

# What's happening in Australia and around the world?

Second-quarter GDP in the US out on Friday, a chance for some early action from the ECB tomorrow, and Boris Johnson has become the new British Prime Minister. If that wasn't enough excitement for a week then how's the revelation that the Reserve Bank of New Zealand is "scoping a project" to introduce unconventional monetary policy tools. More easing ahead?

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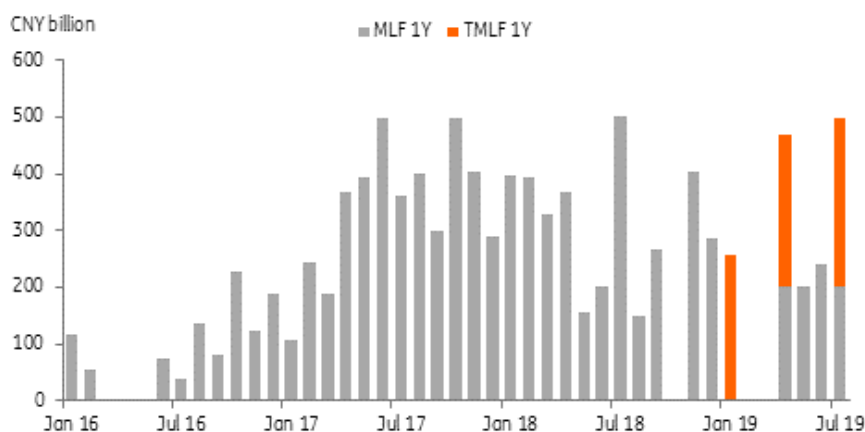


Source: Shutterstock

### PBoC's MLF and TMLF liquidity injection is merely liquidity replenishment

The People's Bank of China added liquidity today using unconventional tools. Its medium term lending facility provided CNY200 billion while its targeted medium term lending facility added CNY297.7 billion, both for one year at interest rates of 3.3% and 3.15%, respectively. TMLF funding can be rolled over twice and so is viewed as a three year liquidity injection with an annual interest rate of 3.15%.

Still, these combined liquidity injections only offset part of the liquidity that matured today. The net result is still an absorption of CNY164.3 billion.



Source: ING, Bloomberg

## Still an easing signal

We consider this liquidity management exercise to be the start of the easing cycle:

1. The newly added liquidity is cheaper in terms of interest costs. Borrowing via MLF and TMLF for one-year at 3.3% and 3.15%, respectively, is cheaper than interbank borrowing at 3.1% for three months.
2. The injection via MLF and TMLF, though, was a net absorption of liquidity, and saw the three-month interbank interest rate move lower, from 3.4% on Monday to 3.1% today.
3. The use of MLF and TMLF replaces regular open market operations - the duration of the liquidity injection is longer and therefore liquidity in the market should be more stable.

## When will the PBoC cut the RRR? Or will it cut at all?

Regular liquidity injections into the system via MLF and TMLF once a quarter are unlikely to be sufficient to suppress the upward pressure on interest rates due to funding demand for infrastructure investment projects.

We have yet to see any RRR cut from the PBoC. But the central bank can't wait much longer if it wants to support the economy, which is being squeezed further by the trade and technology war.

While China has signalled it may be prepared to import US agricultural products again, we still haven't seen concrete action here. And even if there is action, concessions made from the US are likely to be limited. As long as Huawei remains on the US's "entity list", China will continue to set a strong tone in the negotiations. This means the trade truce will likely continue without material improvement.

The Chinese economy will need more liquidity and lower interest rates in 2H19 to support investment in infrastructure projects.

We expect two 0.5 percentage point RRR cuts together with 5bp cuts in the benchmark rate in 3Q and 4Q, respectively. The benchmark rate cuts will send a signal to the market that the PBoC is easing, and could help the market to form self-fulfilling easing expectations, which should push down interest rates further.

It's possible that the PBoC won't cut the RRR as this could result in a large and rigid change in the

system's liquidity, which would be very difficult to reverse. More frequent MLF and TMLF injections could replace RRR cuts instead. But equally, RRR cuts would send a strong message to the market that the central bank is serious about easing. The choice will really depend on the pace of growth in 2H19.

## USD/CNY won't cross 7

The path of USD/CNY will depend on which liquidity tools are used by the PBoC.

1. If there is no RRR cut in 2H19 but more frequent MLF and TMLF operations, the market may not be too alarmed that the PBoC is in fact easing. The USD/CNY will be fairly stable and range bound around 6.90.
2. If the central bank cuts the RRR twice in 2H19, as we expect, the market will receive a strong easing signal from the central bank. This will put downward pressure on USD/CNY. But let's not forget that the USD/CNY is not a market driven exchange rate. And, as we have argued, the PBoC has set an invisible line at 7.0 (once in 2016 and once in 2018) because the central bank can't afford the asset market uncertainty that would likely accompany USD/CNY crossing this key level. So USD/CNY could weaken to 6.95 but is unlikely to touch 7.0.

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## Boris, Brexit, the Bank and Britain's pound

Exactly 100 days until Britain leaves the European Union, how will the markets react?

[Watch video](#)

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# The US economy is slowing, but the Fed needn't worry

US GDP growth looks set to have slowed sharply in the second quarter of this year to 1.8% from 3.1% in 1Q19. However, this reflects trade and inventory...



## GDP figures out on Friday

Friday's US growth numbers are set to show a big dip for the last quarter, but there's not much here to alarm either the president or the Federal Reserve. The US economy has grown strongly over the past couple of years, outperforming key trading partners as a vibrant domestic economy, supported by tax cuts, more than offset the headwinds from weaker external demand. The economy currently has unemployment close to 50-year lows with workers experiencing pay rises while equity and home prices continue to push higher. However, there are signs of that growth is starting to slow, which is principally coming from the confidence-sapping fallout from ongoing trade tensions.

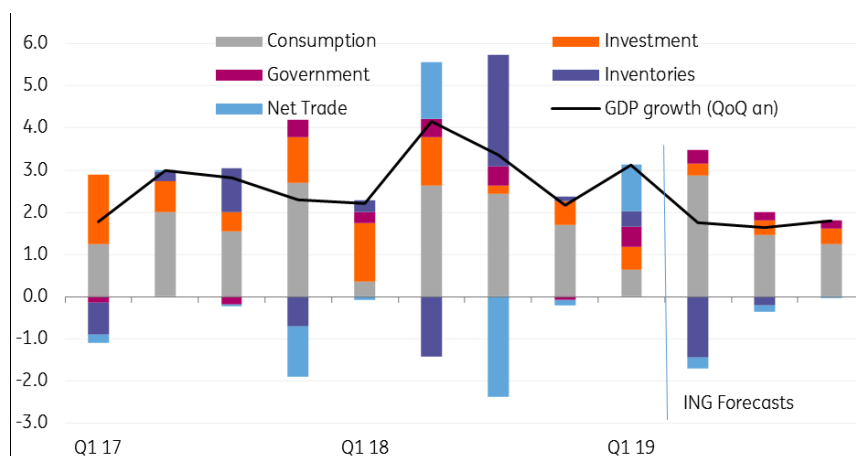
## Tariffs and trade

Those on-off US-China trade concerns have contributed to significant swings in GDP growth rates over recent quarters and look set to be a major story again in this Friday's report. Back in the second half of last year, we saw a surge in imports and a big build-up of inventories as firms looked to stock up on Chinese consumer goods and components ahead of anticipated tariffs. Those tariff

hikes were postponed by President Trump in December, but due to the length of time it takes to order and ship products from Asia there wasn't a great deal that American businesses could do about it in the short-term.

Imports consequently fell back sharply in Q1 2019 but exports held up well, so net trade contributed 0.94 percentage points of the 3.1% total growth. However, imports are set to rebound in the second quarter, so this should be a major drag on 2Q growth. Inventories continued to be built in 1Q (contributing 0.55 percentage points) after big increases in 2H18 so we also expect to see a reversal here with firms running down stocks. This certainly appears to have been a key factor that has led to softer manufacturing output in recent months. In fact, we think the inventory and trade combination could knock as much as 1.7 percentage points off 2Q headline GDP growth.

## Contributions to QoQ% annualised growth



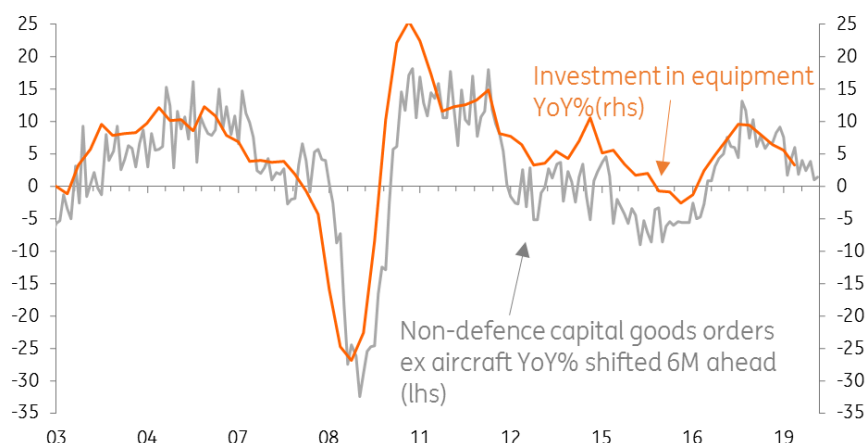
Source: Macrobond, ING

## Investment growth is slowing

Business investment may also be a little disappointing relative to recent trends. Core durable goods orders point to weaker growth here, largely due to the global uncertainty and trade tensions making firms more cautious about putting money to work. Federal Reserve officials have commented on the weakness, including Fed Chair Jerome Powell, who said last month that "growth in business investment seems to have slowed notably". He also attributed this to "concerns about trade tensions and slower growth in the global economy".



## Durable goods orders suggest investment has softened

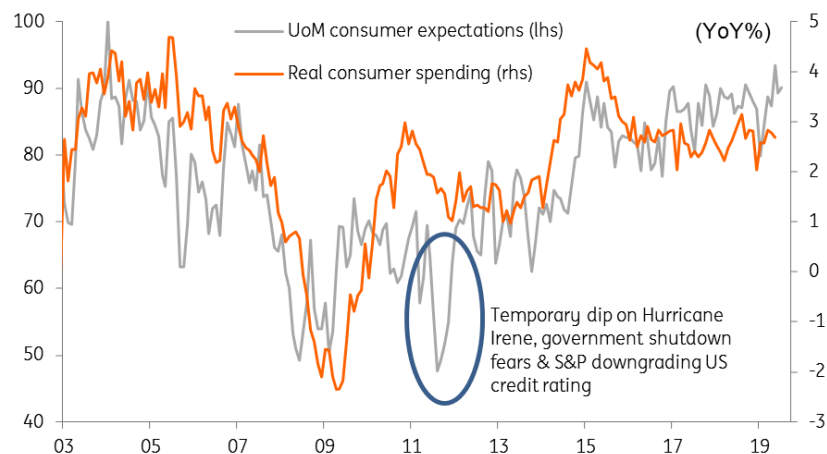


Source: Macrobond, ING

## But the consumer continues to roar

Household consumption will be a massive boost though as the strong jobs market, rising pay and benefits, falling gasoline prices and rising asset prices create the perfect environment for spending. Confidence is understandably high and with cash in their pockets, households are prepared to buy, as we have seen in recent retail sales number, auto sales and mortgage applications for house purchases. In fact, we think consumer spending likely grew in excess of 4% in 2Q19.

## Consumer sentiment and spending



Source: Macrobond, ING

## Fed to take things slow

Recent data has been encouraging, with the consumer sector clearly in a good place and even manufacturing showing renewed signs of life. 2Q GDP will undoubtedly be weaker than in 1Q but, given the volatility in trade and inventories, we think it's better to look at the two quarters together. This gives an average growth rate of 2.5%, which is clearly very respectable. This is slower than the 3% growth seen in much of 2018 and there is the threat that trade uncertainty will continue to act as a brake on activity. To combat this risk, we expect the Federal Reserve to pull the trigger on a precautionary 25bp rate cut on July 31st with a further 25bp move likely in September.

While inflation is benign, to us the economic backdrop doesn't appear bad enough to justify more aggressive action.

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# EUR & ECB: Facilitating the downside to the euro

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**Figure 1: The ECB's Dashboard**

Scenario analysis: How to position for Draghi's alternatives

Current stance	Inflation outlook	Growth outlook	Forward rate guidance	QE discussion	EUR/USD	2-year Schatz	10-year Bund
	"Underlying inflation is expected to increase over the medium term"	"The risks... to growth outlook remain tilted to the downside"	Rates to remain "at their present levels at least through the summer of 2019"	None at this point.			
Very dovish	Symmetry of CPI target under the consideration	Recent data suggest slowdown in activity	20bp interest rate cut & dovish rate guidance	Forward guidance on the start of the QE in September	1.09	-5 bp	-10bp
Dovish	Recent data suggest the CPI pick up will take longer	Recent data suggest slowdown in activity	10bp interest rate cut & dovish rate guidance	The Council "has tasked relevant committees"	1.10	-2.5 bp	-5 bp
ING Base Case	No language change given no new staff projections	No change given no new staff projections	Change to forward guidance: "present or lower levels"	Hint at the re-start of QE should it be necessary	1.11	+2.5 bp	+5 bp
Hawkish	No language change given no new staff projections	No change given no new staff projections	No change to forward guidance	Talk on QE seen as "premature"	1.14	+10 bp	+15 bp

Source: ING

## FX: More downside to EUR...

Despite the market already pricing a 40% probability of a 10bp cut this week, more than one 10bp cut by September and close to 20bp overall easing by the end of this year, we see a downside risk to EUR/USD coming from the ECB meeting this Thursday. This is because:

- (a) The ECB is likely to change the forward guidance and signal the upcoming cuts (in September and potentially beyond), thus cementing the markets' dovish expectations, and
- (b) President Draghi is likely to deliver a dovish press conference, with a potential hint at QE (see [ECB Preview](#) for more details).

The latter in particular should be a negative factor for EUR over the coming months as the expectations for ECB QE will continue to build.

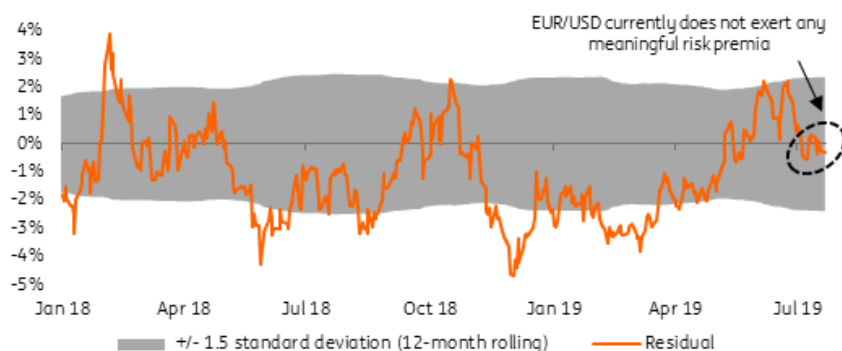
## ... as technicals are not stretched

On a short term basis, EUR/USD currently does not exert any meaningful risk premia (as per Fig 2, the cross is fairly valued based on our short term financial fair value model). Coupled with the fairly light short EUR/USD positioning (Fig 3), there is scope for EUR/USD downside stemming from the

dovish press conference (the short-term effect – coming days) and a further build-up of ECB QE expectations (the medium-term effect – coming months). In Figure 1, we provide a scenario analysis around the possible ECB July meeting outcomes.

## Figure 2: No material risk premium priced into the euro

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

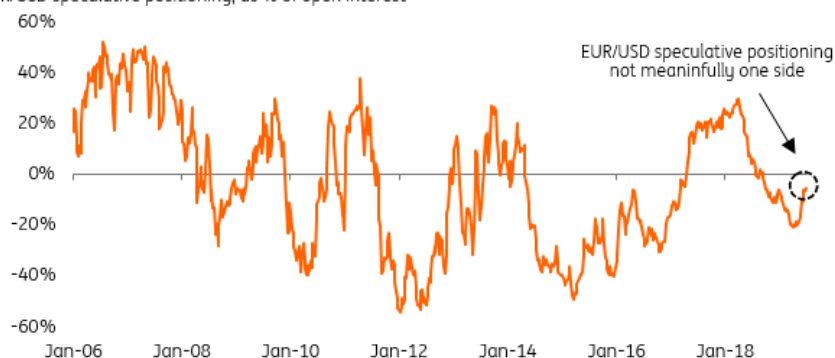


## The ECB is more likely to over-deliver than the Fed

With the market pricing almost three full 25bp Fed rate cuts this year (vs our economists' call for two cuts), from the monetary policy perspective the downside to the USD seems more limited vs the downside to EUR as, in our view, it is the ECB that will over-deliver this year (likely on the QE side). As per [FX intervention: Does President Trump have the means, motive and opportunity?](#), at this point we see the main downside risk to USD stemming for the possible FX interventions (should the US administration frustration with the low EUR/USD rate grow) rather than an overly dovish Fed (given the still solid US data points).

## Figure 3: EUR/USD speculative positioning not materially one-sided

EUR/USD speculative positioning, as % of open interest\*



\* As of 16th July 2019 (data are reported with a lag)

Source: ING, CFTC

## Bond markets: Longer-dated rates at risk of disappointment

An adjustment of the forward guidance to incorporate the possibility of lower rates would set the

central bank on a clear path to cut rates in coming months. This should put the focus on the front end of the curve as markets also gauge where the new lower bound in policy rates will be. The absence of an immediate cut this time around would probably mark only a minor and in our view a temporary disappointment.

Longer-dated yields should be at greater risk of a temporary disappointment if the ECB were to remain vague on the possibility of restarting QE, and given well-advanced market expectations of a dovish press conference some profit-taking cannot be excluded.

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## ECB preview: One final talk before walking the walk

It's a very close call but we expect the European Central Bank to change its forward guidance next week and effectively pre-announce a package of new...



ECB President Mario Draghi delivers a speech at the European Parliament in Strasbourg back in January

A dovish press conference after the June meeting, an even more dovish speech by Mario Draghi in Sintra and very little evidence that the economic outlook is about to improve any time soon.

Against this backdrop it will be very hard for the European Central Bank to send a sufficiently dovish message without actually delivering at next week's meeting. In our view, the discussion within the ECB's Governing Council will be an exciting and heated one.

### **Dovish, more dovish, most dovish or simply action?**

In fact, Draghi's Sintra speech has made clear that the question regarding the short-term outlook for the ECB is no longer "what negative surprise is needed for the ECB to cut rates" but rather "what positive surprise could actually prevent the ECB from cutting rates". This is how we read Draghi's comments that - absent economic improvements - more stimulus will be needed.

Economic data out of the eurozone, as well as the Fed's de facto announcement of a July rate cut,

have clearly pushed the ECB closer towards July action, rather than waiting until September. After some tentative signs of stabilisation at the end of the first quarter, the eurozone economy seems to have slipped once again. What is also worrying is that there are signs the solid domestic part of the economy may be faltering as well. In particular, German data is worrisome with an increase in short-term work schemes, fading momentum in the labour market and falling retail sales.

Consequently, for next week's meeting, the main question is whether the ECB can afford to wait six more weeks before delivering new monetary stimulus or whether it should surprise financial markets by frontloading new measures. In fact, traditional ECB watching argues in favour of compiling more data, waiting for the release of 2Q GDP in mid-August and the next ECB staff projections and only then taking a decision at the September meeting. Draghi's track record of over-delivering and trying to be ahead of the curve, however, could bring new ECB action at the ECB's July meeting. It's a very close call, which will only be decided during the meeting next week.

## What we expect the ECB to do next week

To keep a somewhat friendly balance between the doves and hawks, a typical European way out would be to step up the dovishness once again. And to be frank, it will be the very last time the ECB can talk the talk without walking the walk. In this regard, the only way out is to change the forward guidance to say that interest rates will "remain at their present or lower levels...". A pre-announcement of a rate cut in September and a clear hint that the bank is once again considering quantitative easing.

This approach would allow the ECB to collect more data and, in case macro data continues to disappoint, cut the deposit rate by 20 basis points in September, introduce a tiering system for the deposit facility and (possibly) even restart QE.

While in the past, we often believed that the ECB preferred to deliver new stimulus in small steps and in sequences, this view has changed. In Philip Lane's first encompassing speech on monetary policy as ECB chief economist, he clearly pointed to a package of measures rather than a sequencing of smaller individual steps. This means that instead of incremental moves, the ECB appears to be shifting towards bolder, bundled action.

If we are wrong and the ECB wants to frontload new monetary stimulus, next week's meeting could bring rate cuts and a clear indication that QE could restart in September.

## One final talk before walking the walk

In our view, the latest disappointing macro data, tentative signs that the resilience of the domestic economy is faltering, a potential rate cut by the Fed and continued dovish communication from ECB officials since Sintra, have all pushed the ECB to the point of no return. In fact, the ECB and Mario Draghi have taken the genie of more monetary action out of the bottle and it will be hard to get it back in. The only question is whether words alone, as dovish as they might be, will be enough. It seems as if the ECB will try to talk a very final talk before walking the walk in September. However, the risk to this call remains that Mario Draghi will try to surprise financial markets. It would not be the first time.



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# Brexit and the next 100 days in five charts

New UK prime minister Boris Johnson will face the same hurdles as Theresa May, and crafting a new Brexit deal will be tricky. The new leader may be open...



Source: Shutterstock

## In a nutshell: PM Johnson to face the same hurdles as PM May

With 100 days to go until Brexit, the UK finally has a new prime minister - former foreign secretary Boris Johnson.

Fears are growing that the UK could leave the EU without a deal on 31 October, but at least in the first instance, one of the PM's first acts will be to return to Brussels and seek a reworked deal. But with neither side willing to compromise on the Irish backstop - the mechanism designed to avoid a return to a hard border between Ireland and Northern Ireland - negotiations are unlikely to bear fruit.

This sets the stage for an almighty battle in October as Parliament tries to stop 'no deal' from happening - and a no-confidence vote in the government is likely to happen in the run-up to the Brexit deadline. A general election is getting more likely - perhaps even inevitable. Recent polling suggests that an election might not actually be a bad thing for Mr Johnson -

but given that an election would almost certainly require another Article 50 extension, his party's renewed popularity could falter by the time the vote occurs.

All of this uncertainty makes for a tricky few months for the economy, and this has sparked talk of a UK rate cut later this year. Markets see a 50% chance of easing in 2019, although we're yet to be convinced. Even so, the risks for the pound are intensifying - we could see [EUR/GBP hit 0.92 over the summer](#).

## Our updated Brexit scenarios

	ING probability	How scenario could materialise	Article 50 extension?	Market reaction
Parliament forces a general election	40%	Parliament stops 'no deal' by passing no confidence motion. General election takes place as early as December	✓ At least 3 months	EUR/GBP: 0.95 GBP/USD: 1.18
Revamped deal	25%	To avoid election at all costs, pro-Brexit MPs reluctantly back tweaked deal given there's a Brexiteer in place for next stage of trade talks	✓ Possibly (for legislation)	EUR/GBP: 0.85 GBP/USD: 1.34
Second referendum	10%	Parliament may struggle to force a 'People's vote'. But can't fully rule out PM triggering one as "least worst" option versus an election	✓ At least 6 months	EUR/GBP: 0.82 GBP/USD: 1.40
No deal	20%	If EU rejects further A50 extension, or a new leader pushes for a hard Brexit, Parliament may lack the legislative tools to stop it	✗	EUR/GBP: 1.00 GBP/USD: 1.10
Revoke Article 50	5%	Parliament may prefer this over a 'no deal' exit, but like a 2 <sup>nd</sup> ref, MPs could lack a legislative tool to force the new PM's hand.	✗	EUR/GBP: 0.78 GBP/USD: 1.47

We also wouldn't rule out Mr Johnson asking for a further extension simply to buy more time to break the deadlock - although his recent comments suggest he is highly averse to doing so

Source: ING

## Finding a tweaked deal that both the EU and Parliament can agree to will be challenging

Despite all the 'no deal' rhetoric, we assume the new prime minister will initially head to Brussels in September to attempt a renegotiation of PM May's existing deal. But seeking a meaningful change to the agreement from the EU - and then getting enough MPs to support it - will be seriously challenging.

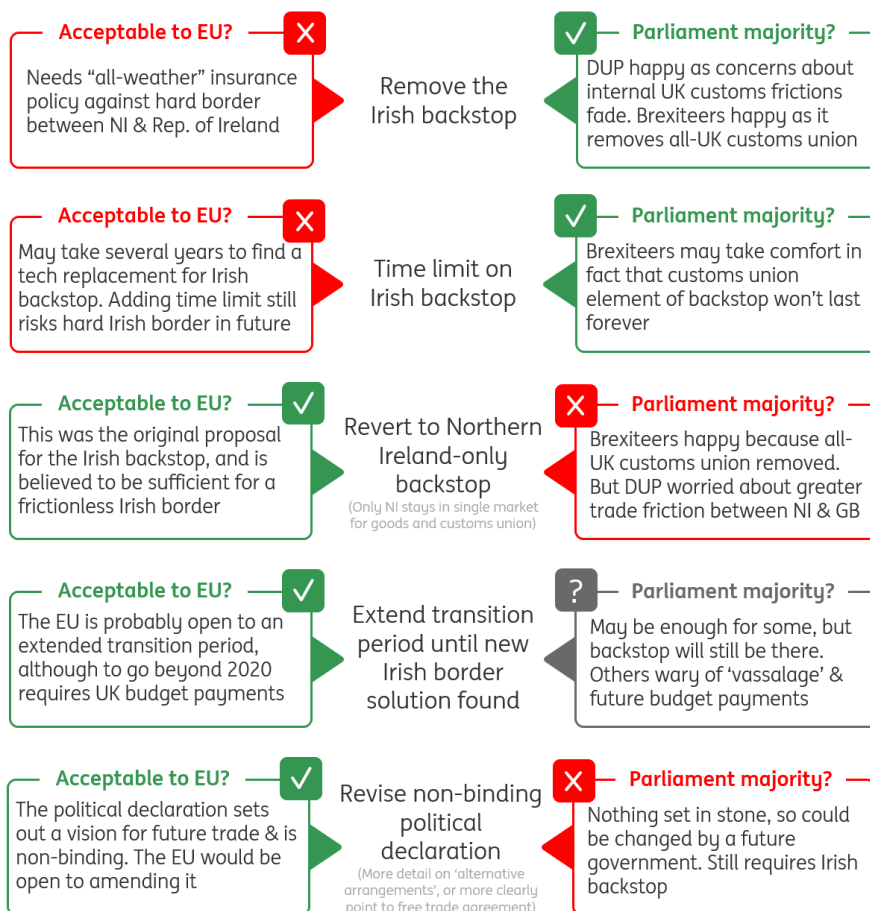
Brussels has ruled out removing, or time-limiting, the contentious Irish backstop - something which Mr Johnson has repeatedly said is a red-line in talks. So what could the new prime minister do? The chart below shows how most proposals would be unacceptable to either the UK or the EU, although one particular idea looks interesting.

One way the new PM might be able to command a majority is if he can convince sceptical MPs that the Irish backstop will never come into effect - and the most obvious way of doing that is to ask for a long transition period with the EU. In theory, that could allow time to find a different - perhaps technological - solution to preventing a hard border on the island of Ireland.

In reality, it could be several years before such technology becomes available (if it becomes available at all), but in principle the EU would probably be open to a more prolonged transition

period. The current deal leaves the door open to a transition until the end of 2022, assuming both sides agree.

## What are Mr Johnson's options for a revised deal?



Source: ING

## If a deal is to get a majority in Parliament, the devil might not be in the detail after all

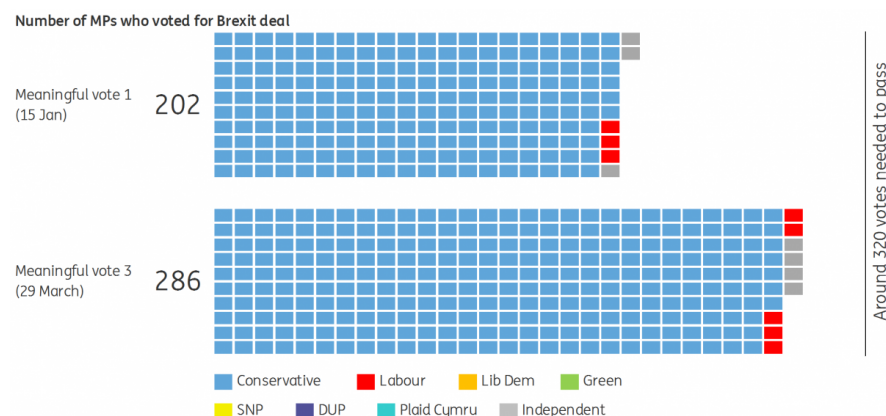
So is the 'long transition deal' a strategy that could work for Mr Johnson? We see three reasons why it probably won't.

1. While it is probably the PM's best chance of demonstrating the Irish backstop will not be needed, the backstop will nevertheless remain a part of the deal. And as long as the backstop stays, leaving open the possibility of regulatory diverge between Northern Ireland and the British mainland at some point in the future, the Democratic Unionist Party (DUP) are unlikely to back the agreement.
2. Secondly, an extended transition period will require fresh budget commitments for the next EU multiannual financial framework (MFF), which begins at the start of 2021. The idea of paying more money, rather than less, to the EU is unlikely to go down well with the domestic UK audience.
3. Thirdly, for many pro-Brexit MPs, an extended transition period would present too much 'vassalage' – staying within the single market but without a say in the rules.

All of that means it's hard to see pro-Brexit Conservative/DUP lawmakers backing such a deal. But as always, the politics matters. If MPs don't back a revised deal, opposition lawmakers may well succeed in forcing an election to avert 'no deal'. Some Brexiteers may conclude that it's safer to 'swallow' a lightly-amended deal, and take the fight to the next stage of talks where the ultimate trading relationship will be agreed than it is to fight an election and risk losing control of Brexit altogether.

Unlikely as that may sound, something similar actually happened back in March, when a number of pro-Brexit Conservatives voted for the deal in the third meaningful vote, on the basis that Mrs May had committed to resigning her post if the agreement passed. The chart below shows that 81 additional Conservative MPs – including Mr Johnson himself - voted for the deal third-time around at the end of March, than in the initial vote in mid-January.

## A number of Brexiteers voted for Mrs May's deal on the third vote



Source: BBC, ING

## The election numbers look good for Mr Johnson - but can they last?

Our base case is that new negotiations will not prove successful, and this could set up an almighty battle in October as Parliament races to try and prevent the new government pursuing a 'no deal' exit. While a 'no deal' is possible (we see a 20% chance at the moment), all of this is more likely to culminate in a no-confidence vote in the government. One way or another, a late 2019 election is getting increasingly likely.

Predicting the outcome of an election is very challenging. But as the polls stand, things are looking good for Mr Johnson. His repeated commitment to get the UK out of the EU one way or another has resonated with many voters.

A recent [YouGov](#) survey found that around 51% of Conservative voters at the 2017 election (64% if you exclude those that aren't sure/wouldn't vote etc.) would vote for Mr Johnson's party at an election, assuming Brexit is done by then. While that is still a sharp fall compared to the last election, polls suggest Labour would fare worse. Less than half of 2017 Labour voters said they would vote for the party again in a post-Brexit election.

*A failure to live up to the promise of achieving Brexit by October would undoubtedly dent Conservative support*

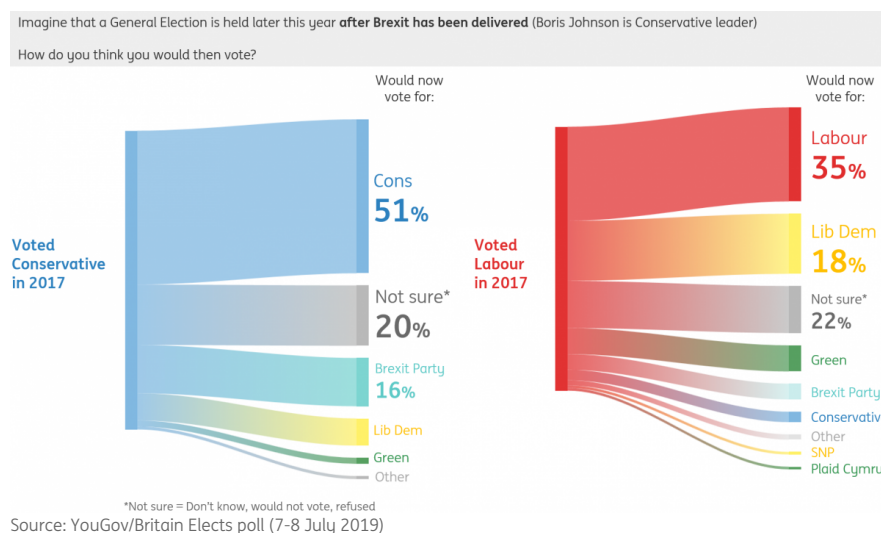
Translating all of this back into the UK's first-past-the-post electoral system is not straightforward, but in theory a Conservative share of the vote of around 30% could translate into a decent result for Mr Johnson. Some commentators have gone as far as to suggest he himself could trigger an election to run on a 'no deal' ticket to 'cash in' this advantage.

We think that's unlikely – not least given the lessons of the 2017 election where Mrs May's polling (which was significantly stronger than Mr Johnson's is now) failed to translate into a Conservative majority when the public had their say.

But the bigger issue for the new government is that an election – however it comes about – would almost certainly require a further article 50 extension. A failure to live up to the promise of achieving Brexit by October would undoubtedly dent Conservative support. And while the new PM may make a 'no deal' Brexit a formal campaign pledge - potentially shoring up support in key Leave-supporting areas - [polling from Hanbury/Politico](#) suggests this could alienate the more centrist Conservative voters in swing seats in areas such as London and Scotland.

It's also worth noting that, while the main opposition Labour Party may not do so well either, the party arguably has a wider pool of potential coalition/confidence and supply partners than the Conservatives. This means a Labour-led coalition is not an inconceivable outcome of a 2019 election, should the Conservatives fail to gain (or come close to) a majority.

**Polls suggest a more divided Labour Party than Conservatives at an election**



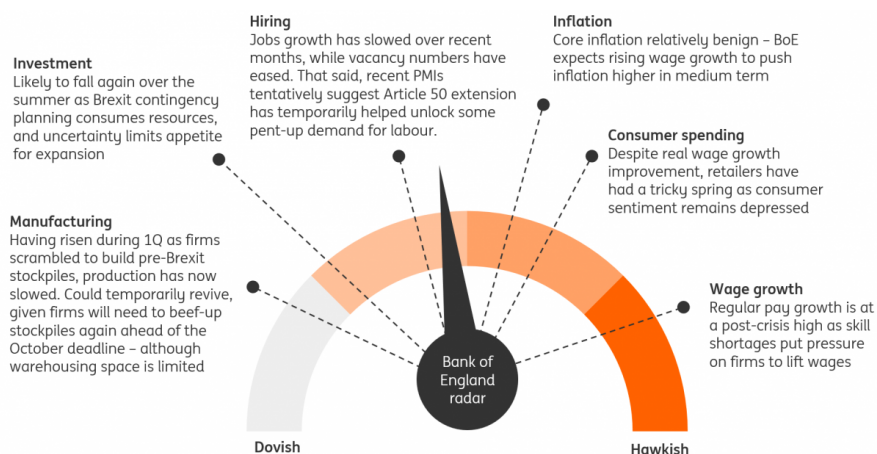
## Uncertainty to take its toll on growth, although rate cuts not yet on the horizon

All of this uncertainty will continue to take its toll on growth. The prospect of further declines in investment, coupled with the recent lacklustre retail spending numbers, suggests underlying quarterly growth (once volatile production/inventory numbers are stripped out) will remain capped at around 0.2/0.3% for much of the rest of the year. Benign inflation projections and the prospects of monetary easing abroad have sparked talk of a UK rate cut - markets are pricing a 50% chance of one happening by the end of 2019.

At this stage, we aren't convinced. Wage growth has reached another post-crisis high, and this has been a key hawkish factor for policymakers over the past couple of years. A lot will depend on Brexit of course, but if an election takes place, or Article 50 is extended to allow more time to break the deadlock, we expect rates to remain on hold for the time being.

However, a further deterioration in UK growth, a significant escalation of global trade tensions, or a 'no deal' Brexit in October, could be catalyst for fresh easing from the BoE.

## BoE radar: Investment set to remain a drag on economic activity



Source: ING

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