What's happening in Australia and around the world?

With the yuan 'cracking seven', it's becoming clear China is going to fight this trade war hard. Meanwhile, the President has been cranking up the pressure and with the triple whammy of greater-than-expected rate cuts in New Zealand, India and Thailand last week, we think it is just a matter of time till the Fed succumbs. Just as well we've changed our view

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You are probably paid less than your boss, but it may not be because of the work he is doing or to keep him motivated. Instead, it is meant to motivate...

Article | 7 August 2019 **United States**

President Trump and the Fed - we've changed our view

President Trump is ratcheting up the pressure on the Fed to support his efforts on extracting concessions from China on trade. Policymakers appear...

Source: Shutterstock

US President Donald Trump and Federal Reserve Chairman Jerome Powell

President piles on the pressure

President Trump has been active again on Twitter this morning, saying that the Fed must make "bigger and faster" interest rate cuts and that it as an institution is "too proud to admit their mistake" of - in the President's view - raising interest rates too aggressively over the past couple of years.

The latest blast follows the sharp sell-off in equities, but the President is also likely to have been irked by the fact that other central banks around the world are easing by more than expected. Today, we saw surprisingly aggressive moves from India, New Zealand and Thailand's central banks. At the same time, the European Central Bank appears to be gearing up for more aggressive stimulus in response to weak growth and low inflation. Meanwhile, in the Federal Reserve, President Trump has a central bank that seems far more reticent to offer the kind of support he feels is necessary as he battles China over trade practices.

In the Fed, President Trump has a central bank that seems far more reticent to offer the kind of support he feels is necessary as he battles China over trade practices

Yesterday, St Louis Fed President James Bullard, arguably the most dovish voting member of the FOMC, pushed back against the market pricing four further 25bp rate cuts over the next 18 months. He admitted that in June he was one of the eight FOMC members to have pencilled in 50bp of policy easing this year to the Fed “dot plot” and said his view has not changed dramatically since then. After all, the US is “not in recession mode here” and that “monetary policy cannot reasonably react to the day to day give and take of trade negotiations”.

Today, Charles Evans from the Chicago Fed talked similarly. He acknowledged the risks have "gone up", which can justify "more accommodation", and acknowledged the other central bank moves, commenting that "once a substantial number of central banks consider repositioning their monetary policy, it's natural that other central banks might be thinking that too".

Trade proving tricky

For now the US economy is in far better shape than other developed markets. Unemployment is low, growth remains “solid” and wages are rising. It was this contrasting story that had emboldened President Trump to push hard on trade with the narrative that trade partners would be desperate to cut a deal.

We simply don't have the visibility on the outlook for trade policy to give us much confidence in our forecasts when President Trump appears to over-rule his trade negotiation team on a whim

It hasn’t worked out that way with China offering domestic monetary and fiscal stimulus whilst also allowing the yuan to weaken against the dollar. Moreover, there is growing evidence that the US activity story is softening, with particular concerns over investment spending. Certainly, escalating trade tensions through higher tariffs and restricted access to markets is hurting sentiment, increasing costs, damaging supply chains and weakening corporate profitability. And the knock-on effect is that this deters companies from putting money to work, such as delaying investment decisions and hiring fewer workers – or even raising the prospect of lay-offs in key impacted sectors such as export manufacturing. This then feeds through into consumer sentiment and spending more broadly in the economy with recession risks mounting.

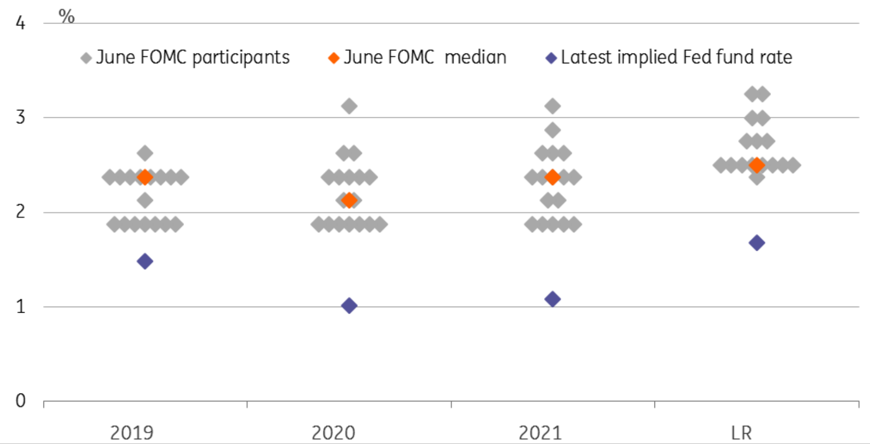
It is important to point out that this is in the realms of the “worst-case scenario”. We simply do not have the visibility on the outlook for trade policy to give us much confidence in our forecasts when President Trump appears to over-rule his trade negotiation team on a whim. It may well be that in the next couple of weeks he rows back on the prospect of additional tariffs. Alternatively, he could go harder.

Things set to get worse before they get better

Our assumption is that the tensions will escalate over the next couple of months, which will add to economic headwinds and result in weaker growth. China talks of the need for "respectful" negotiations, which it doesn't feel it is getting when President Trump takes unilateral decisions, so there is little incentive to offer anything meaningful until there is.

This runs the risk of the US ramping up the pressure on China and further weakening global sentiment and economic activity. With commodity prices falling broadly, particularly oil which is in a bear market, and with the dollar remaining in the ascendancy there are more downside risks for headline inflation too.

Markets are priced for the worst



Source: Macrobond

The market is ramping up the pressure for action

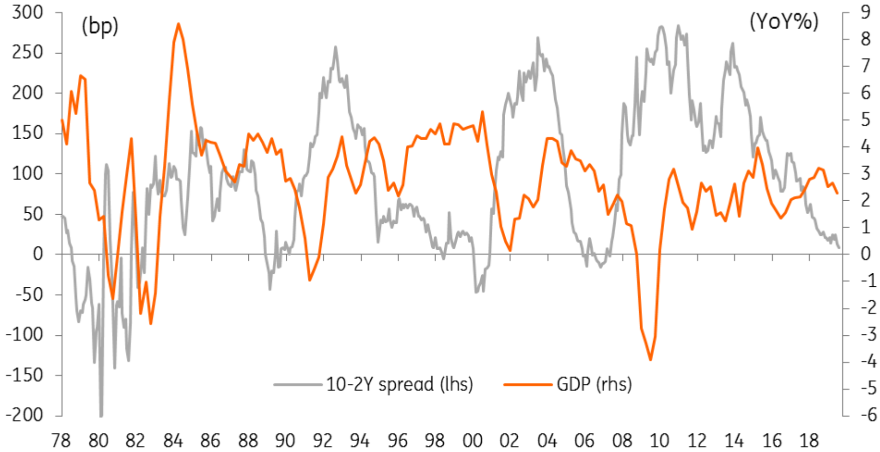
The ever flattening yield curve is also adding to a sense of nervousness. All nine recessions since 1955 were preceded by an inverted yield curve and we are there already on the 3M-10Y and only 8bp away on the 2-10Y. However, there have been false signals before and this time we have to recognise there are factors in play that are depressing longer US dated yields and thereby perhaps overhyping the threat of a recession.

> *What worries us more about a flat/inverted US yield curve is that it hurts banks and can disrupt and deter the process of credit creation*

The lagged effects of the Fed's quantitative easing programme is making the curve flatter than it otherwise would be (relative to previous cycles) while negative yields in Europe are also contributing to the demand for US Treasuries given the US safe-haven status and the fact investors at least get a positive return and the dollar remains strong.

What worries us more about a flat/inverted US yield curve is that it hurts banks and can disrupt and deter the process of credit creation since banks typically receive long term and payout short-term. This means weaker profitability while setting off warning signals about future credit quality in risk models. Less willingness to lend can, therefore, contribute to making the bond market's downturn expectations self-fulfilling.

Yield curve recession warning



Source: Macrobond

Fed set to cut rates further, but not as much as the market wants

All of this suggests to us that our current forecast of just one further Fed rate cut in September is looking too cautious. Growth risks and inflation risks are looking increasingly to the downside in the wake of the latest trade escalation. With other central banks easing aggressively, this risks exacerbating upside pressure on the US dollar, which could further dampen growth and inflation and add to the pressure on the Fed to ease policy.

> *It looks increasingly likely that the Fed will step in with more easing – with two 25bp cuts in either September and October or September and December (our preference)*

As such it looks increasingly likely that the Fed will step in with more easing – with two 25bp cuts in either September and October or September and December (our preference). In this regard, the Jackson Hole symposium 22 -24 August will see a lot of Fed discussion on this topic with Fed Chair Jerome Powell's favourite phrase of late that an "ounce of prevention is worth a pound of cure" likely to crop up again.

Though, we continue to doubt that the market will get the four additional rate cuts they are discounting. After all, we think that President Trump wants to be re-elected next year and recognises that a robust economy with rising asset prices is critical for that to happen. We continue to look for a "deal" even if not all of President Trump's demands are met later this year.

Relief in business and markets that trade uncertainty has been lifted and with interest rates globally offering a decent stimulus, may well give President Trump what he needs.

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FX: The delay in some US tariffs on China and the implications for FX

The announced delay on some of the US tariffs on China is positive news for USD vs low yielding FX such as JPY, EUR and CHF. On the flip side, the dollar...

Stronger USD vs low yielders, weaker USD vs high yielders

The news of the delay of some US tariffs on certain Chinese goods (from September to December) is positive for risk sentiment, although the full details aren't yet known. You can see this by the initial reaction in FX markets with higher beta, high yielding FX such as AUD in the G10 FX space outperforming USD (due to the "risk-on factor") while the likes of EUR, CHF and JPY under-performing the dollar (mainly via "higher UST yield factor" - this is particularly the case for the euro). In terms of the latter, the front-end UST yields spiked on the news (helped by higher CPI as well), with the hawkish Fed re-pricing supporting the dollar against the low yielding FX segment.

JPY the most at risk for now

Among the G10 FX low yielders, JPY is to be a key underperformer (at least over the short term) as the current mix of the higher UST yields and the risk-on environment is very negative for the currency. JPY to underperform EUR and CHF with the latter two currencies both exhibiting lower correlation with risk (yet nonetheless suffer from higher UST yields)

Don't chase GBP higher

While the positive sentiment is also spilling over into GBP (mainly on the EUR/GBP cross), in our view sterling should be the last currency via which one should position for a positive shift in global risk appetite. We retain a strong view that any GBP upside is a fade given the rising probability of early elections or a hard Brexit, with both being bad news for GBP and the Brexit factor being the overriding driver for sterling. We expect EUR/GBP to head to 0.95 this summer.

AUD to keep outperforming NZD

Interestingly, AUD has outperformed the NZD despite very similar exposure to the US-China trade war. There are at least two reasons that explain the relatively higher appetite for AUD to play a de-escalation in trade tensions: monetary policy and economic outlook. Both the RBA and the RBNZ have been cutting rates, but the rate outlook in New Zealand appears more unsupportive for the currency.

Not only did the RBNZ show a more aggressive approach to monetary easing (50bp cut last week) but recent comments by the NZ Treasury Department also paved the way for negative rates and unconventional tools. On the other hand, the RBA has not sounded dovish enough - after keeping rates on hold last week – to trigger significant downward pressure on rate expectations. Looking at the economic outlook, weaker business activity and confidence indicators in New Zealand keep pointing at a slowing economy, whereas the Australian fundamentals appear more robust and suggest a better resilience to external shocks. We continue to prefer AUD to NZD.

CEE the underperformer in the EM FX space

In the EM space, CEE FX should lag other EM regions in terms of potential gains as one of the by-products of the delay in China tariffs is lower EUR/USD (due to the higher UST yield channel). This should keep the CEE FX gains vs USD limited. In terms of the knee jerk reaction, CEE FX should be the EM underperformer, with LatAm FX outperforming now (given its high beta) and Asian currencies catching up as well.

Don't get carried away with optimism

Still, the lack of visibility on the trade war outlook means that the above should not translate into a long-lasting trend. That means that the USD/JPY upside is unlikely to last long while the EM FX gains should be limited in scope too – particularly as the uncertainty about the global growth outlook remains in place.

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Revising yuan forecast

We are revising our USD/CNY forecast following the Chinese government's decision to allow the yuan to cross the 7 handle

We were right and wrong

We didn't think China's authorities would allow USD/CNY to pass the 7.0 handle because of the disruption such a move would cause in asset markets, not just in China but around the world.

We were partly right; the People's Bank of China let the currency pair pass this key level on 5 August, whereupon global markets experienced a sharp fall. China's CSI300 index fell 1.91%, the Hang Seng Index fell 2.85% and the Dow Jones Industrial Average index tumbled 2.90% on the day.

We thought China would refrain from using the yuan as a 'weapon' in the trade war because triggering a currency war would not be helpful to China's economy. But Chinese leaders appear to have concluded that the currency can be used as a tool to provoke Trump and inflict political damage.

Near term: What's next after 7?

We think it unlikely that USD/CNY will fall below 7 unless upcoming trade talks go particularly well, which is not our base case. Both sides are to blame for escalating this situation. The US raised tariffs on $300bn goods to 10%, China stopped buying US agricultural products and let the yuan pass through 7.0, and the US immediately labelled China a currency manipulator. On

Wednesday, the US imposed a ban on federal purchases of equipment and services from five Chinese companies, including Huawei. We expect further retaliation.

In the near term, we think the yuan will trade in a range of 7.00 to 7.10. Further weakness would send a signal that China wants to start a currency war, which we strongly believe is not the case because this would do little to benefit the Chinese economy as other Asian currencies would just weaken along with the yuan.

The market is currently trying to work out how much the yuan will deviate from the fixing price. As such, the difference between the fixing and closing prices of USD/CNY is still quite large (more than 250 pips). We believe that as the market gets used to the yuan's new level, the daily fixing of the USD/CNY will be closer to the closing price.

Medium term: Progress of the trade war is now key for yuan

USD/CNY passing 7.0 shows that China is going to fight this trade war hard, at least while President Trump is in office.

There is a chance, in the medium term, that the yuan could weaken past 7.10 if:

1. The trade war escalates even further and the Chinese government uses the yuan to create market volatility. This could be a tool to frustrate Trump's 2020 re-election campaign.
2. The Chinese government has a plan to compensate for the loss of economic activity caused by the trade war. Asset market turmoil, led by a far weaker yuan, may not hurt China so much as it hurts the US.

We think the chances of this happening are very small but we don't rule out the possibility.

Forecast of USD/CNY and USD/CNH

We forecast the USD/CNY will reach 7.05 (previous 6.95) by the end of 3Q19 and 7.10 by end 4Q19 (previous 6.90). The USD/CNH should be 150 pips higher than USD/CNY.

We think USD/CNY will fall to 7.05 by the end of 1H20 (previous 6.85) and to 7.00 by the end of the year (previous 6.75), as we expect positive progress in the trade war after the US presidential election in November 2020.

RBNZ delivers double-barrel 50bp cut

The Reserve Bank of New Zealand (RBNZ) appears to be adopting the "sooner is better" approach to monetary policy setting - cutting rates 50bp to...

1.0%

Cash rate target

Down from 1.5%

Lower than expected

Not one of the consensus expected 50bp of easing

18 out of 21 economists surveyed by Bloomberg forecast a 25bp rate cut today. We were one of them. The remaining three forecasters opted for no change, and there was a decent argument for that too, following strong employment and wages figures just the day before.

There is a respected stream of economic literature about expected versus unexpected monetary policy decisions. The latter are supposed to deliver more of a real impetus to the economy, whereas the former deliver more of a price level adjustment. The accompanying statement to today's decision does acknowledge the better labour market data, and even that inflation remains within range though below the mid-point of the 1-3% target (latest 2Q inflation was 1.7%, up from 1.5% in 1Q19).

But in keeping with concern over the state of the real economy, there are a number of somewhat perplexing references to weak GDP - the latest release of which was for 1Q19, which is now very dated. Either the RBNZ has some insight into the 2Q figure due on 19 September, which is possible, but still a long way off, or they are imputing a lot of transmitted weakness from the challenging global conditions - namely trade war. This seems a sufficient excuse to justify a 25bp rate cut against a mixed domestic/ external backdrop, but it still doesn't deliver a very compelling case for a double-barrel 50bp cut.

Uncertainty may well weigh on New Zealand's business investment decisions in the months ahead to deliver a weaker 2Q19 GDP result. That would merit a second 25bp rate cut then. But it is hard to make that judgment now and raises the prospect that even today's 50bp of easing may not look like enough later on this year.

NZD on the receiving end of double-barrel rate blast

Not surprisingly, the NZDUSD has taken quite a blow from this policy action, dropping to 0.6423 before pulling back a little. The AUDNZD rate has spiked up to 1.0456, though if this move from the RBNZ was supposed to front-run some of their anticipated easing, then we would expect the RBA to pull ahead in the coming months with further cuts. They are also already at a 1.0% cash rate. The AUD itself has been dragged lower by this action, and AUDUSD fell to 0.6720 on this news.

We will have to consider whether or not to add further easing to our RBNZ forecast, as today's decision delivers what we had penciled in for the rest of the year. Our initial gut feeling is, that we probably will. It also begs a re-look at the RBA forecast, where we only had one further rate cut forecast.

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Opinion | 8 August 2019

3 Central banks cut 110bp yesterday - who's next?

It's all kicking off in Central Bank space with three cuts yesterday from the Bank of Thailand, Reserve Bank of India and the Reserve Bank of New...

But is this actually good news?

Yesterday could hardly be described as "yet another day in the office".

We started off being surprised by the RBNZ move. I think it is fair to say that no-one saw 50bp of easing coming. We were even thinking of chopping our rate cut call altogether - here is our longer view. We then moved on to disappointment, that the RBI did not pause, mixed with bemusement at the 35bp easing. I love the tweet from Lorcan Roche Kelly (see below) which offers an excellent if tongue in cheek answer as to why this odd number.

We switched to elation later on, as the Bank of Thailand finally delivered 25bp of easing, and was probably the only move of the day that was fully justified. I might add, it would not have upset us to see 50bp of easing from the BoT, nothing from the RBI and only 25bp from the RBNZ - that is, if our job was to forecast what central banks "*should*" do (we do stray into that territory from time to time), not what they will do.

BSP today - 25 or 50bp?

Yesterday's CB action puts pressure on Philippine Central Bank Governor Diokno to deliver more than the 25bp of easing priced in by markets. He has already suggested that there will be 50bp of easing before the year-end. but that view may have lengthened after yesterday.

The main thing that may dissuade him would be the PHP, which has been in the vanguard of EM currencies hit by recent market turmoil kicked off by China's relinquishing of the USDCNY 7 level. So 25bp is the more likely outcome, but let's not rule anything out. See Nicholas Mapa's thoughts following recent Philippine inflation figures. GDP data out this morning may add to the debate if they come in on the weaker side.

Will the Fed get in on the action?

It seems that all this rate-cutting is making President Trump jealous he does not have such an acquiescent central bank. Well, we think he does, he just needs to be a bit more patient. James Knightley has just added another cut from the Fed to our house forecast - that's on top of the September cut we had in before. Just for the record, they have already finished quantitative "tightening" though the term is a horrible misnomer. No time for a rant on that today - and it's only a few days since I last let rip on this subject too.

I told you commodities were looking miserable

While I am peppering today's note with tweets, I might as well add one from our Head of Commodity Strategy, Warren Patterson, who more eloquently summed up my clumsy observations on commodities in yesterday's note with this simple tweet...

Back to the matter in hand

This has rather taken me off track from whether any of this is good news or not. Equities have bounced a bit overnight, though in Asia the futures markets look a bit mixed. Good, I think that for once, this is an appropriate response. Yes the prospect of further easing does help the discounted cash flow calculations for equity valuation purposes, but it only makes sense to rally every time a central bank hikes if you don't change your earnings outlook, and that is the point that Warren's commodity chart is screaming loud and clear - the global demand backdrop is clearly slowing.

As for whether it makes sense to front-run or over-deliver on monetary easing - there are many conflicting arguments here, and the answer is partly dependent on what you think the demand outlook really is, the prevailing very low level of interest rates and bond yields, and the absence of much fiscal support. We could spend all day on this, which really means - it isn't obvious.

ECB?

It won't surprise anyone that we are looking for a return to incremental easing from the ECB in September. Yesterday saw some squalid production figures from Germany that suggest GDP growth may have now turned negative. This may not be the time for half-hearted measures.

But with all this monetary easing going on, the principle currency pair - EURUSD, seems relatively stable at about 1.12. If this was a tug-of-war between the ECB and Fed, they both seem fairly evenly matched right now. Currency wars really are a zero-sum game.

Asia today

Two other main events to watch today - both of them China-related:

1. Yesterday's CNY fix at 6.9996 indicates that we should expect a 7 - something fix today. That would be the first in a very long time, so watch out for the market reaction to that. Hopefully quite modest.
2. Chinese Trade data - Exports figures could look quite soft, and of course, this is pre-new tariffs, so whatever we see today, might not mark the low point.

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Asia week ahead: Is this what calm after the storm looks like?

After the escalation of the trade and currency war unleashing a whole load of central bank policy easing in Asia this week, markets may get some room to...

Source: Shutterstock

China: Still, steady as she goes

This week saw a further escalation in trade tensions, further diminishing hopes of the two sides returning to the negotiation table in September. The next event risk could be a hike in the newly-announced 10% US tariffs on $300 billion of Chinese goods, (which are due to come into effect in September) to 25%, or even more as President Trump has hinted.

Despite all of this, the Chinese economy, especially exports have been performing quite well. Following slightly better manufacturing PMI for July, an unusual export bounce in July asserts this view, while also sustaining the upside potential for the rest of July economic data next week. Hence the above-consensus growth forecasts by our Chinese economist Iris Pang, who expects manufacturing to rise by 6.5%, fixed asset investment by 6%, and retail sales by 9.5% (consensus 6.0%, 5.9%, and 8.6% respectively). Meanwhile, July monetary data due any time from now until 15 August should reinforce that the authorities aren't letting their guard down in providing the necessary fiscal stimulus.

China: Exports better than expected with unusual jump in some items

India: Test of RBI's aggressive easing

India's forthcoming manufacturing, trade, and inflation releases will be gleaned in the light of RBI's additional rate cut this week. Like China, India's 2% export growth in the first half of 2019 - the fastest among Asian countries - testifies that the Indian economy is performing well despite external headwinds, while stimulatory economic policies support domestic spending. As this holds a line under GDP growth, rising food price inflation has already begun to drive headline consumer price inflation higher.

> *With the escalation of border tensions undermining growth prospects further, we can't rule out RBI cutting rates further this year. We now pencil in additional 50 bp easing by yearned, replacing our stable policy view.*

So far economic data conforms to our view that the economy has had enough stimulus and the latest RBI rate cut wasn't really required. However, coinciding with the RBI meeting, the events about the disputed state of Kashmir may have had government's heavy hands in the RBI's unexpectedly big, 35 basis point rate cut decision this week. With the escalation of border tensions undermining growth prospects further, we can't rule out RBI cutting rates further this year. We are now pencilling in additional 50 bp easing this year, replacing our stable policy view.

India's RBI cuts more than consensus by 35bp

The rest of Asia: Reeling under export weakness

July trade figures form Singapore and Indonesia will inform on the growth of these economies coming into the third quarter of the year. Singapore seems to be the weakest link in export performance in Asia with contraction in non-oil domestic exports now running in high teens (-17% YoY in June, -20% ING forecast for July). If so, any recovery from a sharp GDP slowdown in the second quarter would be a far cry, though we estimate a slight upward revision to 2Q growth to 0.2% YoY from 0.1% in advance report. Our Singapore watcher, Rob Carnell, sees this week's sharp fall in the 3-month SIBOR (Singapore interbank offer rate) as a clue to the imminent off-cycle central bank policy easing.

However, alongside China and India, Malaysia is also another notable exception to the export-led GDP slowdown, as what we expect the country's GDP report for 2Q to reveal next week. Relatively firmer exports and manufacturing growth led us to raise our 2Q GDP growth forecast to 4.8% from 4.6%, following a brief slowdown to 4.5% in the previous quarter.

Also due next week is Malaysia's inflation data for July, which is likely to underscore the lack of inflation pressures, allowing the central bank to cut rates in the event that growth deteriorates. That's not quite our baseline though, with a forecast of stable BNM policy maintained for now.

Singapore short term rates drop

Asia Economic Calendar

Country	Time	Data/event	ING	Survey	Prev.
		Monday 12 August			
China	-	Jul Aggregate finance (Yuan bn)	1862.9	1625	2262.9
	-	Jul Financial institution loans (Yuan bn)	1400	1275	1663.6
	-	Jul Money supply (M2) (%YoY)	8.5	8.4	8.5
		Tuesday 13 August			
India	1300	Jul CPI (YoY%)	3.4	3.1	3.2
	-	Jul Exports (YoY%)	-5.5	-	-9.7
	-	Jul Imports (YoY%)	-4.5	-	-9.1
	-	Jul Trade deficit (US$bn)	-18.0	-15.2	-15.3
Singapore	0100	2Q F GDP (QoQ Annualised/ YoY%)	-2.9/0.2	-/-	-3.4/0.1
		Wednesday 14 August			
China	0300	Jul Fixed asset investment (YTD YoY%)	6.0	5.9	5.8
	0300	Jul Industrial Production (YoY%)	6.5	6.0	6.3
	0300	Jul Retail Sales (YoY%)	9.5	8.6	9.8
India	0730	Jul WPI (YoY%)	2.0	1.9	2.0
South Korea	0000	Jul Unemployment rate (SA%)	4.1	-	4.0
		Thursday 15 August			
China	0230	Jul 70-cities New home prices (% YoY/MoM)	10.5/0.5		10.8/0.7
Indonesia	0500	Jul Exports (YoY%)	-7.1	-	-9.0
	0500	Jul Imports (YoY%)	-16.2	-	2.8
	0500	Jul Trade balance (US$mn)	-205	-	196
Philippines	-	Jun OCW remittances (YoY%)	-0.1	-	5.7
		Friday 16 August			
Hong Kong	0930	2Q F GDP (Q) (QoQ SA, YoY%)	-/0.6	-/-	-0.3/0.6
	0930	Unemployment rate	2.9		2.8
Malaysia	0500	Jul CPI (YoY%)	1.5	-	1.5
	0500	2Q GDP (QoQ SA, YoY%)	0.9/4.8	-/-	1.1/4.5
	0500	2Q Current account (Q) (MYR bn)	5.3	-	16.4
Singapore	0130	Jul Non-oil domestic exports (MoM SA, YoY%)	3.9/-20.0	-/-	-7.6/-17.3

Source: ING, Bloomberg, *GMT

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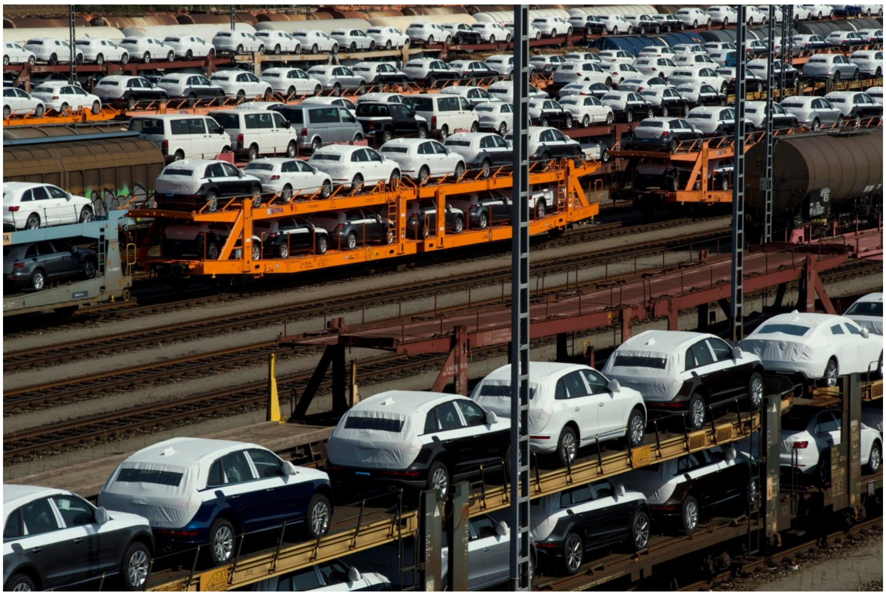
German recession fears, should we blame the Chinese car market?

The current slowdown of the German economy is closely linked to problems in the automotive sector. What role does China play in all of this?



Source: Shutterstock

The German economy appears to be stuck between solid domestic fundamentals and external risks. The industrial slowdown is beginning to have an impact on the domestic economy while the entire economy seems to be flirting with recession.

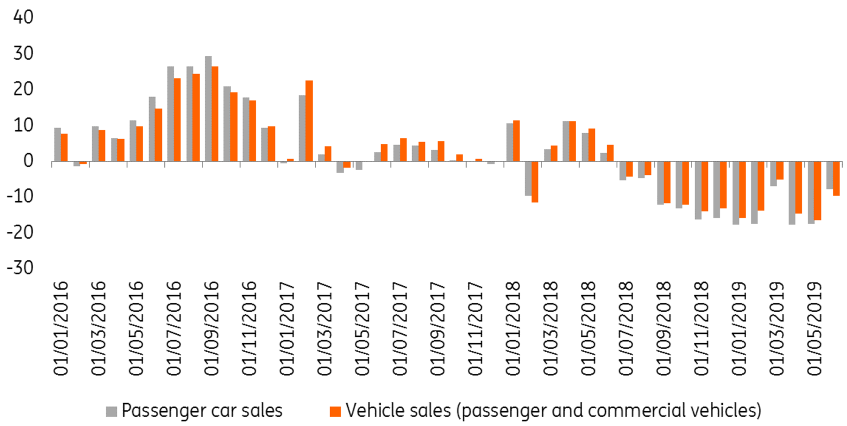
Cars have played and will continue to play an important role in this situation and among the multiple explanations for the problems in the automotive sector, surprisingly is China. Understanding recent developments in the Chinese automotive market is an important piece of the puzzle in comprehending the outlook for the German automotive market.

From WLTP to the US-China trade conflict

The delayed introduction of the new emissions standard - the worldwide light vehicles test procedure, or WLTP - and delays in complying with these new standards led to severe disruptions in German automotive production and delivery. The US-China trade war and subsequent slowdown of the Chinese economy have also contributed to Germany's car problems.

But the data shows a more nuanced picture. In 2018, vehicle sales in China dropped by some 3% YoY, while passenger car sales dropped by more than 4%YoY - the first decrease in over twenty years. However, German car manufacturers saw their sales increase by 2%.

New vehicle sales have dropped 13 months in a row



Source: Refinitiv Datastream

Direct impact of the trade conflict on the German automotive sector

The Chinese market is the most important market for the majority of German car manufacturers. In 2018, almost one-quarter of all cars sold in China were German. BMW and Daimler sold more than one-third of their total car sales in China. For Volkswagen, the share is even bigger at 40%.

Looking ahead, things aren't looking too good for German car manufacturers. New car sales in China have fallen for 13 months in a row, a slump that started in the second half of 2018 when the trade war between China and the US began to heat up.

> *In 2018, almost one-quarter of all cars sold in China were German. BMW and Daimler sold more than one-third of their total car sales in China*

With the introduction of tariffs, US customs duties on Chinese goods worth US$ 250 billion (with US$ 300 billion to follow on 1 September) and Chinese customs duties on US goods worth US$ 110 billion, car and car parts from China are being taxed at 27.5% in the US since July 2018, while China temporarily increased customs duties on US vehicles from 15% to 40%. However, China removed these additional tariffs, so US autos are subject to China's standard tariff rate of 15%.

Given that some German car manufacturers actually export US-produced cars to China, there has been a clear and direct impact of the trade conflict on the German car industry. Having said that, the larger impact seems to be coming indirectly from lower Chinese consumer confidence. According to media reports, BMW and Mercedes car exports from the US to China have suffered due to the tariff hikes, which is probably why BMW has started to manufacture locally in China.

Structural factors and shift in the Chinese automotive market

Another factor, which is well known in Europe and has probably weighed more heavily on sales in recent months, is the switch to the new emission standard. By July 2020, all light vehicles in China need to comply with the China 6a emission standard, based on European and US regulations. But many provinces rushed ahead and made the new standard mandatory a year earlier to comply with environmental protection campaigns.

In Europe, the impact of adopting this new standard placed a huge strain on the passenger car market last year such that new passenger car registrations fell more sharply (in absolute terms) than during the global financial crisis.

In China, although car dealers substantially discounted prices for China 5-standard vehicles before the deadline, consumers were reluctant to make purchases, probably waiting for passenger cars with the new emission standard instead. Automotive retail sales saw a surge only in June, with car dealers offering heavy price reductions. The destocking of China 5-emission standard vehicles might be responsible for lower orders from dealers too. But with the new standard now in place, a rebound in car sales might be round the corner.

Forecasts of the Chinese car market have assumed low ownership rates projecting plenty of growth potential in the coming years, but it's quite possible that this growth potential will be impaired by ride-hailing and/or car-sharing

The phasing out of tax incentives for small cars from the end of 2017, a government programme that ran for three years, is also likely to continue to have an impact on the Chinese market, as car purchases were brought forward.

Alongside cyclical developments, there are also structural changes in the Chinese automotive market affecting German car sales. China is already the largest ride-hailing market in the world, with over 459 million customers and a turnover of around US$ 53 billion. In the US, there are currently 66 million users generating US$ 49 billion in turnover. To put things into perspective, one-third of the Chinese population already uses alternative mobility solutions, while in the US the figure is around 20 percent and in the EU it is just 18 percent - a trend that is likely to grow in the coming years. Admittedly, it's impossible to tell whether users are exclusively using ride-hailing or whether it is complementary to owning a car.

To date, forecasts of the Chinese car market have assumed that low ownership rates offer sufficient growth potential in the coming years, but it's quite possible that this growth potential will be impaired by ride-hailing and/or car-sharing.

Another structural change is the transition towards electric car production and sales, which the Chinese government is supporting. Indeed, sales of electric cars in China are still going strong, increasing by 50 percent in the first half of 2019 compared to 1H18, but the subsidies in this segment will be phased out between 2020 and 2021.

The biggest threat to German automotives is...

So, we think the current crumbling of the Chinese car market appears to be a simultaneous combination of cyclical factors, one-off effects and structural changes.

And for the German economy, it's not actually the trade conflict that is most concerning but the structural shifts in the Chinese automotive market, which could turn out to be one of the biggest threats in the years ahead.

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Article | 9 August 2019 Italy

Three political scenarios for Italy with FX and rates implications

The collapse of Italy's ruling coalition opens the way for three possible scenarios: new elections, an extension of the current coalition or a new...

Italian Deputy Prime Minister, Matteo Salvini, presented a vote of no-confidence in his coalition partners

Three scenarios ahead of the government crisis

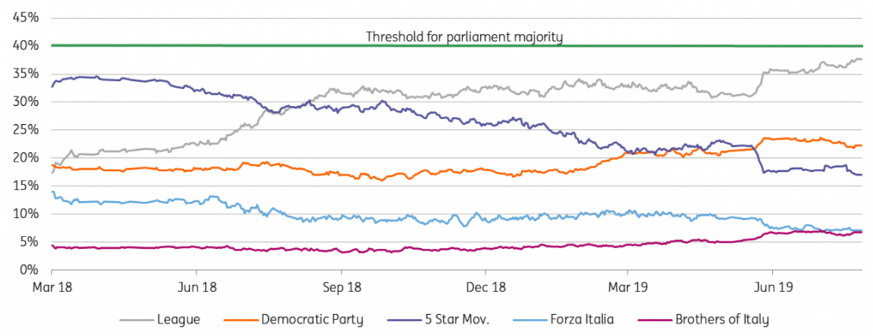
Italy is facing another political crisis after the leader of the country's Lega's party, Matteo Salvini, told the prime minister and the Five Star Movement coalition partner that he wants fresh elections and that the government is now technically dead. It comes after Five Star failed to block the construction of a high-speed train link between Lyon and Turin, something strongly supported by Salvini. Polls suggest that Lega could be close to winning the 40% of votes needed to govern either alone or through a coalition, probably with the ultra-conservative Brothers of Italy (currently at 7%).

> *This crisis comes at a critical juncture*

This crisis comes at a critical juncture. Only last month the prime minister, Giuseppe Conte, managed to get an agreement with the European Commission to avoid an EU disciplinary procedure over its growing debt. But the 2020 budget looks set to become even more challenging and the absence of a working government in October will complicate matters even further.

Timing is the key variable to consider when analysing the possible scenarios for Italian politics. First, it will be crucial to see when Prime Minister Conte will decide to officially resign. That allows the President of the Republic, Sergio Mattarella, to start a period of consultation with the leaders of the main parties whilst weighing the different options. How long these consultations last is relevant: there is not a fixed deadline and it is mostly up to the discretion of the President. The more the decision is delayed, the more complicated it will be for a new government to deal with the busy schedule of budget-related obligations starting in October. At the moment, PM Conte appears reluctant to loosen his grip just yet and he called for a formal no-confidence vote in the parliament. The current situation suggests three possible scenarios ahead.

Opinion polls suggest Salvini is close to a majority



Source: Politico, ING

1 New elections

Salvini has explicitly called for new elections as he pulled the plug on the governing coalition. General elections in Italy can take place no earlier than 45 days after the President dissolves the parliament and announces snap elections. In practice, at least 60 days are probably going to be needed to set up the electoral procedures. Should President Mattarella decide to rush things and dissolves parliament next week, then we would be realistically looking at either the 13th, 20th or 27th of October as the earliest possible dates for an election.

This would inevitably collide with the deadline set by the EU to submit the 2020 budget draft (October 15th), although the Commission may well grant an extension given the extraordinary situation. Waiting much longer to announce snap elections can be very risky: the new government may not have enough time to receive parliamentary approval of the budget before the December 31st deadline. This would increase the possibility that the "provisional system" would automatically come into force. That's a system provided for in the Italian constitution that forces the government to spend only a limited amount of resources each month, thereby blocking any long-term investment previously included in the budget. All parties (and the President) would likely want to avoid this situation given the possible dampening effects on the already-battered Italian economy.

Extension of the current government

With those concerns about the budget deadlines in mind, President Mattarella may decide to try to convince Salvini and his co-deputy prime minister, Five Star's Luigi Di Maio to extend the current coalition at least until the end of the year. He would likely require a commitment by the two parties to deliver on the budget. Such an agreement may include demands for a cabinet reshuffle, with a bigger presence of League representatives in some key roles. This would likely lead to elections at the beginning of 2020.

3 A new technocratic government

Similar to the second option, the President may try to ensure a "calm" budget season, but this time by calling for an external figure to lead an interim government with the specific task of having the budget approved (by the EU and the parliament). The President would inevitably need to ensure there would be a majority backing the technocratic government, which may turn out to be a anything but a simple task. Also in this scenario there would likely be snap elections in early 2020. There's also some speculation of a possible agreement between the 5-stars and the Democratic Party to form a new government, but no official negotiations have started and the parties' political views are, for now, very far apart.

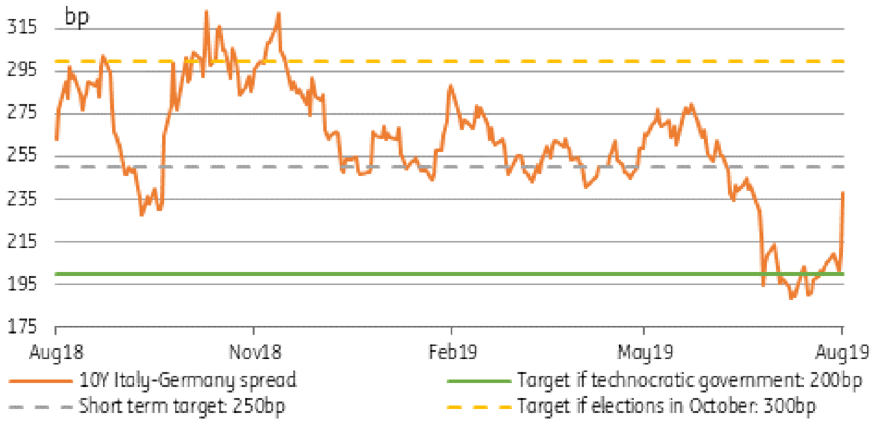
Rates: 10Y BTP-Bund spread to widen

From now until we know the date of the election, we're going to see further volatility in Italian markets. And that prospect is enough to flush out positions established with a view to benefiting from carry over the summer months, in our opinion. This justifies our short-term call for a widening of the 10Y Germany Italy spread to 250bp. The range of possible outcomes discussed above, and market reactions discussed below, also justifies a greater risk premia baked into this spread in the near term.

For investors, the interplay between the election and budget dates will be crucial. The failure to pass a 2020 budget before the election would expose holders of Italian bonds to a period of uncertainty until it becomes apparent whether an Excessive Deficit Procedure (EDP) will be reopened against Italy or not. It could also raise doubts in investors' minds as to whether the ECB would restart PSPP (the Public Sector Purchase Programme) and risk being seen supporting a government breaching EU fiscal rules.

On balance, we think the political turmoil is unlikely to prevent a restart of purchases, given that easing is required by conditions within the eurozone's economy as a whole. The tone of the League's campaign on fiscal issues will also be important, not least because prominent party members have expressed reservations about Italy's euro-membership in the past. More broadly, the prospect of a more assertive, and more powerful, Salvini raises the prospect of protracted tensions with the EU.

Different reactions from the 10Y BTP-Bund spread



Source: Bloomberg, ING

If we get elections in October (scenario 1 above) then the period of uncertainty is likely to be short but intense. League election rhetoric will gain in importance given its implication for the 2020 budget. There is a possibility that the League's economic agenda might ultimately be perceived positively by investors, but the near-term risks surrounding the election should dominate price action, especially as the build-up to the Italian election would coincide with the build-up to Brexit. If we get that, we see the 10Y Italy-Germany spread testing 300bp to the upside during the campaign.

In the event that the current coalition survives the crisis (scenario 2) until after the 2020 budget process, we think the likelihood of a clash between the government in the autumn is high but manageable given the proximity of ECB easing. This was the closest outcome to what markets were pricing prior to this week. We doubt a retracement of the 10Y spread below 200bp is likely in this event, however, because Salvini's strengthened position will give him more leeway to push for his fiscal demands. We see the spread staying around 250bp in this scenario.

If President Mattarella manages to muster a technocratic government (scenario 3) with the main aim to pass a 2020 budget giving no ground for the EC to restart the EDP against Italy, then we expect the 10Y Italy-Germany spread to recover from today's widening, and BTP correlation to other EGB markets to return to positive territory. This outcome would dispel any lingering doubt about the ECB's willingness to include government bonds, and thus BTPs, in its purchases. In this scenario, we see the 10Y spread retracing inside to 200bp into the restart of PSPP.

FX: Another negative added to the EUR outlook

About a year ago, the freshly-formed Lega-5 Star government spread uncertainty in the markets as they announced a 2.4% deficit target to be included in the draft budget. In the following weeks, Italian political uncertainty was a constant dragging factor on the euro. The main takeaway from our scenario analysis is that the breakup of Italy's ruling coalition is probably the first step towards a period of extended uncertainty stemming from the country.

An escalation in political risk is likely going to add more negatives *to the euro outlook*

This may add more negatives to an already clouded outlook for the common currency. Our economists are expecting the ECB to deliver a heavy package of monetary easing in September: a rate cut and the announcement of a new round of quantitative easing. In addition, the global environment continues to bode quite badly for the already-concerning European economic outlook: trade wars may soon hit the EU directly, with President Trump possibly aiming to levy tariffs on autos, The lingering Brexit-related uncertainty also continues to weigh on forward-looking indicators.

An escalation in political risk stemming from Italy is likely going to add more negatives to the euro outlook. In particular, we expect such potential escalation to have a magnified effect on EUR/CHF among other crosses. The pair proved to be highly correlated to the dynamics of the 10Y BTP-Bund spread during the troubled 2018 budget season. On the opposite side, EUR/USD may face more resistance in entering an extended downward trajectory, given that simultaneously-escalating trade tensions may join recent pressure from the White House to suggest more easing by the Federal Reserve, thereby weighing on the US dollar.

Despite the upcoming easing moves by the ECB, the outlook for the EUR-USD rate differential appears more likely to move in favour of the euro. Negative rates in the eurozone may only have limited space for a further drop, whereas an easing cycle by the Fed may keep pressuring the relatively-higher US rates. In the table below, we outline the potential reaction of EUR/USD and EUR/CHF to the three different scenarios discussed in this article.

Scenario	Timeline	Impact on 10Y BTP-Bund spread	Impact on EUR
New elections in October	Parliament dissolved in the next few days. Salvini becomes new PM in late October and negotiates the new budget with the EU.	300 bp (+65 bp)	EUR/USD 1.10 EUR/CHF 1.07
Continuation of current government	The current coalition remains in place at least until year-end for the budget season (possibly with a cabinet reshuffle). Elections in 2020.	250 bp (+15 bp)	EUR/USD 1.11 EUR/CHF 1.08
Technocratic government	The President appoints an external personality to lead the government and have a "thin" budget approved. Elections in 2020.	200 bp (-35 bp)	EUR/USD 1.12 EUR/CHF 1.10

Source: ING

One thing's for sure, the collapse of the Italian government is paving the way for more uncertainty, and not just as far as politics are concerned. The spill-over effect will likely depend on the number of implications about the future Italy-EU relationships and the stability of the battered Italian economy. We believe that the balance of risks for Italian sovereign bonds is tilted to the downside, with the 10Y BTP-Bund spread that may well edge back to the 300bp area in case of new elections in October. Similarly, this scenario would probably add selling pressure to the EUR, with the CHF likely to come up as the main beneficiary: EUR/USD may explore the 1.10 area while EUR/CHF could touch 1.07.

Given the early stages of the government crisis and the lingering uncertainty about the upcoming developments, we're not putting probabilities to the scenarios, although we acknowledge a significant increase in downside risk for eurozone sentiment.

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US FX intervention: What are the chances?

A further tirade from President Trump over the strong dollar begs the question whether he's prepared to weaken it through FX intervention? We would...

Donald Trump nominates Jerome Powell as Fed Chair, November 2017

The dollar is increasingly on the White House's radar

This week's move above 7.00 in USD/CNY and widespread monetary easing across Asia has provided further fuel to the President's criticism that the Fed has kept US interest rates too high and the dollar too strong.

The term 'currency wars' has also made a strong come-back – a term last used as countries were softening their currencies to compete for diminishing external demand after the Global Financial Crisis. We agree with most that China has not devalued its currency this week, but has instead allowed market forces to play a greater role in setting its value.

In fact, the US Treasury's statement supporting the designation of 'currency manipulator' against China reads something like 'if you claim you're so good at controlling your currency, why couldn't you keep $/CNY below 7?'.

Intervention: Is it a strong dollar or weak renminbi problem?

There are two schools of thought on FX intervention:

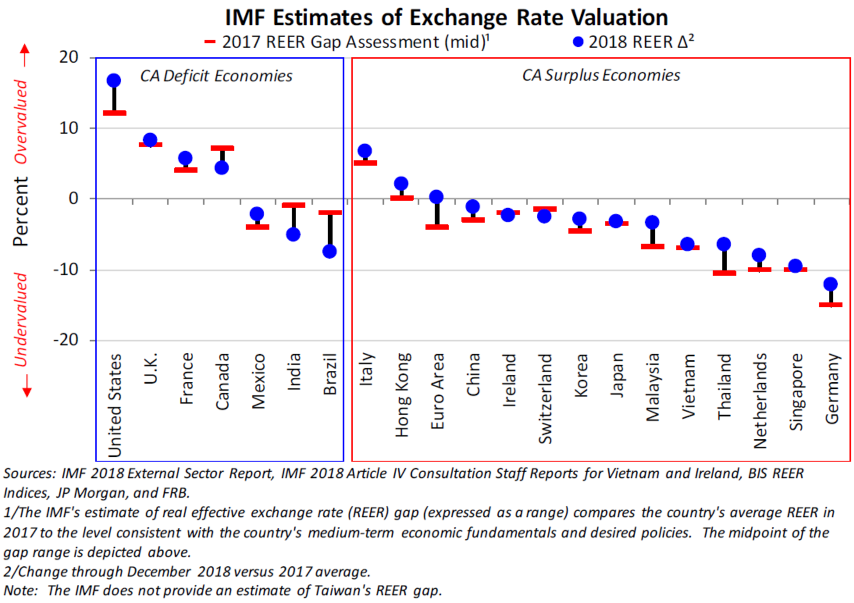
1. Is Washington's key focus an over-valued dollar that is hurting the US manufacturing sector?
2. Is the main concern that China is manipulating its currency lower for trade gain and to offset tariffs?

The answer to these questions will require different policy responses.

Listening to the President yesterday, the former certainly seems to be the case. The response required from the White House to this is largely to pressurise the Fed into more aggressive easing and, in exceptional circumstances, to get the US Treasury to instruct the Fed to sell dollars against the EUR and JPY (the two currencies already in the Exchange Stabilisation Fund (ESF). Washington's sense that the dollar is too strong could be backed up by the IMF's own calculations of FX valuations, where the dollar stands out as over-valued (see below).

The latter issue would see US FX intervention entertained against USD/CNY. After the admission of the Renminbi to the SDR in 2016, China has been welcoming public sector investments into its onshore bond markets. In theory then, the Fed should be able to buy the onshore CNY, with the proceeds parked in onshore CNY government bonds, just as fellow FX reserve managers do.

IMF estimates of FX valuation: over-valued dollar stands out



Source: IMF

What are the chances of intervention?

There is no perfect way to judge the market's view here, but a rough gauge is to look at FX options and see what probability the market attaches to certain outcomes. If we assume that unilateral US FX intervention (near unprecedented) would knock the dollar, say, 3% lower, what probability is attached to that for USD/JPY, EUR/USD and USD/CNY? Looking at One Touch option prices, the probability of the dollar falling 3% over the next month against the JPY, EUR and CNY is 23%, 13%

and 9% respectively. The USD/JPY is more volatile than the EUR/USD and USD/CNY, so the probability of a 3% move is naturally higher – but the exercise does provide some idea of what's priced.

We see the probability of intervention around 25%

We see the probability of intervention around 25%, largely because of the risk of failure. How would the White House react to headlines of 'failed intervention' if after selling USD/CNY at 7.05, the spot rate trades above that level over later days and weeks as the Fed fails to re-appear with a sustained bout of USD/CNY selling?

We've written about the US Treasury's available fire-power here, but after further discussion and assuming that neither: i) Congress approves a massive increase in ESF resources for intervention, raising US debt levels in the process or ii) the Fed decides to print money and support the US Treasury in unsterilized intervention, most seem to think the US Treasury's resources for FX intervention is around the US$100bn mark. Not much by international standards.

Indeed, there is much academic literature on the failure of sterilised FX intervention (i.e. the monetary base doesn't change). And the chances of getting another 1985 Plaza Accord to weaken the dollar, involving co-ordinated FX intervention and co-ordinated monetary policy, look virtually zero.

What would be a significant game-changer here would be if the Fed were to give greater weight to the drag from the international environment, including the strong dollar. The Fed might not wish to risk its credibility in getting sucked into a currency war, but FX intervention backed up by more aggressive Fed easing would be a more compelling proposition for the FX market.

Dollar forecasts

Based on a slowing US economy and the Fed being drawn into deeper easing, we maintain a view that USD/JPY will head down to the 102/103 area later this year. This will be exacerbated by broadening trade tensions over the coming months.

For EUR/USD, we see a risk that the recent narrowing in EUR:USD short rated differentials actually accelerates as US rates fall further, while EUR rates get stuck on the view that the ECB can't cut the deposit rate below the -0.70/80% threshold.

Narrowing rate differentials – and perhaps a re-think over Washington's dollar policy – have prevented EUR/USD breaking down to the 1.08 area. We continue to favour a 1.10-1.15 range for the remainder of the year, but will carefully watch the trade-off between US and Eurozone policymakers within a global slow-down.

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Article | 7 August 2019 Thailand

Bank of Thailand catches markets off-guard

Our high-conviction, low-probability call of a rate cut has paid off. While rate cuts will take some of the appreciation pressure off the Thai baht, we...

Source: Shutterstock

1.50%

BoT policy rate

After 25 basis point cut today

Lower than expected

Our high-conviction, low probability call paid off

Contrary to the solid consensus forecast of no change, the Bank of Thailand (BoT) Monetary Policy Committee voted five-to-two to cut the policy rate by 25 basis points to 1.50%.

We were one of only two forecasters looking for a BoT policy rate cut at today's meeting. All 27 other participants in the Bloomberg survey were looking for rates to stay on hold. The BoT's sustained hawkish rhetoric has solidified the consensus view even as economic growth continued to weaken this year and inflation continued to be subdued.

Indeed, the BoT policy statement noted increased downside growth risks and continued subdued inflation prospects in support of today's move. It also cited weak tourism as a factor dragging the economy into further weakness, while elevated household debt has been weighing on private consumption. On a positive note, the Committee sees economic potential benefiting from the relocation of production to Thailand (amid the ongoing US-China trade war) and implementation of public-private partnership infrastructure projects (Eastern Economic Corridor).

We see today's move followed by a cut in the central bank's growth and inflation forecasts for 2019, currently 3.3% and 1.0% respectively. We have recently cut our growth forecast to 2.8% from 3.1% (read more here), but we are reviewing our 1.0% inflation forecast for a downgrade in view of the recent dip below the BoT's 1-4% policy target (0.9% average in the year to July).

Not a one-and-done, more rate cuts to come

We don't think this is going to be a 'one-and-done' move. The easing cycle has just begun, and today's rate cut merely reverses a 25bp hike the BoT implemented late last year – not yet a real stimulus for the economy given the likelihood of further economic weakness ahead.

Judging by the BoT's routine hawkish rhetoric, it's hard to imagine that it will set itself off on an aggressive easing cycle. However, we don't see any reason why the BoT can't cut rates further, given the economy seems stuck on a low growth-low inflation path. For now, we have pencilled in one more rate cut in the fourth quarter of the year. But there may well be more to come.

What this means for the markets?

The authorities have been worried about rapid currency appreciation pressure with the view that this is potentially bad for exports as well as tourism. Foreign investors have been taking the Thai baht as a safe-haven bet given the strong backing from the large current account surplus and record stock of foreign reserves. As recent BoT measures to stem short-term confidence-sensitive capital inflows are proving inadequate, rate cuts should provide some additional help.

Nevertheless, we don't see the currency losing its luster as a top-performing emerging market currency just yet. We are only revising our end-2019 USD/THB forecast slightly higher (currently 31.0) to 31.5 (spot 30.8) as an intensified currency war could help the THB to sustain its regional outperformance through the rest of the year.

Philippines: BSP slashes rates as economy weakens

Growth in the Philippines slowed to 5.5% in 2Q, prompting the central bank to cut the policy rate by 25 bps

Stalling momentum prompts BSP to cut rates

Consumption in the Philippines failed to offset downbeat capital formation and anaemic government spending as growth in the second quarter stumbled to 5.5 percent, lower even than the 5.6 percent growth in 1Q. With growth below 6 percent for a second quarter and inflation well-behaved, the Bankgo Sentral ng Pilipinas (BSP) decided to give the economy another shot in the arm as the economy hit a big speed bump in the first half of the year.

4.25% BSP overnight borrowing rate

25 bps rate cut

As expected

Durable equipment and construction drag on investment

Reflected in stalling capital goods imports and durable goods in consumer imports, durable equipment contracted from Q2 2018 (-8.5 percent) as the budget delay and high borrowing costs hit hard. Construction was also negative (-4.8 percent), weighed down by public construction as private construction was unable to lift the sector into growth. A drawdown in unsold inventories also hurt overall capital formation.

BSP hits the accelerator to help chase growth target

With growth reeling from the budget delay and elevated borrowing costs, the BSP decided to hit the accelerator and cut rates by 25 bps to hopefully close the year on a high note. BSP continued to walk back last year's ultra-aggressive rate hike to give the economy another shot in the arm to help chase the government's 6-7 percent growth target.

Door open for BSP to cut policy rates again in September, RRR reduction in 4Q

The BSP lowered its inflation forecast for 2019 to 2.6 percent (from 2.7 percent) and 2.9 percent (from 3.0 percent) for 2020 while also revealing its forecast for 2021 inflation of 2.9 percent. We expect the BSP to cut policy rates again by 25 bps at the September meeting given previous comments from Governor Diokno pointing to a total of 50 bps worth of rate cuts before the end of the year.

Furthermore, we expect the BSP to reduce reserve requirements (RRR) further in the 4Q after it completes its 2019 rate cut cycle to help infuse fresh liquidity into the market. RRR reductions will be put on hold as central bank gauges whether additional funds should be diverted to productive activities and not simply parked at its overnight facilities. With the BSP's recent string of easing and government spending back online in 2H, the Philippines will look to finish the year strongly, with growth fueled by all sectors of the economy to get it above 6% by the end of the year.

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India's RBI cuts more than consensus by 35bp

The Reserve Bank of India's decision to cut rates by another 35 basis points today will undoubtedly worsen the Indian rupee's plight during...

Source: Shutterstock

Reserve Bank of India's new Governor Shaktikanta Das

5.40%

RBI Repurchase Rate

After 35 basis point cut today

Lower than expected

Our high-conviction, low probability call fails

Exceeding the consensus expectations of a 25bp cut, the Reserve Bank of India (RBI) Monetary Policy Board decided to provide even more of a boost to the economy with a 35bp cut today. And, just as widely expected, there was no change to the banks' cash reserve ratio, currently 4%.

We were one of the 'only' two odd ones out in the consensus with our call for an RBI policy pause. Most of the 38 other participants in the Bloomberg poll forecast a 25bp rate cut, with a few even forecasting a 50bp cut. Our conviction for no change stemmed from the fact that the RBI had got well ahead on the easing curve with three rate cuts (for a total of 75bp) in as many meetings earlier this year. Moreover, we judged that prudent policy wouldn't want to fuel inflation, which is already slowly creeping up this year on the back of rising food prices, an excessive fiscal policy boost during the elections, and currency weakness since last year.

Further strengthening our conviction was Governor Das' recent remarks that the easing already undertaken was more than the sum of the rate cuts so far, as he viewed the very shift of the RBI policy bias from neutral to easing in the June meeting as amounting to an extra 25bp rate cut.

Is aggressive easing required…?

The consensus view may have been helped by the shift in the RBI policy stance from 'neutral' to 'accommodative' at the last meeting in June. Likewise, recent data signaling continued weak growth prospects could have supported a rate cut view. While these are valid factors supporting the consensus view, we differed, as earlier policy decisions weren't all necessarily consistent with the RBI's prevailing stance (it's easy to find from past statements).

In terms of data, yes, there have been more signs of economic weakness, though we don't see any more downside to overall GDP growth from a five-year low of 5.8% in the final quarter of FY2019 (January-March 2019). Indeed, loose macro policies should prevent growth from weakening further, while favourable base-effects should have begun to push growth higher from the first quarter of FY2020 (April-June 2019) and continue to do so in the rest of the year. Furthermore, the resiliency of the economy to current trade turmoil is also reinforced by roughly 2% export growth in the first six months of 2019 compared with falling exports from other Asian countries this year.

On inflation, we admit that it isn't out of control just yet and that the RBI can afford few more doses of easing in the event that growth does get worse from here on.

… as it adds to the INR's ongoing plight?

The emerging-market turmoil this week triggered by a spike in the USDCNY exchange rate above 7 saw the INR reasserting its status as Asia's weakest currency. And the outlook for the currency has turned more negative still with the move by the government this week to withdraw autonomy from the disputed state of Jammu and Kashmir - escalating border tensions.

In the steepest depreciation among Asian currencies this week, the INR has lost 1.9% of its value against the USD, taking the exchange rate past the 70 level last seen in late February – another of our high-conviction, low probability forecasts, though it's paid off, unlike our RBI policy call.

Judging from the limited negative impact on the INR from the RBI rate cut as of writing, we can only conclude that the cut was already largely priced in. That said, the larger than expected rate cut today may well foreshadow continued policy easing and further currency weakness ahead. As such, we are revising our end-2019 forecast for USD/INR from 70.0 to 72.0 (spot 70.8).

Article | 6 August 2019

Crude oil: Further OPEC+ cuts needed?

There is a clear battle going on in the oil market- uncertainty over demand growth versus a constructive supply picture in the near term. But which will...

Source: Shutterstock

ING price forecasts

Current	2019				2020				2021			
	1Q	2Q	3QF	4QF	1QF	2QF	3QF	4QF	1QF	2QF	3QF	4QF
ICE Brent (US$/bbl)	64	68	65	68	63	61	65	70	68	73	73	71
NYMEX WTI (US$/bbl)	55	60	57	60	56	54	58	63	61	66	66	64
Previous												
ICE Brent (US$/bbl)	64	68	69	73	70	74	76	74	72	77	77	74
NYMEX WTI (US$/bbl)	55	60	61	65	63	67	69	67	65	70	70	67

Source: ING Research

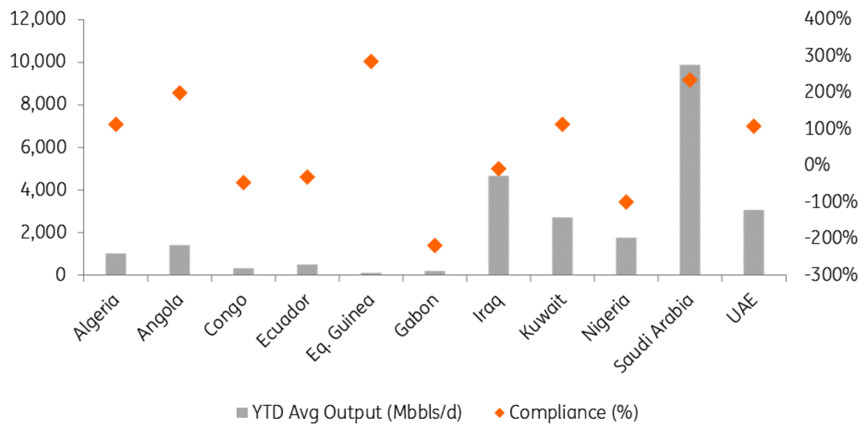
Constructive in the short term

OPEC+ cuts should do a good job in drawing down global inventories for the remainder of this year. Overall, members have over-complied with the deal, and this is largely due to Saudi Arabia producing more than 500Mbbls/d below their quota level. Although there are other producers, such as Iraq and Nigeria, who have failed completely to comply with the production cut deal. Under the deal, Iraq was meant to produce a little over 4.5MMbbls/d, down from 4.65MMbbls/d in October 2018- the reference month for cuts- however the country has in fact increased output, pumping on average 4.7MMbbls/d since the start of the year.

However, strong overall compliance, along with falling Iranian oil supply, coupled with stronger seasonal demand over the latter part of the year should see global inventories fall by around 1MMbbls/d in 3Q19, and a little over 700Mbbls/d in 4Q19. Therefore we continue to believe that prices should trade higher from current levels. Although in the current macro environment it is likely to be a bumpy ride.

Time spreads continue to suggest a tighter physical market. While the prompt ICE Brent spread has been volatile in recent weeks, it remains firmly backwardated along with much of the front end of the curve. Even the US market has tightened up recently. The prompt WTI timespread has swung into backwardation this week, after the front end of the curve was largely in carry. US crude oil inventories continue to decline- they have fallen for seven consecutive weeks, with stocks now down almost 49MMbbls since early June. This has also seen WTI strengthen relative to Brent, with the WTI/Brent discount narrowing from more than US$7/bbl in late July to almost US$5/bbl currently. US inventories should continue to edge lower over the next couple of months, which would be in line with seasonal trends, although keep an eye on US exports- a further narrowing in WTI/Brent could see exports slow.

OPEC-10 YTD compliance



Source: OPEC, Bloomberg, ING Research

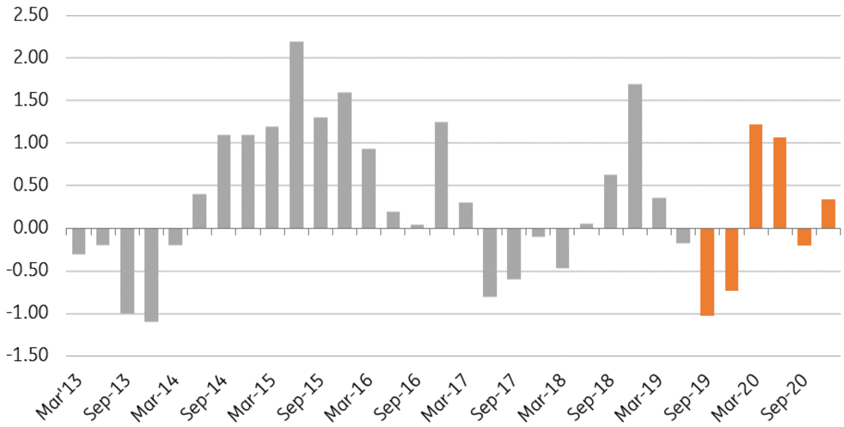
A more bearish 2020

However, the balance changes drastically as we move into 2020, and as a result we have revised lower our price forecast for next year. While OPEC+ cuts are set to run through until the end of 1Q20, weaker seasonal demand in the first quarter of the year means that the global balance is set to see sizeable stock builds over 1Q. This is even assuming that Saudi Arabia keeps production at 9.8MMbbls/d over the period- which is 500Mbbls/d below their quota. As a result of strong non-OPEC supply and weaker seasonal demand, we estimate that the call on OPEC production in 1Q will be around 28MMbbls/d, which is 1.9MMbbls/d lower than estimates for the group's production in July, and 1.2MMbbls/d lower than what we are currently forecasting for 1Q20. This does suggest that we would need to see further action taken by OPEC+. A starting point would be to ensure all members are at least in compliance with the deal, and then look at whether deeper cuts are needed over 1Q20.

At the moment, given the deal is set to end in in 1Q20, the market is also set to see a sizeable surplus in 2Q20. As a result, we believe that OPEC+ will likely have to extend the current deal through until at least the end of the second quarter or risk lower prices. However, such a decision will likely only be made at the OPEC+ meeting in December at the earliest- assuming market moves don't force OPEC+ to act sooner.

Looking at 2020 as a whole, we estimate the call on OPEC will be 29.1MMbbls/d- which is almost 800Mbbls/d lower than estimated production in July.

Global oil market set to return to surplus in 1H20 (MMbbls/d)



Source: IEA, EIA, OPEC, ING Research

Demand concerns linger

Clearly, the current weakness in the market reflects concerns over demand growth for the remainder of this year, as well as 2020, particularly given the current macro environment, and a ratcheting up in the trade war. There is a large degree of scepticism around demand growth forecasts moving forward. The IEA is currently estimating that demand will grow by 1.8MMbbls/d over 2H19, this is up from around 300Mbbls/d in 1Q19 and 800Mbbls/d in 2Q19. Therefore given the current macro climate, this number might be a bit too ambitious for the remainder of the year. Furthermore, the longer the trade war drags on, the more downside risk there is around the demand growth number of 1.4MMbbls/d in 2020.

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Article | 7 August 2019 **eZonomics**

Why (some) of your colleagues and boss are paid more than you

You are probably paid less than your boss, but it may not be because of the work he is doing or to keep him motivated. Instead, it is meant to motivate...

Source: Shutterstock

Competition has ruled workplace payment and reward structures for a long time. In economics, this is called tournament theory – the idea of paying people based on their relative position in a company, rather than their absolute level of output. This reward of higher pay (usually) incentivises all workers to raise their game. While nice in theory, its practice has caught much criticism over the years.

The idea has been around since the late 1970s when two economists suggested that a workplace compensation scheme based on an individual's relative position in a firm was the best way of allocating pay, rather than for just being good at their job. One reason this happens is that it is difficult to calculate what earnings should really be, it's much easier to say Jack is better than Jill.

> *It is difficult to calculate what earnings should really be, it's much easier to say Jack is better than Jill*

However, there is a caveat. Employees who are lower down on the career ladder will only be motivated by "tournaments" if they see a realistic chance of winning. Within large companies, moving up the ladder, especially with substantial pay rises, will often be the exception rather than the rule.

Unwelcome features

Tournament-based pay can be a double-edged sword as the practice could be used to justify unfair payment structures and get in the way of teamwork as employees are judged on individual performance, potentially leading to a desire to outshine rather than aid co-workers.

That's not to say tournaments can't or shouldn't have a place in the modern workplace. A 2019 report covered the topic of gamification at work, where rewards were given more frequently based on, for instance, tasks completed or work well done, rather than a one-off bonus per year. Results showed employees were more engaged and productive in this environment. This type of "tournament" could shift reward schemes away from an employee's relative position and has room to include group rewards to stimulate collaboration.

More than just money

But some research suggests, the phenomenon was never properly tested and often used as a way to justify unfair salaries and compensation distribution.

Experts have also suggested that traditional tournament theory, aimed purely at monetary incentives may work well in the abstract, but has a number of weaknesses for running a company employee reward scheme in modern workplaces. While people might still strive for the status that comes with being rewarded, this isn't necessarily linked to monetary rewards. Experts point out that people value other rewards such as health insurance and a better work-life balance more than purely monetary rewards and these perks often turn out to be of lower cost than increasing salaries.

> *The competitive nature of tournament theory could conflict with the twenty-first century workplace, which is often built around teamwork.*

Moreover, the competitive nature of tournament theory could conflict with the modern workplace, which is often built around teamwork and gravitates more and more towards collaborative performance and away from striving for individual excellence. This is contrary to tournament theory which evaluates individual performance.

This could mean that tournament theory's days are limited in its current form and that it may have to be adapted. The latter might seem more realistic, as competition is fairly deeply embedded in human nature.

All in a game

One solution to rewarding collaboration and creating employee engagement could be gamification.

A 2019 report showed that employees enjoyed receiving rewards, but favoured unexpected rewards (35%). Thirty-eight percent said that working towards more salient rewards and bonuses would make work more fun. Annual bonus structures might often seem too far off to really care about throughout the year as people tend to discount benefits further in the future and value more immediate benefits more.

> *Gamification doesn't have to revolve around an individual's work, but opens the field to team rewards to increase collaboration*

While gamification in this report is viewed more from the perspective of engaging employees and increasing productivity, it could also be the next step for tournament theory, moving it away from deciding on rewards based on someone's relative position and more towards their output. Additionally, gamification doesn't have to revolve around an individual's work but opens the field to team rewards to increase collaboration and helping co-workers to be successful alongside an individual's own success.

Revision of reward schemes like gamification could be an important step forward either through a departure from (certain principles of) tournament theory, an adaptation of it, or a mix of the two.