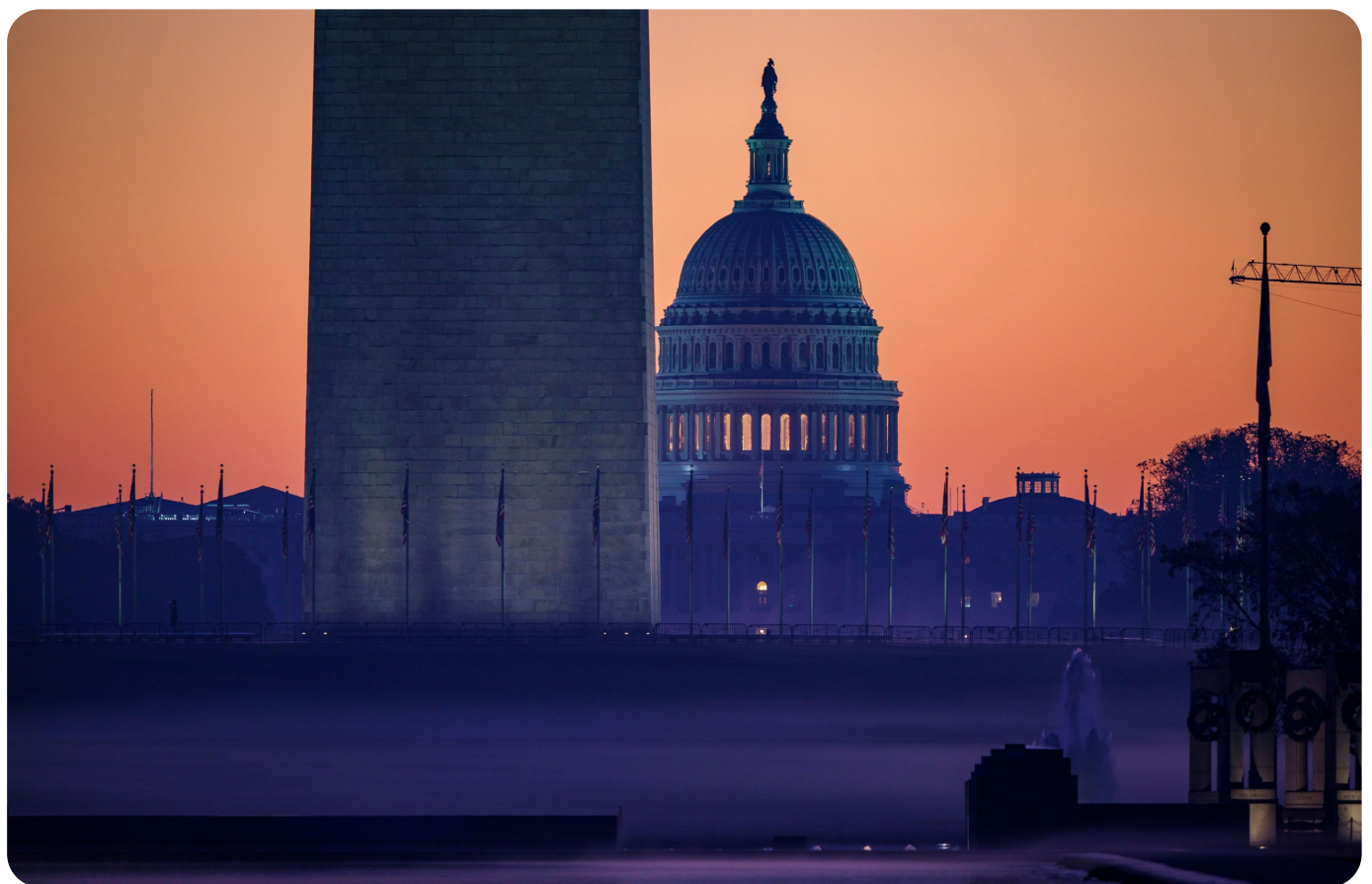


Monthly Economic Update

Navigating a sea of waves

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THINK Economic and Financial Analysis

5 November 2020



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Eurozone: a joyless November

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China: Next Five Year Plan starts in 2021

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CEE: Riding the second wave

- *The CEE region is feeling the heat of the second Covid-19 wave. But with less severe restriction, the economic hit should be less painful too. We also think there will be less pronounced fiscal and monetary support, as deflation seems unlikely. CEE FX remains a global beta, rather than a local alpha story*
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FX: Lowering your sights

- *FX markets have reacted to news of a much closer US election by selling currencies most exposed to the global recovery story and buying USD and JPY. Certainly, the prospect of at least smaller fiscal stimulus, if not an outright contested election – combined with poor Covid-19 trends – favour more defensive positioning this month*
-

Latam: Post-pandemic challenges

- *As the Covid-19 health crisis abates across the region, investors are eager for signals that governments will be able to transition to a more hawkish fiscal policy stance in 2021, amid mounting fiscal concerns*
-

Rates: You think you've seen it all? Wait for it...

- *Picture what many term the most important US elections in living memory. Frame it within a global pandemic not seen in 100 years. Add massive supply to get economies off their knees to a pervasive dusting of structurally negative rates. And then try to make sense of it all for rates – US rates still look like they want to look upwards, even if they go down first*
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Navigating a sea of waves



Hopes of a 'blue wave' in the US election are giving way to concerns over a second wave of Covid-19 across several major economies. This poses serious challenges for an economic recovery that still has a long way to go

November seems to be the month for making waves. In the United States, the anticipated 'blue wave' proved elusive in the presidential election and Joe Biden's narrow lead in some key swing states suggests waves of recounts and possibly also waves of legal allegations and lawsuits could follow the eventual result.

In Europe, a second wave of the coronavirus has led to a second wave of lockdown measures, which will almost inevitably push most economies into a double-dip recession and will probably trigger new waves of monetary and fiscal stimulus.

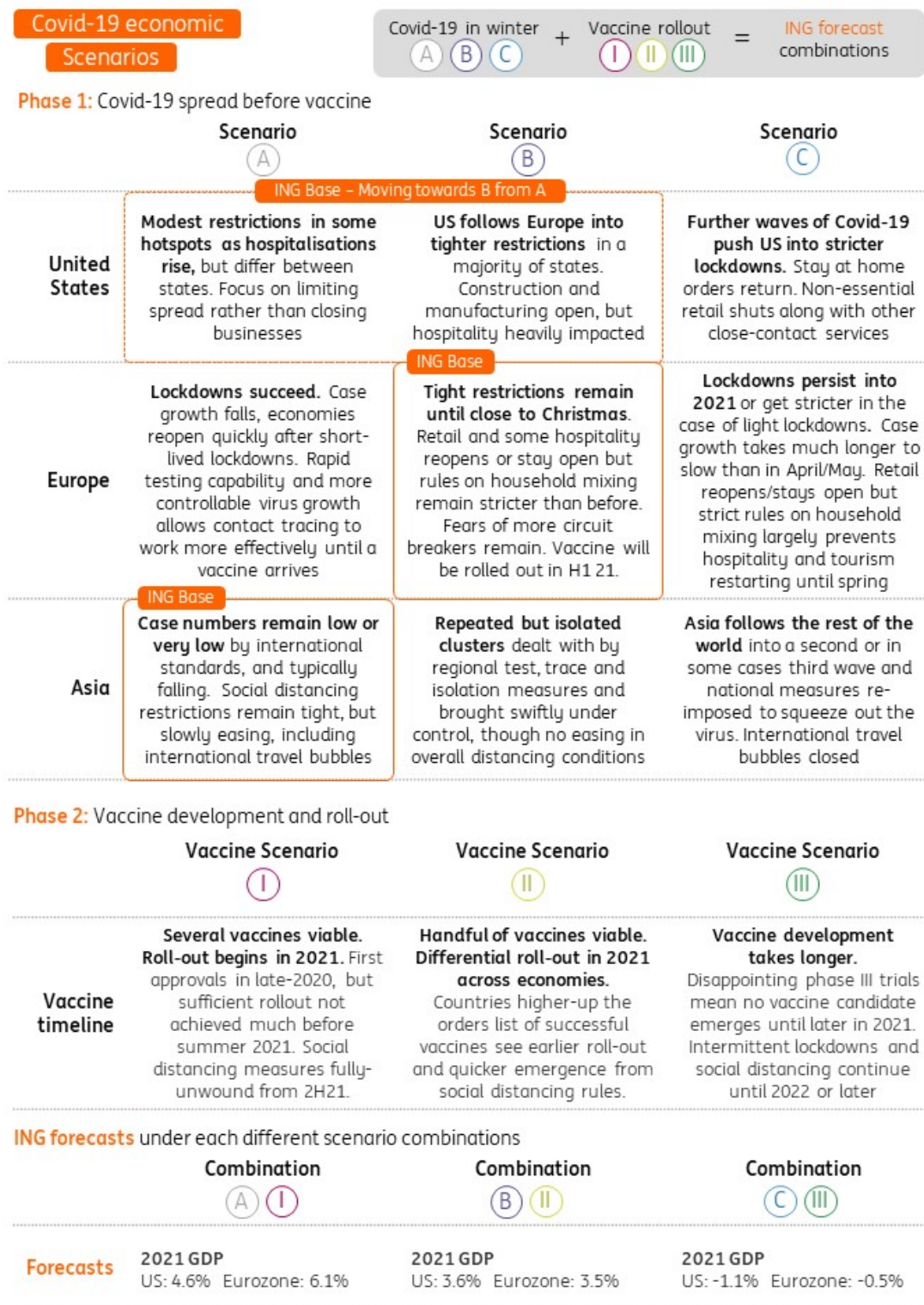
The US election has been a nail-biting event and is, unfortunately, still undecided at the time of finalising our latest Monthly Update. The only silver lining to the election going into extra time (for us, at least) is that our analysis of a Trump or Biden Presidency on the US, Asian and European economies has a longer shelf life. And there will be more excellent coverage of the US elections from my colleague James Knightley. Stay tuned.

In Europe, some social distancing restrictions in October were not enough to prevent a second wave of new infections. As a consequence, many countries have gone back into lockdown again. Some of these lockdowns could be labeled as 'smart', others as 'light' and others simply as 'lockdown 2.0'. What all the lockdowns have in common is that they aim to restrict social interaction, which will mainly hit the service sector. As a result, the eurozone economy will fall into recessionary territory again in the final quarter of the year. The European Central Bank has already pre-announced that a new round of monetary support will follow at the December meeting. It is hard to see that governments will not start their own wave of fiscal stimulus soon as well.

While Europe grapples with a second wave of infections and the US is still in the midst of its first, Asia looks different. Up until now, most Asian countries have managed to stave off a second wave. Better experiences in dealing with past pandemics as well as mask-wearing, testing and sometimes resolute tracking and quarantining are probably the main reasons why Asian countries are doing better than the US or Europe.

Against this background, we have once again updated our three macro-economic scenarios going forward and introduced more region-specific differentiations. The second wave of the virus makes it impossible to come up with a one-size-fits-all underlying assumption. Regarding Europe, the former first risk scenario has now become our base case scenario. New lockdowns, possibly on-and-off until spring next year, and the gradual rolling out of a vaccine in the first half of next year are the underlying assumptions. With the new lockdowns, the eurozone economy will not return to pre-crisis levels before the end of 2022. For the US economy, the base case scenario is still one without new lockdowns but the European experience of the last few weeks illustrates how fast such assumptions can change. The only region for which our underlying assumptions look extremely solid is Asia. Here, to use the ECB's language, risks to the outlook are rather tilted to the upside. To some extent, Asia currently resembles the rock in an economic sea of many waves.

ING's new Covid-19 economic scenarios



Source: ING

US: Groundhog Day

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Indications point to a Joe Biden presidency, absent the 'blue wave' that markets had been anticipating. Political animosity means a substantial near-term fiscal support package is less likely at a time when incomes are being squeezed and rising Covid-19 cases mean containment measures are looking more likely. Economic risks are mounting



Source: Shutterstock

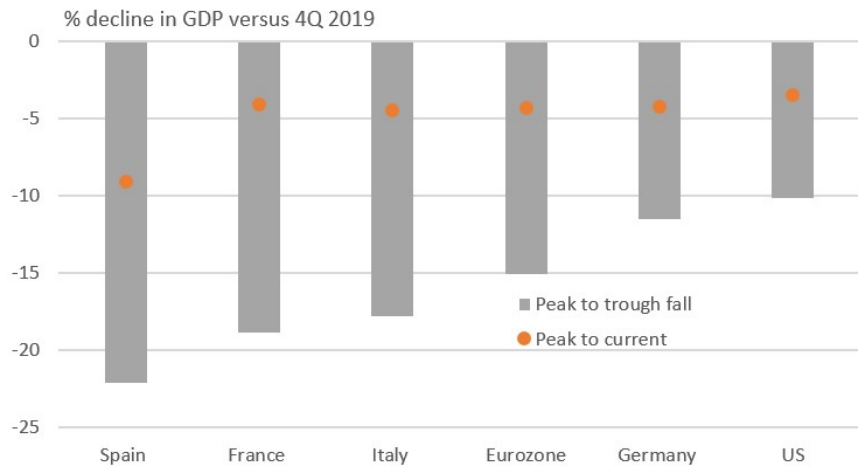
Biden Constrained

Heading into election night there was an expectation that Joe Biden would win the presidency handsomely and this would help sweep the Democrats to an even bigger House majority and control of the Senate for the first time since 2015. While voters turned up in their millions for Biden, they did the same for Donald Trump, making it a far closer outcome than polling suggested was likely. At the time of writing, it looks as though the Republicans have just about clung onto the Senate and have weakened the Democrat House majority marginally.

Nonetheless, Donald Trump seems to be exploring all possible avenues to retain the Presidency. Recounts, legal challenges and possible court cases mean it could be a few more days or even weeks before we have a definitive outcome while a Senate seat run-off in Georgia won't happen until January.

The initial market reaction has seen the Treasury yield curve flatten at lower levels on the basis that this outcome makes an aggressive reflationary fiscal stimulus - that would have led to greater debt issuance (like the \$3.4trn package proposed by House Democrats) - less likely. Republican Senators will simply oppose it. Equities are also up strongly, likely reflecting an assumption that this outcome diminishes the prospect of major corporation tax hikes while regulations surrounding financial services, healthcare, big tech and real estate may end up being less onerous than feared. At the same time, a Biden presidency would likely mean a more predictable global trade backdrop, which is good news for businesses with international supply chains.

US economy still 3.5% smaller than 4Q19



Source: Macrobond, ING

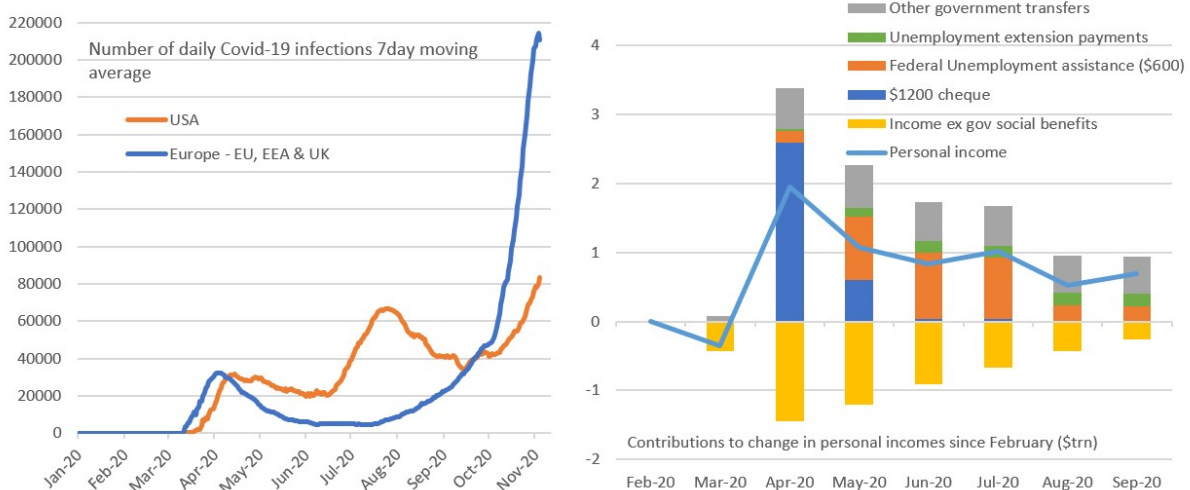
A long time to heal...

However, this positive sentiment could swiftly dissipate. We must acknowledge the risk that political animosity between Democrats and Republicans, especially if there are lengthy legal battles over the election, scuppers the potential for another near-term fiscal support package. This would be very bad news for the economy. While the US recorded a 33.1% annualised growth rate in the third quarter, we should remember that output is still 3.5% below that of the end of the fourth quarter 2019 and there are 10 million fewer Americans in work than in February. There is a long way to go until the economy has fully healed and this process looks set to be further delayed by the headwinds from rising Covid-19 cases and squeezed household incomes.

More than 230,000 Americans have already lost their lives to the pandemic and the fear is that the exponential growth rate in European Covid-19 cases, followed by lockdowns, may be a prelude to what the US faces in coming weeks. Colder temperatures mean more people congregating inside and the potential for virus spread is growing – for example, Halloween parties and the Thanksgiving holiday could fuel the number of cases.

We are already seeing curfews and other restrictions re-introduced in some cities. Should hospitalisation rates rise and healthcare systems start to struggle this may necessitate the return of broader and more restrictive containment measures.

Covid-19 spike and income squeeze threaten the recovery



Source: Macrobond, ING

With more pain to come...

Such action would inevitably bring economic damage. While the construction and manufacturing sectors may escape the scale of lockdown experienced earlier in the year, the service sector is unlikely to be as fortunate. Even if we see only limited action, health fears could mean consumers vote with their feet and not go to shops, restaurants and gyms. Activity would weaken in any case.

New business restrictions would mean rising worker lay-offs and weaker employee compensation at a time when unemployment benefit payments are being cut back. Remember that the \$600/week Federal payment has been tapered to \$400 (and to \$300 in many instances) while millions more have now exhausted their 26 weeks of state unemployment benefits. As such, we have to contend with the very real possibility that household incomes fall in December in the absence of another short-term government support package.

Trying to quantify the impact of this is challenging. The economy has good momentum right now and we see this continuing through November, but December is the big unknown.

Remembering back to the beginning of the year, the economy started brightly and this continued through February. However, just a couple of weeks of lockdown in March was enough to turn what was looking likely to be a 2.5%+ quarterly expansion into a 5% annualised contraction.

Pencilling in a 3.5% month-on-month fall in consumer spending in December and a further 1% decline in January, with some weakness in other components of GDP, leads us to look for sub-2% growth in 4Q and an actual negative GDP reading for the first quarter of 1Q21. The more severe the restrictions, the more severe the contraction.

Vaccine remains critical for recovery

This development would be detrimental for risk appetite with the yield curve flattening at lower levels and be supportive for the US dollar against those currencies exposed to the recovery cycle as the reflation trade gets delayed. In the event of very limited fiscal support, the Federal Reserve may feel compelled to step up asset purchases at the longer end of the yield curve.

This is a more pessimistic forecast than what we were predicting last month, but we believe the set of containment measures will be shorter lasting and less restrictive than those experienced earlier in the year.

Obviously, a vaccine would be a huge boost to sentiment and would allow businesses to plan for the post-pandemic future, with economic activity rebounding once the rollout gets underway. We also still feel there is scope for a decent stimulus package in early 2021 with President Biden at the helm, but it may end up being closer to the \$1 trillion (5% of GDP) package proposed by Senate Republicans rather than \$3 trillion House Democrat package. If we can get this, combined with a vaccine, it still gives us optimism that the economy can post robust growth through the rest of 2021 and into 2022.

Eurozone: Second leg of the recession coming up

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The second wave in Covid-19 infections has led to new lockdowns in the eurozone, most probably leading to a fall back into recession in the fourth quarter. With inflation close to 0%, the European Central Bank has announced more policy action in December



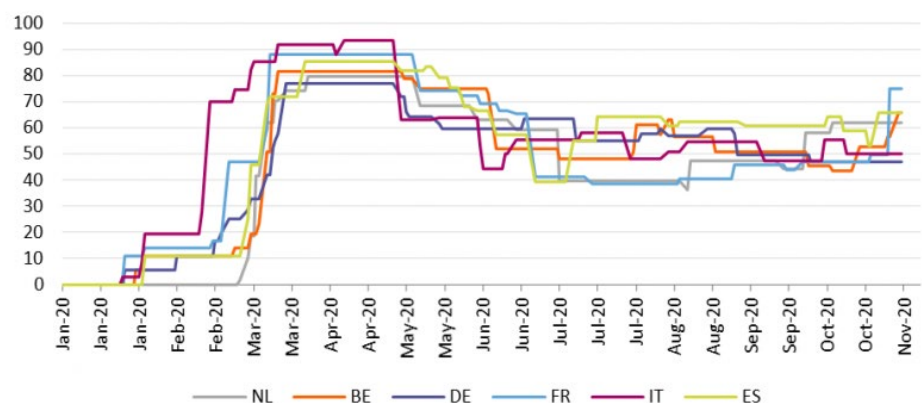
An empty Champs Elysees avenue in Paris, France

Third quarter mirage

With the seemingly unstoppable increase in Covid-19 infections and the consequential pressure on health systems, most eurozone countries have been forced to put in place more stringent confinement measures again. While schools and companies remain mostly open, at least for the time being, bars and restaurants and non-essential stores have been closed in several of the bigger member states. Add to that a higher level of sickness-induced absenteeism and the negative impact on confidence, and negative growth in the fourth quarter seems hard to avoid.

The spectacular 12.7% non-annualised GDP growth in the third quarter was no more than a mirage, caused by the reopening of the economy after the lockdown constrained second quarter growth. Interestingly, amongst the bigger countries, the snap back has been proportional to the GDP contraction in the second quarter, meaning that most are now close to each other in terms of year-on-year contraction. Spain remains the odd one out, with a much deeper recession.

Covid-19 government response stringency index

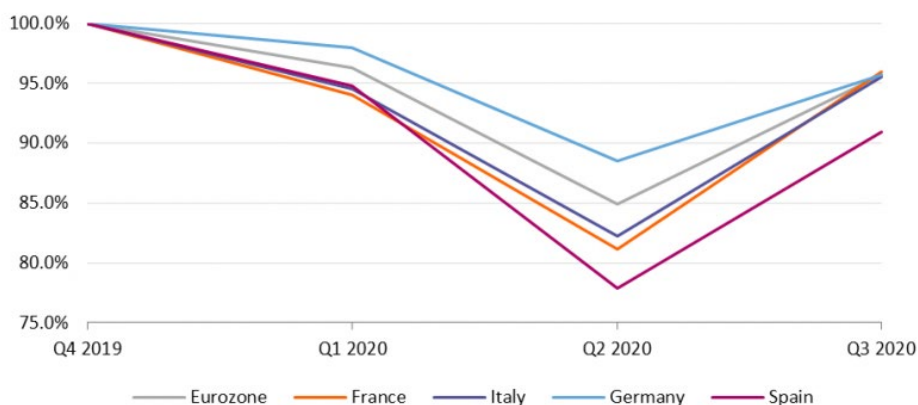


Source: Refinitiv Datastream

2021 growth and inflation forecast downgraded

Manufacturing started the fourth quarter on a strong footing, with PMI figures for October pointing to solid growth. However, the retail sector and services are going to be hurt again by the confinement measures, not to mention the negative effects on confidence. The fall in consumer confidence in October doesn't bode well in that regard. We now expect a 2% GDP contraction in 4Q with risks skewed to the downside. Because of the very strong 3Q growth, we had to revise our 2020 GDP growth estimate upwards to -7.1%, but at the same time we lowered our 2021 forecast to +3.5%. Indeed, this time, authorities will probably be more prudent in the loosening of confinement measures, signalling a rather weak start to the year as a result. Only from the second quarter onwards should things speed up, as this is when a vaccine will probably start to be rolled out. Meanwhile, inflation remains uncomfortably low, with core inflation still at a mere 0.2%. With German elections in 2021 and taking into account the fall back into recession, we think the German government might refrain from hiking VAT rates in January, which will probably keep average eurozone inflation below 1% next year.

GDP evolution since the beginning of the year



Source: Refinitiv Datastream

Fireworks in December?

While the ECB held policy steady at its October meeting, there was a clear signal from President Christine Lagarde that fireworks are in the offing at the December meeting, with a “recalibration of its instruments”. We expect an additional €500 billion in quantitative easing, possibly announced as a monthly instalment and continuing as long as needed. To keep financing costs low, the preferential Targeted Longer-Term Refinancing Operations (TLTRO) rates (allowing the banks to fund themselves cheaply if they don't shrink their credit portfolio) are probably going to be lengthened until the summer of 2022. An increase in the tiering for excess liquidity, exempting a bigger chunk of bank liquidity from the negative deposit rate, is also likely. Just like the Federal Reserve, the ECB might also decide to incorporate bonds of “fallen angels” (companies that lost their investment grade rating this year) into its corporate bond purchase programme. While a deposit rate cut cannot be excluded, it is probably not the most preferred policy measure at the current juncture.

Eurozone: a joyless November

As the second wave of Covid-19 sends much of Europe back into lockdown, we take a look at what you can and can't do in various Eurozone countries

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Woman passes stacked chairs and tables at the famous restaurant 'Hofbrauhaus' downtown in Munich, as a month long partial lockdown becomes effective in Germany
Source: Shutterstock

The next round of lockdowns is here and it's different from the first wave. Governments have taken lessons from the round of March lockdowns on board and have centred the restrictive measures around retail and recreational activity in most countries. This limits social contact – and fun – which is supposed to curb the spread of the virus. Schools, industrial and construction activity remain out of scope for now, which helps to limit economic losses, but that does not mean the impact of the measures will be negligible. Far from it in fact, as we now expect the economy to contract in 4Q 2020. The closing of hospitality and non-essential retail, as well as the potential negative impact on sentiment, will significantly impact the economy and this will, in turn, require a fiscal response to mitigate the lasting damage. The dreaded double dip is here.

The second wave of lockdowns in Europe

	Germany	France	Italy	Spain	Netherlands	Belgium	Portugal	Ireland
Restaurants & bars closed	Yes	Yes	Yes, after 6pm	No, with regional exceptions like Barcelona	Yes	Yes	No	Yes
Curfew	No, but no domestic touristic travel	No, but limited non-essential travel	Yes	Yes, except Canary Islands	No	Yes	No, but limited non-essential travel	No, but limited non-essential travel
Non-essential retail closed	No	Yes	No, with possible local exceptions	No	No	Yes	No	Yes
End of measures	Nov 28	Dec 1	Dec 2	Nov 9, possibly extended until Mar 2021	Mid-Dec	Dec 1	Nov 14	Dec 1

Source: ING Research and national government announcements

China: Next Five Year Plan starts in 2021

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The Chinese government's views on technology development are the most important feature of China's 14th five-year plan, which begins in the new year



China's President, Xi Jinping, on a big screen in a Beijing shopping centre

The 14th five-year plan draws the policy map

It is very important to read and understand the next Chinese five-year plan correctly. This is China's policy roadmap for the coming five years, and the Chinese government's track record has been to stick very firmly to these plans.

The new plan includes extending some policies from the previous five-year plan, for example, 'high-quality' growth still appears as a key theme, which is essentially an extension of China's previous objective of becoming a middle-income society. Though there is no numeric growth target, we understand that the aim is to keep income growth stable, which implies economic growth should also be the same.

The assumed growth in this plan will come from the domestic market, much of which is already middle-class. China also wants to extend the previous plan's objective of narrowing the wealth gap between the rural and urban population.

Tech remains the key focus

The new plan has a dedicated section for technology development and the clear objective is for China to become self-reliant on tech development, create and innovate in this area and build on talent too. These goals echo the current situation that China faces from restricted US exports of technology.

But the plan does not mention how China could survive the technology export market when there is increasing resistance overseas to technology 'Made In China'.

Perhaps the answer is to tap the Belt and Road market as well as the big domestic market, which the plan does mention. However, we don't think this is enough. What concerns us is that the resistance to adopting Chinese technology could become a trend when other economies perceive the increasing power of China as a threat to their own economic growth.

Green also contributes to high-quality growth

The latest plan also targets a "green" living style as part of its ambitions for high-quality growth. The plan's objective is to speed up low carbon economic development and increase efficiency in the use of resources.

The plan not only aims at protecting the environment but also restoring it, which is a new concept in Chinese policy.

Implementation is the focus

The government has already started implementing the plan. More actionable steps will be revealed in the upcoming Two Session meetings, in March.

As we have previously written, the most difficult part will be the export of technology, which we believe the government has tried to address by persuading its Belt and Road partners to use Chinese tech products. But those partners are also under pressure to adopt technology from other big players in this market, so their support cannot be taken for granted.

UK: A turbulent November

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We expect England's lockdown to trigger a sharp contraction in November GDP, albeit perhaps not as steep as we saw back in March/April. Alongside fresh Bank of England stimulus, these tighter restrictions could put additional pressure on the UK and (to a lesser extent) the EU to agree a trade deal over coming days



November 4 2020: UK Prime Minister Boris Johnson leaves 10 Downing Street

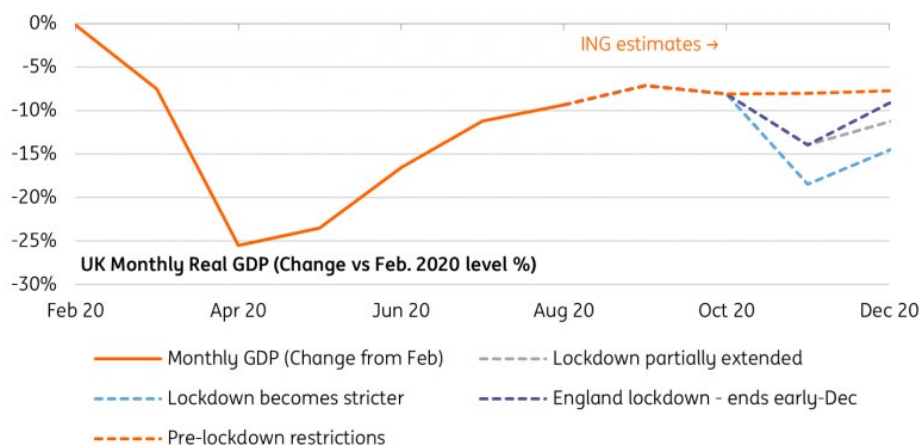
UK GDP set to plunge, albeit not as much as in the first lockdown

By any normal measure, the 6-7% contraction we expect in November UK GDP on the back of England's month-long lockdown is a sharp decline.

But these are not normal times, and importantly, the hit to economic activity is unlikely to be quite as steep as it was in March and April, when GDP plunged by quarter in a matter of weeks. The principal reason is simple: this lockdown is less restrictive for the economy than the first, even if the rules for individuals are comparable. Manufacturing and construction will plough on, as will schools. We also know that businesses are more prepared for this lockdown - we're unlikely to see essential businesses temporarily close, as we did back in March so that they could revamp their operations to be Covid-safe. And in the hospitality and retail sectors, more businesses - particularly smaller ones - will be more geared up for online and takeaway options.

We'd also reiterate that the economy has not fully recovered from the first round of restrictions. In August the size of the economy was still 9% below February levels, and put simply that means there is 'less to be lost' this time around. We expect this lockdown will take the size of the economy some 14-15% below pre-virus levels.

Our estimates of how the English lockdown could hit UK GDP



*Partially extended - shops largely reopen but hospitality mostly stays closed
 Source: Macrobond, ING forecasts

Lockdown adds to economic case for a Brexit deal

All of this has piled on the pressure for the Bank of England to act, but it may also have a bearing on the direction of Brexit talks. Negotiations have appeared to make steady progress following 'intensified' meetings, with the most recent reports suggesting that a deal on fishing rights may be in the offing. If there's to be a deal, most analysts think it could come in a matter of days, given the time needed for ratification.

The return to lockdown on both sides of the Channel will inevitably boost the economic case for a free-trade agreement. Admittedly in the longer-term the difference between having a free-trade agreement and not is perhaps not huge. Both involve the UK leaving the single market and customs union, which is where the bulk of the new costs and headaches for businesses will come from.

But in the short-term, there is hope that a deal could unlock a wider array of measures to help minimise disruption at the ports early on. With Europe still likely to be in the midst of some form of tightened Covid-19 restrictions come 1 January, these sorts of measures could be even more important than they already were likely to be.

The politics are more complicated

But while the economics are clear, the politics are unsurprisingly more complex. There are undoubtedly some political advantages for the Johnson administration to agree a deal. Entering 2021 without an agreement could leave the door open to further criticism from the Labour Party which, according to some polls, is now ahead of the Conservatives. It would also likely play into the hands of the Scottish Independence campaign, which has seen its support boosted during the pandemic, and is an outcome Prime Minister Boris Johnson is keen to avoid.

That said, the compromises required for a deal - on state aid, fishing and on the Internal Markets Bill (which the UK would need to rewrite) - will be deeply unpopular with many Conservative MPs, many of which have publicly voiced their frustration about the latest Covid-19 restrictions.

In our opinion, this does not necessarily reduce the chance of a deal being agreed (we'd unscientifically say the probability is now at around 70%), but it does mean the end-game will have to involve some careful political choreography. That suggests there could still be some dramatic twists set to come. It's not over yet.

CEE: Riding the second wave

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The CEE region is feeling the heat of the second Covid-19 wave. But with less severe restriction, the economic hit should be less painful too. We also think there will be less pronounced fiscal and monetary support, as deflation seems unlikely. CEE FX remains a global beta, rather than a local alpha story



A protester against new lockdown measures in Prague

Central and Eastern European countries have been hit by the second wave of the pandemic and subsequent lockdowns. While Covid-19 cases are substantially larger than during the first wave, we expect the negative impact on the economy to be less pronounced because (a) new measures are less restrictive (b) temporary shutdowns of large factories - such as automakers seems unlikely at this point and (c) compared to the first wave, the pandemic has had a more diverse impact on global regions.

In particular, Asia's resilience may provide some breathing room to the export-oriented CEE countries, either directly or indirectly via German and eurozone exports

Less pronounced fiscal and monetary support

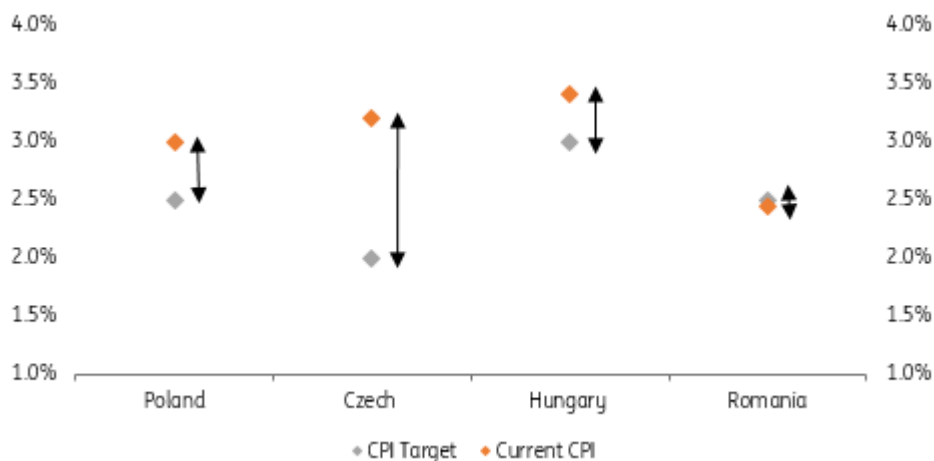
Compared to the first wave, CEE fiscal and monetary support is likely to be less pronounced.

On the fiscal side, this is due to various factors (differing from country to country) such as a move from broad-based to more targeted support measures, less negatively impacted industrial sectors (vs the first wave) and a lower willingness to increase the deficit.

On the monetary side, no urgent easing is expected either. The second wave poses a lower degree of downside risk to the domestic growth outlook and importantly, the ordinary monetary channels have now been more or less exhausted, thus raising the bar for further easing.

In Poland and the Czech Republic, interest rates are close to zero, while in Hungary the interest rate channel continues to be perceived as an FX stabilising tool (hence, limited room to cut rates). Equally, the situation isn't so urgent for local central banks to consider new unorthodox measures - with the exception of Poland's central bank, which we expect to extend its quantitative easing programme into 2021.

Deflation risks nowhere to be found



Source: ING

Deflation risk is not an issue

Vastly different CEE inflation dynamics are one reason why the European Central Bank is bracing itself for another large monetary stimulus (to come in December), while CEE central banks are not – at least at this point.

In sharp contrast to the eurozone, the risk of deflation is not an issue in central and eastern Europe (see chart above) as all countries have had some cushion of high and above-target CPI going into the crisis. In the coming months, we should continue to see more normalisation from the previous high levels towards the inflation target, with limited risk of an undershoot.

Purely from a price stability point of view, the case for more monetary stimulus just isn't there.

CEE FX is a global beta play

CEE currencies (vs EUR) should continue to be primarily driven by their beta (sensitivity to global factors), with limited importance of alpha (domestic drivers).

The deterioration in the domestic and eurozone growth outlook in October led to a meaningful underperformance of local currencies, but with a lot of bad news priced in. With the US election outcome not being a negative for emerging market FX (in fact, the prospects of an end to unpredictable trade wars, a modest US fiscal stimulus and a limited scope for a sell-off in global bond markets should benefit emerging market FX next year) this should provide some breathing room to battered CEE FX too.

We continue to prefer the Czech koruna and Hungarian forint to the Polish zloty, given the larger NBP bias towards easing and higher tolerance towards currency weakness.

FX: Lowering your sights

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FX markets have reacted to news of a much closer US election by selling currencies most exposed to the global recovery story and buying USD and JPY. Certainly, the prospect of at least smaller fiscal stimulus, if not an outright contested election – combined with poor Covid-19 trends – favour more defensive positioning this month



Election 2020, Tokyo, Japan - 04 Nov 2020

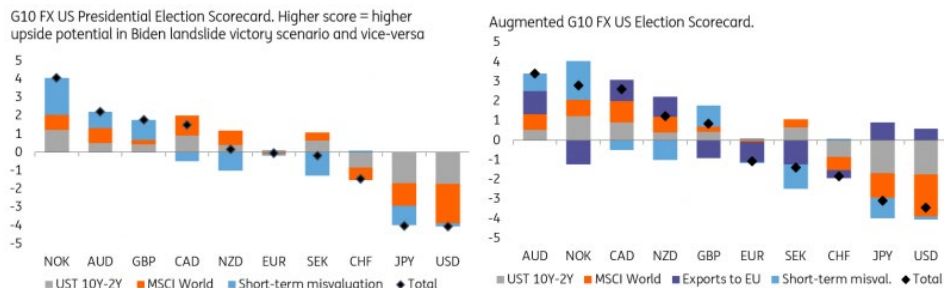
Scaling back the rally

FX markets went into the election priced for a Biden clean sweep. Large fiscal stimulus expected in January, a return to the rules-based trading system, and a Federal Reserve ready to run the economy hot had all contributed to the broad dollar decline and (helped by Covid-19 trends in Asia) generated good demand for those currencies exposed to a rebound in global activity – or the reflation trade.

Instead, it looks very much like the Democrats will struggle to grab the Senate (suggesting a smaller fiscal stimulus as parties continue to bicker) and that whichever candidate secures 270 electoral college votes, that vote could well be challenged. A contested election looks a clear negative for risk assets, recalling the 8% decline in the S&P 500 back in November 2000 as the Supreme Court spent a month deliberating over a Florida recount.

We have been highlighting FX market sensitivities to the global recovery trade in articles such as the G10 FX Election Scorecard and these correlations have been holding up well. Further pressure on US equities and a flatter US yield curve would see Norway's krone and the Australian dollar as the most exposed, while the Japanese yen and US dollar should perform better during this uncertain environment. For choice, we would probably favour the JPY over the USD given the risk of a 'sell US' mentality emerging were the election result to be contested in the courts.

Which currencies are most exposed to the reflation trade/Biden clean sweep?



Source: ING

EUR: The headwinds are growing

Despite Europe heading into second wave lockdowns, EUR/USD had been holding up quite well. This was probably a function of the broad dollar decline – or effectively the global recovery story trumping the setback in Europe. After election night, the global recovery story is clearly providing less support now and instead, the European double-dip may play a greater role in EUR/USD pricing.

Here, the European Central Bank looks set to top up quantitative easing in December – a move the ECB sees as effective in keeping a lid on the euro. Until the US election result is clear, we suspect that EUR/USD trades in a 1.15-1.20 range – gyrating lower on prospects of a Trump presidency (more protectionism, targeting Europe?) and higher on a Biden presidency. Into 2021, however, we still lean towards a post-Covid-19 global recovery trade coming through next summer. An ensuing broad-based dollar decline could still see EUR/USD trade up to 1.25 – but headwinds are growing to that call.

So far, emerging market currencies have actually held up a little better than expected. That may be because both the Fed and the ECB have light-trigger fingers when it comes to supplying fresh liquidity and that low core rates continue to favour a drive out along the credit curve into high yield, emerging market FX. We like this story in 2021, but again feel that an uncertain November – including the threat of renewed US lockdowns in December – favour patience when returning to the EM growth/yield investment theme.

Latam: Post-pandemic challenges

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As the Covid-19 health crisis abates across the region, investors are eager for signals that governments will be able to transition to a more hawkish fiscal policy stance in 2021, amid mounting fiscal concerns



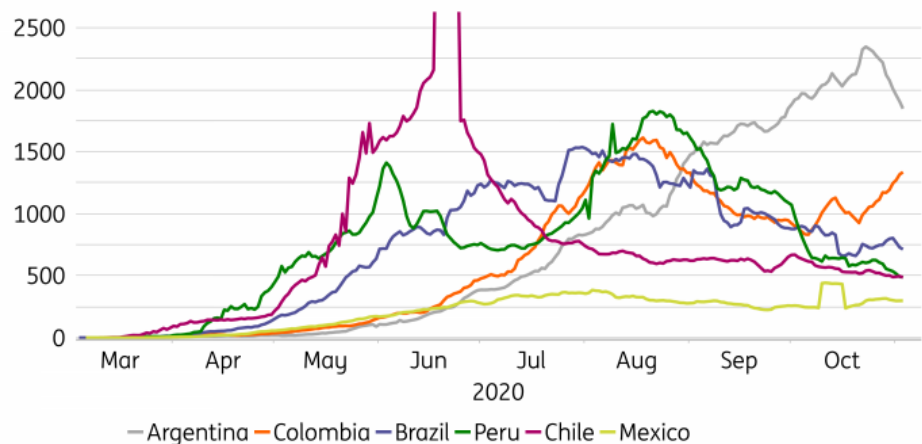
Source: Shutterstock

Recovery should continue, but at a slower pace

Latin America has largely avoided, so far, any signs of a second-wave resurgence of Covid-19 cases, as seen in much of the Northern Hemisphere. As the region reopens, while managing to mitigate the virus's death toll through more targeted restrictions, its macro outlook should improve, especially in contrast to other emerging market regions where mobility restrictions have intensified.

No signs of a second wave yet in LATAM

7-day increase in Covid-19 cases/m people



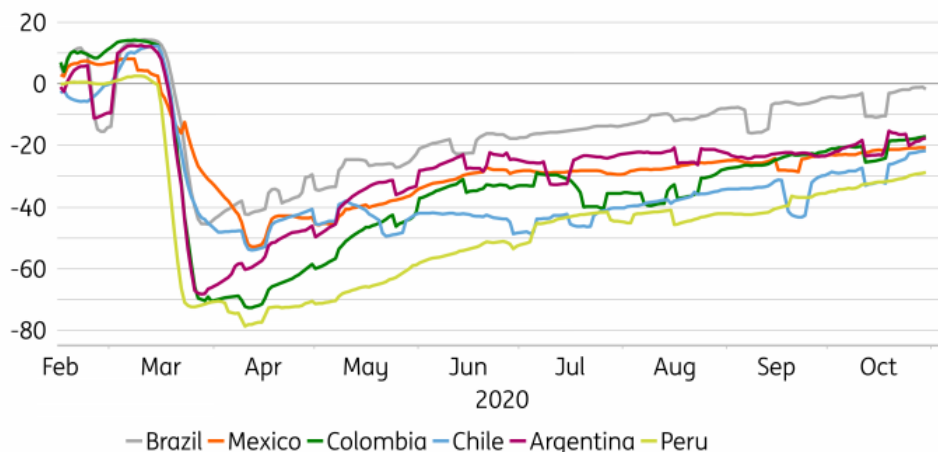
Source: Macrobond, ING

Such an inter-regional divergence would deepen if LATAM manages to avoid a second wave, and further lockdowns, until a vaccine becomes available, possibly early in 2021.

Despite the reduction in Covid-19 cases, mobility indicators (see chart below) suggest that, apart from Brazil, where evidence of a stronger-than-expected recovery is most evident, workplace visits have plateaued somewhat since July. This suggests that the fast pace of recovery generally seen up to July, may have lost steam since then.

Brazil's faster normalisation of workplace visits remains an outlier

Google mobility indicator (workplace)

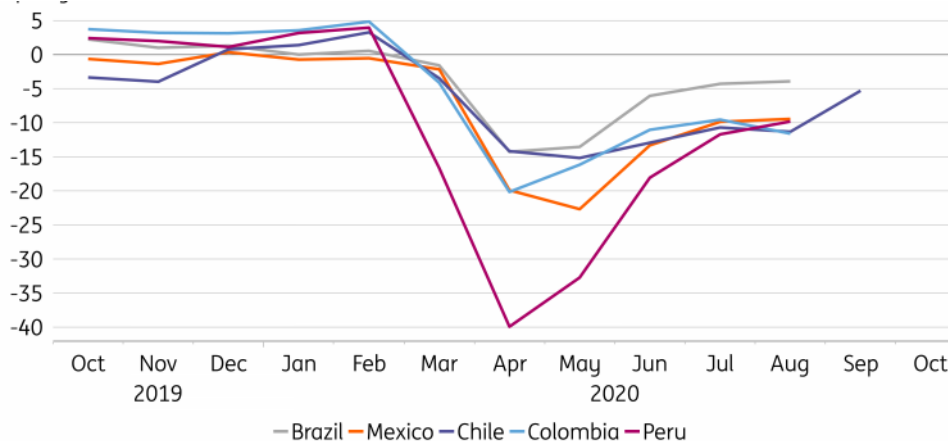


Source: Macrobond, ING

There's some evidence that the recovery lost steam in the third quarter, in some countries (see chart below). This would be consistent with the accumulated impact of job losses and reduced government transfers, while continued fear of Covid-19 transmission and social distancing practices continue to depress certain activities, notably in the service sector.

After a strong 2Q, 3Q has been marked by mixed results in some places

GDP-proxy, YoY%



Source: Macrobond, ING

It's still hard to say how countries will continue to adjust but, overall, recent trends suggest that even in the absence of a second wave, the economic recovery throughout the second half of the year may be insufficient to return economic activity to pre-pandemic levels. This could last possibly until a vaccine is widely distributed.

Coping with a challenging fiscal legacy

Regardless of whether the region surprises with a faster recovery in the second half or disappoints, macro uncertainties are unlikely to dissipate quickly for the region.

The scarring effects left behind in terms of business closures and layoffs, along with the enormous fiscal toll represented by the sharp increase in government spending and reduction in tax collection, suggest that it may take several quarters before we have a clear post-pandemic assessment of regional economies.

For now, fiscal sustainability appears to have become the primary concern for investors across the region, as it enters 2021 with much-weakened fiscal accounts.

This is best illustrated by the underperformance of Brazil's FX and FI assets relative to Mexico's, two countries that adopted vastly different strategies during the pandemic. Brazil reacted to the pandemic by announcing vigorous stimulus measures, including large fiscal transfers to households and businesses. In contrast, the Mexican administration's reaction was unusually muted, both in terms of monetary and fiscal policies.

Thanks in large part to those initiatives, Brazil's post-pandemic activity indicators are the best among major economies in the region. Mexico's recovery prospects are much weaker than Brazil's but, judging by the rally in MXN assets relative to their BRL counterparts, financial markets vastly prefer Mexico's hawkish policy stance.

Testing LATAM's ability to adapt economic policies to a new reality

In our view, faced with the pandemic, LATAM policymakers acted correctly by implementing robust monetary and fiscal policy stimulus. That was the most adequate course of action in March, but it's clear that there's no additional scope for fiscal easing.

Mounting fiscal concerns suggest that fiscal policies must, gradually, turn more hawkish, while monetary policies remain expansionary, with the policy rate kept at or near their technical lower bounds.

In our view, the medium-term outlook for local assets should be determined, to a large extent, by each country's ability to successfully transition to a fiscally-responsible stance in the coming months, while keeping the policy mix slightly expansionary.

In other words, the extraordinary set of circumstances governments faced in 2020 justified, in our view, Brazil's forceful policy stimulus. The problem that Brazil faces now is the political reluctance to firmly commit to normalise spending and/or raise taxes to help offset 2020, and re-anchor fiscal dynamics.

This difficulty in normalising fiscal spending post-pandemic, and to bolster fiscal frameworks to return fiscal trajectories to a sustainable path, is playing out in most countries in the region, including in Chile, Peru and Colombia.

In the shorter-term, so long as fiscal uncertainties remain unaddressed, investors may continue to prefer exposure to Mexican assets while Brazil and, to a lesser extent, Chile, Peru and Colombia, continue to be avoided.

We expect relative-performances to be reversed at some point, as confirmation of a strong recovery in Brazil, for instance, helps mitigate fiscal uncertainties and reduces the risk premium incorporated into local assets. This contrasts with the more difficult prospects for the recovery in Mexico, for instance, which suggests that fiscal risks should remain elevated there, in 2021, reducing the scope for appreciation in local assets.

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Rates: You think you've seen it all? Wait for it...

Picture what many term the most important US elections in living memory. Frame it within a global pandemic not seen in 100 years. Add massive supply to get economies off their knees to a pervasive dusting of structurally negative rates. And then try to make sense of it all for rates - US rates still look like they want to look upwards, even if they go down first



Source: Shutterstock

Plenty of distractions, but a clearer path emerges ahead

While there is confusion and uncertainty in the air in the US, we know far more now than we did before election day.

The outcome being baked into market price action looks beyond potential re-counts or election validity objections that can muddy things in the coming weeks. The focus is squarely on a Joe Biden administration outcome, but constrained, as the Republicans keep the Senate. And crucially, so far, markets are concentrating on the positives from this. Hence the buying of risky assets like equities.

“Where congress acts as a policy bloc to Biden in the coming years, some of the more extreme policies are watered down. Such gridlock gives Wall street less to stress about”

But what about bonds? Typically when equities are in favour, bonds are not, and yields head higher in consequence. Here, the impact effect has seen the 10-year US yield lurch lower, from 95bp to 75bp. A 20bp move is a huge move in proportion to the absolute level of yield. In the bond world, these are big valuation changes

over the course of 24 hours.

Now we ask a two-pronged question, why have we had this impact, and more importantly, where do we go from here.

The constrained nature of the presidential outcome is key

The rationale for the fall in yields reflects a relief factor.

An unconstrained Biden outcome had positives as it would likely come with a large stimulative package, which would then need to be financed. That combination would be

good for growth, but also heavier on supply. In contrast, a constrained Biden likely means a smaller stimulus, with means less of a boost for growth and a smaller increased in supply.

This backdrop together, with an extrapolation where Congress acts as a policy bloc to Biden in the coming years, means that some of the more extreme policies are watered down.

Such gridlock gives Wall street less to stress about, which in part helps to answer the second question. The prognosis remains in place for a 2021 recovery. A boost to growth would ease supply concerns, as the economy keeps better pace with the debt. This maintains a view for a 1 handle for the US 10yr yield in 2021.

Despite the uncertainty, the US is still in the lead vs Europe

While a 1 handle for the US 10yr may not appear to be an aggressive call, it is by definition a definite separation from the negative rates world that the Eurozone continues to endure. The prognosis here is for a re-widening in the spread between US and German market rates.

Pre-Covid-19, the 10yr spread was over 2%. Covid-19 took it to 1%. It should be in the 1.5% to 2% area as a theme in the quarters ahead. Resumed steepening pressure will also likely come from the US, which is good as it means that the curve is discounting deflation of the economy.

There are near-term risks though. Calls for selected re-counts in the US presidential election will add some toxicity to the backdrop. Meanwhile, a Covid-19 resurgence in Europe is acting to keep German rates hammered down in negative territory, and the remedy from the ECB is to buy more bonds - a double whammy keeping market rates hammered down.

Bottom line, the US remains in the driving seat when it comes to eventual resumed upward pressure on yields. But in the short term, expect election volatility to resume itself, and that together with European angst is keeping core rates under wraps generally in the coming weeks.

ING global forecasts

	2020					2021					2022				
	1Q20	2Q20	3Q20	4Q20	FY	1Q21	2Q21	3Q21	4Q21	FY	1Q22	2Q22	3Q22	4Q22	FY
United States															
GDP (% QoQ, ann)	-5.0	-31.4	33.1	1.6	-3.7	-1.5	9.8	4.0	3.5	3.6	3.2	2.9	2.9	2.8	3.6
CPI headline (% YoY)	2.1	0.4	1.3	1.2	1.2	1.1	2.6	1.8	1.9	1.9	2	2.2	2.1	2.1	2.1
Federal funds (% eop)	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
3-month interest rate (% eop)	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
10-year interest rate (% eop)	0.67	0.68	0.68	0.75	0.75	1.00	1.00	1.00	1.25	1.25	1.25	1.25	1.50	1.50	1.5
Fiscal balance (% of GDP)					-19.1					-9.1					-5.3
Gross public debt / GDP					100.7					104.4					103.9
Eurozone															
GDP (% QoQ, ann)	-14.1	-39.4	61.3	-8	-7.1	1.6	4.0	6.1	5.5	3.5	2.5	2.0	1.6	1.5	3.3
CPI headline (% YoY)	1.1	0.2	-0.1	-0.1	0.3	0.5	0.8	1.1	1.2	0.9	1.2	1.3	1.3	1.4	1.3
Refi minimum bid 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
3-month interest rate (% eop)	-0.40	-0.45	-0.49	-0.50	-0.50	-0.50	-0.45	-0.45	-0.45	-0.45	-0.45	-0.45	-0.40	-0.40	-0.40
10-year interest rate (% eop)	-0.47	-0.45	-0.55	-0.6	-0.6	-0.5	-0.4	-0.25	-0.25	-0.25	-0.2	-0.2	-0.15	-0.1	-0.1
Fiscal balance (% of GDP)					-9.4					-5.2					-2.9
Gross public debt/GDP					104.2					103.1					101.5
Japan															
GDP (% QoQ, ann)	-2.3	-28.1	13.5	3.7	-5.9	2.3	2.9	4.3	3.1	2.0	1.6	1.4	1.5	1.4	2.2
CPI headline (% YoY)	0.5	0.1	0.2	-0.1	0.2	0.2	0.6	0.8	0.7	0.6	0.8	0.8	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	-0.01	-0.1	-0.1	-0.1
3-month interest rate (% eop)	0.00	0.00	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.1	-0.10	-0.10	-0.10	-0.10	-0.1
10-year interest rate (% eop)	0.00	0.00	0.00	0.00	0.00	0.00		0.00	0.00	0	0.00	0.00	0.00	0.00	0
Fiscal balance (% of GDP)					-17					-9.8					-8.9
Gross public debt/GDP					223.0					229.0					233.0
China															
GDP (% YoY)	-6.8	3.2	4.9	5.5	1.7	12.0	5.5	5.0	5.5	7	3.0	5.0	5.5	5	4.6
CPI headline (% YoY)	5.0	2.7	2.4	1.9	3	2.0	2.5	2.5	2.9	2.5	2.8	2.6	2.4	2.5	2.5
PBOC 7-day reverse repo rate (% eop)	2.2	2.2	2.2	2.2	2.2	2.2	2.2	2.2	2.2	2.2	2.2	2.2	2.2	2.2	2.2
3M SHIBOR (% eop)	1.95	2.13	2.67	3.00	3.00	3.00	3.10	3.20	3.30	3.30	3.40	3.50	3.60	3.70	3.70
10-year T-bond yield (% eop)	2.59	2.87	3.10	3.15	3.15	3.18	3.20	3.25	3.30	3.30	3.35	3.40	3.45	3.50	3.50
Fiscal balance (% of GDP)					-6.0					-6.0					-4.0
Public debt (% of GDP), incl. local govt.					110.0					115.0					118.0
UK															
GDP (% QoQ, ann)	-9.7	-58.7	81.6	-6.7	-10.9	7.4	7.5	6	5.5	4.7	3.1	2.4	2.2	2.1	3.9
CPI headline (% YoY)	1.7	0.6	0.6	0.6	0.9	0.8	1.3	1.2	1.3	1.2	1.1	1.3	1.5	1.6	1.2
BoE official bank rate (% eop)	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)	0.60	0.20	0.10	0.00	0.10	0.00	0.00	0.10	0.15	0.15	0.20	0.20	0.25	0.30	0.30
10-year interest rate (% eop)	0.30	0.20	0.20	0.20	0.20	0.25	0.30	0.40	0.50	0.50	0.60	0.60	0.70	0.80	0.80
Fiscal balance (% of GDP)					-15					-7.0					-3.5
Gross public debt/GDP					112					110.5					110.5
EUR/USD (eop)															
	1.10	1.13	1.17	1.18	1.18	1.20	1.22	1.23	1.25	1.25	1.25	1.25	1.23	1.20	1.20
USD/JPY (eop)															
	107	107	105	102	102	102	102	102	102	102	102	103	104	105	105
USD/CNY (eop)															
	7.08	7.07	6.78	6.70	6.70	6.60	6.50	6.45	6.30	6.30	6.35	6.40	6.45	6.50	6.50
EUR/GBP (eop)															
	0.89	0.91	0.91	0.88	0.88	0.88	0.88	0.88	0.88	0.88	0.88	0.88	0.88	0.88	0.88

Source: ING forecasts

ING's forecasts under three different scenarios

	2020					2021					2022				
	Q1	Q2	Q3	Q4	FY	Q1	Q2	Q3	Q4	FY	Q1	Q2	Q3	Q4	FY
Scenario 1: Local lockdowns used as vaccines rolled out during 1H21 (base case)															
Real GDP growth (QoQ% annualised)															
United States	-5.00	-31.40	33.10	4.00	-3.50	3.50	5.90	3.50	3.10	4.60	2.90	2.80	2.70	2.70	3.10
Eurozone	-14.10	-39.40	61.30	1.60	-6.50	4.00	5.00	6.10	3.90	6.10	2.50	2.00	1.50	1.40	3.10
China (YoY%)	-6.80	3.20	4.90	5.50	1.70	12.00	5.50	5.00	5.50	7.00	3.00	5.00	5.50	5.00	4.63
Japan	-2.30	-28.10	13.50	3.70	-3.30	2.30	2.90	4.30	3.10	3.15	1.60	1.40	1.50	1.40	1.48
United Kingdom	-9.70	-58.70	81.60	-3.10	-10.70	8.70	8.80	8.00	4.90	6.20	2.80	2.30	2.20	2.10	4.00
Real GDP level (Indexed at 4Q19=100)															
United States	98.73	89.85	96.51	97.46	-	98.30	99.72	100.58	101.35	-	102.08	102.78	103.47	104.16	-
Eurozone	96.27	84.94	95.72	96.11	-	97.05	98.24	99.71	100.67	-	101.29	101.79	102.17	102.53	-
China (YoY%)	98.25	99.03	100.22	101.57	-	104.49	105.90	107.20	108.64	-	109.45	110.79	112.29	113.66	-
Japan	99.42	91.55	94.49	95.36	-	95.90	96.59	97.61	98.36	-	98.75	99.09	99.46	99.81	-
United Kingdom	97.48	78.15	90.72	90.01	-	91.90	93.86	95.68	96.84	-	97.51	98.06	98.60	99.11	-
EUR/USD	1.10	1.13	1.17	1.18	-	1.20	1.22	1.23	1.25	-	1.25	1.25	1.23	1.20	-
US 10-year yield (%)	0.67	0.68	0.68	1.00	-	1.25	1.25	1.25	1.50	-	1.50	1.50	1.50	1.50	-
Scenario 2 - Restrictions tightened but full lockdown avoided. Some vaccines rolled out in 1H21															
Real GDP growth (QoQ% annualised)															
United States	-5.00	-31.40	33.10	1.60	-3.70	-1.50	9.80	4.00	3.50	3.60	3.20	2.90	2.90	2.80	3.60
Eurozone	-14.10	-39.40	61.30	-8.00	-7.10	1.60	4.00	6.10	5.50	3.50	2.50	2.00	1.60	1.50	3.30
China (YoY%)	-6.80	3.20	4.90	5.00	1.58	7.00	5.00	4.50	5.00	5.38	3.00	4.50	6.00	6.00	4.88
Japan	-2.30	-28.10	6.90	0.50	-5.75	1.10	0.80	3.40	1.60	1.73	0.50	1.10	1.10	2.70	1.35
United Kingdom	-9.70	-58.70	81.60	-6.70	-10.90	7.40	7.50	6.00	5.50	4.70	3.10	2.40	2.20	2.10	3.90
Real GDP level (Indexed at 4Q19=100)															
United States	98.73	89.85	96.51	96.89	-	96.52	98.81	99.78	100.64	-	101.44	102.17	102.90	103.61	-
Eurozone	96.27	84.94	95.72	93.75	-	94.12	95.05	96.47	97.77	-	98.37	98.86	99.25	99.62	-
China (YoY%)	98.25	99.03	100.22	101.57	-	104.49	105.90	107.20	108.64	-	109.45	110.79	112.29	113.66	-
Japan	99.42	91.55	93.09	93.21	-	93.46	93.65	94.43	94.81	-	94.93	95.19	95.45	96.09	-
United Kingdom	97.48	78.15	90.72	89.16	-	90.76	92.42	93.78	95.04	-	95.77	96.34	96.86	97.37	-
EUR/USD	1.10	1.13	1.17	1.12	-	1.15	1.18	1.18	1.20	-	1.22	1.23	1.24	1.25	-
US 10-year yield (%)	0.67	0.68	0.68	0.75	-	1.00	1.00	1.00	1.25	-	1.25	1.25	1.50	1.50	-
Scenario 3 - National lockdowns return, while vaccine development takes longer than hoped															
Real GDP growth (QoQ% annualised)															
United States	-5.00	-31.40	33.10	-0.50	-3.80	-15.50	3.90	7.70	5.90	-1.10	4.50	3.70	3.30	2.90	4.70
Eurozone	-14.10	-39.40	61.30	-20.00	-7.90	-2.50	2.60	6.10	6.50	-0.50	5.80	3.40	1.60	1.50	4.50
China (YoY%)	-6.80	3.20	4.90	0.00	0.33	2.00	4.00	3.00	1.00	2.50	3.00	5.00	6.00	6.00	5.00
Japan	-2.30	-28.10	6.70	-1.00	-6.18	-0.70	-0.80	1.20	1.20	0.23	0.80	1.40	5.30	4.20	2.93
United Kingdom	-9.70	-58.70	81.60	-22.50	-11.90	6.00	5.00	2.30	4.20	-0.20	6.80	11.10	6.10	3.80	6.20
Real GDP level (Indexed at 4Q19=100)															
United States	98.73	89.85	96.51	96.39	-	92.41	93.30	95.05	96.42	-	97.48	98.37	99.18	99.89	-
Eurozone	96.27	84.94	95.72	90.53	-	89.96	90.54	91.89	93.35	-	94.67	95.47	95.85	96.20	-
China (YoY%)	98.25	99.03	100.22	100.22	-	100.72	101.71	102.47	102.72	-	103.48	104.75	106.29	107.85	-
Japan	99.42	91.55	93.05	92.81	-	92.65	92.46	92.74	93.02	-	93.20	93.53	94.74	95.72	-
United Kingdom	97.48	78.15	90.72	85.12	-	86.37	87.43	87.92	88.83	-	90.31	92.71	94.10	94.98	-
EUR/USD	1.10	1.13	1.17	1.10	-	1.10	1.10	1.12	1.15	-	1.15	1.18	1.20	1.20	-
US 10-year yield (%)	0.67	0.68	0.68	0.00	-	0.00	0.25	0.25	0.25	-	0.50	0.50	0.50	0.50	-

Source: ING. Note most growth forecasts rounded to nearest whole or half number)

*Scenario two is our current base case for China

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