

## Monthly Economic Update

### Coronavirus: The unknown and unprecedented risk

Financial markets and the global economy are still in the stranglehold of a real global shock that doesn't stop at borders and can't be tamed by words or negotiations: Covid-19. The outbreak of the new coronavirus comes at a time when the global economy was about to gain traction again on the back of the Phase One Deal between the US and China, a turning inventory cycle and a bottoming out of global manufacturing. Instead, the virus, along with its impact on economies and markets, is posing an unknown and unprecedented risk. Economic forecasts are surrounded by even more uncertainty than normal, including our own.



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### **FX: The dollar deflates**

*Given the US dependency on the capital markets for financing, the Fed looks set to be at the forefront of the monetary response to the Covid-19 crisis. The end of US 'exceptionalism' in terms of growth and interest rates means that we should now be looking at a temporary 5-10% correction in the dollar. We revise our 2Q20 EUR/USD forecast up to 1.15*

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### **Rates: Getting dumped**

*Risk assets were the darlings of 2019. Tainted now with virus risks, they are seriously stressed. Core bond markets are the ultimate safe haven. Even 3-month German bills at -0.7% are deemed an acceptable alternative versus the bigger risk implied in equity markets. It's very volatile out there though, and the net effect is low and likely even lower rates*

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# Coronavirus: The unknown and unprecedented risk

**Financial markets and the global economy are still in the stranglehold of a real global shock that doesn't stop at borders and can't be tamed by words or negotiations: Covid-19**



Healthcare workers in protective clothing check passengers' temperatures at an airport in Northern Italy

## Uncertainty continues to grow

The outbreak of the new coronavirus comes at a time when the global economy was about to gain traction again on the back of the Phase One Deal between the US and China, a turning inventory cycle and a bottoming out of global manufacturing. Instead, the virus, along with its impact on economies and markets, is posing an unknown and unprecedented risk. Economic forecasts are surrounded by even more uncertainty than normal, including our own.

There are still many unanswered questions regarding the real nature of the virus and its spread and impact on human health. For once, it is not economists who are struggling to come up with a common all-encompassing analysis of a problem but virologists. Ways to record the number of infected people differ across countries; it also hinges on people's willingness and ability to actually see a doctor or get to a hospital. Also, the fact that humans can carry the virus without showing symptoms suggests that the actual number of infected could be much higher than those currently reported. Although 'upside' is perhaps not the best word to use, it is true that if the number of infections is underreported, the death rate would automatically drop.

It's almost impossible to predict credibly what the economic impact will be of such an unprecedented and still evolving event but still it is our task to give some guidance.

## A supply and demand shock

Several institutions have recently come out with estimates of how much damage the virus could do to the global economy. The OECD, for example, presents two different scenarios. A mild, base-case scenario in which growth would be reduced by 0.5 percentage points, and a risk scenario, in which the virus spreads more widely, which would shave off 1.4 percentage points of growth. In 2006, researchers at the World Bank investigated the impact of several historic flu waves and concluded that a mild flu

outbreak could lower world GDP by less than one percent. These are just ballpark figures; nothing more nothing less.

However, let's not forget that the world has become much more integrated since then, which means that any predictions based on past experiences should be taken with a large pinch of salt. In fact, it is currently not so much the virus itself but the policies trying to prevent it from spreading which are having a significant impact on economic activity. This impact is an unprecedented combination of both a supply and demand shock: a demand shock as illustrated, for example, by the record drop in Chinese car sales in February (-80% YoY), cancelled trips and vacations to Europe or the US or a general fear across all countries to go out. But also a supply shock, given the important role China plays in global supply chains and the impact of preventative policies in Europe and the US to keep employees at home or to cancel business meetings.

Gauging the impact of Covid-19 on our own growth scenarios is, therefore, a snapshot and work in progress rather than a perfect or final analysis. It is like steering in the dark; cautious and step-by-step. We currently use the working assumption that the spread of the virus will slow during the northern hemisphere spring and that the global economy will start to stabilise and gradually rebound during the summer months, notwithstanding clear differences across countries and regions.

### **Calls for action**

It currently looks as if any overshooting in economic activity, which often appears after natural catastrophes, will not materialise; at least not to the same extent. The recent market turmoil reminds me of the financial crisis and explains why there are now so many calls for coordinated action. Why shouldn't what worked back then work right now? While G7 finance ministers came out with a statement that they stand ready to act (a phrase too often used in Europe), the Fed cut its policy rate by 50bp after an emergency meeting.

Some other central banks also eased policies and small countries even saw 'helicopter money'. The other major central banks, such as the ECB, BoE and BoJ, however, remain on the sidelines at least for now. This reluctance to act is mainly driven by two factors: i) very limited room for manoeuvre given the already very accommodative monetary policies and adverse effects, and ii) the awareness that any policy action can only tackle the economic effects but not the root cause. To be blunt, no fiscal or monetary easing could have the same impact as a vaccine against Covid-19.

### **Increasing pressure on central banks and governments**

As the economic impact from Covid-19 and the measures to isolate it become more visible, pressure on central banks and, above all, governments to act is likely to increase. Think of monetary easing, targeted at credit easing, but also of temporary VAT cuts, state guarantees for SMEs to prevent foreclosures, subsidised short-time work schemes or simply plain-vanilla investments.

The eurozone particularly will be at the centre of international attention once again. Will Covid-19 finally be the trigger to get significant fiscal stimulus, which goes beyond some flexibility in the interpretation of the fiscal rule? And, will the ECB under the leadership of Christine Lagarde continue Mario Draghi's 'whatever it takes' policy or will it return to the Duisenberg and Trichet era when the ECB's preferred option was to wait-and-see. Lots to talk and think about.

Our Monthly Update tries to give some answers and to provide some guidance on the possible impact from the coronavirus on the global economy. But don't forget, this is a fast-moving environment. To use an often-heard phrase: we will continue to monitor the situation very closely.

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## US: Hope for the best, prepare for the worst

**Coronavirus concerns are gripping the nation as an initial supply shock morphs into a financial shock and now a demand shock. The Federal Reserve has leapt to action, but we are still in the early phase and the economic disruption will likely intensify in the coming weeks.**



### **A reversal of fortunes**

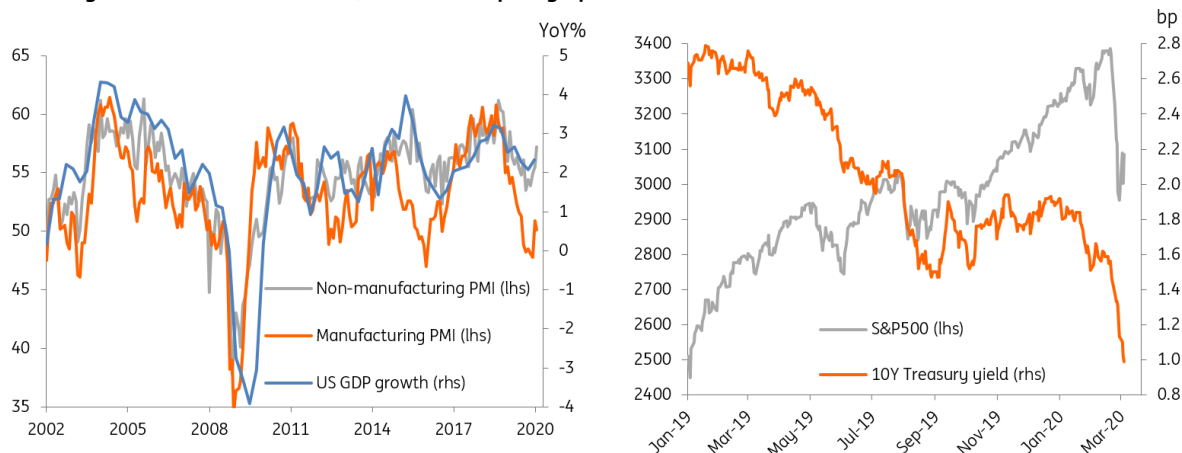
The US economy appeared to have started 2020 on a strong footing with consumer confidence close to record highs, business surveys bouncing back as trade tensions eased and residential investment a key source of strength. However, it is increasingly apparent that the US faces a major economic drag from the rapidly spreading coronavirus. There was already a (relatively modest) supply shock as supply chains faced disruption due to factory closures in China and other parts of Asia, but over the past couple of weeks, this has turned into a financial shock as bond yields and equities plunged. So far there is little sign of distress in high yield and the leveraged loan markets, but this is something the Federal Reserve is closely watching.

On top of this, there is growing concern that the fear factor surrounding Covid-19 will change corporate and consumer behaviour and lead to a demand shock as well. This is most likely through the service sector of the economy with travel, hotel accommodation, restaurants and leisure-related sectors looking vulnerable. Together, these components make up nearly a fifth of consumer spending or a little over 10% of GDP. If they do indeed experience a sharp contraction, a negative second-quarter GDP print will be hard to avoid, especially with exports likely to soften and investment spending weakening as companies become more cautious.

We have revised down our full-year 2020 GDP growth forecast to 1.2%.



## Business surveys had turned the corner, but market plunge points to a reversal



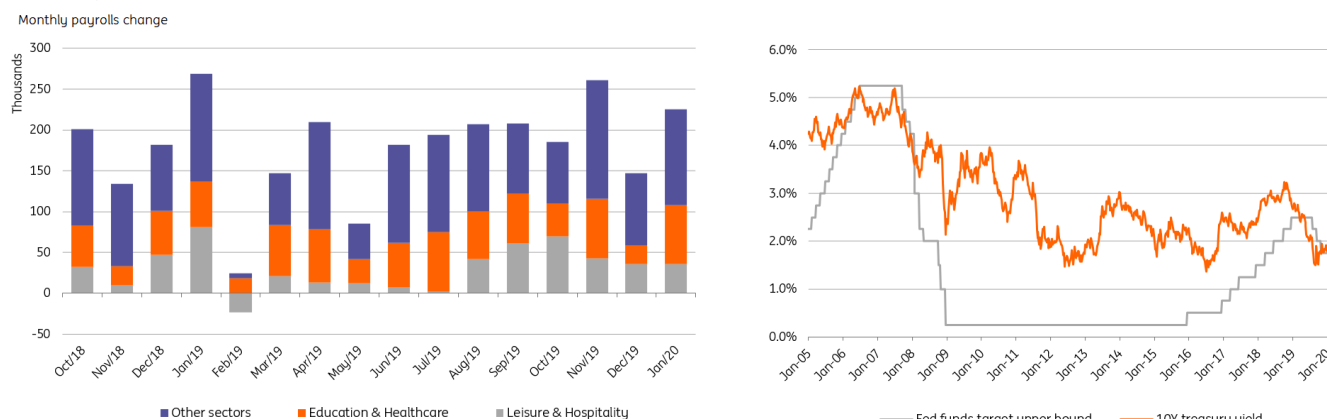
Source: ING, Bloomberg

## Inflation risks to the downside

We have to be cognizant of the potential for weaker jobs numbers too. Leisure and hospitality, which is heavily exposed to the fear factor of Covid-19, has been responsible for nearly 20% of all the US jobs created over the past 18 months. Education and healthcare has been an even bigger contributor to employment growth so if we start to see schools close this component will be impacted, but we could see stronger health and social assistance hiring in its place. Either way, we see a diminished prospect of a substantial acceleration in wage growth in coming months even if labour supply is impacted through illness and worker absenteeism.

Inflation pressures are likely to soften more broadly. Oil and other commodity prices have plunged and this should contribute to a rapid decline in headline inflation while weaker economic demand is likely to offset the supply shock, thereby keeping core inflation contained. For example, retailers and restaurants may end up having to offer significant discounts to entice customers out of their homes.

## US jobs growth composition and US interest rates



Source: ING, Bloomberg

## The rapid response team...

The Federal Reserve responded with an emergency 50 basis point rate cut on 3rd March. We doubt it will trigger a meaningful boost to aggregate demand, but implementing rate cuts should help to mitigate some of the strains in the financial system, particularly if it is accompanied by additional liquidity/credit measures in coming months. We are pencilling in two further 25bp rates cuts for 2Q providing a total of 100bp of easing, but the risks are going to be skewed towards the Fed taking more aggressive action. The 10-year yield has already breached 1%, but we suspect it has further to fall. We target 0.75% in coming weeks.

There has been notional talk about fiscal loosening to support the economy, but we doubt anything meaningful will happen given the fraught Democrat-Republican relationship that was exacerbated by the impeachment process brought against President Donald Trump. The Republicans would likely push for tax cuts that the Democrats would likely oppose in favour of higher spending.

Instead, we should be looking for the release of emergency funding in the tens of billions rather than hundreds of billions. This would likely be focused on testing kits, protective equipment and boosting staffing at healthcentres. The Federal government may also offer support to states through larger Medicaid contributions while temporarily loosening the conditions required to qualify for welfare benefits – you often have to be available (and looking) for work to qualify, but that may not be possible given Covid-19. We may also see support to heavily disrupted businesses such as being able to delay or defer some tax payments plus the potential for business grants or lending facilities to help tide small firms over until the crisis fades.

Our best guess as a team is that the peak economic effect of Covid-19 will be in 2Q20 and that pressures may then start to ease, but this is a massive unknown. Assuming this view is correct we expect to see a gradual improvement in economic activity in 2H20, but with Presidential, House and Senate election campaigning reaching a peak at that time, businesses and households may remain cautious.

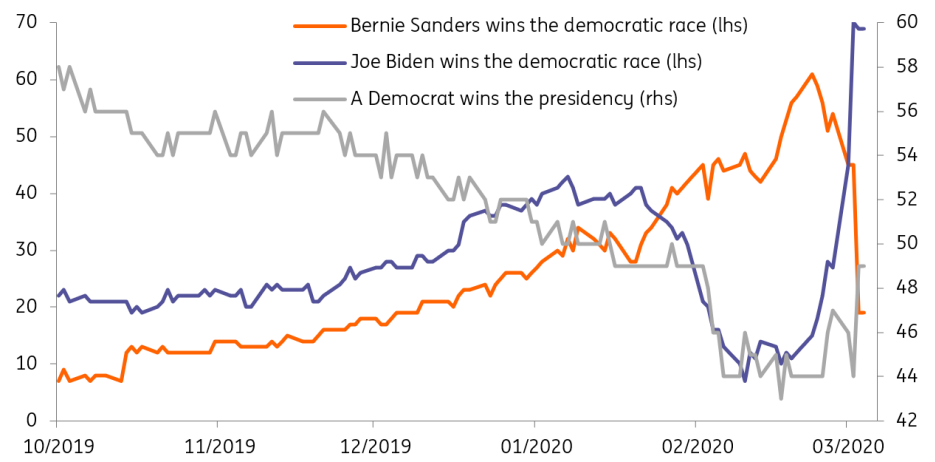
### **The race for the White House is becoming clearer**

That said, it is looking a little clearer as to who President Trump will face in the battle for the presidency.

In recent days we have seen Pete Buttigieg, Amy Klobuchar, Elizabeth Warren and Mike Bloomberg all pull out of the race for the Democrat party nomination. Former Vice President Joe Biden has made a remarkable comeback with sweeping victories on Super Tuesday where 14 states and a third of the delegates were up for grabs in the battle for the candidacy. It appears to be a run-off between the centrist Biden and the self-declared “democratic socialist”, Bernie Sanders. With Biden receiving the backing of Buttigieg, Bloomberg and Klobuchar the momentum seems to have shifted dramatically in his favour as the chart below suggests.

Sanders is very much a progressive and has been emphasising policies that would benefit the poorer segments of the population such as a massive increase in healthcare spending, funded by tax rises for the wealthiest individuals and companies. Biden would be less revolutionary in this regard, but both candidates are certainly pushing for tougher regulatory and environmental standards than US companies currently face. One of the biggest differences is on trade policy with Joe Biden widely regarded as being in favour of deals and deepening trade relationships while Bernie Sanders has taken pride in opposing NAFTA, its USMCA replacement and TTIP.

### Implied probability of victory based on PredictIt website quotes



[www.predictit.org](http://www.predictit.org)

Source: ING, Bloomberg



# Eurozone: Just when things were looking up

## Peter Vanden Houte

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The eurozone economy started the year on a stronger footing. But the coronavirus disruption is likely to become a major drag that might only peter out in the course of the second quarter. Negative GDP growth in the first half now looks likely



## Before and after

Just when we thought that things were looking up and the manufacturing recession was largely behind us, the coronavirus dealt a serious blow to the growth outlook, blindsiding global central banks and sending financial markets into panic mode.

While data from the first two months of the year was encouraging, it largely reflects the level of sentiment before infections started to rise significantly in Europe. As such, it's no guide to the future.

- Like the PMI indicator and the Ifo survey, the European Commission's economic sentiment indicator improved in February, rising to 103.5 from 102.6 in January, which was better than expected.
- The Eurocoin indicator, which is a monthly estimate of the eurozone's growth pace, rose to 0.28 in February, the third consecutive increase.

So the good news is that things were improving before the outbreak, with the inventory correction in the manufacturing sector largely over, setting the stage for a recovery. The bad news, of course, is that Covid-19 is now clearly jeopardising a further gradual acceleration in growth. On top of that, things now also look a bit uglier in the services sector, which was up till now the stronghold of the economy preventing a more severe slowdown. Leisure, tourism and transport will inevitably suffer from a more fearful consumer. The fact that Italy decided to close schools and universities until mid-March might be wise from a precautionary point of view, but is at the same time exacerbating the negative growth impact.

The chart displays two data series: Industrial confidence (grey line) and Services confidence (orange line) from January 2014 to January 2020. The Y-axis represents a confidence index ranging from -10 to 20. Industrial confidence starts at approximately -2 in Jan-14, remains relatively flat until mid-2015, then rises to a peak of 10 in Jan-18. It then declines, reaching a low of -9 in Oct-19, before a slight recovery to -6 in Jan-20. Services confidence starts at approximately 4 in Jan-14, rises to a peak of 18 in Jan-18, and then declines, reaching a low of 9 in Oct-19, before a slight recovery to 11 in Jan-20.

Date	Industrial confidence	Services confidence
Jan-14	-2	4
Apr-14	-2	6
Jul-14	-3	6
Oct-14	-4	5
Jan-15	-4	7
Apr-15	-1	8
Jul-15	-1	10
Oct-15	-1	13
Jan-16	-2	13
Apr-16	-3	10
Jul-16	-2	11
Oct-16	-1	10
Jan-17	1	13
Apr-17	2	14
Jul-17	6	13
Oct-17	9	16
Jan-18	10	18
Apr-18	8	15
Jul-18	6	16
Oct-18	5	14
Jan-19	1	11
Apr-19	-4	12
Jul-19	-7	11
Oct-19	-9	9
Jan-20	-6	11

### Negative growth in the first half

### If the Chinese experience is any guide



As expected, inflation fell from 1.4 to 1.2% in February as lower energy prices started to push the headline figure down. Core inflation inched up from 1.1 to 1.2%, probably stoked by some Covid-19 induced supply disruptions, but we wouldn't call this a lasting trend. Notwithstanding the better business confidence figures in February, selling price expectations actually fell in all sectors except industry, a sign that inflationary pressures are still largely absent. What's more, inflation might face renewed downward pressure in the wake of the economic slowdown.

### **ECB between a rock and a hard place**

Politicians are likely to take some measures to contain the negative impact of Covid-19. The Italian government has already proposed a tax credit for companies experiencing a 25% fall in revenues. At the same time, there will be strong pressure on the European Central Bank, especially given the impromptu Federal Reserve rate cut. The ECB thinks this is a matter for budgetary authorities. And we know that the marginal utility of a further rate cut seems close to zero. But if there is internationally-coordinated action from central banks to counter a tightening of financing conditions, we could still see the ECB, albeit grudgingly, cut rates a bit further, and symbolically increase the amount of asset purchases. However, the ECB will likely try to avoid this scenario and in a first instance work on other levers. As such, we think the Bank is more likely to support the banking system by increasing the size of the negative rate exempt tier of excess liquidity holdings. There is also talk of a Targeted Longer-Term Refinancing Operation directed at small- and medium-sized enterprises, though it will take a number of weeks to work out the specifics. What looks certain is that any thoughts of monetary tightening can now be shelved for quite some time.

# UK: Rate cut coming as consumption risks build

## James Smith

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Like elsewhere, there is a rising risk that the Covid-19 demand shock will cause a decrease in GDP in the second quarter. We expect the Bank of England to cut interest rates later this month, although the bigger focus for markets should be the forthcoming budget, which arguably offers greater scope to tackle the virus impact



## Coronavirus supply shock risks morphing into demand issue

Since December's election, the UK economy had been showing some tentative signs of life. Confidence had increased, and there were tentative signs that business activity was rising – albeit perhaps not quite to the same magnitude that some surveys had suggested.

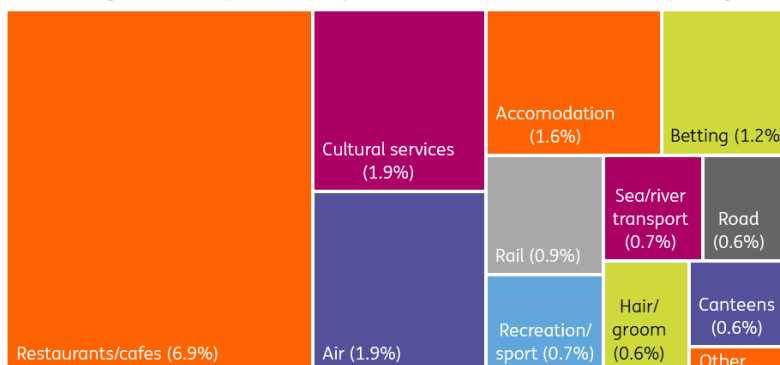
But that's now likely to change. As we've seen in other developed economies, supply chains have been disrupted by issues with sourcing Chinese-made components. Our trade team estimates that around 0.8% of UK output is reliant on value-added from China, although this is unsurprisingly higher for the electronics/electrical equipment industries at around 4%. While the former number may not sound too high, it masks the fact that subsequent parts of the production process may not be able to operate without overseas components. PMIs suggest there are increased delays for manufacturer deliveries.

The question now facing policymakers is how large the demand shock might be, now that the government is expecting a wider outbreak of the virus in the UK. Incoming Bank of England Governor Andrew Bailey said on Wednesday that "what we need frankly is more evidence than we have at the moment", explaining perhaps why policymakers opted against joining the Federal Reserve in a coordinated rate cut.

Like the US, we estimate that roughly 20% of consumer spending is more exposed – things like restaurants/cafes (which make up 7%), hotels, transport, among other things. But unlike America, consumer activity has already been fragile for the past couple of years.

### Consumer goods/services most exposed to virus impact

Categories more exposed make up around **18%-20%** of total consumer spending



Source: Macrobond, ING calculations

Exposed categories chosen qualitatively, and are those assumed to be more vulnerable if there are higher rates of self-isolation etc. Figures are a percentage of total real consumer spending from the national accounts

Admittedly confidence has recovered a little since the turn of the year, and real wage growth should be stronger this year, buoyed by a combination of lower regulated household energy bills and a tight jobs market.

However, the UK household savings ratio – currently 5.4% – is lower compared to historical standards, and has fallen over recent years, partly following the rise in import costs following the Brexit referendum. That's quite a bit lower most international peers – the likes of France, Germany and the Netherlands have savings ratios comfortably above 10%.

There has also been a lot of focus in the media about the UK's lower statutory sick pay levels. Employers are obliged to pay an amount equivalent to a little under 20% of the UK's average salary if an employee is unwell – or in this case, self-isolating. Policies vary considerably across Europe, but according to an [EU report](#), the rate of income replacement from sickness benefits/rules in the UK is one of the lowest. Sick pay also doesn't apply for self-employed workers, and in the UK has a slightly higher rate of self-employment than the [EU average](#).

### Fiscal and monetary action is coming

This all suggests risks to consumer spending, and we are pencilling in a contraction during the second quarter (although of course this depends on how far the virus were to spread). To us, this suggests the Bank of England will cut rates by 25 basis points at its next meeting later in March. However policymakers will be looking closely at the forthcoming budget, where there arguably will be greater scope to limit the economic fallout.

Following the change in Chancellor, there was a lot of excitement among investors that the Treasury was poised to offer a large amount of fiscal stimulus. It is likely that the government will commit to substantially raise government investment over coming years, but the Chancellor is much more constrained on day-to-day spending. A fiscal rule, which commits the government to balance current spending in two-to-three years offers very little headroom to lift spending without taxes – particularly given the extra costs associated with managing Covid-19.

The government has already announced it could expand its "Time to Pay" system, which allows struggling firms to pay back tax bills over a longer period of time in smaller instalments. Andrew Bailey also implied there was a joint Bank of England/Treasury programme in the works to give SMEs access to extra finance.

Like other central banks, BoE officials will be acutely aware that there is only so much their own policy announcements – which may also include some other credit easing measures – can do to solve what is more of a cash flow risk for firms, rather than a debt-serving issue for firms affected by the virus.

# China: The supply chain is still broken

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The spread of the coronavirus in China seems to be slowing down, but the global supply chain remains broken. As a result, we've revised our growth forecast to 4.4% YoY in 1Q20 and 5.2% for this year



## What we know so far

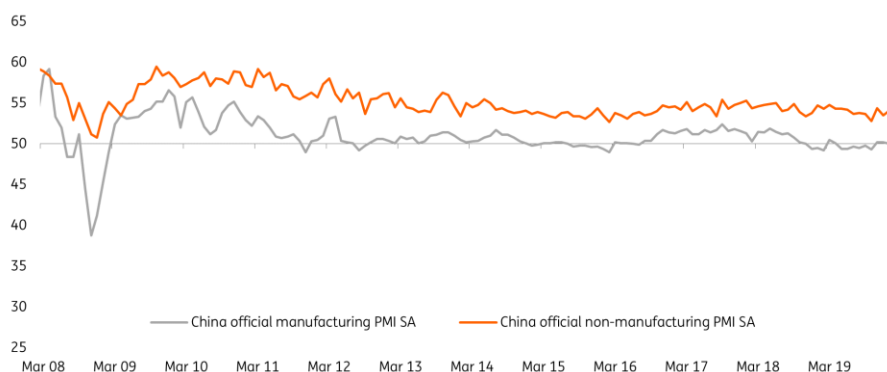
The market expects Chinese activity data from January to February to be fairly disappointing.

China has postponed trade data release for January, so the upcoming data release will be year-to-date February figures, but that won't help much. For most of January and February, exports and imports are likely to be almost negligible.

There wasn't much activity in the manufacturing and retail sector, which was reflected by the PMI. Manufacturing PMI dived to 35.8 and non-manufacturing PMI dived even deeper to 29.6 - both were the poorest reading since the data has been compiled.

We expect industrial production and retail sales to move to the negative territory but fixed-asset investment could experience some growth as two new hospitals have been built to combat coronavirus.

## China's worst PMI in history





### **Factories trying to get back to normalcy**

Some reports suggest, 85.6% of larger factories resumed operation as of 25 February, but others suggest this figure might be overestimated.

As local governments received resumption quotas from the central government, they are eager to show factories in their cities are operating as usual again. Therefore officials are closely monitoring the reopening of factories. Although well-intentioned, as officials could in theory help workers travel to factory locations from their hometowns, but, in reality, there is little they can do. The main issue is traffic, which has been very congested as many workers move from rural to factory hubs.

As a result, some factories, which are trying to circumvent officials' visit, have switched on machinery, despite the lack of workers to inflate electricity usage, which often is a production indicator.

### **Not much will change in March**

A few things we need to note on [the development of the coronavirus](#) for March:

- Imported coronavirus cases increase, but the number is still below 100 as of 4 March 2020.
- Some patients after being discharged from the hospital have tested positive again.

This means the peak of confirmed cases might not be behind us. As more countries report new cases daily, factories in these locations could also temporarily halt production, and this can always lead to the entire supply chain being disrupted.

With expected hurdles in factory production in March, and most consumers too wary to go shopping malls and dine out, and little business investment demand, the prospect of economic growth is still unclear.

We don't think March data will do any wonders.

### **More fiscal stimulus to the rescue**

When activity levels are low, the Chinese government usually delivers a fiscal stimulus to support the economy. There is already a policy in place that waives social security contribution for staff, worth around CNY 1 trillion. More fiscal stimulus is likely to follow if cities confirm they have been able to reduce confirmed Covid-19 cases.

Last month, the Chinese government announced more stimulus measures. Therefore, we revise our projection of fiscal stimulus from around CNY 3.5 trillion to CNY 4 trillion, which is equivalent to 4% of nominal GDP in 2020, and this could be increased if more is required to boost economic growth.

### **Monetary easing beyond rate cut**

We maintain our forecast that the People's Bank of China is going to cut 10 bps on 7D reverse repo, 1-year medium lending facility and 1-year loan prime rate. The loan prime rate cut should be on 20 March.

There will also be a focused RRR cut of 0.5 percentage points for banks to channel liquidity to companies affected by Covid-19.

More than these, the central bank is allowing companies suffering from cash flow problems to request deferred loan repayments. The positive side is that affected companies can concentrate on the resumption of work and not worry about repayment. The negative side is that only banks that have capital buffers can participate in this scheme.

**The global supply chain remains broken**

As most economic activities have been muted in January and February, we're not expecting a V-shape rebound in March, even though more fiscal stimulus and monetary easing is on the way.

Therefore, we scale down our forecast for China's GDP in 1Q20 from 5.0%YoY to 4.4%YoY and 5.2% from 5.4% for the full-year.

# Japan: in search of a paddle

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Last month, we pre-emptively took an axe to our growth forecasts - looking back on it, we may still have work to do



## Recession looking all but inevitable

Last month, in response to the blossoming Covid-19 outbreak in Asia, we decided to take some fairly hefty cuts to our existing mediocre growth forecast for 2020. We did this in anticipation that the covid-19 outbreak would get worse and spread. And that is indeed what is happening.

Since then, we have also had to deal with the fact that fourth quarter GDP was in fact already abysmal, with the aftermath of the consumption tax hike resulting in an annualised decline in growth of 6.3% quarter-on-quarter. It seems hard to imagine any other alternative now than that this big decline in the fourth quarter is followed by a further substantial decline in the first three months of the year, and no guarantee that there is any recovery in the next three.

Indeed, even if Covid-19 does burn itself out in the Northern Hemisphere summer as some have argued, this is not necessarily a precursor to a sharp bounce in the second half of the year. Talk of V-shaped recoveries is, in our view, totally misplaced.

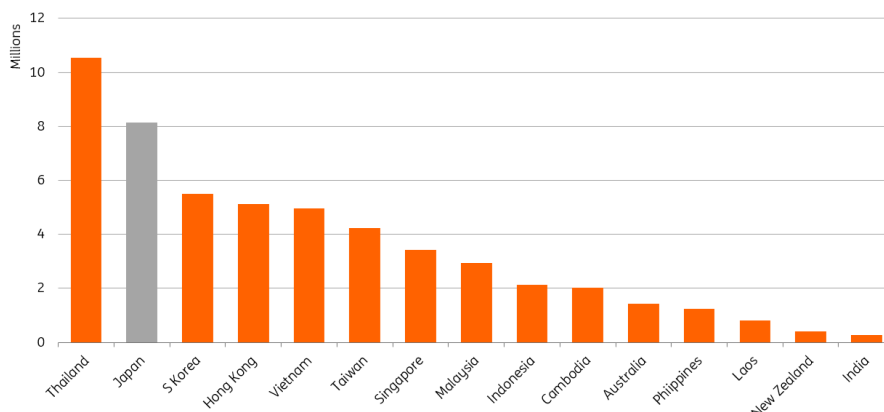
## Olympics may be a victim

Prime Minister Shinzo Abe recently called on the nation to halt, scale back or suspend large public events. Schools have been closed. And one can't help remembering that Japan is due to hold the Olympic Games in Tokyo at the end of July and early August this year. Should the Covid-19 epidemic still be rampaging, it is certainly possible that the timing of the games could be altered to later in the year or even next year. They may be cancelled altogether.

Even if they do go ahead, it seems extremely likely that they will be shunned by overseas visitors, and that many top athletes will also stay away. Although such sporting events have a history of making no financial profit, to do the investment and then not hold the games, or hold them but with massively reduced ticket and ancillary sales looks like a formula for substantial losses.

Japan's tourism industry was already headed for a tough summer. After Thailand, Japan is the second most popular destination for Chinese tourists. They won't be coming this year. And with Japan towards the top end of the Covid-19 confirmed cases table, it's possible no one else will either.

#### Visitors arrivals from mainland China (2018)



Source: [Korea Tourism Organization](#), [Japan Tourism Statistics](#), [Tourism Australia](#), [PartnerNet](#), [India Ministry of Tourism](#), [Association of Southeast Asian Nations](#), [Stats NZ](#)

#### Policy dearth

Curiously, one of the Bank of Japan's (BoJ) most dovish members, Goushi Kataoka, who has been consistently calling for more easing to enable the BoJ to meet its improbable 2% inflation target, has argued against Japan easing rates because of the virus. In his view, the virus is not enough on its own to spur a rate cut whilst the spread of the disease and its effect is highly uncertain. Until recently, these views were partly shared by BoJ Governor Kuroda. He had said that the BoJ is ready to act, but that he didn't believe any action was needed now. Kuroda added that the BoJ stands ready to take appropriate measures as needed and won't hesitate to act if the need arises. This view has undergone some revision. The version that followed the Fed's Jerome Powell comments runs "The BOJ will monitor developments carefully, and strive to stabilise markets and offer sufficient liquidity via market operations and asset purchases." In short, the BoJ will invest in ETF's to try to limit any equity market rout. It won't prevent it, but it may slow a violent drop.

Kuroda also added that he thought it likely that the virus would hit exports, supply chains and tourism (see chart). The strong-sounding words in the face of the virus mask a chronic lack of any effective policy tools in Japan to counter the additional negative shock of the outbreak on the economy following the consumption tax hike. The only consolation here is that this lack of credibility is very old news. And fortunately, neither the currency nor the Japanese government bond or equity markets are particularly reliant on foreign investors for support.

#### It's not just the BoJ that is out of bullets

We have written in recent months about the Japanese government's fiscal efforts to smooth over the impact of both the consumption tax hike and the end of construction associated with the Olympics. The net result of the huge packages promised, when compared in terms of primary budget deficits, was precisely zero. In other words, all the money earmarked for spending in 2020/21 would exactly offset the additional tax revenue supposedly drained out of the economy by the consumption tax hike for no net economic impact whatsoever.

Now it is very clear that the efforts to contain the consumption tax hike have either missed in terms of their timing or in terms of their quantity. Moreover, with the outlook for the Olympics now highly questionable, you'd struggle not to draw the conclusion that either more fiscal easing will be needed, which raises even bigger questions about what happens in 2021, or that the amounts dedicated to propping up the economy in the second half of the year will fall well short of what was intended, requiring us to take the axe to the second half figures too.

In other words, the forecast slashing is probably still not yet over. We currently forecast full-year 2020 GDP to fall 1.2%.

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## FX: The dollar deflates

Given the US dependency on the capital markets for financing, the Fed looks set to be at the forefront of the monetary response to the Covid-19 crisis. The end of US 'exceptionalism' in terms of growth and interest rates means that we should now be looking at a temporary 5-10% correction in the dollar. We revise our 2Q20 EUR/USD forecast up to 1.15



### Trouble sticks to the formerly Teflon dollar

2018 to 2019 was characterised by the tax stimulus-powered US economy and President Trump's trade war. The combination of strong domestic US growth set against a slow-down in more open overseas economies created the investment theme of 'US exceptionalism' and triggered a 10% rally in the trade-weighted dollar.

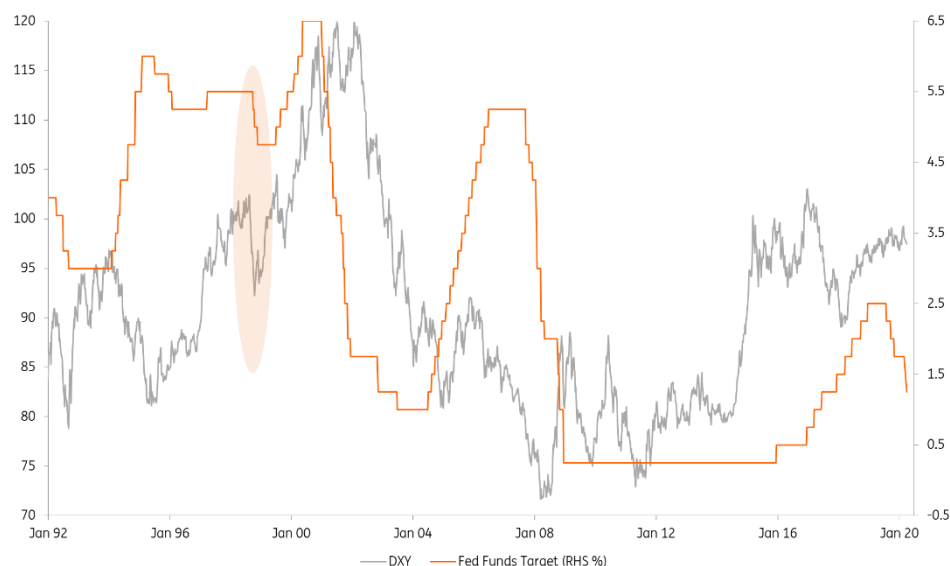
Covid-19, of course, respects no borders and now represents a 'levelling' force in the global economy. US growth and interest rates are therefore converging on the low levels seen overseas and beg the question whether the dollar should still be so strong?

We see (some) parallels here to the 1998 period. Following broad-based dollar strength and US productivity growth from 1995 onwards, US markets received a shock in 1998. The Asian financial crisis spilled over to a Russian sovereign default that year, triggering a collapse in the US hedge fund, LTCM. In response to threats to the financial system, the Fed cut rates 25bp in September, October and November triggering a 10% correction in the dollar.

Arguably dollar fundamentals were a lot stronger then, given the budget surplus and a slim current account deficit, than they are now and explained the quick recovery which saw USD push back to new highs in 2000. Parallels today also extend to the poor European investment climate that existed in 1999-2001. Europe does not look a very attractive investment destination right now meaning that if we are to see a EUR/USD correction this year, it should prove temporary.



### Emergency Fed cuts should start to soften the dollar



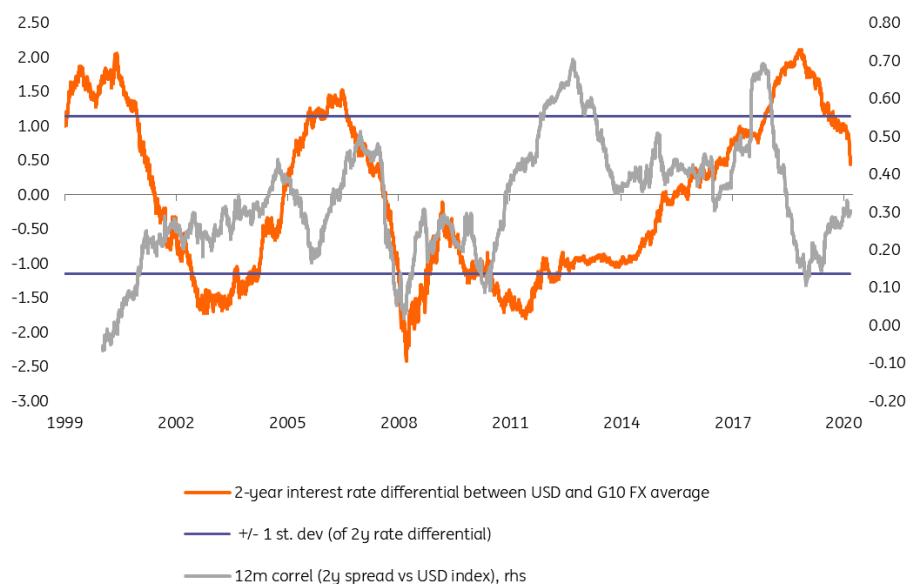
Source: Bloomberg, ING

### The dollar's soft centre

The US economy's dependency on the securities markets for financing means that the Fed will be at the forefront of the monetary response to Covid-19. This is important since no longer are US short-end rates anchored by a Fed needing 'material' changes to move. Instead of bullish flattening in the US yield curve as markets price a late-cycle slow-down, the bullish steepening represents reflationary Fed policy – i.e. a Fed response underway. A weaker dollar is a typical part of the Fed's reflationary tool-kit and is especially the case in this US election year.

Our point here is that the Fed looks set to bow to the increased financial market and later real sector pressure (we expect another 50bp of Fed easing) and US rates will continue to converge on those of trading partners. The narrower interest differentials become, the greater their correlation with FX markets in our opinion. We could easily see US two-year spreads against EUR and JPY narrowing by another 50bp, for example, making it a little easier to FX hedge US bond portfolios.

### As dollar rate differentials return to more normal levels, the correlation between differentials and dollar pricing increases



Source: Bloomberg, ING

## New EUR/USD profile

Now incorporating a 100bp Fed easing cycle and very little room to manoeuvre from the ECB, we look for EUR/USD to correct higher over the next three to four months. This move could carry EUR/USD to the 1.15 area. We then tentatively pencil in a correction back to 1.10 by year-end and throughout 2021.

The lower profile over the longer term incorporates the views that:

- 1) the Fed takes back the 100bp easing cycle in its entirety through 2021 and
- 2) US presidential elections do not demand a significant risk premium of the dollar.

Clearly this scenario can be challenged by:

- 1) a larger US slow-down that keeps the Fed policy rate lower for longer and
  - 2) potentially weaker growth, giving Bernie Sanders a better shot at the White House.
- But that is not our baseline.

Away from the dollar correction, we expect pro-cyclical and EM high yield currencies to under-perform the defensive JPY and EUR through March. We expect asset market volatility to remain high over this period and discourage investors from carry trade strategies. Once equity markets settle down, however, we suspect investors will be positively re-assessing high yield FX markets given that risk-free interest rates will have fallen below 1%.

## Our new EUR/USD forecast profile



Source: Bloomberg, ING

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## Rates: Getting dumped

Risk assets were the darlings of 2019. Tainted now with virus risks, they are seriously stressed. Core bond markets are the ultimate safe haven. Even 3-month German bills at -0.7% are deemed an acceptable alternative versus the bigger risk implied in equity markets. It's very volatile out there though, and the net effect is low and likely even lower rates



### Lots of talk about zero rates

In a flash we find the US 10-year below 1%, and the speed of the move from 1.8% was no doubt a factor behind the emergency 50bp cut delivered by the Federal Reserve. Ahead of delivery, the cut was fully discounted. The Fed just had to turn up and pull that rate cut lever. They did. And now the markets are gunning for at least another 50bp. That would bring the funds rate to the 50bp area. Then the debate starts as to whether the Fed is done, as if they are not, we are then staring down the barrel of the approach of zero rates.

Do zero rates make sense? Not based on what we know. Inflation is at 2% for starters. A -200bp real rate would paint a dire implied market discount for the US economy. What makes more sense to us is a quick dive into negative real rates due to exceptional circumstances that are expected to prove temporary. But as we can't say for sure, there are overshoots. Equity markets getting dumped is one. The exceptional flight into the safety of bonds is another. A rate cutting Fed then chimes with both.

Think of the Fed cuts as a comfort blanket. Rate cuts are no panacea for the flu, but they do help to lubricate the financial system. As an evitable virus-panic-related-slowdown takes hold, high yield corporates would be the first to come under pressure. Company accounts in the black can quickly move into the red, elevating default risk. Easy access to liquidity is a first defence system. That's why loosening from the Fed is a sensible reaction.

And remember, they can be reversed just as quickly if needed.

### Identifying when the angst could end

In the meantime, exceptional volatility means we are never sure on a day-to-day basis whether we've seen the bottom for rates, or risk assets. The background noise on Covid-19 continues to darken though. It is still in expansion mode, especially outside of Asia. We are not yet at a point where we can look through the rise in infections to a macro

recovery. Refuge from warmer months ahead offers the best glint of positivity. But we need to get there first, which likely keeps rates under downward pressure.

As we continue the overshoot to the downside, it is entirely conceivable that the US curve marks out at sub-50bp on the 2-year and the 75bp area in the 10-year. That's based off a comfort factor around the 1% area for the 10-year. A handle of 1 looks even better when compared with alternatives in risk-free space in deep negative territory. That said, even the German 3-month bubill yield at -0.7% can be an acceptable safe haven relative to the downside that equity markets could suffer should things turn down again.

We can envisage a series of Ws for risk assets in the coming weeks, more likely with a net slide further lower, as a trend that will not become immediately obvious until we've had a run of weeks. That backdrop gels with the maintenance of low rates. German yields remain in the -75b area or lower. US yields trend in sub-1% territory, and increasingly closer to zero than 1% on the front end as the Fed continues to cut rates. And it's circular, as risk assets will worry about what that discount actually implies.

Causation so far is from the un-covering of Covid-19 cases to lockdown, and then to market angst in expectation of a pronounced macro hit. The SARS impact 20 years ago reversed when infections peaked after six months. Both interest rate and risk asset markets will be looking for a similar peak beyond which a recovery could be sensibly discounted. We're just not there yet.

## ING global forecasts

	2018					2019F					2020F					2021F				
	1Q	2Q	3Q	4Q	FY	1Q	2Q	3Q	4Q	FY	1Q	2Q	3Q	4Q	FY	1Q	2Q	3Q	4Q	FY
<b>United States</b>																				
GDP (% QoQ, ann)	2.6	3.5	2.9	1.1	2.9	3.1	2.0	2.1	2.1	2.3	1.8	-1.1	1.0	1.8	1.2	3.0	2.8	2.4	2.5	2.1
CPI headline (% YoY)	2.7	2.7	2.6	2.2	2.4	1.6	1.8	1.8	2.0	1.8	2.0	0.6	0.7	0.6	1.0	1.0	2.1	2.1	2.1	1.8
Federal funds (% eop) <sup>1</sup>	1.50	1.75	2.00	2.25	2.25	2.25	2.25	1.75	1.50	1.50	1.00	0.50	0.50	0.50	0.50	0.75	1.00	1.25	1.50	1.50
3-month interest rate (% eop)	2.30	2.35	2.45	2.65	2.65	2.30	2.00	1.70	1.9	1.9	0.9	0.8	0.75	0.75	0.75	1.00	1.25	1.65	1.90	1.90
10-year interest rate (% eop)	3.00	3.00	3.00	2.80	2.80	2.30	2.00	1.70	1.90	1.90	0.75	1.00	1.30	1.50	1.50	1.80	2.00	2.20	2.25	2.25
Fiscal balance (% of GDP)					-4.0					-4.6					-5.0					-4.7
Fiscal thrust (% of GDP)					1.1					0.4					0.0					0.3
Debt held by public (% of GDP)					76.7					79.0					83.1					84.0
<b>Eurozone</b>																				
GDP (% QoQ, ann)	3.2	1.5	0.8	1.4	1.9	1.8	0.6	1.1	0.5	1.2	-0.2	-0.3	1.9	1.3	0.5	1.1	1.0	1.0	0.9	1.1
CPI headline (% YoY)	1.3	1.7	2.0	2.0	1.8	1.4	1.3	0.9	1.0	1.2	1.1	1.0	1.1	1.1	1.1	1.2	1.3	1.4	1.4	1.3
Refi minimum bid rate (% eop)	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
3-month interest rate (% eop)	-0.33	-0.33	-0.33	-0.33	-0.33	-0.32	-0.32	-0.41	-0.40	-0.40	-0.40	-0.40	-0.38	-0.38	-0.38	-0.38	-0.38	-0.30	-0.30	-0.30
10-year interest rate (% eop)	0.50	0.30	0.40	0.24	0.24	-0.07	-0.31	-0.57	-0.19	-0.19	-0.70	-0.40	-0.30	-0.20	-0.20	-0.15	-0.15	-0.10	-0.05	-0.05
Fiscal balance (% of GDP)					-0.5					-0.8					-0.9					-0.8
Fiscal thrust (% of GDP)					-0.2					0.0					0.1					0.1
Gross public debt/GDP (%)					87.8					86.9					86.6					85.3
<b>Japan</b>																				
GDP (% QoQ, ann)	-0.6	2.2	-2.0	1.5	0.8	2.6	2.0	1.8	-6.3	0.8	-1.9	-0.9	2.6	2.0	-1.2	0.4	1.0	0.6	1.2	1.4
CPI headline (% YoY)	1.3	0.6	1.1	0.9	1.0	0.3	0.8	0.3	0.5	0.5	0.5	0.4	0.8	0.6	0.6	1.0	1.0	0.8	0.7	0.9
Excess reserve rate (%)	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	0.0	0.0	0.0	-0.1	0.0	0.0	0.0	0.0	-0.1	0.0
3-month interest rate (% eop)	-0.05	-0.05	-0.05	-0.05	-0.05	-0.05	-0.05	-0.10	-0.05	-0.05	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10
10-year interest rate (% eop)	0.05	0.05	0.10	0.00	0.00	-0.10	-0.15	-0.25	-0.01	-0.01	-0.15	-0.25	-0.05	0.00	0.00	-0.05	-0.05	-0.05	-0.05	-0.05
Fiscal balance (% of GDP)					0.0					-2.6					-2.8					-2.4
Gross public debt/GDP (%)					232.8					224.0					225.6					226.8
<b>China</b>																				
GDP (% YoY)	6.8	6.7	6.5	6.3	6.6	6.4	6.2	6.0	6.0	6.1	4.4	5.2	5.5	5.8	5.2	6.0	5.9	5.7	5.6	5.8
CPI headline (% YoY)	2.2	1.8	2.3	2.5	2.2	1.8	2.6	2.9	4.7	3.0	3.0	2.6	2.5	2.4	2.6	2.5	2.5	2.5	2.5	2.5
PBOC 7-day reverse repo rate (% eop)	2.55	2.55	2.55	2.55	2.55	2.55	2.55	2.55	2.50	2.50	2.30	2.30	2.30	2.30	2.30	2.30	2.30	2.30	2.30	2.30
10-year T-bond yield (% eop)	3.75	3.50	3.65	3.30	3.30	3.07	3.20	3.14	3.10	3.10	2.50	2.50	2.70	2.80	2.80	2.90	3.00	3.20	3.40	3.40
Fiscal balance (% of GDP)					-2.6					-4.5					-4.5					-4.0
Public debt, inc local govt (% GDP)					88.0					102					105					107
<b>UK</b>																				
GDP (% QoQ, ann)	0.2	1.6	2.8	0.9	1.4	2.6	-0.4	2.0	0.1	1.4	0.4	-0.7	1.6	1.6	0.5	0.7	1.4	0.8	0.5	1.0
CPI headline (% YoY)	2.7	2.4	2.5	2.3	2.5	1.9	2.0	1.8	1.4	1.8	1.8	1.2	1.2	1.5	1.4	1.6	1.8	1.8	1.8	1.7
BoE official bank rate (% eop)	0.50	0.50	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.75	0.75	0.75
BoE Quantitative Easing (£bn)	445	445	445	445	445	445	445	445	445	445	445	445	445	445	445	445	445	445	445	445
3-month interest rate (% eop)	0.60	0.80	0.80	0.80	0.80	0.83	0.77	0.77	0.80	0.80	0.60	0.60	0.60	0.60	0.60	0.60	0.75	0.80	0.80	0.80
10-year interest rate (% eop)	1.45	1.48	1.57	1.30	1.30	1.00	0.80	0.50	0.82	0.82	0.10	0.40	0.70	0.80	0.80	0.90	0.90	1.00	1.00	1.00
Fiscal balance (% of GDP)					-1.4					-1.4					-1.2					-1.0
Gross public debt/GDP (%)					86.9					85.7					84.4					83.6
EUR/USD (eop)	1.20	1.17	1.15	1.12	1.12	1.12	1.12	1.09	1.12	1.12	1.12	1.15	1.12	1.10	1.10	1.10	1.10	1.10	1.10	1.10
USD/JPY (eop)	107	110	114	113	113	112	108	108	109	109	107	105	107	108	108	109	110	110	110	110
USD/CNY (eop)	6.28	6.67	6.87	6.88	6.88	6.74	6.90	7.15	7.00	7.00	7.05	7.00	6.95	6.85	6.85	6.80	6.70	6.60	6.50	6.50
EUR/GBP (eop)	0.88	0.88	0.89	0.90	0.90	0.85	0.90	0.89	0.85	0.85	0.87	0.88	0.85	0.82	0.82	0.82	0.82	0.82	0.82	0.82
Brent Crude (US\$/bbl, avg)	67	75	76	69	72	64	68	62	62	64	55	56	60	65	59	64	70	70	68	68

<sup>1</sup>Lower level of 25bp range; 3-month interest rate forecast based on interbank rates

Source: ING forecasts

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