demand for new compatible smartphones. While most semiconductor factories operate at maximum capacity, breakdowns at four Texas facilities due to extreme cold and a fire at a Renesas Naka factory north of Tokyo worsened the situation going into the second quarter.

Suppliers of game consoles and smartphones are having real trouble meeting the demand for their products due to the semiconductor shortage. You can also see it in the automotive industry where there've been production cuts and planned interruptions.

Structural demand for chips is growing rapidly

Although part of this demand shock is temporary, there's a structural dimension to rapidly expanding semiconductor usage. The market is expected to grow by double digits again in 2021 according to IC insights. Many devices that used to be completely analogue are now digital and supported by integrated circuits. For example, smart thermostats or light bulbs compatible with home systems contain significant computational power to support their functionality as well as digital connectivity.

Cars and trucks also require an increasing number of semiconductors thanks to the extension of integrated Advanced Driving Assistance Systems (ADAS) and board computers. The rise in the production of electric vehicles and future steps in autonomous driving will push demand up still further.

Supply issues may spill into 2022

Current lead times for chips can be as long as 26 weeks and up to a year for some specific variants. Recent incidents at facilities in the US and Japan put the lead times further under pressure. Despite significant planned investments in semiconductor production facilities, capacity will remain scarce well into the second half of 2021. Even if the acute shortage is resolved in the second half of the year, semi-conductor manufacturing lines will remain operating at near full capacity in the coming years making the industry sensitive to future supply shocks.

Capital investment boost will raise capacity, but this takes time

In order to meet growing demand, chipmakers started to ramp up investments. The Taiwanese company, TSMC, is boosting capital expenditure from USD17bn in 2020 to USD28bn in 2021. On top of that, the company plans to invest still more, to the tune of some USD100bn in the next three years to grow capacity.

Samsung also plans to increase semiconductor-related capital expenditure by 20%, up to USD31bn this year and announced there’s more to follow. Although these soaring investments will let supply catch up, this takes time and won’t bring much relief this year. Remember, chip production machines have long lead times. In the meantime, we notice that chip manufactures are ending volume discounts and some are also raising prices.

The science bit

- Chips production starts with wafers. A wafer (slice of semiconductor) acts as a substrate for microelectronic devices. Many so-called integrated circuits are printed on 200mm silicon wafers, being provided by silicon producers. Since the introduction of 300mm wafers in 2002, 200mm wafers were expected to phase out. Therefore, most investments in production capacity have been directed to production lines based on 300mm wafers.

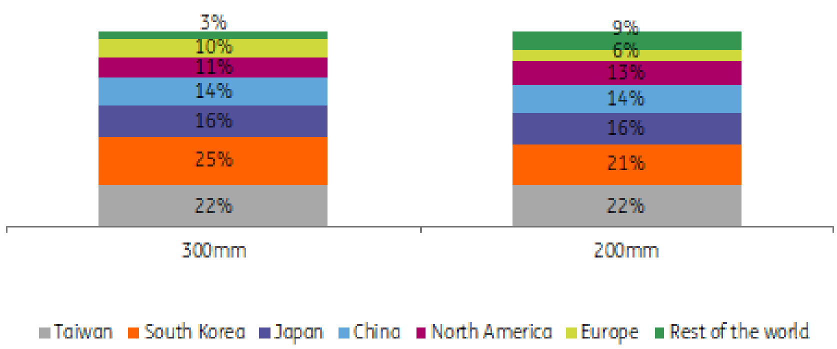
- However, 200mm wafer-based production is technologically mature, offering relatively low development and production costs and very stable manufacturing processes. Therefore, many of the less complex chips such as sensors and transmitters and the more basic processing units are still being developed based on this 200mm technology.
- The rise of smart devices and the Internet of Things (IoT) causes an unanticipated rise in demand for 200mm production capacity contributing to the shortage. Although fresh 200mm capacity is coming available in 2021, foundries may be a bit reluctant to invest in this slightly dated technology since 300mm wafer-based production is still expected to take over once production costs are sufficiently low.
- This means that supply is expected to remain weak compared to demand.

Most wafer production capacity concentrated in Asia

Manufacturers of electronic devices generally outsource their semiconductor production partially to large so-called foundries such as TSMC which produce wafers for third parties. Most installed wafer capacity (the capacity to process blank silicon wafers into chips) is based in Taiwan and South Korea. China and Japan also represent a significant share. Altogether 70-75% of supply is sourced from Asia.

Only a small portion is produced in Europe, making the continent dependent and sensitive to delivery issues. That's why the EU aims to create more capacity in its own region, and the US also intends to ramp up chip production as part of President Biden's recently announced stimulus plan.

Share of installed wafer capacity per region



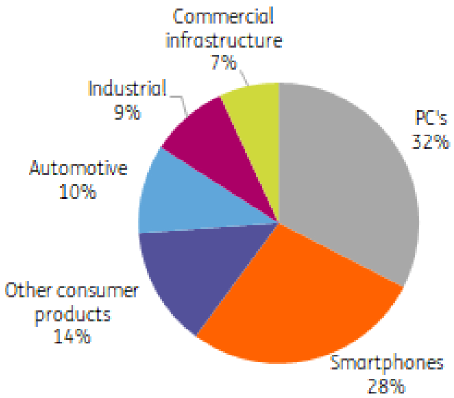
Source: IC insights, figures dec. 2020 (300mm), dec. 2019 (200mm)

Consumer electronics uses almost 75% of chip supplies

In a digitalising world with fast-growing data volumes, various production sectors are increasingly dependent on chip supplies. Manufacturers of laptops and smartphones are obviously the largest consumers of chips, taking almost 75% of the pie. The remainder is delivered to the automotive sector, other manufacturers and infrastructure purposes. However, as we've just mentioned, with objects being increasingly connected and with more intelligence being built-in, demand for semiconductors from all sides is on the rise.

Consumer electronics by far the largest chip user

Share of total worldwide chip spending per sector in 2019



Source: Bain & Company, ING Research

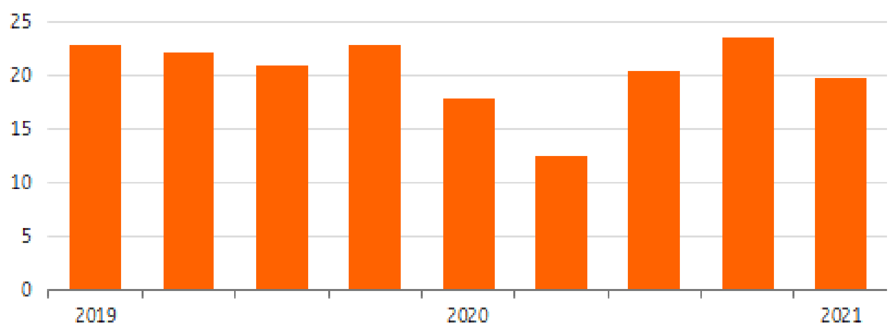
Automotive production takes a hit around the globe

The automotive industry has been especially hit hard by the semiconductor shortage. This is partly due to the common just-in-time manufacturing strategy. When automotive production was down 40% in the early days of the pandemic, many orders for car parts including semiconductors were cancelled. As demand for semiconductors recovered more quickly than expected, the spare production capacity has been allocated away from clients in the industry.

Carmakers seem to have overestimated availability. In the second half of 2020 manufacturers were struggling to get their hands on semiconductors Consequently these manufacturers cut or suspended production at sites worldwide for short periods.

Global car production at lower levels in 1Q 2021

Global production of cars and light duty vehicles in millions



Source: IHS Markit

Continuing chip shortage limits car production recovery in 2021

Chip shortages led to around a million fewer cars being produced in the first quarter of 2021, according to IHS Market; that's some 5% of total production and there were fewer cars being made than in the previous quarter. Compared with last year, global production is starting to recovery, but it's not easy to keep up with demand due to supply issues. Order books are full and lead times for new cars are up. We still expect global new car registrations to bounce back moderately but recovery is expected to remain limited and we'll see just a few percentage point rise.

Shortages add to disruptions felt by manufacturing countries

In terms of impact, the disruption will be felt most in countries with a relatively large dependence on automotive manufacturing, such as Germany. Due to the popularity of lean- manufacturing among automotive companies, production cuts will also be felt by automotive parts suppliers.

Consumer electronics companies are also facing supply chain issues resulting from the semiconductor shortage, which will hit the likes of South Korea. However, this is partly a result of the strong performance of the historically high demand for consumer electronics. Compared to car makers they seem to be in a better contractual position. Nevertheless, the industry would surely perform even better without the capacity constraints it's facing.

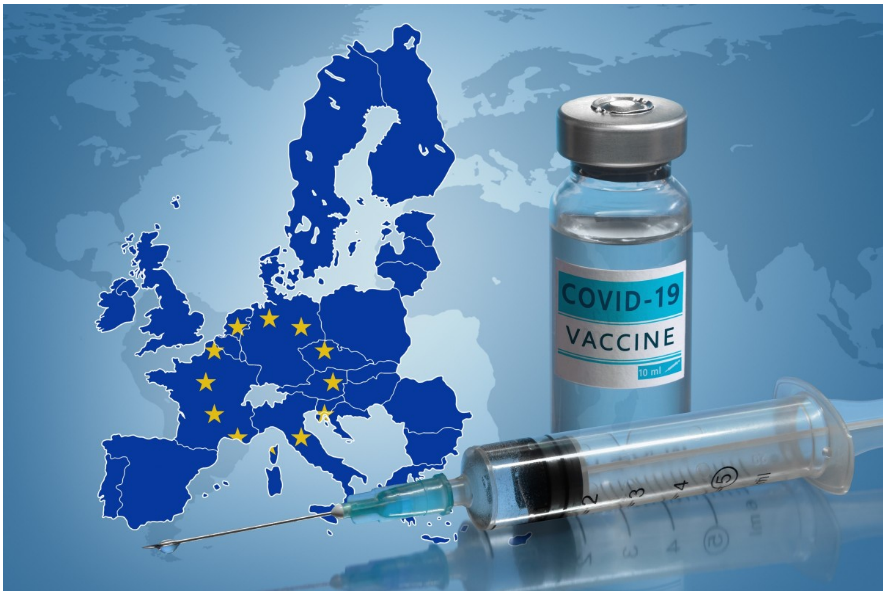
Author

Rico Luman
Senior Sector Economist, Transport and Logistics
Rico.Luman@ing.com

Article | 8 April 2021

Eurozone vaccinations: Is the needle moving?

Second quarter vaccination efforts will be key for eurozone economies' reopenings. For lost ground to be made up, promised supply needs to come in, vaccine take-up needs to improve and logistics need to be ready. If that's the case, eurozone reopenings are a lot closer than many think



Source: Shutterstock

The EU has had a rough start to the vaccination process.

Delayed supplies have followed a slower start than in other advanced economies, concerns about vaccine side effects impacting take-up, and rows with suppliers have turned the mood on the EU vaccination process so frosty that the Pfizer vaccine could be stored in it.

In this piece, we look ahead to see whether vaccination efforts can keep the eurozone economic recovery close in timing to the US and UK.

A rough start indeed...

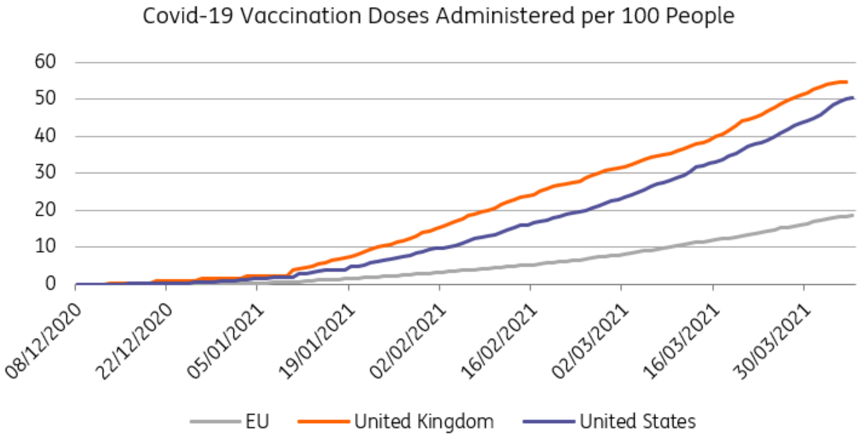
Most eurozone countries started the vaccination process with symbolic jabs at the end of 2020. The process has been one disappointment after another with a slow pace across the board. While individual countries have seen different teething problems, it seems that they are all in the same boat. A very similar amount of vaccines have been provided in most countries, all-around 15% of the population at this point. That compares to numbers between 40 and 50 percent for the UK and the US.

Expectations of when 70% of the adult population will be inoculated differ significantly for the EU.

Expectations of when 70% of the adult population will be inoculated differ significantly for the EU. Most countries still use a soft target of 'end of summer', which is months behind the US and UK and could prove costly as it likely means later reopenings. Bloomberg reported on an internal memo from the European Commission, which revealed the much more ambitious target of 14 July.

This is still significantly behind the US, set to get there in April already, and very ambitious given the weak progress made so far. Recall that US President Joe Biden announced that every US citizen would receive a vaccination offer by mid-April. While this makes the eurozone look far behind, much incoming supply in the coming weeks should help.

Where are we on vaccinations at the moment?



Source: Macrobond, ECDC, ING Research

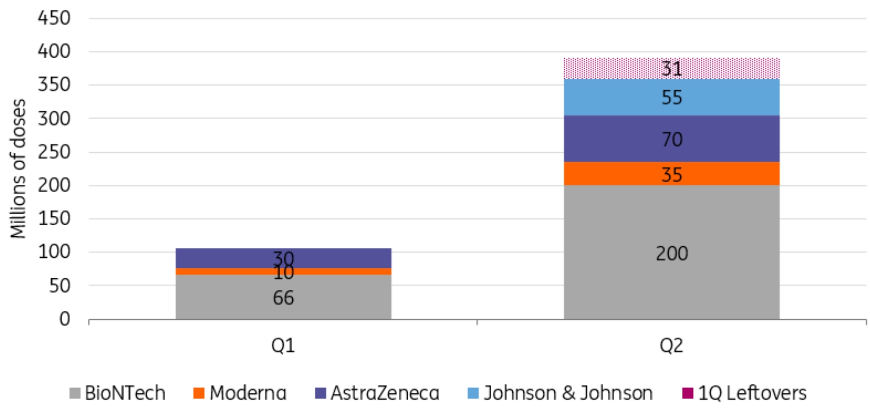
Supply is around the corner, or is it?

The second quarter will see large vaccine inflows, which is why EU countries are so far behind the US and UK at the moment and yet they only trail about eight weeks in terms of planning to reach 70% of the 18-year-old+ population vaccinated. The big question is whether the large suppliers will deliver the promised amounts of vaccines.

We're at the start of the quarter, and bad news has already come in as AstraZeneca has announced cutbacks of 60 million on the promised 90 million shots for 2Q. While this still allows for a total EU inflow that meets the 70% of the population mark, it shows that suppliers continue to struggle to meet their targets for the moment, and this uncertainty continues to cloud the Commission's projections.

Taking the incoming supplies and an estimate of unused vaccines, there will be enough vaccines supplied by the end of 2Q for 71% of the EU adult population to be vaccinated. That brings the 14 July target in play, but any hiccups in production (and eventually also in the take-up of the jabs) can push this out further into the summer.

EU supply is set to increase dramatically in 2Q



Source: European Commission President Von der Leyen March 17 statement, ING estimates

Are Eurozone countries prepared for the supply inflow?

So with the large supply coming in over the course of the current quarter, the next hurdle will be the logistics of vaccinating, which have so far been disappointing.

There are positive developments in this regard though as countries like France and Netherlands have recently made concrete progress in terms of setting up mass vaccination sites that allow for much faster inoculation than has happened until now.

If that is enough to process the large number of vaccines coming the EUs way has to be seen, it is not unlikely that these new efforts to mass vaccinate will still exhibit teething problems over the coming weeks. That adds to concerns about the possibility to achieve the Commission's early July target.

Vaccine doubts: more prevalent in the EU

It's not just supply and logistics that are the problem.

Willingness to get vaccinated continues to be a source of concern in the EU too. While vaccination eagerness increased at the start of the programme, doubts about the AstraZeneca vaccine, including the temporary halt, has increased worries about the take-up. Most recently, the willingness to take a vaccine has been declining in all large countries except for Spain. Instances of no shows at vaccination sites have been plenty, especially in large countries like Germany, resulting in doubts about vaccine take-up over the course of 2Q as well. If other countries show positive effects of the vaccination process like reopening economies and travel using vaccination passports, the impact of unwillingness could prove small, though but it does remain a downside risk.

No shows at vaccination sites are raising doubts about the vaccine take-up over 2Q

Besides that, the regulatory issues that evolve around the AstraZeneca vaccine also eat into the possible use of the 2Q supply. Local stops in using the vaccine due to possible connections to thrombosis and a back-and-forth regarding the recommended age groups for the vaccine have scrambled logistics and have caused further delays in shots. The question is whether this is a temporary or permanent restriction on ages. If the latter is the case, then the total amount of AstraZeneca shots supplied in 2Q may not be fully used again. Due to the sizable downgrade in AstraZeneca supply this quarter, it already lost some importance for total vaccinations, but it remains the second most important supplier.

Willingness to get vaccinated could cause countries to fall short of reaching herd immunity numbers

Source: YouGov, ING Research

Note: survey taken on March 11, with exception of Belgium for which the survey is from early February

Eurozone, still on track for a mid-year reopening

For the time being, things are looking ok.

Ambitious targets of 70% of the adult population vaccinated in early July would require the most optimistic scenario to materialise, which we deem unlikely

While vaccination rates remain well below levels seen in other advanced economies, the EU will see a surge in vaccine supply in 2Q. Ambitious targets of 70% of the adult population vaccinated in early July would require the most optimistic scenario to materialise, which we deem unlikely. Still, sometime this summer is doable but the latest delay could prove to be the tipping point for a summer re-opening, particularly in Southern European countries.

Given the eurozone's rather disappointing track record, however, the risk of more delays and a further falling behind the US cannot be ruled out.

Author

Bert Colijn
Chief Economist, Netherlands
bert.colijn@ing.com

Franziska Biehl
Economist, Germany
Franziska.Marie.Biehl@ing.de

Article | 6 April 2021 Commodities, Food & Agri | Sustainability

Why the dairy industry will struggle to meet the EU's organic targets

The EU Farm to Fork strategy aims to make the food ecosystem more sustainable. While one of the ambitions is to increase the share of organic agriculture to 25% by 2030, there are major obstacles to overcome before it can be met, notably in the dairy sector

Organic dairy cows on a farm in Ireland

Our take on the Farm to Fork strategy and the dairy sector

The EU Farm to Fork (F2F) strategy is part of the Green Deal and provides a high-level ambition for the EU food ecosystem.

While many goals in the F2F strategy impact the dairy sector, the target to have at least 25% of all farmland under organic farming in 2030 particularly catches the eye. Although the dairy sector is an important user of agricultural land, only 4% of the current dairy herd is organic.

Major dairy companies have yet to embrace the organic target

Major dairy companies have yet to embrace the organic target, encompassing a large shift of supply and demand. Proposed policy measures in the F2F tend to focus on developing supply, implying it's mainly up to dairy companies and retailers to stimulate demand for organic products. This only works if consumers are willing to pay a premium or if the EU compensates dairy farmers for their additional efforts.

An increase in organic dairy farming puts pressure on milk volumes and leads to a higher cost price. This could leave dairy processing plants underutilised. Companies that rely on exports and dairy commodities will especially face difficulties translating additional costs into higher product prices.

Obstacles ahead

The road ahead is not without obstacles. Although the F2F targets are clear their ability to bring about change is still uncertain. As for the 'organic' target, we see four major obstacles that will ultimately determine if it will be successful.

1 Support from EU countries and the (dairy) sector

From the beginning, the F2F strategy has received mixed support from farmers, industry organisations and agricultural ministers due to concerns over farm income, competitiveness and food security. The organic target receives mixed support within the dairy sector because it could offset earlier progress on lowering CO2 emissions and land use.

2 Implementing a coherent set of policy measures

Changing food systems requires the integral support of several departments such as agriculture, health and the environment and an interlinked set of measures at the national and European level. However, the discussion on the reform of the Common Agricultural Policy budget shows the difficulties of redirecting EU funds from conventional farming practices towards those which are more linked to sustainability.

3 Overcoming transition costs and risks for farmers

While the number of organic dairy farmers is growing, transition-related costs and risks are a major hurdle for more farmers to follow suit. If society expects farmers to change tack, the bill for their extra efforts must be paid by someone in the end.

4 Creating consumer awareness and willingness to pay a premium

It will take continued effort from companies and policymakers to ensure consumers value sustainability-related efforts made in agriculture. Currently, only one in five EU consumers is willing to spend more on sustainable food, according to a survey by BEUC - the European consumer organisation. On top of that, limited demand for organic dairy in the export and commodity markets is a bottleneck because that's where many dairy companies are earning a large share of their revenue.

Spotlight on organic farming in the farm to fork strategy and the dairy sector

Many of the targets in the F2F and related policy proposals impact the dairy sector. But the one that probably has the biggest economic impact is the target to use at least 25% of total farmland for organic farming by 2030. It's also a complex target to reach because it involves commitment from every stakeholder in the value chain. While it's the first time such a quantitative target has been set, the interest in organic is not new.

For example, the first EU action plan on organic dates back to 2004 and the EU organic sector in general. The organic dairy sector, in particular, has been growing over the past two decades.

25% organic farmland, an ambition but no hard target

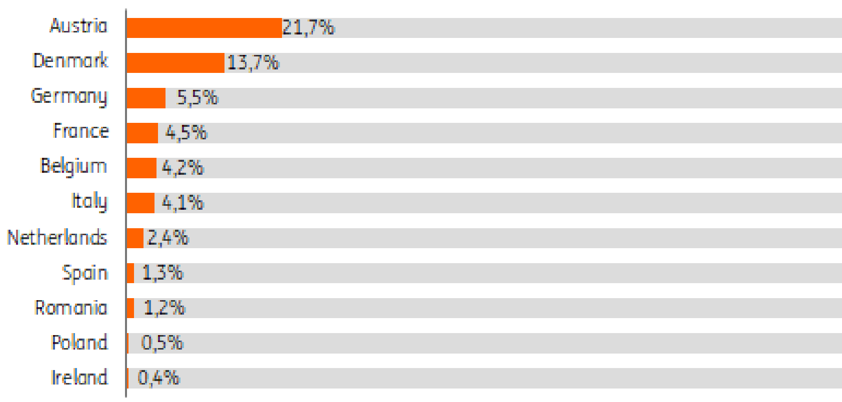
It is worth noting that the 25% organic target is set for all EU farmland, and it seems highly unlikely that there will be a specific target for dairy farming. Still, the dairy sector is an important agricultural land user for grazing livestock and the production of feed crops. Given that around 4% of all the dairy cows in the EU were organic in 2019, it's clear that the sector will have to think about how it can contribute.

If the likes of Germany and France are far from the intended target, it will be quite impossible to reach

EU officials like vice-president Frans Timmermans and Agricultural commissioner Janusz Wojciechowski have indicated that the 25% is an EU average and that every country is supposed to go the extra mile regardless of their current share. What's also clear from the outset is that if agricultural heavyweights such as Germany, France and Spain remain far from the intended target, it will be quite impossible to reach.

The organic dairy herd is relatively small in most EU countries

Share of organic dairy cows in total dairy herd in top 10 dairy producing countries in EU, 2019



Source: Source: Eurostat, ING Research

Organic dairy farming is still quite small

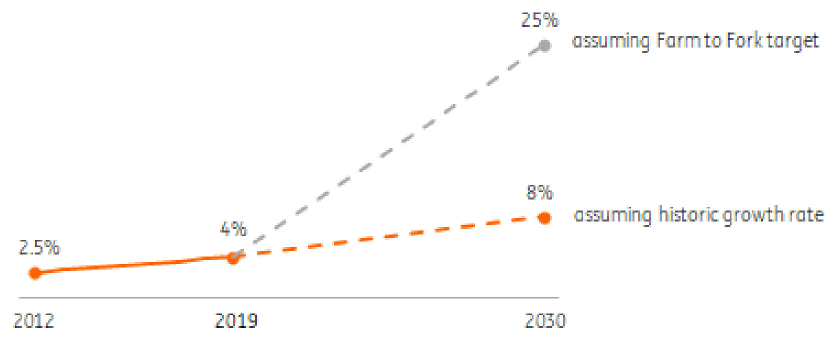
There are big differences between EU countries as far as organic production in the dairy sector's concerned. Austria is the frontrunner as almost a quarter (22%) of the dairy herd is organic. In major dairy-producing countries like Germany, France and the Netherlands, the share lies between 2.5% to 5.5%.

There are big differences between EU countries as far as organic production in the dairy sector's concerned

Although the organic share in the EU dairy herd has been growing from 2012 to 2019 (Compound Annual Growth Rate: 6.7%), a simple continuation of that growth rate wouldn't be sufficient. In that case, the share would end up around 8% in 2030, nowhere near the Farm to Fork ambition.

Historic growth patterns won't be sufficient to reach F2F goal

Percentage organic dairy cows in total dairy herd



Source: Source: Eurostat, ING Research, *first year available

Reaching the target involves every part of the value chain

To support the growth of the organic market, every stage from farm to fork is important.

The share of organic farmland will only increase when there are farmers who want to produce, dairy companies that are able to process the milk and create added value, retailers and caterers who see opportunities to market these products and consumers who are willing to pay a bit extra.

While the F2F strategy proposes measures that can influence everyone involved here, they tend to lean more heavily on influencing the supply side and less on demand related measures. This can prove difficult as a balanced development of both supply and demand is needed.

More organic milk means more value but less volume for dairy farmers

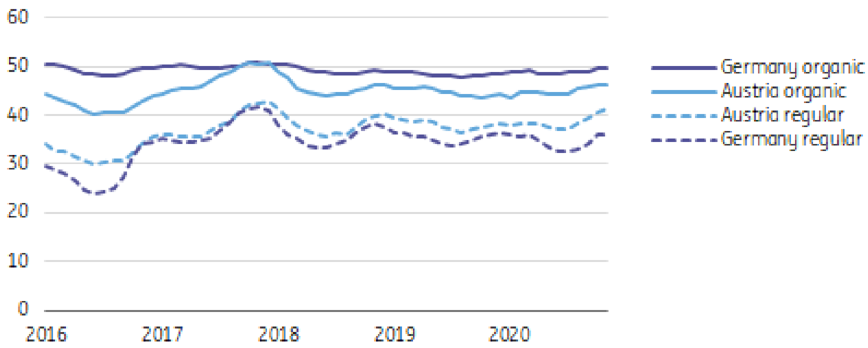
EU projections show a slight decrease in the dairy herd this decade. With that in mind, assuming a 25% share for organic in the dairy herd means the number of organic dairy cows would have to multiply by almost six to around four million in 2030. We estimate more than 100,000 dairy farmers would have to convert from conventional to organic farming in such a scenario. There is definitely interest among dairy farmers to make this step, but the transition period of at least two years and uncertainty about future organic milk prices also pose additional risks for farmers.

The financial perspective can become more attractive because organic milk trades at a premium

Once converted, the financial perspective can become more attractive because organic milk trades at a premium. In Germany, this premium was on average 15 cents per litre in the last five years and in Austria eight cents per litre. Whether this premium is enough to compensate for lower milk production on organic farms (on average more than 20% lower) and a higher cost price per litre differs from farm to farm.

There is a steady premium for organic milk in Germany and Austria

Monthly milk price, eurocent per litre



Source: Source: AHDB, ING Research

Dairy companies need to have balanced supply and demand growth

The EU Green Deal and F2F have far-reaching implications for dairy companies. While the reduction of CO2 emissions has become an explicit target in the sustainability strategy of major dairy companies, increasing organic production is often not yet, at least, part of this strategy. Still, dairy companies play a decisive role in the development of the market. Dairy companies actively coordinate the supply of regular, organic and other added value milk (such as genetically modified or GMO-free), and some have been making a foray into plant-based drinks.

The challenge lies in making sure the supply of organic milk is in line with demand

Simultaneously, they can stimulate demand either individually or in coordination with retailers and food service clients. The challenge lies in making sure the supply of organic milk is in line with demand. Higher cost prices can be successfully passed on to customers to ensure a profitable business model for themselves and associated farmers.

While total dairy supply in the EU is expected to grow towards 2030, an acceleration of organic farming could hamper this trend. And that, in turn, could put pressure on the capacity utilisation at dairy processing plants.

Read more about plant-based drinks here

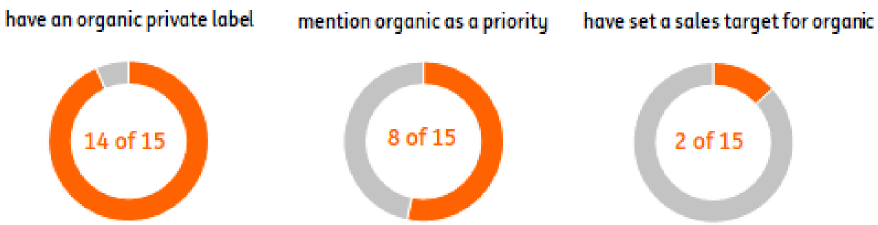
Major food retailers are taking extra steps

Retailers acknowledge the need for greening their supply chains but are also wary of losing price-sensitive customers to competitors. General sales of organic products in the EU reached 41.4 billion EUR in 2019, and conventional supermarkets have introduced more branded and private label organic products across all categories.

An assessment of fifteen major EU retailers shows that more than half of them have earmarked organic as an important element within their sustainability strategy. However, our analysis also finds that hard targets on sales of organic products are uncommon. Given the prominent position of retailers towards European consumers, it would boost the F2F goals when retailers finally incorporate these targets into their sustainability strategy. However, it remains uncertain whether this will happen without more directive policies.

Organic products are mainstream, specific sales targets for organic products are not

Out of a sample of 15 major European food retailers..



Source: Source: Company information, ING Research

The Farm to Fork strategy in a nutshell

In May 2020, the EU Commission presented the Farm to Fork Strategy for a fair, healthy and environmentally-friendly food ecosystem. The Commission charts an ambitious course in which longer-term sustainability gains are favoured over short-term productivity gains in the strategy. The strategy includes promoting organic farming and reducing nutrient loss, use of antimicrobials and pesticides in agriculture towards 2030, plus a set of broader policy actions.

While the 'what' is clear, the 'how' is still a topic of fierce debate in Brussels. Due to concerns about farmers' income, competitiveness and food security, it's not clear how much support the Commission will get from the European Parliament and the member states to effectively carry out the F2F strategy.

Author

Thijs Geijer
Senior Sector Economist, Food & Agri
thijs.geijer@ing.com

Article | 8 April 2021 Transport & Logistics

Rising costs and less capacity: Shipping's extraordinary global predicament

The vessels delayed by the Ever Given incident are on the move but problems aren't over. Ocean freight has already been disrupted by the pandemic, leading to spiking container tariffs and 7 out of 10 vessels arriving late. The Suez incident will keep the market off balance for longer, fuelling ongoing capacity constraints and elevated rates

The Ever Given container ship was refloated in the Suez Canal at the end of March

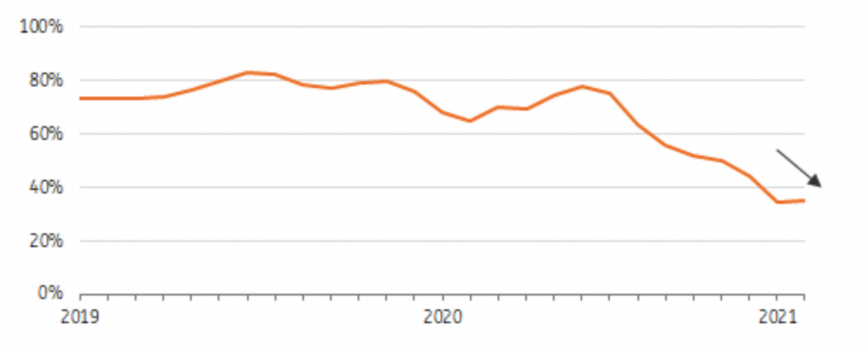
Reliability container shipping further down

After successfully refloating the container carrier Ever Given, the impact on already stretched supply chains is yet to follow. The last of the 350 vessels delayed by the blockage resumed their journeys over Easter, which will lead to an expected wave of calls at Europe's largest port, Rotterdam, from the second half of this week. The port will adapt where possible but longer waiting times to enter the terminals seems inevitable. The port handling bottleneck and transport capacity constraints further down the line will push deteriorating delivery times up further for shippers of electronic products, clothes and manufacturing components; and they will last longer than the Suez blockage itself.

Normally 75% of container vessels arrive on time globally but in the last two months, this reliability measure sank to only a third, as you can see in the chart below. The Suez blockage will drag vessel reliability further down in April, leading to inefficiency and extra costs.

Share of containers arriving on time expected to further drop due to the Suez blockage

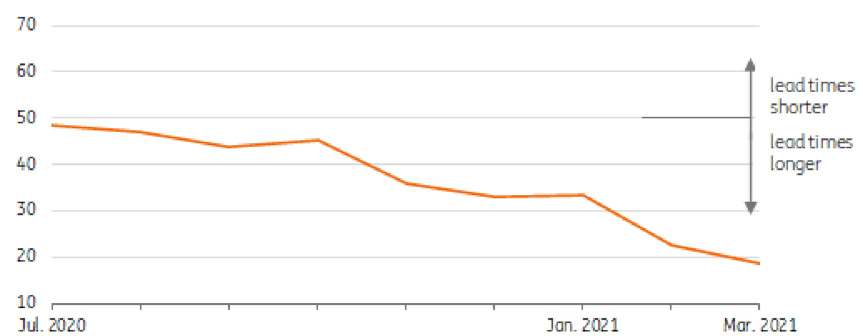
The reliability of container vessels worldwide (share of vessels arriving on time)



Source: Sea Intelligence, ING Research

Lead times for manufacturers in the Netherlands further deteriorate

Index developement of delivery times per month



Source: NEVI

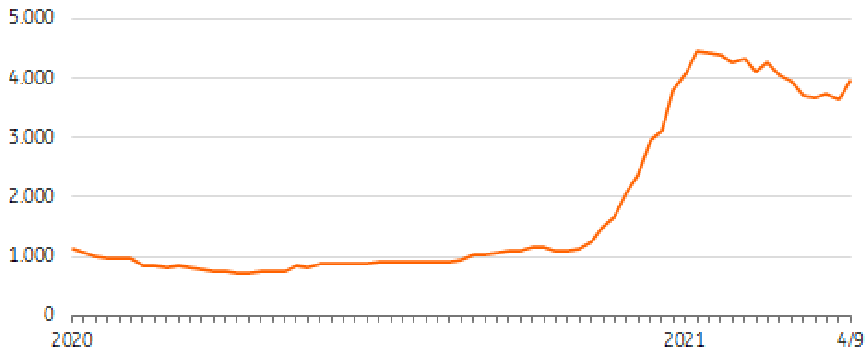
Stretching of supply chains will keep tariffs higher for longer

The grounding of the Ever Given came at a critical moment for global supply chains and the container shipping market. Following the mix of an unexpected swift return of volumes, delayed vessels, capacity constraints in ports and container shortages, tariffs spiked in the fourth quarter of last year, as you can see below.

The cost of shipping a 20ft container from Shanghai to Europe peaked at $4,400 in mid-January, roughly four times the 10-year average. While elevated tariffs on the East-West trade had started to slide after the Chinese New Year, spot rates stopped decreasing. In order to rebalance capacity, the container network liner Maersk even temporarily suspended short term bookings early april. The Suez-delays consequently resulted in additional capacity constraints, while spare capacity is already scarce, putting renewed upward pressure on container rates which had just started to decline.

Suez blockage leads to new upward pressure on container rates

Development of containerised freight rates (spot) Shanghai-Europe trade $ per TEU (20ft) (40ft=*2)



Source: Clarksons, ING research

Author

Rico Luman
Senior Sector Economist, Transport and Logistics
Rico.Luman@ing.com

Macron v Le Pen: How markets could react to a far tighter election in 2022

The 2022 French presidential election campaign has many similarities to 2017, but also some notable differences. Rates markets' reaction should be more contained than then, as long as leaving the EU stays off the agenda. In FX, a risk premium is already visible in implied volatility ahead of the vote, but EUR/USD spot should be unaffected this year

Emmanuel Macron and Marine Le Pen could face each other in a tight election in 2022

Similarities, but mostly differences

In some ways, the French presidential elections scheduled for 8th and 23rd April 2022 may seem like a re-run of 2017: all the polls point to a second-round contest between Marine Le Pen and Emmanuel Macron, with Macron winning.

Yet, on closer inspection, the April 2022 election will be fundamentally different from that of 2017. First, the polls point to a much closer election result. 53% of the votes for Emmanuel Macron vs 47% for Marine Le Pen in the second round. So, a likely re-election then but one that's far from certain. In 2017 Macron won 66% of the vote.

Moreover, the context is fundamentally different. Macron (La République en Marche!) will no longer be at the head of a brand new party but will have to defend the record of his first mandate. And that mandate has been marked by social issues, notably the 'Yellow Vests' crisis and climate protests but also, and above all, by the covid crisis and its economic fallout. This has prevented him from implementing a whole series of reforms promised during his election, particularly with regard to the delicate issue of pensions.

Economic recovery and more optimism could help Macron perform better than polls currently suggest

Nevertheless, if, as we believe, the French and European economy rebounds strongly in the second half of 2021 and early 2022, in turn fostering optimism and confidence, the economic context could help Macron and make it much easier to defend his record. It is possible that Macron's current fragility in the polls is partly related to general discontent because of the Covid-19 crisis and the desire to send a warning. A context of economic recovery and more optimism could help Macron perform better than the polls currently suggest, notably by reducing the number of likely abstentions (which is set to be very high according to current polls).

47% Support for Le Pen in a presidential run-off against Macron in 2022

Compared to 33.9% in 2017

A less aggressive strategy from the right

Marine Le Pen (Rassemblement National) will also be part of a completely different configuration. In 2017, her party had changed its name and was engaged in a campaign of 'de-demonising' the far right. Currently, the party seems to be less inclined towards an aggressive strategy and in a global context, that seems less promising, at both national and international levels. Indeed, at the national level, the issues of relocation and protection of strategic companies, usually favoured by nationalist candidates, has been addressed and defended by the entire French political class following the pandemic.

Internationally, nationalists seem to have less wind in their sails than in 2017

Internationally, nationalists seem to have less wind in their sails than in 2017, as evidenced by the defeat of Donald Trump and the rallying of Matteo Salvini to Mario Draghi's pro-European government in Italy.

Marine Le Pen will probably use the European difficulties of the vaccination campaign to support her nationalist message in her election campaign. However, it is not certain that this narrative will still have appeal in 2022 when herd immunity could well have been achieved and the economic recovery set to be well underway. This is probably why Le Pen is currently trying to position her party on issues other than her current favourite ones, namely security and immigration. Economic issues seem to have become more important in her statements, while promises such as leaving the EU and the euro have disappeared from her programme. The coming campaign will show whether this is a success or not.

A surprise in the first round cannot be ruled out

Even if all the polls currently point to a Macron-Le Pen run-off in the second round of the elections, it is still far too early to be certain about this outcome. The next few months will be crucial, as all parties unveil their candidates for the first round. One of these could still pull off a surprise and make it to the second round. Again, the differences with the 2017 election are significant.

If in 2017 the “Les Républicains” party had long-hoped to make it to the second round before judicial affairs caught up with François Fillon, their hope of making it to the second round is much lower for 2022. François Fillon has been sidelined and former president Nicolas Sarkozy has been caught up in serious legal troubles and convicted (the appeal procedure is underway). The only candidate currently known on the right is Xavier Bertrand, but the polls do not indicate that he has much chance of reaching the second round.

> *Some hope there will be one common candidate for the whole of the left*

On the left, negotiations are underway, with some hoping to present one common candidate for the whole of the left (“Parti Socialiste”, “Europe Ecologie Les Verts” and Jean-Luc Mélenchon's “France Insoumise”). This possibility seems unlikely at the moment, as Mélenchon wants to run anyway and has a personality that is a bit too divisive to bring together the whole of the left-wing electorate. An alliance between the Greens and Socialists remains possible, with a single candidate who could be Yannick Jadot or Anne Hidalgo. However, even if the result of such an alliance would be better than the one obtained by the left in 2017, it would not allow the left alliance to reach the second round, according to the polls.

Ultimately, Emmanuel Macron seems capable of being re-elected in 2022 after defeating Marine Le Pen in the second round. He is currently trying to bring together the left and right strands of the electorate, via a climate and a global security law, and could be helped by an economic recovery. Nevertheless, the campaign has not really started yet, and recent French political history suggests that anything is possible. No scenario can be completely excluded. Social unrest, an epidemic rebound or too long a delay in the economic recovery could change the situation. European issues, notably the discussions on future budgetary rules, could also have a significant impact.

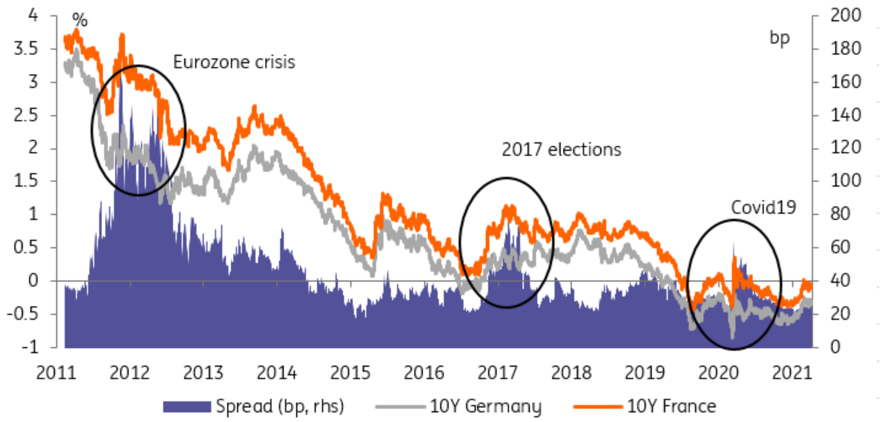
Rates markets: A more benign ‘Le spread’ with Frexit off the table

The run-up to the 2017 presidential vote saw some pretty dramatic price action in financial markets. It is worth looking back on these events to assess the likely reaction to next year’s vote.

The main concern at the time, exemplified by the sharp widening of the 10Y Germany-France spread - jumping over 80bp, compared to a 5-year average of 33bp - was the risk of an exit from the EU and the eurozone. A Frexit.

Looking at the polls in the run-up to the vote, the risk of Le Pen, then a champion of Frexit, reaching the run-off was rightly deemed significant. More importantly in our view, the risk of two pro-Frexit candidates (Le Pen, far-right, and Mélenchon, far-left) making it to the run-off was deemed non-negligible. And indeed, Le Pen made it, and Mélenchon came a close fourth, with only 1.6 million fewer votes than Macron in the first round of voting. In other words, it was a close shave.

The 2017 election saw the second biggest jump in French spreads of the past 10 years.



Source: Refinitiv, ING

Fast forward to 2021, Frexit has dropped off the agendas of both Le Pen and Mélenchon. In addition, while the former now stands an even better chance of making it to the run-off, Mélenchon is credited with less support than in 2017. We would not underplay how much of a shock a Le Pen victory would be for financial markets, but the seismic consequences of Frexit seem to be off the table.

> *We don't underplay how much of a shock a Le Pen victory would be for financial markets*

We would not downplay the risk of a material increase in rates' volatility into next year's vote and, in particular, in French spreads. For one thing, polls show that a Le Pen victory can no longer be dismissed out of hand. We have but a hazy idea of campaign platforms and themes this early before the vote but a long-time eurosceptic in the Élysée Palace would bode ill for future European integration. Also, by April 2022 bond markets won't be able to count on support from the ECB's main asset purchase programme, PEPP.

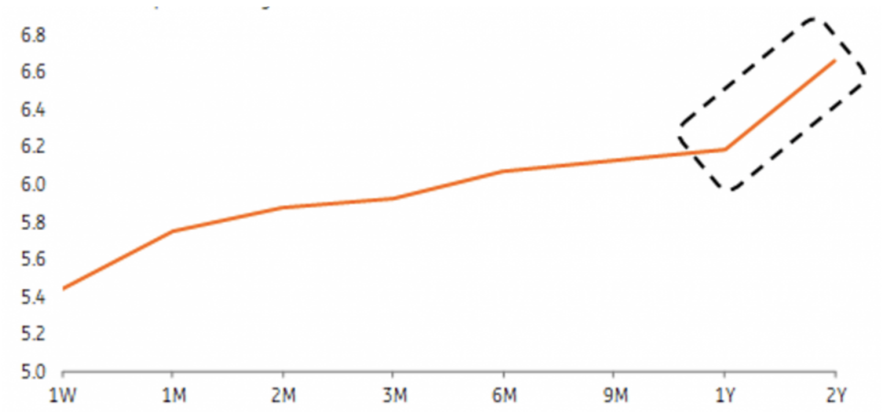
EUR: The French election risk a story for FX volatility for now but not for FX spot

For now, we expect the spectre of the 2022 French presidential election risk to be rather a story for EUR/USD implied volatility markets than for the spot market. As our chart below shows, the EUR/USD implied volatility curve already exhibits a kink in the term structure around the April 2022 election date.

As for the EUR/USD spot, the prime driver for the coming months should be the road towards the expected summer eurozone economic recovery, helped by a faster vaccination process, the resulting improvement in poor eurozone activity data and the re-pricing of the bad news priced into the EUR/USD. This is evident in our short-term fair value model, which sees EUR/USD as undervalued by close to 2% at this point.

French presidential election risk premium already evident in EUR/USD implied volatility

EUR/USD ATM implied volatility term structure

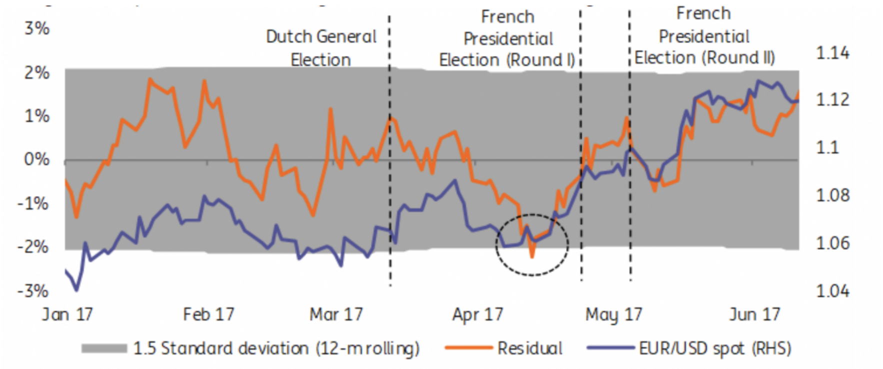


Source: ING Research

Using the same model, we gauge the amount of the risk premium built into the EUR/USD ahead of the French election in 2017. As you can see in our chart below, there was a meaningful risk premium ahead of the first round of the vote, with EUR/USD being more than 2% undervalued and trading outside its 1.5 standard deviation band. This is when market concerns peaked but, as it became apparent that Marcon was still likely to win, the risk premium got fully got priced out by the time of the first round – and EUR/USD jumped.

In 2017, the election risk premium was worth more than 2% in EUR/USD

Residual between EUR/USD financial fair value and spot. Large and persistent mis-valuation is a sign of a risk premium (as other things than normal drivers are affecting EUR/USD)



Source: ING Research

While the polls look much tighter now than back in 2017, things look set to improve in favour of the market-friendly candidate Macron by the time of the election; the economy should recover and the worst of the Covid situation should be over. That suggests that the EUR/USD risk premium ahead of the 2022 elections may not exceed that observed in 2017.

Importantly, the associated election risk premium in EUR/USD spot should be apparent in the cross much closer to the election date (in 2017, the French election risk premium started to be built into EUR/USD less than one month ahead of the event) rather than this year, allowing EUR/USD to focus on eventual positives this summer and the pair to move to the 1.25 level by summer.

Author

Charlotte de Montpellier
Senior Economist, France and Switzerland
charlotte.de.montpellier@ing.com

Antoine Bouvet
Head of European Rates Strategy
antoine.bouvet@ing.com

Article | 7 April 2021

Funky SOFR, or a plug-and-play? You choose

Some segments of the US market have been pining for two characteristics of Libor that are not present in SOFR. The first one will never be present in SOFR – a bank credit element. And the second – term (or forward) rates – are not being promised in a timely manner. That opens the field up to other bank rates, with pros and cons, as such rates have more spike risk

It is theoretically satisfying to separate a borrowers rate out as separate 1. Risk free, 2. Systemic and 3. Credit components

Libor incorporates bank risk. SOFR never will. It is partly the point of SOFR; a risk free rate (the Secured Overnight Financing Rate).

Why could this be an issue? Well, it makes sense to deploy a discount rate that reflects the riskiness of the project being financed. So, banks should discount their banks risks using a discount rate that reflects that risk. Such risks are not risk free; they reflect systemic risk. Furthermore, the rate paid by a borrower from a bank then adds an applicable credit spread.

Within any rate paid to a bank by a borrower, there is a clear separation from the risk free rate (as effectively set by the Fed), plus bank systemic risk, plus the borrowers unique credit spread. A tighter credit spread then would reflect a reward for an improved corporate performance. And if a borrower has a steady credit record, then a rise in the rates it pays should only reflect a rise in the risk free rate or a rise in systemic risk.

With SOFR, there is no immediate impression of the price of systemic risk

With SOFR, there is no immediate impression of the price of systemic risk, as it is effectively lumped into the borrower's credit spread. If systemic risk then rises, the borrower sees it in their credit spread, even if their credit circumstances are steady, or even improving.

In current circumstances, for example, Libor could be compared with the fed funds rate to understand pure bank risk, or players have used the 3mth FRA-OIS spread to achieve a more theoretically sound version.

Hence some calls for a separate bank credit element to be added to baseline SOFR.

Alternatives to Libor that maintain the bank risk element, not contained in SOFR, are on the horizon

Bloomberg had been working on just such an add-on. But they have since changed course, and have instead developed an all-in rate that incorporates a bank credit element. It in fact looks and smells like Libor, as it is forward-looking and contains a bank risk element.

Libor today is effectively where banks fund themselves, through commercial paper and the like. The Bloomberg Short Term Bank Yield Index (BSBY) does something similar by widening the scope to include certificates of deposit and wider deposits so that a critical volume mass is achieved and then finessed by excluding the usual rump of outliers.

BSBY is in effect not too deviant to how Libor is derived today, but with the volumes and benchmark compliance to match.

An analysis of the behaviour of Libor versus BSBY over time shows they trend together. There is on average a spread between the two of a little over 4bp, with BSBY trading below Libor. The spread has seen a high of 19bp and a low of -4bp, concentrated in periods of extreme, like when Covid broke. Beyond that, the 5yr mean is 4.3bp and the 5yr median is a tad below 4bp.

The fact that BSBY is below Libor is likely a reflection of the volumes of deposits included in its calculation, whereas Libor is more structured around the commercial paper print (ever since the Great Financial Crisis effectively killed the interbank volumes that had underpinned Libor).

Bloomberg's BSBY, Ameribor and ICE's bank yield index are all runners

While BSBY has stepped to the fore, it competes with other rates. One is the American Interbank

Offered Rate (Ameribor), which is based off overnight unsecured loans on the AFX exchange, mainly reflecting small, regional US banks. This trades slightly above Libor. There is an Ameribor 30-day term rate, an added positive, but beyond that 1mth point it does not provide longer forward characteristics that some might require. It does have the bank credit aspect though and is supported by 3mth futures (which suggests that a term rate could be derived).

Ameribor is another bank risk in arrears alternative, with ICE's bank index offering forward rates with bank risk incorporated

A hotter alternative comes from ICE, in the guise of the US Dollar ICE Bank Yield Index (BYI). It is forward looking, and is derived by collating unsecured transaction on the primary and wholesale market centred on yields on dollar funds over 1-month, 3-month, 6-month and 12-month periods in large internationally active banks. Preliminary historical data published by ICE show the current difference with 3-month Libor is about 1bp; BYI has been above and below Libor at times, but now slightly below.

And for completness, the aforementioned Bloomberg's BSBY is also an index that has term, mapping out 1-month, 3-month, 6-month and 12-month rates (all forward looking).

The lack of a term SOFR rate at the very least opens the conversation on alternative term rates

Meanwhile, the Alternative Reference Rate Committee (ARRC) has pre-warned that a term SOFR rate may not be available by end-2021, and that participants should make other plans. This is causing some participants to seek alternatives.

There is value in having term rates; the ability to execute a loan or swap today that references, say a 3-month rate, and know the exact rate that will have to be paid in 3 months. Pure 3-month SOFR does not work like that, as the rate to be paid only becomes clear at the end of the 3 month period, calculated as the (compounded) average of the journey of overnight rates over that full period (likely adjusted by a 3-5 day lookback for practicality purposes).

The bulk of players are willing to adjust to the deployment of SOFR in arrears, but there is a sizeable rump that balk at this.

In the UK, expected term-Sonia take-up in the region of 10% of volumes provides a steer as to the potential size of this wider segment for the US. Players involved in trade finance and working capital management are active here, but there is an extension beyond that to operations that simply have a preference to deal with a term plug and play replacement term rate.

Key point - forward rates come with heightened spike risk. This risk is abated in SOFR, especially when set in arrears - a clear positive

To square the circle here, it must be asserted that the likes of SOFR in arrears has a protective structure that significantly mitigates the effect of multi-day spikes in the underlying rate, for whatever reason. This is so, as the benchmark 3mth rate would be a (compounded) daily average, so the impact of a couple of out-sized observations would not be determinative. In contrast a reset using a term (or forward) rate must take the rate on the reset day, which could be at the height of a spike. That's the risk with a forward looking term rate, and especially one that has a direct link to systemic risk.

So, market participants have choices to make. The odds still firmly favor SOFR being the dominant rate. It's risk free and has a handy averaging feature to help dampen extremes. It is a base on top of which other components can be added as required.

The ARRC's decision not to provide timely term SOFR rates (partly on a disappointing build in SOFR volumes) has at the same time opened the field up. Some players that were holding out for a term SOFR rate may prefer one of the alternatives. A subsequent build in volumes in such rates would be self-fulfilling as derivatives are latched on around them.

But don't forget the volatility reducing advantage of the in-arrears construction, and that is where SOFR in it's purest sense will maintain a strong underpinning.

Author

Padhraic Garvey, CFA
Regional Head of Research, Americas
padhraic.garvey@ing.com

Disclaimer