

When doves cry

Just when will the Fed start tapering its stimulus programme? After this week's meeting, the doves no longer rule the roost. Bert Colijn says Europe's businesses are coming out fighting and we have a major outlook for the industrial sector. And more power, flower. We drill down deep into the energy markets as they recover from the Covid-dip

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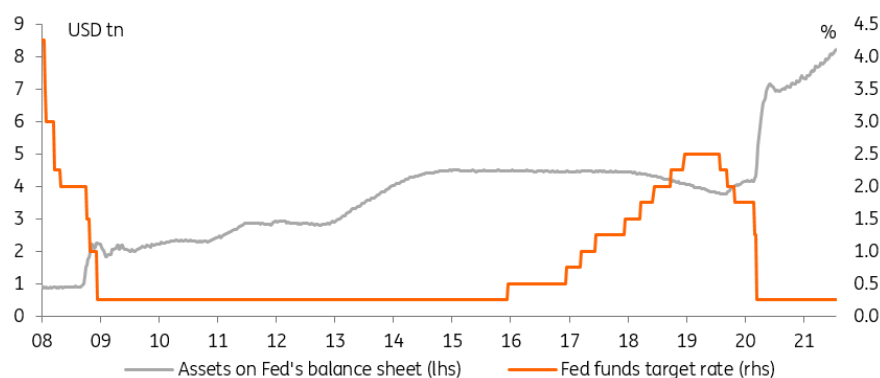
Source: Shutterstock

Singing a new tune

Ahead of time, Fed Chair Jerome Powell made it clear that he continues to believe inflation pressures are largely transitory and there is no need to signal an imminent shift in policy. We got a repeat of the “transitory” assessment in today’s FOMC statement, but we have had clear movement that hints the Fed will in fact start to taper its QE asset purchases later this year.

The Fed funds target rate has been left at 0-0.25% with the monthly QE asset purchases left at a total of \$120bn split \$80bn Treasury securities and \$40bn agency MBS. Previously the statements had remarked that these purchases would continue until “substantial further progress has been made” towards achieving maximum employment and the Fed consistently hitting its inflation target. However, the Fed has seen enough in the data to indicate that “the economy has made progress towards these goals”. This is a significant step in the policy normalisation process.

Assets on the Fed's balance sheet vs. interest rates



Source: Macrobond

That's not to say we are going to see an imminent taper. Employment levels in the United States remain more than 6 million lower than before the pandemic started while the latest Delta Covid wave adds another level of uncertainty that will justify the wait and see stance – although that only got a passing mention in the statement. We also have to remember that the Fed's new monetary framework places a much greater emphasis on ensuring as many people in society feel the benefits of growth. This was accompanied by a move to an “average” inflation target of 2% and a clear signal that the economy will be allowed to run hotter than in previous cycles to ensure these targets are reached.

Inching towards action

Nonetheless we are getting closer to action, as indicated by today's language change, with a growing hawkishness creeping into the viewpoints expressed by several other FOMC members given the strong economy and the fact that inflation is running at more than double its 2% target. Already, the Fed's own 'dot plot' chart of individual members' predictions for the interest rate path has seven out of 18 FOMC members looking for a 2022 rate rise. It only takes three of the 11 members not favouring a 2022 rate hike as of June to switch sides to bring the medium in favour of action next year rather than 2023.

Obviously, talk is already underway about the tapering of the QE asset purchases. We expect to hear much more of this at the upcoming Jackson Hole Conference at the end of August.

Supply disruptions and labour shortages show little sign of abating and in an environment of strong stimulus fuelled demand this is leading to more persistent price pressures. It is also stifling the recovery story with expectations for tomorrow's GDP growth figure having been scaled back due to the supply side of the economy not being able to fulfil all of the demand placed upon it with inventories continuing to be run down.

We expect the strong demand to story continue and with workers remaining in short supply, we see further wage pressure too. While several components that have been at the forefront of the rise in CPI (such as used car prices), are likely to reverse over time, rising housing costs are likely to be an increasing inflation pressure point that lead us to forecast that US headline inflation will stay above 4% until 1Q22 with core inflation unlikely to get below 3% until the summer of next year. We also have to consider financial market conditions. The fall in 10Y yields from 1.7% to 1.25% is a

big additional monetary stimulus for the US economy and is only likely to add to the nervousness of the more hawkish members of the FOMC.

An August signal for earlier action

Given this backdrop, we expect the Jackson Hole Federal Reserve Conference to show Fed officials laying the groundwork for a QE taper with this fleshed out in more detail at the September FOMC meeting before being formally announced in December. We predict a relatively swift reduction that sees QE purchases end in the second quarter of 2022.

The June FOMC meeting saw officials shifting their collective view to a 2023 start point for interest rate increases after having previously been adamant it would not happen before 2024. With the economy continuing to grow strongly, inflation well above target and the jobs market looking strained through a lack of suitable workers there is the outside possibility that the median shifts to a 2022 start point for rate hikes when new projections are released in September. If so, this would then tally with our own view that we will start to see policy tightening get underway in September 2022 with a follow-up interest rate rise in December 2022.

Rates: A heavy dose of scepticism

The Fed signalling progress on the criteria it will use to decide on tapering asset purchases was greeted with a counter-intuitive market reaction. As we have argued before, tapering is widely expected and there is only limited scope for the Fed to surprise the market either way. Instead, rates took the change in messaging as a signal that hikes, the next step on the Fed's tightening path, are coming up soon. In the current market mindset, this was also greeted with scepticism by rates, and the long-end flattened in a reaction that echoed that to the previous FOMC meeting in June. We do not think the gloom is justified, but current market conditions will persist for at least another month, and rates could yet print new lows in the coming weeks, and the curve should flatten further.

Fed keeping dollar's bullish sentiment alive

A rather muted reaction in the FX market to the FOMC statement signalled that a slightly more hawkish message was largely priced in. Indeed, with the Fed that is inching closer and closer to tapering – there is a material possibility Powell will outline a timeline for reducing asset purchases at the Jackson Hole Symposium – markets should feel increasingly comfortable with pricing in a rate hike already in 2022. From an FX perspective, this should at least allow the recent good momentum for the dollar to continue.

With the Fed unlikely to turn into a negative factor for the dollar, it will be up to the global recovery story to change the tide in the FX market. For now, markets remain quite reluctant to re-price a flawless global economic recovery, and the recent bumps in Chinese sentiment may well have blown another hit to the already decreasing portfolio flows into emerging markets, which is another factor that should put a floor to the dollar in the short run.

Authors

James Knightley

Chief International Economist, US

james.knightley@ing.com

Francesco Pesole

FX Strategist

francesco.pesole@ing.com

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Watch: Europe's businesses are fighting back strongly

ING's Bert Colijn says supply, not demand, is the problem for Europe's businesses as they fight back against the coronavirus shock

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Read all about it!

Bert has far more detail on the prospects for industry in Europe [here](#). Alternatively, just click on the 'bundle' link below.

The full report from the team can be downloaded [here](#).

Author

Bert Colijn

Chief Economist, Netherlands

bert.colijn@ing.com

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Authors

Bert Colijn

Chief Economist, Netherlands

bert.colijn@ing.com

Carsten Brzeski

Global Head of Macro

carsten.brzeski@ing.de

Inga Fechner

Senior Economist, Germany, Global Trade

inga.fechner@ing.de

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The EV industry has been a punching bag for Trump's campaign

Worldwide automotive production saw an unprecedented fall in 2020 due to factory and car dealership shutdowns, the distortion of supply chains, and complete lockdowns of countries due to the coronavirus pandemic. All of the main producing countries saw sharp declines, leading to a 16% year-on-year drop in world auto production including cars, trucks and buses, according to OICA data. In the second half of 2020, however, some markets recovered very quickly, with Asian production declining by only 10% year-on-year. The Chinese and South Korean markets performed particularly well due to a quick reopening of their economies and pent-up demand.

Lack of semiconductors will persist

With economies recovering worldwide, car production and sales will continue to rebound in 2021, [potentially by 7% to 9%](#) compared to last year. Yet the road remains bumpy for unhindered car production this year due to supply chain frictions, mainly the lack of semiconductors for OEMs. When car production slumped last year, orders for car parts were cancelled, while demand from other industry branches rose. Together with the production problems in Taiwan due to the drought,

OEMs faced a significant shortage when the overall economic outlook brightened faster than initially expected. The semiconductor problem has turned out to be quite persistent, not only impacting this year's production numbers but also next year's, resulting in a potential loss of five million vehicles this year and three million next, according to the Center for Automotive Research. As our consumer goods become ever smarter, the need for electronics, and thus the need for semiconductors, is rising. This is not only true for car manufacturers, but also for consumer electronics, computing and wireless communication, meaning that the battle for chips will continue.

What about demand?

We [did not expect Covid to hit car demand](#) on a lasting basis, and the data has proved us right. Demand remains high despite the pandemic, with the current problems in the market clearly being due to a supply shock. Order books are full, economic growth is rebounding and consumers are as confident as before the crisis. In the EU and eurozone, economic sentiment hit a 21-year high in June 2021, with the intention to buy a car within the next 12 months almost being back to pre-coronavirus levels. Private balance sheets proved resilient, according to [IMF data](#), despite higher unemployment and shorter working hours, as policy measures helped households maintain financial stability. In the US, consumer confidence also rose strongly and is currently at the highest level since March 2020. In China, however, sentiment has started to falter as of late with demand for cars being soft in May, growing only 4.5% year-on-year as risks to the economy pile up.

Electrification means a battle for chips and batteries

The EU's ambitious 'Fit for 55' climate goals, which must still be ratified, do not represent an immediate risk to our production outlook as OEMs have been working on the electrification of their production targets for some time now. In addition to reliable infrastructure, demand for EVs is key and this has seen a significant surge in the EU over the last year. Sales of battery electric vehicles more than doubled between 2019 and 2020 while sales of plug-in hybrids more than tripled, resulting in over one million units in 2020. If the current speed were to persist, all new registrations in the EU could be electrically powered by 2030. Regardless of the speed, however, competition for batteries and electric components is set to heat up given the ever-growing need for entertainment technology, potentially leading to another round of supply shocks in the next couple of years.

Sales outlook

Overall, we expect global new car production and registrations to bounce back moderately this year, with light vehicle sales growing [7% to 9% in 2021](#). Nevertheless, uncertainty around a potential fourth wave of infections with variants spreading, unresolved supply issues caused by supply chain disruptions and material shortages, as well as rising prices, pose a downside risk to our sales outlook. As for the years ahead, the phase out of fossil fuel vehicles and rise of electric cars will have the greatest impact on production and sales numbers, with a shortage of components likely resulting in moderate growth rates in the medium term.

Author

Inga Fechner

Senior Economist, Germany, Global Trade

inga.fechner@ing.de

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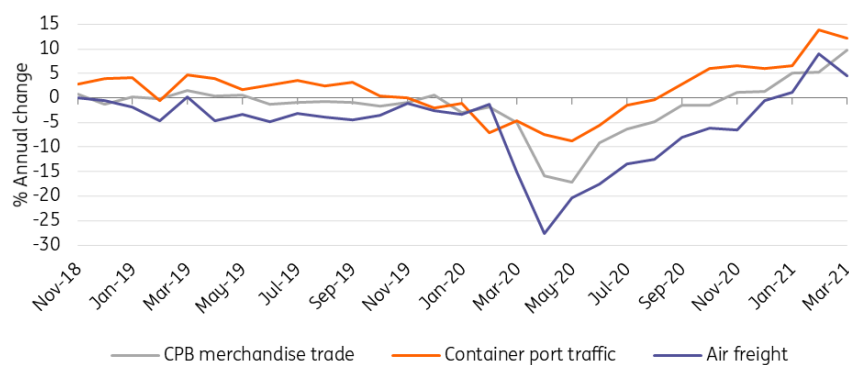
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Volatility and uncertainty in supply chains

During the pandemic, world trade in goods has benefited from the global recovery in retail sales and industrial production, while other sectors remain much harder-hit by lockdowns and uncertainty, so much so that global trade's recovery has outpaced global GDP. Ocean freight, normally responsible for the bulk of world goods trade, has had to compensate for reductions in air freight capacity while passenger travel remains restricted.

Ocean freight has become even more important, putting all capacity under pressure

Global trade in goods and different freight types, annual growth



Source: CPB Netherlands Bureau for Economic Policy Analysis, Institute of Shipping Economics and Logistics (ISL) and Leibniz-Institut für Wirtschaftsforschung (RWI), International Air Transport Association (IATA); and ING calculations.

But the positive picture from world trade volumes has come with supply chain volatility and uncertainty. Trade volumes have bounced back after lockdowns at ports, as well as the blockage of the Suez canal, but supply chain disruptions have accumulated and worsened. With some inputs taking much longer to be delivered, and containers becoming displaced, each setback is causing shortages of inputs and price increases to become more acute.

The faltering of supply chains is partly because of the strange effects that the pandemic has had on global economies. Even as demand for goods overall has remained strong, the stop-start nature of different recoveries has disrupted supply chains at different points, displacing empty containers and becoming one of the pinch points in international trade.

Ocean freight capacity more generally has also reached the limits of what it can deliver while health measures remain in place at ports. The growth in traffic has reached a point where globally, the majority of ships are missing scheduled arrival times, and late ships are being delayed for around a week before new slots open up for them. Reflecting the intense competition for capacity, shipping costs have been growing strongly since autumn 2020, adding pressure on input prices.

Among widespread shortages and price rises, metals stand out

Shortages are rising across sectors, including rubber producers, plastics products, electrical equipment, motor vehicles, wood, and computers and electronics. And among rises in the prices of many inputs, industrial metals stand out with more than 70% increase relative to pre-pandemic levels.

Like other commodities, a combination of pandemic and non-pandemic-related factors are at play. Mine closures in the initial round of lockdowns in 2020 led to a temporary pause in supply, which then resumed but faced unprecedented demand as inventories were rebuilt alongside serving current demand. That demand includes manufacturing, hit less than services during the pandemic, and infrastructure and energy-transition related projects.

The pauses in production which have driven some input prices so high are being magnified by the poor performance of supply chains. Both metals and lumber prices have come down from recent peaks, as falls in supply are replaced by more normal rates. However, new price spikes are possible into 2022 during the next phase in the global recovery, while supply chains and inventories offer little chance of catching up after setbacks.

Shipping costs to remain higher

Globally, capacity on major shipping routes has recovered to levels before the major lockdowns in 2020, although blank sailings (container ship journeys being scheduled but then cancelled) continued to cut 10% of scheduled capacity through the first half 2021. On current plans, cancelled sailings will come down to around 1% in 3Q. But cancellations are partly a response to delays, so the picture may still change.

A flood of new container capacity will ease price pressures, but not before 2023. Having enjoyed outstanding financial results during the pandemic, shipping companies have placed record levels of new orders for container vessels during 2021. But the companies also seem to have learnt how to manage capacity better in their alliances. They may continue to take capacity out of the system at short notice, reducing the price-dampening impact of new capacity coming onstream.

Pressure on ocean freight capacity will rise further as trade partners gradually recover from the effects of the pandemic at different speeds. But uncertainty about the recovery, including the possibility of new port closures, may well continue to exacerbate the displacement of empty containers and delays for key inputs.

Warning signs for global supply chains, will businesses reshore?

Costs have been rising before the pandemic for industries making intensive use of foreign inputs, thanks to increases in trade barriers, which aren't going away any time soon. But the ongoing disruptions to supply have brought the risks of using global supply chains into focus, with a new push to develop domestic capabilities, especially in technology, and create a degree of independence in the supply of essential medicines and technology goods.

The pandemic has seen a rise in trade barriers affecting food and medical products and subsidies to domestic industries across a wide range of sectors. These measures were primarily introduced as an emergency response. But they have largely remained in place as the pandemic has progressed. The measures taken during the pandemic add to the difficulties of access to foreign markets that had been rising before the pandemic, including during the US-China trade war.

But a global effort to dismantle trade barriers is not on the cards. Instead, progress is unlikely to go much beyond piecemeal progress within the context of bilateral talks, such as the suspension of tariffs in the Airbus-Boeing dispute between the EU and the US. Policy effort in China, the EU and the US seems instead to be focusing on reshoring in key sectors, likely through subsidies, which in the case of the US especially have been supercharged by large fiscal stimulus plans.

One consequence of more support for domestic production could be to bring down the relative costs of producing locally, which may tilt the balance for some supply chains to be brought home. Still, reshoring is hard to do and not necessarily the right move for increasing resilience.

Input shortages to continue into 2022

With input shortages to continue into 2022 and container prices remaining elevated into 2023, the supply of inputs is likely to be one of the major challenges for industrial production. Even as some frictions ease as the recovery progresses, trade barriers have risen.

Add to that a policy environment increasingly geared towards reshoring and domestic production, and it becomes clear that while global demand will continue to support industrial production globally, firms face a difficult and more costly environment to get the inputs they need for production.

European power markets ease but prices remain high

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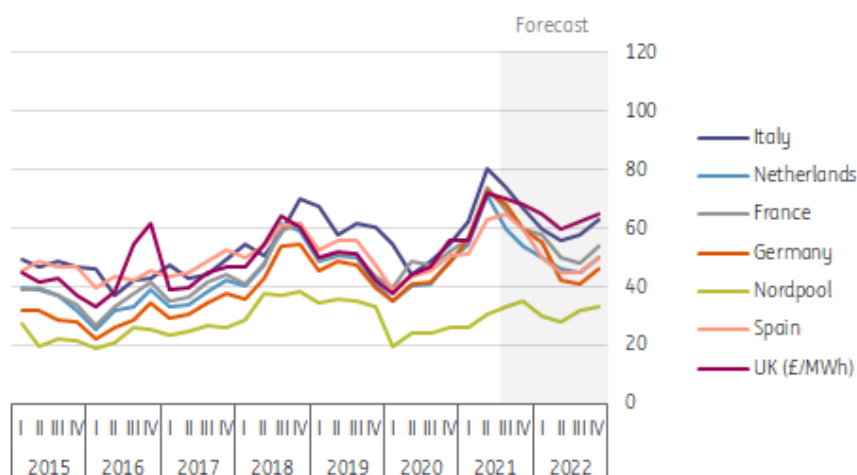


European utilities gain from surging power prices

Power prices have recovered strongly from the Covid-19 induced dip. At the end of 2021, for example, the UK electricity 1-year forward contract was at £72.08/MWh, a level not seen since 2008. As a result, European utilities, especially those largely exposed to power merchant activities, will enjoy a strong recovery in 2021 and 2022. The robust recovery in power prices seen in the first half of 2021 will be a major positive for the sector by the end of this year and even more importantly, from 2022 onwards.

Power prices have recovered from the Covid-19 dip and remain at elevated levels

One year future baseload power price in euro per MWh for European countries and pound sterling per MWh for the UK



Source: ING Research based on Refinitiv

The increase in power prices is the result of multiple factors

- A strong recovery in power demand following the reopening of the economy.
- Rising commodity prices (both gas, oil, coal and carbon prices).
- Adverse weather conditions for renewables and nuclear power plant outages in certain countries with the UK as the primary example.

We will analyse the impact of power demand and commodity prices on power prices in the rest of this article, leaving aside the weather conditions and power plant outages, as these are [hard to predict](#).

Electricity demand recovers from Covid-19 lows

The rollout of vaccination plans and reopening of shops and services in the first six months of 2021 boosted demand for electricity, especially in countries that were most hit by social restrictions in 2020. On a 12-month basis, France's power consumption at the end of June 2021 came in 3.2% stronger than a year ago. Italy and Spain, respectively, registered 2.4% and 1.5% growth.

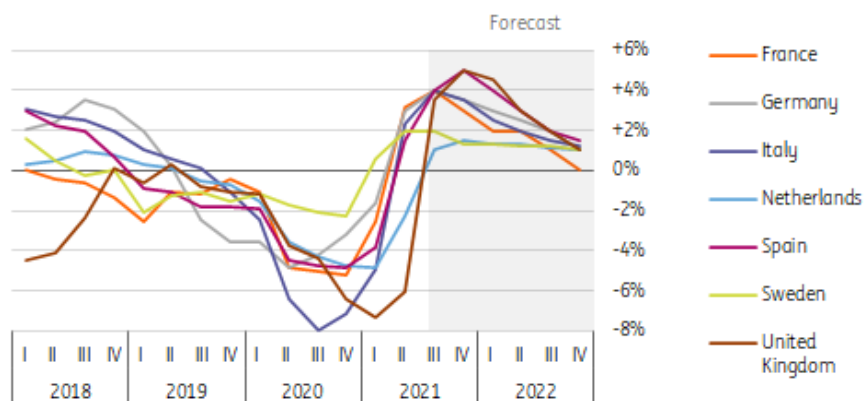
3%

Germany and France's power demand was up 3% year-on-year in June

Despite somewhat disappointing numbers in April and May for industrial production, Germany's electricity demand bounced back remarkably as well, with a 3% increase. The UK and the Netherlands reported negative growth in the second quarter, but growth is likely to turn positive again in the third quarter.

Power demand is back in growth territory

Year-on-year growth in electricity demand, four quarter moving average



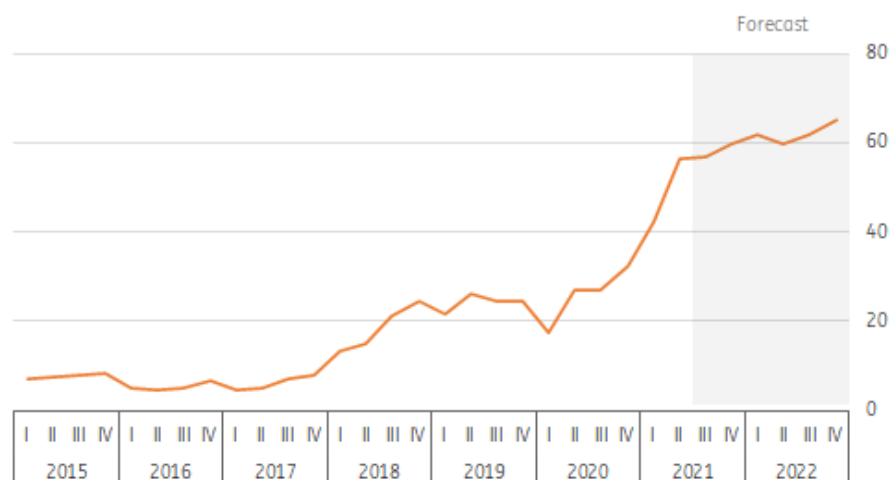
Source: ING Research based on Entso-E

EU 'Fit for 55' strategy increases the cost of carbon

The Emissions Trading System (ETS) is one of the main carbon tax tools put in place in Europe to reduce greenhouse gas emissions. The European ETS price settled at €56.3/CO2 tonne at the end of June 2021. This price has never before been reached in the history of the emissions trading system put in place in 2005.

EU ETS carbon price sets new record in anticipation of increased EU climate ambition

Carbon price in EU ETS scheme in euro per tonne



Source: ING Research based on Refinitiv

In the first six months of 2021 the market surged in the run up to the UK ETS system, with emitters in the UK buying carbon allowances in the EU market. The market also anticipated an increase in the EU emissions reduction target for 2030. On 14 July, the European Commission raised the net emissions reduction target from 40% to 55% by 2030 compared to 1990 levels. The 'Fit for 55' presents some major changes to the EU ETS to reach the higher target (see box).

€56/t

Carbon prices reached a record high at the end of June

Main changes to the EU ETS from the 'Fit for 55' strategy

- The overall emissions reduction target has been increased to 55% compared to 1990 levels. This creates a reduction target for the EU ETS of 61% compared to 2005 levels (the year the ETS started).
- The linear reduction factor has increased from 2.2% currently to 4.2% annually, probably in 2023 or 2024. The cap will also get a one-off rebase. The size of the rebase will depend on the year that the Directive enters into force.
- A gradual reduction of free allowances, which will be completely phased out by 2036.
- Extension of the Market Stability Reserve (MSR) to aviation, which is not currently impacted by the MSR. There will also be a 'buffer intake' which makes the MSR more dynamic in its response to over- and undersupply.
- Extension of the ETS coverage to transportation and buildings, although this is likely to be a parallel system not impacting the carbon price for manufacturing and power generation.

We expect carbon prices to stay at elevated levels up to 2022. Most of the changes have already been factored in by the market. Research from Aurora and PBL shows that there is ample abatement technology available to meet most of the carbon reduction up to 2030 at carbon prices of around 60-70 euro per tonne CO₂, so upside potential is limited. We do expect sustained volatility in carbon prices as traders are still figuring out the interplay of the EU ETS with the UK ETS and the political uncertainty surrounding this, as the Fit for 55 strategy goes through Parliament.

Either way, elevated and volatile carbon prices will drastically reduce the utility sector's dependence on fossil fuel sources to generate electricity. Higher carbon prices are also reflected in power prices as power generators can fully or partially pass them on to the final consumer.

Power prices remain elevated

Surging power demand and buoyant commodity markets suggest that baseload power prices will remain high, with an atypical seasonal pattern for 2021. Lower gas, oil and coal prices should put downward pressure on power prices in 2022, but this is mitigated to some extent by rising carbon prices. It is back to normal again for 2022, with summer prices expected to be lower

compared to winter prices. Note that, as always, actual price levels will depend on how cold winters will be and if summers will be plagued by heatwaves. Increased [growth in renewables](#) is likely to weigh on the power prices that renewable energy assets [capture](#) from the market. All in all, European utilities are expected to profit from strong power markets.

ING power price forecasts

Euro/MWh for European countries and Pound/MWh for the United Kingdom

	2021					2022				
	1Q	2Q	3Q	4Q	FY	1Q	2Q	3Q	4Q	FY
Netherlands	53	71	56	54	59	50	46	45	50	48
Germany	50	60	58	50	54	44	42	41	45	43
France	54	69	62	54	60	58	50	48	54	53
Spain	40	72	65	60	59	50	45	45	50	48
Italy	59	75	74	67	69	60	56	58	63	59
UK (£/MWh)	77	86	77	68	66	65	60	62	65	63

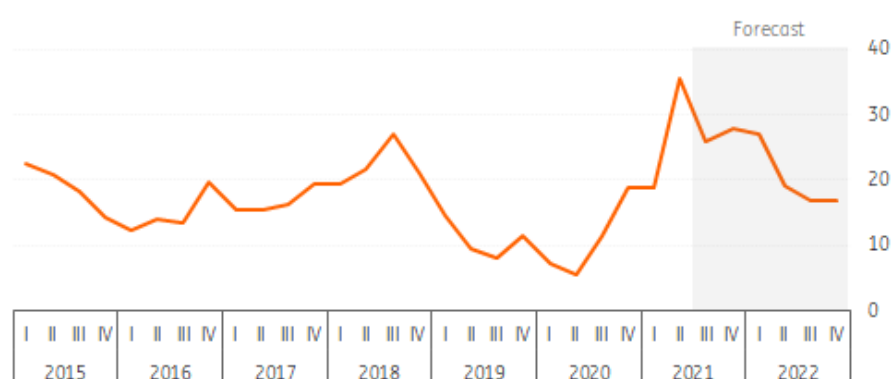
Source: ING Research

Unseasonal strength for gas

Most of the time, gas-fired power plants are the price setting technology in European power markets, so changes in gas prices are extremely relevant for power prices. European natural gas prices have seen significant strength so far this year, with TTF rallying by more than 75% over the first six months of the year and hitting record levels. This is an unseasonal pattern for gas, as prices are normally higher in the fourth and first quarter.

Gas prices hit record levels but are expected to ease

Day ahead forward gas price in Euro per MWh on TTF exchange, quarterly data (price on last day of the quarter)



Source: ING Research based on Refinitiv

There have been several drivers behind the strength of the gas market in the first part of the year.

Firstly, injection season in Europe had a late start because of colder than usual weather in April, and while we have seen the pace of injections picking up more recently, gas inventories in

Europe still remain at a five-year low and around 22% below the five-year average.

Secondly, the strength in carbon prices has been bullish for natural gas; carbon prices in Europe have rallied by more than 67% in 1H21 and have hit record levels. This has ensured that we continue to see coal to gas switching for power generation.

Furthermore, we have seen some heavy maintenance from Norway in recent months, which would have led to reduced flows to Europe. In addition to this, there is also scheduled maintenance for both the Nord Stream and Yamal-Europe pipeline, which further supports the market. Asia has also seen strong demand this summer, particularly from China. As a result, we are seeing Europe having to compete with Asia for LNG cargoes.

As for next year, much will depend on how cold a winter Europe experiences. However, the supply picture should improve, partly because Nord Stream 2 is expected to start up later this year. This should mean that we do see prices trading lower year on year. We are currently forecasting that TTF averages EUR27/MWh over 2H21, while over full year 2022, we expect prices to average around EUR21/MWh.

ING gas forecasts

	2021					2022				
	1Q	2Q	3Q	4Q	FY	1Q	2Q	3Q	4Q	FY
TTF (EUR/MWh)	18	25	26	28	24	27	19	17	17	21
ICE NBP (GBP/therm)	49	62	65	70	62	68	48	43	55	54

Source: ING Research

Limited upside for oil

Gas prices are still closely linked to changes in oil prices, so oil prices are also important drivers for power prices, despite the fact that oil is not used too much as a fuel to generate power.

The oil market has seen a robust recovery so far this year as it rebalances. ICE Brent rallied around 47% over the first six months of the year and has managed to briefly trade above US\$77/bbl, levels last seen in 2018. The pace at which the market has managed to draw down excess inventories has been remarkable due to unprecedented supply cuts from OPEC+. OECD oil inventories are now back below the 2015-19 average, having been almost 260MMbbls above this five-year average back in July last year.

The demand recovery has also helped to draw down excess inventories. After falling by around 9MMbbls/d in 2020, global oil demand is set to grow by 5.4MMbbls/d in 2021, still leaving it below pre-pandemic levels. However, the recovery in demand is set to be more robust over 2H21 as we see vaccination rates pick up around the world, and we are forecasting that we finish 2021 with demand back at around 97% of pre-pandemic levels. As for 2022, demand is expected to continue to recover, growing by around 3MMbbls/d, and by the end of next year, demand is expected to be back at pre-Covid-19 levels.

\$70/bbl ICE Brent will average US\$70/bbl over 2022

We continue to believe that the amount of spare capacity that OPEC+ is sitting on should ensure that oil prices do not move higher for a sustained period. We expect that 2022 will see sizeable non-OPEC supply growth and are currently forecasting that it will grow by 1.75MMbbls/d YoY. This growth will largely come from the US, where the higher price environment should see drilling activity pick up.

The growth of non-OPEC supply, along with easing OPEC+ supply cuts should ensure that the market is closer to balance next year, and as a result we are currently forecasting that ICE Brent will average US\$70/bbl over 2022.

ING oil forecasts

US\$/bbl

	2021					2022				
	1Q	2Q	3Q	4Q	FY	1Q	2Q	3Q	4Q	FY
ICE Brent (US\$/bbl)	61	69	75	70	69	68	70	73	70	70

Source: ING Research

Coal prices set to weaken

Coal is still a major energy source in some European power systems, with Poland and Germany being a case in point.

Coal prices have not been left behind by the surge in energy prices. European coal prices have rallied a little more than 74% in 1H21 and have traded above \$130/t recently. Having seen global coal demand falling by an estimated 4% in 2020, the IEA is forecasting that global coal demand will grow by 4.5% in 2021, taking demand back to pre-Covid-19 levels.

In Europe, a tight gas market has proved bullish for coal. However, there are also supply dynamics which have tightened the coal market such as disruptions in Colombia, a key coal exporter to Europe. China has played a key role in the strength of the market, with strong restocking demand for the summer helping to tighten the market. Nevertheless, one cannot rule out changes to government policy which could have a large impact on the seaborne market.

However, we are of the view that European coal prices should trend lower as we see supply/demand dynamics improve. We expect to see an improvement in supply from Colombia, while in the longer run, it is clear that the outlook for coal demand is weak, particularly for Europe, with policy continuing to drive it out of the energy mix.

ING Coal forecasts

US\$/ton

	2021					2022				
	1Q	2Q	3Q	4Q	FY	1Q	2Q	3Q	4Q	FY
API2 coal (US\$/t)	67	87	90	80	81	80	65	65	70	70

Source: ING Research

Authors

Gerben Hieminga

Senior Sector Economist, Energy

gerben.hieminga@ing.com

Warren Patterson

Head of Commodities Strategy

Warren.Patterson@asia.ing.com

Timothy Rahill

Credit Strategist

timothy.rahill@ing.com

Nadège Tillier

Head of Corporates Sector Strategy

nadege.tillier@ing.com

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