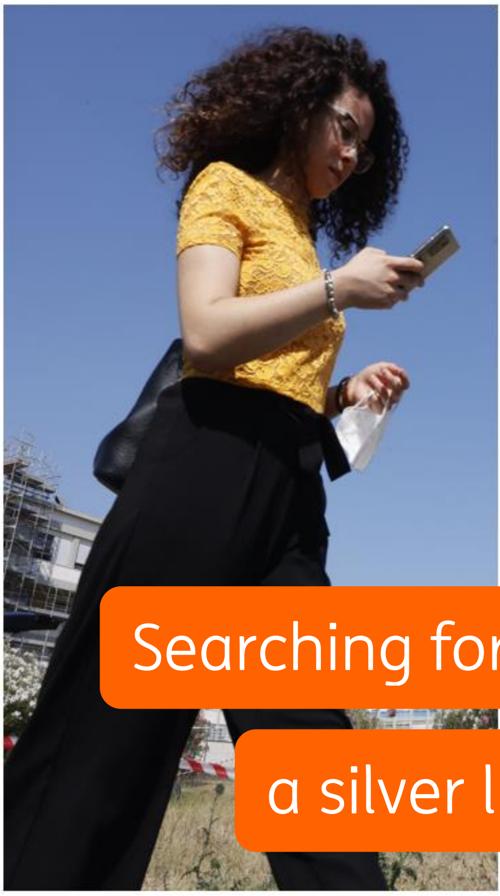
THINK Economic and Financial Analysis

ING Monthly

June 2022




Searching for a silver lining

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Searching for a silver lining

Inflation is on the lips of every central banker. What can they do to curb surging inflation and will it be enough?

The global economy has clearly seen better days. As attention shifts to the role of central banks, ING's Carsten Brzeski raises the question: how far can they actually go?

Inflation: the word on everyone's lips

Inflation remains one of the hottest economic topics of the moment, affecting households and companies and giving central bankers a very hard time. For a long while, central bankers had labelled accelerating inflation as 'transitory', attributing the rise to reopening effects after Covid lockdowns. With inflation surging for the second year in a row, inflation could still be labelled as 'transitory' in the sense that it is mainly driven by global factors like the reopening of economies, supply chain frictions, and the war in Ukraine and its impact on energy and commodity prices. However, it is definitely not 'transitory' in the sense of being temporary. In the Western world, in particular, high inflation has become an enormous concern. Headline inflation rates as seen in the 1970s will most likely be transitory, higher prices won't.

Our key calls this month

- Oil prices should remain supported through the second half of the year as the market remains in deficit. Expect Brent to average $125/bbl in 4Q.
- Inflation will remain elevated for the remainder of 2022 but a gradual fall in energy prices should see headline CPI rates begin to ease back in 2023.
- Despite talk of a pause, we expect the US Federal Reserve to continue hiking with 50bp hikes in both June and July, followed by a series of 25bp moves that take the funds rate to 3% around the turn of the year. Second-quarter US GDP is set to rebound sharply.
- The European Central Bank has effectively pre-announced two, 25bp rate hikes in July and September. But concerns about rising inflation mean a faster, 50bp move remains on the table.
- We now expect three further Bank of England rate hikes, up from two, on the back of new government support targeted at low-income consumers.
- We've kept our China GDP forecast at 3.6% for 2022, despite further stimulus from the government.
- The dollar correction may have come far enough and we still think a 1.00-1.10 trading range for EUR/USD feels about right.
- We continue to expect US 10-year yields to peak in the 3.25% area in the third quarter.
- Despite pockets of lower goods demand, current backlogs mean that supply chain disruptions are unlikely to ease substantially this year.

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Three scenarios for inflation and central banks

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Inflation is uncomfortably high and in the near term, there's unlikely to be much respite for central banks. But the outlook for 2023 and 2024 is shrouded in uncertainty, and inflation will hinge not just on energy prices but on short-term factors like supply chain disruption, as well as the longer-term forces of deglobalisation and demographics

Inflation remains one of the hottest economic topics of the moment, affecting households and companies and giving central bankers a very hard time. For a long time, central bankers had labelled accelerating inflation as 'transitory', attributing the rise to the reopening effects after Covid lockdowns. With inflation surging for the second year in a row, inflation could still be labelled as 'transitory' in the sense that it is mainly driven by global factors like the reopening of economies, supply chain frictions, and the war in Ukraine and its impact on energy and commodity prices. However, it is definitely not 'transitory' in the sense of being temporary. In the Western world, in particular, high inflation has become an enormous concern. Headline inflation rates like those seen in the 1970s will most likely be transitory, higher prices won't.

Most central banks and many private sector forecasters have had their respective inflation forecasts wrong for a long time. The main reason for these forecasting errors has been energy and commodity prices, which have surged over the last year. However, forecasting errors were also related to the underestimation of pass-through effects, ie, the willingness and ability of companies to actually charge higher prices.

In the past, companies often had to squeeze their profit margins in order to maintain market share when faced with higher costs. Strong demand from consumers, higher savings, and relatively stable income developments, however, have given companies huge pricing power. Additionally, the astonishing surge in American home prices and the rapid feed-through into rents, which carry a one-third weighting in the US CPI basket, has provided additional upside impetus. Looking ahead, the shorter-term path for inflation will be highly dependent on energy and commodity price developments, pass-through effects, and wage developments.

Over the longer term, however, other factors will be more important in shaping the inflation outlook. Just think of the peak in globalisation (ie, less global trade, less downward pressure on global goods prices, reshoring or friendshoring), demographics and decarbonisation. We think that all these structural factors will push up inflation globally to higher levels than in the past decade. Higher wage growth in the near term will also add to inflation momentum.

While it is always tough to make predictions, we have developed three scenarios for inflation developments in the coming two years.

1 Our base case

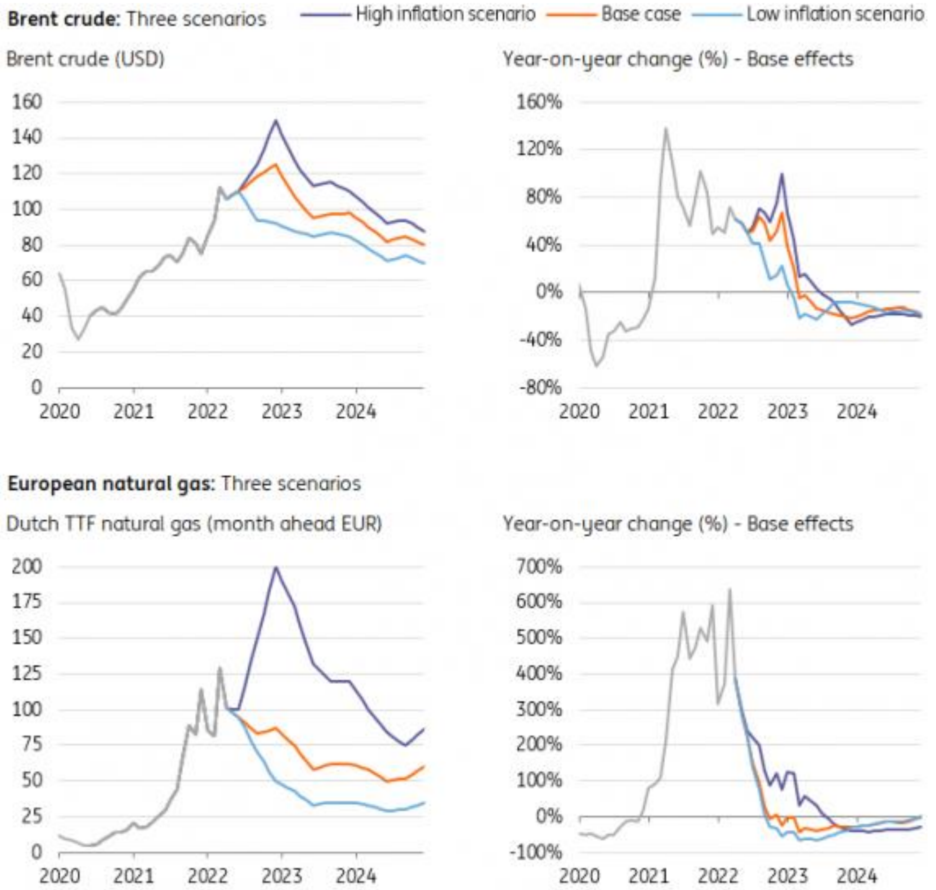
In our base case, we're assuming that energy prices stay supported through 2022 but begin to ease through 2023, perhaps linked to a gradual de-escalation in the Russia-Ukraine war. As our chart below shows in year-on-year terms, energy prices will begin to exert a negative base effect on headline inflation from late this year.

Still, there are plenty of pipeline pressures and pass-through effects should keep core inflation elevated through the remainder of this year. Worker shortages in the US mean there are now almost two vacancies for every unemployed worker, and the resulting wage pressure will mean services inflation remains sticky. Rising house prices have also lifted US core inflation, but Federal Reserve rate hikes should begin to cool the housing market and demand for consumer loans. Weaker house price inflation (and even outright price falls) will begin to pull the rental components within CPI sharply downwards through 2023.

Meanwhile, improving supply chains should bring down new car prices in 2023 and 2024, and there are already signs that used car prices have topped out. Reduced consumer demand for goods, now services have reopened, will also help alleviate one source of last year's supply pressure. That, combined with weaker private consumption in the eurozone given higher energy/commodity prices, will reduce companies' ability to pass on higher costs. Demands for higher wages in Europe will only be partially met, keeping wage growth between 2% and 3% year-on-year.

The Fed takes rates slightly beyond neutral, but the European Central Bank proceeds more cautiously. In both cases, the normalisation process should end around the turn of the year and keep central banks in a 'wait-and-see' mode throughout most of 2023.

Three energy price scenarios and their resulting base effects



Source: Macrobond, ING

2 High inflation scenario

There are several factors that could keep inflation higher for longer, and in this scenario we're assuming:

- The Russia-Ukraine war drags on for years, and Europe has to make the transition completely away from Russian energy and commodities. Oil prices end the year at $150/bbl if secondary sanctions are introduced on Russian crude. Gas prices for next winter go much higher if flows from Russia into Europe are significantly disrupted. But assuming energy prices don't continue to ratchet higher in subsequent years, at least not at the same pace, then we're still likely to get negative inflation base effects from oil/gas, albeit later than in our base case.
- China's zero-Covid strategy continues for the foreseeable future, putting more pressure on supply chains, while the West is increasingly worried about a China-Russia axis. Consequently, Western economies try to re-shore more production to "home" markets.
- Labour market rigidities become more structural and with hostility to immigration, supply problems persist and workers develop an appetite for wage increases with more unionisation.
- Fiscal policy remains highly supportive, offsetting the impact of higher prices on disposable incomes.

Central banks, especially the Fed, will hike more aggressively this year but inflation fails to come down even with a bit of a slowdown/recession in 2023 (albeit one which doesn't generate a pronounced increase in unemployment). That results in even more aggressive rate hikes, in a not-so-subtle attempt to bring about a sharp downturn – essentially a modern-day Volcker moment. Inflation is eventually lower, though not before 2024.

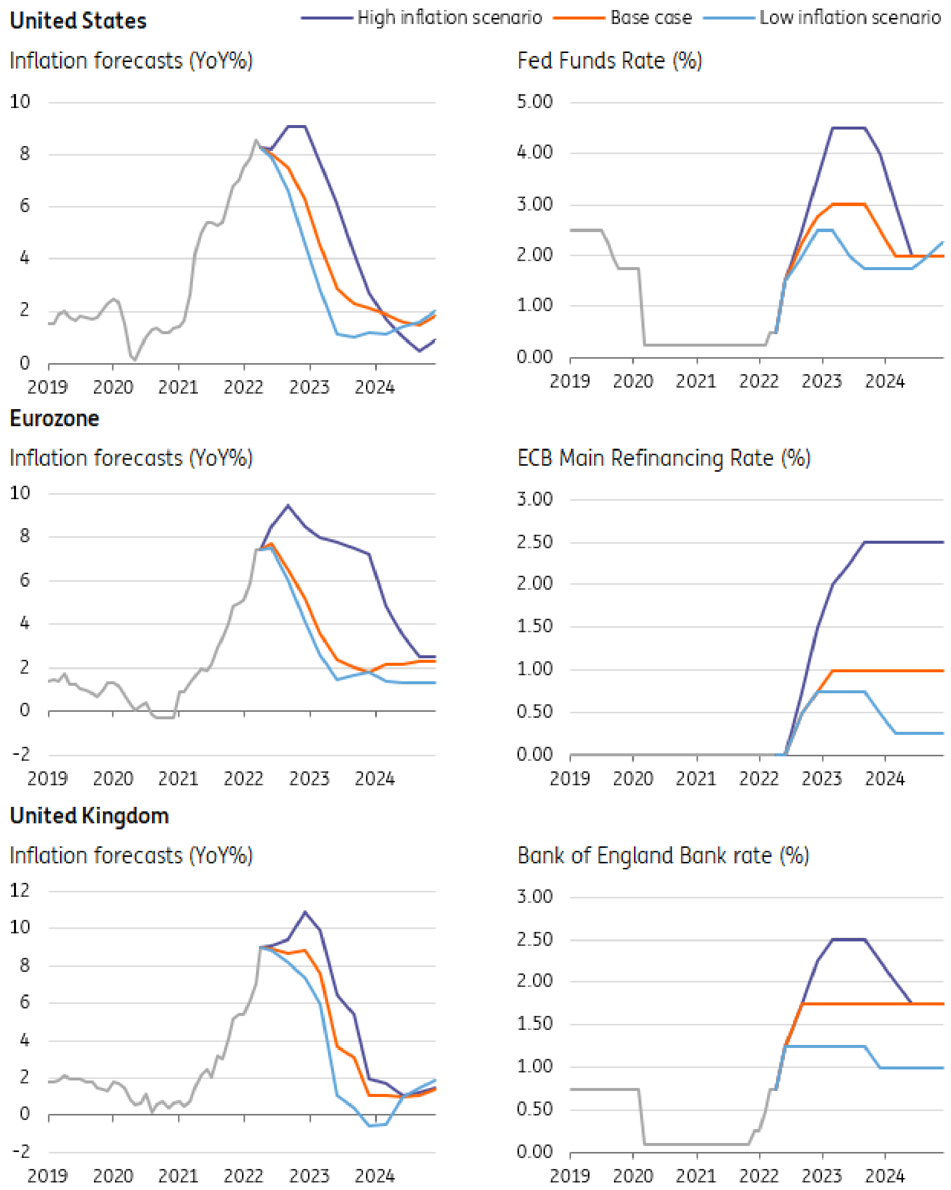
3 Low inflation scenario

Here, a significant de-escalation in the war facilitates a reopening between Russia and the West. Energy and commodity prices drop significantly. China loosens its zero-Covid strategy more quickly than expected, while also adopting Western vaccines to help insulate against future waves of infection. Supply chain frictions ease, particularly when combined with a swift reduction in durable goods demand as consumers rebalance towards services. Goods that saw swift price rises through 2021 see outright price falls, with some retailers grappling with excess inventory as delayed shipments arrive.

Meanwhile, the shortage of skilled workers is solved by increasing the participation rate in labour markets, which could reduce wage pressures. Central banks have overreacted in their policy normalisation, pushing many economies to the brink of recession by the turn of the year and fiscal policy turns restrictive again.

In this scenario, central banks implement the same normalisation as in the base case scenario, stopping rate hikes somewhat earlier and actually starting to cut rates again in the second half of 2023.

Three scenarios for inflation and policy rates



Source: Macrobond, ING

Longer-term inflation outlook

Over the last few decades, central bank credibility, new inflation targets and several global factors had brought inflation structurally down. In particular, globalisation and digitalisation were two enormous drivers of deflation or disinflation. Just looking at these structural trends, we think that the coming years will bring more upward pressure on prices. This is what we call 3D inflation, ie, inflation structurally driven by decarbonisation, deglobalisation and demographics.

Decarbonisation: The war in Ukraine will speed up the green transition in Europe and this decarbonisation is likely to be inflationary, at least in the initial stages. Investment in renewable energies will first bring additional demand for fossil fuels and commodities. The transition toward renewable energies is likely to push up prices initially before renewables and energy autonomy leads to much lower prices.

Also, as we try to move towards net-zero we are likely to see European governments incentivise action by raising and implementing carbon taxes, which could limit the scope for significant falls in energy prices. This is less likely to be a route in the US with the prospect of Republicans regaining control of Congress. At the same time, the move to renewables will significantly boost demand for key industrial and rare earth metals used to generate renewable energy and for battery storage, adding to costs and inflation pressures. Consequently, this is likely to argue for higher inflation in the near term, especially in Europe. The hope is this will mean greater energy security, at least in the shorter term, and fewer fluctuations in global energy prices, which should help to depress inflation pressures.

Deglobalisation: Businesses may look to re-shore activity as a combination of the pandemic and Russia's invasion of Ukraine has highlighted major issues over the durability of supply chains. The purpose of offshoring was to reduce labour costs and allow economies of scale to drive down input costs. Ensuring security and stability of supplies over and above keeping costs low will mean price levels and inflation are likely to be higher and consequently lead to higher wages.

Demographics: This can affect inflation trends in a number of ways. Fast-growing populations mean the demand for food, housing, entertainment, and so on, is going to be growing more quickly, which could generate higher inflation. However, the composition of the population growth is also important. If it is via high childbirth rates this means more mouths to feed, but there won't be an immediate positive impact on the supply capacity of the economy versus, say if population growth was primarily due to immigrant workers in their twenties and thirties.

Another way demographics impact inflation is that as people move through middle age and head toward retirement they tend to earn and spend less. One conclusion is that countries with faster-growing, younger populations are going to see more economic demand and greater inflation pressures than countries with slower population growth and rapid ageing of the population.

Data shows that the US has a younger population than Europe with a median age of 38.4 years versus 47.8 in Germany, 41.7 in France and 40.6 in the UK. In fact, Ireland is the only European country with a lower median age (37.8 years). At the same time, the US is experiencing more rapid population growth of 1% per year versus 0.1% in Germany, 0.2% in France and 0.6% in the UK. Ageing economies are increasingly experiencing labour shortages, which in turn could lead to higher wages.

Will structurally higher inflation lead to structurally higher interest rates?

Even if the current high headline inflation rates are not sustainable and will come down, the era of disinflation or deflation is clearly over. In the coming year, central banks will be facing structurally higher inflation rates than over the last two decades. The question will then be whether Western central banks will try to fight this structurally higher inflation with the same determination that they fought disinflation, knowing that their success could be as disappointing as over the last two decades. This time around, the impact on the real economy from tightening monetary policy too much could be much more adverse than it was in the fight against disinflation.

ING scenarios for inflation

	2022				2023					2024				
	Q2	Q3	Q4	FY22	Q1	Q2	Q3	Q4	FY23	Q1	Q2	Q3	Q4	FY24
Scenario 1: Base case														
Energy prices														
Brent crude (USD)	110	118	125	113	107	95	97	98	99	90	82	85	80	84
Dutch TTF natural gas (EUR)	95	83	87	91	75	58	62	62	64	58	50	52	60	55
Inflation (YoY%)														
United States	8.0	7.5	6.3	7.4	4.5	2.9	2.3	2.1	3.0	1.9	1.6	1.5	1.8	1.7
Eurozone	7.7	6.5	5.2	6.4	3.6	2.4	2.0	1.8	2.5	2.2	2.2	2.3	2.3	2.2
United Kingdom	8.9	8.7	8.8	8.2	7.6	3.7	3.1	1.1	3.9	1.1	1.0	1.1	1.4	1.2
Policy rates (%)														
United States	1.50	2.25	2.75		3.00	3.00	3.00	2.50		2.00	2.00	2.00	2.00	
Eurozone (refi rate)	0.00	0.50	0.75		1.00	1.00	1.00	1.00		1.00	1.00	1.00	1.00	
United Kingdom	1.25	1.75	1.75		1.75	1.75	1.75	1.75		1.75	1.75	1.75	1.75	
Scenario 2: High inflation														
Energy prices														
Brent crude (USD)	110	125	150	121	127	113	115	110	116	101	92	94	88	94
Dutch TTF natural gas (EUR)	100	150	200	138	172	132	120	120	136	100	84	75	86	86
Inflation (YoY%)														
United States	8.2	9.1	9.1	8.6	7.7	6.1	4.2	2.7	5.2	1.7	1.0	0.5	0.9	1.0
Eurozone	8.5	9.5	8.5	8.8	8.0	7.8	7.5	7.2	7.6	4.8	3.5	2.5	2.5	3.3
United Kingdom	9.1	9.4	10.9	8.9	9.9	6.5	5.4	2.0	6.0	1.7	1.1	1.2	1.5	1.4
Policy rates (%)														
United States	1.50	2.50	3.50		4.50	4.50	4.50	4.00		3.00	2.00	2.00	2.00	
Eurozone (refi rate)	0.00	0.75	1.50		2.00	2.25	2.50	2.50		2.50	2.50	2.50	2.50	
United Kingdom	1.25	1.75	2.25		2.50	2.50	2.50	2.25		2.00	1.75	1.75	1.75	
Scenario 3: Low inflation														
Energy prices														
Brent crude (USD)	110	94	92	99	88	85	87	85	86	78	71	74	70	73
Dutch TTF natural gas (EUR)	95	70	50	79	43	33	35	35	37	33	29	30	35	32
Inflation (YoY%)														
United States	7.9	6.6	4.6	6.8	2.8	1.1	1.0	1.2	1.5	1.1	1.4	1.6	2.0	1.5
Eurozone	7.5	6.0	4.1	6.0	2.6	1.5	1.7	1.8	1.9	1.4	1.3	1.3	1.3	1.3
United Kingdom	8.8	8.2	7.4	7.7	6.0	1.1	0.4	-0.6	1.7	-0.5	1.0	1.5	1.9	1.0
Policy rates (%)														
United States	1.50	2.00	2.50		2.50	2.00	1.75	1.75		1.75	1.75	2.00	2.25	
Eurozone (refi rate)	0.00	0.50	0.75		0.75	0.75	0.75	0.50		0.25	0.25	0.25	0.25	
United Kingdom	1.25	1.25	1.25		1.25	1.25	1.25	1.00		1.00	1.00	1.00	1.00	

Source: ING

ING global forecasts

	2022					2023					2024				
	1Q22	2Q22	3Q22	4Q22	FY	1Q23	2Q23	3Q23	4Q23	FY	1Q2	2Q24	3Q24	4Q24	FY
United States															
GDP (% QoQ, ann)	-1.5	4.5	2.5	2.1	2.9	1.2	1.4	1.7	1.9	1.9	2.1	1.9	1.9	2.2	1.9
CPI headline (% YoY)	8.0	8.0	7.5	6.3	7.4	4.5	2.9	2.3	2.1	3.0	1.9	1.6	1.5	1.8	1.7
Federal funds (%, eop)	0.50	1.50	2.25	2.75	2.75	3.00	3.00	3.00	2.50	2.50	2.00	2.00	2.00	2.00	2.00
3-month SOFR rate (%, eop)	0.65	1.45	2.20	2.65	2.70	2.85	2.85	2.75	2.45	2.45	1.85	1.85	1.85	1.85	1.85
10-year interest rate (%, eop)	2.50	3.00	3.25	3.00	3.00	2.75	2.50	2.25	2.00	2.00	2.00	2.00	2.00	2.00	2.00
Fiscal balance (% of GDP)					-4.9					-3.9					-3.4
Gross public debt / GDP					100.3					99.5					99.5
Eurozone															
GDP (% QoQ, ann)	1.1	-0.5	1.8	1.0	2.3	2.2	1.9	1.8	1.6	1.6	1.6	1.4	1.4	1.2	1.5
CPI headline (% YoY)	6.0	7.7	6.5	5.2	6.4	3.6	2.4	2.0	1.8	2.5	2.2	2.2	2.3	2.3	2.2
Refi minimum bid rate (%, eop)	0.00	0.00	0.50	0.75	0.75	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
3-month interest rate (%, eop)	-0.45	-0.35	0.10	0.35	0.35	0.60	0.60	0.60	0.70	0.70	0.80	0.80	0.90	0.90	1.00
10-year interest rate (%, eop)	0.60	1.00	1.20	1.20	1.20	1.15	1.10	1.00	0.90	0.90	0.90	0.90	0.80	0.80	0.80
Fiscal balance (% of GDP)					-5.4					-4					-3
Gross public debt/GDP					102					99.4					97.8
Japan															
GDP (% QoQ, ann)	-1.0	2.0	2.0	1.6	0.9	1.6	1.2	1.2	1.2	1.5	0.8	0.8	0.8	0.8	0.9
CPI headline (% YoY)	0.9	2.6	2.9	3	2.3	2.6	1.7	1.2	1.0	1.6	0.8	0.7	0.6	0.6	0.7
Interest Rate on Excess Reserves (%)	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
3-month interest rate (%, eop)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
10-year interest rate (%, eop)	0.3	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.1	0.1	0.1	0.1	0.1
Fiscal balance (% of GDP)					-10					-9					-7
Gross public debt/GDP					280					270					250
China															
GDP (% YoY)	4.8	-1.0	4.6	5.8	3.6	5.2	6.5	5.5	5.0	5.6	4.8	4.0	5.0	4.5	4.6
CPI headline (% YoY)	1.1	2.3	2.5	2.6	2.1	2.8	2.6	2.0	1.8	2.3	2.2	2.2	2.3	2.5	2.3
PBOC 7-day reverse repo rate (% eop)	2.1	1.95	1.97	2	2	2.1	2.1	2.2	2.2	2.2	2.3	2.35	2.4	2.45	2.45
3M SHIBOR (% eop)	2.38	2.20	2.10	2.20	2.20	2.30	2.30	2.30	2.60	2.60	2.60	2.65	2.70	2.75	2.75
10-year T-bond yield (%, eop)	2.80	2.75	2.75	2.75	2.75	2.80	2.90	3.00	3.10	3.10	3.10	3.15	3.20	3.20	3.20
Fiscal balance (% of GDP)					-4.5					-3.0					-2.8
Public debt (% of GDP), incl. local govt.					130.0					122.0					123.0
UK															
GDP (% QoQ, ann)	3.0	-1.3	1.9	1.3	3.6	1.4	1.5	1.9	1.9	1.4	1.7	1.5	1.5	1.5	1.7
CPI headline (% YoY)	6.2	8.9	8.7	8.8	8.2	7.6	3.7	3.1	1.1	3.9	1.1	1.0	1.1	1.4	1.2
BoE official bank rate (%, eop)	0.75	1.25	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75
3-month interest rate (%, eop)	0.91	1.40	1.70	1.70	1.70	1.70	1.70	1.70	1.70	1.70	1.70	1.70	1.70	1.70	1.70
10-year interest rate (%, eop)	1.70	2.00	2.00	1.90	1.90	1.80	1.70	1.50	1.40	1.40	1.40	1.40	1.40	1.40	1.40
Fiscal balance (% of GDP)					-3.4					-2.3					-2.0
Gross public debt/GDP					95.4					94.2					92.3
EUR/USD (eop)	**1.11**	**1.05**	**1.05**	**1.08**	**1.08**	**1.1**	**1.12**	**1.13**	**1.15**	**1.15**	**1.16**	**1.17**	**1.18**	**1.2**	**1.2**
USD/JPY (eop)	**122**	**130**	**130**	**128**	**128**	**127**	**126**	**125**	**125**	**125**	**124**	**123**	**122**	**120**	**120**
USD/CNY (eop)	**6.34**	**7.00**	**6.80**	**6.70**	**6.70**	**6.60**	**6.55**	**6.50**	**6.45**	**6.45**	**6.40**	**6.37**	**6.30**	**6.26**	**6.26**
EUR/GBP (eop)	**0.84**	**0.85**	**0.85**	**0.86**	**0.86**	**0.86**	**0.87**	**0.87**	**0.88**	**0.88**	**0.88**	**0.88**	**0.88**	**0.88**	**0.88**
ICE Brent -US$/bbl (average)	**98**	**110**	**118**	**125**	**113**	**107**	**95**	**97**	**98**	**99**	**90**	**82**	**85**	**80**	**84**

GDP forecasts are rounded to the nearest whole/half number, given the large magnitude and uncertainty surrounding our estimates
Source: ING forecasts

Commodities: Upside risks remain for the commodities complex

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Commodity markets remain vulnerable to Russia-Ukraine developments. Tightness in several commodities means that markets are likely to be more sensitive to any supply shocks. Tightness in energy and some agricultural commodities is set to persist for the foreseeable future

Russia's invasion of Ukraine has sparked concerns over food security. Malaysia recently banned the export of chicken

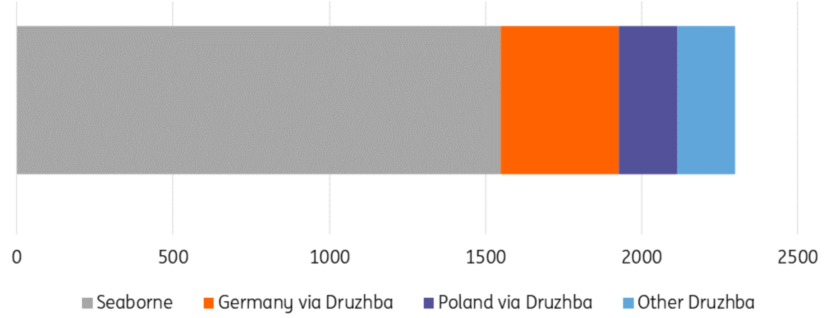
EU leaders agree on a Russian oil ban

EU leaders have finally agreed on a watered-down ban on Russian oil and refined products. The ban will only apply to seaborne crude oil imports, which will be phased out over the next six months, and refined products, which will be wound down over the next eight months. From the 2.3MMbbls/d of Russian crude oil that the EU imports, around two-thirds are seaborne imports. However, we believe the EU will reduce flows by more than this, given that Germany and Poland (which are the largest receivers of oil via the Druzhba pipeline) have signalled that they will work towards reducing Russian imports to zero.

This means that around 90% of Russian oil flows to the EU could be affected. Given the gradual phasing out of Russian oil under the ban, the impact on the market should be much more limited than if we were to see an overnight ban. Instead, buyers in the EU will have time to source other supplies, which should allow for a more orderly shift in trade flows.

Russian oil flows to the EU

Seaborne vs. Druzhba pipeline (Mbbls/d)



Source: Eurostat, IHS Markit, ING Research

How easy it will be to shift trade flows depends on the appetite for key importers outside of the EU to increase their share of Russian oil purchases. Given the significant discount available for Russian Urals, we suspect the likes of India and China will increase the amount of Russian oil they import. This should in theory free up supply from other origins for EU buyers. Whilst OPEC is sitting on enough spare capacity to meet the EU shortfall, the group has been reluctant to increase output more aggressively than it currently is.

OPEC continues to hold the view that the market is balanced and that the volatility in the market is due to geopolitical risks. In addition, it is important to remember that Russia is part of the OPEC+ alliance, and so will have some influence on what the group decides when it comes to output policy. We do not think OPEC will tap more aggressively into its limited spare capacity, which suggests that the oil market will be in deficit over 2H22, which should see prices edge higher (Brent at $125/bbl over 4Q22). Demand destruction has helped to ease some of the tightness in the market although clearly not enough to fully offset the Russian supply losses we expect as we move through the year.

There are clear risks to our view. To the upside, the biggest risk would be if we were to see secondary sanctions placed on Russian oil. This would make it much more difficult for Russia to sell into markets like India and China, which would mean that the global market would be even tighter than we expect. We also assume that Iranian oil supply will grow over 2023. If this fails to materialise, it will leave the market tighter than we are currently predicting for next year.

On the downside, the potential for further Covid-related lockdowns in China over the course of the year could weigh on oil demand.

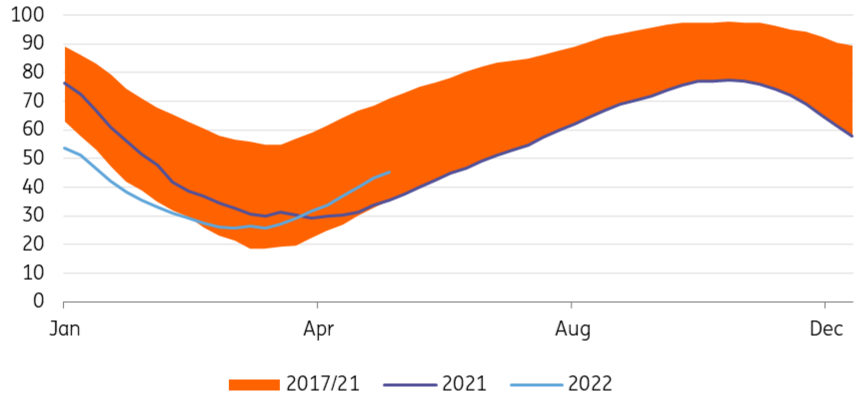
However, the bigger downside risk is if we see a de-escalation in the war or even an end to it (hopefully). This would likely see a significant amount of risk premium given back. Given the steps already taken by the EU, we do not believe that the EU would revert to its old ways and be highly dependent on Russia. However, de-escalation in the war could at least slow the process of moving away from Russian oil.

Natural gas looking more comfortable, but still plenty of uncertainty

European natural gas prices have eased significantly over the last month. In fact, prices are at their lowest levels since the start of the war. This is despite Russia having stopped gas supplies to Bulgaria, Finland, Poland, and more recently the Netherlands. These four countries made up roughly 13% of Russian flows to the EU in 2021. These buyers refused to agree to a new payment mechanism where they open a Gazprombank account to pay euros or dollars, which would then be converted to roubles. This is despite the European Commission suggesting that paying into a Gazprombank account should still be allowed, as long as the transaction is complete once euros or dollars are paid into the Gazprombank account, rather than after the conversion to roubles.

Fundamentally, the European gas market is in a more comfortable state. European gas inventories are 46% full compared to the five-year average of 49%, and above the 37% seen at this stage last year. Strong LNG imports have helped to improve the supply situation in Europe. And if we do not see any disruption to Russian gas flows this summer, European gas inventories should be more than comfortable going into the next heating season. However, no disruption to Russian gas flows is a big assumption to make. Additional buyers could refuse to accept Russia's new payment terms, which would see further gas flows from Russia cut. There is also the potential that Russia retaliates to the EU oil ban by stopping or significantly reducing gas flows. It is due to this uncertainty that we believe European gas prices will remain well supported as we head into the next heating season.

European gas inventories (% full)



Source: GIE, ING Research

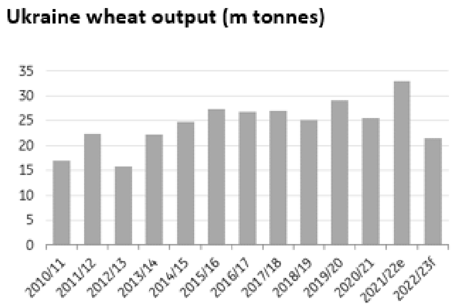
Ukrainian supply hit and protectionist measures in agricultural markets

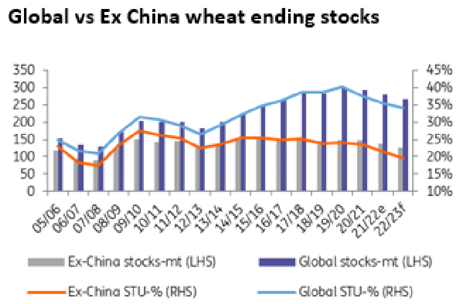
Disruption to Ukrainian agricultural exports remains a concern for global markets. Grain exports from Ukraine remain significantly affected. Exports are not possible through ports, so instead, we are seeing volumes transported via neighbouring countries. However, capacity constraints mean the volumes are significantly lower than what can be shipped via Black Sea ports. Over the first 19 days of May, Ukraine managed to export 643kt of grains (of which 96% was corn), compared to a little over 1.8mt in May 2021. There are efforts to remove blockades of Ukrainian ports. However, this will likely be difficult given that Russia will want some concessions to be made before doing so.

The impact of the war has not only had an effect on 2021/22 shipments, but it will also have longer-term effects, specifically on 2022/23 output. Ukrainian corn and sunflower seed production are expected to be down 54% and 37% respectively due to lower plantings, whilst wheat (of which most would have been in the ground prior to the war) is also likely to suffer in the 2022/23 season, with output expected to fall by 35% year-on-year.

The expected decline in Ukrainian wheat supply, along with some declines from other regions, means that global wheat stocks are expected to decline to their lowest levels since 2016/17. However, more than 50% of global wheat stocks are estimated to sit in China (and are unlikely to ever be exported). Looking at ex-China stocks gives better insight into how tight the market is. Ex-China wheat stocks are forecast to finish 2022/23 at their lowest levels since 2008/09, which suggests that wheat prices will continue to trade at elevated levels.

Global wheat market to continue tightening





Source: USDA, ING Research

It is very clear that Russia's invasion of Ukraine has sparked concerns over food security. There is the direct impact in the form of lost Ukrainian supply, whilst there is also the indirect impact where higher fertiliser prices potentially have an impact on global agricultural yields. Governments will want to avoid a repeat of the Arab Spring that we saw a little more than a decade ago. For some, it is too late. Sri Lanka is a good example of how food shortages have already contributed to unrest. There will be a push by governments to ensure adequate food supply and attempts to rein in domestic inflation, particularly in some emerging markets. Recently, we saw Indonesia briefly ban palm oil exports, India surprised the market by banning wheat exports, which was then followed by the Indian government also imposing a 10mt export limit for sugar this season, and finally, Malaysia has banned the export of chicken. As concerns continue to grow, we could very well see this protectionist stance spread. This leaves a scenario where key importers scramble to boost stockpiles, whilst some exporters limit flows. Overall, this would be a bullish scenario for agricultural commodity prices.

Central banks to keep hiking amid uncomfortably high inflation

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Despite talk of a Fed pause, we expect the US central bank to keep hiking through the autumn, taking rates to 3% around the turn of the year. Meanwhile, the ECB has effectively pre-announced two 25bp rate hikes this summer, although rising inflation means a 50bp in July shouldn't be totally ruled out

Christine Lagarde, president of the European Central Bank

Federal Reserve

The Fed has laid out the case for 50 basis point (bp) rate hikes at both the June and July Federal Open Market Committee meetings, but there is a debate as to what happens thereafter. Some officials want the Fed to continue with 50bp hikes to ensure inflation is brought under control, but this risks moving policy deeply into restrictive territory and heightening the chances of a recession. Others argue that there is already evidence of the growth outlook weakening and inflation pressures tentatively softening, which could justify a pause in September.

We remain optimistic about near-term growth with a strong consumer performance and a positive outlook for capital expenditure pointing to GDP growth in excess of 4% in the second quarter. We also think inflation will be sticky given ongoing geopolitical strife, supply chain issues, and labour market shortages. As such, a September hike is still our base case, but there is a growing chance the Fed will switch to 25bp moves at that meeting and beyond. We expect the Fed funds rate to peak at around 3%, but the weakening housing market, softer growth, and declining inflation should pave the way for rate cuts in late 2023.

European Central Bank

The ECB has clearly passed the stage of discussing whether and even when policy rates should be increased. The only discussion seems to be on whether the ECB should start with a 25bp rate hike in July, or move faster with a 50bp hike. It is the ECB's self-determined 'sequencing', ie first, end net asset purchases before hiking rates, which stops the ECB from hiking in June. The 21 July meeting will be the crucial meeting for the rate lift-off.

Both ECB president Christine Lagarde and chief economist Philip Lane have tried to take back control of the discussion on 50bp vs 25bp, breaking with the ECB's traditional communication strategy to never pre-commit. Instead, Lane spelled out the roadmap for normalising monetary policy, de-facto announcing the end of net asset purchases in early July, a 25bp rate hike at the ECB meeting on 21 July, and another 25bp rate hike at the ECB September meeting. There is nothing wrong with the content of his remarks as it is exactly what we have already been expecting the ECB to do. However, if both headline and core inflation increase further in the coming weeks, a 50bp rate hike in July will still be on the table.

Bank of England

Markets continue to price in at least another six rate hikes over the next year, in addition to the four that have already happened. That still seems like an overestimate, and in fact the Bank of England itself has said that inflation will be well below target in the medium-term if it follows through with that amount of tightening.

That said, it's clear the tightening cycle still has a bit further left to run. We already had an extra two hikes pencilled in for June and August, and we're adding an extra in for September. The combination of new government support, aimed at low-income households, and more persistent worker shortages in the jobs market, give ammunition to BoE hawks to continue hiking a bit further. By September, the Bank rate will be close to something that resembles neutral and amid ongoing concerns about growth, we suspect this is where the BoE will pause.

There's also a fair chance that the Bank commences active bond sales later this year, though it really depends on whether market conditions improve. The incentive to start selling gilts is clear: without it, the Bank's balance sheet is going to take a long time to reduce in size, and indeed shrink below pre-Covid levels. The challenge will be to avoid amplifying future periods of market stress with quantitative tightening.

Neutral interest rates: phantoms worth chasing?

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Officials at the Federal Reserve and European Central Bank have started to talk about the neutral level of interest rates again, some louder than others. But what is this neutral rate, and does it really make much sense?

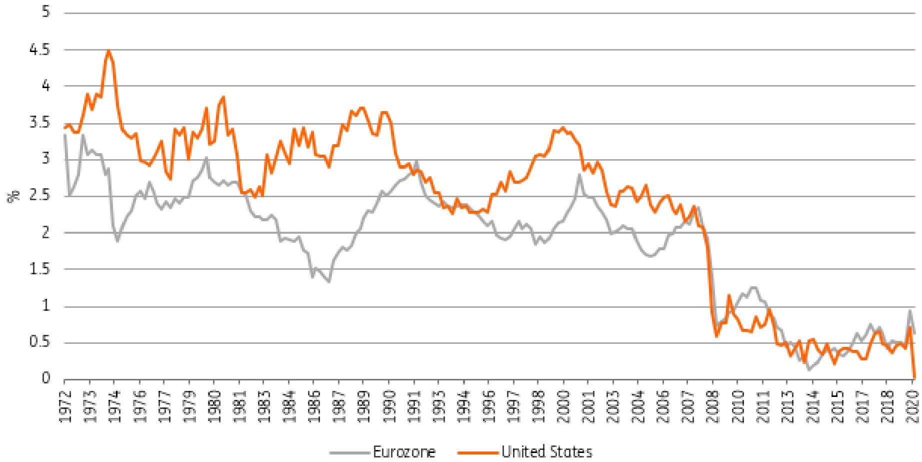
ECB President, Christine Lagarde described the neutral rate as 'unobservable' in a recent blog

In both the US and eurozone, central bank officials have started to talk about neutral interest rates again, using this theoretical level as a benchmark for how much they can potentially hike rates without taking policy into restrictive territory. Of course, every rate hike is a tightening of monetary policy compared with the previous level. The new stance will be less accommodative by definition but it can still remain accommodative.

In the US, the nominal neutral rate has recently been estimated to be around 2.5%. In the eurozone, ECB policymakers such as Villeroy de Galhau have put the nominal neutral level of interest rates in the range of 1% to 2%. But what exactly is this concept of neutral interest rates?

The New York Fed produced estimates of neutral real interest rates until the pandemic, after which they deemed conditions too volatile to properly assess neutral rates

Federal Reserve Bank of New York, HLW natural rate of interest estimate



Source: Federal Reserve Bank of New York

Defining the neutral rate

The concept of a neutral interest rate is often used to describe the stance of monetary policy. If policy rates are below the neutral level, monetary policy is accommodative and if they are above, policy is restrictive. This neutral rate is often defined as the rate or range of rates consistent with full employment, an economy growing at potential, and stable price growth. An economy in this state presumably wouldn't need to be stimulated or slowed by monetary policy. However, defining the neutral rate is much simpler than calculating it.

The neutral central bank rate has no explicit value, it is an estimate, and as economists famously disagree on many issues, they can also disagree on the range in which the neutral rate falls, and how it might change over time. Even the factors that determine the neutral range are complicated and varying. In the early 2000s, Fed Chairman Alan Greenspan was quoted saying: *"It's very difficult to know where that so-called neutral rate is. But we probably will know it when we are there because we will observe a certain degree of balance, which we had not perceived before, which would suggest that we are somewhere very close to where that is."*

"Neutral rates are currently higher than during most of the lacklustre 2010s"

To illustrate the difficulty of estimating neutral interest rates, one only needs to remember how difficult it is to determine when an economy is in a neutral or equilibrium state. We know how often estimates of structural economic growth and estimates of output gaps are revised. A lot. And even if output gap estimates were a safe bet in determining the neutral level of the economy, there have been very few occasions in the eurozone with a closed output gap: 2003-2005 and 2017-2019. The ECB's main policy rate in this period was 2%, 2.25%, and 0%. So where is this neutral level?

Well, what seems to be clear is that neutral rates are currently higher than during most of the lacklustre 2010s. With output gaps almost closed or already positive for the eurozone and US respectively, inflation rates well above target, and inflation expectations higher than during most of the past decade, the neutral rate seems to have been on the move. Still, it is nigh impossible to give a good sense of where this rate currently is. Post-pandemic effects have made it especially difficult for most experts to pinpoint where the economy is in relation to potential (consider factors like reversing stimulus, pandemic spending patterns, increased saving rates, etc.), let alone which interest rates correspond to that neutral state.

An invisible moving target

As much as we acknowledge the attractiveness of having a pseudo target level for policy interest rates which gives the illusion of being neither accommodative nor restrictive, this concept is flawed. Neutral interest rates can be used as an analytical tool, after the fact, to measure the monetary policy stance but they are not useful tools to guide markets or indeed give forward guidance.

A better option for central banks to gauge their normalisation paths, provide forward guidance and have regular assessments of the normalisation process so far would be to revert to the concept of financing conditions. As real interest rates have actually dropped to tremendously low levels on the back of rising inflation rates in recent months, monetary conditions have become looser. However, financing conditions - which not too long ago were a very special needle in the ECB's compass - have actually tightened considerably recently. Just think of nominal bond yields, stock prices, spreads or interest rates on loans to corporates and households. Focusing on monetary conditions or interest rates alone could lead to restrictive monetary policy pretty easily.

Neutral rates are an invisible and moving target and should not be used as a policy target but rather as an ex-post monetary policy stance assessment. We hate the term but, right now, with highly volatile times for the global economy, it would be better for central banks to use a holistic approach to determine when monetary policy might again be neutral.

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US: Greater challenges to come for the hardy consumer

The economy looks set to rebound sharply in the second quarter as the resilient consumer continues to spend and businesses remain in expansion mode. However, there are challenges to come as interest rates rise, the dollar remains firm, and geopolitics and supply chain strains show little sign of imminently helping the growth or inflation outlooks

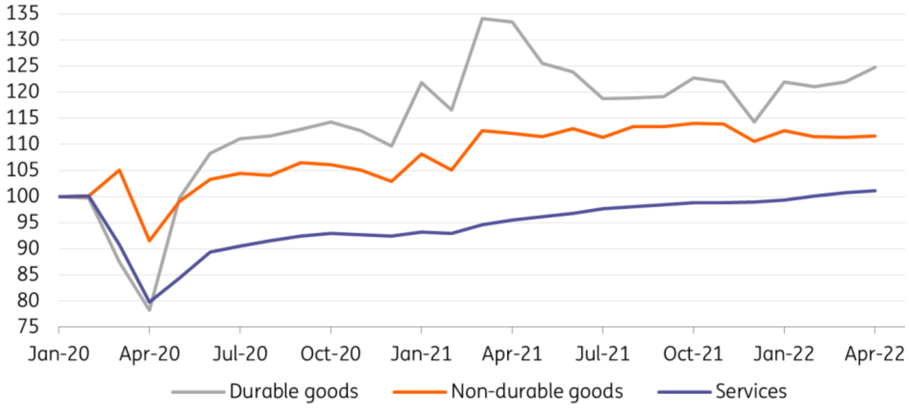
To get inflation to fall quickly we need a big increase in labour supply to limit wage pressures

Second quarter growth returns with a bang

The US economy contracted an annualised 1.5% in the first quarter, but we wouldn't read too much into this. Inventory and trade data have been swinging around wildly over the past year and it was these two components that dragged activity lower in the first three months of the year. Strip them out and the underlying domestic demand story in the economy is much stronger with consumer spending and business capital expenditure showing meaningful improvements.

Consumer spending and investment will also be important growth drivers in the second quarter with monthly data suggesting that while incomes are not keeping pace with the rising cost of living, households are prepared to run down some of their accumulated savings to maintain their lifestyles. People movement data and high-frequency restaurant dining and air passenger numbers also suggest strong spending. At the same time, strong durable goods orders and record-high job vacancies indicate that businesses remain in expansion mode. Inventories are likely to be far less of a drag on 2Q growth, while early trade numbers for April suggest net trade could actually add to GDP growth in the current quarter.

Consumer spending breakdown continues to show goods outperforming (Feb 2020 = 100)



Source: Macrobond, ING

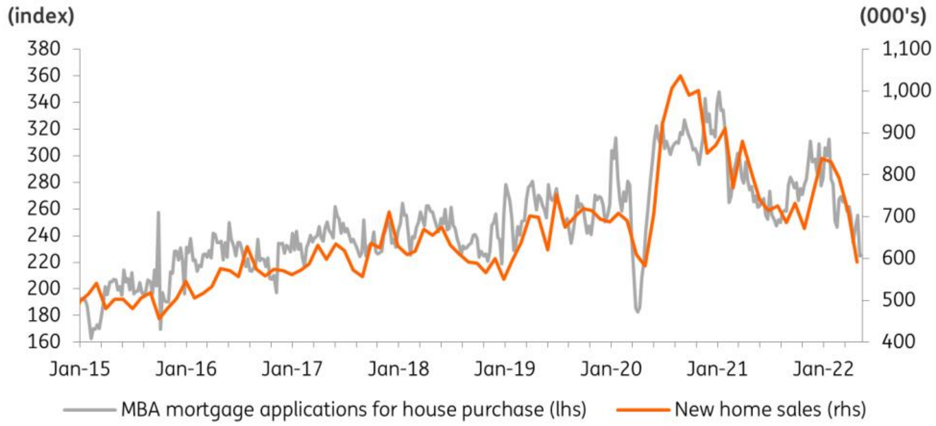
Fed to continue hiking to 3%

We are now forecasting the economy to expand 4.5% annualised in the second quarter, and with the labour market continuing to tighten and inflation pressures remaining intense, the Federal Reserve has advised that 50bp interest rate increases at both the June and July Federal Open Market Committee (FOMC) meetings will likely be required. What happens thereafter is less certain. Some FOMC members have suggested they could continue hiking by 50bp until inflation is under control. Others have hinted they could vote in favour of a pause as early as September, fearing that to tighten too hard, too fast could risk unnecessary economic harm.

The squeeze on real incomes is already a headwind while a strong dollar will also contribute to a slowing economy. A clear concern in the market is that in this environment, aggressive action from the Fed could be the catalyst for a more pronounced slowdown that could tip an economy into recession. We certainly acknowledge that risk and would put around a 40% chance on that happening over the next 18 months, but it is not yet our base case given the strong fundamental underpinnings of the labour market and household savings.

Inflation is likely to remain the Fed's focus in the next few months. To get inflation to fall quickly we need to see geopolitical tensions ease to get energy prices lower, improved supply chains to get products more freely available (and cheaper), and a big increase in labour supply to limit wage pressures. Unfortunately, none are likely to happen soon with Russia's invasion of Ukraine continuing, China's zero-Covid strategy showing little sign of softening, and businesses struggling to find workers at a time when vacancies are at record highs. Consequently, we continue to see the Fed funds rate moving up to 3%, but our previous call for a 50bp hike in September now looks more challenging and we have changed that to a forecast of a 25bp hike.

Housing transactions are slowing in response to falling mortgage demand as rates rise



Source: Macrobond, ING

Slowdown risks for later in the year

In terms of growth later in the year, the housing market remains our main concern with mortgage demand falling sharply as mortgage rates rise. This is already translating into weaker transactions, and with more inventory coming onto the market we see the risk of price falls in the coming quarters. This will eventually mean weaker construction activity and it will be a drag on correlated retail activity, particularly for furniture, home furnishings, and household appliances.

We believe this will contribute to inflation slowing through the year and certainly next year when we could see it get close to target by year-end. A weaker housing market is a very important story given it will eventually mean lower CPI contributions from primary rents and owners' equivalent rent, which account for a third of the inflation basket. On top of this, used car prices with their 4% weighting in the index are now falling and could also help to drag inflation lower quite quickly.

A move from 'restrictive' Fed policy to 'neutral' is on the cards for late 2023

If we can also see some marginal improvements in supply chains and energy markets over the next 12 months this will ease some of the global price pressures, while a weaker US growth story will make it more challenging for businesses to maintain their profit margins and a squeeze here can also contribute to slowing inflation.

If the Fed does see evidence of "clear and convincing" declines in inflation over the next 18 months, it is likely to be a cue for the Fed to start to relax its monetary stance and we expect to see the Fed moving policy out of restrictive territory to a more neutral footing before the end of 2023. The Fed never leaves policy "tight" for long with the average duration between the last rate hike in a cycle and the first rate cut only around seven to eight months over the past 50 years.

Eurozone: muddling through at best

Persistent headwinds are pushing the eurozone into a 'muddling through' scenario, and there is a high probability that the region will see one quarter of negative growth this year. But sticky inflation and higher inflation expectations will force the European Central Bank to abandon negative interest rates in the third quarter

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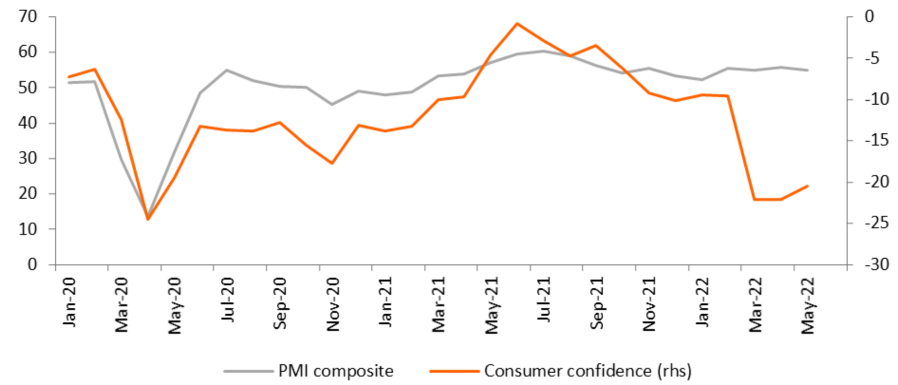
Muddling through? President of EU Commission Ursula von der Leyen and European Council President Charles Michel at a summit this week in Brussels

Farewell to negative interest rates

In a blog on the ECB's website, President Christine Lagarde brought forward the growing consensus that has been building within the governing council, namely that stickier-than-expected inflation requires the quick removal of non-conventional policy measures. A first rate hike in July looks like a near certainty and a 50bp increase cannot be excluded, especially if core inflation comes in higher than expected in the run-up to the July meeting. In any case, negative rates will have disappeared come September. It now seems that the ECB wants to seize the window of opportunity to normalise monetary policy. This requires policymakers to walk a fine line between the rising inflation expectations and economic headwinds.

Sentiment divergence between consumers and businesses



Source: Refinitiv, Datastream

Mixed feelings

The first quarter showed an upwardly revised 0.3% quarter-on-quarter growth rate, but the second quarter looks more of a conundrum. There is no hard data yet and the sentiment data has been rather inconsistent. Since the start of the war in Ukraine, consumer confidence has dropped to recessionary levels, with the May reading showing hardly any improvement. However, business confidence figures have held up better while still declining.

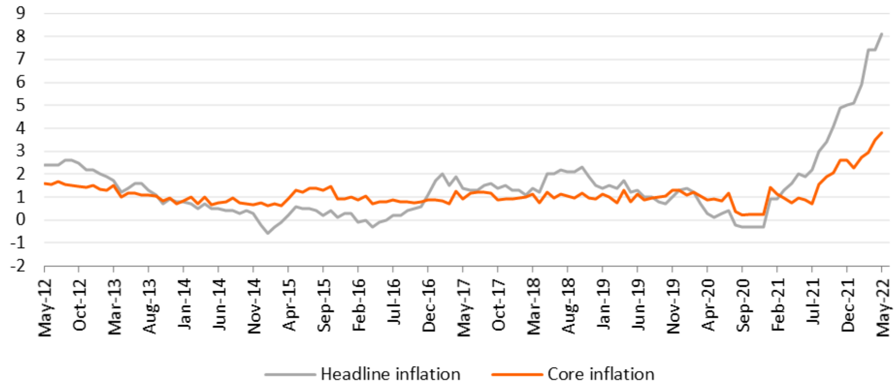
The flash eurozone PMI composite index came in at 54.9, firmly above the boom-or-bust 50 level. This is largely on the back of a strong services sector, which seems to be benefiting from some post-pandemic catch-up demand. Indeed, holiday reservations are back or even above pre-pandemic levels. In the manufacturing sector, the deceleration is more obvious on the back of renewed supply chain problems, higher input prices, and falling orders.

Not exactly the roaring twenties

There is no clear weakening yet in the labour market, but wages, although rising a bit more rapidly now, are definitely not keeping pace with inflation. At the same time, oil prices are climbing on the back of a (partial) European boycott of Russian oil, further sapping households' purchasing power. As such, we don't think that consumption will be a strong growth driver in the coming quarters. And businesses might also become more cautious in their investment plans.

That said, there still seems to be a willingness among governments to support the weakest households with fiscal measures. And as the European Commission has proposed extending the escape clause for the Stability and Growth Pact into 2023, not a lot of fiscal tightening should be expected for the time being. We still believe the second or the third quarter of this year might see negative growth. Thereafter, we think the growth pattern will be pretty much in 'muddling-through' mode. That should still result in 2.3% GDP growth in 2022 and 1.6% in 2023. Not a recession, but not exactly the roaring twenties either. And downside risk prevails.

Both headline and core inflation continue to surpass expectations



Source: Refinitiv, Datastream

Higher inflation expectations

Barring a strong increase in natural gas prices amid fewer imports (or a stoppage of supply) from Russia, inflation is probably close to its peak. In May, headline inflation rose to 8.1%, with core inflation at 3.8%. We expect the decrease to be very gradual and it might take until the second half of 2023 before headline inflation falls back below 2%. At the same time, longer-term consumer inflation expectations have now seen an upward shift to 3% in the most recent survey, which explains why the ECB wants to get rates out of negative territory pretty soon.

In an interview in Cinco Días, Philip Lane, the ECB's chief economist, made it very clear that this should be a done deal by September. What happens afterwards will be data-dependent. We don't think a wage-price spiral will develop, as in the most recent wage agreements the increase foreseen for 2023 is only 2.4%, below the 3% the ECB considers consistent with its 2% inflation objective. That said, we can imagine that the ECB will want to get a bit closer to the elusive "neutral interest rate". Therefore we think the deposit rate will be raised to 0.25% by year-end, moving to 0.50% in 1Q 2023. Thereafter, a long period of 'wait-and-see' might follow.

UK: The Bank of England to keep flying the flag for rate rises into the autumn

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An extra government support package means we've upped our forecast for Bank of England rate hikes this year. We now expect moves in June, August and September, though this is still less than markets are pricing

People in the UK will try to forget any money worries as they celebrate the Queen's platinum jubilee

Extra government stimulus probably means a bit more monetary tightening

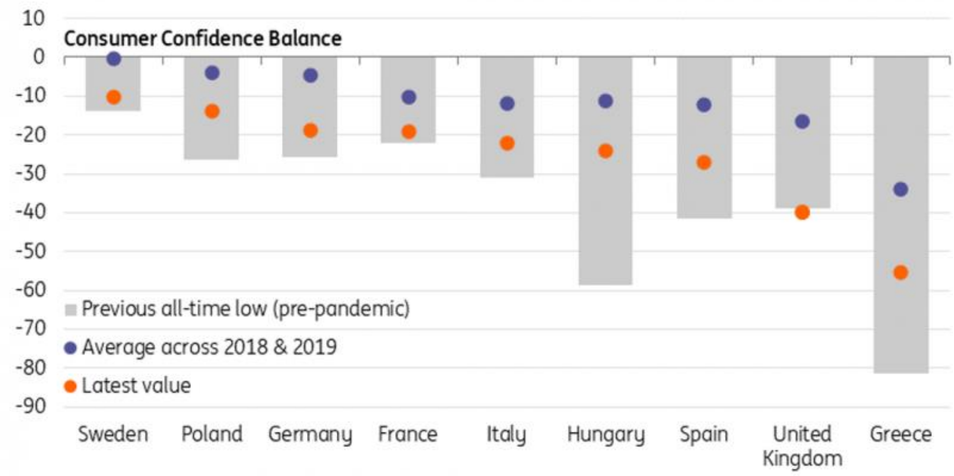
We've had a long-held view that the Bank of England will tighten less than markets expect – and those expectations still imply more than six additional rate hikes over the next year. The Bank itself has said this rate path, if realised, would result in below-target inflation by 2024.

Last month we pencilled in two more rate hikes, in June and August, before a pause. However, two recent developments lead us to add an extra one in for September.

Firstly, the British government has noticeably improved its support for consumers. The £15bn stimulus package roughly doubles what was already announced earlier this year but, more importantly, is much more targeted towards those on lower incomes and thereby most affected by higher fuel bills. The Treasury estimates that the package is equivalent to around 7% of incomes for those in the lowest decile. For those on means-tested benefits, the latest cash support should offset the additional 40% rise in energy bills expected in October.

Until now the UK's support has lagged behind that of some continental European economies and perhaps helps explain why consumer confidence has fallen more sharply relative to elsewhere. We've upgraded our forecast for growth through the second half of the year and the latest measures will undoubtedly lower the odds of a recession.

UK consumer confidence is at an all-time low and has fallen further than elsewhere



Source: Macrobond, ING

Expect 'labour hoarding' as worker shortages persist

Secondly, worker shortages look like they are going to be more persistent than we'd first thought. The key challenge is to identify how much of the shortage issue is down to a post-Covid mismatch in the jobs market, which should diminish, and what is instead down to longer-lasting structural factors. While we think the former is still playing a role, worker participation fell through the pandemic and there are few signs of the situation improving. The fact that a large proportion of this trend is ascribed to long-term illness suggests we shouldn't expect a rapid return of workers. Lower inward EU migration is clearly also playing a role and the ratio of vacancies to unemployed workers is now one-to-one for the first time in the series' history.

Consequently, even as company margins come under ever-increasing pressure, firms have a strong incentive to keep workers on amid concerns about rehiring when conditions improve. Hopefully, that means the marked rise in unemployment being forecast by the Bank of England won't materialise.

Still, there's plenty of uncertainty and we'd expect the BoE to continue to tread carefully on rate hikes. And we expect the committee to become more divided too. The June meeting could feasibly see at least one member voting for no change, with others continuing to back a faster, 50 basis-point hiking path.

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China: the big concern is still lockdowns

We are keeping our low GDP forecast even though the Chinese government is boosting growth through fiscal stimulus and infrastructure spending. We remain concerned that lockdowns will keep happening

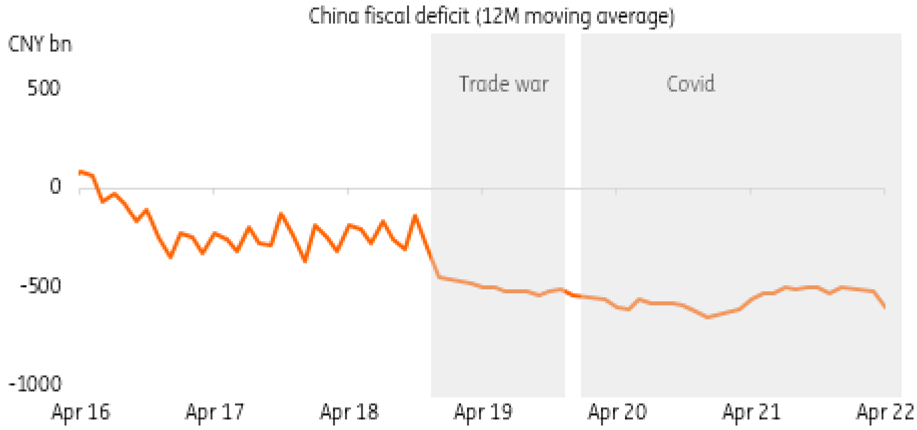
We are worried that lockdowns in China will keep happening

No change to GDP forecasts even though there will be huge stimulus

We are keeping our GDP forecast at 3.6% for 2022 even though the government is going to strongly increase fiscal stimulus. The main reason for this is the high probability of further lockdowns. We cannot rule out the prospect of further lockdowns, in Shenzhen or Shanghai again, or in other cities.

So far, the government has provided stimulus of around 4% of GDP. However, we still expect a year-on-year growth rate of -1% in 2Q22. The main economic issue is not just the slump in retail sales due to lockdowns, which should partially recover after the lockdowns are eased. Our broader concern is about employment. Small and medium-sized enterprises (SMEs) are employing fewer people, and we expect them to keep the number of workers to a minimum, reducing as much as possible the potential impact of another lockdown or measures to tighten social interaction. SMEs contribute more than half of the jobs in towns and cities. As this previously large pool of labour supply now faces fewer job openings, those who are unemployed will continue to find it difficult to find a job. Without stable jobs, these people struggle with lower spending power resulting in a vicious circle.

China fiscal deficit



Source: CEIC, ING

Government stimulus is the main risk to our forecast

The risk to keeping our GDP forecasts unchanged is that the government is pushing stimulus measures, both at the national and local government level. So far, stimulus measures have accounted for about 4% of GDP. With Premier Li Keqiang urging local government officials to achieve positive growth in the second quarter, this implies that more stimulus is coming. We think it will be difficult to achieve positive growth in the second quarter, with only one month to go after the sharp contractions in activity in April and May.

Even if the additional stimulus does not push GDP into positive growth in the second quarter, it could still support growth in the second half of the year. The chances of getting GDP growth above 4% depend heavily on the size and also the nature of the stimulus.

That is where the risk of keeping the GDP forecast comes in – a huge fiscal stimulus package. But we are also concerned that irrespective of the size of the stimulus, it will be extremely difficult to implement such a big boost to growth in such a relatively short time.

Asia: food security - a prisoner's dilemma

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Although energy security has been top of mind since the start of the Russia-Ukraine war, in Asia at least, fears over food security are now being driven by "food hoarding"

Rice for sale at a market in the Philippines

The food domino run

The loss of wheat and sunflower exports from Russia and Ukraine has had clear knock-on effects on many Asian staples. It is also argued by some that China's stockpiling of some foodstuffs is exacerbating this problem.

Within the sphere of grains and cereals, Thai Jasmine rice is up 45% from its November 2021 low. In the edible oils space, palm oil, which is found in everything from noodles to cookies, is up close to 65% over the last 12 months. Such increases also push up animal feedstock prices (soy, corn), and in turn, meat (though recovery from last year's swine fever problems is keeping this more subdued for the time being).

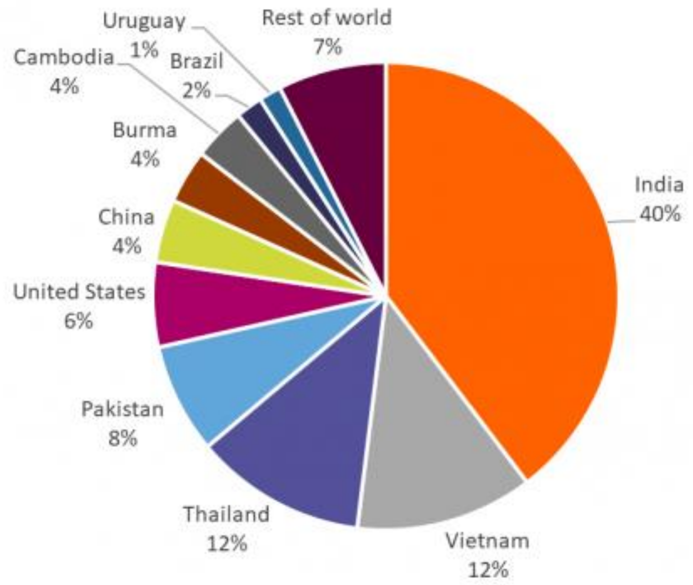
Looking ahead, rising fertiliser prices - a function of natural gas prices, which have also surged - as well as rising diesel prices, threaten planting and future crop yields and prices. This is especially true for poorer nations where difficult choices often have to be made about planted acreage and fertiliser usage.

Export bans to keep inflation limited

The negative consequences of these price increases reach beyond simple cost of living concerns. For example, the debt default by Sri Lanka and ensuing civil and political unrest are at least partly a function of rising global food (and energy) prices. And what is happening there shows that national security and food security are inextricably linked. It is perhaps with a sense of self-preservation in mind, that some governments in Asia have been looking to deal with the problem of rising food (and other) prices by keeping domestically produced food at home, rather than exporting it.

For example, India has imposed curbs on wheat and sugar production (albeit the latter at a relatively high level of 10m tonnes). Indonesia has imposed export bans on some palm oil products. Malaysia, with relatively low inflation right now is seeking to capitalise on this by dropping its export taxes on palm oil. It has, however, imposed a ban on exports of chicken, much to the alarm of neighbouring Singapore, which is 90% reliant on imported food.

World's biggest rice exporting nation



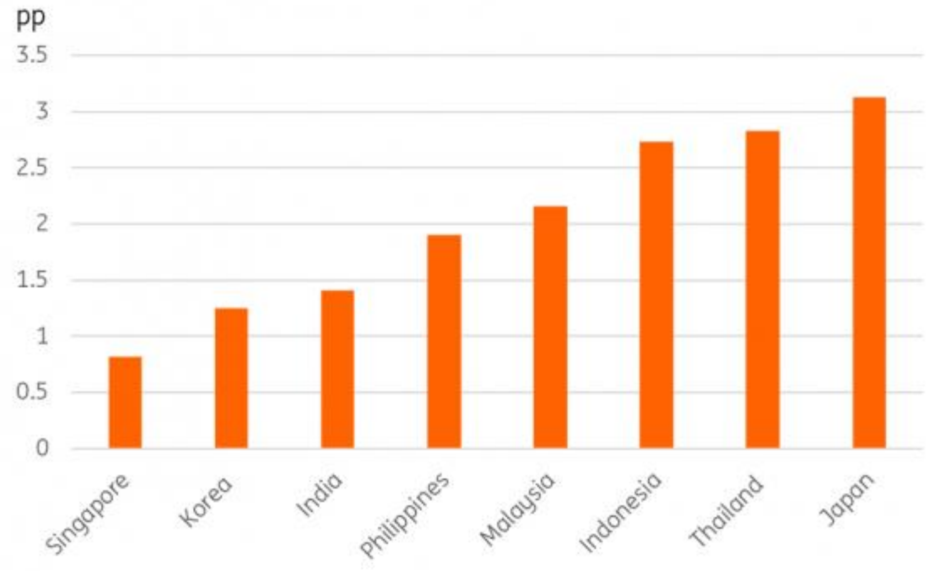
Source: USDA

What's good for me might be bad for you, and actually me too

In every country in Asia right now, food price inflation is pushing overall inflation higher, and this could have further to go. For example, there is now concern that India, the world's biggest exporter of rice, is thinking of limiting rice exports to prevent further food price increases domestically (Indian food price inflation touched 8.4% in April). If it did, it may spur further export curbs elsewhere in Asia to preserve food security, but which would in fact actually worsen it. Asia accounts for about 85% of global rice exports. This is basically a classic version of the prisoner's dilemma, where individual actions aimed at reducing an economic cost can collectively generate a much worse outcome.

One upside risk is that the monsoon season has already started well, which may take some pressure off food prices, and any ensuing actions to keep them subdued.

Difference between food inflation and core inflation in Asia



Food minus core inflation
Source: CEIC, ING

Central Banks - hiking but not totally clear why

If there is a role for central banks in all of this, it isn't 100% clear what that is. Certainly, higher rates can help reduce overall demand and take the pressure off rising prices. Though as food demand is extremely price-inelastic, this may only work by further reducing demand for other goods and services, and that is maybe where growing recession fears stem from. With few other choices, and currency weakness not a viable option in the face of rising global food and energy prices, more rate hikes across the region do look inevitable, though it is less clear what they hope to achieve.

FX: Dollar pauses for thought

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Calling the turn in a major dollar bull trend is a dangerous game and despite the recent 3% correction lower we are not brave enough to say that the dollar has peaked. Instead, with a market now under-pricing our forecasts for the Fed cycle, and over-pricing our views on the ECB cycle, the dollar could make another run at the highs

We are not brave enough to say that the dollar has peaked

Trading partners play catch-up with the Fed

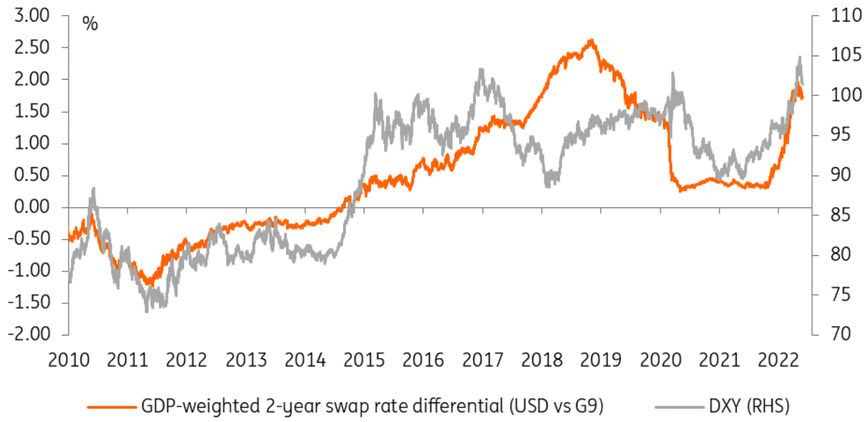
Last month we discussed the perfect storm driving the dollar higher in the form of solid Fed expectations, the sharp adjustment lower in the Chinese renminbi, and sluggish European growth. Since then, some softer US data (largely confidence and housing) has taken around 45bp out of the Fed cycle, At the same time, the renminbi has managed to stabilise too. Perhaps most importantly, expectations of monetary cycles outside of the US have played catch-up with the Fed.

Nowhere is this clearer than in the Eurozone, where a concerted assault from the ECB hawks has managed to lift the Eurozone money market curve, compress Eurozone versus US swap spreads, and bump up EUR/USD. This was probably the ECB's most viable form of verbal intervention to rail against unwelcome euro weakness. It seems strange that the ECB is only now considering the merits of a strong currency given that US and Chinese authorities were considering this a year ago.

And it is not just the ECB that has turned more hawkish. Even the ultra-dovish SNB is sounding more hawkish and detailing the need for a stronger nominal Swiss franc to at least keep the real exchange rate stable. The recent narrowing in short-dated yields between the US and major trading partners has undoubtedly taken some steam out of the dollar's rally.

In terms of the next move and based on our current monetary policy forecasts, this dollar correction might have come far enough. Unless one is prepared to call time on the Fed tightening cycle – and it seems far too early to do that – it seems likely that the dollar can make a run back to its highs. Last month we said that a 1.05-1.10 EUR/USD trading range had shifted to a 1.00-1.10 range – and that still feels about right.

US vs. G9 yield spreads

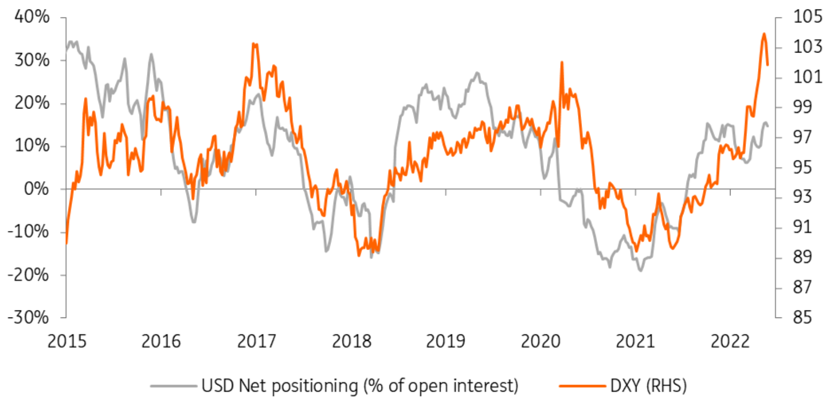


Source: Macrobond, ING

Dollar positioning is not stretched

We also think that speculative positioning should not stand in the way of a further dollar rally this summer. Yes, speculators have quite substantial long dollar positions on board. Yet these are nowhere near as stretched as in early 2017 (Frexit) or summer 2019 (Trump's trade war). Indeed, one could argue that fundamentals have driven the dollar to these highs and if anything, speculators could add to these long positions should they so choose.

Speculative long dollar positioning is not extreme



Source: Macrobond, ING

Fed pause prompts interest the carry trade

There are many investment strategies in financial markets geared against volatility – i.e. assuming that expected levels of volatility are too high. In the FX market, one such strategy is the carry trade, where an investor assumes that a high-yielding currency does not depreciate as much as is priced into the FX forwards market. However, realised volatility levels over recent months have actually been very high and have discouraged investors from chasing high yield returns – those returns largely found in emerging markets.

That said, there are early signs that the Fed pause is encouraging fresh interest in carry trades – especially in Latin America and Eastern Europe. These regions have seen some of the most hawkish central banks in the world, with implied yields through the three-month FX forwards ranging from anywhere in the 6% (Poland) to 12% (Brazil) region. Clearer signs that the dollar bull trend had peaked would certainly help the carry trade. Overall, we feel it is too early for these strategies in that central banks are rushing for the monetary exits and tighter liquidity conditions are typically consistent with higher, not lower levels of volatility. As such we think carry trade strategies still require a health warning.

Rates: Why real rates are the key for direction

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A long-run real return is what you get over and above long-run inflation. In Europe, it's still negative. In the US, it's barely positive. Lower market yields of late have come from an easing in inflation expectations. But with real rates still so low, there is a natural pressure for market rates to be driven higher again, as real pressure slowly re-builds

People walk past a store in Rome, Italy

An easing in long-run inflation expectations is notable of late, especially in the eurozone

Market rates have shown a tendency to ease off the highs in the past few weeks. This has been more pronounced in the US, resulting in a tightening in differentials vis-à-vis eurozone market rates. The big driver has undoubtedly been an easing in inflation expectations. For example in the US, the market-implied average inflation rate in the coming 10 years has eased lower to 2.6%, down from 3%. This market discount is still not low enough for the Federal Reserve to be completely comfortable, but it is heading in the right direction.

The eurozone is experiencing the same with, for example, the implied average German inflation rate now at 2.2%, compared with almost 3% about a month ago. That's quite a move in a very short period of time, and in fact, it likely overstates the degree to which inflation expectations have actually fallen.

German inflation expectations have fallen significantly in recent weeks (%)

Source: Macrobond, ING estimates

The reason for this reflects the construction of 10yr inflation expectations; achieved by subtracting inflation-linked bond yields from regular market yields. In recent weeks, regular market yields have been constrained by weak risk assets and slowdown narratives. But real yields continued to rise from deep negative levels. In consequence, implied inflation expectations have optically collapsed.

The German real yield is on a journey higher (%)

Source: Macrobond, ING estimates

Real yields are still too low and are primed to resume their rise, pressuring market rates up too

So what are real yields exactly? Marketwise, they are yields on bonds that pay the holder delivered inflation, so they are “inflation-protected”. The par coupon paid on such a bond is then a real coupon, i.e. a return above inflation. And as the market moves, that translates into a moving real yield. It’s effectively the yield received after being compensated for inflation.

The thing is, the real yield is still deeply negative in Germany. Even though the German 10yr real yield has risen by some 2.3% since March, it’s still at only -1%. A long-run negative real yield is not a natural state. Even in the US, real yields were negative until recently, and now are barely positive, at just 10bp.

> *“Theory links real yield to productivity and technological improvement”*

Logically, real yields should be positive. Theory links them to growth, with particular links to productivity growth and/or technological change. Negative real yields paint a negative picture. While it can be argued that there are central bank bond-buying complications here, that is far from the complete explanation as to why real yields are still so low. There is room for real yields to rise in both the US and Germany. The US 10yr real yield should rise to 1% and the German 10yr real yields must move to zero at a minimum. If not, we really have not recovered fully.

"A rally in risk assets allows room for higher real yields"

Note that upward pressure on real yields is a threat to risk assets. Higher real yields place direct pressure on equity valuations, as price-earnings ratios contract when real earnings are discounted back to the present. One of the reasons (but far from the main one) that equities have sold off is higher real rates. And should equities stabilise here and push on higher, it would in fact provide more room for a further rise in eurozone real yields, and a resumed rise in US ones.

Should market rates rise from here, expect the driver to be higher real yields

Do higher real yields mean higher nominal yields? Likely yes. But such real pressure should be muted by an ongoing easing in inflation expectations, especially in the US.

For example, hypothesize a rise in the US 10yr real yield to 1%. If that coincides with a fall in inflation expectations to 2.25% to 2.5%, that gives us a nominal yield of 3.25% to 3.5%. Which is as good a target as any for yields to peak at. And that's our call for 3Q.

For the eurozone 10yr, you can easily see how difficult it is to square a zero 10yr real yield with a 2% inflation expectation, and that suggests the 10y should be hitting 2%. As we factor in the energy crisis currently playing out, we're not quite in line with that view, but the rationale for a move in that direction is there.

Euro Focus: The Dutch government outlines new spending commitments

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With high energy prices, geopolitical turmoil, and the postponement of a minimum tax on multinationals, the Dutch government has presented a budget memo with tons of policy measures. These imply an even more expansionary fiscal policy and a further shift of taxation from households to businesses

Dutch Prime Minister Prime Minister Mark Rutte at a European Summit on Ukraine in late May

Higher energy prices inspire new policies

Mark Rutte's fourth administration, which started ruling in January 2022, has announced a lengthy list of policy changes. The expectation of prolonged higher energy and fuel prices has inspired new measures aimed at boosting households' purchasing power, even though similar measures (+0.4% GDP) were already implemented by the previous government. The new measures include the following three already announced in March, together already worth 0.3% of GDP in 2022.

- A temporary 21% reduction in excise duty on fuel.
- A temporary reduction in VAT on energy (9% instead of 21%).
- An increase in one-off energy compensation benefits for lower-income households.

There's now also going to be more spending on pensions and defence. The minimum wage has been increased as have pension benefits.

More tax on corporations and real estate

There's also been notable action to reduce net public spending. They include a reduction in pensioner tax credits and other benefits. And we're also seeing an increase in some taxes, notably for corporations and in the real estate sector.

A pattern is clearly emerging; a shift of taxation from households to businesses, that we witnessed in the previous coalition is being intensified by these new policy adjustments. The government's spring budget update shows lower investment in growth-enhancing, semi-public capital, lower investment in natural capital, and more taxation on entrepreneurial capital (firms, entrepreneurs and property owners) which is paying for higher benefits, higher pensions and better military capabilities. Considering the additional investment of the coalition agreement, minor cuts to these items do not seem to be too onerous, however.

Budget balance worsens but debt ratios improve

The total additional net spending in the spring memorandum for 2022 amounts to 0.4% of GDP, 0.0% for 2023 and 0.2% for 2024. This provides more fuel to an already overheating labour market, while the coalition agreement already implied a large increase in public spending in the medium term. The new measures only cause a one-off jump in the debt ratio: structurally the new tax measures fully match the new spending plans. Reassuringly, the debt ratio estimates were revised downwards, because of better-than-expected GDP developments, even though the government is expecting fewer firms to be able to pay back Covid-related deferred taxes.

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Global supply chains won't improve anytime soon

With the war in Ukraine and China's zero-Covid policy, delays and prolonged supply bottlenecks are defining this year's world trade outlook. Yes, demand is softer, notably from China but the backlog is such that supply chains will remain strained for the rest of the year

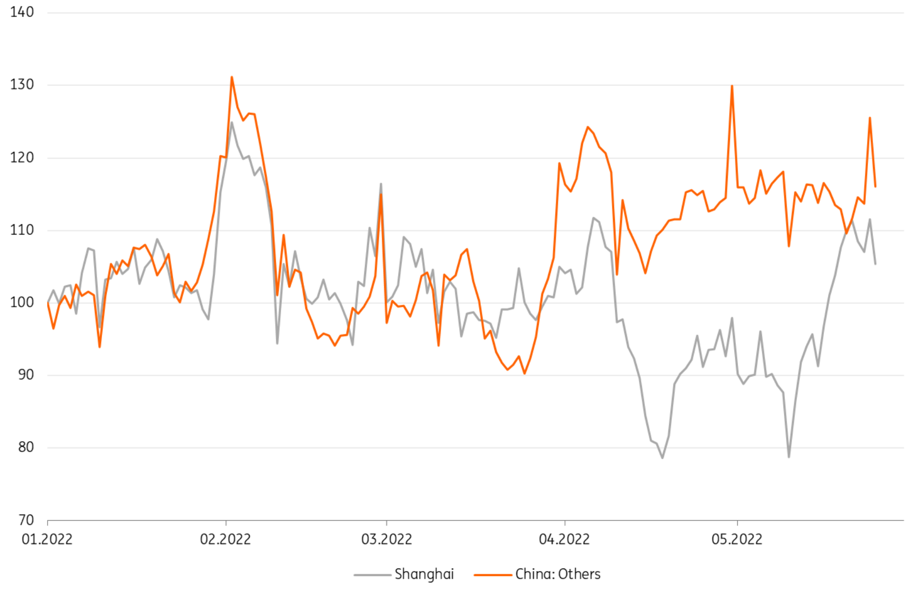
Despite lockdowns easing, there's still congestion in Shanghai's port

World trade fell by 0.2% in March, with imports from China down 12% and Eastern European CIS countries by 16.4%. With China's zero-Covid policy continuing throughout April and May, we don't expect trade data to come in much better in these months. Although global schedule reliability, tracked by Sea-Intelligence, improved slightly in February and March, we expect it to have fallen back in April, overall remaining well below 2021 levels.

April data should not only capture the effects of the war in Ukraine but also the lockdown in Shanghai is having a profound impact on the Chinese economy and on logistics in the country. The container load leaving the port of Shanghai plummeted quite heavily compared to the beginning of the year due to the lockdown as measured by the Kiel Trade Indicator, as you can see in the chart below. And even if cargoes can be cleared, there are difficulties with inland connections; truck drivers are sometimes being caught in quarantine controls, for instance.

Delays on the import side have particularly mounted. As manufacturers lift production, a wave of export containers can be expected. Consequently, we expect the lockdown effects to spill over to other parts of the world in the coming months, although weekly offered transport capacity has been on the rise in the Asia-US shipping route to satisfy still relatively strong demand in the US. Consequently, shipping rates will remain supported at high levels, with the rise in crude oil prices additionally weighing on transport costs. According to Xeneta, average fuel surcharges alone have been rising by 50% across all trade lines since the beginning of the year due to the rise in crude oil prices.

Departures of container loads from Shanghai have plummeted due to the lockdown



Source: Kiel Trade Indicator

Shortages of inputs and labour add to the problem

Material and labour shortages also continue to hinder production and transport. This adds to existing material bottlenecks caused by the pandemic, while sharply increased prices make it difficult for manufacturers to calculate accurately for this year and to commit to prices for delivery to clients much later. More than 12% of goods are currently waiting on container ships at port areas globally, up 1.2 percentage points from April, according to the Kiel Trade Indicator, with most of them in China. Scarcity continues in the current market environment, which leads to enduring pressures. As a consequence, average transport rates remain elevated, although spot rates have eased somewhat. This continues to contribute to higher prices for producers and consumers on top of elevated energy prices.

Despite softer demand, the current backlog is enough to keep supply chains strained throughout the year

Overall, we are still facing a problem of under-capacity, mostly from the supply side. If we look at the latest available trade and supply chain data, pressures remain at historically high levels, and we don't expect supply chain disruptions to ease substantially this year given the extremely volatile environment. Although weaker consumer demand from China due to dwindling growth expectations and Covid lockdowns, and the EU, due to eroding purchasing power, will alleviate some pressure on supply chains, industrial production is holding up well thanks to high backlogs of work due to shortages which is enough to keep supply chains strained throughout the year. We expect these headwinds to result in trade growth of somewhere between 1% and 2%, in our base case.

GDP Forecasts

%YoY	2Q22F	3Q22F	4Q22F	1Q23F	2022F	2023F	2024F
World (USD)	2.5	2.4	2.2	2.7	2.9	3.5	3.3
US	3.0	3.1	1.9	2.6	2.9	1.9	1.9
Japan	0.7	1.9	1.1	1.8	1.1	1.5	0.9
Germany	2.2	-1.4	0.9	0.7	1.4	1.5	1.8
France	3.3	0.5	0.3	0.8	2.1	1.4	1.4
UK	2.6	2.2	1.2	0.8	3.6	1.4	1.7
Italy	3.2	1.0	0.7	1.2	2.7	2.0	1.8
Canada	4.9	4.4	3.4	2.7	3.9	2.7	1.9
Australia	3.3	6.1	3.3	3.3	4.0	3.2	2.9
Eurozone	2.7	0.9	0.8	1.1	2.3	1.6	1.5
Austria	3.6	0.4	2.4	0.5	3.8	1.9	1.9
Spain	0.0	2.0	2.4	2.8	4.0	3.0	2.4
Netherlands	3.5	0.9	-0.1	0.4	2.7	1.3	2.1
Belgium	2.8	0.9	0.6	0.6	2.3	1.5	1.6
Ireland	-0.9	-1.5	4.4	1.8	1.2	1.3	1.8
Greece	3.0	2.2	2.5	2.0	2.9	2.4	2.2
Portugal	-2.8	0.4	0.8	2.8	6.0	2.2	2.0
Switzerland	2.7	1.2	1.4	1.2	2.5	1.4	1.4
Sweden	3.5	1.8	1.0	2.1	2.3	1.5	1.5
Norway	5.3	2.9	2.0	3.2	3.7	2.3	2.0
Bulgaria	3.4	2.9	2.2	1.7	3.2	3.0	3.0
Croatia	4.0	2.6	2.2	2.4	4.0	3.0	2.5
Hungary	5.2	5.0	3.3	3.5	5.4	5.0	4.6
Poland	5.5	3.5	1.9	0.9	4.7	3.8	3.2
Romania	2.7	6.2	5.7	1.7	5.0	3.5	3.5
Turkey	2.6	1.8	0.5	2.4	2.8	4.0	4.0
Serbia	4.2	3.8	3.6	4.2	4.0	4.2	3.5
Russia	-15.0	-18.0	-20.0	-5.0	-12.0	1.0	2.0
Kazakhstan	3.0	3.7	3.9	3.5	3.5	3.8	3.5
Azerbaijan	3.4	3.5	3.7	2.2	3.4	2.5	2.8
China	-1.0	4.6	5.8	5.2	3.6	5.6	4.6
India	15.2	5.9	5.0	3.9	7.3	7.5	8.0
Indonesia	5.8	4.2	4.1	4.2	4.8	4.5	4.7
Korea	2.7	3.1	2.5	2.3	2.5	2.8	2.4
Philippines	7.9	5.5	4.4	4.2	6.5	4.5	5.0
Singapore	4.5	4.2	3.1	3.1	3.9	3.5	3.2
Taiwan	3.0	5.0	5.5	6.0	4.2	5.3	5.5

Source: ING estimates

CPI forecasts (pa)

%YoY	2Q22F	3Q22F	4Q22F	1Q23F	2022F	2023F	2024F
World	6.3	6.3	5.8	4.4	5.9	3.3	2.5
US	8.0	7.5	6.3	4.5	7.4	3.0	1.7
Japan	2.6	2.9	3.0	2.6	3.0	1.0	0.6
Germany	7.9	9.1	8.9	6.3	8.0	3.5	1.8
France	5.7	5.3	4.4	2.4	4.9	2.0	1.9
UK	8.9	8.7	8.8	7.6	8.8	1.1	1.4
Italy	7.0	7.0	5.8	3.9	6.5	2.3	1.9
Canada	6.7	6.5	6.1	4.6	6.2	2.8	1.7
Australia	5.5	5.8	5.3	4.0	2.9	5.4	3.4
Eurozone	7.7	6.5	5.2	3.6	6.4	2.5	2.2
Austria	7.7	6.4	5.7	3.0	6.3	2.0	2.0
Spain	8.7	8.2	6.1	4.0	7.7	2.4	2.1
Netherlands	9.2	7.8	6.5	4.8	8.0	3.9	2.0
Belgium	8.3	7.4	5.3	4.1	7.2	2.9	2.1
Ireland	7.4	6.4	5.2	3.9	6.2	2.6	2.1
Greece	9.4	9.2	7.3	4.8	8.1	2.4	2.0
Portugal	8.1	7.7	5.4	3.2	6.4	2.4	2.0
Switzerland	2.5	2.5	2.1	1.3	2.3	1.0	0.7
Sweden	6.4	6.2	4.9	3.7	5.6	2.7	2.0
Norway	5.5	5.1	4.5	4.4	4.7	3.2	2.0
Bulgaria	15.4	16.3	14.2	11.7	14.0	8.0	5.0
Croatia	9.8	9.2	8.4	6.5	8.5	4.0	2.8
Hungary	10.3	11.6	10.4	8.7	10.1	5.5	3.0
Poland	13.7	15.0	15.2	14.8	13.4	10.9	6.5
Romania	13.9	13.8	12.9	11.3	12.5	8.4	5.0
Turkey	2.6	1.8	0.5	2.4	2.8	4.0	4.0
Serbia	10.1	10.5	8.8	7.8	9.5	5.5	4.0
Russia	16.7	17.1	16.0	7.7	15.5	8.0	6.1
Kazakhstan	15.2	14.6	14.1	9.9	12.9	7.8	5.0
Azerbaijan	13.2	11.9	10.6	8.8	11.9	7.8	5.0
China	2.3	2.5	2.6	2.8	2.1	2.3	2.3
India	7.4	7.8	7.4	6.9	7.2	5.3	4.3
Indonesia	4.5	4.8	4.3	3.5	4.0	3.4	3.5
Korea	5.0	5.2	4.8	4.3	4.7	3.2	2.0
Philippines	5.3	5.2	5.7	4.5	4.8	4.3	3.5
Singapore	4.8	4.2	3.7	3.7	4.3	3.5	3.4
Taiwan	3.5	3.2	3.6	2.3	3.3	2	2.2

Source: ING estimates

Oil forecasts (avg)

$/bbl	2Q22F	3Q22F	4Q22F	1Q23F	2022F	2023F	2024F
Brent	98	110	118	125	113	99	84

Source: ING estimates

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