Bundles | 26 June 2020

What you need to know about the slow Covid-19 recovery

ING's economists have been focusing on Europe's painfully slow recovery from the coronavirus crisis this week. Our podcast, however, looks at why some markets seem to be shrugging off the Covid-19 threat. The Fed's balance sheet comes under scrutiny from our Credit team, and if sustainable bonds are your thing we have that covered in our comprehensive A - Z

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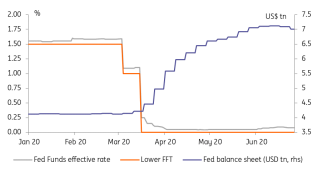

Rates Spark: Fed's balance sheet glides lower, again

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Eurozone Quarterly: The gradual, but not great, re-opening

As ever, the EU is muddling through. The post-pandemic recovery response has been robust, but we think there will be more. The gradual re-opening of the economy provides hope, but with social distancing norms here to stay and inflation still not going anywhere, a subdued recovery is all we expect. And we seem to be inching closer to the common bond dream too

Source: Shutterstock

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Article | 22 June 2020 Germany

Germany: Austerity champion turns into a big spender

Thanks to the government's U-turn on fiscal policy, Germany should be one of the first and strongest countries to emerge from the crisis

Source: Shutterstock
German Chancellor Angela Merkel takes part in virtual EU Summit, Berlin, Germany

Available hard data for the second quarter was dreadful. After declines in March, industrial production and exports continued to drop like a stone in April.

Without any changes in May and June, the economy would contract by up to 30% quarter-on-quarter. However, more experimental and real-time data suggests that the economy has experienced a sharp rebound since the lifting of the lockdown measures. Remember that Germany, together with Austria, was the first eurozone country to start easing the lockdown measures at the end of April.

Google mobility data and the German truck toll mileage index, social-economic activity had returned to some 90% of its pre-crisis level by early June. While the month of April was the worst month ever in terms of economic data, the month of May could become one of the best.

First a 'v' but then what?

Looking beyond the expected imminent rebound, the prospects for the two former growth engines

of the economy do not look too promising.

Industrial production and exports - which had already been suffering from structural disruptions, the trade war, Brexit uncertainty and less demand from China - are unlikely to kick-start the recovery. During the financial crisis, Asian countries played an important role in the swift recovery of German industry. Today, there is no saviour in sight to boost external demand.

Therefore, the strength of the rebound will depend strongly on domestic demand.

Labour market under pressure

Up to now, a strong labour market had been the main argument in favour of continued strong domestic demand.

However, the tentative increase in unemployment and the sharp surge in short-term work schemes have weakened private consumption. In the current crisis, employees subject to these short-term work schemes will receive up to 85% of their last salary for up to 12 months. At the peak of the financial crisis, some 1.5 million employees were on such schemes. However back then, it was largely the manufacturing sector which was hurting the most, with some 80% of all employees in this sector working on short-term schemes. In contrast, the current crisis has hit the economy almost indiscriminately, with between 25% and 31% of all employees in the manufacturing sector, trade and services, working on these schemes. The construction sector is one of the few positive exceptions, which has been barely hit by the crisis so far.

> *We expect German unemployment to increase by another million in the coming 12 months*

The 2008/9 crisis briefly interrupted the structural improvement in the German labour market, which had been driven by structural changes in the mid-2000s and long-lasting economic recovery. But there is a strong possibility that the Covid-19 crisis could enhance structural changes. The labour market had already started to bottom out and to show some surreptitious signs of worsening prior to the pandemic. The longer the crisis lasts, the higher the chance the German labour market could re-live memories of a long-forgotten past: hysteresis.

It is currently hard to tell how strong this effect will be, but we expect German unemployment to increase by another million in the coming 12 months.

The remarkable fiscal u-turn

With the serious risk that external demand will not kick-start a sustainable recovery and the fact that Covid-19 has not altered the structural weakness of the German economy, the need for fiscal stimulus has been high. After years of international criticism over the perceived inactivity of the government in relation to investment and its adherence to fiscal surpluses, Covid-19 has led to a full u-turn.

Since the start of the crisis, the German government has been transformed, from austerity champion to big spender. In the first phase of the crisis, the government made more than 30% of

GDP available to cushion the economic fallout of the lockdown measures. These measures mainly included guarantees and loans for companies but also compensation of income losses for small enterprises and freelancers, as well as short-term work schemes.

> *This change of heart on fiscal policy isn't just good news for the entire eurozone but also good news for the domestic economy*

These measures were augmented by a so-called stability fund, which were mainly aimed at supporting bigger companies by eventually taking stakes. The third and final step of the fiscal response was a stimulus package, including a temporary VAT-reduction as well as income subsidies, incentives to buy electric vehicles and a large portion for investment in innovation, R&D and renewable energies. In total, the government has agreed to close to 10% GDP of cash-out fiscal stimulus and some 30% of guarantees and loans. The latest fiscal package ticks many boxes of a perfect stimulus package as it combines short-term support for the economy with investments and incentives to steer structural changes.

This change of heart on fiscal policy is remarkable. It is good news for the entire eurozone as illustrated by Germany's role in the development of a European Recovery Fund. But it's also good news for the domestic economy as it increases the chances that Germany will not only be in pole position at the start of the race but will remain a leader of the pack in what probably will be a long test of endurance.

The German economy in a nutshell (%YoY)

	2019	2020F	2021F	2022F
GDP	0.6	-5.3	4.9	1.2
Private consumption	1.5	-5.9	7.4	0.5
Investment	2.7	-4.2	4.5	3.1
Government consumption	2.1	4.6	4.8	2.6
Net trade contribution	-0.4	-2.5	0.3	0.0
Headline CPI	1.4	0.1	1.7	1.8
Unemployment rate (%)	3.2	3.8	3.8	3.6
Budget balance as % of GDP	1.8	-8.0	-4.0	-2.0
Government debt as % of GDP	58.0	75.0	74.0	70.0

Source: Thomson Reuters, all forecasts ING estimates

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France: Looking for a breath of fresh air

Now that French economic restrictions are easing, President Macron is looking for a second wind to take him to the next Presidential elections which are due in 2022. At first glance, the recovery announcements made up to now won't get him there

Source: Shutterstock
French President Emmanuel Macron

The French economy is currently paying the price of one of the harshest lockdowns in the Eurozone.

After a record -21.4% quarter on quarter annualised contraction of GDP in the first quarter, we expect the contraction to reach 65% in 2Q20. Indeed, activity surveys have shown that the French economy was running at only 65% and 75% of capacity in April and May, while the Google mobility data for June shows, there is plenty of catching up to do.

On average, 2Q20 GDP is likely to be 20% lower than what we saw in 4Q19, which explains why the current growth forecast for France in 2020 is one of the worst among Eurozone economies (-9.5%).

> *The French economy is currently paying the price of one of the harshest lockdowns in the Eurozone*

If we still believe that the first part of the recovery will be V-shaped, disruptions in supply chains and the labour market should put a brake on growth in 2021. Despite an expected 6.5% rebound next year, the French economy is unlikely to catch-up to its 4Q19 GDP level before the end of 2022.

External trade is likely to weigh on the recovery

On one side, a domestic demand recovery will take place, but at a stunted pace because of widespread corporate caution about future investments and higher unemployment.

On the other side, external trade should also weigh on growth. French exports will take time to recover as we expect weak growth in the Eurozone, the potential threat of a no-deal Brexit on New Year's eve, more trade war pressures and a subdued Asian recovery, while imports will be fueled by the recovery of domestic demand.

Domestic demand will see two brakes

More than half of private-sector employees - 25 million in 4Q19 - are on the French temporary unemployment scheme, which, in terms of direct public spending, is by far the main measure taken so far to safeguard the French economy.

Despite this, the number of unemployed (on top of those nearly 13 million workers) has jumped from 3.2 to 4.3 million between February and April 2020 as interim and short-term contract workers lost their jobs.

We expect that in 4Q20, the unemployed population will have increased by more than half a million people on the year, taking the unemployment rate towards 10.5% (compared to 7.9% in 4Q19). As the weakest workers with the highest propensity to consume will be disproportionately hit (as they are overrepresented in the worst-hit sectors like tourism), we believe it will weigh on the private consumption recovery throughout 2021.

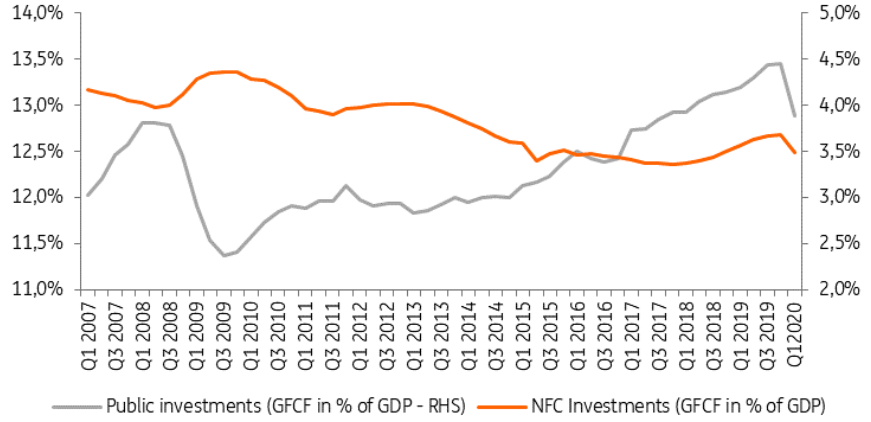
Public v Corporate investments

As far as investments are concerned, public investments will probably substitute corporate investment for a few quarters.

The figure below shows that corporate investments grew faster than GDP in the post-financial crisis recovery, thanks to a mix of supply-side policies. At the same time, public investments remained subdued until 2017. Calls for ambitious public investment plans for 2021 and beyond still have to be designed.

The EU Commission proposal for a Recovery and Resilience facility of EUR 560 bn could bring a framework to these investments together with an incentive to act. If the proposition is approved, each country would have to build an investment plan for the coming years that could potentially go well beyond EU funding intentions.

Can public investments catch-up in coming years?

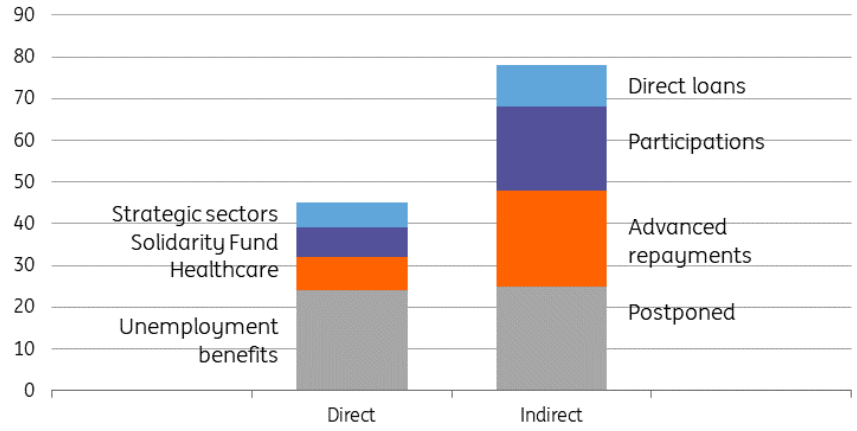


Source: INSEE, ING

Pre-announced economic safeguarding measures are now in place

It is not as if nothing has been done though. The French government has already come up with some recovery plans for three strategic sectors: aeronautics, automobile and tourism industries.

But only part of the measures contained in these plans are actually new: they rely heavily on the instruments put in place earlier in the Covid-19 crisis.
1) Direct spending (at least 2% of GDP) which include an extra healthcare budget (8 €Bn), a solidarity fund for SMEs (7 €Bn) and various adjustments (3 €Bn). The main direct spending is the temporary unemployment scheme which has a direct cost estimated at 24 €Bn in the adjusted 2020 budget. But since this estimate, the number of potential beneficiaries has increased by 50% and the program has been lengthened so that the costs could be 15 €Bn more elevated. On top of these, we estimate that around 6 €Bn will be spent directly in strategic sectors (see below).
2) Tax measures and participations (70 €Bn or 3.1% of GDP): the Treasury has advanced due payments (23 €Bn) and postponed taxes it should have received (25 €Bn). It is likely that part of this amount will end up in the direct spending category, but it is too soon to say in which proportion. The French State will also take participations in “strategic” industries, for an amount that is currently 20 €Bn. “Strategic loans” are also scheduled for 3 specific sectors (see below), so far for around 10 Bn€.
3) Guarantees (315 €Bn or 13.9% of GDP) for various corporate loans issued through the banking sector.



Source: ING

But the last plans for strategic sectors do not go much further

On top of these, specific plans have been decided for three strategic sectors, which largely (for around 90%) rely on the above mentioned measures.

1) Tourism (18 €Bn): tax rebates (for 2 €Bn, part of the 25 €Bn mentioned above that could ultimately end up in direct spending) and higher limits for meal cheques (given by employers as part of a salary package). The headline figure (18 €Bn) is actually relying much on the above mentioned instruments: tourism will specifically use 6.2 €Bn of guarantees for SMEs, 3 €Bn of temporary unemployment benefits, a share of the Solidarity fund and of the participation plan (1.3 €Bn for an investment fund that is supposed to drive a total of 5.4 €Bn investments from the private sector on top of the 1.3 €Bn capital).

2) Aeronautics (15 €Bn): the national airline AirFrance will benefit from a 7 €Bn plan (4€ Bn of credit guarantees and 3 €Bn of direct loans). These are part of previously announced instruments. Apart from military orders for the aeronautic industry (which should reach 0.6 €Bn) and direct R&D investments (1.7 €Bn), the rest of the plan is made of temporary unemployment benefits and guarantees for corporate credits.

3) Car industry (8 Bn€): around 1 €Bn for cleaner car purchases by the general public (up to 200k units) and 0.75 €Bn of investments in the sector together with Renault and PSA (which will add 100 € million each). The rest of the plan (around 6 €Bn) is essentially made of credit guarantees and temporary unemployment benefits.

The lack of fiscal room for maneuver will shadow the two last years of Macron's presidency

The impact on public finances will be sizeable as the deficit is likely to reach 12% of GDP this year (with a hypothesis of 65 €Bn of direct spending, which is 20 €Bn more - than in the April budget estimate).

Public debt should therefore temporarily reach 118% of GDP before coming down to 115% in 2021. This is likely to weigh on President Macron's ability to deliver in the last two years of his mandate which therefore will have to focus on structural reforms, in particular ending the pre-Covid debates on pension reforms. He may need a second breath to achieve this,

which is why a government reshuffling is not unlikely this summer.

However, despite the current rumours, we still find it hard to see a replacement for Mr Philippe as the prime minister at the current juncture.

The French economy in a nutshell

	2019	2020F	2021F	2022F
GDP (%YoY)	1.3	-9.5	6.5	2.4
Headline CPI (%)	1.1	0.4	1.3	1.7
Unemployment rate (eop, %)	7.9	10.5	9.2	8.5
Budget balance as % of GDP	-3.0	-12.0	-4.0	-2.0
Government debt as % of GDP	98.1	118	115	111

Source: ING forecasts

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The Netherlands: Cherishing the restrained shock

We think the Dutch economy will shrink by -6% to -8% in 2020 despite a sizeable public support package. As lockdowns ease, economic activity is resuming again, but a full recovery might not happen until 2022

Source: Shutterstock
Dutch Prime Minister Mark Rutte (L) visits a barbershop in The Hague, The Netherlands

Why the Netherlands stands out favourably

Dutch GDP fell by -1.7% quarter on quarter in 1Q20.

Although still large in absolute terms, this decline is mild compared to the eurozone average of -3.6%. This is because the lockdown in the Netherlands was milder and the wage subsidy scheme generous. As for almost any economy, figures for 2Q20 will be significantly worse. April figures on industrial production (from -1% MoM to -8%, adjusted for working days and seasons) and retail sales (from -2% MoM to -6%) were much worse than the March figures since the lockdown only started two weeks into March.

The very large drop in employment of 160 thousand people (-1.7% of the labour force) in April illustrates that the corona crisis had an unusually quick and large effect, but compared to peer economies the Netherlands stands out favourably.

Outlook for May better due to gradual lifting of lockdown

Industrial production and retail data of May will most likely look only a bit better than April. Sentiment figures were at similar levels in May as they were in April, but the underlying data shows that especially expectations improved, in line with the gradual reopening.

Since 15 May, contact-intensive occupations such as hairdressers and masseurs, are allowed to do business again. At 1 June, also bar, restaurants, cinemas and theatres were allowed to open again, although with capacity restrictions. School re-opened in the first weeks of June. Major restrictions for tourist from most EU countries were lifted 16 June. Fitness clubs and saunas will open on 1 July. Events with large crowds, including soccer matches and night clubs, will have to wait until at least 1 September.

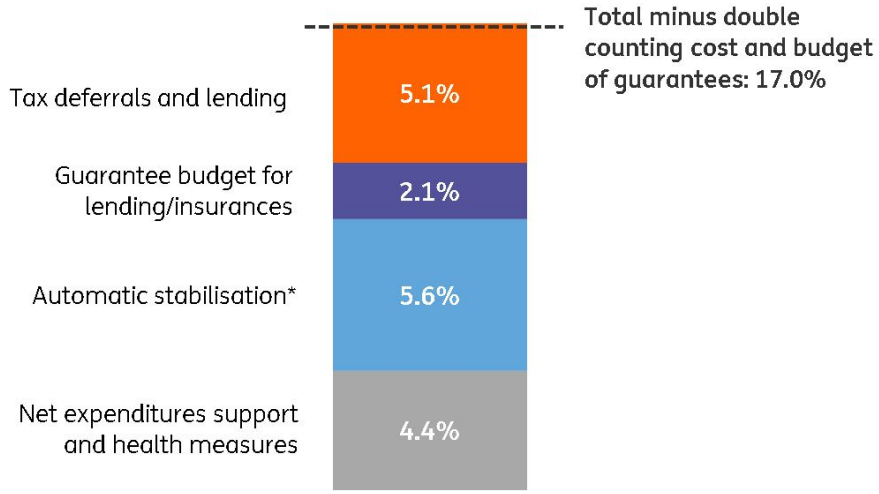
Direct public support large, but tax deferral tops

After the initial support for three months, the Dutch government decided at the end of May to extend the majority of economic support measures by four months until 1 October.

The extension, which initially was intended for three months, was expanded after deliberations with unions and employer associations. The decision meant extension of the main measures such as the wage subsidies, benefits for self-employed and deferral of taxes. Another major intervention, re-insurance of supplier credit, was already valid for the entire year 2020.

Support for 2020 is large in historical perspective, but there are countries which do more, most notably Germany. While the bulk (5.1% of GDP of 2019) of discretionary measures concerns tax deferrals, also the total direct net expenditures are sizeable amounting to about 4.4% GDP in 2020.

Largest discretionary public support in tax deferrals and lending



Source: Government estimates, calculations ING, *Lower tax revenues and higher regular social security expenditures due to lower economic activity

Some tweaks to earlier package

Some of the conditions for support have changed.

For example, firms using the wage subsidy - the main instruments of the support package

shielding almost a quarter of workers - will temporarily (in 2020) be forbidden to pay out any dividends or executive bonuses or execute share buy-backs. Some new instruments were added, such as compensation for firms for fixed cost and support for public transportation.

Corona policy measures by the Dutch government substantial in size

Amount per COVID-19 measure in billion € in 2020

	Direct net expenditure	Guarantee budget	Loan /deferral	Total***
Temporary arrangement for compensation of labour costs (NOW)	22.8			
Benefit assistance scheme for the self-employed (TOZO)	3.0			
Damage compensation firms in affected sectors (TOGS €4.000)	1.7			
Public transport compensation	1.5			
Fixed cost compensation (TVL)	1.4			
Lowering of imputed wage for entrepreneurs	1.0			
Floriculture and chip potatoes industry support	0.7			
Child day-care compensation	0.3			
Cultural industry support	0.2		0.2	
Temporary income support for low income flexible labour (TOFA)	0.2			
Sport club support	0.1			
Support for continuing construction	0.1			
Expansion labour cost scheme	0.1			
Other projected extra expenditures (mostly health care and education)	1.4			
Re-insurance supplier credit	1.0	12.0		
Guarantee Corporate Finance scheme, budget expansion (GO)	0.1	1.4		
Small credit Corona guarantee scheme (KKC)	0.2	0.7		
Corona bridging loans (COL)	?	0.3		
Expansion SME credit guarantee scheme (BMKB)	0.0	0.2		
Credit guaranteefund travel (SGR)	?	0.1		
Expansion Qredits microcredit scheme	0.0	0.0		
Expansion guarantee scheme SME credit agriculture	0.0	0.0		
Air France-KLM support package	?	2.0	2.0	
Tax deferral	0.2		33.5	
Coronareserve corporate tax	?		3.4	
Capital assistance scheme for the self-employed (TOZO)	?		2.5	
Expansion SEED Capital-lending scheme	?		0.0	
Fiscal facilitation mortgage payment break	?		-0.1	
Total of selected measures	35.7			
Total of selected measures in % GDP*	4.4%			
Automatic stabiliser	45.0			
Automatic stabiliser in % GDP*	5.6%			
Total of selected measures incl. autom. stabi.***	**80.7**	**16.8**	**41.5**	**137.6**
Total of selected measures incl. autom. stabi. in % GDP***	**10.0%**	**2.1%**	**5.1%**	**17.0%**

*Due to uncertainty about gdp-developments gdp of 2019 has been used as denominator
**Total may contain some double counting if new measures limit the use of existing policy
***Total minus direct double counting of guarantee cost and guarantee budget

Source: : Government estimates, calculations ING Research, in case of ranges upperbounds used, 50/50% division in case of missing disaggregated figures and constant amounts assumed in case of extension

Better set up for recovery, but it may still take a while

The packages of interventions help maintaining employment and income and keep firms afloat. Nevertheless, a substantial fall in consumption and investment will not be avoided for 2020. The Dutch economy is forecast to shrink by -6% to -8% in 2020 in our base case scenario, keeping the Dutch on the favourable side of the eurozone average. Based on an index measuring vulnerability to a prolonged corona slump, the Dutch economy also seems better set up for a recovery than peripherical eurozone countries.

Nevertheless recovery to the pre-corona level of GDP may not be complete by the end of 2022.

The Dutch economy in a nutshell (%YoY)

	2019	2020F	2021F	2022F
GDP	1.8	-6.8	4.1	2.0
Private consumption	1.4	-5.8	4.4	1.9
Investment	5.3	-13.0	9.2	4.9
Government consumption	1.6	-2.1	0.6	1.3
Net trade contribution (%-point)	-0.3	-0.9	0.2	0.0
Headline CPI	2.6	1.2	1.4	1.5
Unemployment rate (%)	3.4	5.1	6.9	5.6
Budget balance (% of GDP)*	1.7	-9.2	-1.9	-1.7
Government debt (% of GDP)	48.6	65.4	58.2	57.6

Source: Macrobond, all forecasts ING estimates. *Budget balance projection deviate from official forecasts by the Netherlands Bureau of Economic Policy Analysis (CPB) i.a. due to differing views on the output gap.

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Listen: Why markets are shrugging off Covid-19

Covid-19 cases are still rising in the US. But so, too, are financial markets. In this podcast, ING's Chris Turner explains what's been driving these moves and what may lie ahead for the currency markets in the second half of the year

The coronavirus pandemic shows little sign of loosening its grip on the US, where hospitalisations have surged. Yet the S&P 500 is on track for one of its best quarters ever while the Nasdaq recently hit a record high, and the safe-haven dollar is selling off. In this podcast, ING's Global Head of Markets Chris Turner tells Senior Editor Rebecca Byrne why markets have remained so optimistic and whether the positive momentum could continue.

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Report | 25 June 2020 Credit

Sustainable covered bonds: The sustainability frameworks from A to Z

Since the European Commission published its sustainable action plan in 2018, developments in the field of sustainability have only accelerated. This report offers a guide to the existing green, social and sustainability frameworks supporting the sustainable euro covered bond market

Source: Shutterstock

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Article | 25 June 2020

Covid-19 calls for more resilient production chains, but that's easier said than done

Covid-19 has shown how vulnerable supply chains are to disruption. Their resilience can be enhanced by diversifying suppliers or holding more inventory, but both options are costly and far from straightforward, as we illustrate in an analysis of the automotive, electronics and textiles industries

Source: Shutterstock

Overall, we don't expect major changes in the length or location of global value chains in direct response to Covid-19. In the industries we look at, the sheer number of suppliers and their concentration in specific regions present major obstacles to diversifying risks. But reducing the number of suppliers is not necessarily the way to more resilient supply chains. If rising protectionism triggers re-shoring, this could make supply chains more vulnerable to disruption in the future.

Value chains and vulnerability

Until the start of the global financial crisis, more and more firms set up production chains across borders, mainly to benefit from lower wage costs in Asia and Central and Eastern Europe. Many of

the resulting supply chains are complex, meaning that at least three borders are crossed by (parts of) a product before it arrives in the shops.

On average, the share of products made in complex value chains worldwide stopped rising following the global financial crisis. However, in some industries it continued to increase, including electronics which has a relatively large share of production in complex value chains. In the automotive and textiles and apparel industries, the share has been stable (**Charts 1-4**).

Value chains have been on the decline, but not in all sectors

Fig 1 Total

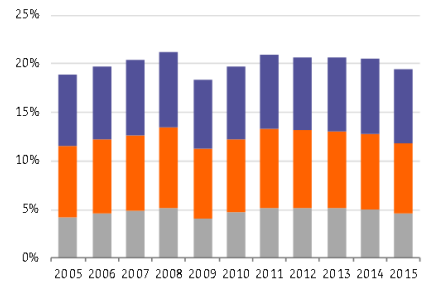
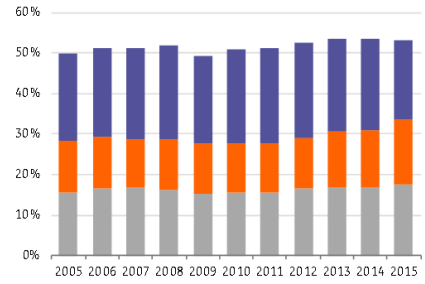


Fig 2 Electronics



Source: OECD ICIOT 2018

Fig 3 Automotive

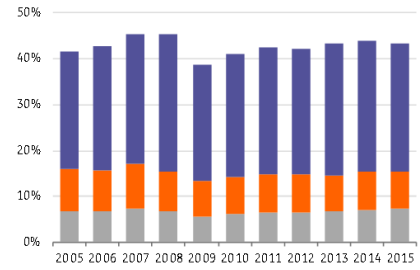
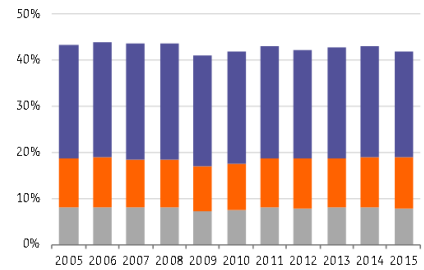


Fig 4 Textiles



Source: OECD ICIOT 2018

By transmitting demand and supply shocks back and forth across different countries, value chains appear to be a source of vulnerability to firms and economies. Diversifying suppliers internationally is one way of protecting against shocks hitting a particular country or region.

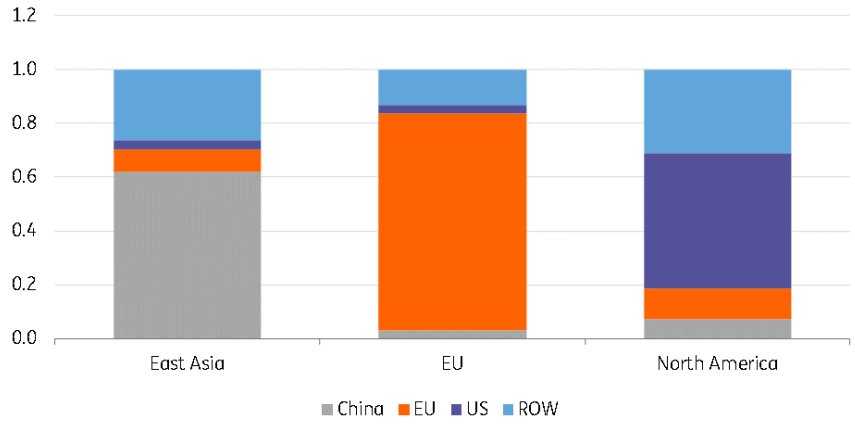
Holding more inventory can also increase supply chain resilience by enabling production to continue when the supply of intermediate inputs is disrupted. Covid-19 has made the costs of supply chain disruption clear. Firms will have to weigh the benefits of avoiding these costs if a similar future shock hit, against the costs of increasing resilience, where each industry faces its own specific challenges.

Automotive: de-risking is costly

Supply chains in the automotive industry consist of a large group of specialised suppliers that are clustered within regions. Most value is added in the region where the cars are sold (**Chart 5**), but the inter-regional links were still able to stop the global automotive industry in its tracks early in the Covid-19 outbreak. The lockdown in Hubei province in China forced factory closures in Europe weeks before European countries went into lockdown.

The costs of supply chain disruption are considerable. In early June, the European Automobile Manufactures Association (EAMA) reported that factory shutdowns due to Covid-19 (30 days on average at the time of reporting) had resulted in a production loss of 2.5 million vehicles in Europe, of which around 617,000 were in Germany, the hub for European car manufacturing.

Automotive production is clustered around regional hubs



Source: OECD Trade in Value Added, ING calculations

In spite of the pain caused by production losses, the business case for increasing automotive supply chain resilience is not straightforward. There are two key reasons that automotive production is clustered within regions. First, components are heavy, bulky and easily damaged, so transport costs are high. Second, final markets often have local content requirements to be free of import tariffs, which can only be achieved by locating production nearby.

With thousands of suppliers involved in a vehicle's value chain, diversifying suppliers to increase resilience involves considerable ongoing costs. Even if they are only used as backups, suppliers need to be able to produce to detailed specifications, and meet quality and safety standards at any time. Holding more inventory also involves higher costs for working capital and storage costs, especially considering the bulkiness of many of the parts.

The shift to electric vehicles will deliver a transformation in supply chains in the automotive industry, which offers opportunities for building in resilience. Electric vehicles have fewer parts than vehicles with traditional engines, so as the share of electric vehicles in total sales increases during this decade, the number of suppliers will go down.

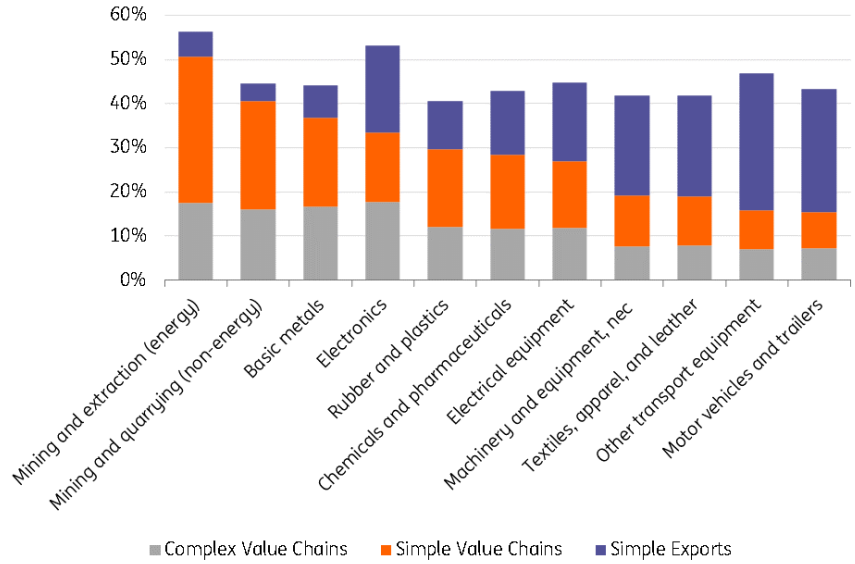
Nevertheless, production in regional hubs is likely to remain the norm, thanks to the pattern of trade tariffs. The European Union also aims to establish production of electric vehicle batteries within the EU. Overall, we don't foresee an industry-wide move to reconfigure existing automotive supply chains. The costs are simply too great, and automotive manufacturers' margins are not in a position to absorb the higher costs of more resilient supply chains.

Electronics: specialisation makes diversifying difficult

The electronics industry boasts one of the most complex supply chains of any industry (**Chart 6**). Components cross borders multiple times before reaching the point of assembly into a final product. Most consumer electronics are produced in Asia, with a high degree of specialisation

across different countries. South Korea and Japan lead in the production of complex electronic components such as optical equipment, semi-conductors (memory chips) and LCD displays.

Electronics production is very reliant on cross-border trade



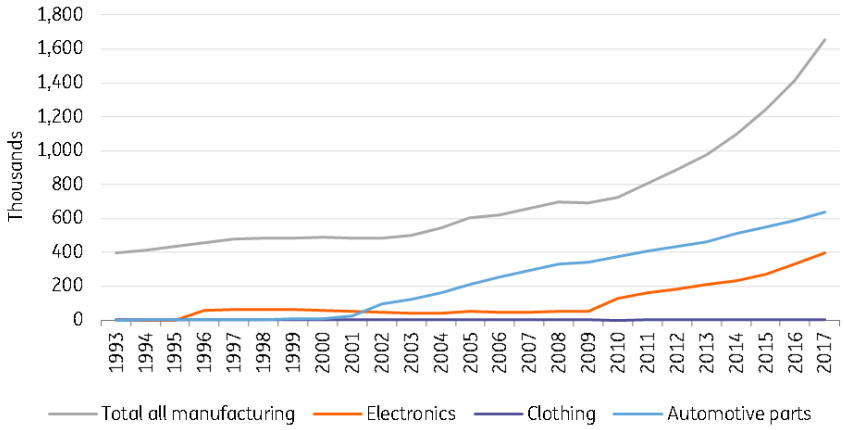
Source: OECD ICIOT 2018

Specialisation in electronics value chains makes it difficult for firms to diversify their suppliers across countries to increase supply chain resilience. For example, South Korea is the major exporter of memory chips. Although some other countries produce these goods as well, quantities are not sufficient to meet global demand in the event of a shock affecting the supply of South Korean producers.

The complexity of electronics supply chains and the limited scope for diversifying suppliers matter because a single input, if unavailable, can disrupt entire supply chains. The same supply chain may have exposure to a given country in multiple stages, or via multiple suppliers, and it is difficult for firms to evaluate these dependencies across different tiers of the supply chain. Even if a firm successfully diversifies the suppliers of 90% of its inputs, a disruption to any of the remaining 10% is still enough to shut down production.

China has been steadily upgrading its position within electronics value chains, helped by investing in robots and automation of lower value-added tasks (**Chart 7**). By becoming more competitive in higher value-added activities within the production of electronics goods and components, China could become a source of alternative suppliers to help firms diversify their supply chain risks.

Robots are increasingly common in electronics production



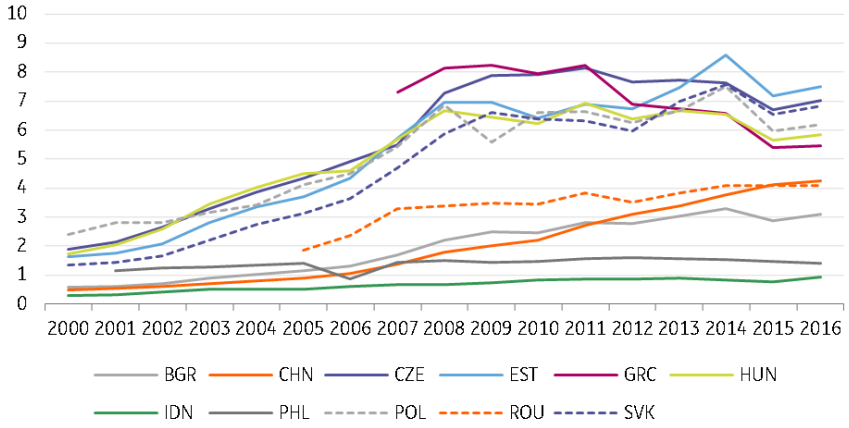
Source: International Federation of Robotics

But at the lower value-added end of electronics production, value chains are increasingly exposed to shocks to China. In recent years, rising Chinese wages and the hiking of US import tariffs on Chinese electronics have led firms to shift lower value-added activities out of China and into other Asian economies. But robotisation and automation in China is enabling it to re-shore some of this activity, partly to serve domestic demand. As a result, options for supplier diversification in electronics value chains are limited, and becoming more so.

Textiles and garments: weak buyer-supplier relationships

Although there are fewer components in a T-shirt than a car or phone, producing textiles and garments also involves complex value chains. Clothing manufacturing is labour-intensive which has led to global production of basic items becoming concentrated in Asia, reflecting relatively low wage costs (**Chart 8**). Supply chains in the industry are relatively changeable, with supplier contracts going season to season. During the Covid-19 outbreak, buyers have simply cancelled their orders.

Wages have risen in China, but labour costs remain relatively low in Asia



Source: ILO, ING Calculations

European buyers of textiles already pursue a strategy of sourcing from geographically diverse suppliers, including from countries within, or on the edges of, Europe. This helps to achieve fast turnaround times between orders being placed and delivery, which is especially important for the 'fast fashion' segment of the market for garments. Although this strategy allows firms a high degree of certainty about being able to get their products into the shops, the low volumes make it very vulnerable to delays in distribution, or in the supply of fabric, which is still mainly imported from Asia.

Even outside the 'fast fashion' segment of the market, clothing has a limited shelf life, meaning that little resilience is gained by holding larger inventories. So the only option for increasing textiles and garments' supply chain resilience is through diversifying suppliers. However, even before Covid-19, pressures within the industry were taking firms in the opposite direction.

Clothing brands have been under sustained pressure to achieve more transparency in their supply chains, following industrial accidents in clothing factories and the poor working conditions of garment factory workers coming to light, as well as demands for the industry to improve its sustainability performance. Survey evidence from 2019 suggested that firms were responding to these pressures by planning to reduce the number of their suppliers. Covid-19 may yet cause firms to re-evaluate the worth of diverse sourcing and maintaining relationships with suppliers.

Protectionism may induce re-shoring, but won't deliver resilience

The current configuration of international supply chains relies on low trade barriers and a degree of certainty that these trade barriers will remain low in the future, or even diminish further. Covid-19 is changing these conditions. It has led to protectionist sentiments and subsequent actions in many countries. At the moment, export restrictions have mainly applied to medical products. However, trade costs are higher for all types of goods due to Covid precautions limiting the processing speeds at ports and at borders.

In contrast to the difficult-to-calculate costs of a future disaster or crisis, higher barriers to trade add to firms' day-to-day running costs, which accumulate along value chains. Firms may decide to re-shore production if value chains start to involve higher costs. But this decision would likely result in a narrowing of their supplier base, and an increased exposure to shocks in the home country. Overall, we don't expect major changes in the length or location of global value chains as a risk-management response to Covid-19. However, if the crisis leads to more protectionism, it could result in some re-shoring of production, and put supply on a riskier footing.

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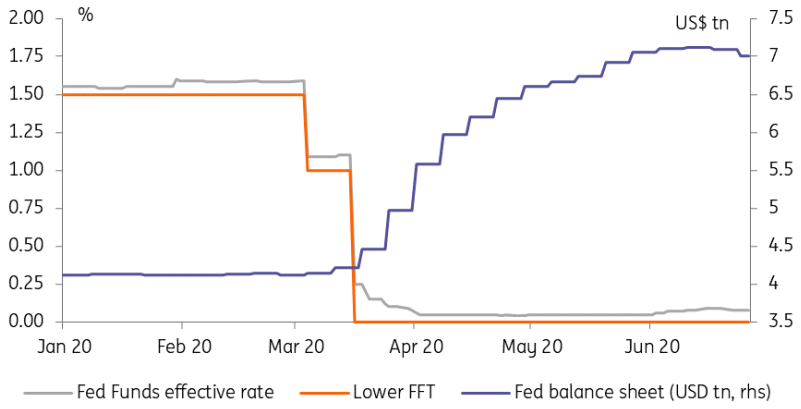
Article | 26 June 2020

Rates Spark: Fed's balance sheet glides lower, again

Fed support for Wall Street continues to fall, as it is now less needed. Even the Fed's buying programme in corporates remains tame. Big falls in central bank USD swap support push in the same direction. Main Street is where the pain is. In Europe, the June minutes should have removed any lingering doubts about the ECB's ability to ease further if necessary.



Source: Bloomberg, ING

The Fed's balance sheet continues to ease lower as financial markets heal

The Federal Reserve's balance sheet has fallen for the second week running, down by another USD75bn, to stand at a little over USD7trn. This is still a huge balance sheet when compared with an economy of around USD20trn, but the fall goes against worries in some quarters that it was on a continuous rising process in coming months, and potentially years.

> *"This is still a huge balance sheet when compared with an economy of around USD20trn, but the fall goes against worries in some quarters that it was on a continuous rising process over the coming months, and potentially years."*

The Fed is still buying bonds, an additional USD36bn for the latest week. But this is more than offset by a USD47bn fall in repo support. Confirmation of reductions in dollar swap lines to global central banks can also be gleaned, now down to USD275bn, having been as high as USD450bn only a month ago. This is indicative of reduced stress in the system, correlating with reduced demand for the safety of USD.

The Fed also continues to reduce its spending on support for money market funds, down by an additional USD2bn. There has been an equal but opposite increase in spending on the paycheck protection programme though. Spending on the latter Main Street programme now stands at USD60bn, versus USD23bn on the money market fund, as a further indication of an increased Fed focus on Main Street, and away from the need to support Wall Street.

Corporate credit facility remains a story of credit buying lite

The Fed started buying corporate bonds direct on Tuesday last week. Before that they had been exclusively buying corporates through ETFs, some 17% of which was in high yield. News that the Fed would commence buying corporate bonds outright caused a stir, and led to a risk-on reaction. We had questioned this outsized positive reaction, as there was no suggestion that this meant a material increase in Fed buying in the corporate space.

> *"Our early observations on the corporate buying programme have not materially changed - the positive effect from Fed buying is more qualitative than quantitative. Big investor inflows have had the bigger effect."*

Latest data confirm our reservations. These show that there was no material change in volumes bought in the corporate space which for the latest week ran at USD1.8bn. This is up on the previous week's USD1.3bn, but clearly not by much. Extrapolating this type of buying would see the Fed buying a cumulative that is not too deviant from the USD50bn to USD75bn range. This is not nothing, but is a fraction of the full potential of closer to USD750bn.

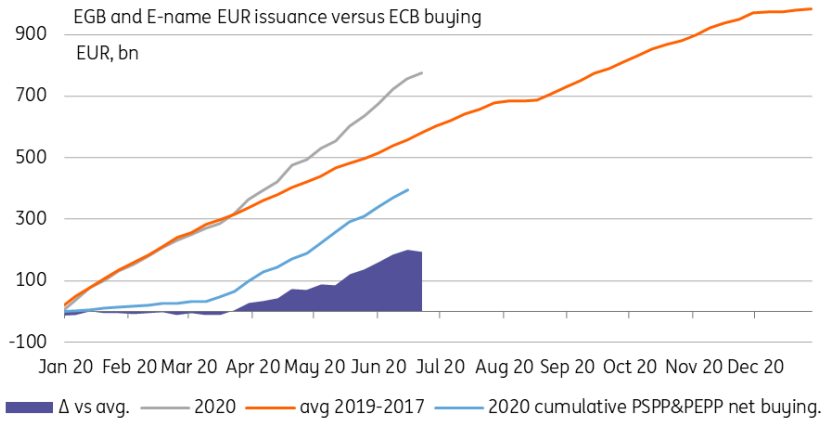
All that the Fed has done is substitute (some) ETF buying with corporate bond buying, with the latter done in a way where the Fed replicates a balanced market-wide portfolio of corporate bonds. In the end this is not much different from buying ETFs, as ETF funds themselves would match Fed buying by buying corporate bonds direct in any case. It would have been a significant switch if it had meant bigger volumes, but the hard data tells us that has not been the case.

More evidence here then of reduced need for the Fed to aggressively support the market; which makes sense given the self-healing that has occurred in the corprate bond space (underpinned by the record primary market activity seen). Our early observations on the corporate buying programme, as outlined here, have not materially changed - the positive effect from Fed buying is more qualitative than quantitative. Big investor inflows have had the bigger effect.

ECB QE now a little more credible

In Europe, a fairly quiet events slate today might be an opportunity to reflect on the prospect of further central bank intervention given the rapidly deteriorating state of risk sentiment. The minutes of the June 4th ECB meeting are adding some elements to this. As our economics team noted, the minutes seemed aimed at addressing the concerns of the German constitutional court's ruling on PSPP. Together with reports that the governing council decided on a course of action this week, including routing some documents to the court, this should remove lingering doubts about the ECB's ability and willingness to act if necessary.

ECB buying ramped up alongside issuance



Source: Debt agencies, ECB, ING

QE already absorbs a good deal of european government bond issuance

The first half of the year drawing to a close, a good time to take stock of the ECB's interventions in government bond markets. To date Eurozone countries and supranational agencies have issued more than €775bn in EUR bonds. Compared to previous years that is almost €200bn more than ususally printed by this time of the year and not far from the €980bn issued on average per year since 2017. That is a notably steeper trajectory of bond issuance, but at the same time the ECB stepped up its purchases via PEPP and PSPP: We estimate that the ECB has bought just shy of €400bn in the public sector to date via the two programmes, absorbing more than just the new funding for crisis measures (for the chart above we have assumed that 80% of PEPP purchases are directed at the public sector).

Detailed data available for those programmes had shown that the ECB has skewed purchases heavily towards buying bonds of peripheral issuers, deviating decidedly from its capital key benchmark for purchase allocations. Yesterday's minutes indicated that this deviation could go on for longer, as it was noted that the reinvestment period was extented until at least end-2022, and could be used to "to reduce possible deviations from the capital key that might arise during the net purchase phase."

Today's Events: US income/spending

May US income and spending are arguably the main data point of an otherwise quiet calendar.

Eurozone M3 growth is also due.

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Article | 24 June 2020 Credit

Reverse yankee supply outlook to reach up to €80bn

We have revised our reverse yankee supply outlook from our original forecast of €65bn to €80bn, but it is unlikely to exceed last year's record-breaking supply of €99bn. We also expect the supply to continue to target the longer end of the curve, where cost-savings are the most beneficial for US corporates

Source: Shutterstock

Driven by the maths

There are many reasons for a US corporate to consider issuing in EUR, such as diversification of investor base or funding its European operations.

But often the reason to target EUR is driven by mathematics, quite simply by issuing EUR and swapping it back to USD, the US corporate can make a significant cost saving of many basis points on often funding of billions of USD. There are many factors that influence whether or not issuing a reverse yankee bond is cheaper than issuing a plain vanilla USD bond.

> *There are many factors that influence whether or not issuing a reverse yankee bond is cheaper than issuing a plain vanilla USD*

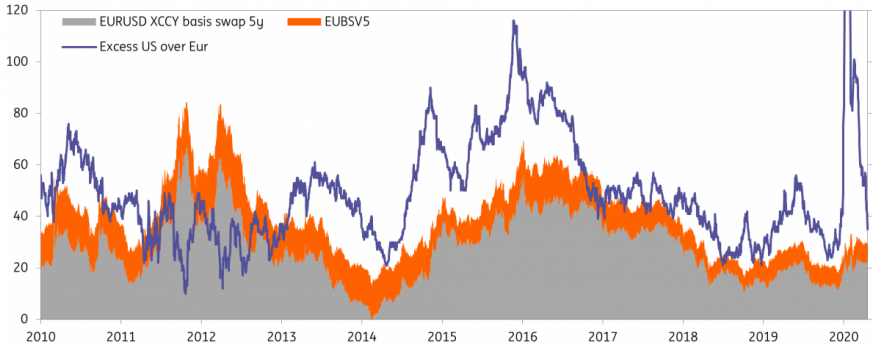
bond

There are many factors that influence whether or not issuing a reverse yankee bond is cheaper than issuing a plain vanilla USD bond. Firstly, the cost of swapping the currency made up of the cross-currency basis swap and the 3m vs 6m Euribor to Libor swap, identified as the grey and orange area in Figure 1. If the cross-currency basis swap goes less negative and the 3m vs 6m swap tightens it becomes cheaper to swap, and therefore more attractive for reverse yankee issuance.

Additionally, the excess of USD EUR spread differential, blue line is an important factor. In asset swap terms, USD credit spreads (for similar ratings, sectors, names and maturities) are higher than for EUR credit. If the spread differential between USD and EUR trends wider, then issuing a reverse yankee becomes more attractive as it will be more expensive to issue in USD. Of course, the spread differential, i.e. the cost-saving of the reverse yankee issuance must be in excess of the cost of swapping.

Currently, looking at the 5-year maturity, the cross-currency basis swap is relatively less negative (and therefore attractive) versus previous years. However, we have seen it widen out on the back of the crisis compared to the low levels seen in 2019, where we also saw record-breaking reverse yankee supply.

Cross currency basis swap and EUR/USD spread differential



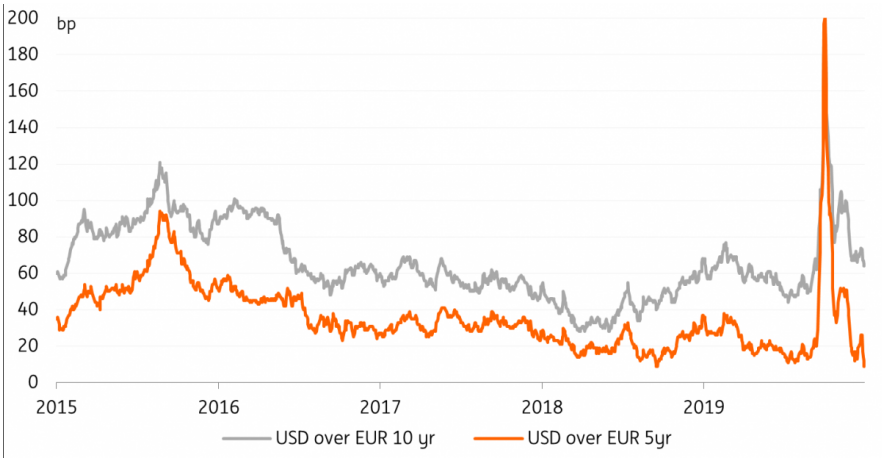
Source: ING, ICE

Naturally, the spread differential between USD and EUR can differ depending on maturities and thus steepness of the curves.

Currently, the Euro credit curves are a lot flatter and were even inverted back in March/April as spreads widened so significantly and the jump to default was being priced in. Whereas USD curves are substantially steep, due to the short-dated support limitations on the Fed's corporate purchasing programmes. The primary purchasing facility is limited to maturities of four years or less and the secondary purchasing facility is limited to remaining maturities of 5 years or less.

Therefore, what we see in Figure 2, is there being a small spread differential between USD and EUR in the shorter end of the curve (5yr), whereas the longer end of the curve (10yr) identifies as a very attractive widespread differential.

USD/EUR spread differential at 5yr and 10yr



Source: ING, ICE

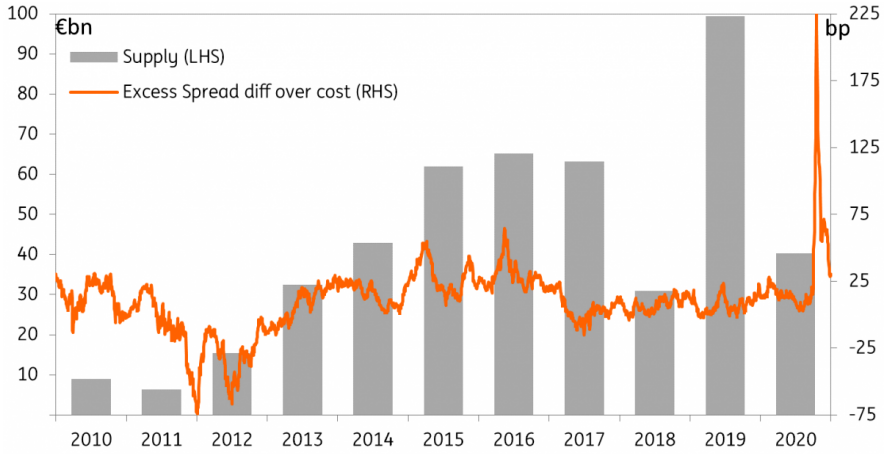
There are other factors that are at play that determine the attractiveness of the reverse yankee issuance.

For instance, in volatile times non-ECB eligible bonds like reverse yankees tend to underperform versus their European peers. Less well-known entities in combination with this ineligibility leads to spread underperformance in the foreign currency (EUR in this case). Naturally, all this is based on average levels, but what is important to note is that it is very dependent on a company by company basis.

Supply & Outlook

Figure 3 illustrates reverse yankee supply and excess net spread differential (over the cost of swapping), as seen reverse yankee issuance has increased over the years, mainly due to the improving attractiveness of issuing in Euro for US corporates. Reverse yankee supply in 2019 hit a record-breaking €99bn, and the excess spread or mathematics was not the main driver, as it also seems the Euro credit market is becoming more mature and thus increasingly receptive to these trades.

Reverse yankee supply & excess spread differential over cost of swapping



Source: ING, Dealogic, ICE

Now that there is little USD/EUR spread differential on the short end, attractiveness is being reserved only for the long end of the curve. Furthermore, the substantial support needed and being offered by both the ECB and the Fed, pushing corporates to stay within their own currency. All of which has resulted in our initial expectations of slower reverse yankee issuance and supply to pencil in less than 2019.

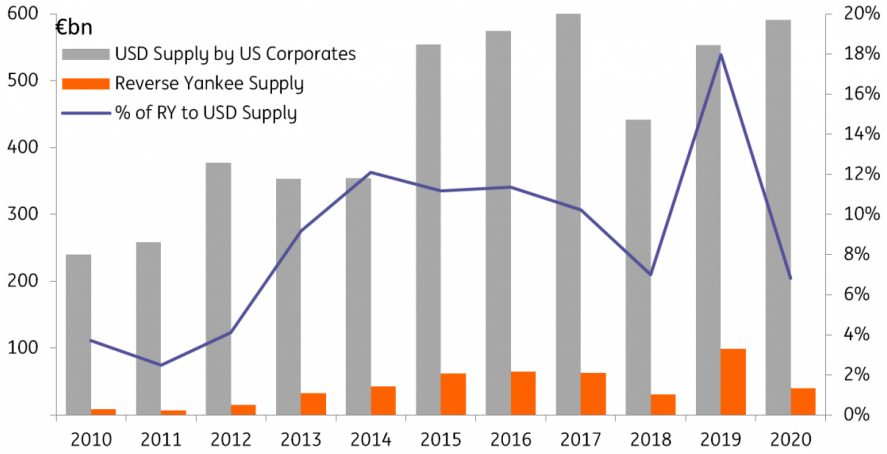
However, thus far in 2020 reverse yankee supply has totalled €45bn. Which is level with the 2019 year-to-date figure of €48bn. Be that as it may, February pencilled in a substantial €15bn in reverse yankee despite unattractive conditions, accumulated by large deals from AT&T, VF and Dow, whom for the most part used the proceeds for European operations.

Furthermore, USD bond supply by US corporates has soared substantially thus far in 2020 pencilling in a considerable $775bn, which has already surpassed previous full years and has even surpassed the record-breaking FY 2017 figure of $696bn. Therefore, it is not surprising to see reverse yankee issuance increasing.

However, the slightly higher than expected reverse yankee issuance is as a consequence of the higher total issuance by US corporates as issuers stack up on liquidity to buffer Covid 19 consequences. This is proven by the fact that the percentage of reverse yankee supply to USD issuance by US corporates, where we identify the substantial relative fall in reverse yankee issuance. This is illustrated in Figure 4, where we see reverse yankee supply running at 7% of USD supply by US corporates, compared to the 18% in 2019.

Similarly, reverse yankee normally accounted for around 20-25% of Euro supply, last year pencilling in the higher end of that range. However, this year is only running at just shy of 16%. This is due to the substantial Euro supply seen thus far in 2020. Much like in USD, EUR supply is well and truly on route for a record-breaking year for supply.

Reverse yankee & USD supply



Source: ING, Dealogic

At this rate, we may still see slightly more reverse yankee supply than previously expected, but remains unlikely it will exceed last year's figure of €99bn. We originally pencilled in a forecast of around €65bn in reverse yankee issuance for 2020, we now expect that it may exceed this slightly and reach up to €80bn. What is also noteworthy, is the reverse yankee supply thus far has and will continue to be around the long end of the curve.

As the Fed is only supporting the short end of the USD curve, current long end attractive levels for reverse yankee offer US corporates an opportunity to issue longer-dated bonds.

To conclude, we forecast an increase in reverse yankee supply from our original outlook, now expected to reach up to €80bn.

As things stand at €45bn year-to-date right now, the slightly slower second half of the year is in line with our overall view of slower supply across the board for the second half of the year, as many corporates have undertaken considerable financing in an attempt to shore liquidity.

Of course our view on less reverse yankee supply still stands in relation to percentage of total USD supply. Now we stand at reverse yankee running at 7% of USD supply.

? What are reverse yankee bonds?

A reverse yankee is a bond issued in EUR currency by a US corporate.

In most cases, this is utilised by US financial and non-financial corporates and swapped back into US dollars to finance US operations. Of course, there are some cases that the funds will remain in EUR and are used for European operations. US corporates can, therefore, issue in EUR to fund European operations or to take mathematical advantage as at times it could be a cheaper source of funding than to issue a USD bond.

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